



Review of the Ex-ante Assessment for the Wales Business Fund

December 2015

Regeneris Consulting Ltd www.regeneris.co.uk

Contents Page

1.	Introduction	1
	Financial Instruments in the ERDF Programme 2014-20	1
	Regulatory Requirements	1
	Scope of the Review	2
2.	Review of the Investment Strategy	4
	Proposed Fund Size and Composition	4
	Funding Sources	7
	Geographical split	9
	Sectoral focus	10
	Modelling assumptions	10
	Value for Money	16
	Governance	17
	Monitoring and evaluation	17
	State Aid	18
	Lessons Learnt	18
3.	Summary and concluding comments	23
	Summary	23
	Concluding comments	28



1. Introduction

Financial Instruments in the ERDF Programme 2014-20

- 1.1 EU investment of nearly £2 billion is available to Wales for the 2014-2020 programming period, which will support economic growth and jobs through research and innovation, business finance, ICT and Transport connectivity, energy, and helping people into work and training.
- 1.2 Separate Operational Programmes (OPs) have been developed in consultation with partners for East Wales and West Wales and the Valleys, which reflect the differing needs and opportunities of these areas, but also the different EU funding status of these areas. The Welsh Government is the Managing Authority for these programmes.
- 1.3 The OPs outline how the funding will be spent in the region through priorities based on social, economic and environmental analyses of the needs and opportunities of the region, and highlight the eligible areas of activity in line with European Commission and Council Regulations.
- 1.4 The European Commission has encouraged Managing Authorities to use financial instruments (FIs) to address business competitiveness (and other) objectives set out in the ERDF Operational Programmes. This is due to the view that these instruments can enable the more efficient and effective delivery of major strands of activity, together with the benefit of providing a longer term financial legacy.

Regulatory Requirements

- 1.5 The development of proposed FIs is subject to the requirements of Article 32 of the Common Provisions Regulations. This requires the Managing Authority to ensure that an ex-ante assessment of any proposed FIs is undertaken, prior to the Managing Authority making programme contributions to FIs. The assessment must be submitted to the Programme Monitoring Committee for information.
- 1.6 In line with Article 37 of the Common Provision Regulation and recently published European Commission guidance, the ex-ante assessment consists of the following requirements.



- (a) 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. This analysis shall be based on available good practice methodology.
- (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.

Source: Common Provisions Regulation, European Commission (http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R1303&from=EN)

Scope of the Review

- 1.7 The Wales Business Fund (WBF) is a new fund to support SMEs across Wales in order to address the market failures affecting the ability of Small and Medium Sized Enterprises (SMEs) to secure the finance they need to start-up and grow, including the commercial exploitation of their research and innovation. The FI is intended to contribute to the direct achievement of Specific Objectives 2.1 and 2.5 in both ERDF programmes.
- 1.8 The purpose of this report is to provide an overview of the ex-ante assessment of the WBF including the draft investment strategy that has been produced by Finance Wales, Welsh Government and WEFO for the proposed FI. The final strategy has been produced based on an iterative process between these partners and Regeneris Consulting. The focus of the report is on reviewing the key features of the proposed Fund, its deliverability and risks, and expected economic impact and value or money. This has included commenting on the reasonableness and robustness of the assumptions and underpinning evidence.
- 1.9 Table 1.1 summarises the various other reports that have been produced as part of the development of the WBF, including a short commentary on their role in the overall process.



Table 1.1 Summary of Reports Produced and Purpose

Report	Purpose
Wales Ex-ante Assessment – Financial	A screening assessment on the high level suitability and
Instrument Stage One Screening	appropriateness of FIs for the range of proposed interventions
(Regeneris Consulting, January 2013)	outlined in the draft 2014-2020 programme documents.
Wales Ex-ante Assessment – Financial	A detailed market assessment of the relevant areas that had
Instruments Stage Two Market	been screened in as part of this process, covering supply,
Assessment (Regeneris Consulting,	demand and market failure in various market segments in
April 2013)	Wales.
Grants for SMEs in Wales: A	A thinkpiece on the role of grant provision for SMEs, the
thinkpiece	conditions that need to be met in order for this to deliver value
	for money and a high level review of the grants landscape in
	Wales.
Draft Investment Strategy (Finance	An investment strategy for the proposed Financial Instrument
Wales, Welsh Government and	to support SMEs in Wales, setting out the overall fund size,
WEFO)	types of finance offered, sources of match funding, financial
	model, delivery and governance.

- 1.10 A number of other reports outside this ex-ante process have been produced and have informed the design of the proposed financial instrument. These include:
 - Venture Capital and Loans Market Assessment for SMEs in Wales, produced by Regeneris Consulting for Finance Wales in June 2014
 - Access to Finance Review, produced by Professor Dylan Jones-Evans for Welsh Government (Stage One report in June 2013 and Stage Two report November 2013).



2. Review of the Investment Strategy

- 2.1 This section provides a review of the investment strategy. The strategy has been developed in an iterative fashion based on review and comment at a number of stages in the process by Regeneris Consulting. We review:
 - The proposed fund size and composition
 - Funding sources
 - Geographical split
 - Sector focus
 - Modelling assumptions, including outputs and outcomes
 - Value for money
 - Governance
 - Monitoring and evaluation.
- 2.2 In each instance we review and comment on the WBF proposal in light of the available evidence, with a concluding comment on the robustness of what is proposed.

Proposed Fund Size and Composition

- 2.3 The Wales Business Fund (WBF) is a proposal for a £135.9m ERDF-backed FI to provide debt, equity and mezzanine finance to SMEs in Wales.
- 2.4 The 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 stated in the investment strategy, the market assessments concluded that there was a case for public sector investment in the following areas:
 - Debt for microbusinesses: microbusinesses have particular difficulties obtaining external finance due to lack of collateral and track record, and this is set to continue.
 - Debt for established SMEs: there is evidence of ongoing market failure, which has been
 magnified by the contraction in the supply of bank lending to SMEs following the financial
 crisis. Whilst supply may recover to a point, this is likely to be matched by an increase in
 demand with the economic cycle.
 - Risk capital: the analysis concludes there is a thin market for provision of equity and mezzanine capital for SMEs in Wales, with very little provision outside of Finance Wales, although demand is constrained by equity aversion.
 - Early stage finance: there is clear evidence of an ongoing structural market failure, with a strong policy position ensuring that a number of initiatives are driving demand for finance amongst start-ups and SMEs.
- 2.5 The WBF is designed to address all of these market failures. However, the Fund will not provide microloans (of less than £50k), as this market failure is expected to be specifically catered for by another Welsh Government Fund, the Wales Microbusiness Loan Fund, which commenced investing in 2013. However, it will provide higher amounts of debt (i.e. greater than £50k) to all SMEs, including microbusinesses.



- 2.6 The market evidence, part of which was prepared by Regeneris Consulting, 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 the associated market failures.
- 2.7 Table 2.1 summarises the conclusions of the two key assessments on the size of the finance gap that is likely to be accounted for by market failure. In both cases the conclusions were based on evidence on the scale of unmet demand in the market segment, on what portion of this overall gap is likely to be accounted for by market failure¹ and how this gap is likely to change in future, given trends in supply and demand. This was calculated both on an annual basis and on the basis of a 5 year investment period (i.e. in line with the current JEREMIE Fund in Wales).
- 2.8 The table also sets out the proposals for the WBF, which is split into two sub-funds:
 - An equity fund (covering early stage and later stage risk capital) and
 - A loan fund (covering debt and mezzanine finance for established SMEs).

Table 2.1 Comparison of Recommended Fund Sizes (£m, nominal prices)						
	Ex-ante evaluation market assessment ^a		Market assessment for Finance Wales ^b		Proposed Wales Business Fund	
	Annual	Total 5 years	Annual	Total 5 years	Annual	Total
Mezzanine, early stage and later stage risk capital	13-19	65-95	15-20	75-100	11.2	78.43
- early stage	4-8	20-40	6-9	30-45	3.9	27.3
- mezzanine	0.11	45.55	0.11	45.55	4.1	28.8
- later stage equity	9-11	45-55	9-11	45-55	3.2	22.3
Debt for established SMEs	10-12	50-60	9-12	45-60	9.6	57.5
Microloans	0.8-1	4-5	0.8-1	4-5	n/a	n/a
Total		119-160		124-165		135.9

^a Regeneris Consulting (2013) Stage 2

Note: WBF proposal does not contain microloans

- 2.9 The types of finance have been categorised slightly differently between the market assessments and the proposed WBF. In the market assessments mezzanine was included within the assessment of risk capital, whereas the WBF investment strategy includes it for strategy and modelling purposes within the loan fund. For the purposes of comparison with the market evidence, in this table mezzanine is therefore included with early and later stage risk capital.
- 2.10 It also should be noted here that the proposed investment period for the loan fund is 6 years (2016/17 2021/22) and for the equity fund is 7 years (2016/17 2022/23). These are somewhat longer than the original plan for JEREMIE investment period but it is based on the actual experience of delivering this fund: the JEREMIE loans sub-fund was fully invested in 6 years after a 1 year extension was secured, and the equity sub-fund was fully invested in 6.5 years, following an 18 month extension. Moreover, Finance Wales has been making the case for a longer investment period for equity investments, particularly for early stage investments which often require several rounds of follow on investment and take time to gain regulatory approvals. Therefore, the WBF investment periods have been designed based on current experience and in order to more closely reflect the needs of the market for equity finance.

¹ That is, the amount that can be supported whilst delivering value for money for the public purse, taking into account the financial and economic development returns that are achievable.



^b Regeneris Consulting (2014)

- 2.11 The key points from the comparison with the market assessment evidence are as follows:
 - The proposed total of £78.4m for mezzanine, early stage and later stage risk capital in the WBF broadly fits with the recommendations from the market assessment for these finance types. On an annual basis it is actually a little below the rate of investment recommended in the market assessments. Within this:
 - The split between early stage and later stage is indicative and there is scope for the appointed Fund Manager to invest the equity sub-Fund in line with demand (indeed, in the JEREMIE Fund, money was vired between risk capital and the early stage portfolios in response to demand trends). On current assumptions, the allocation to early stage is towards the lower end of the recommended range. The later stage risk capital allocation (including mezzanine) is comfortably within the recommended total given the 7 year investment period it is a little below the recommendation on an annual basis.
 - The market assessments did not explicitly recommend a mezzanine fund range. However, mezzanine funding was implicit in the overall risk capital segment. The total allocation of mezzanine within WBF is broadly in line with the level of investment achieved within the current JEREMIE Fund (a total of £27.5m was projected to be invested over the life of the Fund as at December 2014). Again, on an annual basis it is a little below the rate within JEREMIE.
 - The proposed £57.5m for straight debt finance is comfortably within the range recommended by the market assessments. On an annual basis given the 6 year investment period it is towards the lower end of the recommended range.
 - As stated above, microloans are not included in the WBF, as they are expected to be targeted by the Wales Microbusiness Loan Fund.
- 2.12 In interpreting these allocations in the light of the market evidence, it should be noted that in addition to the market evidence the design of WBF has taken into account other considerations, including:
 - Other funds that have been launched by Welsh Government (e.g. the £20 million Wales Capital Growth Fund) and a £7.5 million Technology Seed Fund. Welsh Government is also progressing plans for a Development Bank for Wales.²
 - The need to generate cashflow reasonably early on in the life of the fund to pay back the Financial Transaction Reserve funding - see Funding Sources section below (which points towards a sufficiently large loan element to generate debt repayments from SMEs to the Fund).
 - The need to ensure that there is a sufficient legacy return generated that can be used for future Funds (with equity exits later in the Fund life playing an important role here).
 - The availability of funding from ERDF and other sources at the level of the Fund.

² Following the Access to Finance reviews a feasibility study into the creation of a Development Bank for Wales was published in January 2015. Finance Wales, working closely with the Welsh Government, have reviewed all recommendations from the reviews, feasibility studies, and from the National Assembly for Wales Committees. Proposals have been forwarded to the Welsh Government for consideration. In line with the National Assembly for Wales Committee recommendations it is proposed that the Development Bank for Wales would be based on the strong foundations of Finance Wales and will be the focal point for investment finance and business support for the growth, development and success of Micro to medium enterprises in Wales.



- 2.13 Taking all of these factors into account, it is Regeneris Consulting's view that the proposed size and composition of the Fund broadly fits with the market evidence and has been based on relatively conservative and prudent assumptions on what is deliverable over the investment period of the Fund.
- 2.14 In addition, the investment strategy notes that "investments from the new Fund could be combined with grant support as long as the four conditions set out above are met." These conditions are set out in an additional piece of research for the ex-ante process.³ This is acceptable in principle as long as robust mechanisms are put in place to ensure that the conditions are met.

Funding Sources

Match funding at fund level

- 2.15 The WBF fund sizes quoted above represent the total capital funding available at the fund level, including £75.9m ERDF and a total of £60m in match funding from two further sources:
 - Legacy funding from the current Wales JEREMIE Fund
 - Financial Transaction Reserve (FTR) funding.
- 2.16 The proposed breakdown is shown in table 2.2 below.

Table 2.2 Funding Sources at Fund Level (£m, nominal prices)					
	Equity Fund	Loan Fund	Total WBF	% of total	
ERDF	39.6	36.3	75.9	56%	
Legacy	5	25	30	22%	
Financial Transaction Reserve	5	25	30	22%	
Total	49.6	86.3	135.9	100%	

Source: Wales Business Fund: Investment Strategy July 2015

- 2.17 Whilst the current JEREMIE Fund made use of a loan from the European Investment Bank (EIB) to provide all of the required match funding, external debt funding has been discounted as a match funding option for the WBF. The reason is that such external debt is recorded on the Welsh Government's balance sheet and the corresponding amount comes off its Departmental Expenditure Limit (DEL), with implications for resources available for other spending areas. This has been judged by Welsh Government not to be a desirable approach.
- 2.18 Other sources were therefore investigated. The sources to be used, and associated assumptions, are summarised below.
- 2.19 Legacy funding. A total of £30m in legacy funding is forecast to be used for investment by the WBF, representing 22% of the total Fund. Once the EIB loan for the current JEREMIE Fund is repaid in full, any surplus money from investment returns represents legacy returns which can be reused in line with Structural Fund guidance. The contractual target is to repay the EIB loan in full by 31st March 2017. The current forecast is therefore for legacy to start to accrue after this and in the following realisation period of the current JEREMIE Fund. This legacy can be used as match funding at the fund level for WBF.

³ The conditions are that project: a) has exhausted all other sources of finance; b) would not be able to go ahead without the grant or would go ahead on a significantly reduced scale; c) would deliver significant economic spillovers; d) would not be possible to deliver economically on a repayable basis.



- 2.20 As the investment strategy notes there is, however, material uncertainty attached to the realisation of this legacy fund as it is linked in particular to forecasts for equity exits. The WBF financial model therefore assumes in its base case that legacy will not be available until 2018/19 (Year 4 of the WBF) and that its value will be 50% of the current forecast. Whilst it is beyond the remit of this report to examine the legacy forecast in detail, in our view this is an appropriately prudent and conservative approach to planning and financial modelling given the uncertainties associated to future returns.
- 2.21 **Financial Transaction Reserve.** A total of £30m in funding from the Financial Transaction Reserve (FTR) has been assumed as a source of match funding within the WBF (also representing 22% of the Fund). FTR is a repayable loan (with no fees or interest attached) received by Welsh Government from HM Treasury. The investment strategy document notes the advantages of using FTR compared to external debt, the main one being the absence of interest payments and hence the possibility of a higher legacy return eventually being generated.
- 2.22 Welsh Government submitted a number of bids for FTR funding, one of which was specifically for £30m match funding for the WBF.⁴ The bid was successful. £15 million is available in 2015/16 and the expectation is that the remaining £15 million will be available for drawdown in tranches of £5m p.a. in subsequent years.
- 2.23 Each of these match funding sources is allocated to the fund in the ratio 5:1 towards the loan and equity funds. This is driven in large part by considerations on the level of match that is achievable at deal level for each of these sub-funds, and the timing of the availability of legacy and FTR see below.
- Overall, the arrangements for Fund level match funding look sensible, given that external debt funding is not considered to be a desirable option. The approach to the forecast for legacy funding and hence its assumed contribution to the WBF is conservative, although there remains a residual risk attached to the realisation of this projection. Half of the FTR funding required is expected to be drawn down in future years. This does not have any major implications for the underpinning effectiveness of the financial model (although there is, we assume, the loss of interest payments from the treasury management of this capital sum).

Match funding at deal level

- 2.25 The fund level match funding from legacy and FTR provides 44% of the funding for WBF at the Fund level. The remainder of the required match funding needs to be secured at the individual deal level. This deal level match funding needs to be secured in order to unlock the various tranches of ERDF.
- 2.26 The Fund has targeted a total of £75.9m in deal level match funding to be achieved, implying £1 of deal level match for every £1 of ERDF invested (and £1:£1.79 overall). This 1:1 ratio applies as the target for both the loan and equity sub-funds, so that £36.3m is targeted for the loan fund and £39.6m for the equity fund. Minimum deal level match requirements for the Fund have been calculated based on the required *impact of investment* needed to unlock tranches of ERDF funding. In practice this means that different minimum levels of match funding are required for the two sub-funds:
 - Loan fund: most of the required match funding for the loan fund will be achieved at the
 deal level using the FTR and legacy funding. Consequently only a minimum of £5.4 million
 of deal level match is required.

⁴ The other bids are: £10m of interim funding for the Technology Ventures Investment team to cover the period between the end of the current JEREMIE fund investment period and a £12m top up to the Microbusiness Fund.



- Equity fund: in contrast, a much higher level of deal level match is assumed to be achieved here, given that the legacy and FTR contribution for this sub-fund is not available until later: a total of £20.9m is required.
- 2.27 The investment strategy compares the 1:1 deal level match targets to the private sector leverage achieved in the current JEREMIE (up to end of May 2015). This indicates that the loan fund achieved £0.87 in private sector match per £1 invested, whilst the equity fund achieved £1.27.
- 2.28 The lower level of match for the loan fund has been influenced primarily by the prevailing market conditions, with a sharp reduction in the availability of bank lending and hence Finance Wales often acting as prime lender rather than the gap funder. The evidence suggests that banks are increasing their presence in the SME lending market, a trend which is likely to continue. This should lead to more favourable conditions for securing co-investment. Nonetheless, achieving the 1:1 target will be a challenge and fund performance will need to be carefully monitored in this regard. This is important as the reach of the sub-fund could fall (i.e. the number of SMES assisted) if the WBF has to contribute higher proportions to the finance sought by SMEs.
- 2.29 Although there are some outliers, the equity fund in the current JEREMIE fund has generally been able to secure a much higher level of deal level match funding by building up relationships with co-investors alongside whom Finance Wales has invested. The WBF would draw upon these networks to generate deal flow and co-investment, although this could be influenced by the choice and approach of fund managers.
- 2.30 The deal match targets therefore appear achievable. Although they are more challenging for loans given the experience of the SME debt market in recent years, conditions should be more favourable in the future. The experience from the current JEREMIE fund in securing match for equity deals, and the co-investor networks that have been built up, suggests that the target for equity is achievable. Nonetheless it is a very important element of delivery and fund managers bidding to deliver WBF will need to make clear the precise mechanisms they will use to deliver on this requirement, and their performance will need to be monitored closely.

Geographical split

- 2.31 The WBF will operate pan-Wales. This builds upon the approach of the current JEREMIE fund and is supported by the market assessment evidence, which concluded that, whilst there are sectoral nuances, the fundamental market failures observed apply across Wales.
- 2.32 The market assessment evidence provided some evidence on the spatial split of investments made through the current JEREMIE fund. The data (taking in investments made up to September 2013) showed that:
 - For equity, there was an approximate 50:50 split in the number of investments made in West Wales and the Valleys (WWV) and East Wales (EW). However, the deals in West Wales are larger: 60% of investment by value has been made there, with the remainder in East Wales.
 - For loans, the data showed around a 60:40 split between West and East Wales both in terms of the value and volume of investments made to date.
- 2.33 The allocation of ERDF funding for the WBF is driven by the overall programme level allocations for the relevant Priorities, with the consequence that these are heavily weighted towards West Wales and the Valleys. This is shown in Table 2.3, with West Wales and the Valleys accounting for 85% and 88% of the total ERDF allocations to the Fund for loans and equity, respectively. In order to rebalance out the overall allocations more closely in line with the likely demand for finance, the legacy and FTR funding will be distributed more towards East Wales.



- 2.34 This leads to a 65:35 West: East Wales split for loans, a 70:30 split for equity and a 67:33 split overall. Whilst this is a little more weighted towards WWV than in current JEREMIE fund, partners are comfortable that this is deliverable.
- 2.35 The spatial split in investment should be deliverable, as the West: East Wales split is only slightly higher for WBF than it has been in JEREMIE. Nonetheless, the projected investment is higher relative to the size of the economy (and hence potential demand) in West Wales than it is in East Wales. Therefore, this balance will need to be carefully managed and monitored in the delivery of the Fund.

Table 2.3 Spatial Split in Funding for WBF (£m, nominal prices)										
	Loans				Equity			Total		
	ERDF	Legacy/	Total	ERDF	Legacy/	Total	ERDF	Legacy/	Total	
		FTR			FTR			FTR		
WWV	30.8	25.3	56.0	34.7	0	34.7	65.5	25.3	90.7	
	(85%)	(51%)	(65%)	(88%)	(0%)	(70%)	(86%)	(42%)	(67%)	
EW	5.5	24.7	30.2	4.9	10.0	14.9	10.4	34.7	45.1	
	(15%)	(49%)	(35%)	(12%)	(100%)	(30%)	(14%)	(58%)	(33%)	
Total	36.3	50.0	86.3	39.6	10.0	49.6	75.9	60.0	135.8	

Source: Draft Investment Strategy

Sectoral focus

- 2.36 The investment strategy states that "the Fund will support the Welsh Government's approach to industry-led investments in the nine key sectors" and that "the appointed equity fund manager will be required to adhere to the principles set out in Science for Wales and Innovation Wales in terms of targeting investments to build on Wales' distinct and genuine areas of excellence." This is certainly important in terms of the potential contribution to the SMART Specialisation Strategy.
- 2.37 However, the experience from the current JEREMIE Fund in Wales as well as other JEREMIE Funds in England and SME FIs more generally highlights the importance of maintaining flexibility in the sectoral coverage of investments, so that FIs can maintain their investment rates. An overly prescriptive approach to sectoral eligibility can reduce the necessary flexibility of fund managers in the face of changing market conditions and demand, and can require a disproportionate level of resources to be expended in order to generate deal flow.
- 2.38 The ex-ante appraisers have queried this and partners confirm that supporting the nine key sectors is a general aspiration and that the Fund should be generalist in its sectoral focus, so there will not be any specific sectoral targets for fund managers.
- 2.39 This is in principle a sensible broad approach which ensures that whilst the Fund plays a role in contributing to the Welsh Government's aspirations to develop key industries, it retains maximum flexibility in delivery. However, it will be necessary to carefully consider any steps which are necessary to ensure that the potential contribution to the sector priorities can be effectively promoted through marketing and relationship development.

Modelling assumptions

2.40 The Fund is underpinned by a detailed financial model. Generally speaking this has been based on Finance Wales' considerable experience of delivering financial instruments in Wales, and in

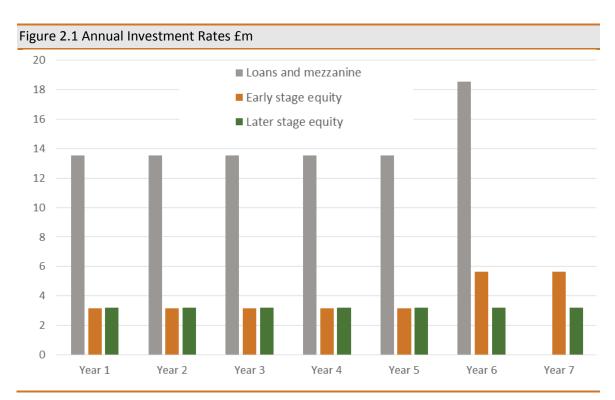
⁵ The £90m of investment in WWV represents 0.35% of annual GVA whilst the £45m investment in East Wales is 0.21% of GVA.



particular on the experience of the current JEREMIE Fund. We review the key assumptions adopted below.

Investment rate

- 2.41 As set out above, the proposed loan Fund is to operate for a 6 year period and the equity fund for 7 years. The profiled investment by year is set out for each sub-fund in figure 2.1:
 - Early and later stage equity are each profiled to invest around £3.2 million per annum (a total of £6.4 million per annum), with £8.9 million p.a. invested in total in early and later stage equity in years 6 and 7.
 - The loan fund is profiled to invest £13.5 million per annum in years 1-5, with £18.6m in year 6.
- 2.42 The increase in the investment rate towards the end of the investment periods is driven by the timing of the availability of the subsequent tranches of FTR and legacy. In the case of the loan fund this represents a fairly significant increase on previous years, although, for comparison, the JERMIE Fund made £14.6 million in loan and mezzanine investments in 2014/15.
- 2.43 However, it should be borne in mind that general inflation should to some degree aid the deliverability of this increase in investment rate.⁶



Source: WBF Financial Model



⁶ 7 years of inflation at the Bank of England's target of 2% is around 15% over the period.

2.44 These assumptions are subject to sensitivity testing, using a slower investment rate for both the loan and equity fund. In this event the full fund would still be invested over the investment period and there would no material impact on the legacy return. 8

Default rate

2.45 Table 2.4 sets out the assumed default rates for each type of finance provided by WBF. Drawing on the investment strategy we also set out how these compare to the current levels of default for the current JEREMIE Fund portfolios, and to the original assumptions within the JEREMIE Business Plan. The overall conclusion is that the assumed default rates are sensible and conservative in the light of the experience of the current JEREMIE Fund.

	WBF assumption	Current JEREMIE as at 31 May	Original JEREMIE Business Plan	Comment
Loans	15%	2015 8.3%	Assumption 20%	The base assumption of 15% default over the life of the Fund is reasonable given the current performance of JEREMIE loans. It should be borne in mind that the current low 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). Whilst there is evidence of banks increasing SME lending, supply constraints will remain, and hence the assumed default rate looks prudent.
Mezzanine	25%	18.2%	28%	The base assumption of 25% default rate is reasonable given the current performance of JEREMIE investments (the considerations cited above are also relevant here).
Early stage equity Later stage equity	40%	36.5%	34%	The assumed default rate of 40% looks to be a reasonable and conservative estimate. It is higher than both the originally assumption for JEREMIE and the current performance of the JEREMIE portfolio, and reflects a prudent approach towards the estimation of equity returns, which are subject to greater uncertainty than the returns from debt.

Source: WBF Draft Investment Strategy

⁸ The legacy return for the loan fund would be £47.597m compared to £47.608 in the base case and the legacy from equity investments would be £27.866m compared to £27.863m in the base.



⁷ It assumed that, as a percentage of the base case, the investment profile in years 1-5 is 70%, 85%, 100%, 115% and 130%.

- 2.46 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 £47.6m to £42.0m (a 12% fall)
 - Reducing the legacy returns from the equity fund from £27.9m to £24.1m (a 14% fall)
 - Slowing the FTR repayment profile, although the date of full repayment of FTR remains unchanged (due to higher repayments occurring later).
- 2.47 The impact on the Fund IRR is set out in the section on Returns below.
- 2.48 The Fund's performance is therefore acceptable in the face of these stress tests.

Pricing

- 2.49 The investment strategy sets out the average⁹ interest rates that will be applied on loans and the average returns expected for non-defaulting equity investments. These are as follows:
 - Loans: average interest rate of 8%; 5 year term
 - Mezzanine: average interest rate of 12%; 5 year term
 - Equity: 1.5 times sunk equity for successful investments.
- 2.50 These are in line with the pricing approach applied within JEREMIE. The Fund Managers will determine prices, based on the need to make investments on a commercial basis and to meet the Market Economy Investor Principle (MIEP) test, thereby ensuring that the public intervention does not constitute State aid. To meet the MIEP test, loans will need to be priced above the European Commission's reference rate and equity investments need to be made on a *pari passu* basis.

Returns

- 2.51 The WBF is projected to generate a total legacy return of £75m (in nominal prices) once the FTR has been fully repaid, consisting of £47.6m from the loan fund and £27.8m from the equity fund.
- 2.52 The projected internal rates of return for the Fund are summarised in table 2.5 on a gross and net basis. The overall IRR for the WBF is 1.27% in gross terms (comparing the investment returns to the cash invested) and -5.58% in net terms (comparing all net cash flows to the cash invested).
- 2.53 The experience of Venture Capital and Loan Funds generally shows that negative net IRRs of this order are common due to the level of defaults and returns experienced in this market. To put these rates of return into context, they are broadly in line with the performance of the JEREMIE Funds operating in England.

Table 2.5 Gross and Net Internal Rate of Return (IRR), by Sub-Fund					
Gross IRR Net IRR					
Loans	3.49%	-5.19%			
Equity	-1.10%	-5.93%			
Total	1.27%	-5.58%			

Source: WBF financial model

⁹ There will be variation around these average as specific rates would be determined on a case-by-case basis, based on an assessment of risk.



Note: Gross IRR calculated based on investments and projected returns; Net IRR calculated based on all net cashflows for the Fund.

- 2.54 The stress tests on default rates outlined above (a 5 percentage points increase in default rates across debt and equity) have the following effect on the rates of return for the Fund:
 - Loan Fund: the gross IRR falls to 1.12% and the net IRR to 7.48%
 - Equity Fund: the gross IRR falls to -2.92% and the net IRR to -7.52%.

Operating costs

- 2.55 Total fund operating costs are presented in table 2.6. It is useful to compare these to the total fund investment value in order to assess their relative scale and benchmark their reasonableness. Total operating costs over the life of the WBF are projected to be £36.6 million, representing 27% of the total fund value. As also stated in the mid-term evaluation of JEREMIE, this is some way below the typical operating costs of umbrella funds.
- 2.56 Projected fund management fees are £21.1 million, equivalent to 16% of the Fund investment value. This compares to 18% for 20 ERDF-backed Venture Capital and Loan Funds reviewed as part of national evaluation work. The annual fund management fee is 1.36% of the total fund value, below guidelines set by the BVCA (1.5%-2.5% p.a.) and the EU (5% p.a.).
- 2.57 Therefore, projected operating costs are reasonable and well within acceptable benchmarks.

Table 2.6 Fund Operating Costs (£m and as % of Fund Value)						
		Loans		Equity		Total
	£m	% of Fund Value (£86.3m)	£m	% of Fund Value (£49.6m)	£m	% of Fund Value (£135.9m)
Fund Management Fee	12.8	15%	8.3	17%	21.1	16%
Holding Fund Fee	8.8	10%	5.7	11%	14.5	11%
Abortive Deal Costs	0.1	0.1%	0.3	1%	0.4	0.3%
Other Fund Operating Costs	0.3	0.4%	0.4	1%	0.7	1%
Bank Charges	0.0	0.0%	0.0	0%	0.0	0.5%
Total Fund operating costs	22.1	26%	14.6	29%	36.6	27%
Source: WBF Financial Model						

Outputs

2.58 A set of core and added value output indicators have been included in the investment strategy The output targets are based on an assessment of the outputs achieved by the current JEREMIE Fund, which are then applied to the WBF using a suitable benchmark indicator (e.g. per enterprise or per £1m invested).¹¹

¹¹ As an example, data from JEREMIE indicates that up to end of March 2014, £56.7 million of equity had been invested, with an associated 725 jobs created by end of March 2015 (there is a one year lag on the capture of outputs). This is equivalent to 13 jobs created per £1m of investment. Applying this to the proposed £49.6m in direct investment in equity for WBF yields a forecast of 635 jobs created.



¹⁰ Regeneris Consulting (2007) Study of ERDF Funded Venture Capital and Loan Funds in England and Wales

- 2.59 Table 2.7 summarises how this has been estimated for the core and added value output indicators for WBF. In some cases, the forecast for WBF has slightly departed from the JEREMIE benchmark. For example, the targets for the cross-cutting theme indicators (eg enterprises adopting and implementing sustainable development/equality and diversity strategies and systems, etc) are higher than those achieved in the current JEREMIE to reflect a desire to enhance the outputs achieved here. This is appropriate but partners will need to ensure that concrete arrangements are put in place to ensure that this happens in practice.
- 2.60 In some instances (e.g. jobs created), the achievements of the current JEREMIE have been heavily influenced by economic conditions, which may be more benign overall for the period in which the WBF operates (JEREMIE has operated over several years of recession and low business confidence). Where this is the case, using the experience of JEREMIE to project WBF performance is likely to be a cautious approach.
- 2.61 We judge the ERDF core and added value indicators to be 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. Given the prevailing economic conditions for the current JEREMIE, this approach is conservative and in some instances may ultimately underestimate the actual outputs achieved by the WBF. We note that additional performance indicators will need to be put in place as part of the contractual arrangements on investment and financial performance between WEFO, Finance Wales and Fund Managers.

Table 2.7 Summary of Projected Outputs							
	Relevant benchmark	1 41141 4 1	Value of benchmark indicator		Output target for WBF		
	indicator from JEREMIE	loans	equity	loans	equity	Total	
Core Indicators							
No. of enterprises supported	Direct investment per enterprise	£236k	£992k	300	115	415	
Employment increase in supported enterprises	Jobs created per £1m invested	32	13	2,950	635	3,585	
Number of enterprises supported to introduce new to the firm products	% of enterprises introducing new products	-	44%	-	25	25	
Enterprises adopting or improving sustainable development strategies and monitoring systems	% of enterprises adopting/ improving sustainability systems	13%	11%	215	50	265	
Enterprises adopting or improving equality and diversity strategies and monitoring systems	% of enterprises adopting/ improving equality and diversity systems	20%	20%	250	58	308	
Value added indicators							



	Relevant benchmark		Value of benchmark indicator		Output target for WBF	
	indicator from JEREMIE	loans	equity	loans	equity	Total
Jobs safeguarded	Jobs safeguarded per £000s invested	68	16	5,869	786	6,655
Number of enterprises co- operating with supported research institutions	% of enterprises engaged in collaborative R&D	-	52%	-	14	14
Number of enterprises supported to introduce new to the market products	% of enterprises launching new to the market products	-	0.67	-	18	18
Number of patents registered for products	Number of products registered per enterprise supported	-	0.60	-	16	16

Source: WBF Investment Strategy

Value for Money

- 2.62 We have examined the value for money implied within the output targets for 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 results are shown in table 2.8 below. The key points are as follows:
 - Based on ERDF investment costs only, the gross cost per gross job created is £21,200. Based
 on all public sector funding into the WBF (ERDF plus JEREMIE legacy plus FTR), the gross
 cost per gross job created is £37,900.
 - The experience of JEREMIE (upon which the output forecast is based) suggests that loans appear to be more efficient at creating jobs than equity investments. This is also supported by evidence on the performance of the JEREMIE Funds in England. 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 benchmarks are from funds which operated in much more favourable conditions.
 - The net costs per net additional job created are illustrative, since we do not know what proportion of jobs created will be net additional.¹³ To arrive at illustrative figures we have taken evidence from the mid-term evaluation of JEREMIE, which indicated that 80% of

¹³ i.e. additional to the Welsh economy after deadweight, displacement, leakage and multiplier effects.



¹² Regeneris Consulting (2013) Mid-term Evaluation of the English JEREMIE Funds

gross jobs created were likely to be additional.¹⁴ The net cost calculation uses the base forecast on the legacy returns generated by WBF and is calculated as the gross ERDF investment cost less the projected legacy return to ERDF once FTR and the Welsh Government legacy have been repaid.

 On this basis, the net cost to the public sector per net additional job created amounts to £10,400 overall. This represents good value for money and compares favourably with evaluation evidence from elsewhere, for example, the performance of the English JEREMIE Funds.

Table 2.8 Value for Money Indicators					
	Loans	Equity	Total		
Gross cost per gross job created					
- ERDF	£12,300	£62,400	£21,200		
- Public sector	£29,200	£78,100	£37,900		
Net ERDF cost per net additional job created	£5,700	£30,000	£10,400		

Source: WBF financial model and Regeneris Consulting calculations

2.63 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

- 2.64 Finance Wales has been appointed as an entrusted entity to act as the Fund administrator. This approach is consistent with EU guidance and is sensible given Finance Wales' experience and status as a subsidiary of Welsh Government. As such, it will be responsible for the overall delivery of the WBF, contracting with WEFO for the use of ERDF grant, and procuring and managing the fund managers
- 2.65 Finance Wales is leading the drafting of the tender specification for fund managers for the subfunds. The National Procurement Service will then lead the procurement process itself. This approach has been pursued following legal advice to WEFO from the Welsh Government Legal Services department. The two sub-funds may be managed by separate Fund Managers or by a single Fund Manager.
- 2.66 The current intention is for Finance in Wales to set up a Special Purpose Vehicle, which would be responsible for:
 - Appointing and contracting with the Fund Managers, following the procurement process
 - Act as a consultee to the Fund Managers as they establish the Investment Committee and Investment Operating Guidelines
 - Monitoring investment activity and managing he performance of the Fund Managers.

Monitoring and evaluation

2.67 A full monitoring and evaluation plan will be produced with the ERDF Business Plan, covering:

¹⁴ Source: Regeneris Consulting and Old Bell 3 (2012) Mid-term Evaluation of the Wales JEREMIE Fund. Note: excludes microloans, which are not provided in WBF. The additionality rate for SMEs in receipts of loans was 80% and for equity it was 86%.



- Systems for data collection and reporting from enterprises
- Methods for monitoring and evaluating long term benefits
- Precise definitions of any indicators included that are outside those required by the EU programmes, and justifications for their inclusion
- Explanations of how the systems will ensure that data is used to refine operations, ensure
 data quality, effective reporting to WEFO and collect other data for performance
 management purposes.
- 2.68 The precise mechanisms used for collecting relevant data will be informed by the experience of the current JEREMIE Fund.

State Aid

2.69 Finance Wales has appointed a legal firm (DAC Beachcroft) to advise on State Aid issues. Full details on State Aid will be provided within the ERDF Business Plan.

Lessons Learnt

- 2.70 The ex-ante assessment provides a summary of lessons learnt specifically from the delivery of JEREMIE in Wales, based on partners' own judgements and the findings of the mid-term evaluation. A final evaluation of JEREMIE is currently being procured, which will provide further detail on lessons from this Fund. These will need to be borne in mind for the WBF.
- 2.71 In addition to the lessons cited in the ex-ante, it is worth also reviewing the evidence from elsewhere (e.g. from the ex-ante assessment of FIs in England). The key messages from this evidence, along with the implications for the WBF, are explored below.

	Summary of Lessons Learnt from Previous FI Interventions								
Key lessons	Commentary	Implications for the WBF							
	or the use of financial instruments								
The balance between economic development and financial objectives	SME finance initiatives generally have twin goals of filling gaps in the provision of finance and delivering on economic development priorities such as enterprise, research and innovation, employment and regeneration. In developing new funds, it is important to ensure the relationship between these two dimensions are absolutely clear, as they	Finance Wales has a great deal of experience in delivering SME FIs and in managing the balance between the need to secure economic development and financial returns.							
	have a direct and very important influence on ways in which finance is targeted at SMEs and the rates of return which can be expected. The evidence suggests that clarity in these aspects provides a stronger foundation for successful delivery and achievement of the underlying goals.	The design of the WBF and the allocation of funding to the subfunds and different finance types has taken into account the need to balance these objectives. The achievement of financial and economic returns will need to be closely monitored throughout the life of the Fund.							
The need to avoid a funding hiatus	It is important to ensure that the transition between different programmes is a seamless as possible, so as to ensure that the provision of finance for SMEs is not affected by hiatuses in funding.	£10m in FTR funding has been bid for and approved, for an interim fund to be drawn down this financial year, in order to allow the Technology Ventures Investment team to continue its operations before WBF commences.							



	Summary of Lessons Learnt from Previous FI I	nterventions
Key lessons	Commentary	Implications for the WBF
		Partners will need to ensure that there is a minimum hiatus between JEREMIE and WBF.
Market assess	sment and business planning	
Importance of ex-ante assessments	Drawing on the experience over the last two programming periods, the EC has clearly identified the need for the Managing Authorities to include an ex-ante assessment of the suitability and appropriateness of financial engineering instruments in the new ERDF programme for England. The Court of Auditors has in particular been critical of the shortcomings in defining correctly the financing gap of the beneficiary SMEs when designing the programmes. This aspect of the ex-ante appraisal is important in informing the development of the specific proposals.	Partners have pursued a rigorous ex-ante evaluation process, commencing from an initial scoping exercise through to detailed market assessments. Several research reports have been fed into this process. The assessment of the finance gap has drawn on the latest EU GAFMA guidance and taken in a wide range of quantitative and qualitative data sources.
Accounting for uncertainty	There are few ERDF backed projects where the robustness of the market assessment and business planning is so important to successful delivery. The ex-ante assessment will provide some but by no means all of the information that partners require. This has a number of implications including the need for partners to fill any key gaps which persist following the completion of the assessment and which have a direct bearing in the design of the investment strategy. The other is the need to recognise that the market assessment can only be a guide to the gap which public sector should be using ERDF to address and it is important for flexibility to be built into the design and delivery of the FIs which enable delivery to be adjusted if circumstances change over time.	The ex-ante market assessment evidence took into account the considerable uncertainty on market failures through the use of indicative ranges for the scale of market failure in different market segments. Partners have drawn on this evidence and for prudence generally allocated funding at the lower end of these ranges. The financial model has been stress tested using sensitivity testing on key variables where there is uncertainty.
Rigorous investment planning	Related to this, in order to ensure a rigorous business and financial planning process, it is useful to build in review at key points in the development and implementation of the project. This is particularly important earlier in the process when key decisions are taken about the design of the project. It also occurs again through the involvement of major external funders and the procurement of fund managers, with each stage offering a further opportunity to test underpinning business plan assumptions and deliverability considerations.	The current financial model draws on the modelling approaches successfully used for JEREMIE in Wales. WEFO's performance review process post approval means that the model and the investment strategy will be under regular scrutiny. The agreement with the funds includes scope to review and revise the strategy and respond to changes in the market as appropriate.
Need for realism	Whilst it is important for SME finance FIs to be of sufficient scale to achieve efficiency and effectiveness in delivery), there is nevertheless the need for realism in terms of the time it takes to setup schemes and commence investment, as well as the scale of potential demand which exists.	The WBF has drawn on a range of evidence on demand for finance from SMEs. This evidence presented what are judged to be reasonable ranges for the level of



	Summary of Lessons Learnt from Previous FI	
Key lessons	Commentary	Implications for the WBF
		investment that can be delivered to SMEs in Wales.
Found shorten		The outputs for WBF have been developed based on the experience of JEREMIE. Given prevailing economic conditions at the time of the delivery of JEREMIE this is likely to be a conservative approach.
Fund design	The wid town and other of the summer IEDEANIE	The MOS is loved in each will
FI models	The mid-term evaluations of the current JEREMIE fund of funds model in England and Wales concluded that the approach provides a good model which can and should be replicated in the next programming round. For reasons of efficiency and effectiveness, these funds need to be of a sufficient scale. By implication, the funds would need to cover large geographical areas, with sizeable business bases. The mid-term evaluations and the pan European review of these instruments by the Court of Auditors concluded that adopting more simplified investment, fund management and corporate service strategies and structures is one way of achieving efficiency. This points to having a maximum of 4-5 funds of a minimum size and not using sector specific sub-funds unless there is a very good case for doing so.	The WBF is large in scale, will operate pan-Wales and includes only two sub-funds, aiding the achievement of economies of scale. The WBF is generalist in its sectoral scope, maximising flexibility. However, the Fund Manager(s) will need to be clear about any mechanisms which will help to ensure consistency with, and contribution to, the smart specialisation priorities.
Revenue funding	It is important to demonstrate how the operational costs associated with a Fund will be funded throughout its life, and that the associated risks have been carefully considered. Unlike for the ERDF backed financial instruments supported in the 2007-13 period, there is no ready source of revenue grant funding which can be used as a contribution towards the set-up and operational costs of the funds.	Revenue grant funding was not used for Wales JEREMIE Fund, and a £10m float has been secured to cover net costs in early years. The current financial model takes into account the operating costs of WBF throughout its life. These are judged to be reasonable based on available benchmarks, although there is merit in this issue being independently tested by financial experts.
ERDF draw down	Unlike the previous programming period, it is now clear the new ERDF guidelines will not allow for the full draw down of the committed ERDF to the successor funds, with capital grant instead being drawn down in tranches in line with investment performance. Project developers must carefully consider the implications of this change in terms of the ability to meet the holding fund and fund management operating costs. They may need to be prepared to vary existing structures if necessary to accommodate this change.	A significant level of match funding for the WBF is required at deal level. Detailed modelling has been undertaken on when this deal level match would need to be secured in order to unlock the various ERDF tranches. Based on the experience of JEREMIE these deal level match targets are considered achievable. Nonetheless clear mechanisms will need to be put in place by Fund



	Summary of Lessons Learnt from Previous FI I	1
Key lessons	Commentary	Implications for the WBF
		Managers to ensure that these targets are met. Again, there is merit in this being tested by external financial experts.
Delivery of FIS		
Need for flexibility	It is important to avoid undermining the overall flexibility and cost-effectiveness of funds by imposing onerous restrictions or constraints on investment. The fund of funds model provides important flexibility to move resources between sub-funds in response to changes in market need and opportunity and the performance of the subfunds (as North East Finance has been able to do in its current fund through a retained pot for future deployment). The EC's intention of tranching the payment of ERDF into funds will also provide a further opportunity for switching resources to where it is most needed by sub-funds.	The WBF has been developed with this flexibility in mind. The approach of viring between subfunds in response to market conditions has been successfully deployed in the delivery of JEREMIE in Wales.
Brand identity	The evaluation of the JEREMIE funds and previous SME finance initiatives has demonstrated the benefits of developing a strong brand identity and coordinated marketing for public sector backed finance advice and provision. Where these brands exist already, the partners involved in designing the new delivery arrangements need to build on these approaches and the awareness where they are proving successful. Where they don't exist, they should pursue consider the merits of these coordinated approaches in collaboration with partners across boundaries, in particular where this may make sense in terms of larger area identities.	Finance Wales has a well-established brand through delivery of JEREMIE and a range of other Funds in Wales. Its role as the Holding Fund for WBF is therefore an important asset from a branding point of view. Partners will need to consider the importance of branding as the Fund is launched and promoted to Welsh SMEs.
Procuring fund managers	Securing fund managers who have the appropriate expertise and will deliver high quality fund management services is vital to the success of Fls. Project developers need to be aware of the strict procurement rules, but also have a well-defined strategy which sets out how they will use the procurement process to ensure they secure the skills they need and to deliver value for the funders. This may include building on the expertise and knowledge that already exists amongst Fund Managers in the region and/or drawing in new expertise which is not currently available. A lesson from the North East and North West JEREMIE funds is the creation of a framework panel for funds managers for the larger funds with multiple subfunds.	Legal advice has been received on the WBF procurement process. The procurement specification has been drafted by Finance Wales as an entrusted entity, and the National Procurement Service is leading on the procurement process itself.
Performance monitoring	The European Court of Auditors set out the need for a small number of measurable, relevant and specific performance indicators for financial instruments, covering the investment, financial and economic performance of the programmes. These measures need to be suitable and tailored to the specific characteristics of the debt and equity	Core and added value outputs for WBF have been put in place in the investment strategy. These will be supplemented in due course by other monitoring metrics, drawing on the experience of successfully delivering JEREMIE in Wales.



	Summary of Lessons Learnt from Previous FI Interventions		
Key lessons	Commentary	Implications for the WBF	
	instruments used, rather than adapted from measures used for grant based initiatives. The ECA also suggests fixing contractually binding minimum leverage ratios and leverage dispositions for the	A Monitoring and Evaluation plan is being put together for the ERDF Business Plan.	
Managamant	respective holding fund or funds.		
	and governance The operational management of FIs (as opposed to	The management and governance	
Drawing on best practice	investment undertaken by fund managers) requires a high level of expertise and a considerable level of resource, especially for the larger and more complex funds (such as the JEREMIE funds). Whilst	of WBF will build on the successful model within JEREMIE and the lessons identified.	
	the approach and extent of the responsibilities can vary, there is a need to ensure these activities are adequately resourced, especially during the investment period (subject to ensuring value for money is attained). There is extensive and helpful guidance on the governance arrangements for investment funds, including HMG and BVCA guidance. The available evaluation evidence points to the importance of having a separate management board and an investment advisory group (which advises on the overall investment strategy), although there can be some value in common membership between the two.	A review is being undertaken on the level of grant funding received by Finance Wales from Welsh Government, with a view to maximising value for money and ensuring that adequate resources are in place.	
Balancing a public sector and private sector ethos	Whilst being wholly funded by public money, the JEREMIE funds are managed by the private sector. This brings challenges of governance and accountability, with the need to balance the responsibilities of public sector funding with a commercial ethos. This is an important principle in ensuring that the funds both establish and maintain credibility with the private sector, and that they deliver the objectives set by their core funding partners. It is important that there are cleared and shared understandings of fund structures and objectives from the outset, and that these are fully reflected in reporting arrangements.	Finance Wales has a strong track record in investing on a commercial basis whilst ensuring that appropriate mechanisms are in place for meeting and reporting on the requirements of public sector funders. It is important that the WBF, like JEREMIE before it, is perceived in the market place as a commercial lender and investor.	
Performance management	Whilst instilling a performance management culture is critical to the success of the funds, it needs to achieve a good balance between ensuring fund managers deliver against key targets while avoiding any excessive interference with their delivery. Project developers need to carefully consider how they can best achieve this, including governance and management structures and the systems and processes they put in place. This needs to be explicitly addressed in the preparation of the business plan, the procurement process and the development of systems.	The mid-term evaluation of JEREMIE in Wales highlighted the strong performance management culture of Finance Wales. The successful approach to performance management will be built on in the delivery of WBF.	



3. Summary and concluding comments

Summary

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



	nmary of Review and Conclusions	Is the properal cound, deliverable and evidence based?
Proposed fund size and	What is being proposed? £135.9m pan-Wales Fund for all types of SMEs, providing:	Is the proposal sound, deliverable and evidence-based? The Fund Size and composition has been driven by market, funding and delivery considerations.
composition	 £86.3m in loans and mezzanine finance 	5511314214151131
	£49.6m in equity funding (early stage and later stage risk capital)	The proposed allocation to both loans and equity is towards the lower end of the recommended ranges (on an annual basis) in the market assessment evidence, reflecting the development of a range of other Funds since these assessments, the extension of the investment period, and the availability of funding.
		In delivery terms the allocation to loans and equity is designed to allow enough cashflow generation from debt repayments (to pay back FTR) and enough return from equity investments to generate legacy returns.
		Overall, the proposed size and composition of the Fund broadly fits with the market evidence and has been based on conservative and prudent assumptions on what is deliverable over the investment period of the Fund.
Funding sources		
- Fund level	The £75.9m in ERDF is matched: at fund level by £30m in legacy funding from current JEREMIE and £30m from Financial Transaction Reserve (FTR).	The approach has been influenced by the infeasibility of using external debt funding as match, given the impact on Welsh Government's DEL.
		The forecast for legacy funding from JEREMIE is reasonable and the central forecast has already been discounted by 50% and its realisation assumed to be delayed in the fund modelling, for prudence. There remains a risk to the achievement of this legacy.
	£5.4m in deal level match is required for loans and £20.9	5 ,
- Deal level	million for equity. Both sub-funds will have a minimum 1:1	for loans given the experience of the SME debt market in recent years, supply
	target for deal level match.	conditions should be more favourable going forward. The experience from
		JEREMIE in securing match for equity deals, and the co-investor networks that
		have been built up, suggests that the target for equity is achievable; nonetheless



	What is being proposed?	Is the proposal sound, deliverable and evidence-based?
		it is a very important element of delivery. Therefore, fund managers bidding to deliver WBF will need to make clear the precise mechanisms they will use to deliver on this requirement, and their performance will need to be monitored closely.
Geographical split	Split in funding between West Wales and the Valleys (WWV) and East Wales (EW): • ERDF: WWV – £65m; EW - £10.4m • Match: WWV - £25.3m; EW - £34.7m	The split in funding at the Fund level between WWV and EW is in the ratio 67:33. ERDF funding is weighed towards WWV due to the allocations at Programme level. This has been rebalanced using the match funding.
	• Overall: WWV - £90.7m; EW - £45.1m	The balance is a little more weighted towards WWV than in current JEREMIE (60:40), but is judged to be deliverable.
Sectoral focus	The WBF will be sector neutral, but it is expected that the Fund will support the Welsh Government's key sectors. The investment strategy states that "the appointed"	Evidence from SME FIs shows that maintaining flexibility in the sectoral approach is important for successful delivery.
	equity fund manager will be required to adhere to the principles set out in Science for Wales and Innovation Wales in terms of targeting investments to build on	Partners have confirmed that supporting the 9 key sectors is a general aspiration and that the Fund will be generalist in its sectoral focus.
	Wales' distinct and genuine areas of excellence."	This is a sensible approach that will ensure sufficient flexibility whilst contributing to Welsh Government aspirations for sector development. Clear plans will need to be put in place for marketing WBF to the key sectors.
Modelling assumptions		
- investment rate	 The model assumes the following investment rates: Loans: £13.5m p.a. with an increase to £18.6m in year 6 Equity: £6.4m p.a. with an increase to £8.9m in years 6 and 7 	The investment profile looks deliverable. Whilst there is a sharp increase in investment in the final year of the loan fund, general inflation should aid the deliverability of this jump in investment rate. Moreover, some of the increase in the investment run rate could be made via follow-on investment.
- default rate	The financial model assumes the following default rates: • Loans: 15% • Mezzanine 25% • Equity 40%	These assumptions compare to the following default rates for the current Fund Loans: 8.3% Mezzanine: 18.2% Equity: 36.5% Taking into account the prevailing market conditions at the time of the JEREMIE Fund, the assumed default rates are sound and conservative in the light of the



	What is being proposed?	Is the proposal sound, deliverable and evidence-based?
- pricing	 The following average interest rates will be charged: Loans: average interest rate of 8%; 5 year term Mezzanine: average interest rate of 12%; 5 year term Equity: 1.5 times sunk equity for successful investments 	These pricing assumptions are consistent with those used in the JEREMIE Fund. They are averages so actual rates will vary around these.
- returns	The financial model assumes that the Fund will deliver: a gross IRR of 1.27% a net IRR of -5.58%	Evaluation evidence shows that a negative net financial IRR is common for SME FIs, given the defaults and returns associated with this market. The expected returns therefore look reasonable.
- operating costs	- Total operating costs of £36.6m (27% of Fund value) - Total fund manager fees are £21.1m (16% of Fund value - Annual fund management fee is 1.36% of Fund value.	Costs are based upon the experience of JEREMIE. Total operating costs are conservative and below levels typical of umbrella funds.
		Fund management fees are below those observed for other ERDF-backed Venture Capital and Loan Funds and the annual fund management fee is slightly below guidelines set by the BVCA (1.5%-2.5% p.a.) and the EU (5% p.a.).
		Projected operating costs are reasonable and within acceptable benchmarks.
- outputs	A range of outputs have been forecast, including a set of core and added value indicators.	The output targets have been forecast by generating benchmarks from the performance of current JEREMIE and extrapolating forward.
		This is a sensible, and in some cases probably a conservative, approach, since the performance of JEREMIE has been heavily influenced by several years of poor economic conditions, which may prove to be more benign for WBF.
Value for Money	On the basis of jobs created, the WBF is projected to have the following unit costs: Gross ERDF cost per gross job created: £21,200 Gross public sector cost per gross job created: £37,900 Net ERDF cost per net additional job created: £10,400	These unit costs compare favourably with the achievements of SME FIS elsewhere, including the English JEREMIE Funds.
Governance	Finance Wales acting as an entrusted entity to act as the Fund administrator. It will be responsible for the overall delivery of the WBF, contracting with WEFO for the use	This approach is consistent with EU guidance and is sensible given Finance Wales' experience and status as a subsidiary of Welsh Government
	of ERDF grant, and procuring and managing the fund managers Finance Wales is drafting the tender specification for fund managers and the National Procurement Service will then lead the procurement process itself. The two	The tendering approach has been pursued following legal advice to WEFO from the Welsh Government Legal Services department.



Review of the Ex-ante Assessment of the Wales Business Fund

	What is being proposed?	Is the proposal sound, deliverable and evidence-based?
	sub-funds may be managed by separate Fund Managers or by a single Fund Manager.	
	 The current intention is for Finance in Wales to set up a Special Purpose Vehicle, which would be responsible for: Appointing and contracting with the Fund Managers, following the procurement process Act as a consultee to the Fund Managers as they establish the Investment Committee and Investment Operating Guidelines Monitoring investment activity and managing he performance of the Fund Managers. 	
/lonitoring	To be produced in ERDF Business Plan.	-
nd		
aluation		



Concluding comments

- 3.2 The review of the investment strategy for the WBF has highlighted that the proposals are generally sound and deliverable, have been based on a consideration of the available market evidence and have taken on board they key lessons from the delivery of JEREMIE in Wales.
- 3.3 As the proposal is developed in more detail through the business planning process and beyond, a number of aspects will need to be managed and addressed. These include the need to:
 - ensure a swift start-up of the Fund. Lessons from elsewhere highlight the importance of avoiding a hiatus in funding and delivery and the need for realism in the time that it will take to procure and appoint Fund Managers.
 - ensure appropriate mechanisms are put in place for securing co-investment at deal level. The funding model being pursued means that some of the ERDF match funding needs to be secured at the deal level. Achieving this will be critical to the success of the Fund. Although the targets are achievable it will need to be ensured that mechanisms are fully embedded into the delivery of the sub-funds to allow this. Potential fund managers will need to demonstrate convincingly how they will secure this leverage and the appointed fund manager(s)' performance on this aspect will need to be monitored closely.
 - closely monitor the forecast for the achievement of legacy returns from JEREMIE and any implications for funding for WBF.
 - make sure that the appointed fund managers have a clear plan and the necessary resources
 to achieve the spatial split in investments that is required by ERDF. This should include
 suitable marketing and business development procedures and resources, and a suitable
 presence in West Wales and the Valleys and East Wales. Progress against these targets will
 need to be carefully monitored.
 - integrate the WBF into the wider business support offer in Wales. The market assessment evidence has clearly highlighted that SME finance in Wales is not just a supply side issue, and that there are particular issues with investor readiness. To be most effective the WBF needs to work with other business support provision.
 - put in place clear mechanisms for ensuring that the conditions for the provision of grant funding alongside repayable finance for SMEs are met. Any delivery of grant must operate alongside the WBF to ensure complementarity and additionality. It must only be used if all other sources of finance have been exhausted and if the other conditions highlighted in the underpinning thinkpiece are met.
 - ensure that there is a robust Monitoring and Evaluation plan in place.
 - consider commissioning an external expert review of the final financial model, subject to
 available time and resource. Finance Wales has a wealth of experience in managing,
 delivering and designing FIs for SMEs. Nonetheless, it is good practice for an external expert
 to undertake a detailed review of the financial model (as was done for the JEREMIE Fund).
 - ensure clarity in the governance arrangements for the Fund, including legal structures and contractual arrangements.
 - ensure that the financial model and investment strategy remain under regular scrutiny, including provisions for review and revision of the strategy in response to changes in the market, as appropriate.



