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Update of the Ex-Ante Assessment of the Wales Business Fund – Executive Summary

1. The Wales Business Fund

1.1 The Wales Business Fund (WBF) continues a long-term commitment within Welsh Government, with the support of the European Union, to use 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 finance to early stage and growth orientated businesses across Wales and securing substantial economic benefits.

1.2 The WBF is split into four operations which are defined by the geographies of the two 2014-20 ERDF programmes in Wales (the East Wales and West Wales and the Valleys programmes) 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 of Priority Axis 2: SME Competitiveness)
- Innovative and R&D orientated early stage and growth orientated SMEs (Specific Objective 2.5 of Priority Axis 2: SME Competitiveness).

1.3 The revised fund therefore has an investment value of £181m, split £55.4m and £125.5m between East Wales (EW) and West Wales and the Valleys (WWV), and £88.5m and £92.5m between loan and equity finance.

2. Part A – Market Assessment

Performance of the Wales Business Fund

2.1 The Wales Business Fund (WBF) has had strong overall investment performance, exceeding its investment target to date by over 20%. The fund has performed well in EW where demand has been strong for both debt and equity, and the fund is nearly fully invested. However, there have been some investment performance issues in WWV where the equity investment rate is below the delivery plan rate. There is around £46m of equity remaining to be invested in WWV over the next three years in order to meet the investment rate (equivalent to £15m per annum).

2.2 Financial performance has generally been strong, with consistently lower than projected default rates. However, given COVID-19 this has risen sharply over the last quarter as the DBW has moved to place provisions for investments considered to be highly vulnerable. The default rate stands at 7%.

2.3 Economic development performance has generally been strong, however the fund is behind on its jobs created target to date. Some of this underperformance could be due to the time lag in collection of data from investee businesses, rather than just poor economic development performances from investments.

Continued Relevance & Consistency - Policy Context

2.4 The key policy developments in the UK centre around the Industrial Strategy which recognizes the need to improve access to finance for SMEs.

2.5 In Wales, policy priorities are focused around a more regional model of economic development, with emphasis on a smaller number of cross cutting, thematic sectors, and a commitment to supporting the foundation economy. All of these priorities will continue to require access to growth finance.

2.6 The exit of the UK from the EU is also a key policy development. Whilst it is still unclear what investment priorities and approach to allocating resources will be adopted by the UK Government after Brexit, SME competitiveness and access to finance is likely to remain a key priority.

2.7 COVID-19 has sparked considerable EU, UK and Welsh government response to help mitigate the impact. A key focus of this response has been the provision of financial support to SMEs (eg Coronavirus Job Retention Scheme, Economic Resilience Fund, CBILS, CWBLS).

2.8 The DBW has significant traction and presence in the market. It currently delivers 17 funds with a total value of over £650m and has played a key role in the Welsh Government’s COVID-19 response, delivering the £100m COVID-19 Wales Business Loan Scheme.

Continued Relevance & Consistency - Economic Context

2.9 Prior to COVID-19, the Welsh economy experienced reasonably strong growth in output, productivity, and the number of businesses, although growth rates still lagged behind the UK average. However, the COVID-19 pandemic has plunged the world economy into unprecedented times. Globally, output growth is projected by the IMF World Outlook Update to fall to -4.9% in 2020. In the UK, GDP has fallen by nearly 20% from March to May.

2.10 Alongside dramatic losses in output, there has been a significant increase in unemployment – in Wales the claimant count increased by 95% between March and June (with 117,000 claimants in June).

2.11 Given the very dynamic situation with COVID-19, it is difficult to be precise about the economic impact of COVID-19 to date. In the medium to long term, there is considerable uncertainty regarding what future output levels could be. The consensus amongst many economic forecasters is that a v-shaped bounce back in the economy is unlikely. The future recovery scenario is to an extent tied to the development of a vaccine and subsequent easing of social distance restrictions.

2.12 It is also clear from the forecasts that the challenges for businesses vary significantly across different sectors. The Welsh SME business base is dominated by wholesale and retail trade; agriculture; construction; and professional, scientific and technical sectors. There also continues to be a disproportionate number of microbusinesses in lower value-added sectors, such as agriculture, wholesale and retail.

SME Finance Market Assessment

2.13 There continues to be strong growing demand for debt finance (loans, overdrafts and credit cards) by SMEs in Wales. There has also been a significant increase in the start-up rate and stock of microbusinesses in Wales over the past few years.

2.14 Wales performs strongly on innovation indicators, a proxy for the demand for early stage finance. This varies by spatial area given the sectoral make-up of the SME business base. In EW, demand could be higher, where growth is driven by professional services companies. It could be lower in WVV where employment is dominated by the public sector, manufacturing and construction.

2.15 In terms of supply, there has been falling bank lending across Wales. For microbusinesses, their finance needs are largely catered by public sector backed initiatives. For both early and later stage equity finance, the data shows the market is maturing, with a shift towards larger later stage deals. In Wales, the DBW is the main provider of increased equity lending for SMEs.

2.16 There is considerable uncertainty regarding the implications of COVID-19 on SME finance markets. Much of the impact has not been borne out in the data yet, and it is very much a dynamic picture. This is further compounded by the fact that government support schemes are still in place and it is uncertain as to when they will finish (and what the market will look like when they do finish).

2.17 Business in Wales have been worst affected by the pandemic, with higher proportions of businesses reporting losses in turnover, and the highest proportion of furloughed employees compared to the other devolved administrations. As a result, business confidence has plunged, and there has been a shift in the demand for external finance from growth finance to survival and working capital.

2.18 Wales had the highest rate of applicants to government support packages, with particularly high rates of furloughing and use of emergency grants. There is some evidence that the high street banks are better prepared to lend compared to the 2008 recession, although it is still uncertain given that many government support packages are still in place. Early stage equity investment in particular could be under threat, as many investors either hold onto their investment capital or follow on investment in their existing company. There could also be a shift towards later stage, less risky deals.

Implications for the WBF's Investment Strategy

2.19 Based on the findings in Part A of the assessment, this results in the following implications for the WBF's investment strategy:

- A shift in demand for debt finance from growth to working capital
- Increase in default rates and lower legacy and economic development returns
- Allow some early stage investment at a lower co-finance rate
- Re-allocate growth equity investment to debt in WWV (£20m-£26m overall)
- Increase the amount of investment capital in both WWV and EW (£5m-£10m pa in both areas)
- Continue to use flexibility in repayments to support businesses to borrow
- Adjust the KPI targets given the change in economic conditions.

2.20 Based on these implications, the DBW revised the investment strategy. This is reviewed in Part B of the Ex-Ante Assessment.

3. Part B – Review of Proposed Changes to the Investment Strategy

3.1 The investment strategy review focuses on the key changes compared to the previous investment strategy reviewed in the 2018 update of the ex-ante assessment. A summary of our view of each of the key elements of the strategy is outlined below.

Metric/ Amendment	Previous Investment Strategy	Revised Investment Strategy	Summary Comment
Additional Investment capital in WWV	£125.5m	£140.5m	Justified on basis of expected demand for working capital and debt finance as outlined in this market assessment
Reallocation in WWV from growth equity to debt	£25.4m virement of investment capital from growth equity to debt		Justified on basis of this market assessment and expected nature of the demand for finance
Reallocation in EW from debt to equity	£1.6m virement from debt to equity		The market assessment does not support this amendment but this is justified on basis of the DBWs pipeline of investments (plus deals completed since March 2020)
Investment Rate	£4.5m left to be invested in EW		Should be achievable given investment rate to date and pipeline of investment in EW
	£70.5m left to be invested in WWV (£17.5m per annum)		The required investment rate for debt finance is £13m per annum. This is in line with Wales JEREMIE investment rates and also what has been achieved by the fund to date. For equity, the required investment rates is £3.6m per annum. This is lower than rates achieved to date, and should be achievable. Even if more challenging economic conditions were to occur (leading to a fall in demand for equity for the rest of year), this rate, whilst challenging, should still be achievable.
Write-Off Rate	15% loans 40% equity	20% Loans 40% equity	These rates are likely to be challenging to achieve given the uncertain economic conditions (particularly for equity which is set at lower than the JEREMIE outturn). We recommend the DBW plan on the basis of the more pessimistic scenario (30% loans and 50% equity)
Jobs Created	4,208	2,160	Reduction reflects underperformance to date for the fund, and also adjustments to account for lower than expected job creation as a result of COVID-19. Reasons for underperformance need to be carefully explored through monitoring and evaluation, as this has implication on the funds value for money
Jobs Safeguarded	-	1,865	This is now a core KPI, therefore no target in the previous investment strategy. Overall in our view this is a conservative estimate, given that it is based on past performance of the fund which was lower than expected, plus the shift in nature of demand from growth to survival is likely to result in more jobs safeguarded.

No. Enterprises Supported	522	488	Reduction reflects higher than expected average investment values to date. We would expect this average to fall (given that the demand is expected to be for working capital) but DBW pipeline suggests in the short term the demand will be for larger deals. This needs to be very closely monitored.
Private Sector Leverage	£139m	£333m	Reflects overperformance to date for this target. Should be achievable
Legacy Return	£99m	£107m (base case) £82m with higher write-off rate	Legacy dependant on write-off rate. The base case scenario is higher than the previous investment strategy given (in our view) relatively optimistic assumptions on write-offs. Given the uncertain and challenging economic conditions, we recommend the higher write off rates are used for the legacy forecast.
Value for Money	Gross cost per job = £31,800 Net Cost per net job = £9,500	Gross cost per job = £76,800 Net Cost per net job = £31,700 - £45,100	Reduction in value for money is due to lower job creation figures as a result of the reasons outlined above (ie underperformance to date, COVID-19 adjustments), plus lower legacy returns due to high write-off rates. This does not consider the benefits of supporting survival/safeguarding of business and jobs. The full impact of the fund (and value for money) will need exploring through the mid-term and final evaluation.

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Full Research Report: Hatch (2020) Update of the Ex-Ante Assessment of the Wales Business Fund.
Available at: https://gov.wales/ex-ante-assessment-wales-business-fund-wbf-update

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