



Final Evaluation of the Wales Business Fund

A Final Report by Hatch
December 2023

Development Bank of Wales

Final Evaluation of the Wales Business Fund

December 2023

www.hatch.co.uk

Executive Summary

- i. The report sets out the findings of the final evaluation of the Development Bank of Wales' (DBW) Wales Business Fund (WBF). The WBF was launched in 2016, is investing in SMEs until the end of 2023, and will generate repayments and realisations on its investments until end of December 2028. The evaluation has been undertaken by Hatch and Belmana.
- ii. The final evaluation has been undertaken throughout Spring and Summer of 2023, in order to meet reporting requirements for the evaluation of European funding. Therefore, the most up-to-date data on performance to date and future projections have been used throughout, and all sources are referenced to their date of production.
- iii. The WBF has continued 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 built on the success of the Wales JEREMIE Fund, which invested over the period 2009-15.
- iv. 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 the West Wales and the Valleys programmes) and the thematic investment focuses of these programmes, which are as follows:
 - finance for business start-up and business expansion (Specific Objective 2.1 of Priority Axis 2: SME Competitiveness)
 - finance for innovative and R&D orientated early stage and growth orientated SMEs (Specific Objective 2.5 of Priority Axis 2: SME Competitiveness).
- v. The Final Evaluation report provides an assessment of the relevance and consistency of the Fund; its performance against investment, financial and output targets; contributions to Cross-Cutting Themes; delivery and management performance; outcomes and impacts; and value for money. The report builds on the findings of the Mid-term Evaluation (MTE) conducted in 2020/21. Whilst the Final Evaluation focusses more on impacts and value for money than process points, it does conclude with a set of reflections on the lessons from the delivery of the Fund, and more widely from the experience of the EU Structural Fund-backed SME investment Funds in Wales from the past two decades.
- vi. A summary of the headline findings of the evaluation is provided below.

Relevance and Consistency

- vii. **The WBF was well designed from the start, to address ongoing market failures:** the Fund is the latest in a series of funds in Wales providing debt and equity finance for SMEs where there is market failure. The original design of the Fund used strong, independent evidence on the market and market gaps,¹ and a robust public sector intervention logic. The DBW maintains close working links with the private sector, which helps it to establish an ongoing view of market failure to inform the targeting of its funds. Importantly, the financial structure of the Fund – using repayable Financial Transactions Capital (FTC) alongside ERDF – put it on track to maximise its

¹ Regeneris Consulting for Finance Wales, Venture Capital and Loans Market Assessments for SMEs in Wales, 2014.

legacy fund. FTC had to be repaid first, but did not have any fees or interest attached to it. This was in contrast to the JEREMIE Fund, which used a loan from the European Investment Bank (EIB), which did attract fees and interest and subordinated other funding sources.

- viii. **The Fund has adapted well to a series of significant economic shocks.** The Fund has operated in a period which has seen several defining shocks: Brexit, the COVID pandemic and inflationary pressures in particular. These have had major impacts on the wider economy and on the nature of demand for finance from SMEs. In response, the Fund has been quick to switch its focus where necessary, and to ensure that this is underpinned by good evidence. Ex-ante assessments have been used to provide evidence on the need for changes, and these have been seen by public sector stakeholders as good practice. In particular, DBW introduced a jobs safeguarded output target and switched its provision of debt finance from growth to working capital support, as SMEs became acutely focussed on survival rather than expansion. The Fund's proactive and well organised approach has ensured that the WBF has remains relevant, even as further shocks have arisen since the height of the pandemic.

WBF Performance

- ix. **The Fund has expanded very significantly in size since inception:** In response to changes in the market and in the availability of ERDF funding from the current programme, the WBF has grown from £136 million to £216 million. WEFO saw the opportunity to allocate shortfalls in ERDF Funding from elsewhere in the programme to the Fund, seeing DBW as a trusted partner and recognising the potential to generate a legacy fund in future from the returns it generates. This was underpinned by evidence of strong demand and gaps in private sector provision.
- x. **Investment performance has been consistently strong, even with these increases in the scale of the Fund:** The Fund is currently at 95% of its total lifetime investment target and is projected to be fully invested by end of December 2023. The strong investment performance is especially remarkable given the unprecedented scale and depth of Government intervention in SME finance, as both the UK and Welsh Governments injected emergency loan funding into SMEs (e.g. the UK Government's £5.6bn Coronavirus Business Interruption Loan Scheme and the £47.6bn Bounce Back Business Loan Scheme). The fact that the Fund has been able to invest significant amounts of debt into Welsh SMEs on a commercial basis in this context is indicative of the ongoing gaps in the market and the retrenchment of banks since the major Government interventions.
- xi. **Equity investment has been more challenging.** Whilst demand for debt funding has been strong, it has been more difficult to meet the targets for equity investment in established SMEs. This reflects both long-term issues around lack of awareness and an aversion amongst business owners to giving up equity, as well as the effects of the economic context in dampening growth and risk appetite across the board. In response, with WEFO's approval, DBW has vired funds from equity to debt. Despite this, the Fund has invested over £60m in equity into SMEs as at end of June 2023, and consultees recognise the organisation as a primary provider in Wales of these relatively small amounts of equity (on a deal by deal level). DBW has also focussed more recent marketing and business development activities on an equity campaign, which has included a special conference outlining its benefits and providing case studies and role models.
- xii. **It has been easier to get investment out to firms in East Wales than it has in West Wales and the Valleys.** As was found to be the case in the MTE, sourcing suitable investees in WWV has been challenging, especially when it comes to equity investment. This reflects the smaller pool

of businesses overall, and of those suitable for specific finance types. As is the case for equity funding, DBW similarly has put extra focus recently on marketing the Fund to potential investees in WWV. There is some evidence that, compared to the predecessor JEREMIE Fund, this marketing effort may have helped, since investment rates are higher in some parts of WWV than was the case in JEREMIE. However, for future funds it will remain more difficult to invest in WWV than in EW.

- xiii. **Defaults and write-offs have remained well below planning assumptions.** Despite the highly challenging economic conditions, the Fund's investments have performed well. The default rate (including actual write offs and provisions) stands at 10% at the time of writing. Our analysis and consultations suggest that this is due to a mix of factors, including conservative business plan modelling, and strong due diligence processes developed by DBW over a number of years. The Fund adopted a prudent provisioning approach, which for example, included applying a blanket 50% provision against portfolio companies that were highly vulnerable to COVID impacts (most of which has been released). Our consultees suggest that COVID-related Government support for SMEs has probably also had some impact in cushioning SMEs against financial difficulties, which may have added to the Fund's financial performance.
- xiv. **As a result, the Fund is projecting a strong legacy fund.** DBW is expecting its WBF investments to generate a legacy Fund of £104 million (this is the net legacy, taking into account projected investment returns and remaining Fund expenses). This will be available for recycling into future investments in SMEs in Wales. Given the inherent uncertainties, we subject this projection to sensitivity testing in the value for money assessment (see below).
- xv. **Economic development targets largely exceeded.** The Fund's economic development output targets were revised in line with the changes in the Fund size and composition over its life. Based on the position at end of June 2023, the Fund has exceeded all of its lifetime targets, apart from the *enterprises assisted* KPI, which is due to a greater use of follow-on investment than anticipated within the original business plan. There has been particularly strong performance against the innovation indicators driven by the early-stage investments (for example, 115 new to firm products have been introduced, against a lifetime target of 34). The Fund has also met its lifetime target for jobs created and safeguarded. The period of analysis used means that these KPIs will continue to increase for the remainder of the investment period and into the realisation period.
- xvi. **The Fund has been successful in leveraging private sector co-investment.** Overall, the Fund has levered in £322m of private sector investment as at end of June 2023, which represents £1.60 for every £1 invested by DBW. This has been particularly high in East Wales (with an induced investment ratio of 2.8), and co-investment from WWV has been much more difficult given the nature of the market and the location of private sector investors.

Contributions to the Cross Cutting Themes

- xvii. **Genuine awareness and commitment to embedding the cross-cutting themes (CCTs):** DBW has demonstrated substantial progress in its approach to embedding CCTs. It has responded very positively to improvements that were suggested in the evaluation of JEREMIE, and implemented measures at the front end of the design of the project. Our consultations have found that stakeholders are very positive on this point and see DBW as an example of good practice.

- xviii. **CCT delivery has been supported by an effective relationship with Business Wales.** Consultees report that this mechanism has helped DBW to promote opportunities for the CCTs to be achieved whilst DBW focuses its resources on responding to the SME finance gap. Between April 2021 and the end of March 2022 (the latest Annual CCTs report provided), the WBF referred 510 businesses to Business Wales, and received 320 referrals from Business Wales.

Delivery and Management Performance

- xix. **Positive feedback on management, governance and delivery:** In line with the findings of the MTE, our consultees have been positive in their feedback on the management, governance and delivery of the Fund. The DBW (and previously, Finance Wales) has built up capacity and expertise as a result of the experience of delivering a series of similar Funds, and consequently holds a rare combination of financial and public sector economic development expertise, as well as a good working relationship with WEFO. This has helped the Fund to be run smoothly.
- xx. **Effective portfolio management structures and risk pricing strategies:** there are clear structures in place to manage portfolios, identify and mitigate risks of underperformance early. The pricing strategy in place is cognisant of not displacing the private sector, therefore charges are higher than the private sector (to reflect the higher level of risk generally taken) and the DBW regularly goes out to the market to get an understanding of the interest rates others are charging and reflects the level of risk associated with the investment propositions. The pricing strategy is therefore considered to be effective in avoiding the distortion of the market and appropriate given the level of risk, whilst securing a reasonable financial return for the purpose of the WBF and its class of investment.
- xxi. **Rigorous reporting and auditing requirements:** DBW consultees indicated that the increased level of regulation and audit required for the WBF relative to other DBW funds (due to EU funding requirements) has brought a level of rigour to the organisation which has been helpful, and the DBW has benefited from this across its other funds. However, it was also highlighted that this scrutiny can delay the release of cash, where the WBF is close to its available headroom, which can limit the availability of cash to continue to invest at times. Financial and KPI claims are completed on a quarterly basis, and a management verification team undertakes an audit of a sample, which can take some time ahead of releasing the next tranche of funding.
- xxii. **Efforts to provide a service across all of Wales:** there have been significant efforts invested in providing a service across all of Wales, for example through opening a head office in Wrexham, opening regional offices and hiring regional Business Development staff. The launch of the WBF, as well as the DBW, marked an important step change in terms of going beyond previous funds in addressing SME gaps and market failures. The shift from Finance Wales to DBW is seen as being really positive among consultees. Marketing has focused on promoting SME access to finance, rather than specific funds and this has helped to improve awareness that the DBW is there to provide finance at scale to meet the needs of businesses in Wales.
- xxiii. **Feedback on marketing and business development generally positive:** the launch of DBW was noted at the time of the MTE as being successful in building strong market awareness among financial intermediaries and business representative organisations which has facilitated deal flow. Consultees reported good visibility of DBW in the market. Evidence from the MTE survey found that the most popular response for how businesses had heard of the WBF was directly via DBW. In response to the relative lack of take up of equity funding and challenges in investing in WWV, DBW has put a focus on both of these issues in its most recent marketing and business

development activity. There are deep-rooted issues and barriers here, so this kind of investment may need to be built on in future, for any other similar SME investment Funds in Wales.

Outcomes and Impacts

- xxiv. **The WBF has clearly addressed market failures in SME finance:** that is, through filling a gap in the market where the risk of failure is perceived to be too high and returns too low for private sector investment. The Fund has worked well with the private sector, evidenced by our consultations with financial intermediaries and the data on private sector leverage into the Fund.
- xxv. The key findings from the counterfactual economic impact evaluation (CIE) are as follows:
- The performance of 293 WBF beneficiaries has been able to be tracked by matching to a control group of non-supported businesses with similar characteristics. The support they have received amounts to a total of £139.2m of direct investment. These businesses have experienced strong employment growth in the years following investment from WBF. Total employment across these supported businesses has increased by 2,515 jobs, equivalent to 8.6 jobs per business.
 - The CIE analysis indicates that approximately 58% of the employment growth was additional. That is, although around 40% of the jobs would probably have been created anyway, most of the growth is attributable to receiving finance from WBF. This equates to a total additional increase of 1,466 jobs, an average of 5.0 jobs per business. All of the estimates on employment additionality are statistically significant.
 - The beneficiaries' real (i.e. adjusted for inflation) turnover increases by a total of £319.9m in the years following support, which reflects an average £1.09m increase in real turnover per business. The beneficiaries outperform the comparison groups in terms of growth in sales, indicating that part of the increase is attributable to the funding received.
 - Around 60% of the increase in turnover was additional. This amounts to a total additional turnover of £190.7m, approximately £650.8k per supported business. However, it is worth noting that a statistically significant difference is only found for three years after support is received.
 - The beneficiaries that received equity rather than loans show a higher impact in employment growth in the years following support. However, no additional impact on real turnover is observed for this group until three years after receiving support, which may reflect the large share of equity investment that is being made in early stage, pre-revenue companies. This contrasts with the businesses which receive loan funding, who experience a positive impact on both employment and turnover in the years following support, though these effects are more modest.
 - Impact has been assessed for the two regions of Wales separately. No evidence of a significant difference in impact is found when comparing the impact on East Wales against West Wales and the Valleys beneficiaries.

Cost Effectiveness and Value for Money

- xxvi. The economic impact evidence generated through the CIE has been used to estimate the total net additional economic impact of the Fund, by grossing up from the sample to all investees,

and estimating the impact on Gross Value Added and employment in Wales, taking account of displacement and multiplier effects. This has then been compared to the public sector costs of delivering WBF to estimate value for money.

- xxvii. **It is estimated that the fund will deliver total net additional² economic impacts of 3,200 jobs and £205 million in GVA in Wales.** These are conservative results: although they assume that the investments not covered within the CIE will generate similar impacts to those that are covered in that analysis, the estimates do not take into account possible future impacts that may be realised from investments made in the investment period e.g. from equity investments made early in the investment period that reach significant milestones in future years.
- xxviii. **The WBF is expected to have a cost per net additional job created and safeguarded of £25,500, and an associated benefit-cost ratio (BCR) of 2.5** (i.e. £2.50 of GVA will have been created per £1 of net public sector investment). This represents “high” value for money according to UK Government guidance.³
- xxix. Since there is some uncertainty on the level of the legacy fund return, we have also run a scenario where the legacy fund is 20% lower than projected. This is judged to be unlikely, since most of the remaining legacy fund returns are based on projected loan repayments, which are more predictable and less volatile than equity realisations. Moreover, the base case legacy fund projection itself includes a 20% default rate within the forecast debt cashflow. Under this scenario, the BCR would still be around 2.0 and the cost per net additional job would be £31,900.

The role and legacy of Structural Funds

- xxx. The WBF is the last in a series of financial instruments for Wales backed by European Structural and Investment Funds (ESIF). This enables a number of observations and reflections to be made from this long experience, and broad lessons to be identified.
 - **ESIF facilitated the testing of approaches to repayable finance in Wales.** Prior to these financial instruments, there was a prevailing grant culture in Wales (and other places in the UK). The Structural Funds have enabled the testing and subsequent scaling up of repayable finance, which has brought with it greater discipline, enabled lessons to be learned on addressing market failure, and generated ongoing legacy funding for re-investment. Indeed, the UK has widely been seen as being at the forefront in Europe in the use of Financial Instruments to address market failure.
 - **The creation of the Development Bank itself was ultimately underpinned by Structural Funds aligned to Welsh Government funding.** The DBW would itself not exist had it not been for the EU Funds and the capacity and learning that they created. The initial testing of repayable finance led to the creation of Finance Wales, which then evolved into the DBW in 2017. The DBW now runs a large number of Funds, targeted at various segments of the market where there is market failure.
 - **The Funds have helped to build wider capacity in Wales.** As a consequence of the operation of these Funds over an extended period, the growth in the size of the funds and the lessons learned, Wales has been able to build significant capacity and expertise in

² That is, after deadweight, displacement and multiplier effects.

³ E.g. see [DLUHC appraisal guide - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/614442/2017-06-27-DLUHC-appraisal-guide-2017-2020.pdf)

SME finance. It has a bank of staff at DBW with a long track record in the delivery of these interventions. More widely, it has built a community and network of professionals across Wales, who understand the market and the role of publicly backed venture capital and loan funds in addressing market failure. Even for those DBW staff who move on to private sector roles, many will remain part of the ecosystem and be sources of leads and co-investment for publicly backed Funds.

- **The Funds have served to boost Wales’ profile as a place to invest.** The majority of venture capital and private equity investors are located in London and its environs. The growing presence of the DBW and its predecessor, Finance Wales, and the creation of a track record and case studies of successful investments in SMEs, has helped to grow the profile of Wales as a place for investment (both from investors and companies). This creates a virtuous circle where it becomes gradually a little easier over time to attract a network of co-investors from these centres of finance (indeed, the early-stage equity funds run by DBW have attracted investment from Silicon Valley). The DBW is now the fifth biggest equity investor in the whole of the UK, by volume of investments.⁴
- **Pan-Wales coverage has been valuable.** The fact that WBF and its predecessors have both operated at the Wales level and had targets for investment and outputs at a sub-regional level is important. By having explicit targets for West Wales and the Valleys, the Funds have been forced to invest beyond East Wales and its higher density market to source investment opportunities and to develop a presence in WWV. Although this has been challenging at times, it has generated economic benefits that would not otherwise have been secured.
- **The approach has enabled a head start on Environmental Social and Governance (ESG) issues.** Given the centrality of the “S” part of ESG to the SME finance interventions in Wales, this meant that the strategies, systems and processes for addressing this part of the equation are already in place at DBW. Further, the stringent EU requirements on administration, management and reporting, whilst stretching, has meant that high standards and good practice are in place on the “G” part of ESG. Similarly, the EU requirement to build in CCTs has meant that DBW has had to think about the “E” part of ESG too. These good practices are used as standard in the administration of other DBW Funds.
- **The Funds have instilled a need for a strong evidence base.** Although the EU Structural Funds brought rigorous evidence requirements, this has helped to “raise the bar” for when business cases needed to be made for changes in funding through ex-ante assessments. It has also left the organisation in a good place for bidding for funds from UK Government in future i.e. from the British Business Bank (BBB).

xxxi. It will be important for future interventions in SME finance in Wales to build on the progress made over the past two decades, and the lessons learned.

⁴ Source: Beauhurst

HATCH



www.hatch.co.uk

London: 0207 336 6188 Manchester: 0161 234 9910