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

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Update of the Ex-Ante Assessment of the Wales Business Fund
A Final Report by Hatch

HATCH

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Views expressed in this report are those of the researcher and not necessarily those of the Welsh Government

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Glossary

Acronym/Key word	Definition
BBB	British Business Bank
BBLS	Bounce Back Loan Scheme
BICS	Business Impacts of COVID-19 Survey
CBILS	Coronavirus Business Interruption Loan Scheme
CJRS	Coronavirus Job Retention Scheme
CRII	Coronavirus Response Investment Initiative
CRII+	Coronavirus Response Investment Initiative Plus
CWBLS	COVID-19 Wales Business Loan Scheme
DBW	Development Bank of Wales
EC	European Commission
ERDF	European Regional Development Fund
EW	East Wales
FI	Financial Institution
FSB	Federation of Small Businesses
FTC	Financial Transaction Capital
FW	Finance Wales
MTE	Mid Term Evaluation
SEISS	Self-Employment Income Support Scheme
SFI	Stabilisation Fund for Individuals
SFO	Stabilisation Fund for Organisations
TFSA	Tax-Free Saving Account
UFRI	Urgent Response Fund for Individuals
VC	Venture Capital
WAP	Working Age Population
WBF	Wales Business Fund
WEFO	Welsh European Funding Office
WG	Welsh Government
WIV	Work in View
WLGA	Welsh Local Government Association
WWV	West Wales and the Valleys

1. Executive Summary

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.

Part A – Market Assessment

Performance of the Wales Business Fund

- 1.4 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).

- 1.5 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%.
- 1.6 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

- 1.7 The key policy developments in the UK centre around the Industrial Strategy which recognizes the need to improve access to finance for SMEs.
- 1.8 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 these priorities will continue to require access to growth finance.
- 1.9 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.
- 1.10 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).
- 1.11 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

- 1.12 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.

- 1.13 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).
- 1.14 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.
- 1.15 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

- 1.16 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.
- 1.17 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.
- 1.18 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.
- 1.19 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).
- 1.20 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.
- 1.21 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 Investment Strategy

1.22 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.

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

Part B – Review of Proposed Changes to the Investment Strategy

1.24 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.

Table 1.1: Summary of Investment Strategy Review

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

Table 1.1: Summary of Investment Strategy Review

Metric/ Amendment	Previous Investment Strategy	Revised Investment Strategy	Summary Comment
			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.

Table 1.1: Summary of Investment Strategy Review

Metric/ Amendment	Previous Investment Strategy	Revised Investment Strategy	Summary Comment
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	<p>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.</p> <p>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.</p>

2. Introduction

The Wales Business Fund

- 2.1 The Wales Business Fund (WBF) continues a long-term commitment within Welsh Government, with the support of the European Union, to using repayable financial instruments to address market failures in the provision of external business finance to SMEs in Wales. It builds on the success of the Wales JEREMIE Fund which invested over the period 2009-15, providing finance to early stage and growth orientated businesses across Wales and securing substantial economic benefits.
- 2.2 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).
- 2.3 The WBF was initially proposed as a £136m fund following the original ex-ante assessment. The business plan was then revised to account for an additional £45m as a result of the availability of additional ERDF grant. £35m of this was initially secured in 2018 with £10m secured the following year.
- 2.4 The revised fund therefore has an investment value of £181m, split £55.4m and £125.5m between East Wales and West Wales and the Valleys, and £88.5m and £92.5m between loan and equity finance.

Table 2.1: Wales Business Fund Allocation

	Original ERDF Contract	Revised Business Plan (+£45m)
EW	45.1	55.4 (+23%)
<i>Loan</i>	<i>30.2</i>	<i>27.9 (-8%)</i>
<i>Equity</i>	<i>14.9</i>	<i>27.5 (+85%)</i>
WWV	90.8	125.5 (+38%)
<i>Loan</i>	<i>34.7</i>	<i>60.6 (+75%)</i>
<i>Equity</i>	<i>56.1</i>	<i>64.9 (+16%)</i>
Total	135.9	180.9 (+33%)
<i>Loan</i>	<i>64.9</i>	<i>88.5 (+36%)</i>
<i>Equity</i>	<i>71</i>	<i>92.4 (+30%)</i>

Source: Update of the Ex-ante Assessment for the Wales Business Fund, 2018.

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

Findings of the 2016 and 2018 Ex-ante Assessments

2.5 The original ex-ante assessment for the Wales Business Fund provided a detailed market assessment based on:

- Analysis of the economic and policy context
- Detailed analysis of finance demand and supply and the evidence of a finance gap
- Extensive consultation to inform the above strands of activity and to test options and detailed proposals
- A review of the literature and evaluation evidence to inform an assessment of good practice in public sector backed business finance.

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

- 2.7 The original assessment pointed to investment with Welsh SMEs of between £24m and £32m per year or £120m to £160m over five years (excluding debt for microbusinesses) and concluded that the proposed fund of £136m was justified and appropriately supported by the investment strategy. However, it noted that the robustness and continued appropriateness of this conclusion was dependent on a number of factors including: the prevailing market conditions; resolving any remaining uncertainty over the SME eligibility rules; and the risk and return profile which was adopted in practice during the investment period (recognising that the balance of risk and reward of investment can fluctuate within the investment strategy's operating guidelines).
- 2.8 The updated ex-ante assessment undertaken in 2018 considered the justification for the increase in the fund size to £181m. This update was driven by a higher investment rate than anticipated, differing spatial investment rates between EW and WWVs, and proposals at the time for an ERDF programme modification. It concluded that the increase in the size of the fund was justified given the market evidence, including market failures, and the revisions in the investment strategy. It noted however the potential challenges of achieving the proposed level of investment in West Wales and the Valleys programme area, as well as the anticipated level of co-investment for equity investment across both programme areas. In addition, it noted that the same exposure to risks and uncertainties identified in the original ex-ante assessment still applied.

Rationale for an Updated Ex-ante Assessment

Impact of COVID-19

- 2.9 COVID-19 has created a number of major challenges for SMEs in Wales with many being closed over the lockdown period. Whilst others have continued to operate, they have faced drastically reduced demand, as well as a host of issues related to their supply chains and service/product delivery. Although the UK and Welsh Governments have been able to assist many businesses through flexibilities (eg rent, business rates, business tax holidays), the Job Retention Scheme and a combination of grants and loans, they will nevertheless continue to face major trading and cashflow issues.

2.10 In the short-term, the situation is critical. Businesses have indicated that the Job Retention Scheme and other support packages have temporarily helped to mitigate some of these impacts. However, many business owners indicate that once temporary support measures are ended, redundancies are inevitable. In contrast however, other businesses in certain sectors have been able to adapt fairly well to the new environment, including benefiting from the additional demand for particular types of goods and services the crisis has generated.

2.11 This has the potential to impact on the WBF in a number of ways:

- The fund has performed well to date with strong investment rates, good repayments and low defaults. Higher failures and cashflow issues amongst portfolio companies will impact negatively on repayments and investment returns, as well as the flexibilities offered by DBW delaying loan repayments.
- Many of WBF's existing loan and equity portfolio businesses will shift their focus from growth to survival, with some seeking additional cash injections (and flexibilities) from the Development Bank, as well as postponing major business investments. This in turn will impact on the timing of capital returns and interest income to the fund, as well as on jobs created as companies move into survival mode.
- The pattern of demand for finance from WBF may shift away from equity investment to debt (which will make the already challenging equity target all the greater).

Additional Flexibilities

2.12 The update of the ex-ante assessment is a requirement of item 9f) of Article 32 of the Common Provisions Regulation. More specifically the Ex-Ante Assessment for the WBF recommended that the financial model and investment strategy remain under regular scrutiny, including the update of the market assessment and revision of the investment strategy in response to changes in the market or policy if appropriate.

2.13 There are flexibilities within the Coronavirus Response Investment Initiative (CRII) regulations which relax the requirements to update the ex-ante assessment if certain changes are made to existing FIs to address an immediate

response to the public health crisis. However, there is the possibility to repurpose some of the ERDF funding under PO2, which could be allocated to the WBF depending on the conclusion of this assessment. As this could potentially be a significant re-focussing of the Fund, a review is necessary to ensure any proposed changes are evidence based.

Assessment Requirements

2.14 The overarching aim of this review is to assess whether **the Investment Strategy of the WBF, in its current form, remains fit for purpose** in light of the impact of COVID-19. Bearing this in mind, the assessment needs to consider the following specific points:

- Is the focus of the WBF still optimum? This needs to be informed by analysis of the SME finance market to assess whether there are any increased or additional market failures or gaps in the provision of finance to SMEs. It needs to consider whether:
 - The type of finance offered, and the range of purposes for which it is used, is still appropriate? This could be debt, equity or grant support, or a combination of these, as well as the extent to which the WBF can fund working capital.
 - The fund is targeting the appropriate stage of business development and type of business? The fund has focussed on growth orientated businesses, but it could also shift its focus to also prioritise business survival and to support sole traders.
 - The deal terms are still appropriate? This needs to consider the ability of SMEs to repay additional finance on current terms or if these terms need to be revised in the future.
- Is the scale of funding offered by the WBF appropriate? This is focussed on the overall size of the WBF and needs to consider new and existing financial support available across Wales, the UK and Europe.
 - Is more funding required for the WBF? The assessment needs to conclude whether overall there is increased demand for finance from SMEs, (especially as emergency funding options in place are time limited), whether the WBF is the right mechanism to deliver

this increase in lending to SMEs, the ability of SME business base to absorb further finance.

- Is less funding required? Other sources of finance have been made available (although may be time limited) and, as outlined above, the ability of the SME business base to absorb any additional external finance may be limited. Also, the ambitions of the business base (focusing on survival rather than growth or expansion) could result in reduced demand for external finance.
- Are the KPIs appropriate given economic conditions? The current economic development KPIs for the fund are focussed on business growth (given the aims and priorities of the WBF at the time it was established), however current conditions may necessitate the revision of current targets and the introduction of other indicators (eg such as jobs safeguarded, business survival, no of sole traders supported etc).

2.15 Drawing on the above, the assessment needs to provide recommendations on whether any changes to the current investment strategy should be adopted. This should include specification of the expected results this would achieve in terms of:

- Impact on current forecasts for returns within a range of scenarios.
- Impact on current forecasts for KPIs within a range of scenarios.
- Contribution to priority objectives for the Wales Business Fund and the ERDF programmes including consideration of the new outputs set by the Commission in response to COVID-19.

Important Caveats to the Assessment

2.16 There are a number of factors which need to be borne in mind in undertaking the ex-ante assessment, which centre around dealing with uncertainty caused by COVID-19:

- The manner in which COVID-19 will impact on the performance, prospects and ultimately survival of SMEs will be subject to considerable uncertainty. It will depend heavily on the success of the pandemic health response, as well as the depth of the recession and subsequent

economic recovery. The latest OBR forecasts clearly illustrate both the depth and possible prolonged nature of these impacts.

- The effect of a recession on the supply of finance may only emerge over a longer period, as banks and investors respond to higher risk and uncertainty by changing their lending behaviour and pricing in higher risk (although this is in the context of historically low interest rates). It is not clear at this time if there is the potential for a future credit crunch.
- The changes in economic conditions and the demand and supply finance will not yet have been picked up in many datasets and hence there will be a need to also examine leading indicators (although these will have varying relevance and statistical robustness).
- Many of the financial support measures which have been put in place for SMEs are time limited, although it is possible that these may be superseded by longer term measures in due course.
- Whilst the ex-ante guidance seeks a quantification of the finance gap, it is challenging to quantify the scale and nature of the gap which is accounted by market failure with precision and likewise the change in the size and nature of this gap due to changes in economic and market conditions. Hence it is also challenging to make recommendations of the optimum scale and type of public sector intervention. One of the main reasons for this is that the finance gap is not directly observable and is also shaped by the public sector's own preferences for balancing risk and return (both financial and economic development) in its response to economic shocks.
- The testing of any proposed changes to the investment strategy needs to be an iterative process with DBW and Welsh Government. Whilst the updated market assessment will provide important evidence to inform the updating of the strategy, DBW are best placed to develop the specific proposals. The role of the ex-ante assessment is to test the appropriateness and impact of these changes from the perspective of businesses, the Welsh economy and society.

Report Coverage

2.17 The report covers:

- Part A: Update of the Market Assessment
 - An analysis of the performance of the WBF to date, looking at investment, financial and economic development performance
 - An assessment to determine whether the current focus of the WBF is still consistent with the economic development policy priorities
 - An assessment of the economic performance in Wales, including an overview of the impact of COVID-19 and future scenarios for recovery
 - An assessment of the demand and supply of SME finance up to the beginning of 2020.
 - An assessment of the emerging impact of COVID-19 on the demand and supply for SME finance
 - The implications of any changes in policy, the economy and SME finance markets for the WBF
- Part B: Review of Proposed Changes to the Investment Strategy
 - An assessment of the proposed changes to the Investment Strategy, focussing on the continued relevance, consistency and appropriateness of the Investment Strategy and hence the ERDF contract

PART A – Update of the Market Assessment

3. Performance of the WBF

Key points

- The 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.
- 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).
- 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%.
- 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.

Investment Performance

Business Plan Modifications

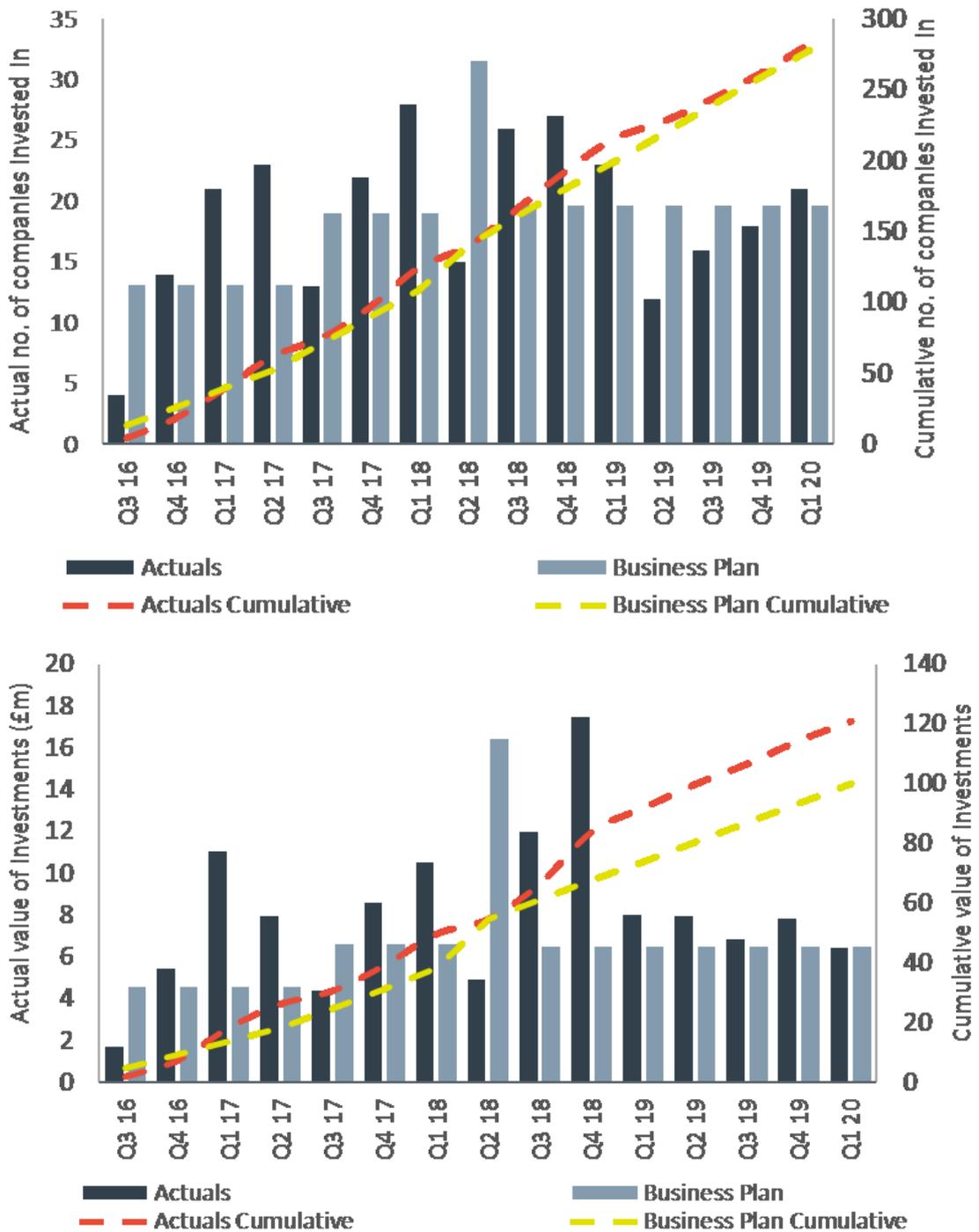
- 3.1 There have been a series of adjustments to the WBF, relating to both its size, funding sources and profile of funding since it was originally launched. The WBF was initially proposed as a £136m fund following the original Ex-Ante Assessment. In August 2016, more ERDF funding became available within Priority 2 leading WEFO and Finance Wales to discuss the option of increasing the fund size.

- 3.2 As a result of these discussions, the business plan was adjusted to account for an additional £45m ERDF funding. £35m of this additional ERDF funding was confirmed in December 2016 (£30m WWV, £5m EW), increasing the total size of the fund to £170.9m.
- 3.3 In December 2018, the additional £10m of ERDF funding was secured, and there was a substitution of the £13m legacy funding with ERDF funding. This increased the total size of the fund to £180.9m, with associated delivery profile and targets revised accordingly.
- 3.4 The revised fund has 30.6% (£55.4m) allocated to EW and 69.4% (£125.5m) allocated to WWV and is 49% (£88.5m) debt finance and 51% (£92.5m) equity finance.

Strong Investment Rate Overall to Date

- 3.5 The WBF has made strong progress to date, exceeding the Business Plan delivery profile for both number of companies invested in and amount invested. As of March 2020 (the latest figures provided), it has invested in 283 companies against a target of 278, investing £120.9m, against a target of £100m. This overall investment rate is 21% higher than profiled.

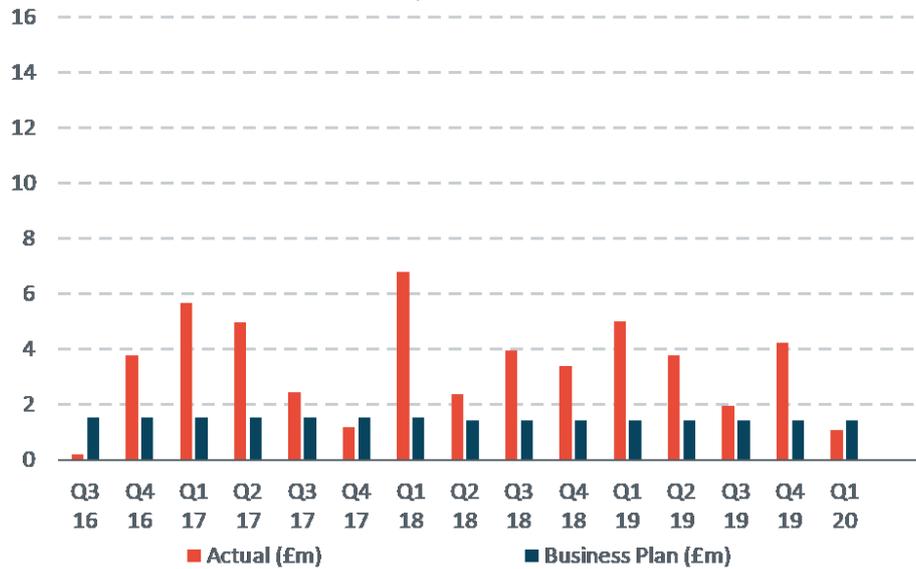
Figure 3.1: Number and Value of Investments in Wales, Q3 2016 to Q1 2020



Source: WBF Performance Data Pro-Forma, provided in July 2020

3.6 Figure 3.2 and Figure 3.3 show quarterly investment by region of EW and WWV against the Business Plan profile.

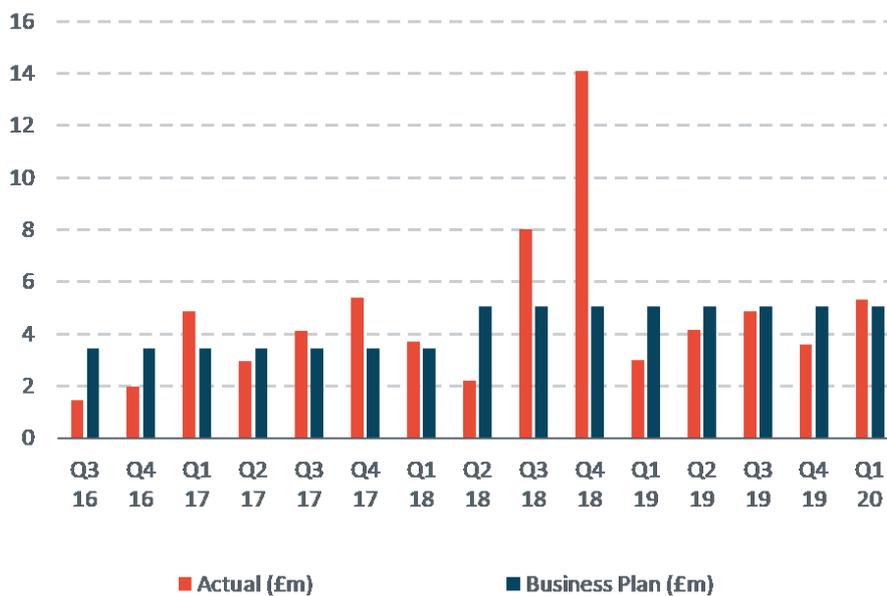
Figure 3.2: Value of Investments in EW, Q3 2016 to Q1 2020



Source: WBF Performance Data Proforma and Delivery Profile

Note: From Q2 2018 the Business Plan values are based on the 2018 Investment Strategy Update

Figure 3.3: Value of Investments in WWV, Q3 2016 to Q1 2020



Source: WBF Performance Data Proforma and Delivery Profile

Note: From Q2 2018 the Business Plan values are based on the 2018 Investment Strategy Update

3.7 Table 4.1 below illustrates the strong overall annual investment rate that has been achieved to date.

- The fund has performed particularly well in EW for both debt and equity finance with annual average investment rates above the delivery plan.
- The fund has performed well in WWV in terms of debt, achieving an annual average investment rate above the delivery plan.
- The annual equity investment rate overall is below the delivery plan annual average, driven by a shortfall in the annual equity invested in WWV.

3.8 It should be noted that the annual averages presented in the table below do not take into account the projected increase in the annual investment rate later on in the investment period (particularly for equity investments), which the DBW have profiled in their delivery plan.

Table 3.1: WBF Annual Investment Rates (as at Q1 2020, £m)

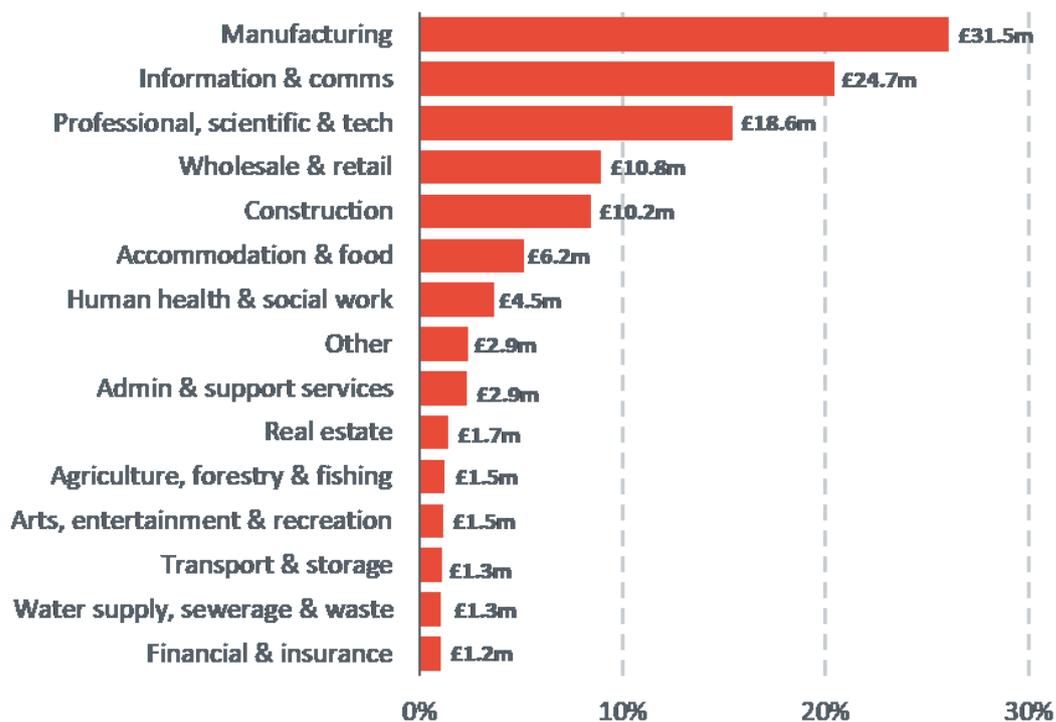
	Total Investment (to date)	Annual Investment (to date)	Delivery Plan Annual Average	Variance
EW	50.9	13.6	7.9	+5.7
<i>Debt</i>	23.3	6.2	4.0	+2.2
<i>Equity</i>	27.7	7.4	3.9	+3.5
WWV	70.0	18.7	17.9	+0.8
<i>Debt</i>	51.4	13.7	8.7	+5.0
<i>Equity</i>	18.6	5.0	9.3	-4.3
Total	120.9	32.2	25.8	+6.4
<i>Debt</i>	74.7	19.9	12.6	+7.3
<i>Equity</i>	46.3	12.3	13.2	-0.9

Source: WBF Performance Data Pro-Forma, WBF Monitoring Reports and Delivery Profile provided in July 2020

Investment Has Varied by Sector

3.9 Of the £120.9m invested to date, the majority (62%) has been invested in firms operating in manufacturing, information & communications and professional, scientific & technical sectors.

Figure 3.4: Value (£m) and proportion of Investment, by Sector as at Q1 2020



Source: WBF Monitoring Reports

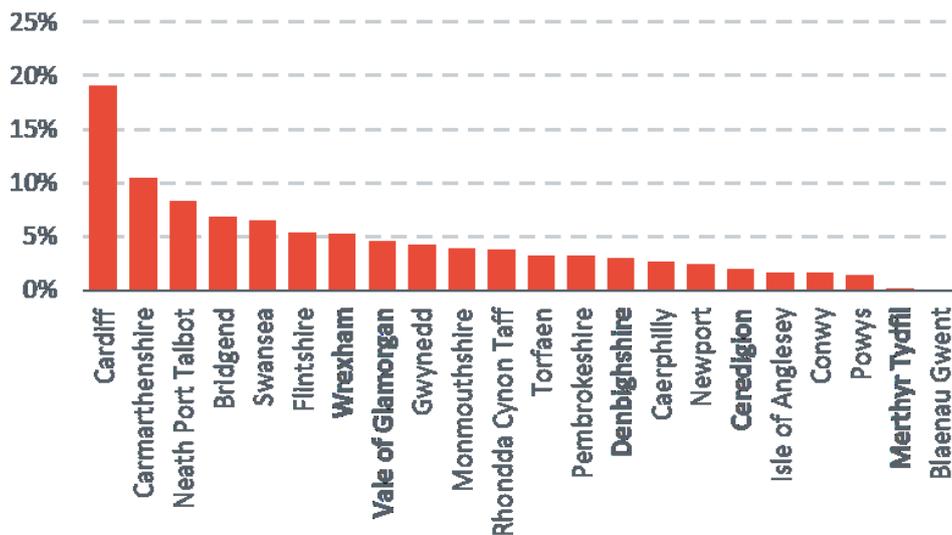
Note: Sectors accounting for <1% investment to date have been grouped together into “Other”, which includes electricity, gas, steam and air con, mining & quarrying, education and other services.

3.10 Of the 283 enterprises receiving investment to date, 20% (57 firms) operate in the manufacturing sector, 13% (36 firms) in information and communication and 13% (37) in professional scientific and technical activities. Accommodation & food (30 firms) and wholesale & retail (29 firms) also account for a large proportion of the firms that have received investment to date (21% across the two sectors).

Highest Proportion of Investment in Cardiff, Carmarthenshire and North Port Talbot

3.11 The local authority with the largest amount of investment to date is Cardiff, which has received £23.1m investment across 51 enterprises (19% of all investment), followed by Carmarthenshire (£12.7m) and Neath Port Talbot (£10.1m).

Figure 3.5: Proportion of Total Investment by Local Authority, as at Q1 2020



Source: WBF Monitoring Reports

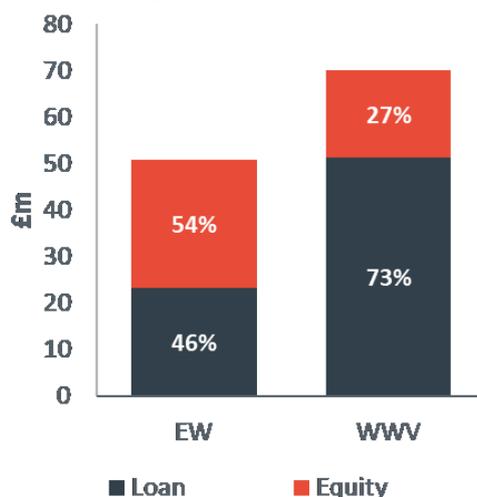
3.12 Looking at investment to date per 10,000 Working Age People (WAP), Neath Port Talbot has received the most investment to date (£1.15m per 10,000 WAP), followed by Carmarthenshire (£1.14m) and Cardiff (£0.94m).

Lower Rate of Equity Investment in WWV

3.13 The Business Plan anticipated a 49:51 split between debt and equity (by value of investment). The latest quarterly report indicates that loan investments account for 62% of total investment to date.

3.14 The split between debt and equity in EW to date is close to what was envisaged in the Business Plan. However, as Figure 3.6 indicates, the majority (73%) of investments to date in WWV are accounted for by loans.

Figure 3.6: Investment Type by Programme Area (as at Q1 2020)



Source: WBF Performance Data Pro-Forma, provided in July 2020

3.15 The value of equity investments to date in WWV is significantly lower than in EW (£19m in WWV, relative to £28m in EW).

Exceeding Investment Targets

3.16 The WBF covers all areas of Wales but is allocated between the two ERDF programme areas (EW and WWV). When compared to the profiled investment for Q1 2020, both EW and WWV are exceeding the value of investment anticipated.

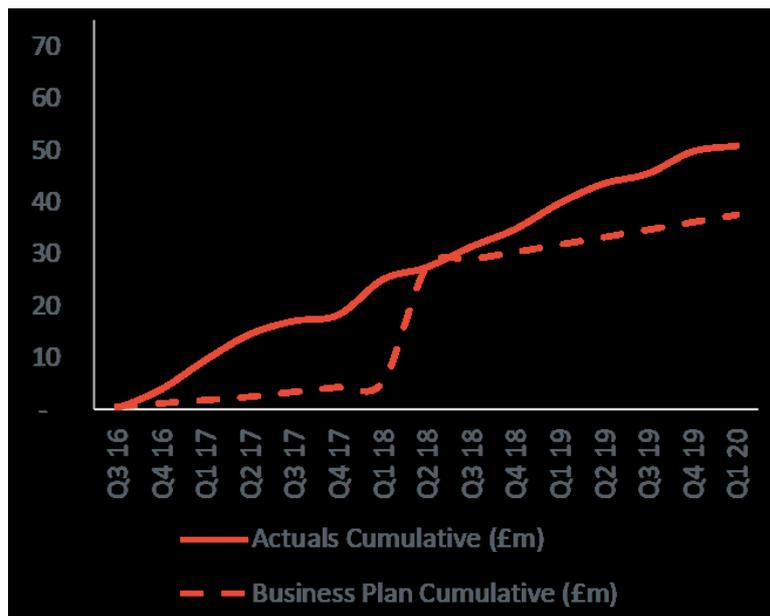
Table 3.2: WBF Investment to Date, by Programme Area (as at Q1 2020, £m)

	Amount Invested	Profiled Investment	% of Delivery Profile
EW	50.9	37.6	136%
WWV	70.0	62.8	112%
Total	120.9	100.0	121%

Source: WBF Performance Data Pro-Forma, provided in July 2020

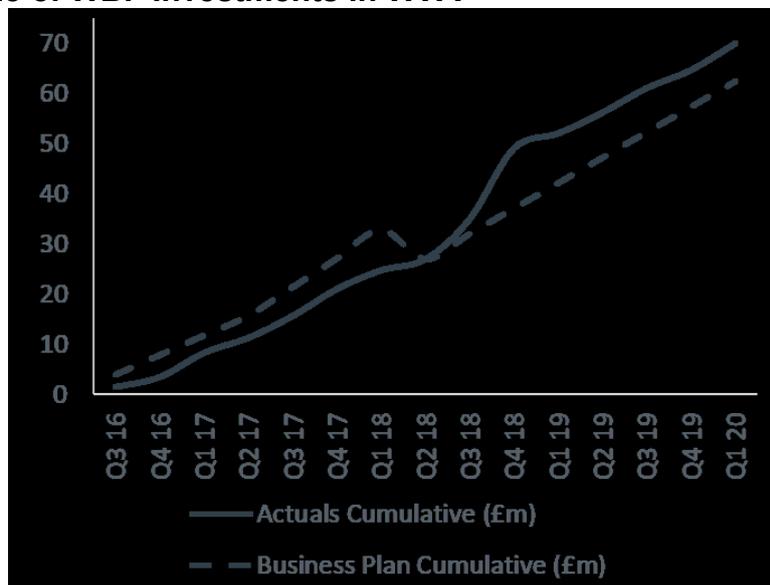
3.17 Figure 3.7 and Figure 3.8 show that the value of investment in WWV and EW has consistently exceeded the Business Plan profile since Q2 2018. It should be noted that the Business Plan was reprofiled in June 2018 (but the Business Plan figures preceding this date were not revised). In WWV, investment has been in line with or exceeded business plan targets throughout the investment period.

Figure 3.7: Value of WBF Investments in EW



Source: WBF Performance Data Pro-Forma, provided in July 2020. Note: business plan figures were reprofiled in Q2 2018, but the figures for the period prior to this were not revised.

Figure 3.8: Value of WBF Investments in WWV



Source: WBF Performance Data Pro-Forma, provided in July 2020. Note: business plan figures were reprofiled in Q2 2018, but the figures for the period prior to this were not revised.

Induced Investment

- 3.18 The Business Plan anticipated that by the end of Q1 2020, £139.9m (reprofiled as at June 2018) private sector investment would be leveraged alongside the WBF direct investment. The fund has significantly exceeded this target, with around £250.7m private sector investment induced.
- 3.19 Both the amount and the ratio of induced investment has been higher in EW than in WWV. The difference is particularly pronounced for loan investments, for which the ratio of induced investment in EW is more than double the figure for WWV. Around £158m (or 63% of all investment induced) has been in EW, relative to £92m in WWV. The ratios are higher for equity investments, which is in part due to the requirement that all equity investment must include 30% co-investment from a private independent partner.

Figure 3.9: Induced Investment Ratio, as at Q1 2020



Source: WBF Performance Data Pro-Forma, provided in July 2020

Economic Development Performance

- 3.20 Table 3.3 below indicates that the WBF is on track or exceeding the targets to date for the majority of economic development KPIs. Performance has been particularly strong against the targets for new to firm products, number of enterprises cooperating with research institutions and new to market products, for which the current performance is more than double the target to date.

- 3.21 The WBF is currently lagging behind one of the core targets, jobs created, with only 77% of the target to date and 28% of the lifetime target achieved as of Q1 2020. There are various possible reasons for this underperformance to date that have been explored in consultations, including lower investment than expected in WWV (which was expected to create a large proportion of the jobs), as well investments resulting in fewer, but more high quality jobs (although it is difficult in practice to observe this. This will need to be explored in the Mid-Term Evaluation.
- 3.22 In terms of jobs safeguarded, the WBF fell slightly behind target (by 3%) and has achieved 47% of the lifetime target as of Q1 2020 which seems relatively low compared to the rate of investment to date and rate of achieving the other KPIs to date (consultee suggested this could be due to the reliance of self-reporting by businesses at the commencement of the investment, plus optimistic targets set).
- 3.23 It should be noted that the latest WBF performance monitoring report indicates that these figures are based on impact investment questionnaire forms which have a rate of return of 79%.

Table 3.3: WBF Economic Development KPIs (as at Q1 2020)

	Achieved to date	Target		% of Target	
		To Date	Lifetime	To Date	Lifetime
Jobs Created	1,169	1,513	4,208	77%	28%
Jobs Safeguarded	3,516	3,615	7,482	97%	47%
New to firm products	43	19	47	226%	91%
Cooperating with supported research institutions	41	15	26	272%	158%
New to Market Products	44	16	34	282%	129%
Patents Registered	21	16	30	134%	70%

Source: WBF Performance Data Proforma, provided in July 2020

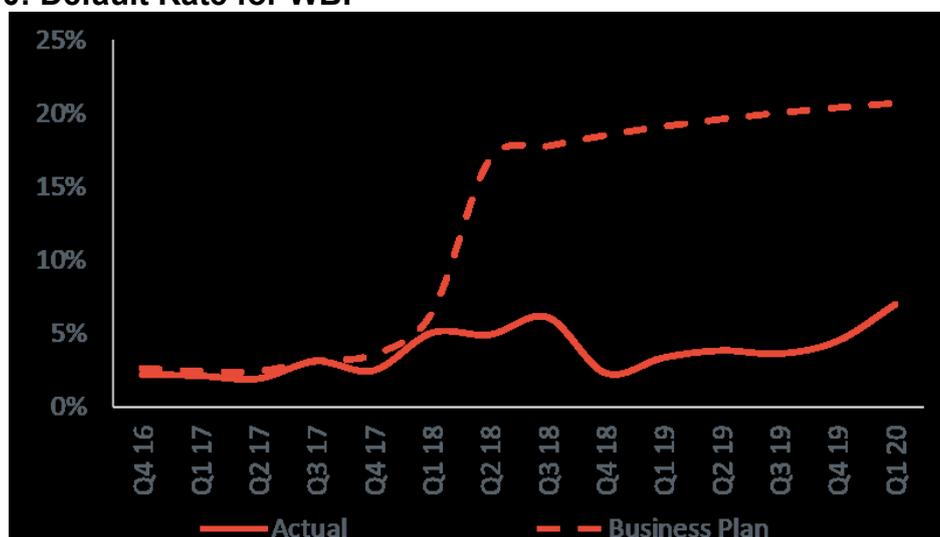
Financial Performance

Defaults and Write-offs

- 3.24 The overall default rate for the WBF has been consistently below the target set out in the Business Plan.

- 3.25 It should be noted, however, that from Q4 2019 to Q1 2020, default levels (which includes specific provisions and write-offs) increased by £3.4m (from £5.1m to £8.5m).
- 3.26 Performance monitoring reports indicate that this is due to a sector wide review that has taken place following the onset of the COVID-19 pandemic, through which portfolio companies were all reviewed and those considered to be highly vulnerable to a negative impact from COVID-19 (ie those operating in public-facing sectors such as retail, recreation, food and drink and accommodation sectors) have been applied with a 50% blanket provision (unless performance from a specific portfolio company suggested otherwise). £0.07m was also written off across 3 firms during Q1 2020.

Figure 3.10: Default Rate for WBF



Source: WBF Performance Data Proforma, provided in July 2020.

Note: business plan figures were reprofiled in Q2 2018, but the figures for the period prior to this were not revised

Operating Costs

- 3.27 The total fund operating costs as of Q1 2020 are presented in Table 3.4. Overall, these costs are in-line with the projections in the Business Plan, despite experiencing a higher rate of investment. Professional fees are currently exceeding the projections in the Business Plan by approximately £300k.
- 3.28 Total gross operating costs currently represent around 18% of the amount invested. This is in line with an 18% average across 20 ERDF-backed Venture Capital and Loan Funds reviewed as part of Hatch Regeneris' national

evaluation work and is considered low relative to the 27% for the Wales JEREMIE Fund.

Table 3.4: WBF Operating Costs (as at Q1 2020, £m)

	Business Plan	Actual	Variance (%)
Management Fees	12.8	12.7	99%
Holding Fund Fee	7.7	7.6	99%
Professional Fee	0.7	1.0	158%
Total	21.2	21.4	101%

Source: WBF Monitoring Reports

4. Continued Relevance and Consistency- Policy Context

Key points

- The key policy developments in the UK centre around the Industrial Strategy which recognises the need to improve access to finance for SMEs.
- In Wales, policy priorities are focussed around a more regionally focussed model of economic development, a focus 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.
- The exit of the UK from the EU is also a key policy development. Whilst it is still unclear what the 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.
- COVID-19 has sparked considerable EU, UK and Welsh government response to help mitigate the impact. A key focus of these response has been the provision of financial support to SMEs.
- 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.

4.1 This chapter provides an overview of the policy context in the UK and Wales in which the Wales Business Fund operates, specifically looking at key policy developments for SME competitiveness and access to finance.

UK – The Industrial Strategy

4.2 The UK Industrial Strategy was published in November 2017 and oversees long term national economic policy, including the plan to overcome the UK's problem of persistent low productivity. The strategy includes various interventions to improve the supply of finance to businesses and confirmed that access to finance was still recognised by policy makers as a major challenge that SMEs face. Interventions announced include:

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

Wales – Prosperity for All: Economic Action Plan

- 4.3 In 2015, Welsh Government introduced the Well-being of Future Generations Act¹, a ground-breaking piece of legislation requiring public bodies in Wales to put long-term sustainability at the forefront of their thinking. The principles of the Future Generations Act are reflected in Welsh Government's current five-year programme, Taking Wales Forwards (2016-2021). This programme has since been planned in more detail in the national strategy, Prosperity for All, and its accompanying Economic Action Plan published in December 2017.
- 4.4 The Prosperity for All Economic Action Plan sets out a new approach for delivering the objectives of Prosperity for All. At the heart of this new approach is the new “economic contract” between businesses and Government, founded on the principle that delivering improved wellbeing is a shared responsibility of business and Government, and that support for business should be conditional on a commitment to upholding the principles of fair work, investing in skills, promoting health and reducing their carbon footprint.
- 4.5 Other important changes in the action plan include:
- a more regionally focused model of economic development, which gives more power over decision making to local bodies and aims to build on each region's distinctive strengths and capabilities.

¹ National Assembly for Wales, Well-Being of future Generations Act 2015, effective from 1st April 2016

- a focus on a smaller number of cross-cutting, thematic sectors, marking a move away from narrowly defined priority sectors. This better recognises the increasingly blurred boundaries between different sectors such as technology and financial services.
- a commitment to support the foundation economy, including tourism, food, retail and care sectors which make an important contribution to the wellbeing of Wales, both as large employers and deliverer of services.

- 4.6 The Economic Action Plan identifies some familiar and longstanding priorities for the Welsh economy (reducing inactivity, raising productivity and combatting regional inequality), and identifies supporting businesses as one of several critical building blocks for addressing these priorities at a national and regional level.
- 4.7 In terms of SME competitiveness, the Economic Action Plan outlines the new Economic Contract between businesses and government to stimulate growth. The Economic Contract will initially apply solely to direct Welsh Government (WG) financial support, but it may be extended to other parts of the public sector, including the Development Bank of Wales.
- 4.8 The Economic Contract requires businesses seeking investment from WG to demonstrate the following commitments before support is provided: growth potential; fair work; promotion of health, skills and learning in the workplace; and progress in carbon footprint reduction. Businesses will also be required to demonstrate delivery of one of the following actions: decarbonisation; innovation, entrepreneurship and headquarters; exports and trade; high quality employment, skills development and fair work; R&D, automation, and digitalisation.
- 4.9 Also of relevance to SME competitiveness is the sectoral approach to business support. The priority sectors identified in the Economic Action Plan have been split into two groups: thematic sectors and foundation sectors. Thematic sectors are priority sectors which Welsh Government will proactively work with. Foundation sectors are those which provide essential goods and services to residents, and in some areas (ie rural areas) they are the main source of economic activity.

Table 4.1: Economic Action Plan Priority Sectors

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

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

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

4.11 This approach aims to deliver:

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

Brexit

4.12 The exit of the UK from the EU will draw to an end the role of the Structural Funds and other EU research and innovation programmes on 31 December 2020. Whilst these programmes have had a strong thematic and spatial dimension to them and played a key role in development within Wales, it is still unclear what the investment priorities and approach to allocating resources will be adopted by the UK Government after Brexit (through the proposed UK Shared Prosperity Fund or alternative mechanisms).

4.13 The Shared Prosperity fund is intended to reduce inequality between communities across UK nations and deliver sustainable, inclusive growth. The 2019 Conservative Party Manifesto committed to at least match the size of European Structural funds in each UK nation. On average over the period of 2014-2020, EU spending in Wales was equivalent to about £0.4 billion or £123 per person (House of Commons Briefing Paper, 2020). However, as of the last

full budget in March 2020 (and pre COVID-19), no detailed delivery plans and funding have been committed to by the UK Government other than to address the issue through the next budget.

4.14 Given the continued uncertainty around the nature of the Shared Prosperity Fund, the Welsh Government has undertaken extensive discussions about the successor arrangements in Wales with stakeholders. It has agreed four broad priority areas to provide a focus for further development work (reducing income inequalities, more productive and competitive businesses; transition to a zero-Carbon economy; healthier and more sustainable communities). The intention is to develop a set of outcomes in each area, suitable measures of success, and identify priorities for investment. There is a continuing commitment to maintaining a strong cross-cutting approach to equality, sustainable development and supporting the Welsh language.

4.15 Welsh Government is actively planning its approach to regional economic development within Wales, including the development of the regional frameworks, linking devolved budgets to spatial needs and opportunities, and the role of multi-level governance processes. Welsh Government is working with the OECD and WLGA on a study of good practice in regional working and governance to help inform decisions on implementation. Welsh Government is also examining regional budget allocation methodologies as part of its approach to regionalization.

COVID-19

4.16 The global COVID-19 crisis has sparked considerable EU, UK and Welsh government responses over a short period of time. The National Audit Office reports that the UK government has committed £82.2 billion of support for businesses in response to the COVID-19 crisis as of late May 2020 (National Audit Office, 2020). Predicting inflation to fall to 0.6% in 2020, the Bank of England also cut interest rates to a record low of 0.1% in March to help stimulate borrowing. Welsh Government also offered £1 billion of support to businesses in May 2020.

4.17 Table 4.2 lists UK and Welsh Government led business support interventions available to Welsh SMEs² as part of the COVID-19 response.

² Department for Business, Energy and Industrial Strategy, Ministry of Housing, Communities and Local Government and HM Revenue and Customs, Financial support for businesses during coronavirus (COVID-19)

Table 4.2: UK and Welsh Government measures to support SMEs in response to COVID-19

Scheme, description	Organisation responsible, delivery body	Beneficiary requirements	Value per business	Value remaining out of total value	Period of operation
Coronavirus Job Retention Scheme ³ (CJRS) – taxable grants to provide a portion of salary to furloughed workers	UK govt., HMRC	-All UK business with UK PAYE schemes and a UK bank account -Must have used scheme by 30 June 2020 to use going forwards	80% of salary up to £2,500 per furloughed employee, plus NIC and pension contribution	Est. £12bn per month Scheme currently continues to 31 July 2020	19 March 2020 to 31 July 2020, currently
Coronavirus Sick Pay Rebate Scheme – grants to cover the cost of sickness due to coronavirus	UK govt., HMRC	-UK PAYE created pre-March 2020 -SMEs only -Sick pay must be due to coronavirus	Up to £95.85 per week of employee sickness pay for up to 2 weeks	Depends on claim no.s to end of scheme	13 March 2020, ongoing
Self-Employment Income Support Scheme (SEISS) – taxable grants to provide a portion of average monthly trading profit for the self-employed with reduced trading due to coronavirus	UK govt., HMRC	-Self-employed individuals/partnerships adversely affected by coronavirus -Trading profits less than £50k or at least equal to non-trading income -Closed to new claims on 14 July 2020	-First grant - average trading profit 2016 to 2019 -Second grant – 70% average monthly trading profits for a total of 3 months, up to £6,570	Depends on claim no.s to end of scheme	26 March to 19 October 2020
Deferral of Self-assessment Payment – flexibility to reduce pressure on firms	UK govt., HMRC	-Registered in the UK for self-assessment	Can make second payment up to 31 January 2021	-	15 May 2020 to 31 January 2021

³ <https://www.gov.uk/guidance/claim-for-wage-costs-through-the-coronavirus-job-retention-scheme>

Scheme, description	Organisation responsible, delivery body	Beneficiary requirements	Value per business	Value remaining out of total value	Period of operation
cashflow given coronavirus		- Difficulties making second payment by 31 July due to coronavirus			
Coronavirus Business Interruption Loan Scheme (CBILS) – loans to SMEs with cash flow disrupted by coronavirus	UK govt., BEIS and BBB 50 lenders provide loans	-UK SMEs -Annual turnover up to £45m -Viable business w/o coronavirus & adversely effected by coronavirus - For loans above £30k, must not have been a business in difficulty on 31 December 2019 - N/a for banks/insurers/reinsurers and public sector	-Up to £5m, 80% Govt. guarantees, plus interest and loans for 12 months -Overdrafts & Invoice finance facilities up to 3 years -Loans and asset finance facilities up to 6 years	£12.2bn	23 March 2020 to 23 September 2020
Future Fund – early stage equity investment through convertible loan notes subject to match funding	UK govt., BEIS, HMT & BBB	-UK incorporated before 1 January 2020 -At least half UK-based employees, at least half revenues from UK sales -raised £250k equity from third party investors in last 5 years -No listed shares	£125k to £5m, at least equal match funding required, minimum aggregate loan of £250k	Oversubscribed Over £250m public funding provided, plus match funding initially. Currently £468.7m	20 May 2020 to September 2020

Scheme, description	Organisation responsible, delivery body	Beneficiary requirements	Value per business	Value remaining out of total value	Period of operation
Bounce Back Loan Scheme (BBLs) – smaller loans for businesses facing disrupted cash flow due to coronavirus	UK govt., BEIS, 11 lenders	-UK SMEs established pre-March 2020 -adversely affected by coronavirus -if business in difficulty on 31 December 2020 must comply with state aid -n/a for banks/insurers/reinsurers and public sector -n/a if claiming CBILS or COVID-19 Corporate Financing Facility but could transfer to BBLs by 4 November 2020	-Between £2k and 25% turnover up to £50k, 100% govt. guaranteed, no fees or interest for first 12 months, then 2.5% interest per year -Six-year term loan, but no fee for early repayment	£32.79bn ⁴	4 May 2020 to 4 November 2020
Deferral of VAT Payments - flexibility to reduce pressure on firms cashflow given coronavirus	UK govt. HMRC	-All UK VAT registered businesses	Delay of payment with no interest or penalties	-	26 March 2020 to 31 March 2021
Deferral of Self-assessment Payment - flexibility to reduce pressure on firms cashflow given coronavirus	UK govt., HMRC	-UK businesses registered for VAT self-assessment and struggling to meet self-assessment payment deadline due to coronavirus	Delay of payment with no interest or penalties	-	15 May 2020 to 31 January 2021
Business Rates Relief – targeted business rates relief	Welsh Govt., local authorities	-Wales specific -Occupied premises only	100% rate relief for premises with a rateable value up	-	Depends on business type:

⁴ <https://www.gov.uk/government/collections/hm-treasury-coronavirus-COVID-19-business-loan-scheme-statistics>, as of 19 July

Scheme, description	Organisation responsible, delivery body	Beneficiary requirements	Value per business	Value remaining out of total value	Period of operation
depending on hardship due to coronavirus		<ul style="list-style-type: none"> -Covers agricultural land and buildings including fish farms, buildings for training or welfare of disabled persons, buildings registered for public religious worship and church halls -Other schemes more suitable for some businesses (retail, hospitality and leisure relief; charitable and non-profit organisations relief; relief for businesses with empty properties, small business rates relief) -Rateable value up to £12k 	to £6k, tapered basis up to £12k		Registered Childcare Premises – to 31 March 2022
Retail, Leisure and Hospitality rates relief – sector specific business rates relief	Welsh govt., Business Wales	All retail, leisure, and hospitality businesses with a rateable value of £500k or less	100% non-domestic rates relief in 2020-21	-	1 April 2020 to 31 March 2021
Economic Resilience Fund – grants for SMEs not claiming other Welsh govt. grants	Welsh govt., Business Wales	<p>Round 1 businesses must be VAT registered but no VAT restriction on round 2.</p> <p>For microbusinesses:</p> <ul style="list-style-type: none"> -Over 40% reduction in turnover since 1 March 2020 Not entitled to business rate relief grants -Can demonstrate efforts to sustain business activity 	Grants of £10k for microbusinesses, £100k for small and medium sized businesses	Now closed due to high numbers of applications £300m round 1 £100m round 2	First round: April 2020 Second round: June 2020

Scheme, description	Organisation responsible, delivery body	Beneficiary requirements	Value per business	Value remaining out of total value	Period of operation
		<ul style="list-style-type: none"> -N/a if claiming other Welsh govt. non-repayable grants For small and medium sized businesses: -Sustainable post-Covid business plan -Over 60% reduction in turnover since 1 March 2020 -Not eligible for business rate relief grants, or amount will be deducted -N/a if claiming other Welsh govt. non-repayable grant 			
COVID-19 Wales Business Loan Scheme	Welsh govt.	-	-	Fully subscribed (£100m)	April-July 2020
Start Up Grant – small grants and advice to support start-ups	Welsh govt., Business Wales and local authorities	<ul style="list-style-type: none"> - Start-ups set up between 1 April 2019 and 1 March 2020 which do not qualify for SEISS -Turnover less than £50k - Income fall of over 50% April - June 2020 -Must align with WG Economic Contract principles -n/a if received funding from Economic Resilience Fund or Non-Domestic Rates grant 	£2.5k plus Business Wales start-up support and advice	£5m	29 June 2020 to TBC

Scheme, description	Organisation responsible, delivery body	Beneficiary requirements	Value per business	Value remaining out of total value	Period of operation
Culture Resilience Fund – sector specific grants	Welsh govt., Business Wales	-Suitable for museums, collections, self-employed conservation services, archives and libraries	-	£1m	-
Arts Resilience Fund including Urgent Response Fund for Individuals (URFI), Stabilisation Fund for Individuals (SFI) and Stabilisation Fund for Organisations (SFO) – sector specific small grants	Welsh govt., Arts Council of Wales	URFI -Available for freelance creative practitioners -Only available if no other option SFI -available for individual artists and freelancers who lost income due to COVID-19 and are looking to adapt their future creative work/practice SFO -arts organisations in not-for-profit sector experiencing loss of income due to COVID-19	URFI– grant up to £2.5k SFI – grant of £1k to £10k SFO – grant up to £35k	£7m (£1.5m to individuals, £5.5m to organisations)	URFI applications open 14 April 2020 to 6 May 2020 SFI applications open 29 May 2020 to 15 June 2020 and projects should be completed within 6 months SFO applications open 21 April 2020 to 8 May 2020 and projects should be completed

Scheme, description	Organisation responsible, delivery body	Beneficiary requirements	Value per business	Value remaining out of total value	Period of operation
					within 6 months
Sport Emergency Relief Fund – sector specific not for profit focused small grants	Welsh govt., Sport Wales	-Available for not-for-profit sports clubs	Up to £5k per club	£400k (£200k Welsh Govt., £200k Sport Wales)	Applications open April 2020

- 4.18 In part, UK and Welsh Government SME support offers have been supported by the response and regulatory flexibilities of the European Union. In response to the COVID-19 pandemic the European Commission (EC) has introduced regulatory flexibilities to its Structural Funds, including the Coronavirus Response Investment Initiative (CRII), Coronavirus Response Investment Initiative Plus (CRII+) and Temporary Framework for State Aid. Under the CRII the EC provides flexibilities to Member States to reallocate financial resources to address the priority areas of healthcare, short term work schemes and working capital for SMEs⁵. The CRII+ allows transfer between remaining cohesion policy funds (European Regional Development Fund, European Social Fund and Cohesion Fund) to be used to address the effects of the crisis on EU economies and societies and simplifies the requirements placed on transfer of resources.
- 4.19 The Temporary Framework for State Aid seeks to ensure liquidity and access to finance for EU businesses and in particular SMEs (European Commission, 2020), which might otherwise be prevented under State Aid rules. Any aid granted under the Temporary Framework must demonstrate to the EC that measures are necessary, appropriate and proportionate to the potential impact on the economy.
- 4.20 An amendment to the Temporary Framework introduced the potential for targeted support⁶ and expansions to zero interest loans, equity or 100% guarantees on loans up to €800,000 per company. EU member states can provide support under the Temporary Framework to all micro and small companies, even if they were already in financial difficulty on 31 December 2019. The Temporary Framework was also extended to encourage private investors to contribute to recapitalisation aid measures.
- 4.21 The flexibilities of the Temporary Framework were used by Welsh Government to provide the £100m COVID-19 Wales Business Loan Scheme (details provided in the table above).

⁵ European Commission, Cohesion Policy Action Against Coronavirus

⁶ I.e. Support via deferred tax payments, wage subsidies, coronavirus related R&D or facilities building or improvement, and the production of products to tackle the outbreak.

The Development Bank of Wales

- 4.22 The Development Bank of Wales Investments (14) Ltd is the appointed Holding Fund manager for the WBF (i.e. managing and administering the fund on behalf of Welsh Government), appointed by Welsh Government as an Entrusted Entity. DBW FM Ltd, a subsidiary of the Development Bank of Wales, were selected as the fund managers for the WBF through a competitive procurement process and are responsible for managing the investment with SMEs.
- 4.23 A Task and Finish Group was appointed by the Minister for Economy, Science and Transport in June 2014 to produce a report on the possible form, function and feasibility of a Development Bank for Wales (DBW). The report identified a number of issues with regards to the provision of finance for Welsh SMEs, and noted that there was a geographic bias regarding the availability of bank credit, informal investment and venture capital to businesses in Wales.
- 4.24 The report concluded that a more efficient government intervention should be implemented compared to what was currently in place. Therefore, a new institution was proposed - the DBW - that integrated the functions of Finance Wales and would be the UK's first regional development Bank. Following this, the DBW was formally established in October 2017.
- 4.25 The DBW intended to provide a step change in the scale and flexibility of finance to better meet the needs of SMEs to start up and grow. The DBW follows a hybrid model where the primary focus is on addressing market failure in key sectors of the SME community by working more closely in partnership with key stakeholders to deliver a wider range of financial products and services to Welsh SMEs. The DBW also manages its own funds, including those developed in partnership with other organisations. The shift from FW to the DBW has been perceived positively by stakeholders. Consultees suggest that it has continued to gain a high level of awareness and has significant presence and traction in the market with Welsh SMEs, evidenced by its high investment rates across the funds the DBW manage. A summary of the funds the DBW manage is shown in the table below.
- 4.26 The DBW played an important role in Welsh Government's response to COVID-19. This included the setup, management and delivery of the £100m COVID-19

Wales Business Loan Scheme, which is now fully invested. In terms of its other funds, the DBW provided flexibility to investee businesses in order to assist them through the crisis. For the WBF, this included a drop-in interest rates on all new investments (to around 4-5%), and a three-month capital and monitoring fee repayment holiday for both new and existing investments, which has subsequently been offered for another three months.

Table 4.3: Funds Currently Managed by the DBW

Current Funds and total value	Deal Range	Business Lifecycle				Deal range			Deal Type		Size	
		Early stage	Growth	Succession	Turn-around	Up to 10+ years	Up to 5 years	Up to 18 months	Equity	Debt	SME	Non-SME
Wales Micro Loan Fund £16.2m	£1k-£50k	✓	✓			✓				✓	✓	
Wales Flexible Investment Fund £100m (plus £30m recycled capital)	£25k-£5m	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Wales Business Fund £180.9m	£50k-£2m	✓	✓	✓			✓		✓	✓	✓	

Current Funds and total value	Deal Range	Business Lifecycle				Deal range			Deal Type		Size	
		✓	✓					✓		✓	✓	
Wales Capital Growth Fund £25m	£50k-£2m	✓	✓					✓		✓	✓	✓
Wales Management Succession Fund £25m	£500k-£3m			✓			✓		✓		✓	✓
Wales Property Fund II £42m	£150k-£5m	✓	✓				✓(24 months per project)			✓	✓	✓
Wales Technology Seed Fund II £20m	£50k-£250k	✓				✓			✓		✓	
Wales Stalled Sites Fund	£250k-£4m	✓	✓				✓			✓	✓	

Current Funds and total value	Deal Range	Business Lifecycle				Deal range			Deal Type		Size	
£40m (can be recycled 4x)												
Wales TVI Interim Fund	£50k-£1m	✓	✓			✓			✓		✓	
Wales Angel Co-investment Fund £8m	£25k-£250k	✓	✓				✓		✓		✓	
Wales Rescue and Restructuring Fund £10-15m	£25k-£2m				✓		✓			✓	✓	
Wales Commercial Property Fund	£250k - £5m		✓				✓			✓	✓	✓

Current Funds and total value	Deal Range	Business Lifecycle				Deal range			Deal Type		Size	
£55m												
Wales Tourism Fund £50m	£100k-£5m	✓	✓			✓				✓	✓	
Local Energy Fund	£50k to £2m		✓			✓				✓	✓	
COVID-19 Wales Business Loan Scheme £100m	£5k to £250k	Companies experiencing cash flow problems as a result of the pandemic.					✓			✓	✓	✓in exceptional circumstances

5. Continued Relevance and Consistency - Economic Context

Key points

- 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.
- 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.
- 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).
- 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.
- 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.

5.1 This section of the report reviews the economy which Welsh SMEs have operated in over the period up to 2020 and whether the WBF continues to be consistent and appropriate given these trends. It goes onto consider the manner in which COVID-19 has affected the performance and prospects for the Welsh economy and the potential implications of this for the relevance and consistency of the WBF.

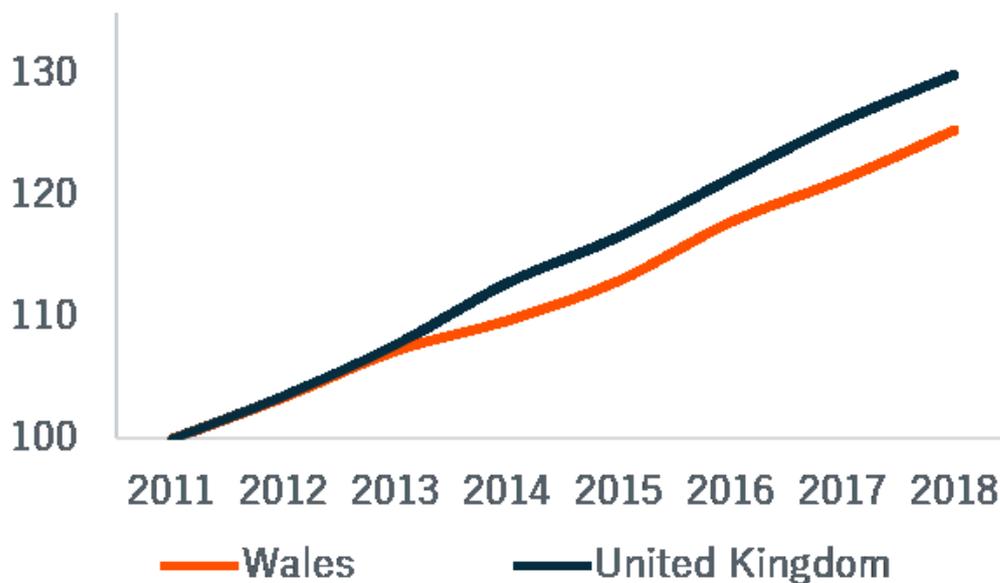
Output and Productivity

5.2 In 2018, the Welsh economy produced £65.1 billion in goods and services (ONS, 2018b), equivalent to 3.4% of UK GVA in 2018. It is home to 3.2 million residents

(ONS, 2019a) and 106,000 businesses (ONS, 2019b) providing 1.3 million jobs (ONS, 2018c).

5.3 Since 2011 the Welsh economy has grown by over 25%. Whilst this is reasonably strong growth in the context of a major recession at the start of the decade, it is lower than the growth across the UK in this period (30%) with a resulting increase in the output gap between Wales and the UK, as shown by **Error! Reference source not found.**

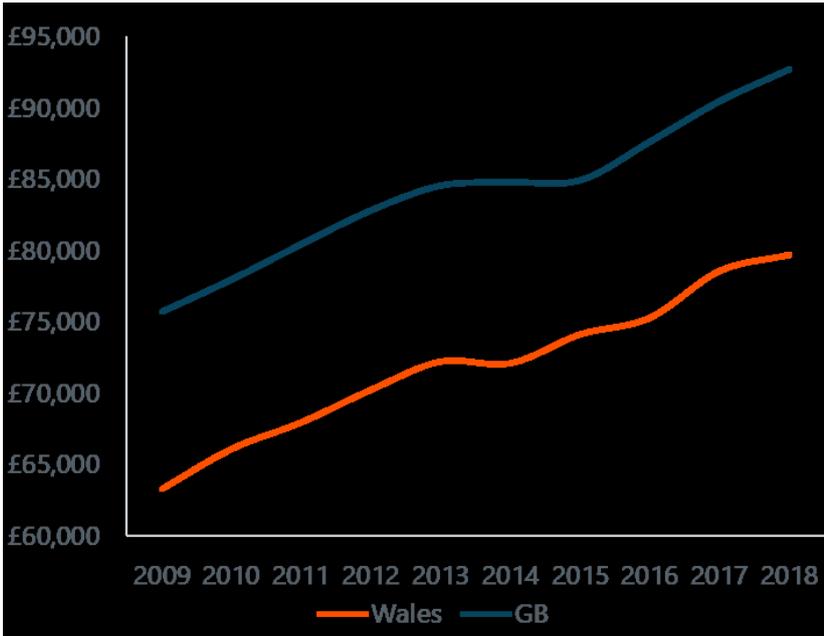
Figure 5.1: GVA growth in Wales and the UK 2011-18, indexed at 2011 levels



Source: ONS, GVA (balanced) at current basic prices, 2018a

5.4 Wales has also experienced good growth in productivity since 2009 (defined as GVA per full time employee) out-pacing productivity growth in Great Britain (ONS, 2018b & 2018c), as shown by Figure 5.2 (26% in Wales vs 22% in GB). However, Welsh productivity has remained far below Great Britain levels and, as Figure 5.3 shows, in 2018 Wales had the fourth lowest productivity of all UK regions.

Figure 5.2: GVA per full time employee in Wales and Great Britain, 2009-2018



Source: ONS, Regional GVA (balanced), current price estimate 2018b & ONS, Business Register and Employment Survey 2018c

Figure 5.3: GVA per full time employee by UK region (£), 2018

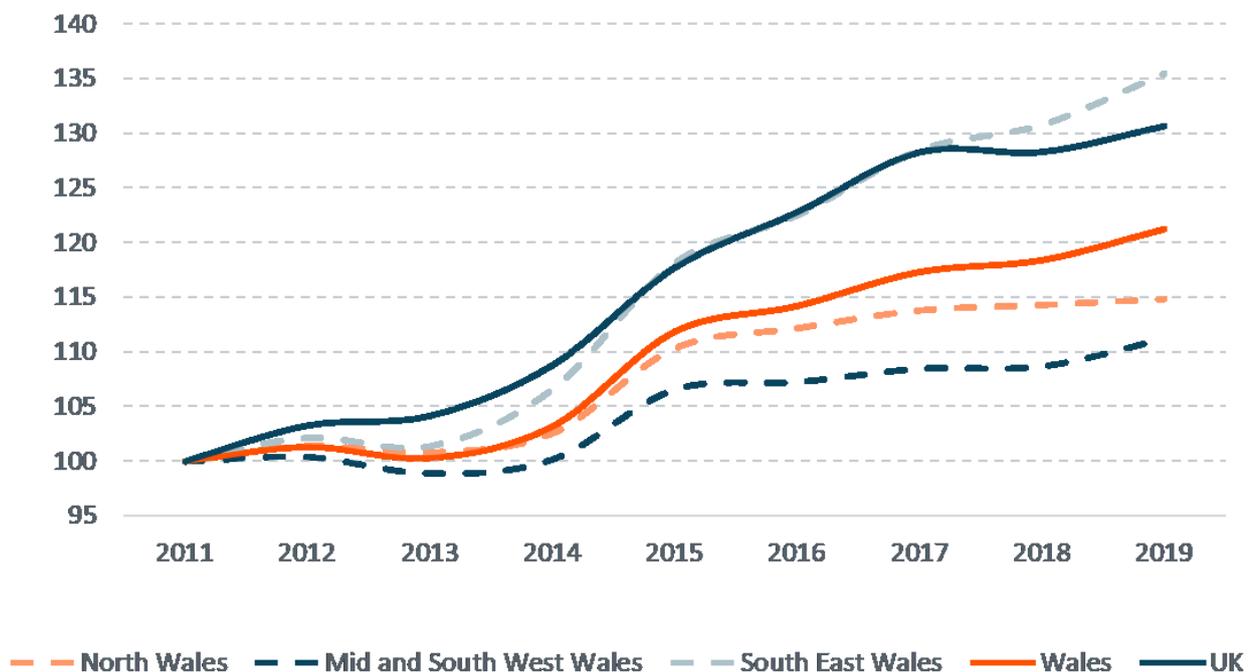


Source: ONS, Regional GVA (balanced), current price estimate 2018b & ONS, Business Register and Employment Survey 2018c

Business

- 5.5 As of 2019, there are 106,000 businesses in Wales, accounting for 4% of total UK businesses in 2016. With the Welsh population equivalent to 5% of UK residents, Wales has a lower number of businesses per resident than the UK as a whole.
- 5.6 Between 2011 and 2019, the number of UK businesses grew by 31% compared to 21% for Wales. Business growth across Wales has varied, with growth of 36% in South East Wales and just 11% in Mid and South West Wales. Figure 5.4: Business Growth Index (2011=100) Figure 5.4 shows how growth in numbers of business in South East Wales kept in line with or exceeded UK growth since 2014, while business numbers in North and Mid and South West Wales have grown more slowly over this period.
- 5.7 The growth in the business base in Wales has been stronger amongst microbusinesses (+20% across Wales between 2014-19)⁷. Compared to the UK medium sized businesses have grown at a much faster rate compared to the UK, at the expense of the growth in the number of small businesses which has been significantly lower than across the UK.

Figure 5.4: Business Growth Index (2011=100)

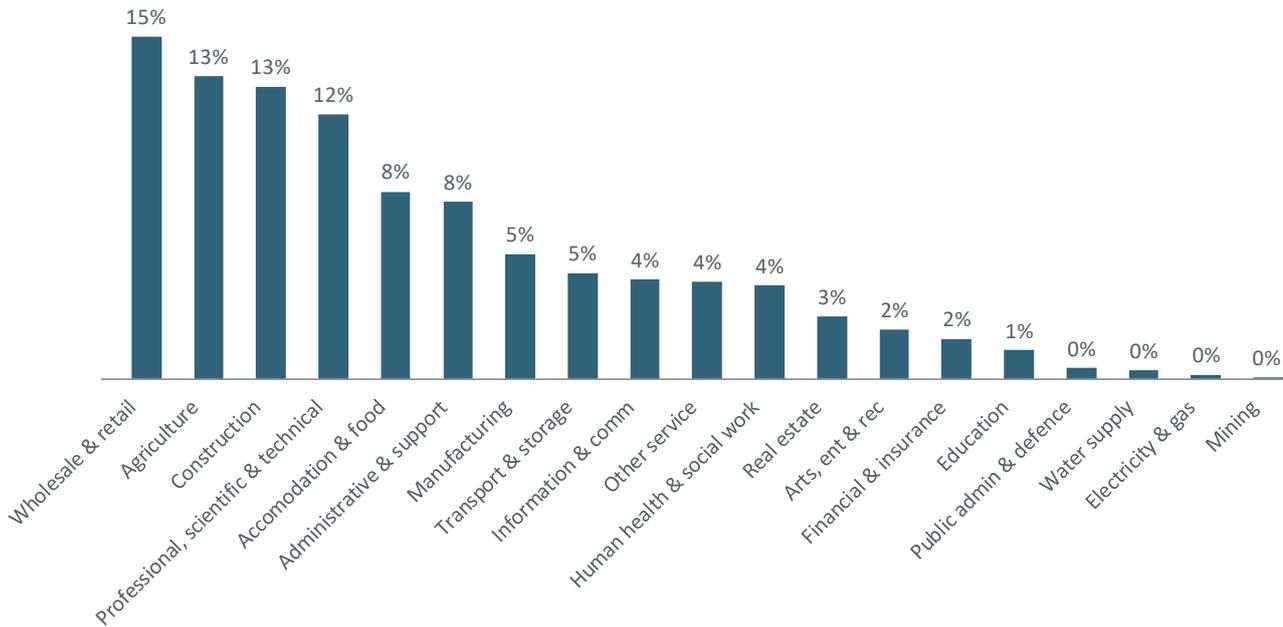


Source: ONS UK Business Counts, 2019b

⁷ Based on ONS UK Business Count Data. In Wales, according to StatsWales data there has been revisions to the data for 2018-19 but this has not been reflected in the ONS time series data shown here.

The majority of Welsh SMEs are in the sectors of wholesale and retail trade; agriculture; construction; and professional, scientific and technical sectors, as shown by **Error! Reference source not found.** There continues to be a disproportionate number of microbusinesses in lower value-added sectors, such as agriculture, wholesale and retail. A large proportion of professional firms serving local markets (such as solicitors and accountants), as well as construction firms, are also microbusinesses. Relative to the UK business base, the most pronounced SMEs sectors in Wales are agriculture, public administration, mining and quarrying and accommodation and food services – these sectors all have a location quotient above 1.

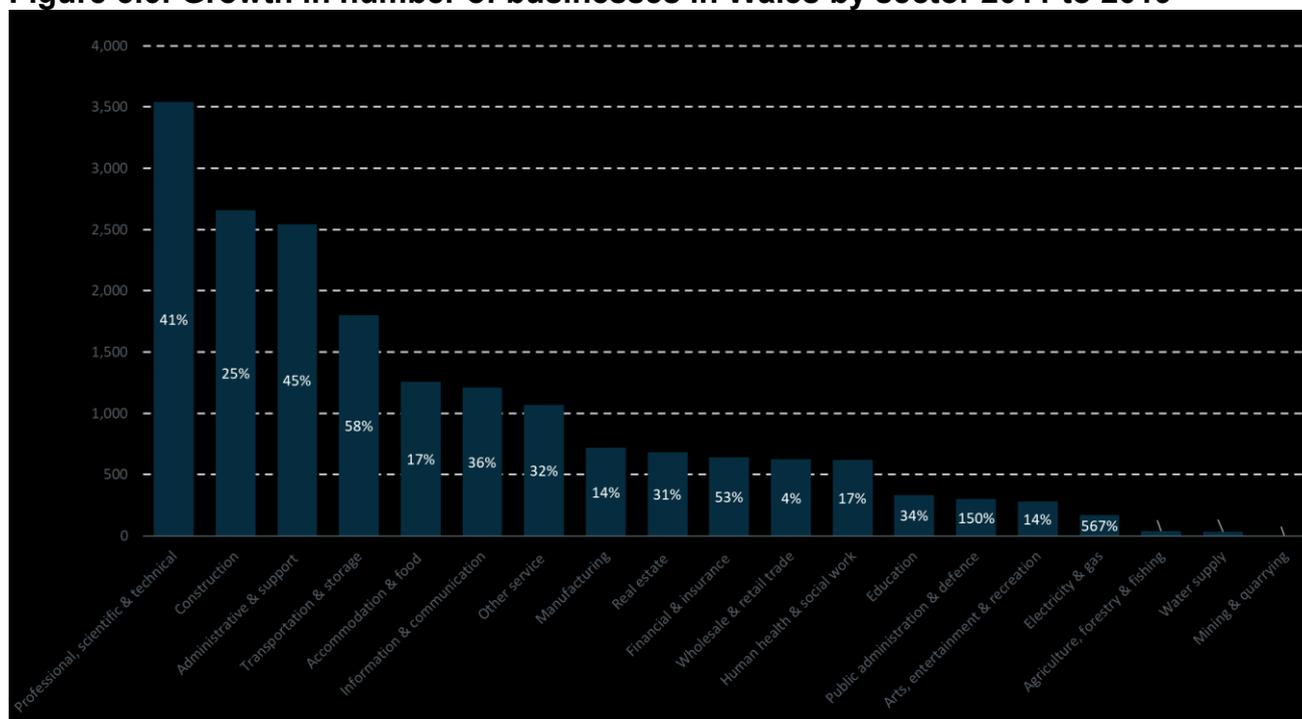
Figure 5.5: SMEs by sector as a proportion of total SMEs, 2019



Source: UK Business Counts, 2019b

5.8 Differences in the sectoral make-up of the Welsh and UK economy appear to be reducing. Growth in business numbers in Wales between 2011 and 2019 has been driven largely by growth in the low location quotient sectors of the professional, scientific and technical sector and administration and support activities (shown below).

Figure 5.6: Growth in number of businesses in Wales by sector 2011 to 2019

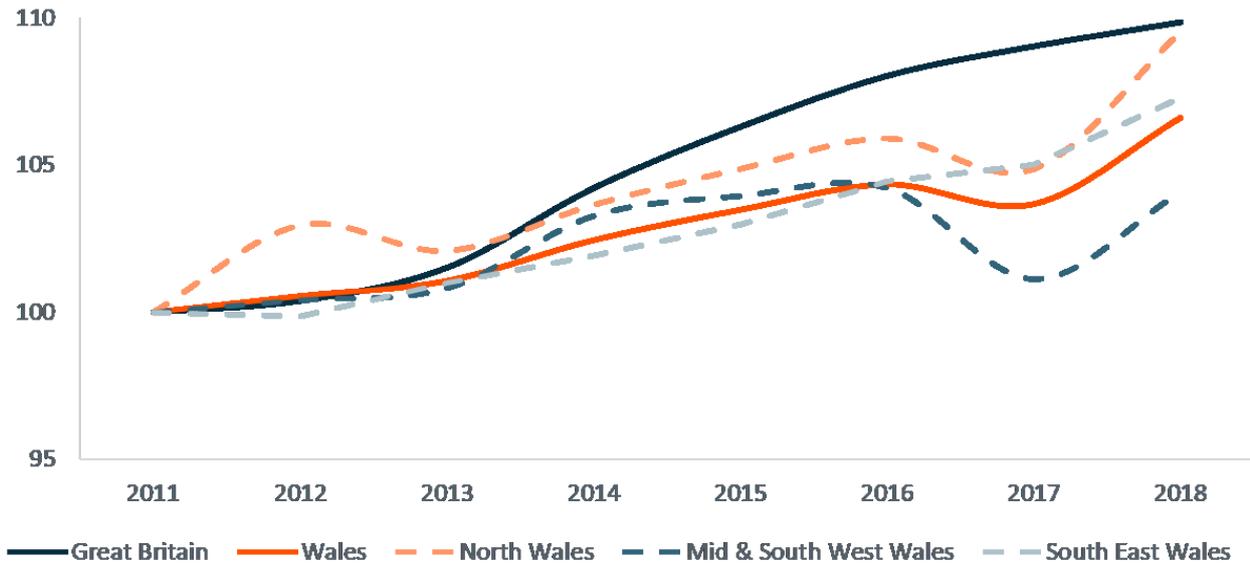


Source: UK Business Counts, 2019b

Employment

5.9 The Welsh economy supports 1.3 million jobs, with growth of 7% from 2013, which is much lower than the UK (10%; ONS, 2018c). Of these jobs, 48% are in the South East Wales region, 28% in Mid and South West Wales and 23% in North Wales. Since 2011, North Wales has experienced above average employment growth for Wales, however in 2017 both North Wales and Mid and South West Wales experienced a sharp drop in employment growth (before experiencing sharp recoveries) – reasons for this include political uncertainty regarding the EU Exit negotiations and impact on business confidence and investment.

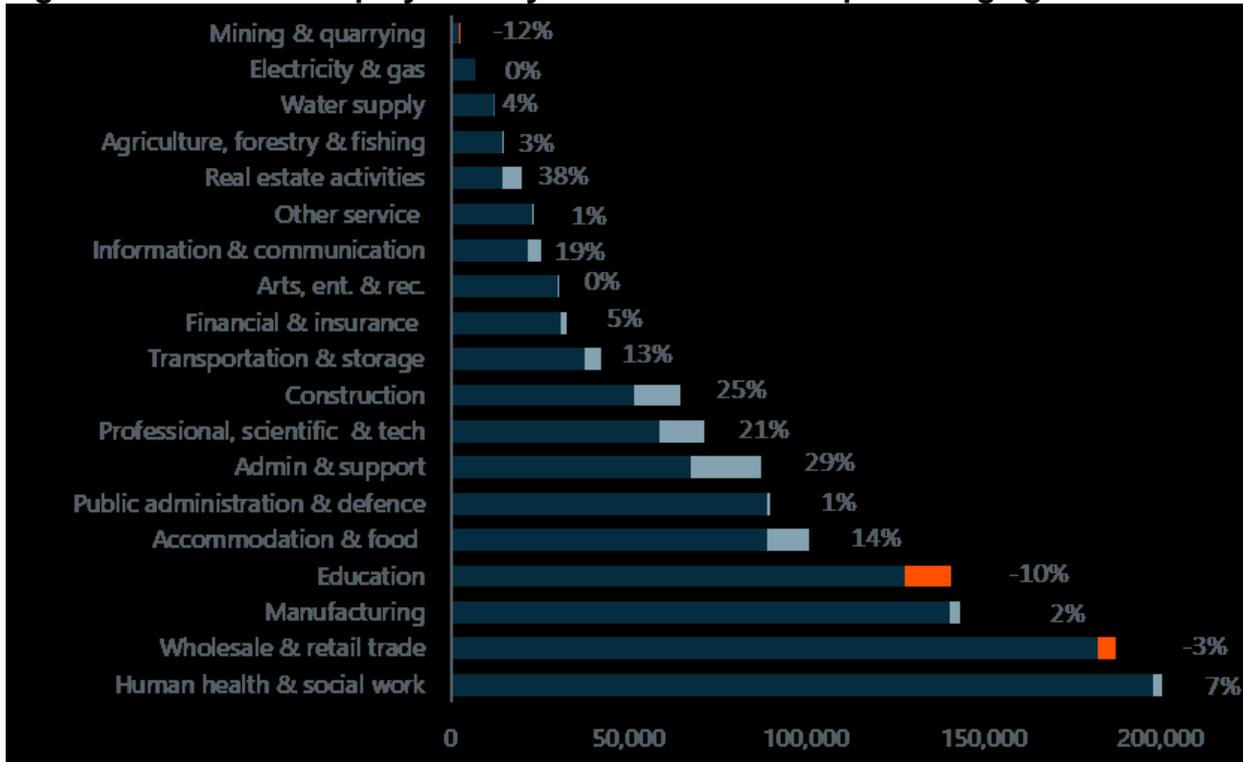
Figure 5.7: Employment growth 2011-2018 by Welsh region, indexed to 2011 levels



Source: ONS, Business Register and Employment Survey, 2018c

5.10 The three most dominant sectors in the Welsh economy in terms of their employment are health and social work, wholesale and retail trade, and manufacturing. However, this varies by sub-region. In West Wales and the Valleys, there is a higher proportion of employment in health and social work (which tends to be more public-sector employment and therefore lower propensity to access external finance). In East Wales, there is a larger proportion of employment in higher value sectors, such as professional scientific and technical activities, administration and support services, and information and communication (which tend to have higher demand for external finance).

Figure 5.8: Level of employment by sector in 2019 and percentage growth since 2013



Source: ONS, Business Register and Employment Survey, 2018c

Impact of COVID-19

5.11 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. From mid-March 2020, the UK economy was reduced to essential work and that which could be undertaken from home, resulting in a fall in UK output in April of a historic 20% (following on from a 6.9% decline in March; ONS 2020a). As social distancing restrictions eased, UK GDP rose by just 1.8% in May (much lower than economists' predictions of a c.5% growth). This resulted in an overall reduction in GDP from March to May 2020 of 19.1%. The ONS has reported the number of employees on UK payrolls fell by 650,000 from March to June 2020 and that the UK Claimant Count increased 112% to 2.6m between March and June 2020 (ONS, 2020b). In Wales, the Claimant Count increased 93% over the same period to 117,000 people.

Short Term

5.12 Given the very dynamic situation with COVID-19, it is difficult to be precise about the economic impact of COVID-19 to date and especially the potential future economic impact in terms of its severity and duration. This is further compounded

by uncertainty regarding the UK's future relationship with the EU. In the very short term, the Bank of England forecasts a 14% contraction in the UK economy overall in 2020 (and an increase in unemployment from 4% in 2019 to 8% in 2020). The IMF forecasts a reduction of 6.5% reduction in GDP in the UK in 2020, with unemployment rising to 4.8% in 2020. These short-term forecasts are driven by:

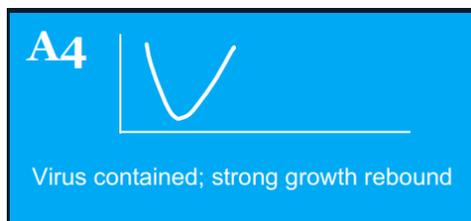
- **Fall in consumer spending:** Social distancing restrictions have curtailed the ability of households to spend on some goods and services. Consumption patterns have changed as people spend more time at home, but also shift spending from the high street to online purchases. In addition, reduced income, job security and rising unemployment contributes to uncertainty which means people are more cautious in their spending, which could weaken consumer spending for some time. These negative forces could see consumer spending fall by at least 10% in 2020 according to KPMG UK forecasts (June 2020) and recover modestly by 1.3% in 2021, as possible vaccine or effective treatments come too late in the year to boost spending significantly.
- **Hampered investment:** in the short term it is challenging for businesses to rely on established supply chains and anticipate customer demand as it is unclear as to the duration and extent to which restrictions will be in place (these were being relaxed as early July 2020, but this varied depending on the sector, and there is the looming threat of a second wave and/or local enforced lockdowns). Further, many businesses will be reluctant to invest until they are clearer on the future trajectory of the economy and their markets, as well as their need to conserve cash whilst revenues are low. All of these challenges mean that business investment could fall by 12.6% during 2020 according to KPMG forecasts for the UK, recovering only marginally as investment grows by around 1.8% in 2021.
- **Slowdown in exports:** this is a global pandemic and countries are at different stages in their own economic recession/recovery (and until a vaccine is rolled out globally, there is the continuous threat of a second wave). Thus, demand is likely to be volatile and depressed in export markets. Further, exports could be hampered by EU exit, with the possibility of tariffs and quotas. Even without these, there could be additional trade friction due to the requirement for customs inspections.

Medium to Long Term

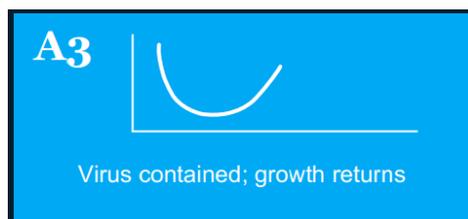
- 5.13 In the medium and long term there is considerable uncertainty. To combat this, many institutions and organisations are developing scenarios for future economic recovery. These are, in the main, tied to the timeframe of the development and roll out of a successful vaccine. Whilst there are many different scenarios, based on our review of the literature, we have outlined three which we think covers the full array of potential recovery scenarios for Wales.

Figure 5.9: Future Economic Recovery Scenarios

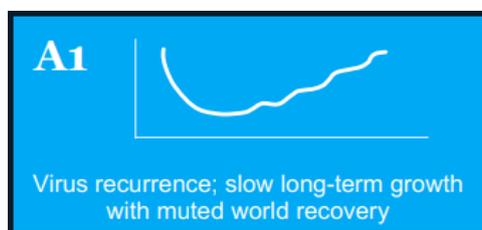
- 1) **V shaped recovery** - a quick bounce back to pre COVID-19 economic output (2019Q4 levels) in late 2020/early 2021. Economic policy responses are effective in stopping the decline of the economy. A vaccine is developed at the start of 2021, after which most social restrictions can be removed. Pent-up demand assists in a strong economic recovery.



- 2) **U shaped recovery** - a longer bounce back to pre-COVID-19 economic output, with output returning to 2019Q4 levels in late 2021/early 2022. Economic policies are effective to an extent but are insufficient to raise confidence and restart growth in the short term. A vaccine is developed in summer 2021. This scenario accommodates a longer timeline for clinical research, manufacturing and roll-out. According to KPMG, there are currently over 100 candidate vaccines in the pipeline that are likely to kick start with clinical trials soon, with the probability that will be effective treatment by July 2021 relatively high.



- 3) **L shaped recovery** – slow long-term growth insufficient to deliver full recovery of output to 2019Q4 levels until 2023. Long term structural damage to the economy, with a continued slowdown in investment, employment and productivity growth. No vaccine or treatment is developed at all in 2021, and so some social restrictions have to remain in place in the medium term. Governments and the international scientific community have dedicated a significant amount of resources to developing an effective vaccine, and so in many cases this scenario is considered to have a lower probability than the other recovery scenarios, but its impact is significant and it is still a possibility.



Source: Hatch Regeneris drawing on: McKinsey & Company, COVID-19 Briefing Materials, June 2020 & KPMG UK Economic Outlook, June 2020

5.14 For the UK, this could translate itself into the following GDP growth scenarios.

Table 5.1: UK GDP Growth for Alternative Scenarios (% change on previous year)

Recovery Scenario	2020	2021
V-Shaped	-6.5%	4.9%
U-Shaped	-7.2%	2.8%
L-Shaped	-7.2%	0.9%

Source: KPMG UK Economic Outlook, June 2020

- Forecasts for Wales are highly uncertain, but the KPMG economic outlook forecasts a 7.2% reduction in GVA in 2020 and then a 3.3% increase in 2021 (based on a U-shaped recovery scenario).
- Whilst not available for Wales, the IMF forecast a 10% reduction in GDP in 2020 and a 6% increase in 2021 for the UK. Globally, a 4.9% reduction is forecasted in 2020 and then a 5.4% increase in 2021 (IMF, 2020).
- The OECDs June Economic Outlook forecasts two scenarios – a single hit scenario where a second wave of infections are avoided, and a double hit scenario where a second wave of infections hit before year end. Under the single hit scenario, UK GDP is forecasted to fall by -11.4% in 2020. With a second wave, it could fall by as much as 14%. In 2021, an increase of just 2.8% is forecasted (under the single hit scenario – no forecast is provided for the double hit scenario).

5.15 Future prospects for the recovery are tied to the sectoral composition of the economy, given that, as outlined above, different sectors have different challenges and prospects for recovery:

- **Travel and hospitality:** these sectors have borne the brunt of the damage of social distancing restrictions. These sectors are not deemed ‘essential’ which is likely to cause further damage as people cut back on discretionary spend. Further, as work patterns shifts (ie more permanent home workers, more virtual meetings), long term prospects for business travel remain uncertain. These sectors account for around 14% of jobs in Wales.
- **Manufacturing:** this is the third most dominant sector in Wales in terms of employment and accounts for around 5% of SMEs. COVID-19 has caused a significant shock in global supply chains, which is likely to continue as social restrictions remain in place. Transport related manufacture (which accounts for 3% of total manufacturing in Wales) linked to air travel and cars could experience a significant fall in demand (as already seen with redundancies at Airbus).
- **Education:** prospects for the education sector remain fairly uncertain. Higher education is likely to account for the majority of the damage, with substantial falls

in international students, increased distance learning and Brexit uncertainty. This will be a particular challenge for those cities in Wales that rely upon the university and student expenditure to support the local economy (eg Aberystwyth, Bangor, Cardiff and Swansea in particular).

- Healthcare: has seen an increase in demand, which is likely to continue until a vaccine is rolled out, but may fall after that in the longer term. The pharmaceutical industry could sustain demand in the longer term as the industry prepares for the next pandemic/global health threat.
- Logistics: there has been a significant increase in online retailing during the lockdown, and this is likely to continue as consumers realise that they can purchase many of their essential goods online. Further, as businesses try to be better prepared for future significant global events (such as more pandemics), they will be looking to build additional resilience into their supply chains, translating into higher demand for warehouse/storage space.

5.16 Economies most reliant on travel, tourism and manufacturing are likely to see the greatest economic damage in the medium and long term – these are termed heavily impacted sectors, as defined below in the KPMG economic forecasts for the UK. Those with a high proportion of essential and least impacted sectors will fare better - these are health, pharmaceuticals, postal/logistics and IT.

5.17 Within Wales, in Mid Wales, there are a large proportion of agricultural and hospitality firms, meaning future prospects for businesses there are likely to be challenging. In South East and South West Wales, whilst there are a high proportion of hospitality firms, there are also large proportion of health/education firms, as well as financial and business services, whose future prospects are much more optimistic.

Table 5.2: Sectoral Concentration & UK Regional Forecasts

	2020 GVA Forecast	Proportion of heavily impacted sectors	Proportion of essential and least impacted sectors
West Midlands	-9.1%	10.3%	21.2%
London	-8.1%	5.8%	19.6%
South West	-7.9%	8.0%	23.0%
East of England	-7.9%	6.1%	19.9%
East Midlands	-7.8%	6.6%	20.8%
North West	-7.6%	8.1%	24.5%
South East	-7.4%	6.2%	24.6%
Wales	-7.2%	7.8%	26.5%
Yorkshire & Humber	-7.1%	5.4%	22.3%
North East	-6.8%	6.8%	29.2%
Scotland	-6.8%	6.1%	26.1%
Northern Ireland	-6.4%	5.3%	26.3%

Source: KPMG UK Economic Outlook, June 2020

6. SME Finance Market Assessment

Key points

- There continues to be strong growing demand for debt finance (loans, overdrafts and credit cards) by SMEs in Wales.
- There has been a significant increase in the start-up rate and stock of microbusinesses in Wales over the past few years.
- 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 WV where employment is dominated by the public sector, manufacturing and construction.
- 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.

6.1 This section explores the trends in the demand and supply for finance up to the lockdown of the economy in March 2020 and hence period in which the WBF has operated for most of its investment period to date. We have drawn on a range of public data sources, including survey evidence, to build up a picture of both the demand and supply of external finance to the SME community in Wales. This has been supplemented with evidence from consultations with public sector bodies, business representatives and the financial community to provide a richer view of the trend in the demand and supply for finance in Wales.

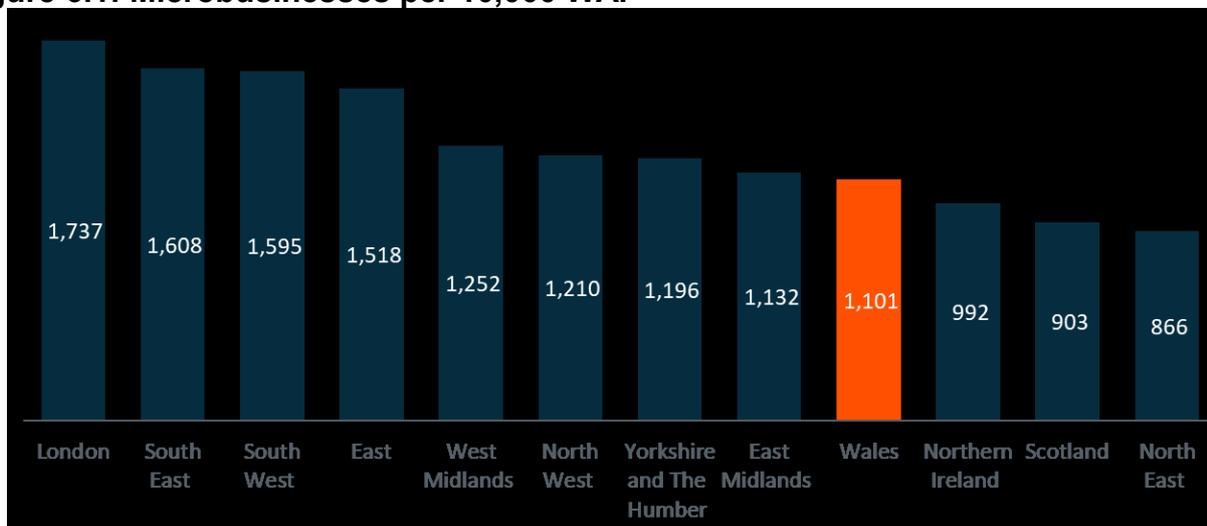
Demand for Finance - Finance for Microbusinesses

Increasing stock of Welsh microbusinesses and start-up rate

6.2 The latest ONS Business Counts indicate that there are around 95,000 microbusinesses in Wales. However, the number of microbusinesses in the UK has increased more strongly over the past six years growing by 27% compared to 22% in Wales (an increase of 17,000 microbusinesses).

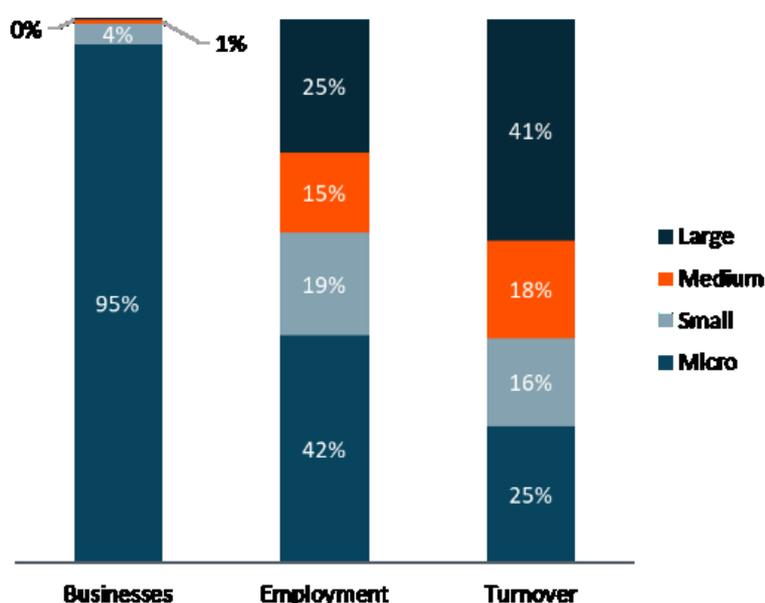
6.3 In 2018, in Wales there were 73 business starts per 10,000 working age people. Whilst this is lower than the UK average (91 per 10,000 WAP), the start-up rate in Wales has been rising rapidly - growing by 87% over the period compared with just 62% in the UK (ONS, 2019c).

Figure 6.1: Microbusinesses per 10,000 WAP



Source: ONS, Population Estimates 2019a & Business Population Estimates, 2019e

Figure 6.2: Welsh business base, employment and turnover by business size



Source: ONS, Population Estimates 2019a & Business Population Estimates, 2019e

6.4 Start-ups and microbusinesses tend to require smaller amounts of finance and early stage finance than larger businesses, so with growing microbusinesses and start-up numbers, we expect a greater demand for this. However, microbusinesses in the UK have been consistently less likely to achieve successful applications for finance compared to other SMEs (which can be an indicator for demand), suggesting there

could be a shortage of small scale and early stage finance. There has been a small amount of progress in this as the success gap has narrowed between 2016 and 2019, as Table 6.1 shows.

Table 6.1: Outcome of Application for Finance, UK Businesses

Outcome	2016		2019	
	All	Micro	All	Micro
Obtained any finance	75%	73%	78%	77%
Did not obtain any finance	13%	15%	14%	15%
Don't know/still pending	12%	12%	8%	8%

Source: Longitudinal Small Business Survey, 2019

Demand for Finance - Debt for Established SMEs

Increase in SME stock and strong demand for debt finance

6.5 As outlined in the Economic Context section above, the number of non-micro SMEs (businesses employing 10 to 250 people) in Wales increased by 2% from 2017 to 2019 (an additional 270 non-micro SMEs) to make up 11% of the total Welsh business base in 2019. Whilst there has been an increase in the stock of SMEs, overall the proportion of those obtaining finance has fallen, although it has risen compared to 2016 (shown in Table 6.2 below).

Table 6.2: Outcome of application for finance, UK non-micro SMEs

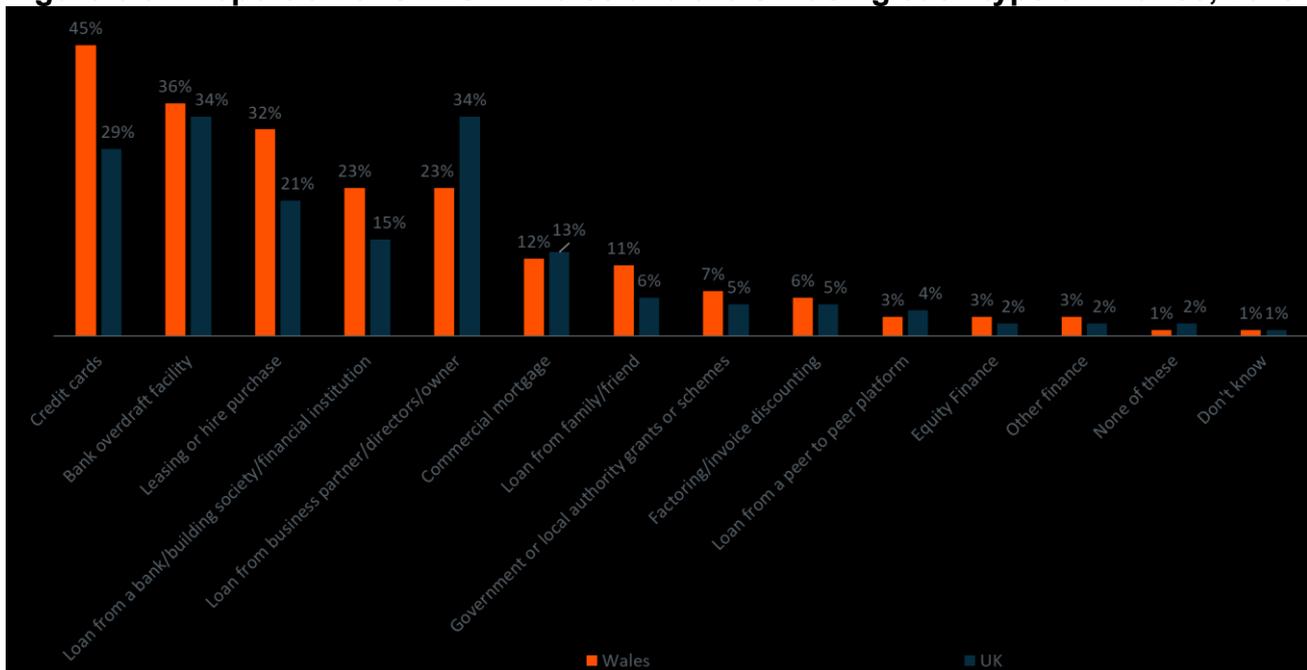
Outcome	2014		2016		2019	
	Small	Medium	Small	Medium	Small	Medium
Obtained finance	85%	87%	80%	84%	82%	86%
Did not obtain any finance	13%	7%	10%	6%	9%	5%
Don't know/still pending/refused	3%	6%	10%	10%	9%	10%

Source: Longitudinal Small Business Survey, 2019

6.6 Examining the types of finance accessed can also provide insight into the demand for debt finance of established SMEs. The 2019 Small Business Survey found that a higher proportion of Welsh SMEs are accessing most forms of external finance, including banks, equipment related financing and unsecured finance such as credit cards, than UK SMEs (as shown by Figure 6.3). Debt is found to be the most used form of finance for Welsh SMEs, with a higher proportion relying on credit and loans from banks than SMEs in the UK as a whole. Nearly twice the proportion of SMEs in Wales use loans from family/friends compared to the UK – likely due to the large number of family run microbusinesses where there can be resistance to seeking

external finance from the private sector (particularly outside the major urban conurbations).

Figure 6.3: Proportion of SMEs in Wales and the UK using each type of finance, 2019



Source: Longitudinal Small Business Survey, 2019

Strong demand for debt finance from Welsh SMEs

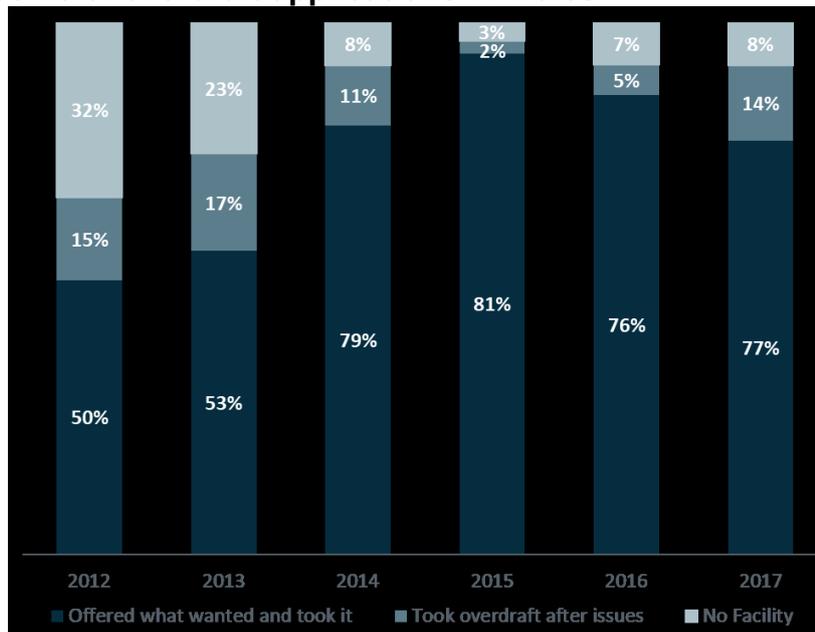
6.7 The latest SME Finance Monitor also paints a picture of strong demand for external finance from established SMEs in Wales, particularly for debt finance. The latest data (2018) shows that:

- 44% of SMEs in Wales were using external finance compared to 36% across the UK. Further, 40% of SMEs were using core finance (loans, overdrafts or credit card) vs 32% across the UK.
- The proportion of SMEs in Wales using external finance has remained constant over the past 6 years (since 2012), compared to a 7 percentage point drop for SMEs across the UK.
- 43% of SMEs in Wales are defined as permanent non-borrowers, lower than the rate for the UK (48%).

Looking specifically at loans and overdrafts, the SME Finance Monitor found that the proportion of SMEs surveyed who successfully applied for overdrafts has fallen slightly since 2015. The success rate amongst Welsh SMEs applying for loans dramatically increased in 2017 (consultees suggested this was a reflection of

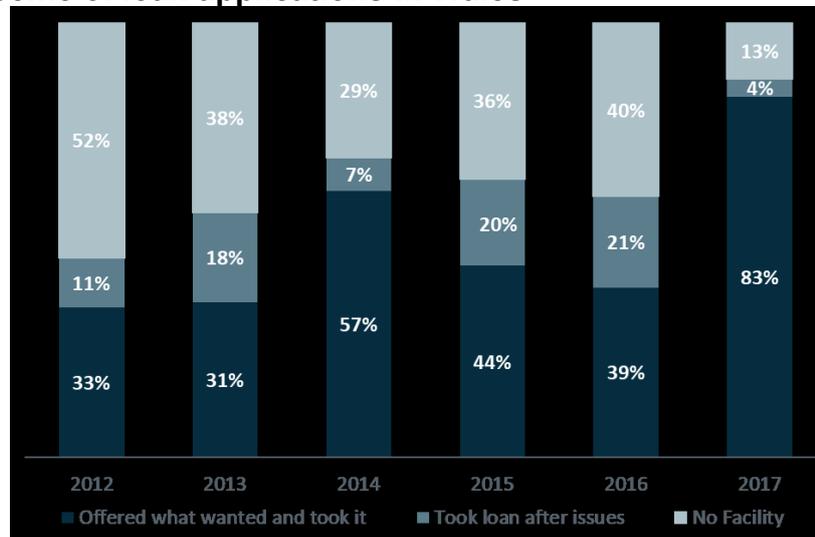
stronger business propositions and/or more willingness to lend by the high street banks and organisations like DBW).

Figure 6.4: Outcome of overdraft applications in Wales



Source: SME Finance Monitor, 2017. Note Welsh SME results were not recorded post-2017.

Figure 6.5: Outcome of loan applications in Wales



Source: SME Finance Monitor, 2017. Note Welsh SME results were not recorded post-2017.

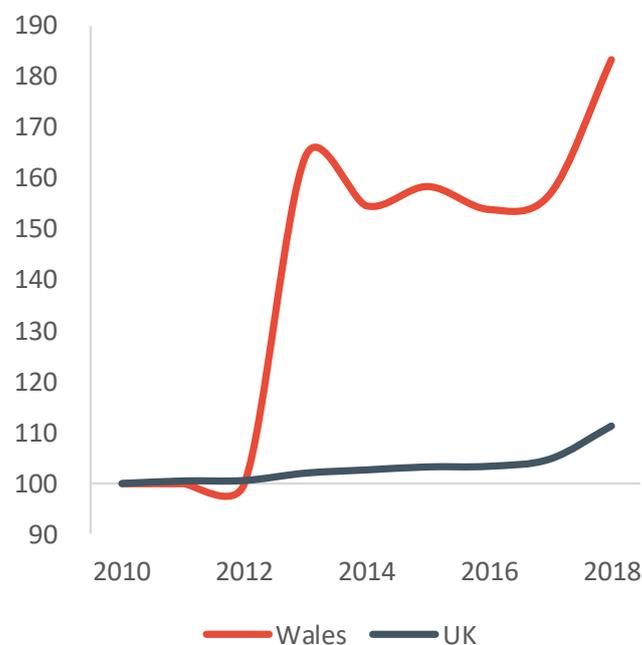
Demand for Finance - Equity for early stage SMEs

6.8 There is little directly observable evidence on the demand for early stage equity in Wales. One way to get a picture of demand is to use proxies, such as the spend on R&D activity and the level of innovative businesses, as well as trends in the stock of start-ups and spinouts. Innovative businesses tend to experience higher growth and therefore have greater demand for external finance. The nature of innovation activity can place greater emphasis on the use of equity finance rather than debt finance.

Growing stock of SMEs suitable for early stage equity finance

6.9 The scale of investment in R&D provides an indication of innovation activity and the scale of early stage ventures. In Wales, there was an estimated £800 million in higher education and business R&D expenditure in 2018. Wales has experienced higher than average growth in this spending over the recent period of around £350 million since 2010 (albeit from a low base), due to increased business expenditure on R&D. This increase in business expenditure of R&D could be an indicator of increased demand for early stage equity finance.

Figure 6.6: Higher Education and Business R&D Expenditure Index, 2010-18

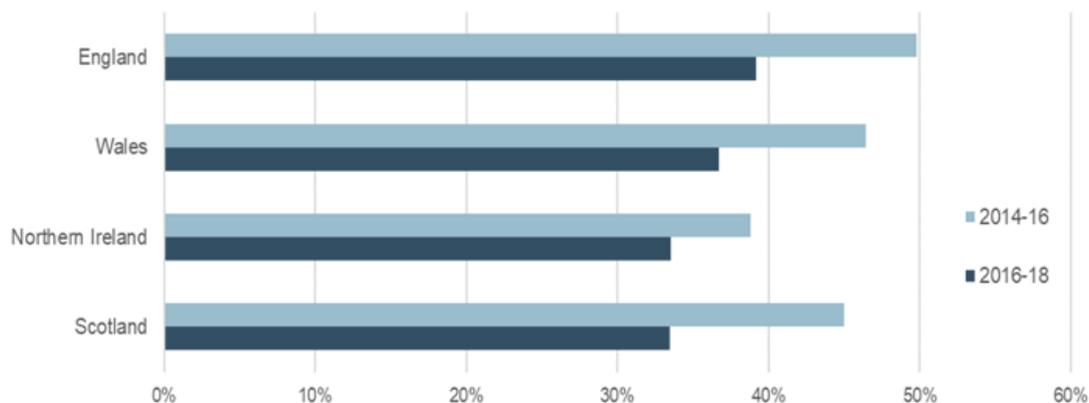


Source: ONS, Higher Education and Business Expenditure on R&D, 2019d

6.10 Across the UK, the proportion of businesses which are innovation active⁸ fell in 2016-18 compared with the previous two years. Wales continues to have a lower proportion of innovation active businesses than England, however still fares well compared to the other UK nations.

⁸ Innovation active businesses are those which engage in the introduction of a new or significantly improved product or process; innovation projects not yet complete, scaled back or abandoned; or new and significantly improved forms of organisation, business structures or practices, marketing practices or strategies.

Figure 6.7: Proportion of innovation active businesses by country, 2014-16 and 2016-18

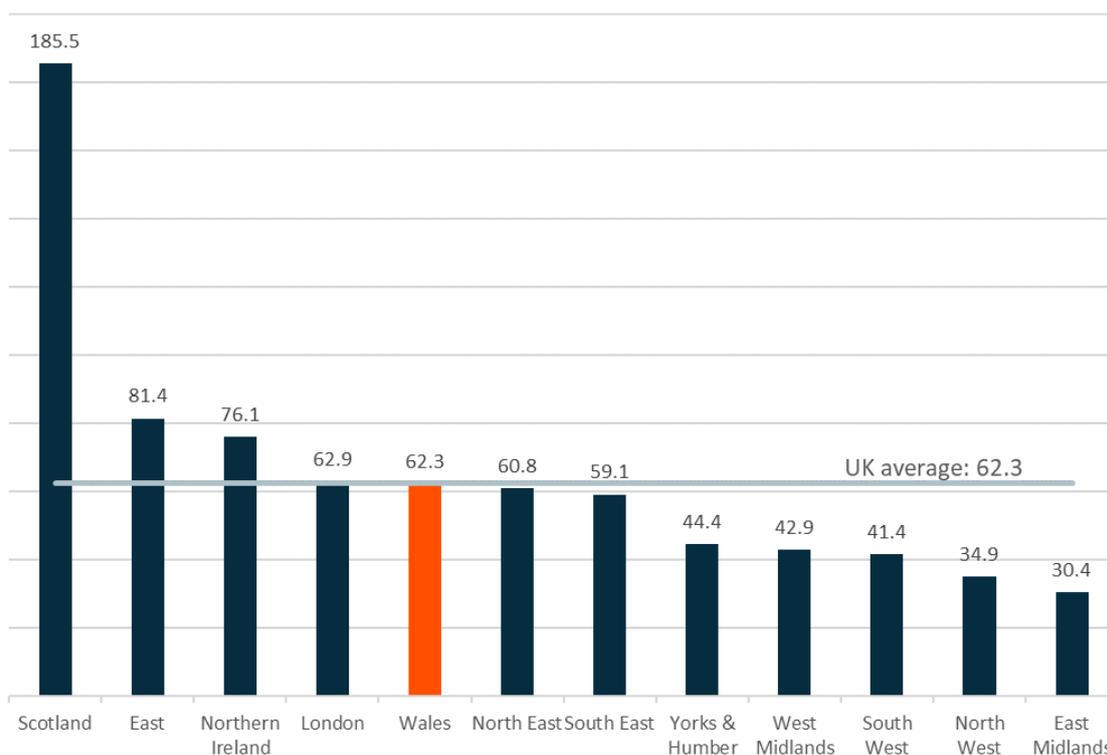


Unweighted base = 14,040 in 2016-18 and 13,194 in 2014-16

Source: BEIS, UK Innovation Survey, 2019

6.11 The number of spinouts and start-ups from universities also provides an indication of entrepreneurial and start-up activities in Wales. Welsh Universities are productive in terms of their spin out and start-up activities and have produced the highest increase in spin outs and start-ups of any UK region since 2017. They achieve the same proportion of start-ups and spin outs per 1m working age people as the UK as a whole and just fewer than London. The vast majority of the spin outs and start-ups from Welsh universities (nearly 90%) are from the Universities located in South Wales - 40% are from Swansea University, 35% Cardiff University and 14% from the University of South Wales.

Figure 6.8: Spin outs and Start-ups per 1m working age people by UK region, 2020



Source: Spinouts UK, 2020

Demand for Finance - Expansion equity for established SMEs

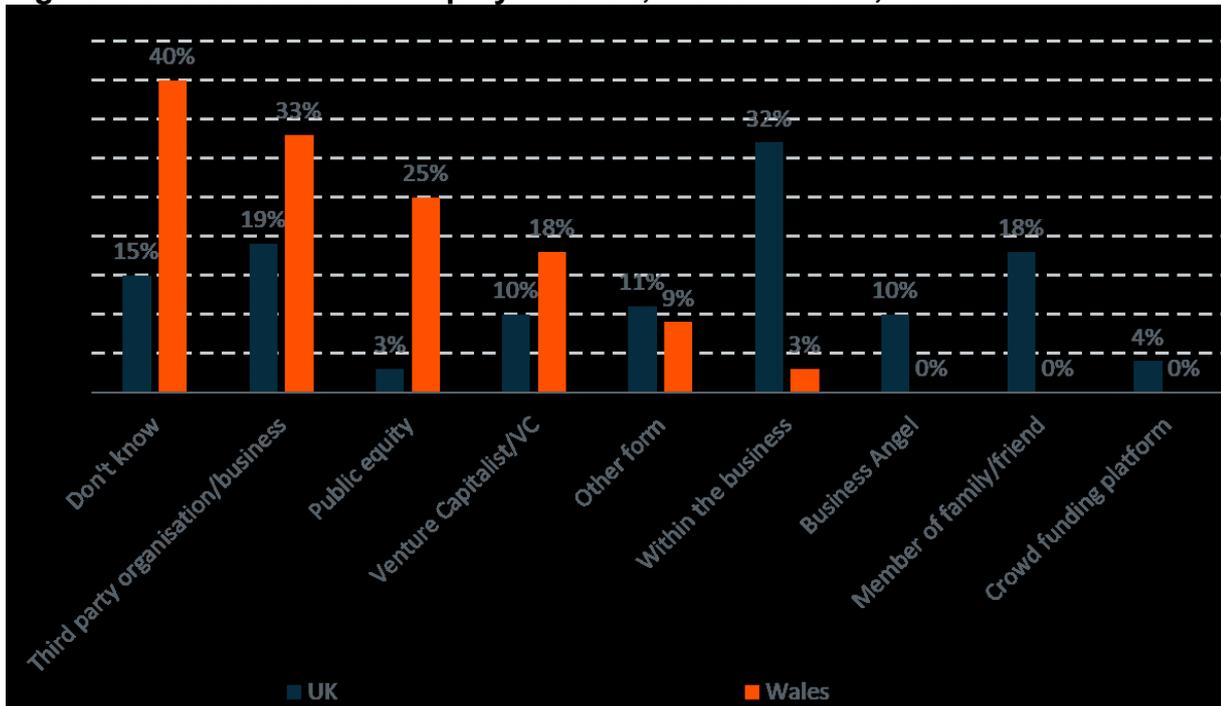
Lower than average demand for expansion equity from Welsh SMEs

- 6.12 As outlined above for early stage risk finance, equity finance tends to be suitable for a small minority of firms that have good long term growth potential but a high level of risk associated with their business plans, and there is very little direct evidence of demand.
- 6.13 The Small Business Survey (2019) indicated that only 1% of Welsh SMEs surveyed using equity finance compared to 2% of UK SMEs surveyed, supporting the idea that this type of finance is rare (especially from the private sector). Of Welsh SMEs who did take on equity, this was more likely to be obtained from another third party organisation or business or public equity, although certainty is low because of the low proportion of businesses using equity and the high proportion of respondents who did not know the source of their equity finance.
- 6.14 Consultees suggested this is likely to be due to the historic equity aversion/lack of knowledge of equity finance that has been present in parts of Wales (particularly in West Wales and the Valleys), as well as the importance of family businesses in the

SME stock. This is illustrated by data from the SME Finance Monitor which outlines that:

- 3% of SMEs in UK were planning on using equity finance in the near future vs just 2% in Wales.
- 15% of businesses in Wales are reluctant to give up some control of their business, higher than rate for the UK (10%).

Figure 6.9: Source of SME Equity Finance, Wales and UK, 2019



Source: Longitudinal Small Business Survey, 2019

Supply of Finance - Finance for Microbusinesses

Public sector and alternative finance are main sources of finance for microbusinesses

6.15 Given the risks and returns associated with microloans, this is not a space that high street banks typically operate in without public support/subsidy or the anticipation of developing a long term relationship with a dynamic entrepreneur. This is supported by data on bank lending below. The average value of new bank loans approved to smaller businesses has increased by 12% since Q3 2011, while falling by 5% in the UK during the same period. The average value of loans approved to Welsh small businesses stands at around £80,000, well above the EU microloan upper limit and the amount typically sought by microbusinesses.

Figure 6.10: Average Value of High Street Bank Loans Approved to Small Businesses in Wales



Source: UK Finance Lending Data.

Note: data is not yet available on a consistent basis after Q1 2017.

- 6.16 The Start-Up Loans initiative was set up in 2012 to provide new and early stage businesses with access to affordable finance and mentoring support. It has had an impact in Wales and is one of the most well known publicly backed initiatives amongst SMEs and finance providers. According to the latest lending statistics, the average loan size has been £8,000 with the Start Up Loans Company has lent approximately £27m to start-ups in Wales (c 3,375 loans) out of a total £544m across the UK (5%, indicating an overrepresentation when compared to the Wales' 3% share of start-up businesses).
- 6.17 Development Bank of Wales also offer the £16.2m Microbusiness Loan Fund to small businesses, sole traders and social enterprises based in or relocating to Wales to 2025. The fund provides loans of between £1-£50k with over £14m lent so far to microbusinesses in Wales.
- 6.18 Young microbusinesses make use of a range of sources to fund themselves, including informal arrangements with friends and family, and personal credit sources such as credit cards. Clearly these are typically low amounts of finance often provided on an informal basis. Consequently, there is much less evidence on the amounts of finance provided through these sources.

Supply of Finance - Debt for Established SMEs

Fall in value of lending by high street banks

- 6.19 UK Finance provides an overview of trends in loans and overdrafts to SMEs from high street lenders. The most recent figures indicate that the value of SME lending in Wales stood at £3.9bn in Q4 2019. There has been a general downward trend over the past six years, with the value of bank lending falling by 13% in Wales and 14% across the UK.

Figure 6.11: Value of Quarterly High Street Bank Lending to SMEs 2013-19

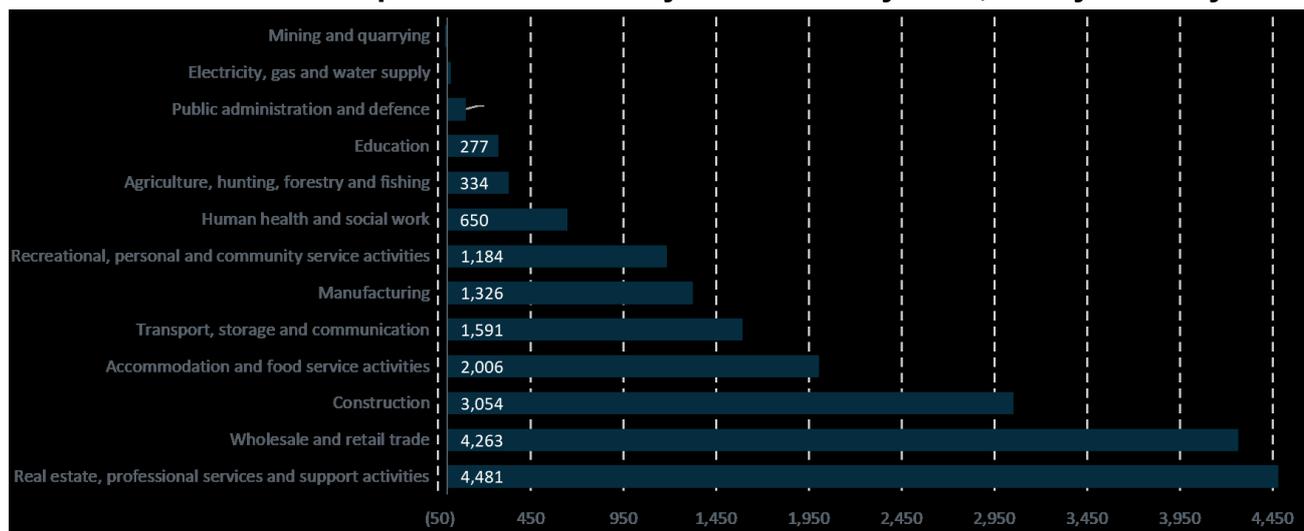


Source: UK Finance

But an increase over the past 12 months in the UK, as COVID-19 impacts are beginning to be felt

- 6.20 Data from the Bank of England provides an overview of the total value of financial institution loans to UK SMEs over time and finds lending increased by £19.3 billion in May 2020 relative to May 2019. The reason for this is that this data includes overdrafts and the increased role of other private sector institutions is not picked up by UK Finance data above. This impact was particularly strong in industries which were more affected by COVID-19 measures, such as real estate and retail trade.

Figure 6.12: Difference in monetary financial institutions' gross lending to UK small and medium-sized enterprises between May 2019 and May 2020, £m by industry



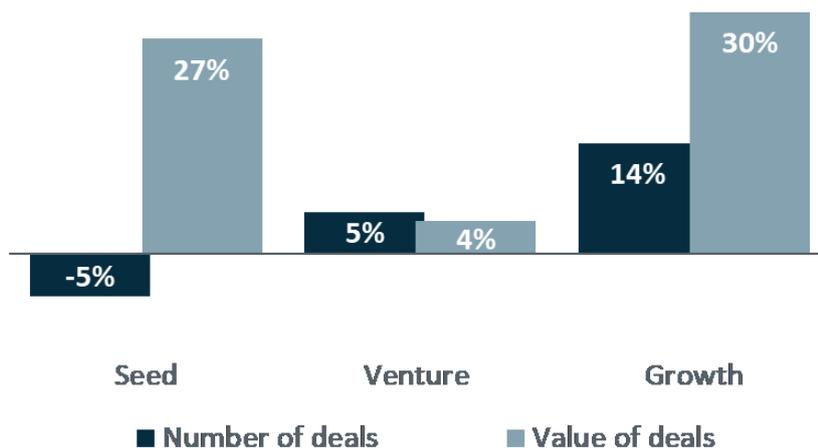
Source: Bank of England, Bankstats Tables 2020

Supply of Finance - Expansion Equity

Maturing equity market across the UK

- 6.21 There were 1,850 SME equity deals in the UK in 2019 (a 4% increase compared to 2018), amounting to a total value of £8.5 billion (+24% increase from 2018), according to the latest British Business Bank Small Equity Tracker. The number and value of deals has been increasing over the past few years across all business development stages, with the exception of the number of seed deals which has fallen by 5% since 2017 – with a shift towards growth stage deals.
- 6.22 Further, in 2019 the annual amount of investment going to seed stage companies declined for the first time, ending continuous year on year growth since 2011, indicating that even before COVID-19, there were signs the UK equity market was beginning to soften (although it should be noted that this refers to year on year change which can be volatile for equity investment). This decline in seed stage investment coincides with 2019 being the first year where the number of companies receiving follow on investment exceeded the number of companies receiving equity finance for the first time. This, in conjunction with the increase in average equity deal sizes (see Table 6.3) illustrates a maturity in the UK Equity funding ecosystem.

Figure 6.13: Growth in number of UK equity deals between 2017 and 2019



Source: British Business Bank, Small Business Equity Tracker 2019

Note: Seed funding is typically the first stage of funding for start-ups or SMEs and can be small in value. Venture funding provides capital for start-ups or SMEs with strong growth potential. Growth funding can be invested in relatively mature SMEs which require finance to undertake dramatic growth.

Table 6.3: Average value per UK SME equity deal, by stage

Stage	2017	2019
Seed	£0.76m	£1.10m
Venture	£3.29m	£3.25m
Growth	£12.37m	£15.27m
Total	£3.64m	£4.59m

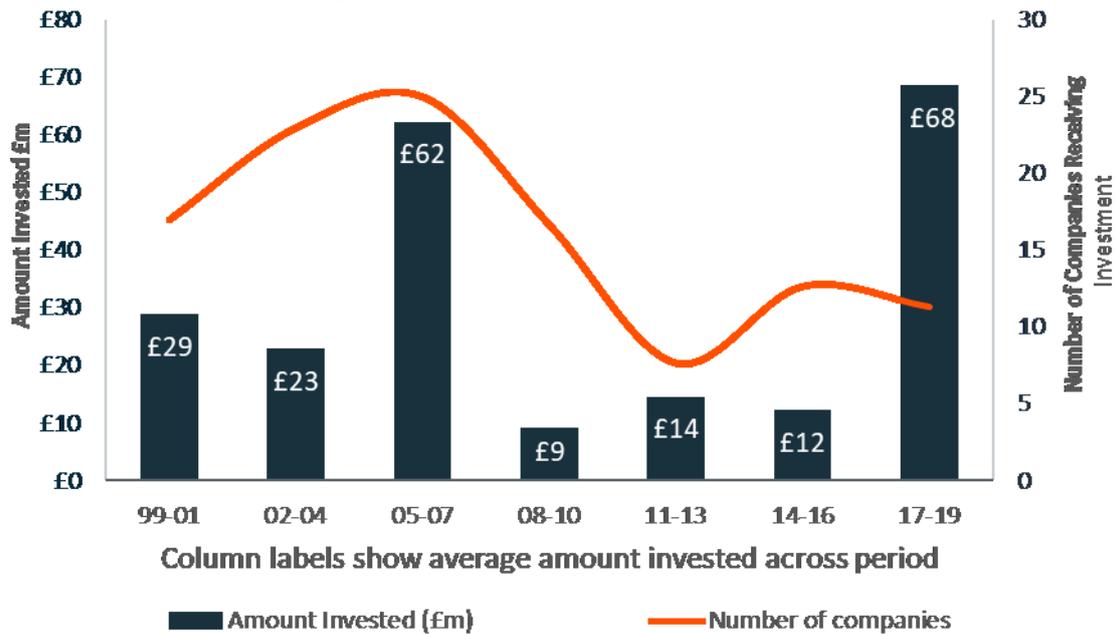
Source: British Business Bank, Small Business Equity Tracker, 2019

- 6.23 The latest equity market update from Beauhurst reports on the first half of 2019. Comparing H1 2020 data with that of H1 2019 shows some emerging impacts of the COVID-19 crisis. Although values fell significantly by 30% on H1 2019 to £4.77bn, deal numbers fell just 9% to 911 deals. Still, deal values not as low as much as might be expected due to strong equity performance up to 2020.
- 6.24 As expected, early stage investors appear to be focusing their resources on their existing portfolio companies (this was also confirmed by consultees). The number of seed-stage deals has grown by 7% on H2 2019, while first time fundraising fell by 15% compared to H2 2019. Beauhurst suggest the increase in seed-stage deals is likely demand and supply driven, as businesses require funding to stay afloat, adapt operations to suit social distancing measures or in a few cases, meet increased demand and investors reduce investment into first time funds. In terms of growth stage equity, the average deal size doubled to a record high of £10m in H1 2020. This may reflect falling investment values in other finance stages.

DBW helping to increase supply of expansion equity to Welsh SMEs

6.25 In terms of expansion equity in Wales, the level of investment activity has been growing, especially in the last three years, with a three year average of £68m invested between 2017 and 2019 compared to just £14m in 2011-13. The average deal size has also risen, to £6.0m compared to £1.8m in 2011-13. Further, Wales has the second highest amount of expansion equity invested as a proportion of GVA of all UK regions in 2018, double the proportion of the UK average (0.22% vs 0.12% across the UK). Government backed funding, such as the WBF, is an important driver of this. According to the British Business Bank, 60% of all announced equity deals in Wales in 2019 involved a Government fund, and this is backed up by consultation evidence which suggests the DBW has had much more success in penetrating the market and investing in SMEs compared to other UK wide equity schemes (eg Enterprise Capital Fund and UK Innovation Investment Fund).

Figure 6.14: Expansion equity investment in Wales



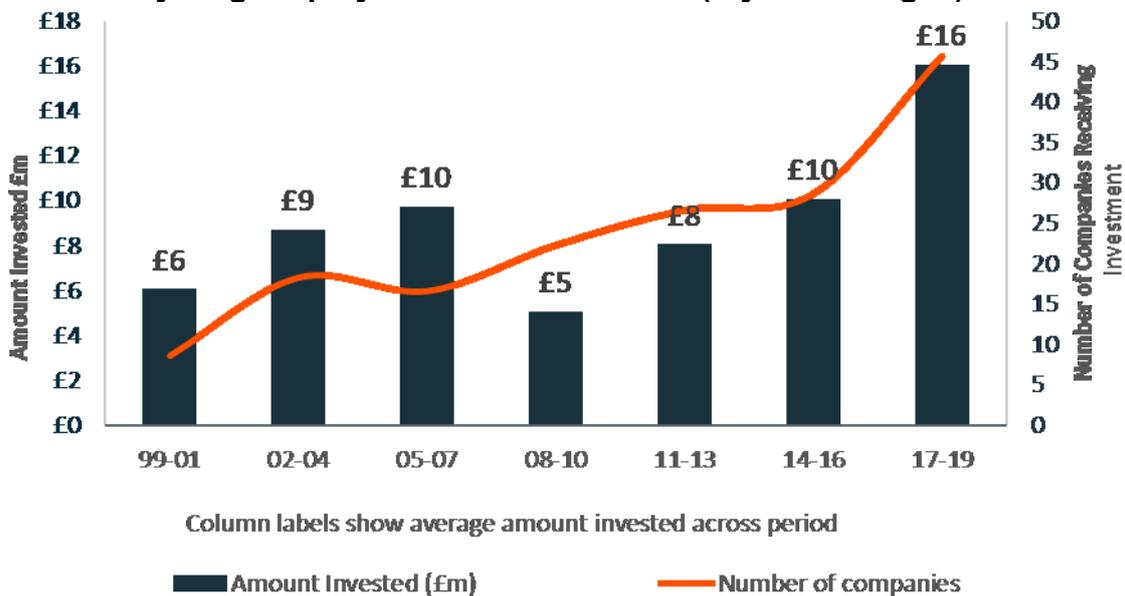
Source: BVCA Private Equity and Venture Capital Reports on Investment Activity.
 Note: BVCA data can be volatile year on year, therefore we have presented three year averages to smooth out fluctuations.

Supply of finance – Equity for early stage SMEs

Increase in early stage equity investment lending in Wales, but DBW is the main provider

6.26 In Wales, the amount and value of venture capital has increased strongly over the past 10 years, although not as quickly as the UK levels as amounts grew 100% in Wales compared to 107% in the UK from 2011-12 to 2017-19. Similar to the UK there has been a shift towards larger deals, with the average deal size rising to £350,000 (a 17% increase in average size), although this increase has been slower than the national rate (56% increase), and is still much smaller than the average size across the UK (which is just over £1m). This data includes any publicly backed interventions, so will include investments made by Finance Wales and the Development Bank of Wales in the JEREMIE fund (£13.5m invested from the JEREMIE fund via the Technology Ventures Investment sub-fund over 7 years). This is backed up by anecdotal evidence from consultees that suggests that particularly in technology based SMEs, the DBW has been the most active provider of equity finance over the last 2/3 years.

Figure 6.15: Early stage Equity Investment in Wales (3-year averages)



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

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

6.27 The Global Alternative Finance Market Benchmarking Report 2020 finds that equity based crowdfunding has become an establish source of finance for seed and early stage companies in the UK. Still, in 2018 equity based crowdfunding accounted for less than 12% of total seed and venture stage equity investment in the UK.

7. Implications of COVID-19 for SME Finance Markets

Key points

- 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).
- 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.
- 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 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.

7.1 COVID-19 will have major implications for SME finance markets. Wales and the UK started to experience the impacts of the pandemic in March 2020, and as such the impact has not yet been picked up in the quarterly and annual datasets covering the demand and supply of SME finance. We analyse the emerging impact and likely future implications for UK and Welsh SME finance markets below, based on the available research and datasets, including drawing on the experience of the financial crisis in 2007/08, as well as evidence from consultations.

Demand for Finance

Businesses in Wales have been worst affected by the pandemic in terms of loss of turnover

7.2 Compared to the UK regions, businesses in Wales have been the worst affected by the pandemic. SME confidence fell to its lowest level yet as 21% of SMEs had to

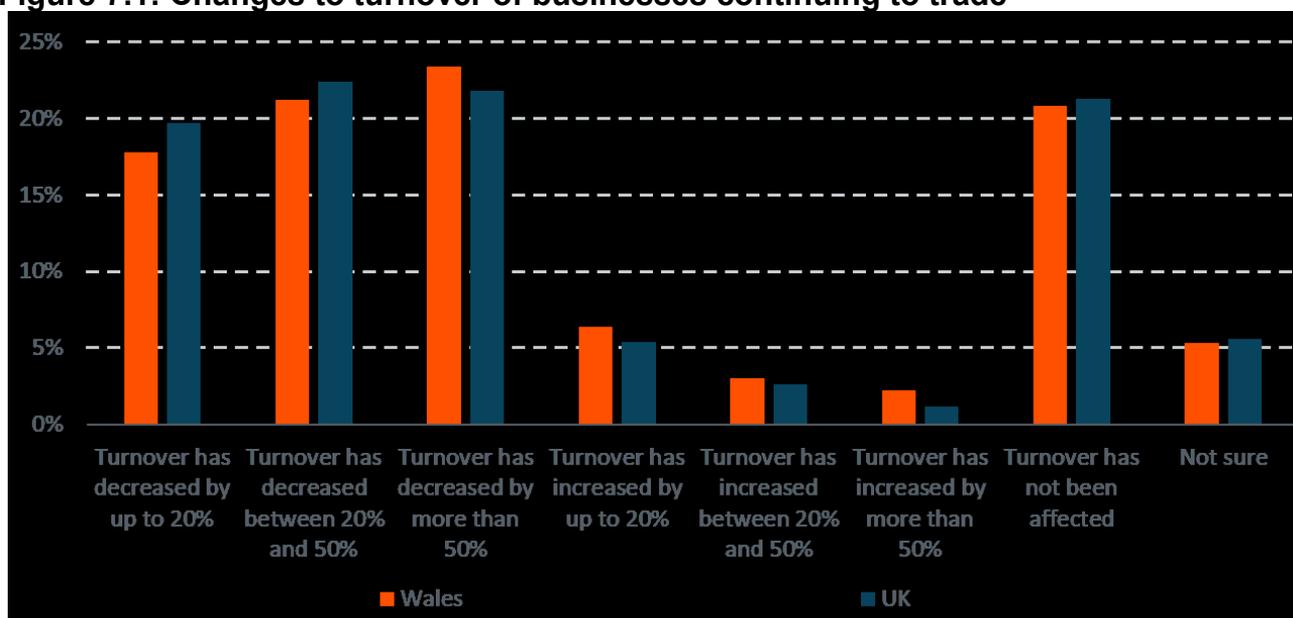
temporarily close⁹. 66% of SMEs saw a fall in turnover, the highest rate of all UK regions.

7.3 The fortnightly Business Impact of COVID-19 Survey (BICS) reports respondent business’s turnover, wages, trade and business resilience over the previous two weeks. The survey shows that:

- whilst a slightly smaller proportion of Welsh businesses experienced a fall of less than 20% and 20% to 50% compared to the UK, a greater proportion expected their turnover to fall by over 50% (23.4% compared to 21.8%)
- Wales recorded the lowest share of SME respondents that reported that their turnover had been unaffected compared to the other devolved administrations (just 21%).

7.4 There are however some positive trends emerging too. In the first two weeks of June 2020, 14% of surveyed businesses in Wales reported temporary closure or a pause in trading, down from 20% in the previous two weeks. Further, Wales has greater proportion SMEs reporting increases in turnover compared to the average rate across the UK.

Figure 7.1: Changes to turnover of businesses continuing to trade



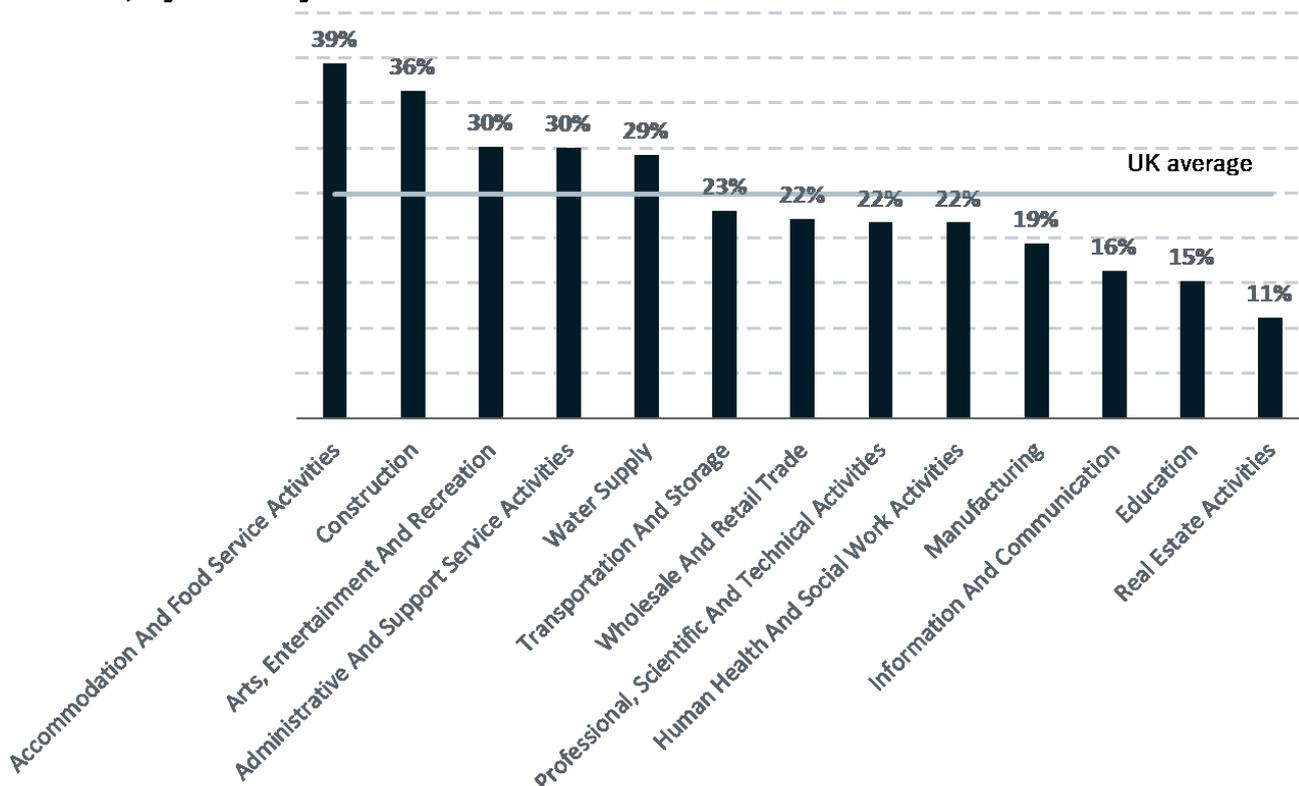
Source: ONS, Business Impact of COVID-19 Survey data 1 June to 14 June 2020. Note: Based on a survey of 6,092 businesses.

⁹ Economic Intelligence Wales, Annual Report, June 2020

- 7.5 The impact of the pandemic has so far played out differently for different sectors. Broadly, those that rely on customer contact have been more impacted by social distancing measures (such as retail and tourism/hospitality), and those able to continue to operate remotely have fared better (some professional service companies). This is reflected in the BICS analysis of sectors perceived as most at risk of running out of cash reserves - accommodation and food; construction; arts, entertainment and recreation; and administrative and support services, as shown in Figure 7.2 below.
- 7.6 More recent BICS data of surveyed UK businesses finds operating costs have increased for 74% of SMEs applying COVID-19 related safety measures, and 12% of these report the increase to be substantial¹⁰. Across all sizes of UK businesses surveyed, operating cost increases are found to be most prevalent across the sectors of accommodation and food (91% saw an increase), water supply (84%), construction (83%) and manufacturing (79%). This demonstrates an expected increased requirement for working capital.

¹⁰ ONS, Business Impact of COVID-19 Survey (BICS), Wave 9, 29 June to 12 July.

Figure 7.2: Proportion of UK businesses surveyed who have not permanently stopped trading and think their enterprises' cash reserves will last less than 3 months, by industry



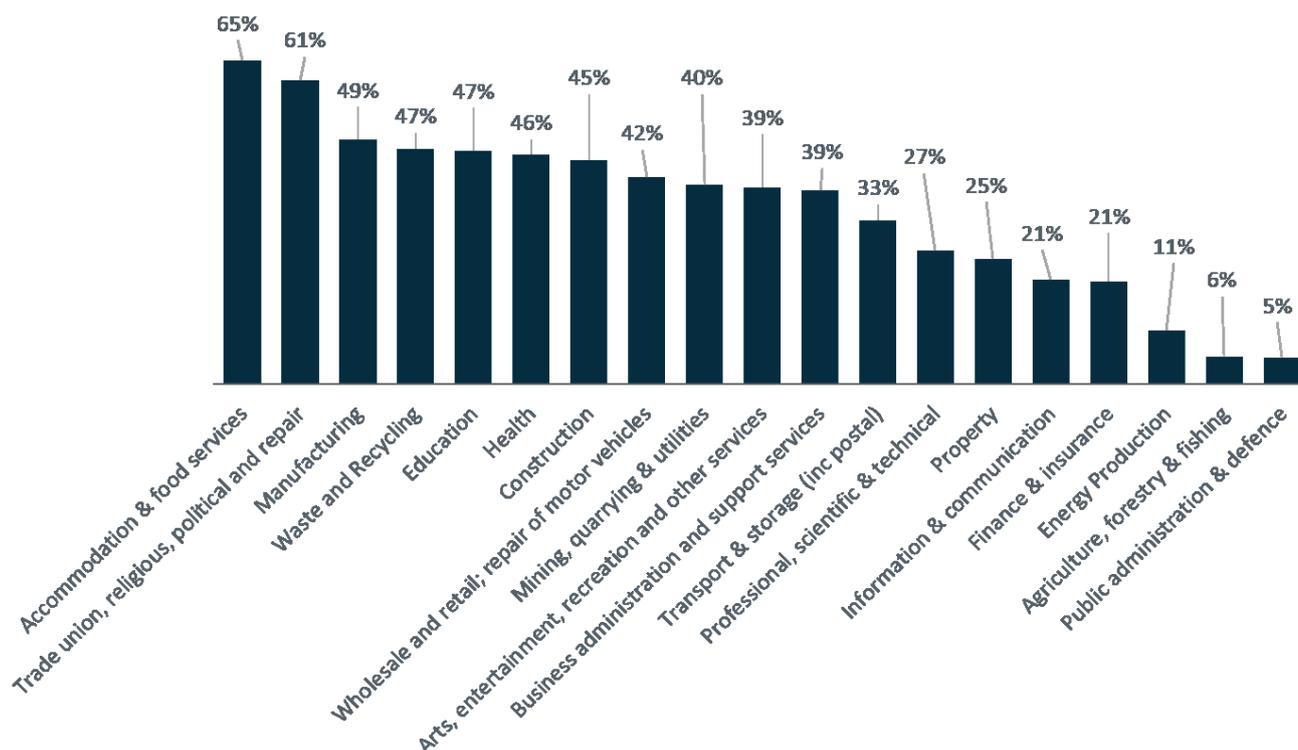
Source: ONS, Business Impact of COVID-19 Survey data 1 June to 14 June 2020. Note: Based on a survey of 6,092 businesses.

Wales also had the highest proportion of furloughed employees

7.7 Wales has had the highest proportion of furloughed employees of any region by June 2020, with at least 25% of all employees furloughed. Within Wales, North Wales has had the highest proportion of furloughed employees (26%), followed by Mid and South West Wales (25%) and South East Wales (24%).

7.8 This reflects, to some degree, the business sectors that are prevalent in those areas. North Wales and the Mid and South West Wales have high proportions of wholesale and hospitality businesses. The accommodation & food and manufacturing sectors saw particularly high levels of furloughing in June across all business sizes as a result of social distancing requirements of these sectors, as shown by Figure 7.3. South East has a higher production of business, professional and public sector services employment, where the incidence of furlough was lower.

Figure 7.3: Proportion of employers furloughing staff by sector, June 2020 UK



Source: Coronavirus Job Retention Scheme statistics: June 2020. Note: Based on a survey of 6,092 businesses.

Falling business confidence

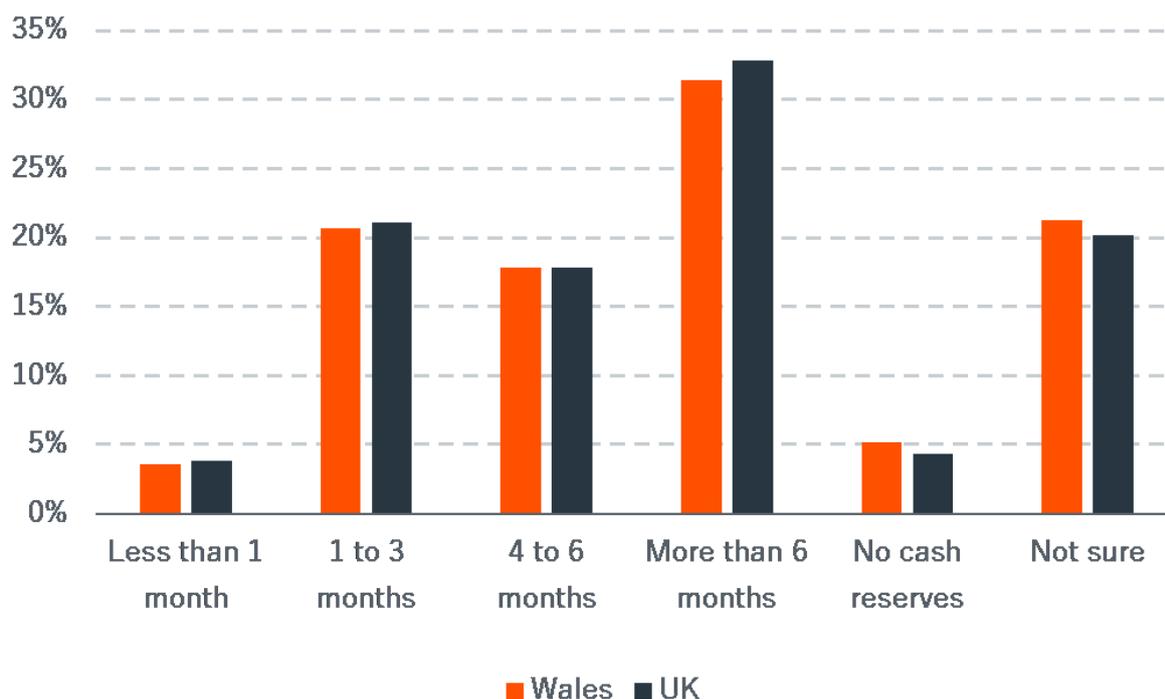
7.9 The rapid decline in turnover and increase in furloughing (plus the time limited nature of response schemes in place) has resulted in unprecedented falls in business confidence. The latest Federation of Small Businesses (FSB) Small Business Index shows the fall in confidence of UK SMEs (-143 points of the Small Business Index score) overall, along with sectors including retail (-155), arts, entertainment and recreation (-178), and accommodation and food service activities (-187) experiencing the greatest fall in confidence the Index has ever reported. The report also finds that 9% of small businesses plan to sell, close or hand on their business.

7.10 Falling business confidence has significant implications for ambition and growth prospects of SMEs, and therefore demand for growth finance. The latest SME Finance Monitor report finds that 73% of SMEs reported they would prefer to accept slower growth rather than to borrow and the proportion of businesses expecting to decrease their capital investment rose 40% in the first quarter of 2020 compared with the previous year.

Shift to demand for finance for survival

- 7.11 BICS also shows that many SMEs have sought to cope with the economic contraction by rearranging overdraft and loan payments, cutting costs (through furloughing and reduced hours), and seeking short term finance for cashflow and working capital purposes, with many taking measures in advance of the pandemic arriving in the UK.
- 7.12 The FSB Small Business Index Report shows that the rate of small businesses applying for credit increased by 2% in Q1 2020 (and hence only covers the period up to the end of March) and the proportion of successful applications increased by 4% to 67%. The SME Finance Monitor reported that future appetite for finance has increased across all SME firm size bands in the 3 months to April 2020, and the majority of this is to help the sustainability of the business as opposed to expansion/growth.
- 7.13 The need for working capital is compounded by the shorter cash reserves SMEs in Wales have, although the differences with the UK as a whole are modest. BICS shows that 29% of businesses in the UK had either no cash reserves or a cash flow remaining for up to 3 months, compared to 30% for Welsh SMEs (the second highest of all UK regions). Wales also has the highest proportion of SMEs with no cash reserves – 5.2% compared to 4.3% across the UK.

Figure 7.4: Time that cash reserves are expected to last for SMEs



Source: ONS, Business Impact of COVID-19 Survey data 1 June to 14 June 2020. Note: Based on a survey of 6,092 businesses.

7.14 This shift to demand for working capital (and primarily debt finance) was observed during the 2008 financial crisis and subsequent recession. The Wales JEREMIE fund experienced a dramatic increase in the demand for debt finance at the expense of the equity based sub-funds, although it should be noted that this crisis was a supply side shock which led the high street banks to retrench from the market.

7.15 The immediate requirement is the access to flexible forms of, typically, debt finance to manage the fall in demand and turnover. As such the extra demand for finance amongst SMEs is likely to vary by sector, depending on the extent to which their output demand is impacted by COVID-19. As noted in Paragraph 7.6, businesses applying COVID-19 safety measures are likely to have a higher operational expenditure requirement and so this is likely to boost demand for working capital.

Some reluctance from SMEs to take on additional external finance

7.16 Despite low interest rates and good available access to finance, there has been reluctance by SMEs to take on external finance from the private sector. According to the SME Finance Monitor, the use of external finance by SMEs fell from 38% in January to 30% in April 2020. This was largely driven by the fall in the use of external finance by the self-employed and medium-sized firms. Further the

proportion of SMEs that had injected personal funds (internal finance) increased from 19% in January to 27% in April 2020.

- 7.17 However, reasons for this could be that many of the emergency response schemes are still in place. The picture of demand will become much clearer once these schemes have come to an end.
- 7.18 Another important consideration for the demand for external finance is that SMEs will be required to make their repayments (of any emergency funding they have sought, as well as existing debt) in unfavourable economic conditions, including the possibility of a prolonged recession. Plus, high gearing by SMEs means they could face difficulties in obtaining additional external finance in the medium term from the private sector.

Growth prospects for some sectors

- 7.19 There may be some sectors whose growth prospects have been enhanced as a result of COVID-19 (such as manufacturers who have switched to producing PPE, sectors supporting working from home infrastructure and the pharmaceutical industry), however the extent to which this is the case, and the impact of this on their appetite for external finance, is highly uncertain.
- 7.20 There is also emerging anecdotal evidence from consultees that demand for finance from start-ups and early stage technology companies has remained strong and could rise. This is because:
- Many early stage technology companies and start-ups rely less on face to face customer contact (so are unaffected by social distancing restrictions). In addition, some of the pre-revenue businesses will still be in their initial R&D phase.
 - There could be a 'push factor' for individuals who have been furloughed or have been made redundant to start their own business. This could increase demand for finance.

Supply of Finance

Wales had the highest rate of applicants to UK Government Schemes

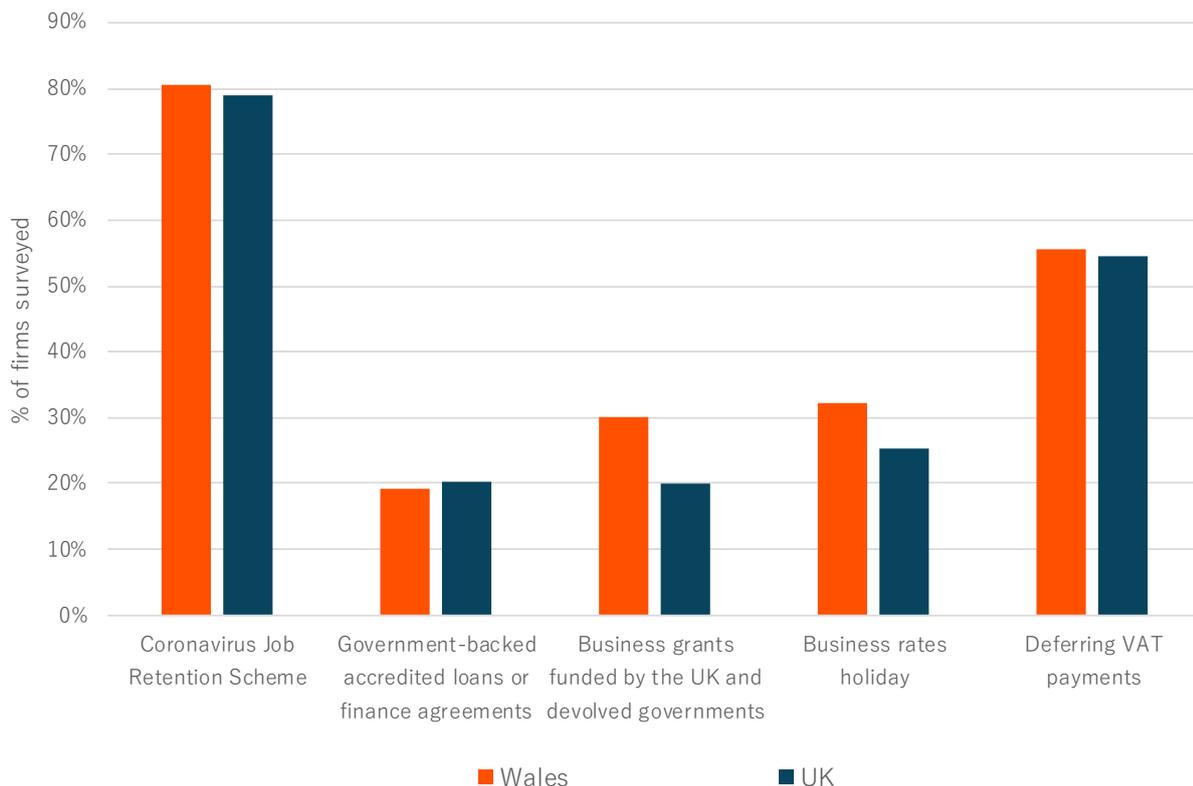
- 7.21 We have outlined in Chapter 3 the range of UK and Welsh government support measures that have been put in place to provide support for businesses. As of June 2020, the total value of financial support in Wales offered stands at £1.35bn.¹¹

¹¹ Economic Intelligence Wales Annual Report, June 2020

From this, £696m was related to the business rates grants scheme that was launched by the UK Government and £235m was grants from the Economic Resilience Fund, while the Development Bank of Wales received 1,608 applications for the newly established Covid19 Wales Business Loan Scheme. The latter was fully subscribed one week after its launch with take up of £100m of debt funding.

7.22 The latest data from the BICS survey shows that for all the government support packages, Wales had a higher share of firms applying compared to the UK average. 81% of firms surveyed in Wales applied for the Coronavirus Job Retention scheme, the second highest of all devolved administrations. Notably, 30% of firms surveyed in Wales applied for emergency business grants (vs 20% across the UK) which is the highest of all devolved administrations (due to the greater use of emergency grant funding as policy response in Wales vs the rest of the UK). The take up of repayable finance has been lower than other forms of support amongst Welsh firms (c19%), with only a modest difference to the overall UK take-up.

Figure 7.5: Applications by firms surveyed to government support packages to assist with impacts of COVID-19

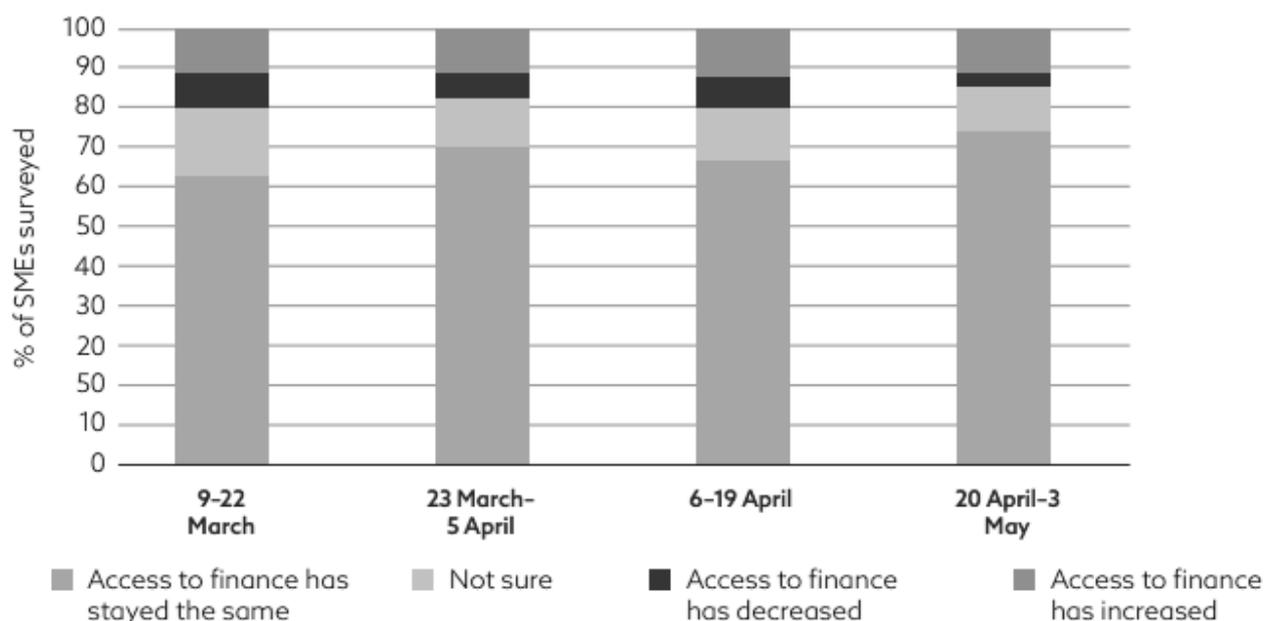


Source: ONS, Business Impact of COVID-19 Survey data 1 June to 14 June 2020. Note: Based on a survey of 6,092 businesses.

High street banks are better prepared compared to 2008 recession

7.23 There is some emerging survey and anecdotal evidence that the commercial finance providers (including high street banks) are in a healthier position now compared to the 2008 financial crisis. The BICS survey shows that while access to financial resources has remained unchanged for most SMEs, the share of SMEs surveyed reporting that access to finance has decreased has fallen from 8.8% in March to 4.7% in April/May (government support schemes are likely to have contributed to this).

Figure 7.6: Change in UK businesses' ability to access finance



Source: Economic Intelligence Wales Annual Report (June 2020), drawing on the ONS BICS

7.24 Other evidence of this is the flexibility offered for existing lending (such as mortgage holidays, interest free overdrafts). However, this is to the backdrop of the range of government support schemes (including guarantees on loans from the Government). It is still uncertain as to how these flexibilities and willingness to lend will be impacted once these support schemes are no longer active.

Early stage equity investment under threat

7.25 In 2020, there was already a slowdown in equity investment. In Q1 2020, there were 420 announced equity deals, an 8% decrease from the previous year¹².

7.26 Anecdotal evidence from consultees suggest that it could be new equity investment which is most impacted by COVID-19. Under the conditions of high uncertainty and a contracting economy, there is an incentive for venture capital (VC) investors to concentrate on protecting/conserving their existing portfolios, rather than investing in new propositions.

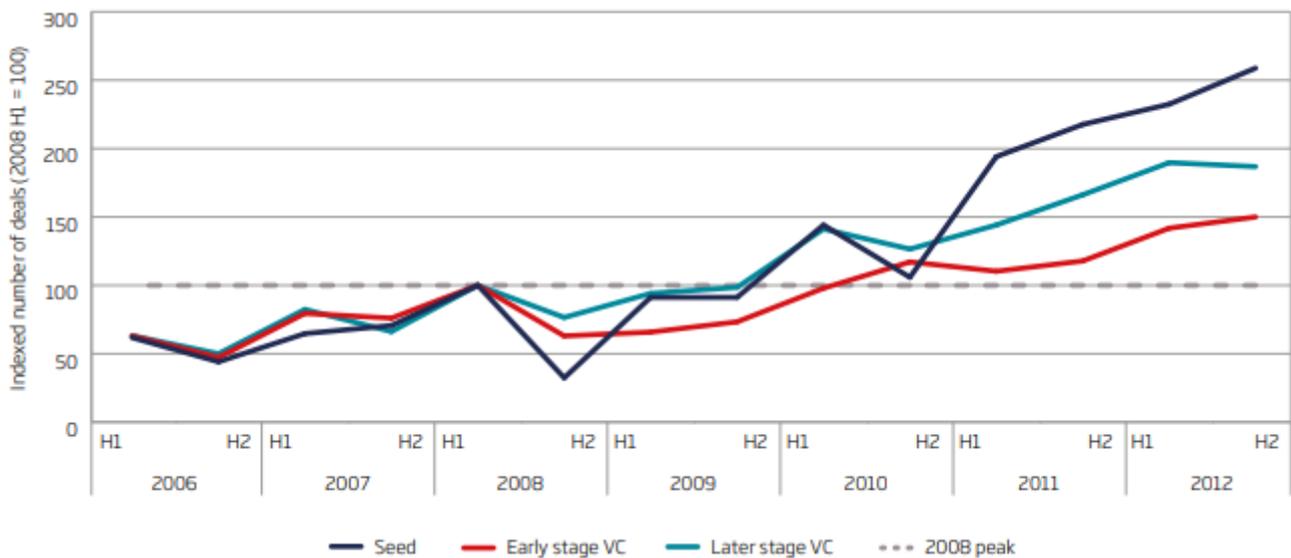
7.27 There is some evidence however that VC's could continue to invest despite the challenging economic climate. UK VC funds currently have record amounts of resources ready to invest. Data from Preqin shows UK VCs collectively have £9.5bn of reserves, which potentially equates to 13 to 17 months of investment based on

¹² BBB Small Business Equity Tracker, 2019

2018 and 2019 VC investment levels. Whilst the potential for losses within their portfolios is currently unclear, the appetite for new equity investment in Welsh SMEs will remain to some degree.

7.28 Data from the 2008 financial crisis could provide some insight into the behaviour of VCs (noting that the nature of the shocks are different, but there was still considerable uncertainty and a contracting economy present in 2008 similar to the current situation). The data shows that there was sharp initial decline in the number of deals but then recovery within 12 months. PitchBook data shows the value of UK VC deals declined by 44% between H1 2008 and H1 2009 and the number of deals by 38%. The impact was greatest at the earlier VC stages due to their higher levels of perceived risk. PitchBook data shows the number of deals at the seed stage also declined by 68%, compared to 37% for early stage VC and 24% for later VC stages between H1 2008 to H2 2008. The decline in investment value was even greater, with seed stage investment declining by 78%, early stage VC declining by 33% and later stage VC declining by 51% between H1 2008 and H1 2009.

Figure 7.7: Number of UK VC deals by VC stage 2006 to 2012, indexed to 2008 H1 levels



Source: British Business Bank analysis of PitchBook data

Shift towards investment in later stage companies

7.29 The impact of COVID-19 could cause companies to appear less viable to investors due to reduced demand for their products/services, difficulty in forecasting revenue streams & therefore developing strong business plans. Companies are also likely to be missing existing KPIs and milestones due to the challenging economic

conditions. As a result of these factors, investors are likely to become more selective in their investment focus and will concentrate on investing in later stage companies perceived to be lower risk as they can demonstrate existing revenue streams and viability post COVID-19. Likewise, seed stage deals are the most likely to be affected as they are the highest risk; despite being generally less directly affected by changes in product market conditions.

8. Implications for the Finance Gap

8.1 This section considers the implications of COVID-19 and the economic recession for the finance gap facing SMEs in Wales and the actions which may be necessary to ensure the WBF is best placed to address these challenges. It also takes account of the performance of the WBF to date across the two ERDF programmes areas.

8.2 It is important to reiterate a number of considerations here which have a bearing on the analysis which follows:

- The finance gap which SMEs face in seeking and securing external finance is not directly observable given the manner in which it is shaped by market failures in finance markets; it is necessary to use a range of different types of data to determine an appropriate basis for the public sector to intervene given the risks and returns (economic and financial) it is willing to secure.
- This is exacerbated by the current recession which is evolving quickly. It is subject to considerable uncertainty about the impact on the performance of businesses and their need for external finance, with a lag in much of the data used to assess the demand and supply conditions in the SME finance market. This will also be affected by future health related measures.
- Whilst many of the short term measures to aid SMEs will be ending in the coming months, it is not clear what additional measures the UK government may pursue to assist businesses. There is the potential for these measures to have a significant implication for the proposed actions for WBF.
- Whilst the financial sector currently has good liquidity in contrast to the recession following the global financial crisis, which has helped them (along with government resilience measures) to continue lending to SMEs. It is not clear how their behaviour may change as defaults and bad debts increase.

8.3 Table 8.1 below sets out an initial high level summary of demand and supply conditions for different types of SME finance which the WBF targets. It also highlights the current view on the possible impacts of COVID-19.

Table 8.1: Summary of Market Conditions by Finance Type

	Demand Conditions	Supply Conditions	Finance Gap Implications
Finance for Microbusinesses	<ul style="list-style-type: none"> • Pre-COVID-19, there was evidence of a large stock of microbusinesses that is driving growth in the Welsh SME business base. • There was also a significant increase in the start-up rate in Wales over the past few years. • Not yet clear how recession will accelerate death rate amongst these businesses. However, as a result of COVID-19, demand for cash flow credit facilities has increased significantly. 26% of businesses in the UK had either no cash reserves or cash flow remaining for up to 3 months – majority of these are likely to be microbusinesses. • There could also be increased demand from microbusinesses due to the push factor of furloughed/redundant workers who start their own businesses. 	<ul style="list-style-type: none"> • Bank lending data before COVID-19 shows the average value of loans made to smaller businesses is much higher than the amount typically sought by microbusinesses. • The sub-£50k space has largely been catered by publicly backed initiatives - SUL and Wales Microloans Fund. • There has been strong take up of the emergency COVID-19 response funding by Welsh SMEs (Wales has the highest rate of applications compared to other devolved administrations) with take up of around £796m in emergency loans, grants (note that is unclear as to how much of this take-up is by microbusinesses). 	<ul style="list-style-type: none"> • The evidence suggests there will be growing demand for debt finance for microbusinesses, with a focus on working capital. At the microloan level, there appears to be adequate supply through other publicly backed schemes (including other funds that the DBW manage) and government support measures (although these are time limited).
Debt for Established SMEs	<ul style="list-style-type: none"> • Pre COVID-19, there was strong demand for external debt finance from established SMEs in Wales • Prominent & growing sectors in Wales including retail, manufacturing, construction and accommodation/food services all have a greater propensity to make use of debt finance when they have funding needs. These sectors are also those that have borne the brunt of damage from COVID-19. 	<ul style="list-style-type: none"> • Pre COVID-19 there was falling bank lending in Wales, falling by 13% (£0.8bn) from 2013. • Pre COVID-19, the use of alternative finance has grown but remains small in the context of overall lending in Wales. • Supply conditions are likely to remain stable post COVID-19 for established SMEs as banks are in a healthier position relative to the 2008 financial crisis. However, this will become 	<ul style="list-style-type: none"> • The evidence suggests there is a case for the increase in provision for debt finance, with a focus on providing working capital in both EW and WWV.

	Demand Conditions	Supply Conditions	Finance Gap Implications
	<ul style="list-style-type: none"> • As a result of COVID-19, there is likely to be an increase in the requirement finance for survival and sustainability rather than growth. Wales had the highest rate of applicants of UK govt emergency COVID-19 loan/grant funding. • Demand for external finance could fall for these sectors as they may be already highly geared & have bleak future trading prospects. 	<p style="text-align: center;">much clearer when the government support schemes end.</p>	

	Demand Conditions	Supply Conditions	Finance Gap Implications
Early Stage Equity	<ul style="list-style-type: none"> • Pre COVID-19, Wales performed strongly on innovation indicators – a proxy for demand for early stage equity. • In EW, employment growth before COVID-19 was driven by professional services and ICT companies, which could indicate stronger demand for equity finance in the future under normal economic conditions. • In WWV, employment is dominated by the public sector, manufacturing and construction. These sectors tend to have low propensity for equity finance. • The strategic direction of the Welsh economy before COVID-19 suggested that in the coming years there could be a growing need for equity finance given the nature of the sectors which are earmarked for growth - all of the National Thematic Sectors & those outlined in the UK Industrial Strategy have a strong focus on innovation. • COVID-19 likely to curtail businesses growth & investment plans (which is the main use of equity finance). This could suppress demand in the medium term. 	<ul style="list-style-type: none"> • Pre COVID-19, there was an increase in supply of early stage equity in Wales, but this was mainly driven by the DBW. • But WBF has been struggling to meet equity investment rates in WWV. There has been strong investment performance in EW. • There were signs the UK equity market was beginning to soften in 2019 before COVID-19, with a decline in seed stage investment. There has been a general maturity in the UK early stage equity ecosystem, with a shift towards larger deal sizes. • There are few other significant players in this area in Wales. For those active players, COVID-19 could force them to conserve and invest in their existing portfolio, rather than in new companies. • As a result of COVID-19, there is likely to be a shift by the market into later stage, less risky businesses, at the expense of early stage businesses. 	<ul style="list-style-type: none"> • The evidence suggests there is a strong case for reducing the amount of equity investment in WWV. The required investment rates will be very challenging to achieve, especially as demand for equity finance by SMEs in WWV is expected to fall as a result of COVID-19. • In EW, the WBF is nearly fully invested. There could be a case for an increase in early stage equity investment however the demand here is also expected to be for debt finance for working capital.
Expansion Equity	The demand conditions are the same as outlined for early stage equity.	<ul style="list-style-type: none"> • Pre COVID-19, the WBF has helped to increase the supply of expansion equity in Wales over past few years. There are very few other active players in Wales, and so the DBW is 	The finance gap implications are the same as outlined for early stage equity.

	Demand Conditions	Supply Conditions	Finance Gap Implications
		<p>still the main provider of expansion equity.</p> <ul style="list-style-type: none"> • There is likely to be a shift towards later stage less risky businesses as a result of COVID-19, but there could be fewer investible propositions coming forward, especially in WWV. 	

Principles and Considerations

8.4 In thinking about the potential implications of the assessment for the WBF, the following considerations should be borne in mind:

- COVID-19 has led to an unprecedented impact on the UK and Welsh economies to date and, although uncertain, the recession is likely to be deep and prolonged. The full impacts on Welsh businesses and the economy is not likely to be seen until the Autumn. Even allowing for the UK and Welsh Governments' response, we expect this to result in a major shift in the nature of the demand for external finance from WBF. Whilst there will continue to be a need for growth orientated finance, there will be a big shift in demand to working capital over the next 9-12 months in order to ensure the survival of many businesses and safeguard employment (noting that given the dynamic circumstances it is difficult to predict how long this requirement will last).
- Whilst there may well be a major shift in demand for finance to working capital over the next year, there is also a need to be as flexible as possible in the mix of debt and equity which the WBF is able to provide to businesses (alongside other DBW funds). This reflects the uncertainty about how deeply the economy is impacted, including scope for substantial variations across and within sectors in Wales.
- Whilst there may still be a case for further grant assistance or soft loans to the worst affected SMEs in Wales, it is important that the WBF (and DBW) continues to focus on repayable finance provided on a commercial basis (and targeting the finance gap). This is important to maintaining the brand and market positioning which has been established by the Bank.¹³
- Likewise, it is important that WBF maintains its financial discipline and prudent investment. Whilst higher defaults and write-offs is inevitable in the face of higher risks, the need to provide much needed finance to businesses needs to be balanced against the ability of the businesses to repay the finance (and to continue to contribute to the Fund's overall legacy return). In effect, there is a need to balance the important role WBF can play now in helping businesses to

¹³ The exception to this is the COVID-19 Wales Business Loans Scheme. This is an emergency funding scheme in response to COVID-19 and therefore there is temporary provision of lower interest rates to respond to the crisis and in line with pricing of the British Business Banks Bounce Back Loans.

survive, with its role in securing the legacy return and hence economic development benefits in the future.

- We expect there to be a greater need for a patient investment approach across the early and growth equity portfolios (together with a willingness to take some higher risks in order to secure longer term payback) as the recession impacts on realisations. Even though WBF has a full decade until the end of the realisation period, the experience from the last recession and the JEREMIE Fund clearly highlighted the importance of this patient approach (and avoiding fire sales).

Implications for the Investment Strategy

What does the assessment mean for the remainder of the WBF's investment and realisation period?

1. Shift in demand for debt finance from growth to working capital

- There is likely to be strong demand for debt finance in both programme areas. Given the challenging economic conditions, many of the SMEs which the WBF targets will have shifted their ambitions from expansion and growth to focussing on survival and sustainability over the next 12 months at least. This suggests there will be a significant shift in demand towards increased demand for finance for working capital purposes across both ERDF programme areas. The evidence for this is as follows:
 - The scale of the economic impact of COVID-19 on the Welsh and UK economies. The latest Bank of England forecasts indicate that GDP is projected to fall by around 14% in 2020. A key driver of GDP is the turnover and profitability of businesses and an unprecedented fall in GDP is a good indication of the extent to which the working capital of businesses is being eroded.
 - Survey evidence on the impact of COVID-19 on businesses turnover shows that around 65% of businesses in Wales have experienced a fall in turnover. 47% of Welsh businesses have had their turnover fall by over 20%, the second highest of all UK regions. Further, around 25% of Welsh businesses have less than 3 months cash reserves, the highest proportion of all UK regions.
 - Take up data for CWBLS shows a significant take up of finance for working capital purposes in a very short space of time. Over £92m has been invested in Welsh businesses over a 4-month period, and the

fund was fully subscribed within a week. The average CWBLS loan was around £67k (compared to an average loan size of £322k for the WBF). When looking at the CWBLS data for the range at which the WBF invests (i.e. so excluding loans below £50k), the average investment is around £113k.

- It should be noted that changes to policy and the nature of economic recovery could have implications for this recommendation. A v-shaped recovery could imply less finance for working capital, and a prolonged economic downturn could extend the requirement of funding for working capital longer than the 12 months we have suggested here.
- Given this increased requirement for working capital, the fund should be allowed to fund sole traders/proprietors. Many of their requirements will be for finance lower than £50k (this is below the current limit that the WBF can invest in). Whilst there could be increased demand for finance at this sub £50k level, the market assessment evidence indicates that this can be met by other suppliers and initiatives (eg the Start-Up Loans scheme, and other DBW funds such as the Microloans fund). Therefore, the WBF should continue to not fund investments below £50k.
- The assessment has shown that the delivery of equity investment in West Wales and the Valleys was already much more challenging to achieve than DBW expected (and it should be borne in mind that this was a stretching target), with the Fund behind on its profile investment rate for equity (-3%), particularly for later stage equity investment where the fund is 32% behind its investment target. This will be further exacerbated by COVID-19, as the demand for equity finance is expected to fall at least for the next twelve months. However, the demand for early and growth equity has been strong in the East Wales programme area (across WBF and other DBW funds operating in this area, with equity investment at 50% above profile).

Suggested Actions

- Provide greater flexibility for the WBF to meet businesses requirements for working capital at least over the next 9-12 months.
- This could affect the average size of new loans (if demand is similar to CWBLS, it is likely to be on the lower end of its current loan range i.e. c£50,000-£150,000). However, the DBWs current investment pipeline is for

larger deals, as the private sector has been active in smaller investments due to the Bounce Back Loan scheme and CBILS. This will nevertheless need to be considered in the revised investment strategy and financial modelling by the DBW.

- DBW will also need to consider the timing of the expected shift back from the demand for working capital towards growth finance (although there will be some variation in this by sector) in the revised investment strategy.

2. Increase in default rates and lower legacy and economic development returns

- The current economic crisis will have implications for default rates and write-offs for the Fund, affecting both the current portfolio and future loans and equity investments. As trading conditions and business prospects are now much more challenging, it is expected that the default rate for the WBFs investments will increase. The evidence for this includes:
 - The write off rate assumed in the business plan (pre COVID-19) was 25%, with 15% for loans and 40% for equity. The fund has been consistently below this with an overall write-off rate of 7% as at Q1 2020. Following COVID-19 and the portfolio review, the current assumed write off rate for the WBF is 20% for loans, 25% for existing equity investments and 50% for new equity investments.
 - The DBW have recently completed a review of the portfolio and applied a provision of 50% for all investments deemed to be at risk from COVID-19, amounting to £8.5m in specific provisions and write offs as at March 2020.
- The overall financial return and hence the legacy return that the WBF could generate is likely to be lower than expected (in both programme areas, but especially WWV) due to:
 - Lower returns on investment given the expected higher rate of defaults and write offs
 - Lower realisations due to an expected shift in the overall balance between equity and loan investments than expected in the future
 - Delayed returns due to a more patient investment approach (for both debt and equity investments).

- This will in turn have significant implications for the economic development KPIs for the fund. The economic forecasts point toward no overall economic growth for the next year at least. Businesses that were expecting to grow in this period (and therefore generate economic development returns) will now do so further in the future (and potentially after the ERDF programme has closed for monitoring purposes), whilst others may not survive. We outline in further detail below the implications for the KPIs.
- It should be noted that changes to policy and the nature of economic recovery could have implications for this recommendation. A v-shaped recovery could imply lower defaults (as businesses shift back to growth). A prolonged economic downturn could increase the default rate even further which would result in a significantly lower legacy than is currently projected.

Suggested Actions

- DBW to remodel the legacy forecast in the revised investment strategy.
- DBW to continue to review the portfolio on a regular basis and update default/write-off assumptions (and the implications of this for the legacy).

Is there a need to change the focus and delivery of the WBF?

3. Allow early stage investments at a lower co-financed rate

- Given the scale of the challenge in meeting the equity investment target in the WWV programme (both due to existing conditions and the impact of COVID-19) – the fund is at 31% of its profiled investment target for later stage equity investment - there may be scope to use the Temporary Framework for State Aids to enable WBF to make early stage investments at a lower co-financed rate. DBW estimate that this could enable a further £2.5m of investments to be made, subject to the duration of the flexibility (it is currently due to end in December 2020) as well as the usual investment appraisals and due diligence. The evidence for this includes:
 - The annual investment rate for early stage equity in WWV has been around £2.8m, against a target of £3.5m (for equity overall in WWV it has been £4.1m per annum against an £8.1m target). This is likely to fall further over the next 12 months given the evidence suggests economic conditions will be challenging going forward (and the demand will be predominantly for working capital, as outlined above).

- The experience of the Welsh JEREMIE fund illustrates a sharp fall-off in demand following the last recession, due in part to the deterioration in the flow of good investment propositions. The average annual equity investment rate in WWV fell to £6.3m between 2012-15 from an average of around £10.8m in between 2009-11.
- The DBW do not envisage using the Temporary Framework for many investments. As an indication, it is envisaged that it could be used for 3 investments before the end of 2020, with investment of £2.4m. This is out of a total proposed investment of £3.8m this financial year for early stage equity in WWV. If the State Aid Temporary Framework is extended, a similar volume and value of investments could be made under the framework in WWV in 2021/22.
- Therefore, even with the additional investments that could be made from a lower co-finance rate, the investments targets are unlikely to be achieved (suggesting a need to move investment capital out of this Strategic Objective).

Suggested Actions

- There is a case for providing flexibility for the WBF to fund early stage equity investments in the WWV at lower co-finance rate than the current requirement of 30%. However, whilst the market assessment provides little firm evidence to indicate the scale of additional investment which this could unlock and how this varies by the scale of the reduction in the co-financing rate (i.e. between 30% and 0%), the DBW have provided an indication of the investment that could be unlocked, and that it would be used for a small number of deals. DBW will need to include the expected change in the overall investment rate for early stage equity in WWV if this change is implemented in its financial modelling.
- Consideration also needs to be given to the implications of a lower co-finance rate to match funding at the overall fund level (noting however that the fund is currently at 180% of its profiled private sector leverage target. Therefore, undertaking a small number of investments at lower than 30% match is not expected to have a significant impact on this target.).

4. *Re-allocate growth equity investment to debt in WWV*

- If the WWV programme is to respond to the prevailing finance gap, there is a need to reallocate ERDF grant allocated to equity investment to debt finance. This is justified on the basis of expected demand for investment under SO2.1 (growth equity), but also could be justified under SO2.5 (although this will be influenced by any flexibility related to nic which could increase investment). Whilst this will have implications for the economic development KPIs and the legacy of the fund compared to the original targets, it would play an important role in helping to protect businesses in the programme area. The scale of the re-allocation from equity to debt also needs to take account of the future call on equity to meet the need for follow-on and possibly refinancing requirements of existing portfolio investments.
- It is difficult to be precise about the scale of reallocation that is required given the uncertainty regarding future economic conditions. The annual investment rate for growth equity in WWV has been £3.2m behind profile to date (annual average investment of £1.3m per annum) and this is expected to fall further over the next 9-12 months (and possibly longer) as businesses retrench and reappraise their growth plan. There is however, the possibility of new sources of demand for equity finance as businesses pursue the opportunities for growth created by the pandemic and Welsh Government prioritises its support for growth orientated businesses through the Accelerated Growth Programme.
- Whilst the nature of the crisis was different, evidence from the Welsh JEREMIE fund provides a useful indication. As outlined above, the annual investment rate for equity in WWV was £8.2m. Between 2009-11 the average annual investment rate was £10.8m, but between 2012-15 it fell to £6.3m (a 60% reduction) due in part to the impact of the recession on the flow of growth orientated businesses seeking equity investment.
- As an illustration, we assume that the annual investment rate for growth equity will initially fall by 50%, and then a 25% reduction (relative to current levels) in the following year, before returning to trend. This equates to a shortfall of around £6.6m per year compared to the business plan, or £26m overall.
- However, later in the investment period, the rate could increase due to the effects of the reorientation of the Accelerator Growth Programme plus any

policy responses that stimulate economic growth and therefore the recovery. As an illustration, if in 2022 and 2023 investment rates are at the current annual target (of £4.6m), the shortfall would then be £20m or £5m per annum overall.

Suggested Actions

- DBW to test the investment strategy on the basis of a re-allocation of growth equity finance to debt in WWV of around £5-£7m per annum (or £20-£26m overall).

Is there a need to change the scale of the fund?

5. Increase funding in WWV

- The amount left to be invested in WWV is £55.5m over 3 years (of which just £9.2m is allocated to debt), equivalent to an annual average investment rate of £18.5m. Based on the implementation of the actions highlighted above, the assessment suggests there would not be a need to reallocate ERDF grant out of the WWV programme. The market assessment, allowing for the uncertainties, provides evidence to support this conclusion.
- The scale of the challenge facing businesses points to a continuing need for substantial levels of additional external finance in WWV which is unlikely to be provided by high street banks given market failures and the changes in the finance gap. There are several aspects of uncertainty in this regard however including the possibility of an extension of current supply side measures by the UK government (and the existing gearing of these businesses) or the introduction of new measures.
- In terms of the demand for additional external finance the evidence currently available includes the following:
 - The take up of CWBLS (as well as other schemes such as CBILs, BBL and grants from the Economic Resilience fund) by businesses in WWV provides an indication for the demand for finance, particularly for working capital. CWBLS experienced unprecedented demand, lending around £56m to 817 businesses in WWV (at average value of around £68,400).
 - The previous JEREMIE fund provides an indication of the extra demand for short term debt finance created by an economic shock (although in that instance it was a supply side shock, and there are

more debt providers active now compared to the financial crisis).

Following the financial crisis, debt investment in WWV stood at £27m which was nearly £8m higher (+37%) than the profiled investment rate, with an average investment per SME of around £90k.

- It is also highly likely that businesses which have not yet taken advantage of the COVID-19 related external finance available may require it as the impact of the COVID-19 impacts persist, as well as existing borrowers who will require additional external finance. However, there is considerable uncertainty regarding the scale and duration of this additional demand for working capital, as well as possible changes to the behaviour of the private sector commercial lenders and further UK government responses (either extension of current schemes or the launching of new ones). However, the overall message is that over the next 9-12 months at least, there will be continued demand in WWV for external finance.
- Subject to this considerable level of uncertainty, there could be scope to increase investment in WWV by an additional £5m-£10m per year over the period which the additional demand for working capital persists (e.g. a minimum of 9 to 12 months). This range is based on our judgement in considering the evidence above, and considers not just businesses requirement for finance, but also the extent to which this addresses market failure, the requirement to generate economic benefits and financial returns, and to minimise defaults/write-offs. Given this reliance on judgement here, it will be important that DBW critically considers the evidence related to demand and models the scenarios using the best available information to help inform the assumptions relating to potential write-offs and the financial return.
- The upper bound of an additional £10m per year is suggested in light of the strong take up of CWBLS (£56m over just three months – even if demand were 50% of this, it would still be significant and require additional funding in WWV. However, it should be noted that CWBLS offered lower interest emergency funding at a time when other providers were not as active/responsive, and so is difficult to draw direct comparison to the WBF). The requirement for additional investment capital would be higher in the very short term (i.e. the first year of the remaining investment period) and then is

likely to tail off as economic conditions recover and businesses shift their priorities towards growth.

- It is possible that other national SME finance initiatives are extended or are introduced in order to provide working capital to SMEs on a similar basis to that proposed through the WBF. It is unlikely that this would remove the justification for the proposed additional finance for WWV through WBF, as national initiatives are unlikely to have the same penetration as the WBF with SMEs in WWV. However, we have also suggested a lower bound to reflect this possibility, as well as other uncertainties associated with the level of demand.

Suggested Actions

- DBW to test the implications for the WBF investment strategy of an additional investment capital of between £5m and £10m for debt finance in WWV over the period which the additional demand for working capital may persist (e.g. a minimum of 9 to 12 months).

6. Increase funding in EW

- In the EW programme area, the WBF has just £4.5m left to be invested (£1.5m per annum), all of which is allocated to debt finance. As in WWV, there is a strong case to increase the scale of investment in response to the expected increase in the demand for working capital. There may be some scope here for increased equity investment too (e.g. particularly in technology & life science companies).
- Allowing for the scope to support companies in EW through other DBW funds, there could be a case for an additional £5-£10m of investment capital per year in EW. The evidence to support this includes:
 - In addition to the strong demand observed in the WBF in EW, data from the take up of CWBLS in EW also provides an indication of the demand for finance. £30m has been invested in 476 businesses in EW (at an average value of £63,000 [add average excluding loans of less than £50,000]). This represents 1.1% of all SMEs in EW (the figure is 1.3% in WWV). An additional £10m would increase this to 1.3% and 1.4% in EW and WWV respectively.
 - If the additional investment was allocated in proportion to the size of each of the programmes (i.e. the proposed increase in investment

capital in EW was in proportion to the proportionate increase in WWV), the increase in EW would be around £4.6m per annum. We are suggesting a higher figure here though in recognition of the scale of demand for working capital in EW, the difference in ability of businesses to access finance in each area, plus that the WWV is benefiting from investment capital switched from equity to debt.

Suggested Actions

- DBW to test the implications for the WBF investment strategy of additional investment capital per year of between £5m and £10m for debt and equity finance in EW.

Is there a need to change the terms on which the WBF operates

7. Use flexibility in repayments to support businesses to borrow

- There will continue to be a need for WBF to provide businesses with flexibility related to the terms of their repayments (including repayment holidays) in order to minimise defaults and write offs. This will however have implications for the timing of the legacy.
- As noted earlier, we expect there to be a greater need for a balance between patient and prudent commercial investment approach across the early and later stage equity portfolios in response to the impact of the recession on realisations.
- The WBF should practice a patient approach to investments (in terms of generating returns and repayments). This is usually applied in the context of equity investment but given the challenging economic conditions, it is recommended that this is applied to loan investments as well.
- Under the current circumstances there is not an immediate requirement to amend the investment or realisation periods for the WBF (and the scope to change the former may be limited). The need for the latter needs to be monitored over time.
- Another mechanism to reduce the cost of borrowing is to lower interest rates. However, given the principles outlined at the outset of this note (prudent investment practices and the DBW's commercial ethos) rates for new loans should continue to be set at the prevailing market rate, adjusted for the level of risk of the businesses that the DBW invests in. This is applicable to both working capital and growth finance. For working capital, the Temporary

Framework has provided flexibility until December to lower interest rates. Even with this flexibility available, and the likely requirement for working capital beyond December, we recommend that the interest rates for the WBF continue to be set at the market rate.

- Repayment flexibility and interest rates need to be monitored in-line with changes to policy and the nature of economic recovery. A v-shaped recovery could imply stronger growth prospects and therefore less flexibility in repayments (although we would still recommend a patient approach to investment). A prolonged economic downturn could extend the requirement of more flexibility.

Suggested Actions

- DBW to revise investment strategy to account for repayments from businesses over a longer period.

Are the KPIs still appropriate?

8. Adjust existing KPI Targets

- As indicated earlier, given the economic conditions and proposed changes there is a need to reassess the lifetime KPI targets. This includes:
 - Investment KPIs - number of investments, value of investments (initial and follow-on), average value of investment
 - Economic Development KPIs – jobs created, jobs safeguarded, survival of firms
- For the innovation focussed KPIs, performance has been above profile (and in some cases lifetime targets have already been met). However, removing investment capital from equity in WWV will have implications for these KPIs going forward. Overall, there is no need for these to be reconsidered given the strong performance experienced to date.

Suggested Actions

- Hatch to work with the DBW to consider the implications on KPIs of the possible changes to the investment strategy following initial modelling of the above recommendations by DBW. This needs to also consider the reasons for the underperformance to date on the job creation KPI in so far as it may be relevant to any revision of the overall WBF KPIs and have implications for the ERDF programme targets.

Part B - Review of Proposed Changes to the Investment Strategy

9. Review of Investment Strategy

9.1 This section provides a review of the updated investment strategy, which has been revised following the sharing of the findings from Part A of this assessment (referred to as the revised investment strategy). It focuses on the key changes compared to the previous investment strategy reviewed in the 2018 update of the ex-ante assessment (referred to as the previous investment strategy). Where no changes have been made, this has been stated. The investment strategy has been revised by the DBW based on discussion with Welsh Government and Hatch. We review:

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

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

Proposed Fund Size and Composition

9.3 The WBF will be a £195m fund (an overall increase of £15m relative to the current investment strategy). The revised investment strategy for the WBF draws upon DBW's own investment experience since the start of the COVID-19 pandemic, as well as findings from Part A of this updated ex-ante assessment.

9.4 A summary of the proposed changes are outlined in Table 9.1 below. Based on this, and the market assessment, the key points to note are:

- There is an increase of £15m in investment capital in WWV, based on:
 - A virement of £25.4m of investment capital from growth equity to debt (a reallocation within Specific Objective 2.1), and £2.4m from early stage equity to debt (a reallocation between Specific Objective 2.5 to Specific Objective 2.1).
 - An additional £15m of investment capital for debt finance (an increase in Specific Objective 2.1)

- This is at the upper scale of the additional investment suggested in Part A of this market assessment, and has been justified by DBW based on the expected demand for finance (particularly for debt and working capital). This is appropriate given the unusual circumstances and unprecedented economic shock. There is also some flexibility in the investment strategy to provide growth finance if the economy and nature of demand for finance recovers quicker than is expected. Given the Funds' previous experience of underinvestment of equity in WWV, this flexibility is important.
- The majority of this increase in the investment capital for debt is from a virement from growth equity. This is sensible, given:
 - The conclusions from the market assessment on the weight of evidence about the major shift to working capital (debt) and simultaneous reduction in demand for growth finance
 - The already challenging investment targets in WWV for growth equity, and the fact that the fund is behind its profiled targets.
- In EW, there is no change to the overall investment capital. As in WWV, the market assessment pointed to an increase in the demand for finance here too (of c £5-£10m), however the unavailability of additional investment capital (from ERDF or other WG sources) means that there is no additional investment capital allocated to EW.
- Within EW, there is a virement of £1.6m from debt to equity. The market assessment does not specifically recommend this change. However, this has been justified by DBW on the basis that the fund is nearly fully invested (and so there is limited scope for any virement of funds to debt finance and no additional investment capital available) and is based on deals completed since March 2020 and the pipeline of new and follow-on equity investment that the DBW has identified in EW (and hence the requirement for investment). This would also help to partially offset (albeit at a much low scale) the reduction in equity in WWV. Based on our review of the current work in view (WIV) for the WBF, this adjustment is appropriate.

Table 9.1: Changes to Composition of WBF Investment Allocation (£m)

	Previous Investment Strategy		Revised Investment Strategy		Change	
	EW	WWV	EW	WWV	EW	WWV
2.1 Debt	£27.6	£60.6	£26.0	£103.4	-£1.6	£42.8
2.1 Equity (Growth Capital)	£9.4	£36.7	£11.1	£11.3	£1.7	-£25.4
2.5 Equity (Early Stage)	£18.4	£28.2	£18.3	£25.9	-£0.1	-£2.4
Total	£55.4	£125.5	£55.4	£140.5	£0.00	£15.0

Source: Wales Business Fund Investment Strategy Revised (August 2020). Note: this shows level of investment that the WBF is making and does not include the deal level private sector matched finance

Table 9.2: Updated WBF Composition

Sub-Fund	Previous Investment Strategy		Revised Investment Strategy	
	Investment Capital (£m)	% of-WBF	Investment Capital (£m)	% of-WBF
Loans	£88.5	49%	£129.4	66%
Equity	£92.4	51%	£66.5	34%
-early stage	£41.1	23%	£44.1	23%
-later stage (growth)	£51.3	28%	£22.4	11%
Total WBF	£180.9	100%	£195.9	100%

Source: Wales Business Fund Investment Strategy Revised (August 2020)

9.5 Overall, the changes to the composition of the fund are consistent with the latest market assessment and available evidence. The approach adopted also provides some flexibility to adjust the provision of finance type if the economy recovers quicker than expected. However, it does not allow for the possible consequences, in economic or public policy terms, of a major second lockdown and/or a much more prolonged or deeper recession.

Sector Focus

9.6 Similar to the previous investment strategy, the WBF will be flexible with regard to the sector focus. The Investment Strategy states that “*The Fund is generalist, rather than sector-specific, which will give the Fund flexibility to invest across all eligible sectors. ERDF eligibility criteria will apply. The Fund will support the Economic Action Plan, the Welsh Government’s delivery approach to the 2017 Prosperity for all: a national strategy Economic Action Plan sets out the new regionally focused model of economic development*”.

9.7 This is a sensible approach which ensures that the Fund contributes to Welsh Government's aspiration to develop key sectors, whilst maintaining maximum flexibility in delivery. The need for finance amongst sectors which are not eligible for WBF investment is to some extent met by other DBW funds. Also whilst the pandemic has created a major requirement for financial assistance which will not be met by the private sector across all sectors, specific financial and non-financial support for WBF non-eligible sectors has been put in place by the Welsh Government.

Investment Strategy Modelling Assumptions

9.8 The WBF is underpinned by a detailed financial model, based on the DBW's experience of delivering financial instruments in Wales. Many of the key assumptions within the financial model remain the same as in the previous investment strategy. We review the key changes which have been made to the main assumptions below.

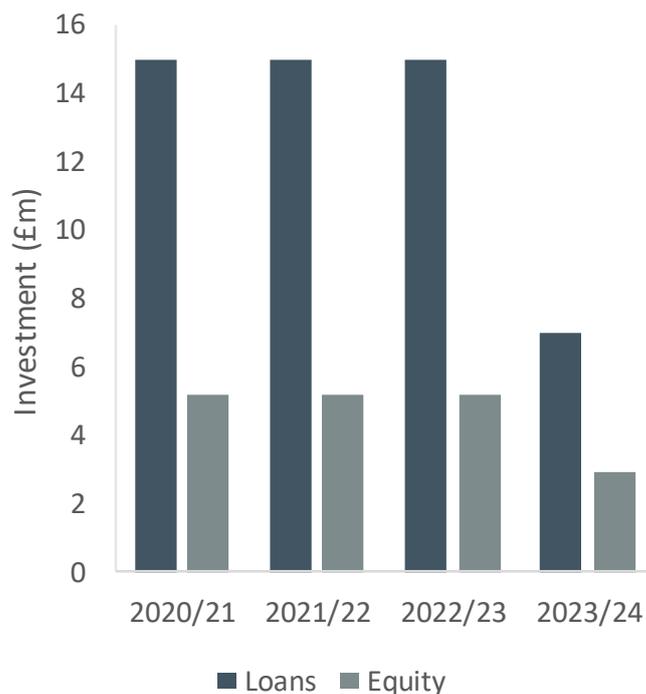
Investment Rates

9.9 In EW, the fund is nearly fully invested with just £4.5m left to be invested up to the end of 2023. All of this is profiled to be invested in 2020/21, with much of the investment already in the pipeline. Given the investment rate to date (£13.6m per annum overall) there is no obvious reason why this should not be achieved.

9.10 In the WWV programme area, there is now, based on the proposed revised strategy, £70.5m remaining to be invested (equivalent to around £17.5m per annum):

- For debt finance the required investment rate is £13m per annum. This is in-line with the rates for the Welsh JEREMIE Fund for debt and what has been achieved to date by the WBF in WWV (£13.4m and £13.7m per annum respectively). Whilst this is in-line with the market assessment evidence, it should be noted that there is uncertainty regarding the absorptive capacity of SMEs to take on additional debt finance, or the scale of investment risk if there is a large increase in the failure rate. Therefore, this needs to be very carefully monitored.

Figure 9.1: Revised Annual Investment Rates in WWV (£m)



Source: Wales Business Fund Revised Investment Strategy (August 2020)

- For equity, this is equivalent to £3.6m per annum. This is lower than the previous Welsh JEREMIE fund (£8.2m pa) and the experience of the WBF to date (£5m per annum). Assuming there is continued demand for equity finance in 2020/21, this rate should be achievable. A collapse in the demand for equity investment for the rest of the year (2020) would result in a required investment rate of £4.8m for the remaining investment period, per year, which is in-line with the equity investment rate achieved by the WBF in WWV to date. Further, in the previous investment strategy the DBW were too optimistic in terms of the achievable investment rate for equity in WWV (although this was mainly for growth equity, which now has a much lower amount of investment capital allocated to it). This suggests that if even more challenging conditions were to emerge in 2020, the required investment rate could still be achievable but it needs to be very carefully monitored.

Defaults/Write offs

9.11 The table below sets out the assumed write-off rates for each finance type in the WBF, compared to the previous investment strategy and the write-off rates achieved in the JEREMIE fund. The overall conclusion is that whilst the assumed rates are in-line with experience from the Wales JEREMIE Fund, they could be challenging to achieve given the difficult and uncertain economic conditions and

need to be carefully monitored throughout the remainder of the investment period. We recommend that the more pessimistic scenario in the investment strategy is used as the central case for future projections for the fund.

Table 9.3: Revised Write-off Rate Assumptions

	Previous Investment Strategy	Revised Investment Strategy	JEREMIE Fund Outturn	Comment
Loans	15%	20%	13%	<p>The revised assumption of 20% write-off over the life of the fund is reasonable given the performance of the JEREMIE loan fund (although it should be borne in mind that this is partly influenced by the supply conditions which saw banks reduce SME lending, and therefore investment propositions coming to JEREMIE were of a higher quality than originally anticipated, reflected in the lower write-off rate compared to the business plan). The extent to which this is the case for the WBF will depend on whether supply constraints continue going forward, but also that the economic shock here is a demand side issue rather than supply side (and therefore very different compared to JEREMIE).</p> <p>The current WBF default rate (write offs to date plus actual provisions) for loans is 12%, higher than its profiled rate, mainly due to COVID-19. This is expected to rise given future expected challenging economic conditions (although more investment capital for loan investments now means there is more potential for diversification). This could nevertheless be challenging to achieve and needs to be very carefully monitored.</p>
Equity	40%	40%	55%	<p>The assumed write-off rate for the WBF is lower than the current rate for the Wales JEREMIE Fund, which itself is much higher than its original business plan assumption (of 34%). The closer relationship between the DBW and Business Wales compared to the time of the Wales JEREMIE Fund could play a role here in a lower rate – as could the reduced provision of equity investment in WWV. However, given the pressure that COVID-19 and economic conditions are placing on businesses, (plus what has been observed in the JEREMIE Fund), this could provide the justification for a higher write off rate (eg in the sensitivity test below, the rate increases to 50%, which in our view is a much more sensible assumption to use).</p>

9.12 The default rates have been subject to sensitivity testing, examining the implications of an increase across all portfolios (shown below). In all scenarios, FTC funding of £30m is repaid in full, and so changes to the default rates affect the legacy only (it is also assumed the fund is fully invested and therefore changes to default rates have no implication on other KPIs).

Table 9.4: WBF Default Rate Sensitivity Test

Scenario	Legacy (£m)	Change on Base Case Legacy	ERDF % Return
<i>Previous Investment Strategy</i>	£99.3	-	74%
Base case (Revised Investment Strategy)	£107	-	63%
Increase equity to 50%	£97.6	-£9.3 (-9%)	59%
Increase debt to 30%	£91.4	-£15.6 (-15%)	55%
Simultaneous increase	£82.1	-£24.9 (-23%)	49%

KPIs

9.13 Each of the WBF KPIs have been reviewed and adjusted in the revised investment strategy. These adjustments are driven by:

- Changes to (i) the overall amount of investment capital, and (ii) the investment capital by different types of finance. Each type of finance results in different returns on investment for each KPIs (eg jobs created per £ of debt or equity investment).
- The performance to date of the WBF – the approach the DBW have taken to adjust the KPIs is to calculate benchmarks for the KPIs achieved per £ of investment to date for the WBF (by different types of finance). In some cases this has resulted in a reduction in KPIs (despite an increase in investment capital) due to lower than expected performance to date.
- Adjustments to reflect economic conditions from COVID-19 – some KPIs will be adversely affected due to challenging economic conditions as a result of COVID-19 (eg jobs created). Therefore, a set of specific adjustments have been made to some KPIs to ensure they are realistic and deliverable.

9.14 We review below for each KPI how they have been calculated and comment on the appropriateness of the adjustments. We have outlined:

1. The previous KPI for the previous investment strategy

2. The new target for the revised investment capital based on using the assumptions in the previous investment strategy (ie applying unit cost assumptions from the previous investment strategy to the new £195.9m investment capital).
3. The actual revised KPI which is stated in the revised investment strategy. This is calculated based on performance of the KPI to date and the application of COVID-19 specific adjustments.

Table 9.5: Revised WBF Core KPIs

KPI	Previous Target	New target based on applying previous investment strategy assumptions	Adjusted KPI (i.e. new target)	Commentary on nature of adjustment/calculation
Investment in Enterprises (£m)	£180.9	-	£195.9	This has been described above. Note that in the DBW investment strategy (and in previous ex-ante assessments) this refers to direct investment by the DBW (ie not including deal level private sector match funding).
Jobs created	4,208	4,545	2,160	<p>Based on the increase in investment capital and the assumptions from the previous strategy, the revised job created target would be 4,525 FTEs. This has then been adjusted to 2,160 FTEs however to reflect the following factors:</p> <ul style="list-style-type: none"> • Underperformance in the jobs created target to date (77% of current profile). Using this rate of jobs created results in a target of 3,994. The reasons for this underperformance need to be carefully explored in the MTE. It could be that the jobs created are of a lower quantity but of higher value (ie more productive jobs). It could be that the targets set were too optimistic, as was the case in the JEREMIE Fund (which Hatch evaluated), or they were specifically too optimistic for WWV (which accounts for the majority of the underperformance for this KPI). It could also be that there is a low response rate from investee businesses on monitoring forms which the DBW uses to compile its monitoring reports. In practice, it may be a combination of all three of these issues, plus other macroeconomic factors such as tightness of the labour market. Overall, this is 12% lower than what would have been expected when applying the previous investment strategy target rate to the new total investment capital. • The expectation that businesses are likely to shift their focus to survival rather than growth. The adjustments applied are to reduce the number of jobs created (from all investments) by 50% in the current year, and then 25% for the following two years. Note that this is from all investments (so not just new investments). This results in the revised KPI of 2,160 (a 54% reduction compared to 3,994 ie the forecast when using the job creation rate achieved to date). It is difficult to draw comparisons given the unique nature of this economic shock, but this is broadly in-line with the JEREMIE Fund where jobs created was 46% behinds its revised target during the financial crisis). <p>This revised KPI will have important implications for the potential value for money of the fund (we highlight these implications below).</p>

Jobs Safeguarded (as Core Indicator)	N/A	N/A	1,856	<p>Given that the market assessment has concluded that businesses are expected to focus on survival and sustainability rather than growth, jobs safeguarded has now been defined as a core indicator rather than a value added indicator. Only jobs safeguarded going forward have been included in this KPI. Whilst there could have been merit in including additional KPIs to capture this survival aim, it is sensible to use jobs safeguarded given that it is already being monitored by the Welsh Government's Economy Skills and Natural Resources Group and is an agreed and accepted measure by stakeholders (noting some of the caveats of using it).</p> <p>This revised KPI has been calculated by applying benchmarks for safeguarded jobs per £ invested to date to the revised investment allocations (noting that this is based on self-reporting by businesses at the point of investment). With 3,561 jobs already safeguarded by the fund to date, this means that overall, there will be around 5,400 jobs safeguarded by the fund. This is lower than the overall safeguarded KPI in the previous investment strategy (7,482). This reflects the performance to date (but also the nature in the way this is recorded, relying self-reporting by investee businesses, which may not always be accurate).</p> <p>On the whole, we would have expected the rate at which jobs are safeguarded to increase relative to the investment period to date, given the shift in focus to survival (and so in practice it may not be appropriate to use the rate of safeguarded jobs achieved to date as the basis for the future estimate). The estimate is therefore conservative in our view and further evidence should be provided to justify why it has been calculated on this basis.</p>
Number of enterprises supported to introduce new to the firm products	47	50	65	<p>This KPI has been revised upwards (relative to using the figure when applying the rate from the previous investment strategy) based on overperformance by the fund to date. Whilst we would expect this to fall (given reduced investment capital for equity), performance to date suggests this should be achievable.</p>
No of enterprises supported	522	550	488	<p>Applying the rate from the previous investment strategy to the £195.9m total investment capital, this results in a revised figure of 550 supported businesses.</p> <p>However, when applying the rates of what the fund has achieved to date, the revised target is 488 business supported. This reflects the higher than expected average</p>

				<p>investments (across all finance types in all areas), particularly for equity investment. The average values of investment have been 6% higher than profile for loans, 45% for later stage equity and 134% higher for early stage equity.</p> <p>Going forward, on the one hand we would expect average investment values to be lower than what has been experienced so far, given there is more finance allocated to debt and increased demand for working capital. On the other hand, the current pipeline of investment for the WBF is still for relatively large deals, and later on in the investment period is where more follow on investments are undertaken (which increases the levels of investment per supported business). This KPI needs to continue to be closely monitored, particularly for debt in WWV.</p>
Private investment induced (Deal Level)	£139m	£201m	£333m	<p>This is a significantly higher figure than the previous target. This is because the fund has already significantly outperformed its target (£260m private sector induced investment as at June 2020, against a profiled target of £97m and lifetime target of £139m).</p> <p>Applying the previous target to the £190m investment capital results in target of £201m in private induced investment. Going forward, the projections have been adjusted to reflect the fact that there will be fewer equity investments (and also the potential difficulty in attracting the same levels of match funding as previously given challenging economic conditions). The projections have therefore been based on a 1:1 ratio of match funding to direct DBW investment for all new investments. This is a sensible assumption, and despite strong performance to date, this should still be closely monitored to ensure that the fund continues to invest as much as possible alongside the private sector.</p>

Value for Money

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

- Based on ERDF investment costs only, the estimated lifetime gross cost per gross job created is £76,800. Based on all public sector funding into the WBF (ERDF plus Welsh Government and FTC contributions), this gross cost per job created is £90,700. This is significantly higher than the unit costs based on the previous investment strategy (£31,800 and £43,000 respectively), given the increase in investment capital (and therefore costs), reduction in the number of expected jobs to be created and lower legacy return (compared to amount of ERDF investment). This is significantly higher than for previous public sector backed funds we have evaluated (with an average of around £20,000 gross cost per gross job).
- This increase in the unit cost metrics (and therefore reduced value for money) relative to the previous investment strategy is driven by the reduction in the rate of job creation to date, adjustments to job creation targets as a result of COVID-19, and reduced legacy due to a higher write-off rate.
- As shown in the table below, the experience of JEREMIE and other publicly backed FIs suggests that loans are more effective in creating jobs than equity investments. However it should be noted that the jobs created measure only captures one element of the benefit of equity investments, many of which are innovation intensive, are typically higher paid jobs, and have much higher productivity rates per job. This is one rationale for the added value output indicators for the WBF equity sub-fund.
- The net cost per net additional job created are illustrative, since we do not know the proportion of jobs created that will be net additional. To come up with net additional figures, we have taken evidence from the Final Evaluation of the Wales JEREMIE Fund, which indicated that around 86% of gross jobs created were likely to be additional. The net cost calculations use the forecasts on the legacy

returns generated by the WBF and is calculated as the gross ERDF investment cost less the projected legacy return to ERDF.

- For the base case legacy return (£107m), the net cost the public sector per net additional job is estimated at £31,700. When looking at the legacy return for higher default rates in both the loan and equity portfolios (so legacy at £82m), the cost per net additional job is £45,100. The latter is what we would suggest as the base case (given that the base case assumes no change to the write-off rate for equity investments).
- This is also higher than the value for money for other business support programmes (with value for money at around £21,000 cost per net additional job).

Table 9.6: WBF Value for Money Indicators

	Equity	Loans	Total
Previous Investment Strategy			
Gross cost per job created			
-only ERDF grant	£59,100	£21,200	£31,800
-total public sector investment (ERDF and FTC)	£78,100	£29,300	£43,000
Net ERDF cost per net additional job created	£26,800	£3,200	£9,500
Revised Investment Strategy			
Gross cost per job created			
-only ERDF grant	£108,000	£67,900	£76,800
-total public sector investment (ERDF and FTC)	£140,000	£76,800	£90,700
Net ERDF cost per net additional job created – base case*			£31,700
Net ERDF cost per net additional job created – increase in defaults*			£45,100

Source: Hatch based on WBF Investment Strategy (Revised August 2020) *includes adjustments to account for deadweight and displacement, and the legacy return.

9.16 The value for money assessment here is driven by job creation. The caveats of this are:

- As outlined above, the shift towards the demand for working capital and survival, coupled with the underperformance to date against the jobs created target, has reduced the job creation KPIs. This has therefore worsened value for money (especially in gross terms, it is high relative to other programmes).
- This framework does not reflect any changes in the quality of jobs or productivity (which would be better reflected by looking at wealth creation). This needs to be explored as part of the emerging economic impact of the fund in the MTE.

- When looking at net costs, value for money improves, but this is dependent on the forecasted legacy being achieved.

9.17 Further, impact from safeguarded jobs are not captured in the above framework. Investments from the WBF will support enhanced productivity in investee businesses which will safeguard jobs (rather than create jobs, which we would expect under normal economic circumstances), however it is difficult to source empirical evidence on this (and translate this into the value for money assessment). As an illustration, if these jobs are safeguarded for over 1 year, this is equivalent to £73m GVA retained in Wales. The MTE and final evaluation needs to provide a comprehensive overview of the range of economic impacts that the fund could deliver.

9.18 Whilst we have compared value for money to previous initiatives, it should be noted that it is difficult to draw direct comparisons to the WBF given the unique economic conditions that are prevalent (plus future uncertainty).

Governance

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

Monitoring and Evaluation

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

- The DBW operates a suite of IT systems to monitor and record fund performance data, which they have used previously to monitor ERDF backed investment funds.
- Formal quarterly reports are produced, providing the basis for regular review meetings between the DBW, the DBW FM Ltd, WEFO and WG. Reports are also produced for the Programme Monitoring Committee.
- More detailed Annual Implementation Reports are produced for the European Commission.

- Mid-term and final evaluations of the WBF have been commissioned, with external consultants appointed in June 2020 following a formal competitive procurement process.

9.21 We judge that suitable monitoring arrangements and plans for evaluation are in place for the WBF. A number of the issues highlighted in this review can be explored through the MTE including:

- Lower job creation
- Conservative jobs safeguarded targets
- Equity investment rates in WWV.

9.22 Further, in the quarterly reports, the DBW need to provide commentary on the use of the fund for working capital and growth, so that WEFO/WG can understand how this changes as economic conditions change (and the subsequent impact on the KPIs). The quarterly reports are also an important place to specifically focus on the issues identified above (in advance of the publication of the MTE).

Table 9.7: Summary of Investment Strategy Review

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 DBW's 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 fund's 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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Annex A – Consultee List

Table A.1 Consultees	
Consultee	Organisation
Rhian Elston	Development Bank of Wales
Simon Thelwall-Jones	Development Bank of Wales
Neil Maguinness	Development Bank of Wales
Rob Hunter	Development Bank of Wales
David Kingdon	Development Bank of Wales
Claire Miles	Mid Wales RET
Carwyn Jones-Evans	Mid Wales RET
Josh Miles	FSB Wales
Sue Price	Welsh Government
Karl James	Welsh Government
Duncan Hamer	Welsh Government
Huw Bryer	Business Wales
Mel Brown	Welsh Government
Mark Hambly	British Business Bank
Steve Conibear	British Business Bank
Melanie Goward	Maven
Warren Lewis	HSBC
Jessica Shipman	NatWest
Katherine Broadhurst	Baldwins