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Eich cyf/Your ref
Ein cyf/Our ref: MB/EH/1959/14

Llywodraeth Cymru
Welsh Government

Jocelyn Davies AM
Chair, Finance Committee

13 May 2014

Dear Jocelyn

INQUIRY INTO FINANCE WALES

You requested further information following the Finance Committee meeting on 30 April 2014 which I now provide below.

Additional evidence for Finance Committee Inquiry into Finance Wales

1. Percentage of businesses referred to Finance Wales from the banking and other professional sectors

Banks	Public Sector	Direct from SME*	Other Private Sector	Incomplete record
35	59	65	55	21
15%	25%	28%	23%	9%
TOTAL: 235				

* This would include referrals from portfolio companies for follow on investment, i.e. repeat business

2. Terms of reference for the review being undertaken by Robert Lloyd-Griffiths and an update on the work undertaken to date

2a) Terms of Reference for the review being undertaken by Robert Lloyd-Griffiths

Aim

In his capacity as Chair of the Business Wales Strategic Board, Robert Lloyd Griffiths will lead a review to consider how the Welsh Government's non-financial support can best align and support the financial support that is available for businesses in Wales with a view to maximising the economic impact of both.

Considerations

Potential areas the Review will address include:

1. Examine the nature and type of financial and non-financial support available through Welsh Government and Finance Wales to identify any gaps in services for SMEs.
2. Examine if Business Wales should deliver finance tools on behalf of Finance Wales or a Development Bank for Wales.
3. Establish where opportunities exist to work more effectively with Finance Wales, other Welsh Government financial support initiatives and the private sector to remove duplication, improve services, outcomes and offer a joined-up approach for SMEs.
4. Investigate what services are available outside of the Welsh Government that could add value to the Welsh Government's non-financial support offer and how the Welsh Government might maximise the benefit of these for Welsh businesses.
5. Provide suggestions for new support services which would sit alongside Welsh Government and Finance Wales' support, helping to increase the success of these investments, and how they might most effectively be delivered to ensure maximum economic impact.
6. Work with the Financial and Professional Service Sector team to consider how some of the specific recommendations in the access to finance review could be incorporated into the financial and non-financial support available for SMEs in Wales.
7. Consider the particular issues of supporting working capital and company valuation, including intangible assets and employee buy-outs.
8. Seek advice and engage with the business community, Welsh Government Priority Sectors and key stakeholders to ensure the review is evidence based and business led.

Outcome

Develop an action plan to align Welsh Government non-financial support and financial support mechanisms to improve the provision of financial and non-financial support available for SMEs in Wales and improve their accessibility by SMEs. A recommendations paper will be presented to the Minister for Economy, Science & Transport by the end of Sept 2014.

A scoping and evidence gathering exercise is currently underway and a number of stakeholders meetings have been held to date, with a number in the pipeline. The following shows those stakeholder groups that have been consulted and those that are due to be met:

2b) Update on the work undertaken to date

A scoping and evidence gathering exercise is underway and a number of stakeholders meetings have been held to date, with a number in the pipeline.

Stakeholder meetings held to date: Finance Wales, HWB Cymru, Chartered Institute of Marketing, Barclays, Natwest, Santander, Lloyds, Wales Co-operative Centre, Professor Dylan Jones Evans, C2It Commercial Collections, Business in Focus

Upcoming stakeholder meetings: HSBC, Principality Building Society, National Association for Commercial Funding Brokers (NACFB), Business Wales Consortium Board, Charity Bank

3. Send a copy of the report on interest rates

This is included as a separate pdf document and you may also access the report through the following link:

<http://wales.gov.uk/topics/businessandconomy/policy/access-to-finance/?lang=en>

4. Statistics of categories of business that have received funding from Finance Wales

The following table indicates the sector breakdown of investments made by Finance Wales showing both value and number of investments made.

Overall FW Sector Analysis			
Sector Analysis - at 31 March 2014	No.	£'000	%
Agriculture, Forestry and Fishing	41	2,541	0.92%
Mining and Quarrying	8	1,290	0.47%
Manufacturing	1,020	91,076	33.11%
Electricity, gas, steam and air conditioning supply	19	4,900	1.78%
Water supply, sewerage, waste management and remediation activities	34	5,407	1.97%
Construction	169	15,507	5.64%
Wholesale and retail trade; repair of motor vehicles and motorcycles	311	21,375	7.77%
Transportation and storage	88	15,698	5.71%
Accommodation and food service activities	109	18,100	6.58%
Information and communication	172	19,452	7.07%
Financial and insurance activities	15	661	0.24%
Real estate activities	3	323	0.12%
Professional, scientific and technical activities	492	38,089	13.85%
Administrative and support service activities	152	9,609	3.49%
Education	57	2,563	0.93%
Human health and social work activities	83	10,327	3.75%
Arts, entertainment and recreation	63	2,816	1.02%
Other service activities	242	9,720	3.53%
Unknown/Blank	52	5,592	2.03%
Total	3,130	275,045	100.00%
Excludes Creative and Spinout			

Finance Wales has undertaken further analysis of the above in order to show the level of investment made to retail sector businesses, the results are shown below:

	Number	Value (£)
Retail sale in non-specialised stores	20	292,205
Retail sale not in stores, eg mail order	5	21,400
Retail sale of pharmaceutical and medica	2	342,999
Retail trade, except of motor vehicles and motorcycles	52	1,738,263
Retails sale of food, beverages and toba	24	336,000

The retail segment is one of a number of excluded sectors under ERDF rules and thus off-limits to any Fund containing ERDF such as the Wales JEREMIE Fund. It was to recognise this funding gap that Finance Wales and Welsh Government proposed that the Wales SME Fund, Wales Property Fund and Wales Microloan Funds should be set up without ERDF but using WG monies. This allows Finance Wales to lend via these funds into both retail businesses and property companies which are also an ERDF

excluded sector. The other main excluded ERDF sectors are shipbuilding, coal and steel production, primary food production, financial services, and activities provided by government (i.e. healthcare).

5. Schedule listing the funding sources that contribute to Finance Wales and the expected returns

The following schedule shows the funding sources that contribute to Finance Wales and the expected returns by fund:

FW - Funding Sources/Returns For Current							Fcst Return
As at 31 March 2014	WEFO	WG	FW	Barclays	EIB	Total	To Public Sector
	£'000	£'000	£'000	£'000	£'000	£'000	£m
Interim	0	15,000	0	15,000	0	30,000	7 - 8
Jeremie	67,195	0	15,305	0	75,000	157,500	40 - 65
Wales SME Fund	0	20,000	0	20,000	0	40,000	15 - 16
Wales Micro-Business Fund	0	6,000	0	0	0	6,000	4 - 5
Wales Property Fund	0	10,000	0	0	0	10,000	8 - 9
Total	67,195	51,000	15,305	35,000	75,000	243,500	


Glossary:

WEFO – Wales European Funding Office

WG – Welsh Government

FW – Finance Wales

EIB – European Investment Bank



Finance Wales Interest Rate Review

Background & Summary

1. Following Professor Jones-Evans' second stage review of access to finance in Wales a further review into the interest rates charged by Finance Wales was conducted.
2. The review focused on:
 - The comparability of FW's interest rate charges with those which may be charged by "the market";
 - The overall financial position of the Funds in which they are applied; and
 - Consideration, at a high level, of the implications of offering subsidised rates in the future.
3. To assist in the review an independent expert was commissioned to review a sample of loan cases from across funds operated by Finance Wales and to indicate the likely costs of the finance if "the market" were to have funded the deal. The detailed report is attached at Annex A.
4. In summary the review found that:
 - For 71% of cases Finance Wales were found to be charging below market rates. On average, setting aside the one large discrepancy case, they were around 5% lower than the market rate.
 - 6% were judged to be at market rate.
 - In 23% of cases Finance Wales were charging a rate that was deemed to be above the market rate. These tended to be in relation to lower risk deals. The rates averaged c2.5% higher than the market might charge but this differential would reduce when fees are taken into account.
 - The arrangement fees charged by Finance Wales are significantly lower than comparable market fees. The security and monitoring fees are at the lower end of the scale of those charged by "the market".
 - During the review the base case and latest forecasts for the Wales JEREMIE fund, the SME Investment fund and the Interim fund were examined. These funds are already subsidised using public funding (to cover the losses on the Funds) and were neither created, nor are they currently operated, with the expectation of delivering commercial rates of return.

Interest Rate Review of Individual Deals

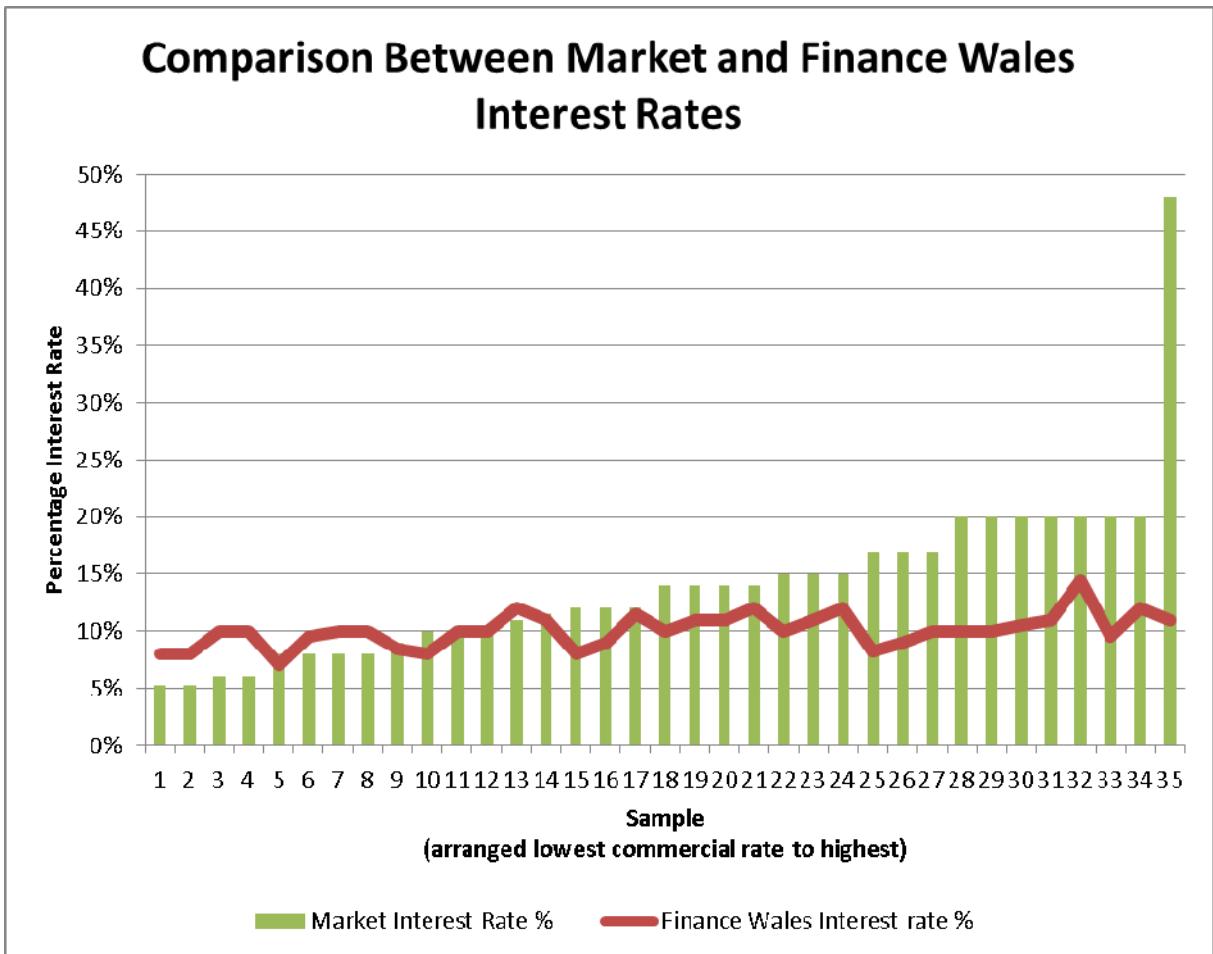
5. In order to establish the “reasonableness” of FW’s interest rates and charges compared to those a commercial organisation might charge, an independent, commercial finance broker was tasked with reviewing a random sample of deals from across FW’s funds. The following table shows the breakdown of the 35 cases that were reviewed:

Table highlighting headline projects funded above, below or at the market interest rate

Portfolio Fund	Sampled Number	Interest below market rate	Interest above market rate	Interest at market rate
JEREMIE Fund for Wales	25	19	5	1
Wales Micro Business Loan Fund	5	4	1	0
Wales SME Investment Fund	4	2	1	1
Wales Property Development Fund	1	0	1	0
Total	35	25	8	2

Note – The Property Development Fund has only recently commenced investing. At the time of the sample, it had only made 2 investments.

6. The analysis of each investment in the sample is shown below:

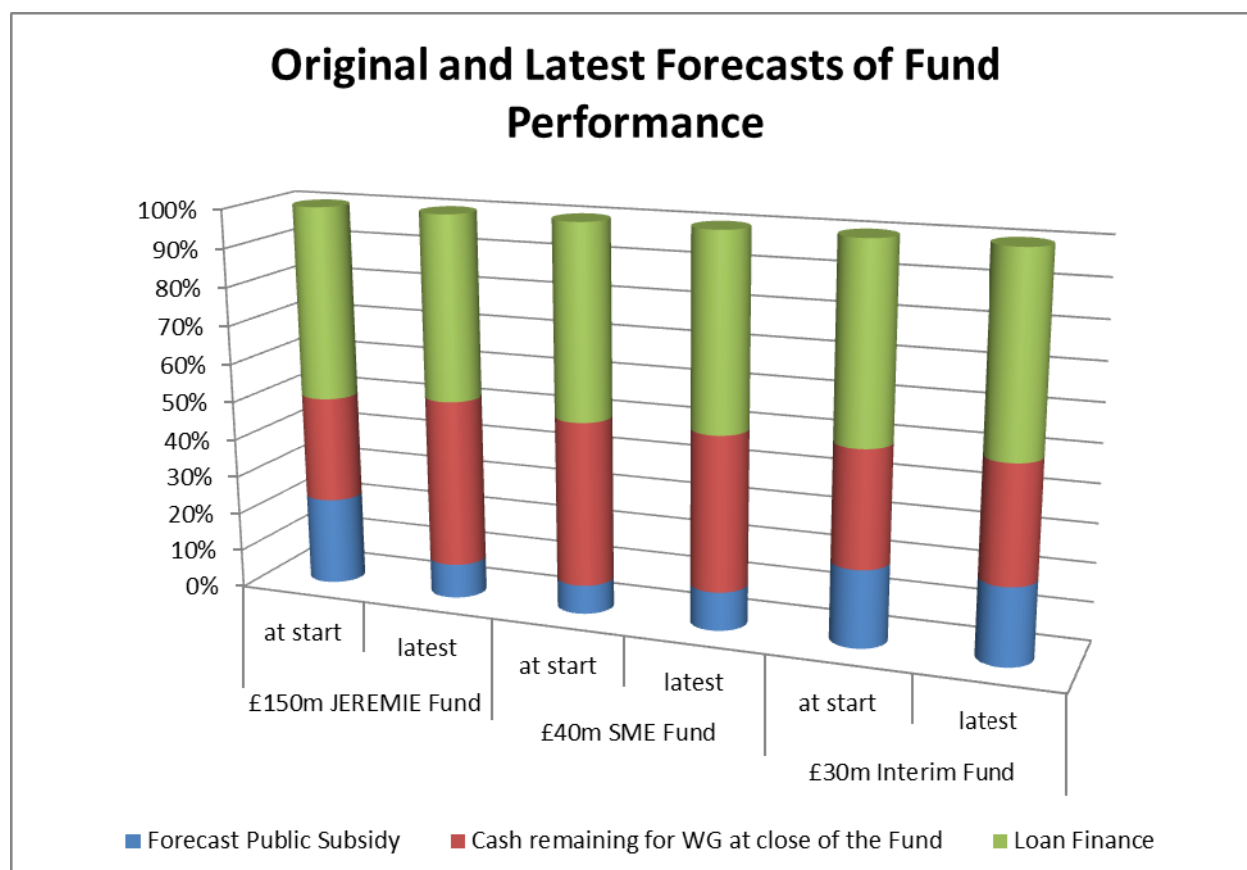


7. The above chart indicates that Finance Wales have determined a rate typically higher than the “market” where risk of the investment is low.

8. The chart also shows that the interest rates charged by the market would typically range from around 5% to 20% for the deals Finance Wales undertake. This compares to a typical range charged by Finance Wales of between 7% and 12%.

Underlying Fund Dynamics

9. As part of the review the original business case projections and most recent forecasts for the three key funds managed by Finance Wales were examined. All of these funds were originally forecast to require a public subsidy (effectively a loss on the fund). This is still the case when the latest forecasts are taken into account. These subsidies are summarised in the chart below:



10. FW's investments are typically made in businesses which have little or no security to offer and/or which are beyond the traditional risk criteria of banks. As a result, FW experience default rates of over 10% on the loans they make. This is far higher than the default rates of the banks which are more in the region of 1-5%.
11. Overall, whilst the latest forecast subsidy is lower across the combined funds, the total subsidy of £24 million represents a best case estimate and still equates to just over 20% of the public funds invested. None of the funds were ever envisaged to produce a positive Return on Investment (ROI).

Modelling the Potential Impact of Interest Rate Subsidies

12. It could be argued, based on the above analysis, that the Welsh Government is already offering a degree of interest rate subsidy in Finance Wales' existing funds. As part of the review Finance Wales was asked to model the impact of further reductions in interest rates.
13. By reducing interest rates charged on investments in Welsh businesses income from investments will fall and the levels of Government subsidy will need to increase. This could possibly be offset by steering the investment strategy towards lower risk investments which have less chance of default. However, the evidence from this review suggests that the market can offer equal or better deals particularly at the low risk end of the market.
14. Assuming a default rate of 20%, the estimated impact of interest rate reductions on a theoretical, pure loan fund of £60m would be:

Example £60m Loan only fund			
Average Interest Rates	5%	8%	10%
	£m	£m	£m
Welsh Government Investment	30	30	30
Cash remaining at close of fund	11	16	20
Forecast Public Subsidy	19	14	10

Note – This Example Fund assumes £30m is sourced from a bank as match funding.

15. The current subsidies are mainly driven by the costs of running the funds, the interest charges from the private sector contributors and the high default rates.
16. There is little doubt that by using existing state aid rules Finance Wales could offer further interest rate subsidies. There would however need to be consideration of the impact of any changes on applicant businesses, Finance Wales and any third party investors in their Funds.
17. This review has not examined the state aid implications of further subsidising the existing funds as this is better left to be conducted when reviewing the specific proposals that will come from the next stage of the strategic work in to Access to Finance.

Finance Wales – Interest Rate Review

Scope of the project:-

Provide the Welsh Government with an impartial view on the “reasonableness” or otherwise of the interest rates charged by Finance Wales on a number of their investments across their funds, over the last few years.

Project Sample:-

I was asked to review a sample from a number of Finance Wales’ funds. This sample was chosen for me by Welsh Government [Appendix 1]. For reference I have listed the funds, overall number of projects from which the sample was chosen and the sample size I reviewed from each.

Portfolio Fund	Total Number of Projects in the Fund	Number Sampled
JEREMIE Fund for Wales	537	25
Wales Micro Business Loan Fund	61	5
Wales SME Fund	23	4
Wales SME Property Fund	2	1
Total	623	35

Methodology: -

For the whole of this review I adopted the following approach.

I spent between 20 to 30 minutes reviewing each file across the whole of the sample selection. This involved reading each Investment Sanction Paper, together with the accounts and full supporting due diligence.

On each file I made a note of the key areas of risk, level and type of security that was available [if any], together with all fees and interest rates associated with the lend.

I then made a brief summary note with regards to whether the deal could have been funded by a more traditional / mainstream funding option and the comparable likely costs of such finance.

Findings:-

The overall quality of the files under review was excellent. The sample of 35 files was written by a number of different advisors, but their individual approach was consistent throughout all of the files. The reports and files were certainly of a high enough quality to be submitted straight into the credit teams of most of our panel of funders.

Table highlighting headline projects funded above, below or at the market interest rate

Portfolio Fund	Sampled Number	Interest below market rate	Interest above market rate	Interest at market rate
JEREMIE FUND for Wales	25	19	5	1
Wales Micro Business Loan Fund	5	4	1	0
Wales SME Fund	4	2	1	1
Wales SME Property Fund	1	0	1	0
Total	35	25	8	2

Table providing the average Finance Wales interest rate against the average market rate of interest.

Portfolio Fund	Sampled Number	Finance Wales average interest rate	Market average interest rate
JEREMIE FUND for Wales	25	10.03%	13.42%
Wales Micro Business Loan Fund	5	11.00%	19.20%
Wales SME Fund	4	9.88%	13.81%
Wales SME Property Fund	1	8.00%	5.25%

Table providing the average Finance Wales arrangement fee against the average market arrangement fee.

Portfolio Fund	Sampled Number	Finance Wales average arrangement fee	Market average arrangement fee
JEREMIE FUND for Wales	25	1.56%	3.84%
Wales Micro Business Loan Fund	5	1.30%	3.80%
Wales SME Fund	4	1.56%	3.50%
Wales SME Property Fund	1	1.00%	2.00%

It should also be noted that Finance Wales charge an average annual monitoring fee of 0.5%. In the current financial market, I am finding lenders charging in the region of 0.5% to 1% on an annual basis. Finance Wales also charge a "security fee" of circa £275 per case, whereas the UK banks and lenders charge from £250 to £450 per legal charge registered.

Of the 35 files reviewed, the market comparisons were derived from a mixture of High Street lenders, Asset Based lenders, Peer to Peer funders and a number of specialist funders as were relevant to each individual case.

Summary:-

As you can derive from the above tables, in the main [77.14%] of projects were funded at or below the market interest rate.

The 8 projects that were considered to have an interest rate charged above that of the market rate can be analysed as follows: -

- 3 were property related projects
- 1 was a Peer to Peer type project
- 1 was an invoice financing project
- 3 were asset finance proposals

All of these were considered to be able to be funded by mainstream lenders at below the interest rate charged by that of Finance Wales.

In all of the cases, the arrangement fees charged by Finance Wales were significantly below that as would be charged the by market.

Finally, of the 35 sampled projects, assuming that the businesses had continued to achieve or exceed their forecasts, then a fair proportion of these deals could now be refinanced back to more mainstream funders. Certainly for the projects that were funded back in 2010/11, there are many more innovative entrants into the UK funding market that would provide viable funding options for them, however not necessarily at a lower interest rate.

Report compiled by: -

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