Key Facts

7
FUNDS IN OPERATION

Total investment funding for SMEs of
£181m

£104m
57%
Funded by Invest NI

Total Fund Manager Fees of
£34m

£25m met by Invest NI

Funding Breakdown

GRANTS	£8m
LOANS	£55m
EQUITY	£118m

The strategy funds will operate between

MARCH 2009 and JULY 2024

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Introduction

1. Small and medium-sized enterprises (SMEs)[1] contribute significantly to the Northern Ireland economy providing approximately three-quarters of all private sector jobs and turnover. Access to finance is crucial in assisting the development and growth of SMEs. In 2009, commercial lending to SMEs in the UK began to contract considerably due to the global economic crisis.

2. In response to this reduction in bank lending, and also to address funding gaps evident from the historically weak local venture capital industry, Invest NI has progressively been developing an Access to Finance Strategy. The strategy is providing a range of funding which seed[2] and early stage SMEs can avail of and can potentially progress through as they achieve growth.

3. The strategy comprises a range of large venture capital and loan funds and a number of small proof of concept grant[3] funds. Between 2009 and 2024, the strategy is providing funding of £181 million[4] to SMEs. Invest NI is contributing £104 million and £77 million of private investment has also been levered through seven different funds. In line with Invest NI's strategic objectives, funding is restricted to businesses which are growing or exporting, or which have such potential.

Key findings

Developing the Access to Finance Strategy

4. The availability of information on demand for, and supply of, finance has improved in recent years. However, some key indicators are still not being measured and more formal and structured measurement would provide stakeholders with a better basis upon which to design and evaluate policy interventions.

5. Northern Ireland SMEs have traditionally been more reliant on external finance than their UK counterparts and a high proportion have finance in place. However, recent demand from the sector for external finance has reduced significantly.

6. The proportion of SME applications for bank funding being approved and the amount of funding released have increased significantly since 2012. However, the number of SME applications for bank funding has declined. This could be attributable to a combination of factors, including uncertainty over the economic climate, SMEs considering bank terms and conditions too onerous and SMEs being discouraged borrowers[5].

1 Businesses with 0-249 employees.

2 Early-stage, high-potential growth companies.

3 A demonstration in principal with the aim of verifying that some idea, concept or theory has commercial potential.

4 Net of the Development Funds Fund Manager fees. The £181 million available could increase if additional private investment is secured.

5 SMEs which may have enquired about accessing funding but have been discouraged from applying by banks or other providers of finance.

7. Data currently being gathered in Northern Ireland does not facilitate complete and accurate measurement of the SME funding gap[6]. The level of uncertainty over the extent of the funding gap emphasises the need for more detailed analysis of this key area.

8. The level of venture capital and equity activity in Northern Ireland has historically lagged behind the rest of the United Kingdom (UK). Analysis by Invest NI has attributed this to significant market failure which has created equity gaps, and this has been a key factor influencing the development of its access to finance activities. In contrast, the Varney Review on the Competitiveness of Northern Ireland (April 2008) and the Independent Review of Economic Policy (IREP) (September 2009) attributed historically low levels of venture capital activity in Northern Ireland to a lack of demand for this type of finance, rather than a lack of supply.

Managing funds

9. Invest NI has appointed fund managers to oversee each fund (see paragraph 3). The fund managers are responsible for: levering private finance; approving, monitoring and managing investments, loans and grants; advising and supporting investee companies; and deciding when to exit from investments[7]. In addition to its £104 million investment funding, Invest NI will pay approximately £24.8 million of the £33.9 million fees which Fund Managers will receive.

10. Fund managers receive an annual fee for managing and overseeing investments. An industry benchmark is that fees for venture capital funds are up to 2 per cent of committed funding per year[8]. The fees payable by Invest NI broadly reflect this benchmark. Overall, Invest NI's annual fees are 1.88 per cent of committed funding per annum, but fees for its venture capital and equity funds are 2.16 per cent per annum.

11. Invest NI's fund manager fees will equate to 23.7 per cent of its investment funding, ranging from a low of 13.5 per cent to a high of 32.1 per cent of individual funds. The small size of some funds has created economy of scale issues and contributed to the relatively high fee levels for some funds. The Invest NI fund management fees are broadly comparable with three UK funds operating under a European funding regime, but its total fees are lower, mainly because Invest NI has adopted an internal approach to holding fund management. However, under the European model, Invest NI may have been able to avail of funding from the European Investment Bank at lower interest rates than it is paying to private investors in two of the strategy's largest funds.

12. Whilst Invest NI's fee structures broadly reflect industry norms, payments are heavily weighted towards fund management and investment activity. There are relatively small bonuses for achieving financial return targets and no sanctions for not meeting these targets.

6 The funding gap is the difference between SME demand for finance and the finance available.

7 With the exception of the Co-Fund, where investments are identified and led by private investors.

8 To illustrate how this benchmark works, a ten year fund which had £20 million of investment funding and fund manager fees of 2 per cent per annum would incur annual fees of £0.4 million and total lifetime fees of £4 million (£20 million x 2% x 10 years).

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Furthermore, as state aid requirements stipulate that funds are to be managed on a profit-driven basis, bonuses or sanctions cannot be linked to the achievement of wider economic benefit targets, such as increases in employment, Gross Value Added and productivity. However, terms of fund manager contracts do permit fund investors to take action, should serious concerns arise over fund manager performance.

13. For one of the earliest strategy funds, Invest NI, having taken legal advice, withheld fees from the fund manager (E-Synergy) in October 2014. As part of a mediation process, Invest NI re-commenced paying fees in March 2015. In November 2014, both parties had issued legal proceedings. E-Synergy issued proceedings to have the fees re-instated and Invest NI commenced legal action against E-Synergy with the objective of having the fund manager contract terminated. However, the respective arguments of both parties were never tested in court, and Invest NI reached a mutual agreement with E-Synergy whereby it resigned as fund manager in January 2017. The agreement terms also resulted in E-Synergy being paid all fees due up to January 2017, and a settlement fee of £0.45 million. E-Synergy has also undertaken not to pursue investee companies for monitoring fees. The Department considers that this settlement is in the best interests of the investee companies.

14. Over an eight year period between 2009 and 2017, E-Synergy was paid management fees of £2.75 million due under the terms of the original contracts.

15. Invest NI told us that the provisions in this fund manager contract presented challenges. It highlighted that the clauses in respect of withholding fees would have been slow to implement, and that it also required a court order to terminate the contract in the absence of mutual agreement. Invest NI told us that in all subsequent fund manager contracts, it has included robust termination clauses and has the ability to withhold fees when there are significant performance issues.

Measuring and reporting performance

16. In terms of its overall investment cycle, the Access to Finance Strategy is still at a relatively early stage. Investments by the funds will in some cases continue until 2019 while the loan repayments or exits from investments will continue until 2024. Therefore, it is too early to measure the overall performance of the funds or the strategy as a whole.

17. Invest NI has established key performance indicators (KPIs) to monitor the activities of the funds. These relate to the number of investments, loans and grants and also the value of funding disbursed. To date, £124 million, 68 per cent of the funding available, has been allocated. In several funds both the volume and the value of activity is

behind schedule. These targets may still be achieved as fund managers identify and develop new investment propositions.

18. A key measure of overall performance and value for money achieved by the Access to Finance Strategy will be the extent to which investments and loans from the funds help generate increases in key economic indicators such as employment, Gross Value Added and turnover. Targets for these indicators have been established for most, but not all, of the relevant individual funds. However, no aggregated targets or KPIs have been established for the overall strategy or the Fund of Funds, a central holding fund which Invest NI has established to recycle and reallocate funding.

19. Based on the targets set for individual funds, it is estimated that the loan and investment activity could generate almost 4,500 jobs. Although targets have been set for increases in Gross Value Added and turnover, these have not been prepared on a consistent basis for all funds. The benefits achieved will be quantified by interim and final evaluations for each fund. Interim evaluations of the Access to Finance Strategy's two loan funds have projected strong future economic benefits on the basis of a combination of results to July 2015 and a survey of SMEs. However, Invest NI needs to ensure that final evaluations robustly measure actual outcomes achieved.

20. Whilst the funds are likely to obtain some form of financial return on their initial loans or investments, Invest NI told us that it is investing in these for wider policy reasons, and not solely for a narrow commercial return. Targets or forecasts were only set for four of the funds. Forecasting returns at this stage of the funds' lifecycle is problematic and estimates need to be treated with caution. Overall, Invest NI may recoup around £73 million of its overall £101 million of loans and investments[9]. Conversely, private sector investors may recoup £121 million for their £77 million of loans and investments. The variance in the respective rates of return reflects that Invest NI has had to subordinate much of its funding to secure private investment. This means that private investors are fully repaid their investment as well as an annual return before Invest NI recoups any of its investment. It also reflects the differences in the reasons for investing, with the private sector having a purely financial objective, whilst Invest NI is also seeking to generate wider economic benefits. These arrangements mean that the private sector recovers its investment and receives a return before Invest NI recoups any funding.

21. Experience of an earlier fund which pre-dated Invest NI's Access to Finance Strategy illustrates the challenges facing Invest NI in obtaining a financial return on its investments. The Crescent Capital I Fund invested a total of £14 million (£7 million from Invest NI and £7 million

9 This excludes the NISPO and Techstart NI Proof of Concept schemes but includes the fund manager fees which Invest NI will pay for the Development Funds.

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from private investors) and supported 12 companies. The fund realised total returns of £13 million. Private investors received all £13 million of this return because Invest NI had subordinated its investment in order to secure private funding and to try to develop the local venture capital market. Some £55 million of Invest NI's investment in its current funds is subordinated and therefore at higher risk of not obtaining a return on investment.

Conclusion on value for money

22. Invest NI's Access to Finance Strategy is providing an important source of finance to SMEs. Investments from the funds are long-term in nature and at this stage sufficient evidence is not available to demonstrate that these are delivering value for money.

23. In the longer term, performance in a range of indicators including financial returns realised by Invest NI, the extent of growth achieved by supported SMEs and the contribution of the strategy to developing the local risk capital industry, will determine the strength of value for money achieved.

24. To help maximise the potential for success, Invest NI can take a number of steps. It can ensure that fund managers are actively working to maximise returns from investments. It should also review and, where necessary, revise targets set for individual funds. Invest NI also needs to more clearly define what the strategy is expected to deliver. It should set aggregated targets for its programme of funds and identify the specific outcomes which need to be achieved to stimulate the venture capital industry.

Recommendations

Measuring SME demand for finance and the extent of market failure

1. The Department for the Economy (the Department) would benefit from a wider range of information to inform its policy decisions. It should work with other key stakeholders to establish a formal and ongoing means of measuring the demand for, and supply of, finance in the SME sector, and develop a methodology for quantifying the SME funding gap in Northern Ireland.

2. The Department should review the SME financing environment every three to five years to assess the extent of market failure and the need for public sector intervention.

Structure of funds

3. Invest NI should seek to fully benchmark the costs and benefits of its Fund of Funds model and the European JEREMIE model[10] to establish which mechanism represents the most appropriate means of delivering its future access to finance activities.

Availability of funding for programmes

4. Invest NI should identify the extent of the funding shortfall which is likely to arise following the future loss of EU funding and quantify the level of additional baseline

10 JEREMIE – The Joint European Resources for Micro to Medium Enterprises is a joint initiative set up in 2007 by the European Commission in co-operation with the European Investment Bank.

expenditure which will be required to deliver its operations.

Fund management

5. It is important that Invest NI continues to work to ensure that fund manager fees broadly align with industry benchmarks and to reduce costs where possible. Invest NI should be able to clearly demonstrate the steps which it has taken to minimise fee levels and that it is liaising on an ongoing basis with other UK agencies, including the British Business Bank, to take account of best practice in establishing fund manager fees.

6. Within its monitoring of investment activity, Invest NI and Fund Advisory Committees should seek to identify changes in the levels of investment, including significant spikes in activity, and challenge fund managers to demonstrate that investment decisions have been subject to appropriate evaluation.

7. The selection of fund managers is critical to the success of funds. Invest NI must ensure that all appointment competitions rigorously test the ability of bidders to provide a high quality service. Invest NI must also ensure that its oversight of fund managers is capable of promptly identifying issues such as breaches of contract and potential conflicts of interest and of gathering sufficient evidence to take action to tackle poor fund manager performance.

Performance evaluation

8. As the funds have been operating for a number of years, Invest NI should review its approach to performance monitoring and target setting. Invest NI should assess whether initial targets for individual funds should be revised to take account of performance to date. Invest NI should also clearly articulate what the overall strategy is expected to deliver and establish a suite of aggregated targets for key areas including overall financial returns and wider economic benefits.

9. Co-investment arrangements offer a number of advantages to Invest NI, including the equal sharing of investment risk and returns, a focus on investments led by the private sector and lower fund management fees. Invest NI should seek to maximise the level of co-investment activity within its Access to Finance Strategy and assess the scope for delivering future planned funds through co-investment arrangements.

10. Invest NI should clearly define the medium-term and long-term outcomes it aims to achieve in developing the local risk capital industry. In particular, it should establish indicators or targets for future levels of private investment leverage and subordination.