Interim evaluation of Invest NI Fund of Funds

Final Report

June 2014

CONTENTS

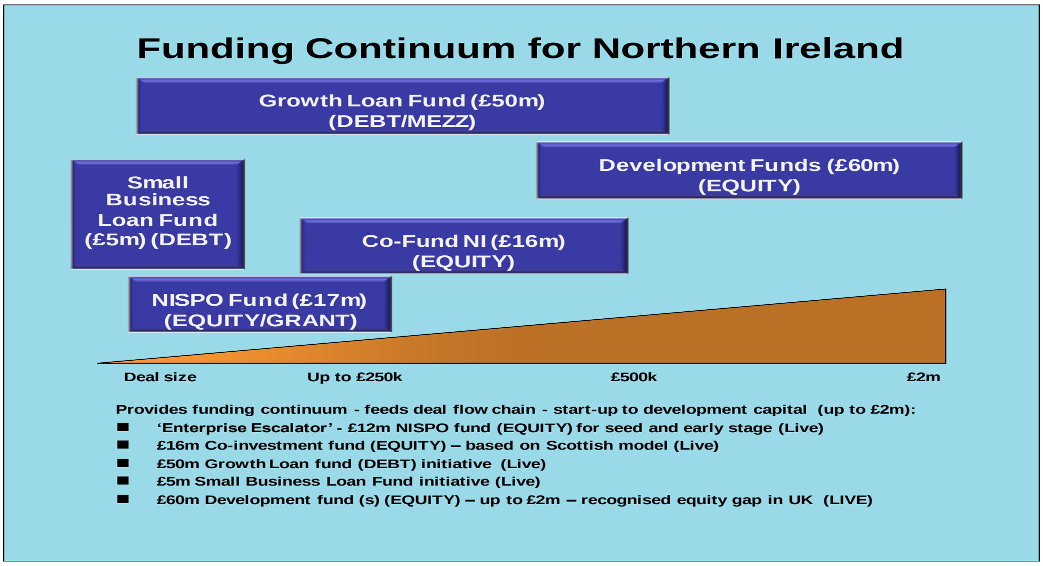
EXECUTIVE SUMMARY

Background

1. In January 2014, Invest Northern Ireland (Invest NI) commissioned Urbis Regeneration Ltd (Urbis) to undertake an evaluation of its Fund of Funds model. Developed as part of its Access to Finance Strategy, the Fund of Funds is a continuum of risk capital investment funds totalling £160m and underpinned by a mix of investment through Invest NI, the European Regional Development Fund and private sector investors.

2. Under the umbrella of the Fund of Funds, Invest NI has a portfolio of five investment funds encompassing a mix of debt, equity and mezzanine investment and each operated by an independent fund manager. Each fund addresses a specific market failure in the provision of risk capital, encompassing deal sizes from £1,000 to £2m. Figure 1 below summarises the continuum of risk capital funds currently operated by Invest NI:

Figure 1 Risk capital funding continuum



(Source: Invest NI)

Market failure rationale and ongoing validity

3. The development of the Fund of Funds was set in an increasingly challenging market context for both bank lending and equity investment, caused by the onset of the global recession and the subsequent shift in investor attitudes to risk. Whilst the issues facing Northern Ireland businesses in accessing finance have mirrored those across the UK, the decline in bank lending and equity investment has been exacerbated by unique factors including the fall in property values and overhang of property debt which has constrained otherwise investible businesses; and the dependency on non-UK owned banks which has limited the effect of UK Government/Bank of England measures to stimulate bank lending.

4. In practice, since the Fund of Funds approach secured Ministerial approval in late 2010, there is evidence to suggest that the position on bank lending to SMEs in Northern Ireland has in fact worsened. The need for the development of the Growth Loan Fund and Small Business Loan Fund to provide mezzanine/loan products to address the gap in SME lending whilst the market re-adjusts provides further evidence of worsening lending conditions. The Fund of Funds model will enable both products to be reconfigured, and potentially withdrawn, if bank lending returns to pre-recession levels and provides the mechanism to reallocate resources to other areas of market failure.

5. Whilst the market failure in bank lending is a result of the global recession and banking crisis, the failures inherent in Northern Ireland's equity/venture capital markets are more longstanding and reflect a sustained period of under-investment by the private sector. There are a range of contributory factors, including Northern Ireland's peripherality from the main UK VC markets and a smaller pipeline of investment ready businesses.

6. VC investment is also cyclical, and in reducing opportunities to achieve successful realisations from earlier investments, the recession has also impacted the value of VC and business angel investments in recent years. This notwithstanding, levels of business angel investment and Co-Investment in Northern Ireland have held up comparatively well. The successful establishment of the two Development Funds, albeit with a higher level of subordinated investment by Invest NI than the previous attempt to launch a later stage fund in 2010/11, is also indicative of the relative health of the equity investment market in Northern Ireland. Both funds were successful in leveraging new investment from outside Northern Ireland from institutional and private sources

7. In this context, we conclude that the market failure rationale for the five individual funds remains valid. Invest NI has a series of established mechanisms in place to review the market conditions relating to each of the funds on a regular basis and, via the Fund of Funds model, to vire resources between funds in response to demand or other market signals.

8. As three of the five funds are still at an early stage of their active investment period, there is no evidence to indicate that the quantum of the Fund of Funds (£160m when the two Development Funds are fully capitalised, with just over £90m of public sector investment) should be changed at this stage. This is broadly comparable with the scale of the JEREMIE programmes for Wales and the North East and North West of England when fully capitalised.

9. The evaluation research identified a number of additional areas where potential market failures exist, although further detailed analysis is required to validate and quantify these findings. In addition to the potential extension of the Co-Investment Fund, which has already been identified as an opportunity by Invest NI, they included:

   - later stage equity investment deals in the £2m-£5m range; there is strong evidence at UK level that the formal VC market has effectively retrenched from investments below this size as a result of fixed due diligence and related costs; although the number of deals of this size are comparatively small, and there are also State Aid considerations which currently limit the level of public investment to €1.5m for each SME over a 12 month period, potential demand and evidence of market failure should be considered as part of the forthcoming DETI research on venture capital in response to the EAG report

   - funding for Management Buy Out/Buy in activity; at present replacement capital is not included within the European Commission's risk capital guidelines although this is expected to change; there is evidence to indicate that Northern Ireland has secured less than its per capita market share of private equity investment in this space and this should also be considered as part of the DETI VC research, building on the success of the Growth Loan Fund which has targeted more established SMEs

   - reviewing the mechanisms available to support those UK banks with significant property loan exposure in Northern Ireland to reduce the burden of property debt on otherwise investible businesses; this is an issue requiring more extensive analysis to quantify the scale of the problem and consider the range of solutions which could be taken forward as part of the work of the Access to Finance Implementation Panel

   - testing the demand for a bespoke social enterprise investment offer; anecdotal evidence of demand was cited during the evaluation and there are some interesting new approaches emerging around the Local Impact Fund model elsewhere in the UK, based on providing a mix of unsecured lending, small scale grants and wider business support.

10. We conclude that the implementation of the Fund of Funds model has created a robust, long-term platform for the management of Invest NI's risk capital funds, creating the framework to manage the funds flexibly and to address reinvestment and other opportunities as they emerge. To date, Invest NI has had limited requirement to make use of the flexibilities inherent in the model but, over the next three to four years this is likely to change and key decisions will be required in several key areas. This reinforces the value of the Fund of Funds approach and the need to ensure it is maintained and developed as an integral part of Invest NI's Access to Finance Strategy.

Governance and management of the Fund of Funds

11. Fund of Fund Committee members feel that they have an appropriate mix of skills and experiences, benefiting from the co-option of one non-Board member and that the Committee has now 'bedded in', having met nine times since November 2011. In this context, Board members have identified the scope for the Committee to balance its current oversight/challenge role – with potential for more direct engagement with individual fund managers – with a longer-term, more strategic perspective on the access to finance issues facing NI businesses. This should have a clear focus on building and maintaining a clear picture of the market and market failure across the spectrum of business finance needs.

12. To date, the Committee has not had to make any significant decisions in relation to shifting resources between funds or concerning the recycling of legacy returns, although this is likely to change in future. We conclude that the governance mechanism is fit for purpose, but that as the need to make more complex decisions around reinvestment of funds becomes apparent, Invest NI should continue to review its approach to governance. At present, the Fund of Funds model is 'below the radar' for some stakeholders in Northern Ireland's investment community.

13. In the short-term, Invest NI should benchmark its governance and management approach, including the level of resource allocated to holding fund management, with that adopted by Scottish Enterprise through the Scottish Investment Bank. There are also concerns regarding the potential loss of expertise within the Fund of Funds Committee as Invest NI Board members reach the end of their period of appointment to the main Board.

Future approval process

14. A substantial proportion of Invest NI's £90m funding commitment to the Fund of Funds is approved and committed but remains unspent at this stage as the majority of the funds are at an early stage in their investment cycle. Moving forward, we conclude that Invest NI should seek to maintain a revolving Fund of Funds 'pot' of around £100m of public sector capital – consistent with the approach adopted by Scottish Enterprise. Invest NI will wish to keep the size of the unallocated Fund of Funds 'pot' under regular review and develop an active strategy to 'top up' the Fund of Funds.

15. In the context of the long-term objective to establish a sustainable revolving fund, the evaluation found no evidence to justify a significant change in the current approval process which operates at the level of the individual funds rather than the umbrella holding fund. The current process is based on evidencing specific market failures and developing individual funds in response and, in our view, this approach remains essentially sound; there are potential risks attached to seeking high level approval for a much larger, overarching Fund of Funds where this is not underpinned by very detailed evidence of target markets or proposals for specific funds. However, building on experience from Scotland and the North East, if possible, Invest NI may wish to consider the creation of flexible, unallocated pot (potentially £5-10m) which can be utilised flexibly and rapidly in response to demand. This is likely to facilitate a more rapid, proactive response than the current, sometimes lengthy process involved in securing approval for the extension of individual funds.

Key Performance Indicators

16. The Fund of Funds currently does not have any Key Performance Indicators associated with it as these are all attached to the individual funds, each of which typically has KPIs relating to numbers of deals and value of investment. Some also have targets relating to the numbers of investors, or new investors engaged with the fund. Unlike the JEREMIE initiatives, few have specific targets relating to the creation of jobs or output/GVA as Invest NI consider that they will generally accrue during the realisation phase (typically years 5-10 of an equity investment fund). In the case of Finance Wales, comparatively optimistic employment/GVA targets have generated some scrutiny as the programme moves into the final few weeks of its investment period.

17. One stakeholder also highlighted the anomaly that the Growth Loan Fund is identified separately as a headline measure within the Programme for Government, unlike the other funds within the continuum. For the 2015-2019 PfG/Corporate Plan period, Invest NI could consider aggregating the individual KPI targets at Fund of Funds level to provide a more complete picture of its performance.

18. As ultimately, the performance of the risk capital funds will be judged not only on their impact on loan/equity investment markets, but also on their economic impact, we conclude that Invest NI should develop aggregated,

Fund of Fund level KPIs to feed in to the next Invest NI Corporate Plan round. These could include target number of investments/deals, amount invested and jobs created, cumulated at Fund of Funds level. Appendix 1 draws together the existing sub-fund outputs and forecast impacts and details initial proposals for job/GVA outputs at Fund of Fund level. Recommendation 10 also refers.

19. The stakeholder consultation concluded that, in order to support a wider and more strategic role for the Fund of Funds Committee, Invest NI (with partners) should assemble a broader range of market indicators which provide an up to date picture of changing market trends in both the supply of and demand for equity finance. We also conclude that Invest NI should consider, as contracts for new funds are let, the adoption of fund-level reporting measures which encourage collaboration between fund managers to develop the deal flow chain/pipeline and encourage progression between the different funding streams.

Strategic impacts, incremental outcomes and wider/regional benefits

20. The Fund of Funds model does not result in any specific economic outputs or outcomes as these are realised at the level of the individual funds. Nonetheless, the flexibility afforded by the Fund of Funds undoubtedly represents a significant incremental outcome which would not have been achieved had Invest NI continued to operate a series of separate, individual funds. It is important to note that, as yet, Invest NI has not been required to utilise any of the flexibilities created through the Fund of Funds although it is anticipated that this will occur in future as legacy returns are realised; the level of incremental outcomes is expected to increase significantly in future. In this context, we conclude that the Fund of Funds has contributed to the achievement of a number of wider and regional benefits including:

- contributing to increasing the scale/quantum of public sector investment in risk capital funds in Northern Ireland; the Fund of Funds has created a robust mechanism to facilitate the long-term management of investment returns and other matters which unlocked Departmental and Ministerial approval for a larger quantum of funding than could have been the case had the funds been operated and managed in silos

- securing new sources of private sector investment as a result of the need to replace EIB investment in the Fund of Funds following the decision not to develop a JEREMIE programme in Northern Ireland

- developing investment and fund management capacity in Northern Ireland; the Fund of Funds approach has engaged local fund managers and investors in the risk capital process and strengthened the capacity and longevity of locally-based fund managers

- building the capacity and capability of the Invest NI's Board around the theme of access to finance through the establishment of the Fund of Funds Committee

- market adjustment; the Fund of Funds is designed to support the adjustment of Northern Ireland's loan and equity investment markets by providing the flexibility to re-allocate resources in response to changes in demand and other market signals.

21. The scale and persistence of these impacts will increase over time as the benefits of the flexibilities associated with the Fund of Funds model are realised.

Complementarity with other access to finance/business support initiatives

22. By acting as an umbrella for Invest NI's individual risk capital funds, the Fund of Funds is unique in a Northern Ireland context. There are no other programmes or activities in place which seek to address the same issues or opportunities in the area of access to finance. In addition, we conclude that the Fund of Funds is complementary to Northern Ireland's wider innovation and business support 'eco system' by creating a long-term platform for investment for the pipeline of businesses supported through Propel, NISP Connect and related initiatives.

Additionality

23. Although the level of additionality associated with the Fund of Funds was not quantified, we conclude that the initiative has demonstrated low levels of deadweight and displacement. At individual fund level, a degree of product market displacement will be present as businesses supported secure market share from other firms who have not benefited from support.

Value for money

24. The Fund of Funds demonstrates both **economy** and **efficiency** in the use of inputs/resources to manage the programme. In terms of economy, Invest NI considered a range of options (including both in-house and external management of a holding fund) as part of the casework process. In recommending the preferred option (in-house management based on the successful model adopted by Scottish Enterprise) the casework report concluded that the Fund of Funds approach could realise all of the flexibilities and other benefits inherent in the JEREMIE approach but at a substantially lower cost.

25. This point can be developed further in considering the **efficiency** of the Fund of Funds approach. There are no quantifiable outputs associated with the Fund of Funds therefore the assessment of efficiency is based on the costs associated with realising the strategic or wider/regional benefits summarised earlier in section 5.

26. Although Invest NI does not allocate a specific budget heading to the Fund of Funds, it is estimated that the overall staffing costs associated with the Fund of Funds, including Board member input, is £80,870 per annum or 0.09% per annum of the public sector capital invested through the Fund of Funds. In contrast, North East Finance has occurred whole life holding fund management costs of £14.5m or some 11.6% of the capital invested in the holding fund. This is equivalent to around £2.9m per annum. Although the level of resource devoted to holding fund management is substantially larger in the projects benchmarked in section 6, there are no significant differences in the general approach to holding fund management.

27. The project's **effectiveness i**s related to its impact on longer-term outcomes and to the strategic objectives of Invest NI, DETI and the Northern Ireland Assembly through the Programme for Government. We conclude that the project has demonstrated its effectiveness through its contributions to the objectives and targets set out in the 2011-2015 Corporate Plans of both organisations and makes an additional, direct contribution to Programme for Government targets through the Growth Loan Fund. On this basis, we conclude that, to date, the Fund of Funds has demonstrated clear value for money for the public purse.

Longevity of the Fund of Funds

28. Our analysis of the loan/equity finance market in Northern Ireland and overview of the performance of Invest NI's risk capital funds suggests that market failure continues to be present in both investment spaces and will be for some time. It appears unlikely that Northern Ireland's banks will return to SME lending at pre-recession levels for the foreseeable future whilst the equity investment market is subject to longer-term, structural market failures, particularly in relation to seed stage investment.

29. The added value of the Fund of Funds model is derived from the flexibilities inherent within this approach. As we highlight earlier, the incremental outcomes associated with the Fund of Funds will increase over time as legacy returns are generated from earlier risk capital funds and/or the need to vire resources between sub-funds arises. For these reasons, we conclude that Invest NI should adopt a long-term approach to the Fund of Funds model and that, whilst subject to regular review, it should remain in operation for at least the next six years (to 2020) coincide with the new European Structural Funds programme period; subject to further evaluation, the Fund of Funds model could be rolled forward into the next (2020-2026) EU programme period.

Equalities impacts

30. The Fund of Funds initiative was subject to a policy screening process by Invest NI to determine whether an EQIA was required and was 'screened out' as it was not expected to have an impact on any of the Section 75 categories and thus were not subject to EQIA. The evaluation found no evidence that Invest NI delivered the project in a way which is likely to have a detrimental impact on the Section 75 equality of opportunity or good relations categories.

Recommendations

31. The evaluation identifies a series of recommendations for Invest NI and other stakeholders that are summarised in figure 2 below. These relate both to the wider policy environment (identified by the prefix ‘P’ in parentheses) in which Invest NI’s risk capital funds operate and also to specific aspects of the delivery of the Fund of Funds initiative in the future (identified by the prefix ‘D’).

Figure 2: Recommendations

No	Recommendation	Justification
1(P)	Invest NI should seek to extend the remit of the Fund of Funds Committee beyond oversight of the performance of the individual funds. Alongside this, the Committee should develop a more strategic role, focusing on longer term demand and supply-side issues.	Stakeholders including Committee members highlighted the need for a more strategic, long-term focus on access to finance for Northern Ireland SMEs.
2 (P)	Working with the Fund of Funds Committee, Invest NI should revise/update the Access to Finance Strategy with a dual focus on stimulating business demand for finance and addressing market failures/gaps in supply. Forthcoming DETI research in response to the recommendations of the EAG report should inform this process.	Stakeholders highlighted the need for a more strategic, long-term focus on access to finance for Northern Ireland SMEs.
3(P)	To support the Fund of Funds Committee in implementing recommendations 1 and 2, Invest NI and DETI should draw together a series of existing indicators reflecting market trends in demand for and the supply of SME finance. These should be presented on a quarterly basis.	Stakeholders highlighted the need for a more strategic, long-term focus on access to finance for Northern Ireland SMEs and a lack of appropriate metrics to inform this.
4(P)	Invest NI should liaise with DETI to ensure that the forthcoming research on venture capital considers the following potential market failures in the medium-term: • later stage equity investment in the £2m-£5m range • investment in MBO/MBI activity • property-related debt, including support for non-Irish banks with a significant property exposure • social enterprise support and the availability of community development finance.	The stakeholder consultation and desk research highlighted a number of potential gaps/market failures across Northern Ireland’s loan/equity investment markets.
5 (D)	Within the framework of the existing Departmental and Ministerial approvals for the Fund of Funds, where possible, Invest NI should seek to explore opportunities with DETI and DFP to establish a sustainable revolving fund for risk capital investment. The revolving fund should maintain a public sector funding allocation of around £100m to ensure continuity in the supply of risk capital funding.	Stakeholder consultation and benchmarking highlighted the need to ensure a long-term approach to public sector investment in risk capital which maximises opportunities for re-investment of legacy returns from earlier funds.
6(D)	Linked to the 2014-2020 European Structural Funds programme, if practically possible, Invest NI should seek approval to establish a flexible risk capital pot of between £5-10m that could be allocated rapidly to an individual fund in response to market signals. This would reduce the time associated with securing separate approvals to extend a fund.	The benchmarking research highlighted the benefits of retaining flexibility in the allocation of funding in Scotland and North East England.

No	Recommendation	Justification
7 (D)	Invest NI should undertake a more detailed benchmarking exercise with Scottish Enterprise to compare governance structures and staffing resources to deliver the Fund of Funds/holding fund model.	The research suggests that Invest NI is delivering the Fund of Funds model at significantly less cost than comparator organisations – although they may be delivering a larger volume of relevant activity. A more detailed benchmarking exercise would test this assumption and Scottish Enterprise/Scottish Investment Bank is the most appropriate benchmark case study as it did not adopt the JEREMIE approach.
8(D)	Invest NI should undertake an early review of its communications strategy relating to the Fund of Funds. This should include exploring the potential to develop the use of the Invest NI brand as the primary gateway for those businesses seeking access to finance rather than rely on the marketing activities of the individual funds.	The benchmarking exercise highlighted that Finance Wales/Scottish Investment Bank have a much higher profile and brand as a gateway to business finance.
9 (D)	Building on the ex-ante evaluation of financial instruments undertaken by DETI, Invest NI and DETI should liaise concerning the development of the 2014-2020 EU Structural Funds programme and agree the broad allocation of ERDF to be utilised as part of the Fund of Funds. This could include extension of the existing ERDF-supported Co-Investment Fund or the creation of a more flexible funding pot in response to recommendation 6.	Stakeholder consultation highlighted the need to consider this issue.
10 (D)	Building on the material presented in Appendix 1 of this report, Invest NI should develop aggregated KPIs at Fund of Funds level to feed in to the Corporate Plan cycle. These could include target number of investments/deals, amount invested and jobs created/GVA targets, cumulated at Fund of Funds level and reported annually. The GVA target for each fund should be assessed at the end of the 10 year operational period through Post Project Evaluation.	Stakeholder consultation highlighted the need to consider this issue.
11 (D)	Whilst recognising that investment cycles are not always linear, Invest NI should introduce and monitor new reporting measures at fund level which encourage collaboration between fund managers to develop the deal flow chain between the seed, early and development stages of funding	Stakeholder consultation highlighted the need to consider this issue.

No	Recommendation	Justification
12 (D)	Invest NI should support the development of the industry-led Propel Forum which brings together key stakeholders across the investment and innovation communities. Invest NI should monitor the impact of the Forum as • an industry lobbying group • a sounding board to test evolving DETI/Invest NI policies • a mechanism for signposting/referral of investment opportunities.	Stakeholder consultation highlighted the need to consider this issue.
13 (D)	When Fund of Fund Committee members reach the end of their tenure on the Invest NI Board, Invest NI should consider extending their period of appointment to the Committee through the use of existing co-opting arrangements. For the medium/long-term, Invest NI should review the Terms of Reference for the Fund of Funds Committee to ensure mechanisms are in place to retain skills and expertise whilst maintaining an appropriate balance of serving Board members and co-optees.	Stakeholder consultation highlighted the need to consider this issue.
14 (D)	Invest NI should review the engagement of each of the key seed stage/start up business support initiatives with the Invest NI funds to ensure that relevant programme managers/client executives have full awareness of the range of funds available.	Stakeholder consultation highlighted the need to consider this issue.
15 (D)	Invest NI should continue to review the Fund of Funds delivery model every three years, benchmarking the approach against best UK and European best practice. The review should test the costs and benefits of the current approach against those of an independently managed holding fund	Keeping delivery arrangements under regular review reflects best practice in comparator programmes.

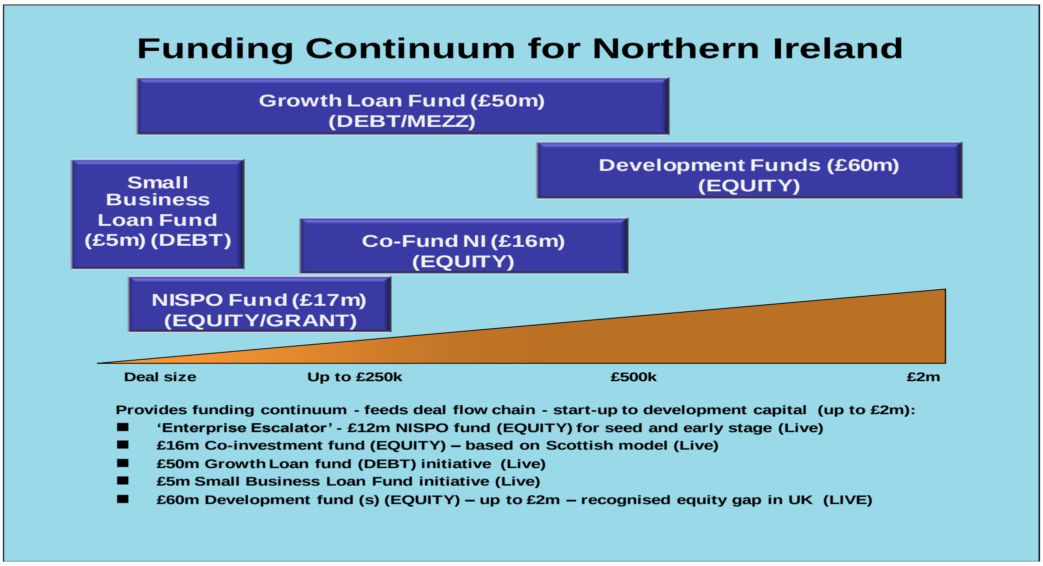
1 INTRODUCTION

Background

1.1 In January 2014, Invest Northern Ireland (Invest NI) commissioned Urbis Regeneration Ltd (Urbis) to undertake an evaluation of its **Fund of Funds** model. Developed as part of its Access to Finance Strategy, the Fund of Funds is a continuum of risk capital investment funds totalling £160m and underpinned by a mix of investment through Invest NI, the European Regional Development Fund and private sector investors.

1.2. Under the umbrella of the Fund of Funds, Invest NI has a portfolio of five investment funds encompassing a mix of debt, equity and mezzanine investment and each operated by an independent fund manager. Each fund addresses a specific market failure in the provision of risk capital, encompassing deal sizes from £1,000 to £2m. Figure 1.1. below summarises the continuum of risk capital funds currently operated by Invest NI:

Figure 1.1: Risk capital funding continuum



(Source: Invest NI)

1.3. The Fund of Funds approach was developed following discussions between DETI, Invest NI and the European Investment Fund (EIF) on the potential to utilise the European Union's Joint European Resources for Micro to Medium Enterprises (**JEREMIE**) model for risk capital investment in Northern Ireland. These were initiated through the Barroso Task Force[1], established following EU President Jose Manuel Barroso's visit to Belfast in 2007. Initial research by the EIF in 2008[2] had highlighted market failures impacting on debt finance, business angel and venture capital investment in Northern Ireland and advocated the establishment of a JEREMIE holding fund underpinned by a European Investment Bank (EIB) loan matched against ERDF and Invest NI funding.

1.4. Subsequently, Invest NI had specifically explored the potential to secure EIB investment to underpin the development of the Growth Loan Fund. However, EIB investment was not pursued for a variety of reasons including the limited scale of the fund proposed at that time and set-up/management costs. Invest NI sought and secured approval from the Invest NI Board, Department for Enterprise, Trade and Investment (DETI) and Department of Finance and Personnel (DFP) for an alternative Fund of Funds model during 2009 and 2010.

1.5. The Fund of Funds model aimed to emulate aspects of the JEREMIE approach – including the flexibility to shift resources between individual funds and to recycle legacy returns – but without EIB participation or the high management costs associated with JEREMIE delivery. Invest NI's approach also sought to

- provide the flexibility to shift resources between funds, in response to market conditions or the performance of individual funds
- support the establishment of a deal pipeline/flow across seed, early stage and development funds

1 Communication from the Commission to the Council and to the European Parliament on the Report of the Northern Ireland Task Force COM (2008) 186 final, April 2008

2 JEREMIE SME Financing Gap Assessment, Interim Report for Northern Ireland, European Investment Fund, April 2008

- facilitate recycling of legacy returns of up to £10m per annum.

1.6. Whilst a freestanding holding fund has not been established, Invest NI acts as the holding vehicle for public investment through the individual funds, with governance and accountability provided through the Invest NI Board. A separate Fund of Funds Committee, operating as a formal sub-committee of the Invest NI Board, was established in 2011 to provide both oversight and challenge of the Fund of Funds approach.

1.7. As the Fund of Funds represented a novel approach to the management of risk capital, approval was required from both DFP and the Minister for Enterprise, Trade and Investment. This was secured in December 2010. At that time, just one seed stage fund (NISPO) was operational, although proposals for a business angel Co-investment Fund and Development Fund (for later stage equity investment) were at an advanced stage. Proposals for a loan fund were at an early stage of development. Since 2010, the scale and mix of sub-funds has changed significantly through

- the extension of the original NISPO fund and the establishment of NISPO II, currently subject to a formal tender process

- the establishment of the Small Business Loan Fund operated by UCIT/Enterprise NI, offering loans up to £50,000

- the development of a Growth Loan Fund serving larger/more established small and medium-sized enterprises providing a hybrid mezzanine investment product

- the successful launch of two £30m Development Funds, both of which have raised significant private investment at first close, following a failed attempt to establish a fund in 2010/11.

1.8. As a result, the Fund of Funds continuum now encompasses just over £160m of public/private risk capital funds, an increase of 60% since 2010 when the initiative was established. Although some of these funds have been invested (section 3 provides further details) the quantum of funding available through the Fund of Funds continuum is certainly comparable with that achieved through the larger UK JEREMIE programmes (including the £155m North West Fund, £150m Finance Wales fund and £125m North East Finance fund).

The study brief

1.9. The Invest NI brief identified a number of separate objectives for the evaluation, including

- review the strategic context for the Fund of Funds and consider the operational fit with the objectives of the Invest NI and DETI Corporate Plans and the Programme for Government, drawing on evidence of the contribution made to date, or anticipated

- review the rationale for Fund of Funds outlining the nature and scale of the market failures that it is seeking to correct; identify the scale of need and demand and conclude on the extent to which the rationale remains valid

- review performance to date of Fund of Funds against the original objectives and, if appropriate, identify reasons for any divergence

- examine the extent to which the delivery of Fund of Funds has met the requirements of the approving bodies – Invest NI, DETI and DFP – through a review of its governance, management and control mechanisms

- assess the appropriateness of the Fund of Funds model and highlight any lessons learned for the future architecture of Fund of Funds

- review the overall quantum and mix of sub-funds and consider whether there are gaps in provision or the continuum of funds is complete

- consider whether a holistic approach should be taken to seeking approval for the funding of Fund of Funds or whether the current approach to approval of each individual fund is more appropriate

- consider whether the Fund of Funds architecture is likely to deliver more incremental economic outcomes than individually-managed debt or equity funds
- review the longevity of the Fund of Funds model
- assess the operation and management arrangements adopted for Fund of Funds and determine its effectiveness in meeting strategic objectives
- examine the degree of complementarity with other Invest NI products and any other relevant publicly funded products, including financial support for investment
- identify the main risks that have emerged during the operation of Fund to Funds to date, assess any actions taken to reduce these risks and whether the overall approach to risk management is robust and proportionate
- consider whether the Fund of Funds should have a specific suite of key performance indicators associated with it
- assess the impact of Fund of Funds in increasing equity and debt investment
- assess the extent to which Fund of Funds has generated strategic impacts, including wider and regional economic benefits (in line with Invest NI's EAM); benefits should be quantified as fully as possible or, if quantification is not possible, a qualitative analysis should be presented of their scale and persistence
- benchmark the Fund of Funds against similar approaches, including JEREMIE programmes, from elsewhere in the UK and Europe
- determine the extent to which value for money has been or will be secured through the Fund of Funds model, taking account of the full range of benefits which have been/will be achieved and the benchmarking analysis; value for money at fund level is assessed during the individual fund evaluations
- take into account the equality impacts of the programme with particular regard to Section 75 of the Northern Ireland Act 1998 and the Disability Discrimination Act 1995
- make SMART recommendations including lessons learned and highlight any aspects of delivery and performance which could inform future development of the Fund of Funds model.

1.10. The interim evaluation is focused on the operation of the Fund of Funds structure rather than providing a detailed analysis of the performance and impact of the five Invest NI-supported risk capital funds which form the Fund of Funds continuum. These matters are addressed through an ongoing programme of interim and post-ante evaluations for each of the funds; where appropriate, our research has drawn on these evaluations and they are referenced through the report.

Research methodology

1.11. The evaluation fieldwork took place in January and February 2014. Our research methodology included:

- a desk review of the earlier evaluations and economic appraisals; key DETI/Invest NI policy documents and performance management information relating to the individual funds which comprise the Fund of Funds continuum
- interviews with key stakeholders including Invest NI Board members and executives; DETI executives; and fund managers from Clarendon; Crescent Capital; E-Synergy; Kernel Capital; UCIT and Whiterock Capital Partners
- benchmarking the project against other comparator initiatives in the rest of the UK including North East Finance; Finance Wales and Scottish Investment Bank
- exploring the counterfactual position for the project, and assessing its value for money based on its economy, efficiency and effectiveness

- developing SMART recommendations to inform the future development of the Fund of Funds model by Invest NI.

Report structure

1.12. Section 2 considers the market and strategic context for the project. Section 3 reviews the development and delivery of the Fund of Fund approach in more detail. Section 4 considers the issues raised by the various stakeholders consulted as part of the evaluation.

1.13. Section 5 considers the strategic impact and value for money of the project. Section 6 benchmarks the Fund of Funds model against comparator projects in the UK. Section 7 presents our conclusions and recommendations.

2. CONTEXT

2.1 Section 2 considers the strategic and market context for the development of the project including:

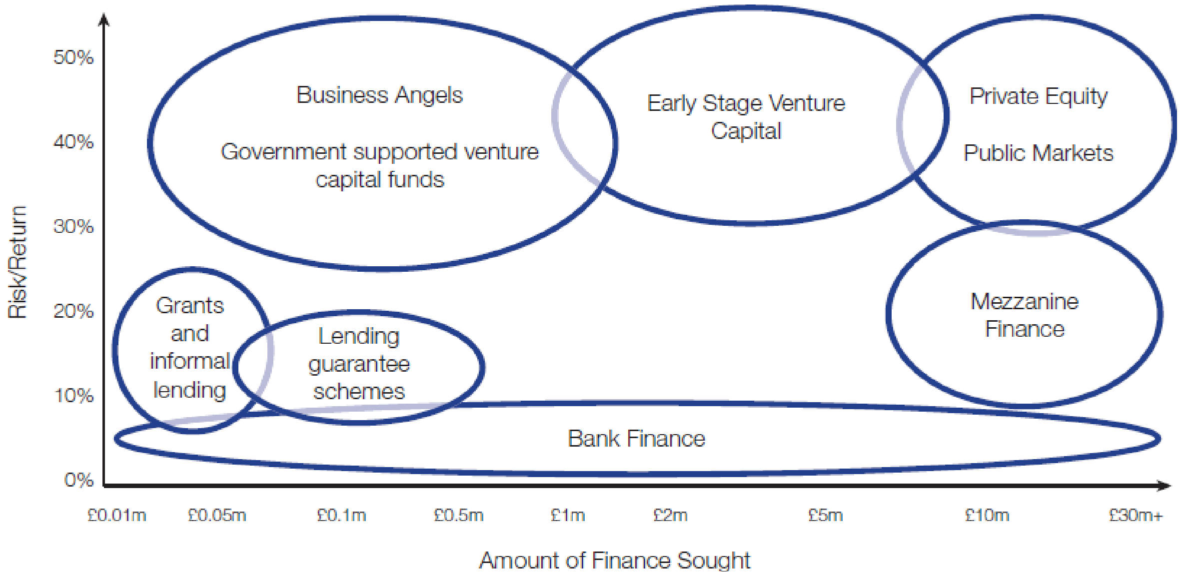
- a brief review of market trends in business lending and equity investment in the UK and Northern Ireland
- the strategic/policy framework for the development and delivery of the Fund of Funds that was in place during the period covered by this evaluation.

Market context

Propensity to use external finance

2.2 Businesses have a wide range of external finance options, including debt, equity and hybrid finance products (e.g. mezzanine finance) which combine both elements. The type of external finance most suited to an individual business, and its availability, will depend on a range of factors including the life stage of the business; the levels of risk associated with it; the amount of finance sought and the level of risk/return sought by the investor. Figure 2.1 below summarises the key sources of external finance and the relationships between them:

Figure 2.1: The 'finance ladder'



Source: Rowlands Review: the provision of growth capital to small and medium-sized enterprises, 2009

2.3 A significant proportion of UK SMEs use external finance of some type, although they remain in the minority. The SME Finance Monitor[3] - which includes a sample of 1,000 Northern Ireland businesses -notes that 41% of UK SMEs reported using some form of external finance in the third quarter of 2013 and this figure has been broadly stable since mid 2012. In Northern Ireland, recent research by the Economic Advisory Group (EAG)[4] suggests that Northern Ireland SMEs may have a greater propensity to access external finance – 58% compared with 41% for the UK as a whole, with a particular focus on overdraft facilities to provide working capital.

2.4 At UK level, the SME Finance Monitor notes that use of 'core' financial products (loans, overdrafts and credit cards) fell from 40% of SMEs (Q1 2012) to just 33% in Q3 2013, with use of overdraft facilities falling significantly from 21% of SMEs to just 16% in the year from Q3 2012. Use of non-core external finance (including leasing or hire purchase, non-bank lending, equity investment or invoice finance) fell more slowly during the same period.

3 SME Finance Monitor Q3 2013, BDRC Continental, November 2013

4 Review of Access to Finance for NI businesses; Economic Advisory Group, March 2013

Market failure

2.5 HM Treasury's Green Book[5] notes that

"Economic efficiency is achieved when nobody can be made better off without someone else being made worse off. Such efficiency enhances prosperity by ensuring that resources are allocated…. in the most productive manner possible. One potential cause of inefficiency is where… the private returns which an individual or firm receives….differ from the returns to society as a whole. Market failure is a description of a situation where, for one reason or other, the market mechanism alone cannot achieve economic efficiency."

2.6 In relation to business finance, market failure is generally a result of imperfect information. In an efficient market, investors would have a complete picture of the level of risk associated with each investment and agree a commensurate rate of return with the investee business; furthermore, investors would lend to all firms where expected investment returns were at acceptable level above investment costs. However, in practice, firms seeking finance have a much clearer picture of the level of risk associated with their business than investors. This is known as 'asymmetry of information'.

2.7 In these circumstances, debt/equity markets may not provide sufficient investment to meet the needs of businesses seeking finance. Those businesses which are perceived to represent a higher level of risk, or generate a commensurately low rate of return, are likely to be subject to credit rationing, even if they are willing to pay higher rates of interest to secure investment[6].

Bank lending

2.8 Historically, **bank lending** has been competitively priced and comparatively easy to access. The stock of loans to UK non-financial businesses more than doubled between 2002 and 2007[7]. As more recent analysis of the subsequent global and UK banking crises and economic recession has highlighted, the first part of the last decade was characterised by strong competition between banks for business lending and an aggressive attitude to risk, resulting in high loan to value ratios.

2.9 Net lending to UK businesses (the difference between gross bank lending and gross loan repayments) declined dramatically from +£20bn in September 2008 to -£15bn in July 2010.[8] Although it improved during 2011, peaking at around +£3bn, it remained negative during 2012 and 2013. UK banks have adopted much more stringent lending criteria since 2008, focusing on lower risk, asset-backed propositions offering higher margins. During this period, most UK banks have withdrawn from what they would perceive to be higher risk sectors including property or construction.

2.10 9% of UK SMEs applied for a new loan or overdraft facility during 2012[9], this figure had fallen to just 7% by Q3 2013. British Banking Association (BBA) data[10] (which covers Great Britain rather than the UK as a whole, as three of the four major Northern Ireland banks do not input data to BBA) indicates that the number of SMEs applying for loan/overdraft facilities declined from 492,000 in 2012 to 331,000 in the first three quarters of 2013. EAG note that only 8% of SMEs in Northern Ireland had applied for bank loan finance during 2012; two thirds applied for loans of less than £50,000.

2.11 Recent research by BIS suggests that the rejection rate for term loans increased from 5% in 2007/8 to 23% in 2011/12; this is broadly consistent with recent SME Finance Monitor data which suggests that 25% of UK loan or overdraft applications tracked by the report's authors between 2011-2013 were unsuccessful. The EAG report indicates that a slightly higher proportion (30%) of Northern Ireland SMEs had applied unsuccessfully for a bank loan or overdraft facility.

2.12 The SME Finance Monitor notes that a minority of UK SMEs (7% in Q3 2013) were 'would be seekers' of finance, in that they wished to apply for a bank loan or overdraft but were discouraged from doing so. In 2010, research by the ACCA/CBI[11] argued that

5 The Green Book: appraisal and evaluation in central government, HM Treasury July 2011

6 Stiglitz, Joseph and Weiss, Andrew, Credit Rationing in Markets with Imperfect Information, The American Economic Review, Vol 71, No. 3 (June 1981), pp. 393-410.

7 Financing a private sector recovery, HM Treasury/BIS, July 2010

8 Trends in UK lending, Bank of England, January 2013

9 SME Finance Monitor Q3 2013, BDRC Continental, November 2013

10 Bank Support for SMEs 4th quarter 2013, British Banking Association May 2014

11 Small business finance and the recovery; results of the 2010 SME credit and finance surveys, ACCA and CBI 2010

"As the recovery gets underway it is creating a need for working capital and thus a great deal of latent demand for finance. Only a small part of this, however, translates into actual requests for new funds. One reason for this is discouraged demand – the perception that banks and other providers will simply not lend is forcing SMEs to abandon their financing plans and instead tap their suppliers, their customers, or even friends and family, for finance."

2.13 The EAG report notes that the proportion of discouraged borrowers in Northern Ireland is also 7%. Around 30% of these SMEs did not apply because they perceived that their bank would reject their application, whilst a further 23% cited the general economic climate and 22% highlighted affordability concerns.

2.14 The SME Finance Monitor notes that, for Q3 2013, 38% of SMEs had reported an injection of personal funds into their business in the previous 12 months. Smaller, younger SMEs, those with a higher than average risk rating and those that had been 'would-be seekers' of finance, were most likely to have done so.

2.15 Although some commentators have argued that credit conditions are beginning to improve, over 66% of UK businesses surveyed by the Federation of Small Businesses in Q3 2013 considered that credit availability was either 'poor' or 'very poor'. This had fallen from 74% in Q3 2012.

2.16 The EAG report highlights the particular issues facing Northern Ireland SMEs burdened with property-related debt - 8% of all firms and 20% of medium-sized enterprises (with between 50-250 employees) fall into this category. Between 2007 and 2012, average asking prices for residential property fell by over 46%[12]; prime industrial values declined by 50% over the same period, with office property falling in value by 17%[13]. The EAG research highlights that those Northern Ireland SMEs with property related debt were four times more likely to have sought bank loan finance in recent times than those SMEs without a property debt overhang.

2.17 In the Republic of Ireland (ROI), the Irish Government established the National Asset Management Agency (NAMA) to acquire loans linked to property development projects financed by the Allied Irish Bank; Bank of Ireland; Anglo Irish Bank; Irish Nationwide Building Society; and EBS Building Society. This involved the transfer of assets worth more than €71bn to NAMA, including a large number of Northern Ireland projects; over €10.6bn of assets have been sold since 2010. Although the fall in values in Northern Ireland is comparable to that experienced in the ROI, as yet there has been no move to develop a similar scheme; the EAG report recommends that DFP/DETI engage further with the Northern Ireland banks on the property debt issue, whilst noting that

"There is also no doubt that the property debt overhang is causing problems in the market in that viable trading businesses with property exposure are experiencing more constrained access to finance…..property debt is a relevant factor in maintaining existing terms for the business and in raising new finance…. Without the unlikely event of some form of forgiveness of this debt, it will take some time….for this overhang to work its way through the system."

2.18 The particular structure of the Northern Ireland banking system – two of the four main banks are ROI-owned and a third has significant operations there whilst the Danish-owned Danske Bank also has a growing presence – means that, in practice, some of the measures adopted by the UK Government to stimulate bank lending have had a limited impact in Northern Ireland. For example, of the main Northern Ireland banks, only the Ulster Bank, Barclays and Santander have participated in the Bank of England/HM Treasury **Funding for Lending Scheme** (FLS) which aims to incentivise banks and building societies to lend to both business and mortgage customers by providing funding at below market rates.

2.19 Elsewhere in the UK, net lending by FLS participants for Q3 2013 was +£5.8bn, the highest quarterly net lending flow since the scheme was launched in 2012. Whilst the scheme has undoubtedly had a significant impact on mortgage lending – to the extent that it was withdrawn from this sector by the Bank of England in November 2013 amid concerns of the emergence of a house price bubble in southern England – there is less evidence of its impact on SME lending.

12 Northern Ireland Quarterly House Price Index Q3 2013, University of Ulster/Bank of Ireland

13 Northern Ireland Property Market Outlook 2013, CBRE January 2013

2.20 The **Enterprise Finance Guarantee (EFG)** scheme, launched by the Labour Government in 2009 to encourage bank lending to SMEs who were unable to provide sufficient security, has also had a limited impact in Northern Ireland. Under the EFG the Government guarantees up to 75% of loans between £1,000 and £1m for viable SMEs. However, Northern Ireland has the lowest take up of EFG loans of all of the UK regions – the number of loans drawn down per 10,000 businesses is 14.5 compared with 36.2 for the rest of the UK. In contrast, the North East – which shares some characteristics with the Northern Ireland economy – has the highest uptake of EFG.

2.21 By the end of 2012/13, just £22.9m of EFG loans had been drawn down in Northern Ireland[14]. The EAG report cites the lack of critical mass of lending activity by Northern Ireland banks operating the scheme; the limited number of large SMEs in eligible sectors; low levels of SME awareness and the costs associated with EFG as the main causes for low take-up. The report recommends that these issues are considered by DFP/DETI, the UK Government and Bank of England; another recommendation emphasises the need for the British Banking Association to work with Northern Ireland's main banks to produce accurate SME lending data to inform future policy development.

2.22 In 2008, the European Investment Fund undertook an analysis of the risk capital market in Northern Ireland.[15] This was a precursor to the DETI review supported by Invest NI over the establishment of a JEREMIE Fund (considered in more detail in section 3 of this report. The EIF study concluded that

"The identified market failures and weaknesses of the Northern Irish SME financing market mainly lie in the area of SME financing by the commercial banks in particular segments (micro financing, guarantees), in the underdevelopment of the venture capital investments, business angel activity and in technology transfer activities and export capability".

2.23 In this context, Invest NI has identified market failure in two distinct areas of the commercial lending market

- Small Business Loan Fund – an economic appraisal noted particular market inactivity in relation to small business lending between £1,000 and £50,000, resulting in the establishment of the Small Business Loan Fund in 2013 with an Invest NI-backed investment fund of £5m

- Growth Loan Fund – in 2011, an economic appraisal concluded there was a gap in the market for a £70m mezzanine finance product, whilst acknowledging that public sector intervention could not replace bank lending in Northern Ireland; this led to the establishment of the Growth Loan Fund providing £50 million of typically unsecured lending at higher interest rates with a profit share arrangement replacing a conventional equity stake in the investee business and a lending range of between £50,000 and £250,000.

Equity investment

2.24 **Equity investment** is a form of finance suitable for both start-up businesses with rapid growth potential who are unable to generate sufficient revenues to service more conventional borrowing, and more established SMEs that are seeking to grow. The latter may also be suitable for mezzanine finance which enables providers of loan finance to secure an equity interest in the investee company. Equity investment generally involves both a higher level of risk, and commensurately higher returns for investors, than more conventional forms of debt finance. As highlighted in figure 2.1, each type of equity investment has a different risk/return profile. **Only 2%** of UK SMEs use external equity as a source of finance[16] - research for the EAG report indicated that this was even lower (1%) for Northern Ireland firms - and it has been argued that this is a result of structural market failure. In particular, the Rowlands Report argues that *"the market for all types of risk capital suffers from failures associated with imperfect information….where both SMEs and investors have insufficient information to make optimal investment decisions."* Rowlands also argues that many business owners have a clear aversion to diluting their equity and that this also serves to limit demand for equity investment.

2.25 In recent years private equity investment in the UK has had an increasing focus on providing funding for Management Buy Outs (MBO) and the provision of expansion/growth capital for established SMEs and large firms. Management Buy Outs generally involve the acquisition of some or all of a company from its existing owners by its management team, supported through private equity or other forms of external finance. A Management Buy In (MBI) is where an external management team acquire a business utilising private investment.

14 Review of Access to Finance for NI Businesses, Economics Advisory Group March 2013

15 JEREMIE Interim report for Northern Ireland, SME Financing Gap Assessment, April 2008

16 Finance survey of SMEs, IFF Research for BIS, 2010

2.26 Although MBO/MBI and other forms of replacement or growth capital funding have declined since 2008, together they accounted for over £4.4bn of investment by British Venture Capital Association (BVCA) members in 2012 – 73% of all investment by BVCA members. UK investment in MBO/expansion finance by BVCA members peaked at £11.5bn in 2006, falling to £2.1bn in 2009 then recovering strongly to £6.4bn in 2010 before a further, steady decline in 2011 and 2012.

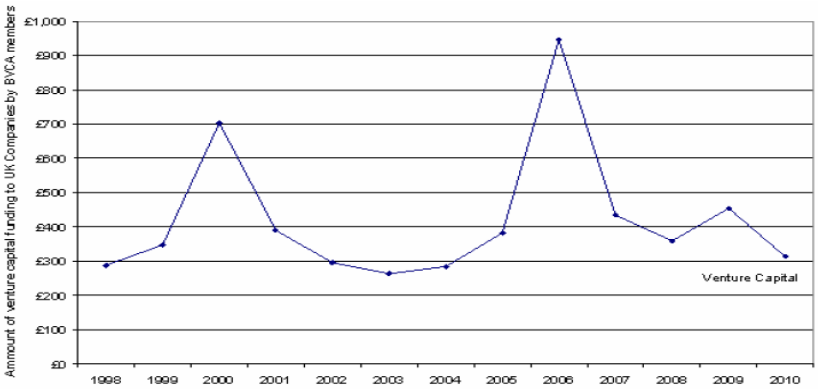
2.27 MBO/growth capital investment in Northern Ireland forms a very small proportion of total UK investment of this type by BVCA members, averaging just over £5.4m per annum over the period from 2005-2012. These figures exclude one large (£150m) MBO supported by private equity in 2010. Northern Ireland remains significantly under-represented in this form of investment; based on its proportion of active (VAT and PAYE registered) enterprises, Northern Ireland's share of total UK MBO/expansion investment should have been around £104m in 2012. BVCA members invested in just 3 such deals occurred in Northern Ireland in 2012 generating a total investment of £1m[17], although this data should be treated with some caution as some of Northern Ireland VC firms are not members of BVCA.

2.28 In 2013, Invest NI's Growth Loan Fund commenced operation in part of this market, providing expansion/growth capital to established SMEs through a hybrid form of mezzanine finance. The EU's current risk capital guidelines do not currently support the inclusion of replacement capital investment in public sector-backed venture funds, and thus Invest NI's Growth Loan Fund does not support MBO or Management Buy In (MBI) proposals. However, the EU has published revised draft guidelines[18] which, from July 2014, should make provision for replacement capital funds supported through public sector investment. We return to this issue later in this report.

2.29 **Venture Capital** (VC) firms can play a pivotal role in accelerating the growth of innovative businesses, enabling them to rapidly transform ideas into marketable products; research[19] shows that venture capital-backed firms grow significantly faster than other firms. Typically, venture capital firms will seek to invest in businesses that have the potential to generate a large return on their investments over a five to seven year timeframe.

2.30 However, earlier stage investment by VC firms accounted for comparatively small amount of investment by BVCA members – equivalent to just 4% of total investment in 2010 and 6% in 2012. VC investment has been particularly cyclical, driven by a requirement to achieve successful realisation of earlier investments to generate funds for reinvestment. Figure 2.2 below highlights notable peaks in VC investment in 2000 and 2006 followed by periods of significant decline in investment activity. The 2012 BVCA activity report[20] indicates that VC investment in the UK increased slightly between 2010 and 2012 from £313m to £343m.

Figure 2.2: Value of UK venture capital investment 1998-2010 by BVCA members



Source: British Venture Capital Association from SME Access to External Finance, BIS 2012

2.31 Over two-thirds of UK VC investment has focused on the IT/software, communications and life sciences sectors. There are also some significant regional disparities in investment levels, with a very strong focus on London and the Greater South East reflecting an historic concentration of R&D activity, technology-based start-ups and venture capital firms.

Figure 2.3: Venture capital investment in Northern Ireland, 2000-2012

17 BVCA Private equity and venture capital report on investment activity 2012, British Venture Capital Association May 2013

18 Draft European Union guidelines on State Aid to promote risk finance investments, December 2013

19 The impact of venture capital on innovation behaviour and firm growth, M.Peneder in Venture Capital:International Journal of Entrepreneurial Finance, 2010

20 BVCA Private equity and venture capital report on investment activity 2012, British Venture Capital Association May 2013

Year	Value of UK venture capital investment (£m)	No of investee firms	Average deal size (£m)	Value of NI venture capital investment (£m)	No of investee firms	Average deal size (£m)	NI% share of UK VC investment by value
2000	703	409	1.72	14	12	1.17	0.020
2001	390	408	0.96	5	11	0.45	0.013
2002	295	398	0.74	11	31	0.35	0.037
2003	263	427	0.62	9	33	0.27	0.034
2004	284	454	0.63	5	20	0.25	0.017
2005	382	491	0.78	3	13	0.23	0.007
2006	946	500	1.89	4	16	0.25	0.004
2007	435	502	0.87	4	9	0.44	0.009
2008	360	455	0.79	7	18	0.39	0.019
2009	454	365	1.24	2	7	0.28	0.004
2010	313	397	0.78	5	14	0.36	0.016
2011	347	405	0.86	20	10	2.00	0.057
2012	343	431	0.80	2	24	0.08	0.005
Total	**5515**	**5642**	**0.98**	**91**	**218**	**0.42**	**0.016**

Source: British Venture Capital Association.

The data relates to investments by BVCA members at the 'venture capital stage' as defined by BVCA and therefore includes some larger, later stage investments. The totals for 'value of venture capital investment' are rounded to the nearest million by BVCA and therefore average deal size should be regarded as indicative only.

2.32 Figure 2.3 does not present a complete picture of VC investment in Northern Ireland as a number of VC firms who are active investors are not members of the BVCA. As such the figures should be considered as indicative and we are unable to qualify the completeness of figure 2.3.

2.33 With these caveats, Figure 2.3 suggests that the average VC deal size in Northern Ireland is less than half of the UK average. Based on Northern Ireland's share of VAT/PAYE registered businesses, its pro-rate share of UK VC investment over the 2000-2012 period should have been £130.7m rather than the £91m actually realised over this period. Excluding the 'outlier' year of 2011, early stage VC investment in Northern Ireland businesses by BVCA members averaged £5.92m per annum between 2000 and 2012. The VC investment secured by selected comparator regions over this period (based on aggregate BVCA data) is as follows:

Figure 2.4: Venture capital investment by BVCA members in comparator regions, 2000-2012

Region	Value of venture capital investment 2000-2012 (£m)	% share of UK VC investment 2000-2012	% of UK VAT/PAYE registered businesses 2012
Northern Ireland	91	1.65	2.37
North East	89	1.61	2.68
Scotland	262	4.75	6.67
Wales	104	1.88	3.71
Yorkshire and Humber*	248*	4.50	6.99
London and South East	3022	54.79	34.56

Source: BVCA * includes £113m invested in 2006 – the most recent peak of VC investment in the UK

2.34 Whilst emphasising the dominance of London and the South East in the UK VC market, Figure 2.4 shows that the majority of Northern Ireland's comparator regions have under-performed in attracting VC investment relative to their share of the UK company base. On these relative terms, Northern Ireland has outperformed the North East, Yorkshire and the Humber and Wales although Scotland achieved a higher market share in relation to its share of UK VAT/PAYE registered businesses.

2.35 Typically venture capital firms make few investments under £2 million as their high fixed transation costs (for due diligence etc) render smaller investments unviable. This, in turn, has led to a shift away from venture capital investment in seed stage or early stage growth businesses (for whom bank lending is often unsuitable as they are unable to service borrowing) towards more established businesses with growth potential - leaving a clear 'equity gap.'

2.36 In 2003 the HM Treasury paper 'Bridging the Finance Gap[21]' noted that early stage growth businesses faced major challenges in accessing relatively modest sums of risk capital. Subsequent research for BIS[22] in 2009 notes that

21 Bridging the finance gap, HM Treasury 2003

22 The supply of equity finance for SMEs: revisiting the equity gap, SQW for BIS 2009

'*even in normal market conditions a structural equity gap remains…..the parameters of the gap… stretch from £250k to at least £2m (with some putting the ceiling at £5m*).'

2.37 Recent research by BIS[23] reinforced this view, noting that *"although some do go lower, very few private sector Venture Capitalists invest below £5m."* Other BIS research[24] notes that

"There is an under-supply of equity finance to young, high growth potential businesses due to the divergence of private and social benefits from investing in these businesses…investing in early stage businesses can lead to a number of positive spill over effects through innovation and knowledge transfers……..which private investors do not take in to account when making their decision to invest."

2.38 BVCA[25] adopt a commercial rather than policy perspective on this issue, stating that

"the problem for early stage firms is exacerbated by the way the financing cycle has moved…because companies have been forced to raise equity funding in difficult circumstances after their first, unrealistic business plans have not been fulfilled, it has made later stage investing more attractive…later stage funds have benefited…from lower entry pricing and then a shorter period of time to exit."

2.39 Invest NI has sought to respond to the market failure at the lower end of the VC investment spectrum. The 2009 evaluation of the Crescent Capital I and II funds concluded that market failure continued to exist for larger equity investments of up to £2m, notionally the minimum deal size viable for venture capital investment, recommending that a successor fund should be established. Subsequently Invest NI secured approval to establish a £30m Development Fund, underpinned by subordinated investment from Invest NI, but this failed to secure a first closing. The opportunity was revisited by Invest NI in 2012 when a further economic appraisal indicated that there was a market gap of between £45m-£60m for equity investments between £450,000-£2m and recommended the establishment of two £30m Development Funds; following a tender process, Crescent Capital and Kernel Capital were appointed as fund managers and both have successfully completed a first closing of £15m.

2.40 In response to the withdrawal of VC investors from seed stage activity, in Europe and the US, informal venture capital or **business angel** investment is playing an increasingly important role in providing early stage finance for new or growing companies. Business angels **–** defined [26] as "*an individual acting alone or in a formal or informal syndicate who invests their own money directly in an unquoted business in which there is no family connection* " are now the most significant source of investment in seed (pre-revenue) and early stage growth firms in the sub-£2m space[27] in the UK.

2.41 Because they do not incur the transaction costs of venture capital firms, business angels are able to make smaller investments, well below the minimum deal sizes considered by venture capitalists. Business angels are also increasingly likely to adopt a 'cradle to exit' investment policy, investing alongside venture capital firms.

2.42 Nonetheless, the UK business angel investment market has also been impacted by the recession, falling from £57.8m in 2008/9 to £50m in 2009/10 [28], a reduction of over 12.6% on the previous year. Although BIS has discontinued its annual reporting of business angel investment activity, more recent research by Deloitte for the UK Business Angel Association[29] indicated that angel investment had indicated to £76.2m in 2012/13. Key findings from this research included:

- 50% of the angel investments analysed through this research were in digital and internet businesses
- 23% of investment was in seed stage (pre-revenue) businesses with a further 14% in businesses at the start-up stage

23 SME Access to External Finance, BIS Economics Paper No 16 January 2012

24 Ibid 19

25 Consultation response from BBAA to 'Financing a Private Sector Recovery Green Paper', July 2010

26 Cited in Siding with the Angels, Professor Robert Wiltbank for NESTA, 2009

27 Consultation response from BBAA to 'Financing a Private Sector Recovery Green Paper', July 2010

28 Annual report on the Business Angel Market in the United Kingdom 2009/10; Mason and Harrison for BIS, June 2011

29 Taking the pulse of the angel market, Deloitte for UK Business Angel Association 2013

- businesses that were beyond start-up stage but still considered to be in their 'early growth' stage secured 53% of angel investment; this may indicate a shift away from seed stage investments, reinforced by the average deal size analysed in the research (£290,000)

- London and the South East attracted 54% of angel investment (mirroring the concentration of later stage VC investment in this part of the UK), followed by the South West (13%), Midlands (11%) and Northern Ireland (6%)

- 74% of angel investors considered that the Government's Enterprise Investment Scheme (EIS) – which provides a series of income and capital gains tax reliefs to investors who acquire ordinary shares in small, unquoted trading companies – as either 'highly significant' or 'significant' in their investment decisions

- the Seed Enterprise Investment Scheme (SEIS), introduced in 2012 to offer additional tax reliefs to investors in seed stage businesses, was utilised in 12% of the deals analysed by Deloitte; however, over 75% of angel investors interviewed as part of the research considered that the introduction of SEIS (and the additional investment that this had attracted) had artificially inflated investee valuations of their business

- several business angel networks (see below) and commercial providers have developed online crowdfunding platforms and this has been identified as a comparatively low-risk means of introducing angel investing to new investors.

2.43 In 2008, Invest NI identified a clear need to address the gap in provision of seed/early stage equity investment and the need for a comprehensive package of measures to support the growth of knowledge/technology-based start ups. The economic appraisal for the Northern Ireland Spin Out (NISPO) Fund set out the need to provide a mix of grant support for Proof of Concept development, investment readiness and intellectual property advice and equity investment for seed and early stage start ups, building on the earlier NITECH fund supported through Invest NI. A subsequent interim evaluation of NISPO I in 2012 indicated that market failure continued to exist for deal sizes of between £50,000-£250,000 and recommended that the fund should be extended; the NISPO II economic appraisal (2013) suggested a market gap of at least £16m for seed stage equity investment.

2.44 In some parts of the UK, most notably Scotland, the development of a **syndicated investment model** has enabled angel investors to spread risk across a wider portfolio of investments, thereby increasing the prospect of securing successful exits. Scottish Enterprise emphasise the importance of business angel syndicates in filling the gap in seed stage investments left by venture capital firms. This model is also beginning to emerge in Northern Ireland where one formal syndicate has emerged; there are a number of active syndicates in the Republic of Ireland.

2.45 Since the late 1990s, business angel networks have been established in various parts of the UK to bring together angel investors with investee companies, deliver investment readiness support and other activities designed to overcome information asymmetry and related market failure. Halo NI is the business angel network for Northern Ireland, funded through Invest NI and delivered by the Northern Ireland Science Park.

2.46 Established in 2004, Halo NI was subsequently remodelled in 2008/9 and funding was secured from Invest NI and InterTradeIreland. Between May 2009 and April 2011, the network supported angel investments totalling £2.92m across 19 deals, leveraging a further £3.38m of investment from other sources. Between May 2011 and April 2013, Halo NI secured a further £3.06m of angel investment through 24 deals, leveraging £4.58m of additional investment. The network has exceeded its cumulative targets for investment and deals since it was reconfigured in 2009.

2.47 Building on experience from Scotland and other parts of the UK, Invest NI developed the Co-investment Fund to stimulate both the size and number of business angel investments. The economic appraisal for the Co-investment fund highlighted a market gap of £16m for business angel co-investment in the £250,000-£450,000 investment space; the subsequent interim evaluation of the Co-investment Fund recommended that the fund should be extended and the maximum deal size should be increased to £1m.

Policy context

2.48 The Fund of Funds was developed within a framework of European Union economic policies which include the EU Risk Capital Action Plan, prepared by the European Commission in 1998, which set out a programme to reduce barriers to risk capital within Member States and on a cross-border basis; and the recently adopted Regulation on European venture capital funds[30] which sets out plans for a common quality framework for venture capital funds in the EU through use of the 'EuVECA' designation.

2.49 The Fund of Funds initiative was developed at the end of the 2008-2011 corporate planning period and just prior to the development of the 2011-2015 Programme for Government and related DETI/Invest NI corporate plans. Both sets of documents are included here.

2008-2011

2.50 The Programme for Government (PfG) 2008-2011 highlights 'Growing a Dynamic, Innovative Economy' as a key priority for the Northern Ireland Executive and sets out a range of goals and targets relating to inward investment and export activity, including the overall aim to *"halve the private sector productivity gap with the UK average excluding the Greater South East of England, by 2015."*

2.51 The DETI Corporate Plan details three Public Service Agreements for which it has responsibility for delivery, alongside its business regulation and consumer affairs role. The Fund of Funds approach contributes to two PSAs – PSA 1 'Productivity Growth' and PSA 3' Increasing Employment' and demonstrates a clear strategic fit with the following, more detailed objectives for each PSA:

- PSA 1 Objective 1: Promote a competitive and outward-looking economy
- PSA 1 Objective 2: Attract and support high quality investment, both foreign and locally owned; this relates to investment by businesses
- PSA 1 Objective 4: Promote higher value-added activity through innovation and the commercial exploitation of R&D
- PSA 3 Objective 3: Increase employment opportunities by attracting high quality inward investment and supporting domestic investment
- PSA 3 Objective 4: Promote business growth.

2.52 Invest Northern Ireland's 2008-2011 Corporate Plan reflects DETI's PSA objectives and details how its activities will contribute to achieving them. It sets out three specific objectives:

- realising client potential through growth in productivity
- shifting the sectoral focus towards higher value added activities, primarily (but not exclusively) through foreign direct investment in key sectors including financial and business services and software
- long-term investment in 'frontier technologies' through enhancing research and development and commercialisation activity in key sectors including biotechnology and the creative industries.

2.53 The 2008/11 Invest NI Corporate Plan advocated improving the quality of business start ups and the need to accelerate R&D, innovation and the commercialisation of research. The Fund of Funds plays a key role in supporting innovative, technology driven companies and as such demonstrates a clear fit with the Corporate Plan.

2.54 In 2008, Invest NI produced its Venture Capital Strategy[31]. This highlighted Invest NI's role in leading the creation of commercially driven funds to address specific gaps in access to finance and to develop the venture capital sector in Northern Ireland. By virtue of the reluctance of venture capital funds to invest in seed or early stage growth firms, particularly high risk technology businesses, the Venture Capital Strategy highlights the need for further sources of seed capital.

2.55 This theme was subsequently developed through Invest NI's Access to Capital Strategy[32], which builds on research including the EIF study cited in paragraph 2.43 and identifies a number of market failures including Northern

30 Regulation (EU) no 345/2013 on European venture capital funds, Official Journal of the European Union 25 April 2013

31 Venture Capital Strategy, Invest NI 2008

32 Access to Capital Strategy, Invest NI 2011

Ireland's peripherality for the majority of UK-based venture capital firms, and the legacy of the Troubles; a limited supply of seed stage technology businesses which are suited to later-stage VC investments; a lack of funding to encourage technology transfer and the development of University-based spin outs; and the need for Co-investment Funds to match business angel investments.

2011-2015

2.56 The 2011-2015 PfG[33] *identifies 'Growing a sustainable economy and Investing in the Future'* as the key priority, with a series of related commitments aimed at rebalancing the economy to develop a larger, more export-driven private sector through improving competitiveness and rebuilding Northern Ireland's labour market. One of the commitments is to *"Aid liquidity of Small and Medium Size Enterprises (SMEs) through a £50 million loan fund (DETI) (£28 million in the three years covered by the Programme for Government)"* with a target to support 50 SMEs per annum for the three years from 2012/13. This relates specifically to the Growth Loan Fund.

2.57 In response to the 2011-2015 PfG, the DETI Corporate Plan 2011-2015[34] identifies seven strategic objectives for the department, including stimulating innovation, R&D and creativity; helping Northern Ireland businesses compete in the global economy and encouraging business growth. The Corporate Plan does not include any specific access to finance targets but the Fund of Funds model will contribute to the targets relating to promoting 6,300 jobs, securing £400m of investment commitments and £120m in new wages in locally-owned companies.

2.58 The Invest NI Corporate Plan 2011-2015[35], sets out the role of the agency in supporting wealth creation in Northern Ireland and in contributing to the achievement of the DETI Corporate Plan and PfG. The Corporate Plan details the Access to Finance Strategy and the full suite of Invest NI-backed funds, and sets out how Invest NI will achieve the DETI Corporate Plan targets summarised in the above paragraph. It also includes an additional target to

"enable 300 small and medium sized enterprises to access the funding required to drive growth through our Access to Finance Strategy."

Conclusions

2.59 The development of the Fund of Funds was set in an increasingly challenging market context for both bank lending and equity investment, caused by the onset of the global recession and the subsequent shift in investor attitudes to risk. Whilst the issues facing Northern Ireland businesses in accessing finance have mirrored those across the UK, the decline in bank lending and equity investment has been exacerbated by unique factors including the fall in property values and overhang of property debt which has constrained otherwise investible businesses; and the dependency on non-UK owned banks which has limited the effect of UK Government/Bank of England measures to stimulate bank lending. However, whilst there is still widespread market failure, levels of business angel investment and some parts of the venture capital market have held up comparatively well. Section 3 includes a high level overview of the performance of the five Invest NI risk capital funds.

2.60 The project was developed and delivered within a broad framework of policies over the period from 2004-2011. In broad terms, the project demonstrates a clear fit with DETI and Invest NI objectives and PSA targets developed over successive corporate plans and in particular with those objectives and targets focused on attracting inward investment, supporting the commercialisation of research and stimulating technology/innovation-driven business start ups.

33 Programme for Government 2011-2015, Northern Ireland Executive March 2012

34 DETI Corporate Plan 2011-2015

35 Invest NI Corporate Plan 2011-2015

3. PROJECT DEVELOPMENT AND DELIVERY

Introduction

3.1 Section 3 presents a review of

- the economic appraisal and Invest NI Board approval processes
- the overall performance of the five Invest NI funds which, together, form the Fund of Funds continuum

Project development

3.2 The Fund of Funds approach was developed following discussions between DETI, Invest NI and the European Investment Fund (EIF) on the potential to utilise the European Union's JEREMIE model for risk capital investment in Northern Ireland. These were initiated through the Barroso Task Force[36], established following EU President Jose Manuel Barroso's visit to Belfast in 2007. Initial research by EIF in 2008[37] highlighted market failures impacting on debt finance, business angel and venture capital investment in Northern Ireland and advocated the establishment of a JEREMIE holding fund underpinned by a European Investment Bank (EIB) loan matched against ERDF and Invest NI funding.

3.3 Subsequently, Invest NI had specifically explored the potential to secure EIB investment to underpin the development of the Growth Loan Fund. However, EIB investment was not pursued for a variety of reasons including concerns around set-up/management costs and the ability to service the EIB loan through the suite of public sector-backed funds that were in place at the time. The scale of EIB investment sought by Invest NI – up to £25m – was also thought to be insufficient to secure EIB involvement.

3.4 Although ultimately EIB investment was not secured, DETI and Invest NI continued exploration of the JEREMIE model as part of the Barroso initiative. A 2009 discussion paper prepared by Invest NI notes that

"The JEREMIE initiative offers EU Member States, through their national or regional Managing Authorities, the opportunity to use part of their European Union (EU) Structural Funds to provide finance for SMEs by means of equity, loans or guarantees, through an over-arching, revolving Holding Fund….the JEREMIE instruments have the added benefit of a revolving character, meaning that a given pool of funds can be re-invested several times….The JEREMIE Holding Fund Manager can re-allocate resources between financial instruments and products in response to funding gaps and demand from SMEs."

3.5 The report considers the experience of the North East of England, which was to launch a JEREMIE initiative in early 2010, as well as that of Scotland and the West Midlands which both considered the adoption of JEREMIE but ultimately implemented alternative proposals. The report explored a range of costs and benefits associated with the JEREMIE model including:

- affordability – through JEREMIE, EIB provides a loan on commercial terms which must be drawn down in full at the start of the programme and repaid within five years; in circumstances where EIB acts as the fund manager for the holding fund, it charges fund management fees on commercial terms
- subordination – EIB generally treats its loan to the holding fund as senior debt (meaning it is to be repaid first and other investors funds are subordinated) which can limit the attractiveness of the JEREMIE model for other private sector investors
- critical mass – EIB has generally indicated that it will only participate in holding funds of at least £100m where it provides 50% of the capital via a loan
- governance – as it represents a significant investment, the EIB loan is generally required to be taken 'off balance sheet' to meet HM Treasury requirements, typically requiring the establishment of a separate arms length delivery vehicle with potential implications for public sector accountability and control

---

36 Communication from the Commission to the Council and to the European Parliament on the Report of the Northern Ireland Task Force COM (2008) 186 final, April 2008

37 JEREMIE SME Financing Gap Assessment, Interim Report for Northern Ireland, European Investment Fund, April 2008

- flexibility to vire investment between sub-funds; the holding fund structure facilitates the rapid shift of resources between sub-funds in response to market signals or fund performance, although the report notes that non-JEREMIE programmes have retained this flexibility through the contractual arrangements applied to individual funds

- recycling of legacy funds – both JEREMIE and alternative funding models enable ERDF and potentially national block resources to be reinvested in a revolving fund; in the case of ERDF, legacy funds must be reinvested in SMEs.

3.6 The report highlights a clear divergence in approach between those UK regions seeking to adopt risk capital funds, with North East Finance and Finance Wales adopting the JEREMIE approach and Scottish Enterprise and the now defunct Advantage West Midlands implementing different models which required both parties to secure private sector investment from alternative sources to match public sector funds.

3.7 The report concludes that "*it is possible to achieve all (of) the objectives without the expense of the JEREMIE mechanism"* and outlines proposals for an Invest NI Fund of Funds mechanism, with the objectives of

- promoting a continuum of funds
- creating a deal flow chain across seed, early and development funds
- retaining and building on the skills and capability of the venture capitalists based locally.

3.8 The report further outlines options for the governance/management of the Fund of Funds, including establishing a separate company limited by guarantee to manage the holding vehicle (similar in practice to the model adopted in Wales and the North East of England) or constituting a sub-committee of the Invest NI Board to provide the necessary governance arrangements.

Casework and approvals

3.9 Invest NI prepared a casework submission for the Fund of Funds for the Invest NI Board in May 2010[38], building on the key findings of its earlier 2009 report. The submission notes that DFP/Ministerial approvals are required for the key operating principles of the Fund of Funds as a novel approach was proposed, and that DETI approval is required for the alternative Fund of Funds architecture to the JEREMIE approach.

3.10 Acknowledging the role of the NISPO I fund in providing Proof of Concept and seed stage equity investment, the report highlights three specific funding gaps in the continuum of risk capital funding in Northern Ireland at that time:

- business angel co-investment (for deal sizes of £250,000-£1m)
- early stage venture capital (in the £500,000-£2m investment space).
- SME loans (although the overall quantum of the market failure was not known at that stage).

3.11 Drawing together these proposals, the casework submission estimates that the Fund of Funds would require Invest NI/ERDF investment of between £50.6m-£55.6m over a five to six year investment period. The report notes that *"the objectives can be met through a Fund of Funds model that does not use the JEREMIE architecture"* – as by that point, Invest NI's initial negotiations with EIB had concluded unsuccessfully. EIB considered that the level of investment sought by Invest NI was insufficient to warrant its co-investment at that time. The casework report argued that Invest NI's alternative proposals could deliver the flexibilities inherent in the JEREMIE approach whilst demonstrating greater value for money.

3.12 The casework submission considers various issues relating to the inclusion of ERDF funding within the Fund of Funds structure. These include proposals for both ERDF and Invest NI's regional block funding to be recycled for the purposes of reinvestment in SMEs; and the desirability of enabling ERDF to be matched against both public and private sector funding. It sets out different budget proposals with and without private sector match for ERDF which have very different implications for the level of national block (Government) funding required for the funding continuum.

38 Submission to Invest NI Board for Fund of Funds proposal, Invest NI May 2010

3.13 In practice, although we understand that Invest NI is able to utilise private sector match against European funds, to date only the Co-Investment Fund has included any contribution from ERDF. This is because it is not possible to use ERDF to match public sector funding which is to be subordinated to private sector funding (as in the case of the Development Funds).

3.14 The report evaluates the options for governance/management of the funds summarised in paragraph 3.5 against criteria including accountability; delegated authority; independence; transparency; operational flexibility and conflicts of interest. The report acknowledges that *"a separate company will easily and evidently achieve the criteria. However, it is considered that setting up a sub-committee of the Board of Invest NI will achieve the same objectives."*

3.15 In conclusion, the report recommends that the new committee of the Invest NI Board should act as the holding vehicle and that its terms of reference should give the committee

"powers to establish funds; to procure venture capital fund managers and loan fund managers and to make decisions about how recycled funds are applied in the future. It will also have the powers to achieve flexibility….so that monies can be switched between funds by ensuring that there are performance clauses in fund manager contracts to allow contracts to be terminated and monies switched to other funds."

3.16 Invest NI's Board Casework Committee considered the Fund of Fund proposals on 7th June 2010. The minutes highlight a range of discussion points including:

- the costs/benefits of the JEREMIE model adopted elsewhere in the UK including the establishment of a separate, arms length company to manage the holding fund

- clarifying relationship between the proposed Invest NI Board sub-committee and the main Board; each new fund would require the usual process of Board approval but the sub-committee would make decisions on the reinvestment of legacy returns and consider/approve recommendations from Invest NI executives on shifting resources between funds.

3.17 In addition to the approval of the Invest NI Board, separate approvals were also required from DFP, DETI and the Minister for Enterprise, Trade and Investment. Invest NI prepared a further submission for DETI and DFP[39] which built firmly on the proposals approved by the Invest NI Board but considered four separate options for the Funds of Funds architecture:

- do nothing
- establish a JEREMIE holding fund structure
- establishing a new sub-committee of the Invest NI Board supported by in-house management and monitoring of the individual funds by the Corporate Finance, Appraisal and Advisory Division
- establishing a separate holding fund (without EIB support) operated by an independent fund manager.

3.18 The options were appraised against five core objectives for the Fund of Funds architecture. This is summarised in Figure 3.1 below:

Figure 3.1: Fund of Funds – delivery options

Criteria	Option 1 Do Nothing	Option 2 JEREMIE	Option 3 In-house	Option 4 Dedicated manager
Recycling	No	Yes	Yes	Yes
Flexibility	No	Yes	Yes	Yes
Governance	No	Yes	Yes	Yes
Fund management	No	Yes	Yes	Yes
Cost	£0	£2.5m	Not material	£2m

Source: Invest NI

3.19 The report discounted Option 1 but emphasised the significant cost savings inherent in Option 3 and recommended Option 3 as the preferred option. The paper further recommends that DETI has a clear oversight role in the governance of the Fund of Funds, with the right to be co-opted onto the proposed Board sub-committee and to become a member of any of the separate Advisory Committees attached to the individual funds. Finally, the paper

39 Fund of Funds Access to Capital Initiatives October 2010

considers a number of potential risks associated with the Fund of Funds model, and their associated mitigation, including:

- the potential for recycled returns to be allocated to the wrong funds – this would be mitigated by the need for any decisions to be based on independent economic appraisal and casework recommendations from Corporate Finance
- recycled sums would not be invested in SMEs – this would be mitigated by the Access to Finance Committee
- lack of accountability - mitigated through the preparation of clear terms of reference for the sub-committee and the wider processes in place concerning appointment/training of Board members
- conflicts of interest – these would also be addressed through established Invest NI procedures.

3.20 DFP approval for the proposals was granted by letter dated 4th November 2010[40]. The approval confirms that Invest NI would be allowed to recycle baseline capital and profits of up to £10m in any one financial year; any uplift on this figure would result in the surrender of an appropriate portion of the baseline amount. The approval was subject to regular monitoring and independent evaluation of the Fund of Funds. DETI/Ministerial approval for the Fund of Funds was granted in December 2010.

Fund of Funds Committee

3.21 With the delegated authority of the Invest NI Board, the inaugural meeting of the Fund of Funds Committee took place on 29th November 2011. The full terms of reference of the Committee are included at Appendix 1 of this report; in summary, they include:

- approving the overarching strategy for the Fund of Funds and to champion Access to Capital
- overseeing the performance of the Fund of Funds including review against KPIs
- providing advice and guidance and making recommendations to the Board on proposals for the creation of new funds or extension of existing funds, underpinned by economic appraisals and casework
- approving the shift of funds between sub-funds where it has been demonstrated that a funding gap no longer exists or an individual fund has under-performed in relation to its contractual obligations
- determining the most appropriate funds to receive recycled legacy returns
- considering the affordability of proposals presented to it.

3.22 The terms of reference enable the Fund of Funds Committee to have up to five members, of which three must be Invest NI Board members whilst the remainder (who must have relevant expertise/experience) may be co-opted. The tenure of Invest NI Board members will be coterminous with their membership of the full Board, whilst co-opted members will be appointed annually for a period of up to two years. The quorum for committee meetings is two Invest NI Board members. The committee is to meet at least twice a year and is serviced by Corporate Finance.

3.23 As of March 2014, the Fund of Funds Committee had met on nine occasions and had five members, including one co-opted member. The Committee has not yet had to make any decisions relating to the re-allocation of resources between individual funds or to the recycling of legacy returns. For each meeting, Corporate Finance present an overview of the performance of the individual funds with a focus on any issues arising; analysis of the minutes of the committee meetings highlights that the issues raised through the committee over this period include:

- the need for a clearer marketing and communications plan for the continuum of funds – building on the 'umbrella' approach adopted by, for example, Finance Wales or Finance Yorkshire

---

40 Letter from Stuart Stevenson, DFP Central Finance Group to Invest NI 4 November 2010

- considering the requirement for the extension of the Proof of Concept element of the NISPO I fund (an additional £4m was subsequently approved) and whether funding could be re-allocated within the programme to support those elements for which there was greatest demand

- the changing picture concerning the availability of ERDF to provide match funding for the Development Fund or Growth Fund

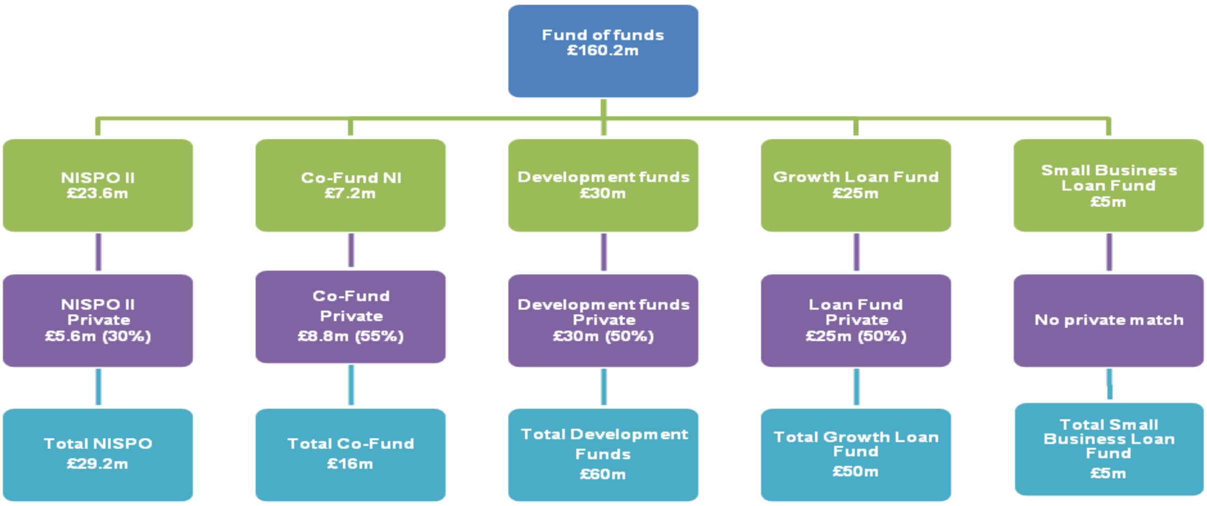
- as funds reach the end of their active investment phase, the need to align evaluation/appraisal/approval processes to ensure that full coverage across the Fund of Funds continuum can be maintained.

3.24 Whiterock Capital Partners presented an overview of the performance of the Growth Loan Fund to the November 2013 meeting of the committee. This approach, which affords the committee the opportunity to scrutinise or challenge fund managers on the operation of the funds is likely to become a more regular feature of Fund of Fund Committee meetings.

Overview of fund performance

3.25 As highlighted in section 1, it is important to note that the overall quantum of Invest NI funding has increased substantially since the Fund of Funds model was approved at the end of 2010, along with the breadth and complexity of the individual funds. Figure 3.2 below summarises the level of public and private investment that has been secured for each of the funds:

Figure 3.2: Fund of Funds continuum

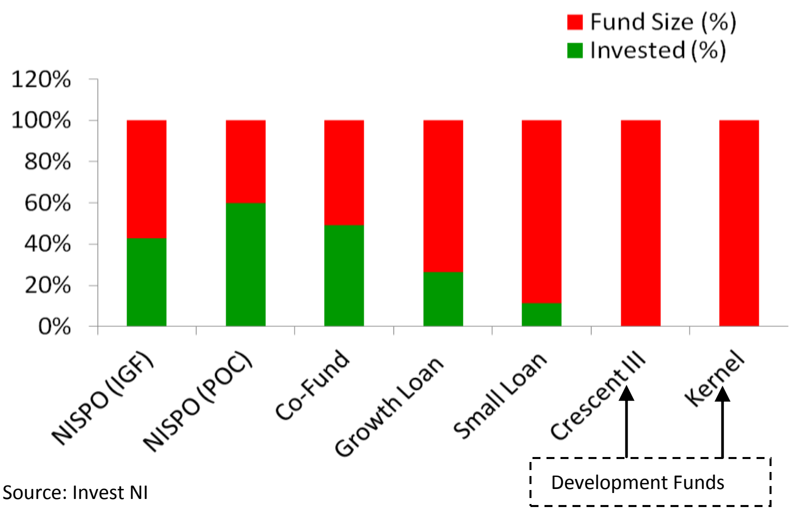


Source: Invest NI

3.26 Figure 3.2 shows that the balance of Invest NI investment in equity and loan funds is weighted more towards equity investment – excluding the NISPO II Proof of Concept grants, some £53.2m of the £83.2m of public sector funds (equivalent to 64%) with the remainder focused on loan provision (including the Growth Loan Fund, which is effectively based on a loan plus profit share rather than conventional equity investment). This is broadly comparable with the equity: loan split for the Finance Yorkshire JEREMIE programme although just 44% of the Finance Wales JEREMIE funds are for equity investment. We return to the balance of loan/equity funds in comparator programmes in section 6.

3.27 Figure 3.3. below shows the current level of investment achieved by each of the five Invest NI-backed funds:

Figure 3.3: Level of investment, Invest NI risk capital funds September 2013



Source: Invest NI

3.28 Figure 3.3. highlights that three of the five funds (Growth Loan, Small Business Loan, Development Funds) are at a reasonably early stage of their investment cycle. The Co-Investment Fund, launched in June 2011, has entered the third year of a six year investment phase. The expanded NISPO I funds will cease investment at the end of March 2014. Although demand for Proof of Concept grants has been consistently high since NISPO was launched in 2009, there was a significant increase in the volume of equity-funded deals through NISPO during 2012 and 2013 following a slow start and it is anticipated that the fund will achieve at least 35 investments against a cumulative target of 35 deals. As of December 2013, the performance of the other funds was as follows:

- the Co-Investment Fund had achieved 24 investments by December2013, ahead of target
- for the Development Funds, Kernel Capital had completed one deal (against a target of four per annum) whilst Crescent Capital had has also completed one deal (a follow on investment for a project originally supported through NISPO I) and issued two term sheets
- Whiterock Capital through the Growth Loan Fund had approved 64 loans by the end of December2013 – ahead of target in terms of level of investment but behind target on number of deals, reflecting greater demand from larger, more mature SMEs than originally anticipated
- 45 loan approvals had been made through the Small Business Loan Fund – ahead of target but also experiencing demand for larger loans than anticipated; following a decline in the rate of new applications during summer 2013 there has been an increase in applications in the final quarter of 2013.

3.29 At present there are no Key Performance Indicators for the Fund of Funds as outputs and gross/net impacts are measured at the individual Fund level. Appendix 1 draws together the KPIs for the existing funds and details initial proposals for collective job/GVA targets for the Fund of Funds.

Conclusions

3.30 Invest NI's case for developing the Fund of Funds model was based in part on the aim of retaining established governance and accountability mechanisms for the substantial level of public sector investment in the Fund of Funds continuum, and also on the significant level of additional cost associated with the appointment of the European Investment Bank or an independent fund manager to manage a holding fund. There were also concerns around the timescale required to establish an arms-length delivery structure.

3.31 Three of the five Invest NI-backed funds are in the early stages of their active investment phase and the Co-Investment Fund is just half-way through its six year investment period. Although initial progress was slow, it is expected that the expanded NISPO I fund will achieve its investment targets. Interestingly, the demand profile for both loan funds has differed from that originally envisaged with, in both cases, more mature SMEs or post-seed stage start ups underpinning demand.

3.32 The Fund of Funds Committee has provided oversight and challenge both to Invest NI executives and to the individual fund managers, maintaining an overview of the performance of each fund. To date, the Committee – which has met on nine occasions since late 2011 - has not had to make any significant decisions in relation to shifting resources between funds or concerning the recycling of legacy returns.

4. STAKEHOLDER CONSULTATION

4.1 As part of the evaluation process Urbis undertook both face to face and telephone interviews with key stakeholders including Invest NI Board members and executives; consultees from DETI; and fund managers from Clarendon; Crescent Capital; E-Synergy; Kernel Capital; UCIT and Whiterock Capital Partners.

4.2 The interviews covered a number of themes including:

- the market context for commercial lending and equity investment in Northern Ireland
- the performance and impact to date of the Invest NI funds
- current and future gaps in the provision of risk capital funds in Northern Ireland
- strengths and weaknesses of the Fund of Funds approach
- views on JEREMIE and other different models
- the future of the Fund of Funds and if/how the model should change in future.

Market context

4.3 There was broad consensus on the current market position in Northern Ireland, on the particular characteristics of the Northern Ireland market which distinguish it from the rest of the UK and on market failure. Several respondents noted that, in addition to the widely acknowledged barriers to business lending across the UK, NI faces additional challenges including

- an unprecedented fall in the book values of industrial, commercial and residential property, creating a property debt overhang which has had a significant impact on bank attitudes to levels of risk associated with otherwise robust businesses

- the prevalence of Irish or European-owned banks in Northern Ireland, limiting the impact of UK Government initiatives seeking to stimulate SME lending

- unlike their Irish counterparts, those UK-owned banks operating in Northern Ireland have been unable to participate in the Irish Government's NAMA programme to strip out 'bad' property loans from their portfolio; some stakeholders identified the need to adopt a similar approach for the UK-owned banks with significant property exposure in Northern Ireland

- a strong culture of grant dependency across Northern Ireland's SME community, impacting on the willingness to consider other forms of finance.

4.4 Several stakeholders highlighted the depressed nature of SME demand for debt finance, citing the rise in 'discouraged borrowers' who no longer apply for loan or overdraft finance on the basis that the banks are more likely to refuse their application. Some indicated that there was a need for Invest NI to further strengthen its efforts to stimulate and support demand-side business growth alongside supply-side activity including the Fund of Funds continuum. We explore this further overleaf. Most respondents considered that banks will only re-enter the SME lending market very cautiously and will continue to be highly risk averse when they do. As a result, the majority of respondents considered that there will continue to be demand for non-bank lending, even at higher interest rates than those charged by the banks, or for mezzanine finance for more established businesses, for the foreseeable future.

Performance of the funds

4.5 The majority of stakeholders painted a very similar picture of the overall performance of the Invest NI-backed funds, acknowledging that three of the five remain in the comparatively early stages of delivery and that, in their case, it is too early to consider their effect on the market. The key issues cited by stakeholders included

- a mixed view of the performance of NISPO I, acknowledging both the difficulties associated with delivery of the first half of the programme and a significant increase in deal flow since 2012; most stakeholders suggested the need for a continued focus on Proof of Concept support to provide initial stimulus for seed stage, pre-revenue businesses but indicated that the University Funds, and the wider approach to stimulating commercialisation of University intellectual property assets, should be revisited at an early stage in the delivery of NISPO II

- there are still relatively few examples of firms progressing up the ladder of finance – e.g. receiving support through NISPO and seeking downstream support from the other, later stage equity funds for second, third or subsequent rounds of investment; some stakeholders suggested that relationships between fund managers were still fractured in some instances and that, as a result, the later stage funds tended to develop their own deal pipeline

- consultees perceived that the Co-Investment Fund is performing above expectations and that this reflected the continued buoyancy of Northern Ireland's business angel community; the majority of the deals have involved angel investors who are not fully connected to the Halo NI business angel network, evidencing the presence of a wider group of hitherto 'below the radar' investors with whom the fund managers and Invest NI should continue to engage

- the Growth Loan Fund is achieving forecast levels of expenditure but through significantly fewer, larger deals during the first year or so of their operation and both are finding their target market is with more mature/established SMEs that initially anticipated; the hybrid nature of Whiterock's mezzanine finance offer (involving a repayable loan typically unsecured and profit share instead of a formal equity stake) has been important in sustaining demand from businesses who might otherwise have been reluctant to consider equity investment although some stakeholders indicated that market failure in the MBO/MBI sector (in which Northern Ireland is under-represented in terms of its share of UK private equity investment) should also be addressed through a similar offer

- demand for loans from the Small Business Loan Fund has also been 'further up the food chain' than originally anticipated with the result that there are fewer, larger deals; there were strong levels of latent demand initially, reflecting the depressed position on commercial lending, following a subsequent decline in the rate of new applications UCIT/Enterprise NI undertook a marketing campaign to target harder to reach businesses and the rate of interest and applications has subsequently increased again; to date, demand for this product from Northern Ireland's social enterprise sector has been limited and further market research may be required to establish whether this is a market gap that should be addressed by Invest NI/DETI in future

- although both Development Funds remain in the very early stages of delivery, there was widespread acknowledgement of the need to address this key area of market failure for early stage businesses and for Invest NI to offer a greater degree of subordination (50%) than during the initial attempt to establish the funds in order to unlock private sector leverage; the value of the Development Funds in attracting private sector investment from outside Northern Ireland was also recognised although a number of stakeholders highlighted the retrenchment of VC firms from the sub-£5m market, indicating a widening of the market gap/failure for larger VC deals – although the current General Block Exemption Regulations limit the maximum amount of investment in an individual firm to €1.5m in any 12 month period, the new EU Risk Capital guidelines[41] adopted in January 2014 propose to grant block exemption for investment of up to €15m for the full development cycle of an SME.

Demand-side intervention

4.6 Some stakeholders emphasised the need for greater integration of Invest NI's efforts to both stimulate business growth and address market failure through the provision of risk capital. Stimulating demand – encompassing a wide range of activity from raising awareness/providing information on the sources of business finance through to intensive business support interventions – was seen by some stakeholders as arguably more important than addressing supply-side barriers to finance. For example, focusing on support for seed stage firms, it was argued that there was a need for Invest NI to achieve greater connectivity/ signposting/ referral across the various elements of the 'eco system' for high growth start ups – e.g. Propel, NISPO, the emerging Accelerator proposals and NISP Connect. Some stakeholders considered that Invest NI, as key funder of the majority of these initiatives, should play a key role in joining up provision, addressing duplication and ultimately improving the quality of the equity investment pipeline/deal flow.

41 Guidelines on State Aid to promote risk finance investments OJEU 2014/C 19/04

Perceptions of the Fund of Funds model

4.7 All stakeholders identified the need for an overarching strategy to guide Invest NI's approach to Access to Finance and for a clear framework to integrate the actions of the five Invest NI funds. The majority of stakeholders considered that the Fund of Funds model made a significant contribution to these objectives, although some consultees identified areas in which further development may be required.

4.8 Some stakeholders considered that there was a need to adopt a long-term perspective on access to finance in Northern Ireland and to integrate the work of Invest NI, EAG and the Access to Finance Implementation Panel (recently established to take forward some of the recommendations of the EAG report). Some stakeholders considered that the development of a long-term Access to Finance Strategy, setting out how Government aims to work with the main commercial lenders and a providing longer-term direction for the Fund of Funds, would send positive market signals to businesses and investors. We understand that DETI is now commissioning further research to take forward some of the key recommendations of the EAG report that is likely to address this requirement.

4.9 Some stakeholders – particularly the Fund Managers – tended to view the Fund of Funds as a broad concept rather than as a critical factor influencing the day to day operation of the funds themselves; reasons for this included

- to date, there has been limited evidence of businesses progressing through the continuum of funds in a linear manner (e.g. from NISPO through Co-Financing to the Development Funds) as their requirement for investment increases; some argued that in practice, the range of factors influencing commercial investment decisions mean that the market does not operate in this way; others suggested that, if Invest NI wanted to encourage the development of the 'ladder of finance', further intervention was necessary to stimulate (or potentially require) closer collaboration between fund managers

- since the Fund of Funds model was established in 2010/11, there has been no requirement to vire resources between funds, to recycle legacy returns or add new funds to the continuum and as a result it is 'below the radar' for some stakeholders; some argued that this was only likely to change when the Fund of Funds Committee began to make significant decisions of this type

- comparisons with JEREMIE programmes elsewhere in the UK which are perceived to have a greater degree of independence by virtue of the establishment of a separate, arms-length delivery vehicle and independent fund manager to operate the holding fund; most stakeholders did not appreciate that the Fund of Funds model can achieve the same level of flexibility as the JEREMIE model.

4.10 Some of the stakeholders argued that one of the clear benefits of the Fund of Funds approach has been the development and retention of local investment and fund management capacity in Northern Ireland. Had Invest NI adopted the JEREMIE approach with direct involvement of EIB as fund manager, this outcome may not have been realised as there would have been limited scope to utilise local fund management capacity.

4.11 There was some discussion around the 'Fund of Funds brand' and whether the continuum of funds had featured sufficiently prominently in Invest NI's wider communications on the theme of access to finance. Some stakeholders considered that other parts of the UK (for example Wales or North East England) had used the JEREMIE/holding fund model as a more active element of their marketing campaigns and had emphasised the 'one stop shop' approach in their engagement with businesses. This issue has been raised through the Fund of Funds Committee and we return to it in section 5 of the report.

Fund of Funds Committee

4.12 Although the wider group of non-Invest NI stakeholders were aware of the Fund of Funds Committee and its members, they had very limited knowledge of the role, function and operation of the Committee. Consultation with the members of the Committee and relevant Invest NI executives highlighted the following issues:

- the Committee is perceived to have successfully bedded-in; the benefits of engaging Board Members with the implementation of the Access to Finance Strategy and broadening and deepening their collective knowledge of the sector have been acknowledged by both its members and Invest NI executives

- members of the Committee are fully cognisant with its terms of reference and are satisfied with its role, level of delegated authority and relationship with the Invest NI Board

- members consider that the Committee has a complementary mix of skills and experience; the decision to co-opt an additional member from outside the Invest NI Board has been viewed as a positive step and whilst members did not identify any specific skill sets which should be added to the group, they were open to further co-option in the future if this would add value to the Committee's work
- the management information presented to the Committee has evolved since 2011 and is perceived to be working well; however, some members highlighted the need for a series of wider metrics on the operation of the market and this is considered further below

- some concerns were raised about the co-termination of Committee appointments with those of the Invest NI Board and highlighted the risk of losing some expertise when members ceased their rotation on the Board (this is typically for between three and five years[42]); there were concerns that the need to bring new Board members 'up to speed' could have a negative impact in the short-term.

4.13 There is a widespread acknowledgement that much of the Committee's activity to date has focused on oversight/scrutiny of the performance of the individual funds and of Invest NI's client role. This is perceived to be working well – with the move to increase the level of engagement with individual fund managers by inviting them to present to the Committee on a regular basis being welcomed.

4.14 Some members highlighted the need for the Committee to have a clear understanding of the delivery timeframes for the current suite of funds and of the lead-in times to establish replacement funds to maintain continuity of provision. Lead-in times for the design and procurement of new funds are typically 18-24 months. Continuity should be maintained through the procurement of the NISPO II Fund – but there will be a requirement for Invest NI to consider the need/market failure rationale for a follow-on Co-investment Fund during 2014/15 and to engage the Committee in helping to shape this thinking. There may also be a requirement to consider the expansion of one or both of the loan funds if demand is sustained and bank lending remains suppressed.

4.15 Moving forward, some members considered that the Fund of Funds Committee should balance high level oversight of individual fund performance with a more strategic perspective on the access to finance issues facing NI businesses. This should have a clear focus on building and maintaining a clear picture of the market and market failure across the spectrum of business finance needs – and would in turn address the issues raised during the consultation around longer-term strategy, highlighted in paragraph 4.8.

European funding

4.16 Some stakeholders noted that whilst there had been difficulties in utilising ERDF under the previous European Union Structural Funds programme, the new EU funding programme for the 2014-2020 period has a strong focus on the use of financial engineering instruments – loans, guarantees, equity investments and other sources of finance which replace traditional grant programmes. Whilst in the short-term, the need to 'top up' the Fund of Funds through ERDF is likely to be limited, the requirement for ERDF match may be more significant in the second half of the 2014-2020 programme. Several stakeholders highlighted the need to ensure that ERDF match can be optimised.

Monitoring performance

4.17 There was some debate around the issue of monitoring the performance of the Fund of Funds and of the individual funds. At present, each of the funds has a series of annual and cumulative targets/KPIs which underpin Invest NI's contractual relationship with fund managers and which tend to focus on hard output measures relating to number of deals and volume of investment. This is in part because, particularly in relation to equity investments in businesses which may take some time to become revenue-generating, the economic impacts (jobs, economic output/Gross Value Added) are unlikely to be realised until after completion of the fund's active investment phase.

---

42 Section 3, Schedule 1 of the Industrial Development Act (Northern Ireland 2002) establishes a five year maximum term for appointments to the Invest NI Board

4.18 Although high level aggregated information is presented to the Fund of Funds Committee, there are no formal KPIs associated with the Fund of Funds or attached to the approvals from DETI/DFP. As a result, neither the Invest NI or DETI Corporate Plans make direct reference to the Fund of Funds in terms of KPIs although the 2011-2015 Programme for Government cites the Growth Loan Fund as a Key Commitment to which specific milestones/targets are attached. Some stakeholders argued that there may be merit in aggregate reporting of key deal/investment KPIs at Fund of Fund level to feed in to the Invest NI/DETI Corporate Planning process. Appendix 1 draws together the existing sub-fund outputs and forecast impacts and presents proposals for aggregated KPIs for the Fund of Funds.

4.19 A number of stakeholders argued that the Fund of Funds Committee should have access to a much wider series of measures of market activity/market failure. These might include volume of bank lending; number of loan applications and refusals; levels of private equity/venture capital investment including from outside Northern Ireland; analysis of the equity investment pipeline; and, MBO/MBI activity. Echoing the findings of the EAG report, several stakeholders highlighted the need for stronger evidence on bank lending activity and on business demand for finance – potentially building on or extending the quarterly SME Finance Monitor research to include a small sample of SMEs from Northern Ireland. These would extend beyond performance of individual funds and inform a broader, more strategic perspective on access to finance around which the Committee could develop its role. This is consistent with the recommendations of the EAG report which cited a lack of effective metrics – including, notably, bank lending data – upon which the Northern Ireland Assembly could develop its access to finance policy.

4.20 Other consultees highlighted the need for the Fund of Funds Committee and others to be able to compare the longer-term economic impacts of the various funds – in terms of key metrics including not only gross/net employment creation and GVA, but also business start up survival rates, levels of innovation/intellectual property activity etc. For the reasons cited overleaf, net impact information of this type is not usually available during the early phases of fund delivery due to the long lead-in times to realising impacts and may not always be available at the level of individual funds or companies. As a minimum, net employment/GVA impacts should be considered as part of the final evaluation of each of the individual funds.

4.21 Some consultees highlighted the need to introduce measures which encouraged greater collaboration between the individual fund managers in relation to deal flow and demonstrating business progression through the different stages of investment. For example, this could require fund *x* to demonstrate that they have engaged with *n* businesses seeking later stage finance that were originally supported by fund *y.* Whilst it may prove difficult to establish such measures as formal/contractual KPIs, they could be included as part of the overall reporting process. Both the Halo business angel network and NISPO report against similar indicators.

4.22 Other stakeholders highlighted the potential for Invest NI to facilitate regular networking events across the fund managers and wider investment community. One stakeholder noted that these linkages have tended not to happen organically. Recently, Invest NI has facilitated the establishment of the Propel Forum which includes key members of the investment and innovation community and has an independent chair. To date, the forum has met on only one occasion.

Conclusions

4.23 Stakeholders were in consensus around the issues facing businesses in accessing finance in Northern Ireland, the current gaps in provision of funding and associated market failures. Most emphasised the need to stimulate demand for finance through efforts to support business growth alongside the provision of the Fund of Funds continuum to address supply-side gaps in the provision of funding.

4.24 To date, Invest NI has had limited requirement or scope to utilise the flexibilities inherent in the Fund of Fund model and the Fund of Funds Committee has not yet had to make any decisions of real significance in relation to either the continuum or individual funds. As a result, the Fund of Funds has remained to some extent 'below the radar' as far as individual fund managers are concerned, although this will change as the Committee broadens its scrutiny of the individual funds. The Fund of Funds Committee is perceived to have 'bedded in' and to have the right mix of skills and experience to advice the Invest NI Board on access to finance issues. The Committee has focused on providing oversight/scrutiny of the individual Invest NI-backed funds; moving forward, it has been argued that the Committee should adopt a more strategic perspective on access to finance issues, informed by appropriate reporting against a wider range of indicators which reflect market trends in relation to both demand and supply of finance.

5 PROJECT IMPACTS

Introduction

5.1 Section 5 considers the economic and other impacts of the project, including:

- achievement of project objectives and contribution to higher level objectives including the Programme for Government and DETI/Invest NI Corporate Plans
- strategic impacts and wider and regional benefits
- establishing the counterfactual or additionality arguments – what would have happened in the absence of the project?
- value for money
- equalities impacts.

Achievement of objectives

Project level objectives

5.2 Invest NI's objectives for the Fund of Funds, as stated in the May 2010 casework, were as follows:

- promoting a continuum of funds
- creating a deal flow chain across seed, early and development funds
- retaining and building on the skills and capability of the venture capitalists based locally.

5.3 The first project level objective of the Fund of Funds has been realised. The Fund of Funds mechanism has allowed Invest NI to establish a continuum of funds and to address failure in commercial lending and equity investment markets, providing funds for businesses ranging from those at pre-revenue, seed stage to mature SMEs. All five funds forming the continuum are now in their investment phase with one fund (NISPO I) to be replaced and increased in size during 2014/15.

5.4 This notwithstanding, it could be argued that Invest NI have not actively **promoted** the Fund of Funds continuum as part of wider marketing efforts or actively used the Invest NI brand to promote the funds to indigenous businesses or inward investors. This is in contrast to the approach adopted in Scotland and Wales, described further in section 6. In effect, the Scottish Investment Bank and Finance Wales are used as the gateway or single point of entry for businesses seeking finance; in Northern Ireland, businesses are more likely to approach the individual funds directly or via an intermediary. Although information on the individual funds is available, a more visible approach to marketing the Fund of Funds as a gateway to Invest NI's suite of risk capital funds – through, for example, the nibusinessinfo.co.uk or Invest NI websites – could realise benefits including raising the awareness of SMEs of the range of fund available or supporting inward investment activity. We return to this issue in section 7.

5.5 To date, the second objective – to create a deal flow chain across seed, early and development funds – has been realised only partially. As NISPO I concludes its five year investment phase, a small number of businesses who received Proof of Concept support at pre-revenue stage have gone on to secure equity funding from the NISPO Invest Growth Fund or the Co-Investment Fund. To date, there has been one Development Fund investment in a NISPO-supported company, although both Development Funds are at an early stage in of their investment programme. Some may go on to seek development stage funding in the future; this will be a key measure of the long-term impact of NISPO.

5.6 There are several reasons for this. Businesses may simply follow a more organic growth path rather than a linear model, seeking funding from different sources outwith Invest NI's 'ladder of finance'; some businesses (for example those in the life sciences) may take considerably more than five years to reach the post revenue stage or require a level of investment which is not readily achievable in Northern Ireland. Fund managers and investors at the development stage may choose to nurture their own pipeline rather than rely on the efforts of others to do so. Finally, the difficulties experienced by the NISPO fund managers during the early phase of the programme and the consequent need to rebuild relationships with other stakeholders, may also have contributed to the limited success to date of efforts to build a deal flow chain across the continuum of funds.

5.7 Despite this, there is clearly potential to strengthen the deal flow chain moving forward – and also to connect more disparate parts of the funding continuum. For example, there are opportunities for firms supported through the Co-Investment Fund to form part of the development phase pipeline for Crescent Capital and Kernel Capital. In addition, there is scope to link some Growth Loan Fund investees – who have been exposed to a hybrid form of mezzanine finance and may have gained an improved awareness of equity investment – with the Development Funds.

5.8 Invest NI has made substantial progress towards achieving the Fund of Funds third objective - retaining and building on the skills and capability of the venture capitalists based locally. Following a three year period between 2010 and 2013 when Northern Ireland did not have access to a later stage venture capital fund, the re-establishment of the two Development Funds during 2013 has enabled Crescent Capital, a Northern Ireland-based fund manager, to sustain its presence and Kernel Capital, supported by the Bank of Ireland, to develop a new operation in Northern Ireland.

5.9 Clarendon Fund Managers, also Northern Ireland owned and operated, is now three years into the delivery of the Co-Investment Fund and is a partner in Whiterock Capital Partners, a joint venture involving Clarendon, Braveheart Investment Group and NEL Fund Managers. The Ulster Community Investment Trust won the contract to deliver the Small Business Loan Fund in partnership with Enterprise NI. Therefore, following robust procurement processes, four of the five Invest NI funds are being managed by Northern Ireland owned/managed fund managers; the fifth (NISPO I) has been managed by E-Synergy, an English firm. There were integration issues initially but these appear to have been addressed to some extent during the second half of NISPO's investment phase.

5.10 Although some progress has been made, arguably Invest NI could be more proactive in developing the collective capacity of the fund management community through networking and related activity. We explore this further in section 7.

High level objectives

5.11 The evaluation considers the contribution of the Fund of Funds to Invest NI's strategic objectives as detailed in its 2011-2015 Corporate Plan; the Fund of Funds was approved in the final few months of the previous Corporate Plan period and as such in practice made only a limited contribution to the 2008-2011 plan. This, in turn, contributes to the achievement of DETI's 2011-2015 Corporate Plan and ultimately to the achievement of Programme for Government objectives.

5.12 Access to finance is a key enabling activity supporting three of Invest NI's key economic drivers including:

- stimulating innovation and creativity – by supporting the commercialisation of research and the growth of seed stage, technology businesses
- competing in the global economy – by supporting export-focused businesses, including more established SMEs, to invest in growth
- encouraging business growth – access to finance is cited as a priority to support an increased flow of innovative start-ups; support export activity in international markets; enhance competitiveness and reduce business costs; and improve productivity.

5.13 As highlighted in paragraph 5.2, the Fund of Funds model has created a robust governance structure, linked to the Invest NI Board, which has helped build the confidence of DETI, DFP and Ministers to extend the quantum of public sector funds managed from just over £50m in 2010 to £90m by 2014. The Fund of Funds architecture is undoubtedly a factor in that decision.

5.14 As the overall quantum of the Fund of Funds increased, there was a greater need to address critical issues including the ability to vire resources between funds, to recycle legacy returns and to establish a revolving fund for the long-term. The Fund of Funds approach has created a mechanism which will enable these matters to be addressed by Invest NI, even though as yet, Invest NI have not needed to utilise any of these flexibilities.

5.15 Without the Fund of Funds model in place, it is questionable whether Departmental/Ministerial approval would have been forthcoming to support the expansion of public sector risk capital funds on the scale that has been achieved since 2010. The ability to recycle legacy funds – unlocking the potential for a long-term, revolving fund – and to vire resources between sub-funds in response to market signals and/or fund performance, were especially important in this respect.

5.16 Failure to put these measures in place and to unlock additional public sector investment in risk capital funds could have significantly compromised investor confidence and Invest NI's ability to leverage private sector investment from within and outside Northern Ireland on the scale that has been achieved through the funds. This is especially pertinent as during the process of developing the Fund of Funds approach, negotiations with the European Investment Bank concerning an underpinning loan failed to reach a positive conclusion. Moving forward, as the UK Government continues to reduce public sector expenditure, the ability to utilise legacy funding through a revolving fund, and to manage the funding continuum flexibly is likely to increase in importance.

5.17 It is also important to note (as highlighted in paragraph 2.56) that the Fund of Funds contributes to the achievement of Programme for Government milestones as the latter includes a specific target in relation to the Growth Loan Fund. This is the only risk capital fund to which direct reference is made through the PfG.

Strategic impacts and wider/regional benefits

5.18 The Fund of Funds does not currently have any specific KPIs or targets associated with it and the economic impacts arising from Invest NI's risk capital investment will be realised at the level of the individual funds. Thus a full analysis of the gross and net economic impacts of the programme is not possible and as a consequence, the evaluation focuses on the strategic impacts, or wider and regional benefits which have resulted from the establishment of the Fund of Funds model.

5.19 The stakeholder consultation indicated that the main added value resulting from implementation of the Fund of Funds is the operational flexibility achieved through this approach; this includes the ability to vire resources between sub-funds and to reinvest legacy returns in SMEs with the latter unlocking the potential to create a long-term, revolving fund for risk capital investment. The establishment of robust governance structures to strengthen the accountability of the Invest NI Board for the Fund of Funds, through the Fund of Funds Sub-Committee, was also cited.

5.20 Although it is premature to consider the longer term impacts of the model, the flexibility afforded by the Fund of Funds undoubtedly represents a significant incremental outcome which would not have been achieved had Invest NI continued to operate a series of separate, individual funds. However, it is important to note that, as yet, Invest NI has not been required to utilise any of the flexibilities created through the Fund of Funds although it is anticipated that this will occur in future as legacy returns are realised. As a result, although the incremental outcomes associated with the Fund of Funds are relatively modest at this stage, these are likely to increase substantially over time as the future benefits of this approach are realised.

5.21 In this context, drawing together findings from interviews with stakeholders and aspects of the desk research, we conclude that the Fund of Funds has contributed to realising the following wider and regional benefits:

- supporting the increase in the scale/quantum of public sector investment in risk capital funds in Northern Ireland since the introduction of the Fund of Funds in 2010/11; as cited overleaf, establishing the Fund of Funds created a robust mechanism to facilitate the long-term management of investment returns and other matters which unlocked Departmental and Ministerial approval for a larger quantum of funding than is likely to have been the case had the funds been operated and managed in silos

- developing investment and fund management capacity in Northern Ireland; the Fund of Funds approach has engaged local fund managers and investors in the risk capital process; strengthened the capacity and longevity of locally-based fund managers as they have successfully tendered for fund management contracts and widened the pool of Northern Ireland investors (ranging from institutions to high net worth individuals) actively investing in Northern Ireland SMEs

- as cited overleaf, the Fund of Funds has been partially successful in creating a pipeline/deal flow chain although some investee businesses may follow a more organic rather than linear pathway to securing later stage equity investment; in future, as seed stage businesses mature and seek further investment, there will be further opportunities to strengthen the deal flow chain

- introducing the Fund of Funds Committee as a key element of the governance of the Fund of Funds has provided additional oversight and beneficial challenge not only for Invest NI's Corporate Finance team managing the funds, but also for the independent fund managers who have been subject to increased external scrutiny, and more of the latter is planned; establishing the Committee has also helped to develop the knowledge and capacity of Invest NI Board members in relation to risk capital and this will enhance its effectiveness in future when required to make strategic decisions in relation to the Fund of Funds or individual funds

- as an alternative to the EU JEREMIE approach, implementation of the Fund of Funds model has required Invest NI and its fund management partners to seek new sources of private sector investment; by creating a stable, long-term platform to manage investment flexibly across the funds and facilitate future recycling of legacy returns, the Fund of Funds model has contributed, alongside other factors, to building investor confidence in the Northern Ireland risk capital market; as a result that both institutional investors from outside Northern Ireland have invested in the Development Funds and high net worth individuals who had not previously engaged with local business angel networks have invested in individual businesses on a co-investment basis

- market adjustment; the Fund of Funds is designed to support the adjustment of Northern Ireland's loan and equity investment markets by providing the flexibility to re-allocate resources in response to changes in demand and other market signals; there is some anecdotal evidence that at least one of the loan funds, in addressing the growth capital requirements of SMEs, has had the wider benefit of supporting businesses to renegotiate the terms of their existing loan/overdraft facilities by de-risking the process for banks

- developing the seed stage 'eco-system'; access to equity investment is a key factor in the formation and growth of new technology/knowledge-based businesses and in strengthening investment/fund management capacity in Northern Ireland, the Fund of Funds has contributed to the development of the support eco-system

- knowledge transfer and capacity building; the establishment of a long-term approach to risk capital in Northern Ireland through the Fund of Funds has enabled fund managers to work collaboratively with companies in their portfolios to build their investment readiness, management capacity and financial standing as part of a long-term process; in turn and in due course, this may also realise spillover benefits for the Northern Ireland economy as intellectual property and technologies are commercialised and 'mainstreamed'

- Foreign Direct Investment (FDI); by creating a stable, long-term platform for risk capital investment in Northern Ireland, the Fund of Funds has contributed to the attraction of FDI by assisting the development of the support 'eco system' for knowledge/technology-driven start ups and early growth phase SMEs including strengthening indigenous/fund management capacity; the availability of venture capital plays a key role in the attraction of FDI.

Establishing the counterfactual

5.22 Establishing the counterfactual – what would have happened in the absence of the project or intervention – is an important outcome for any evaluation. This can be calculated on either a quantitative or qualitative basis; in this case, as there are no specific economic outputs/outcomes attributed to the Fund of Funds, a qualitative approach has been adopted. In this context, it is necessary to consider both deadweight and displacement effects.

5.23 Deadweight represents the quantification of outcomes under the reference case. In this case, as the Fund of Funds is specifically focused on the provision of risk capital funds and support which are subject to specific market failures which are reviewed regularly by Invest NI, we conclude that the project demonstrated low levels of deadweight.

5.24 Displacement arises where the intervention takes market share (known as product market displacement) or labour, land or capital (referred to as factor market displacement) from other existing firms within the geographical area of the project. In this case, there are several factors to consider:

- the Fund of Funds provides a framework to deliver public sector investment in loan, equity and mezzanine finance where there is clear evidence of market failure relating to the reduction in bank lending to SMEs and the long-term under-representation of VC investment in Northern Ireland; the Fund of Funds provides a mechanism to adjust Invest NI's response to changes in the market over time, shifting resources between the funds in response to market signals

- both loan products operating within the Fund of Funds continuum typically offer loans at higher interest rates (but typically unsecured) than those typically charged through the banks to reflect the increased level of risk; however, those firms applying have generally failed in their efforts to secure a conventional loan therefore the additionality associated with both products is high

- there is evidence to suggest that 'new' investors – including institutions and business angels – have been engaged and made investments since the establishment of the Fund of Funds

- some indirect product market displacement will have occurred as businesses supported through the individual funds have increased their market share relative to competitors in Northern Ireland who did not seek or secure investment.

5.25 Whilst acknowledging that some product market displacement is present, this is largely manifest (and measured) at the level of the individual funds. As a consequence, we conclude that the Fund of Funds has demonstrated low levels of displacement.

Value for money

5.26 In considering the value for money achieved by the project *economy, efficiency* and *effectiveness* are critical factors:

- economy measures are concerned with demonstrating that the inputs (the resources used to deliver the project and realise its outputs) have been obtained at least cost

- efficiency addresses the inputs/processes developed to deliver the project and relates the costs or other resources used in delivering the project in relation to the scale or value of the outputs realised

- effectiveness relates to the impact of the project on longer-term outcomes or strategic objectives.

5.27 The Fund of Funds clearly demonstrates both **economy** and **efficiency** in the use of inputs/resources to manage the programme. In terms of economy, Invest NI considered a range of options (including both in-house and external management of a holding fund) as part of the casework process. In recommending the preferred option (in-house management based on the successful model adopted by Scottish Enterprise) the casework report concluded that the Fund of Funds approach could realise all of the flexibilities and other benefits inherent in the JEREMIE approach but at a substantially lower cost. As a result, the benefits of the JEREMIE model did not, in Invest NI's view, outweigh the costs.

5.28 This point can be developed further in considering the **efficiency** of the Fund of Funds approach. There are no quantifiable outputs associated with the Fund of Funds therefore the assessment of efficiency is based on the costs associated with realising the strategic or wider/regional benefits summarised earlier in section 5.

5.29 The fund management costs associated with the individual Invest NI-backed funds are based on BVCA and EU guidelines and are generally set as a fixed percentage of the capital invested. However, evidence from JEREMIE programmes elsewhere (see section 6) suggests that the costs associated with management of the holding fund (either independently or by the JEREMIE managing authority) can be up to 2% per annum of the capital sum. In the case of North East Finance, holding fund management costs over the lifetime of the programme are expected to be £14.5m or 11.6% of the capital invested.

5.30 In the case of Invest NI, the Fund of Funds management function is delivered by 1.1 FTE posts, incorporating 1 FTE post at Grade 7 and 0.1 FTE post at Grade 5. Based on adopting the mid point of standard Northern Ireland Civil Service pay grades and including salary plus on-costs at 21% we estimate that the average annual cost of the fund management function is approximately £68,870 per annum. In addition, the cost of Board members and co-opted members time is approximately £12,000 per annum. On this basis, the estimated cost of delivering the Fund of Funds support function is approximately £80,870 per annum or just 0.09 % per annum of the public sector capital contribution to the Fund of Funds.

5.31 Although the level of resource devoted to holding fund management is substantially larger in the projects benchmarked in section 6, there are no significant differences in the general approach to holding fund management. Thus the Fund of Funds demonstrates very clear efficiency in the use of the resources deployed by Invest NI. We return to this issue in the conclusions and recommendations.

5.32 The project’s effectiveness is related to its impact on longer-term outcomes and to the strategic objectives of Invest NI, DETI and the Northern Ireland Assembly through the Programme for Government. These are explored overleaf and also in section 2. In summary we conclude that the project has contributed to the objectives and targets set out in the 2011-2015 Corporate Plans of both Invest NI and DETI and makes an additional, direct contribution to Programme for Government targets through the Growth Loan Fund. We conclude that the Fund of Funds has demonstrated effectiveness in this context.

Equalities impacts

5.33 Section 75 and Schedule 9 to the Northern Ireland Act 1998 came into force on 1 January 2000 and placed a statutory obligation on public authorities, in carrying out their various functions, to have due regard to the need to promote equality of opportunity between:

- persons of different religious belief, political opinion, racial group, age, marital status or sexual orientation
- men and women generally
- persons with a disability and persons without
- persons with dependants and persons without.

5.34 Section 75 of the 1998 Act highlights a number of equality of opportunity or good relations categories who should be given particular consideration in identifying the equalities impacts of public sector interventions, including religious belief, political opinion, racial group and sexual orientation. Invest NI has a ratified Equality Scheme in place which sets out its commitment to the Section 75 Statutory Equality Duties and contains a timetable for undertaking a series of Equality Impact Assessments (EQIAs).

5.35 The Fund of Funds initiative was subject to a policy screening process by Invest NI to determine whether an EQIA was required and was ‘screened out’ as it was not expected to have an impact on any of the Section 75 categories and thus were not subject to EQIA. The evaluation found no evidence that Invest NI delivered the project in a way which is likely to have a detrimental impact on the Section 75 equality of opportunity or good relations categories.

6 BENCHMARKING

6.1 Section 6 benchmarks the Fund of Funds initiative against comparator projects elsewhere in the UK, identifying any key lessons learned which are of relevance to the evaluation. Section 6 considers the following projects/programmes in more detail:

- Scottish Investment Bank
- Finance Wales, which manages a £150m JEREMIE holding fund
- North East Finance, which manages a £125m JEREMIE holding fund.

Scottish Investment Bank

6.2 Scottish Enterprise (SE) has adopted a long-term approach to access to finance, making over £200m of equity/loan investments in Scottish businesses since 2002 which in turn have leveraged over £300m of private investment. The majority of the investment has been through SE/ERDF supported funds although SE retains the capacity to make direct investment in firms; this tends to make up a small proportion of invested funds.

6.3 In response to the increased demand for both equity and debt financing resulting from the recession, the Scottish Enterprise Investment Team was rebranded as 'the Scottish Investment Bank' (SIB) in December 2010. This coincided with the introduction of the Scottish Loan Fund (see below) to broaden access to finance for more established SMEs with growth potential. The SIB is not authorised or regulated by the Financial Services Authority.

6.4 In 2012/13, SIB invested over £32m in equity and loan deals, leveraging more than £60m of private sector funding. This represented a 20% increase on 2011 investment levels. SIB manages a portfolio of investments in 237 companies – over 40% of which are in the technology/engineering sectors and 25% in life sciences. Renewable energy firms make up a small (3%) but increasing proportion of the portfolio. Income from realisations was over £12m in 2013.

6.5 SIB has established five separate investment funds:

- the **Scottish Seed Fund**, which makes equity investments of between £20,000-£250,000 in seed stage businesses or firms at or near the end of their product development/commercialisation phase; potential investee firms must secure at least one external equity investor and at least 50% of the total investment must be derived from the private sector; the Seed Fund invested £1.4m in 15 deals in 2012/13

- the **Scottish Co-Investment Fund**, part-funded by ERDF, which can invest between £100,000-£1m on a pari passu basis in any firm in deals up to £2m; the SCF works with a wide range of VC fund managers, business angel syndicates and other investors, who typically source and negotiate investment deals and must contribute at least 50% of the funding for any deal; the Co-Investment Fund has been established for over 10 years and invested £7.8m in 48 deals in 2012/13

- the **Scottish Venture Fund**, also supported through ERDF, which makes investments of between £500,000 and £2m alongside private sector partners in deals of between £2m-£10m; the SVF cannot invest more than £2m in one firm but can invest through equity, mezzanine or debt instruments on a matched basis with the private sector; equity investments are on a pari passu basis; the SVF invested £9.1m in 11 deals in 2012/13

- the **Scottish Loan Fund**, a £94m fund launched in 2011 supported by Scottish Enterprise, Highlands and Islands Enterprise, ERDF and the private sector; the fund provides mezzanine loans ranging from £250,000 to £5 million to qualifying Scottish SMEs on a wholly commercial basis and is focused on established businesses that have growth potential or are engaged in exporting but are unable to access growth finance; the SLF had its second and final close in March 2012, taking the total level of SLF commitments to £113.2 million

- **the Renewable Energy Investment Fund (REIF**), launched in October 2012 and underpinned by £103m of funding from the fossil fuel levy; the REIF will provide loans, equity investments and guarantees for projects that will increase the growth of the marine renewable energy sector; increase community ownership of renewables projects or deliver district heating networks.

6.6 SIB is also an investor in the newly established Rock Spring Ventures Fund, launched in early 2013 to support equity investment in early stage life sciences and health technology companies. It is anticipated that the final size of the fund will be £50m.

6.7 Scottish Enterprise had previously sought to participate in the EU JEREMIE programme and developed proposals to unlock up to £70m of EIB funding. However, SE was unable to agree a way forward on various governance matters with HM Treasury and the proposals were abandoned in December 2009. SE also had concerns around fund management and other costs associated with the JEREMIE programme.

6.8 As a consequence, SIB now operates an internal holding fund/Fund of Funds model that includes the main funds and accounts for around 70% of the deals. The holding fund is a separate block of SE funds and managed by the agency. Excluding the REIF, current public sector investment in the suite of funds is around £90m but SIB retains around £10m of unallocated resource (effectively a reserve) that it can allocate flexibly in response to demand. This represents an area for further exploration by Invest NI and we return to this issue in the conclusions and recommendations.

6.9 The current mechanism also enables resources to be vired between funds if required by building in appropriate KPIs to the contracts for those externally managed funds. Both ERDF and Scottish Enterprise legacy funds can be recycled. Each fund has individual KPIs, including employment and GVA impacts. External evaluations conducted every three years provide the independent view of these data.

6.10 Although detailed costs were not made available to the consultants, SIB reported that the management costs associated with the holding fund approach were significantly below the European Commission's fee ceilings for holding/sub-fund managers – currently no more than 2% of the annual capital contribution to the holding fund[43]. They are considered to be competitive by SIB's private sector partners.

6.11 From the SIB's perspective, HM Treasury rules on requiring EIB loans to be taken off balance sheet have significant implications for public sector governance/accountability, and this reduces the attractiveness of the JEREMIE model. As part of Scottish Enterprise, SIB has a robust governance/accountability process, including a public/private sector investment committee which provides full oversight of the process, underpinned by Scottish Enterprise's wider governance processes.

6.12 In England, lines of public sector accountability for the three JEREMIE programmes have been complicated by the closure of the Regional Development Agencies in 2012, mid-way through their investment period. In some areas their replacement Local Enterprise Partnerships or local authorities have no relationship with the holding company board and this has generated tensions. There are also potentially significant cost implications of setting up a separate arms length holding fund management vehicle, particularly if private sector fund managers are appointed to operate it.

6.13 In relation to communications/marketing, the Scottish Enterprise brand (with SIB as its investment division) features very prominently in all marketing activity. The aim is to promote the continuum of funding to build long-term certainty for investors and businesses on the visibility of the investment pipeline and the availability of funding.

6.14 As funds near the end of their active investment phase, SIB aim to introduce a follow-on fund to provide a period of overlap; for example the current Co-Investment Fund will cease investment in March 2015 but a replacement fund will be operational during the latter part of 2014. Typically the approval process can take 12-24 months.

6.15 SIB will aim to maintain a revolving holding fund of around £100m for its risk capital programme. Alternative sources of capital are being actively pursued but SIB are unlikely to approach EIB as a potential investment partner in future.

6.16 As highlighted in section 2, Scotland has 'punched above its weight' in terms of the attraction of venture capital investment and has a mature business angel community driven by the syndication model which sustains the equity investment pipeline from seed stage. However, SIB estimate that without their sustained intervention, the Scottish equity investment market would be 40-50% smaller than at present and there would be fewer syndicates. SIB also

43 Commission Regulation (EC) no 1828/2006

noted that the Scottish model had played a significant role in developing and sustaining local investment and fund management capacity and skills; some of these firms are now exporting their expertise to other parts of the UK.

Key lessons for Invest NI

- Frequent, regular assessments of the market, identifying movements, are of critical importance
- Determining the long term strategy to grow the investor base is challenging; an under-developed market will take 10 – 15 years to achieve a sustainable mix of investors
- Ensure demand-side activity is given equal weighting with supply in developing access to finance interventions
- Securing some headroom within the holding fund allocation to allocate resources on a more flexible, responsive basis is an alternative to a complex and time-consuming performance management process to extract from under-performing funds

Finance Wales

6.17 Finance Wales (FW) was established by the Welsh Assembly Government in 2001 to improve access to finance for growth-oriented businesses in Wales, building on the previous activities of the Welsh Development Agency. Following the decision to pursue JEREMIE as part of the 2007-2013 European funding programme, Finance Wales was reconstituted as a limited company in which the Welsh Government is the only shareholder. Currently, Finance Wales operates as fund manager for a number of EU and Welsh Government-backed funds in Wales including

- the £150 million Wales JEREMIE Fund, launched in 2009
- the £40 million Wales SME Investment Fund, supported by the Welsh Government and Barclays
- the £6 million Wales Micro-business Loan Fund (Welsh Government)
- the £10 million Wales Property Development Fund (Welsh Government).

6.18 Through its subsidiary FW Capital, Finance Wales manages two funds in the North East of England – the North East Growth Plus Fund, part of the North East Finance JEREMIE programme considered overleaf, and the Tees Valley Catalyst Fund which provides loan guarantees and warranty bonds – and the North West Funds for Loan Plus, part of the North West of England JEREMIE programme.

6.19 The Wales £150 million JEREMIE Fund received State Aid approval in November 2008 and was launched in April 2009. Finance Wales administers the JEREMIE holding fund, overseen by an investment board. Finance Wales Investments Ltd, a subsidiary of Finance Wales plc, was appointed as fund manager for the programme following an open procurement process. It manages all five sub-funds. Investment decisions are undertaken by an independently appointed Investment Committee; funding can be vired between the sub-funds as required.

6.20 The Fund operated over a five year investment period to April 2014 with a further five years for investments to be fully exited or repaid. The portfolio of funds is as follows:

- a £5m **micro-financing scheme** to support new microbusinesses providing loans of £5,000-£25,000

- a £55m **loan finance scheme** to provide debt finance to start ups and existing SMEs from £25,001-£1m; all loans are provided under market conditions to ensure State Aid compliance

- a £65m **risk capital scheme** to support venture capital investments in high growth SMEs, making investments of between £100,000 and £2m; at least 70% of the fund must be in equity investments

- a £10m **Co-Investment Scheme** to support business angels and other private investors on a pari passu basis; 50% of the funding for each investment will be from the private sector

- a £15m **Technology Transfer Scheme** to support commercialisation of research and the development of University spin-outs and non University start ups, with a maximum investment of €1.5m per SME over a 12 month period.

6.21 Support is provided for SMEs in both the Tier 1 Convergence Area (West Wales and the Valleys) and the Tier 2/3 Regional Competitiveness and Employment Area covering the east of Wales. 50% of the funding takes the form of a loan from the European Investment Bank, 40% is funded through ERDF with the remaining 10% provided by the Welsh Government. The ERDF/Finance Wales funding is subordinated to the EIB funding in that the EIB will secure the return of its capital and interest before the other funds are repaid.

6.22 Finance Wales perceive the funds to be performing adequately overall and have repaid the EIB loan earlier than forecast. The Fund's targets include supporting 800 businesses, creating over 15,000 jobs and leveraging almost £340m of private investment. As of June 2013, the fund had supported 479 businesses and invested £108m.

6.23 Finance Wales believe that access to finance for SMEs has worsened since the launch of the fund. Market failure continues to be apparent in relation to unsecured lending, seed and early stage development; earlier Government support is felt to have had a very limited impact on the market. It has taken a long time to develop and launch funds and the size and persistence of the recession has undoubtedly impacted on both the performance of the funds and investee businesses.

6.24 To date, FW perceive that the economic outcomes have been disappointing. FW has recently been the subject of some scrutiny as part of the Welsh Government's Access to Finance Review with a particular focus on how it secures an appropriate balance between its role as a commercial fund manager and in delivering economic development objectives as an arm of the Welsh Government. Despite this, Finance Wales highlight the following benefits from the JEREMIE/EIB approach:

- flexibility created by a holding fund approach is felt to be a big strength; this includes the ability to vire funding between sub-funds (£7m has been vired to date); however EIB is relatively process driven and some limits on flexibility remain
- the EIB has been a key player in advising on the development of the programme as well as providing funding
- ensuring State Aid compliance through the JEREMIE model was comparatively straightforward, with Finance Wales seeking and receiving a specific State Aid notification from the European Commission in 2008; however, the recent Access to Finance Review challenged Finance Wales on its failure to use the General Block Exemption Regulations which could have increased aid intensities for some firms
- this is perceived to be simpler than the model adopted by the Department for Communities and Local Government for the English JEREMIE programmes (and risk capital schemes in other English regions) which operates under the General Block Exemption Regulation and Regional Aid guidelines and can only offer maximum aid intensities to SMEs in Assisted Areas
- Governance/accountability – there is regular reporting to the holding fund which is also involved in the selection of individual fund managers. EIB provide further oversight and scrutiny comes from EIB and the ERDF monitoring/audit process provides a further layer
- Procurement of the holding fund manager (Finance Wales Investment) was comparatively straightforward and there have been benefits in recruiting fund managers and housing them under the FW umbrella
- the ability to recycle investment returns – the funds will start generating returns shortly and these will be available to underpin the development of a revolving fund.

6.25 The affordability of the JEREMIE programme (in terms of fund management fees and borrowing costs) has been a concern for Finance Wales, although all fund management costs are within EU risk capital guidelines.

6.26 Performance is monitored at holding fund level, with KPIs agreed with the Welsh Government and Welsh European Funding Office. Monitoring activity is strengthened by a regular programme of evaluations at holding and sub-fund level.

6.27 FW continue to believe that there is an ongoing need for public intervention and support of the type that is already in place. FW is developing proposals for a new £150m programme and is likely to re-engage in negotiations with EIB to secure the underpinning investment through a holding fund model; there may also be potential to involve one of the main UK commercial lenders in the fund although subordination to EIB may be a barrier to this.

6.28 Attracting local private investors will continue to be a challenge although business angels and high net worth individuals could still provide opportunities. FW indicate that it is likely that a significant proportion of the holding fund will need to be generated through recycling of legacy funds.

6.29 Finance Wales has been utilised as the main brand for the programme rather than the individual sub-funds. This has enabled FW to engage with businesses in an holistic manner and tailor their support accordingly.

Key lessons for Invest NI

- Achieving a clear and transparent balance between commercial and economic development objectives for the risk capital programme at the outset
- Developing a robust market assessment at the outset of the programme and keeping this under regular review
- Use of the Finance Wales brand to engage with the wider business community rather than adopt a more fragmented approach based on the individual funds.

North East Finance

6.30 North East Finance (NEF) was established in the early part of the last decade by the former Regional Development Agency One North East to deliver two early stage investment funds supported through the 1999-2006 ERDF Objective 2 programme. The funds were a £10m Proof of Concept programme (now fully invested in 180 SMEs) and a £23m Co-Investment Fund targeting later stage investments (fully invested in 34 SMEs). NEF also helped to establish the region's first specialist venture capital business – North Star Equity Investors – which has now been spun off into the private sector.

6.31 Building on these activities, NEF successfully assembled a £125 million holding funding package under the JEREMIE initiative which was launched in 2009. £62.5m of the capital takes the form of an EIB loan – unlike the situation in Wales, the EIB funding was received in three tranches. £44.25m was allocated from the 2007-2013 North East Competitiveness ERDF Programme and £18.25m from One North East.

6.32 NEF was established as an independent company limited by guarantee in order to meet HM Treasury requirements. The North East scheme incorporates the following separate funds:

- **Angel Fund** – a £7.5m fund (managed by Rivers Capital) making investments between £50,000-£150,000 in investments led by business angels where at least 30% of investment is leveraged by the private sector

- **Proof of Concept Fund** – a £15m fund intended to support the early stages of development for technology-led businesses, including both University and non-University opportunities; the fund makes investments of between £20,000-£100,000 with the potential for follow-on investments; the fund is managed by Northstar Ventures

- **Accelerator Fund** – a £20m fund to invest in companies and pre-start enterprises predominantly at the start-up and seed capital stages; the fund can complete investments of between £50k and £750k, with the maximum investment into any one company being limited to £750k per year or 10% of the total fund size in aggregate; the Accelerator Fund is also managed by Northstar

- **Technology Fund** – a £25m fund which invests in technology companies at any stage of their development or maturity, extending from proof of concept through to seed and development capital stages; the fund can complete investments of between £50k and £1.25m, with the maximum investment into any one company being limited to £1.25m per year and to 10% of the total fund size in aggregate; the fund is managed by the IP Group

- **Growth Fund** – a £23m fund which aims to invest in more mature companies at development and growth stages; the fund can complete investments of between £50k and £750k; until recently the Fund has been delivered by NEL

- **Growth Plus Fund** – a £17m fund intended to invest in relatively mature companies at development and growth stages in any sector looking for growth capital; the fund targets the higher-end of the equity gap – investing on average a total of approximately £570k per SME – and can complete investments of between £350k and £1.25m; Finance Wales is the fund manager.

6.33 The active investment phase will cease in December 2014. The suite of funds was established with a limited degree of overlap to stimulate competition between providers. Across the programme, funds make a mix of equity and loan investments; whilst this is in part driven by business need, it is also influenced by the requirement to service the EIB loan. Certainly the sub-fund structure is more complex than a number of comparator UK JEREMIE programmes.

6.34 The NEF holding fund utilises all of the flexibilities inherent in the JEREMIE model, including the ability to vire resources between funds and recycle investment. £12.5m (10% of total fund) was originally kept in reserve. In 2013, £5m of this was allocated to the Accelerator fund, and £0.5m to the Microloan fund – based on demand levels and performance of these funds. £3m was re-allocated from the 'Growth Plus' to the 'Growth' Fund based on demand levels. £7m has been held back to support follow-on activity in 2014/15.

6.35 By June 2013, NEF had invested £74.2m (60%) of the £125m fund, achieving its target when the decision to hold back £7m for 2014/15 is factored in. All of the funds focused on micro and seed stage investments are on or over target, with the Accelerator Fund demonstrating particularly strong performance. However, the three funds with a focus on later stage investments are behind target; the Growth Plus Fund has achieved only 76% of its investment target to date and this contributed to the decision to reallocate funds to the Growth Fund.

6.36 Detailed information on operating costs is available from the recently published mid-term review of the English JEREMIE Funds[44]. This report estimates lifetime gross operating costs of £53.4m (42%) of the value of the funds under management – including estimated EIB costs of £6.8m – of which approximately £14.5m relate to holding fund costs. Assuming the majority of the holding fund costs are incurred during the investment phase, this suggests annual holding fund costs of around £2.9m per annum. NEF's operating costs are significantly higher than those of Finance Yorkshire (£28.7m including EIB costs) but this is because the NEF programme is larger and has a more complex mix of sub-funds.

6.37 NEF cite the development of local fund management capacity as a key benefit of the fund; local fund manager Northstar Ventures has played a key role in the delivery of the programme, managing two funds and developing skills and experience capable of being exported elsewhere. Other benefits of the JEREMIE model highlighted by NEF include

- the flexibility of holding fund approach in responding to changing market conditions
- the role of EIB – considered 'very helpful in every respect'
- ability to recycle investment and establish a revolving fund
- although fund management costs appear high, NEF reiterates that these are within EU risk capital guidelines

6.38 KPIs are in place at both Fund of Funds and sub-fund level; this was a key requirement for both ERDF and EIB. NEF's cumulative targets at holding fund level are as follows:

- 594 companies supported
- £91.9m invested from the funds
- £114.4m private sector secured
- 1068 new jobs created
- 1994 jobs safeguarded.

6.39 Unlike Finance Wales and SIB, North East Finance avoids involvement in marketing. They expect that individual Fund Managers will be more successful in attracting investment funds using their own brand and credentials as compared with centralised branding – but acknowledge that some confusion may result from this approach. The question is the extent to which businesses want a single point of engagement with the funds or a choice – in NEF's view, the latter applies.

44 Mid-term review of the English JEREMIE Funds, Regeneris for British Business Bank November 2013

6.40 Legacy funds from the earlier (1999-2006) programme will be available from 2015. Recent research for NEF's partner body North East Access to Finance proposed the creation of a £200m successor to the JEREMIE programme, overarching 4-5 sub-funds, to cover the North East and Tees Valley Local Enterprise Partnership areas and funded through legacy funds, ERDF and potentially EIB and other sources of investment. The aim is to have the new programme operational by 2015/16.

Key lessons for Invest NI

- Holding a proportion of capital in reserve to allocate in response to market demand/fund performance
- Developing local fund management capacity has been a long-term objective of the approach in the North East; need to build in time for fund managers that are new to the region to build capacity and networks
- Use of individual funds as primary branding
- Use of General Block Exemption rather than individual notification to optimise aid intensities.

7 CONCLUSIONS AND RECOMMENDATIONS

7.1 Section 7 presents our conclusions and recommendations, reflecting the terms of reference for the evaluation which are summarised in paragraph 1.9.

Contribution to DETI/Invest NI strategic objectives

7.2 The Fund of Funds model secured final approval from Ministers in December 2010. Since then the quantum of public sector investment committed to the continuum of funds has almost doubled from £47m to £90m. We conclude that:

- Invest NI has achieved two of its three objectives for the establishment of the Fund of Funds, namely promoting a continuum of funds and retaining and developing local fund management/investment capacity, and has made progress towards achievement of the third – creating a deal flow chain across seed, early stage and development funds
- Access to Finance is explicitly identified in the 2011-2015 Corporate Plan as a key enabler of Invest NI's efforts to encourage business growth; the Fund of Funds has contributed to this objective and hence towards DETI employment/GVA targets by creating a robust platform for the long-term management of the risk capital programme, building both Departmental and investor confidence and helping to unlock additional funding that may not have been released in the absence of the Fund of Funds/holding fund mechanism
- the Growth Loan Fund makes a specific contribution to the achievement of one of the milestones/targets in the 2011-2015 Programme for Government; to date, the fund manager has achieved the target for investment but not that relating to the number of deals as demand for the product has been driven by larger, more mature SMEs than envisaged during project design.

Market failure rationale and ongoing validity

7.3 The development of the Fund of Funds was set in an increasingly challenging market context for both bank lending and equity investment, caused by the onset of the global recession and the subsequent shift in investor attitudes to risk. There are also some Northern Ireland-specific issues including the level of property-related debt and the prevalence of Irish and European-owned banks. Since the establishment of the Fund of Funds in late 2010, lending conditions have worsened. The market failures in Northern Ireland's equity/venture capital are more longstanding although levels of business angel investment, including through Invest NI's Co-Investment Fund, have held up well. The successful establishment of the Development Funds, albeit with a comparatively high level of subordinated investment by Invest NI, is also indicative of the relative health of the equity investment market.

7.4 In this context, we conclude that the market failure rationale for the five individual funds remains valid. Invest NI has a series of established mechanisms in place to review the market conditions relating to each of the funds on a regular basis and, via the Fund of Funds model, to vire resources between funds in response to demand or other market signals.

7.5 As three of the five funds are still at an early stage of their active investment period, there is no evidence to indicate that the quantum of the Fund of Funds (£160m when the two Development Funds are fully capitalised, with just over £90m of public sector investment) should be changed at this stage. This is broadly comparable with the scale of the JEREMIE programmes for Wales and the North East and North West of England when fully capitalised.

7.6 The evaluation research did identify a number of additional areas where potential market failures exist, although further detailed analysis is required to validate and quantify these assumptions. In addition to the potential extension of the Co-Investment Fund, which has already been identified as an opportunity by Invest NI, they included:

- later stage equity investment deals in the £2m-£5m range; there is strong evidence at UK level that the formal VC market has effectively retrenched from investments below this size as a result of fixed due diligence and related costs; although the number of deals of this size are comparatively small, and there are also State Aid considerations which currently limit the level of public investment to €1.5m for each SME over a 12 month period, potential demand and evidence of market failure should be considered as part of the forthcoming DETI research on venture capital in response to the EAG report

- funding for Management Buy Out/Buy in activity; at present replacement capital is not included within the European Commission's risk capital guidelines although this is expected to change; there is evidence to indicate that Northern Ireland has secured less than its per capita market share of private equity investment in this space and this should also be considered as part of the DETI VC research, building on the success of the Growth Loan Fund which has targeted more established SMEs

- reviewing the mechanisms available to support those UK banks with significant property loan exposure in Northern Ireland to reduce the burden of property debt on otherwise investible businesses; this is an issue requiring more extensive analysis to quantify the scale of the problem and consider the range of solutions which could be taken forward as part of the work of the Access to Finance Implementation Panel

- testing the demand for a bespoke social enterprise investment offer; anecdotal evidence of demand was cited during the evaluation and there are some interesting new models emerging around the Local Impact Fund model elsewhere in the UK, based on providing a mix of unsecured lending, small scale grants and wider business support.

7.7 We conclude that the implementation of the Fund of Funds model has created a robust, long-term platform for the management of Invest NI's risk capital funds, creating the framework to manage the funds flexibly and to address reinvestment and other opportunities as they emerge. To date, Invest NI has had limited requirement to make use of the flexibilities inherent in the model but, over the next three to four years this is likely to change and key decisions will be required in several key areas. This reinforces the value of the Fund of Funds approach and the need to ensure it is maintained and developed as an integral part of Invest NI's Access to Finance Strategy.

Governance and management of the Fund of Funds

7.8 Fund of Funds Committee members feel that they have an appropriate mix of skills and experience, benefiting from the co-option of one non-Board member and that the Committee has now 'bedded in', having met nine times since November 2011. In this context, Board members have identified the scope for the Committee to balance its current oversight/challenge role – with potential for more direct engagement with individual fund managers – with a longer-term, more strategic perspective on the access to finance issues facing NI businesses. This should have a clear focus on building and maintaining a clear picture of the market and market failure across the spectrum of business finance needs.

7.9 To date, the Committee has not had to make any significant decisions in relation to shifting resources between funds or concerning the recycling of legacy returns, although this is likely to change in future. We conclude that the governance mechanism is fit for purpose, but that as the need to make more complex decisions around reinvestment of funds becomes apparent, Invest NI should continue to review its approach to governance. At present, the Fund of Funds model is 'below the radar' for some stakeholders in Northern Ireland's investment community.

7.10 In the short-term, Invest NI should benchmark its governance and management approach, including the level of resource allocated to holding fund management, with that adopted by Scottish Enterprise through the Scottish Investment Bank. There are also concerns regarding the potential loss of expertise within the Fund of Funds Committee as Invest NI Board members reach the end of their period of appointment to the main Board.

Future approval process

7.11 A substantial proportion of Invest NI's £90m funding commitment to the Fund of Funds is approved and committed but remains unspent at this stage as the majority of the funds are at an early stage in their investment cycle. Moving forward, we conclude that Invest NI should seek to maintain a revolving Fund of Funds 'pot' of around £100m of public sector capital – consistent with the approach adopted by Scottish Enterprise. Invest NI will wish to keep the size of the unallocated Fund of Funds 'pot' under regular review and develop an active strategy to 'top up' the Fund of Funds.

7.12 In the context of the long-term objective to establish a revolving fund, the evaluation found no evidence to justify a significant change in the current approval process which operates at the level of the individual funds rather than the umbrella holding fund. The current process is based on evidencing specific market failures and developing individual funds in response and, in our view, this approach remains essentially sound; there are potential risks attached to seeking high level approval for a much larger, overarching Fund of Funds where this is not underpinned by very detailed evidence of target markets or proposals for specific funds. However, building on experience from Scotland and the North East, Invest NI may wish to consider the creation of flexible, unallocated pot (potentially £5-10m) which can be utilised flexibly and rapidly in response to demand. This is likely to facilitate a more rapid, proactive response than the current, sometimes lengthy process involved in securing approval for the extension of individual funds.

Key Performance Indicators

7.13 The Fund of Funds currently does not have any Key Performance Indicators associated with it as these are all attached to the individual funds, each of which typically has KPIs relating to numbers of deals and value of investment. Some also have targets relating to the numbers of investors, or new investors engaged with the fund. Unlike the JEREMIE initiatives, few have specific targets relating to the creation of jobs or output/GVA as Invest NI consider that they will generally accrue during the realisation phase (typically years 5-10 of an equity investment fund). In the case of Finance Wales, comparatively optimistic employment/GVA targets have generated some scrutiny as the programme moves into the final few weeks of its investment period.

7.14 One stakeholder also highlighted the anomaly that the Growth Loan Fund is identified separately as a headline measure within the Programme for Government, unlike the other funds within the continuum. For the 2015-2019 PfG/Corporate Plan period, Invest NI could consider aggregating the individual KPI targets at Fund of Funds level to provide a more complete picture of its performance. As ultimately the performance of the risk capital funds will be judged not only on their impact on loan/equity investment markets, but also on their economic impact, we conclude that Invest NI should develop aggregated, Fund of Fund level KPIs to feed in to the next Invest NI Corporate Plan round. These could include target number of investments/deals, amount invested and jobs created, cumulated at Fund of Funds level and reported annually, although the GVA target for each fund should be assessed through Post Project Evaluation. Appendix 1 draws together the existing sub-fund outputs and forecast impacts and details initial proposals for job/GVA outputs at Fund of Fund level. Recommendation 10 also refers.

7.15 The stakeholder consultation concluded that, in order to support a wider and more strategic role for the Fund of Funds Committee, Invest NI (with partners) should assemble a broader range of market indicators which provide an up to date picture of changing market trends in both the supply of and demand for equity finance. We also conclude that Invest NI should consider, as contracts for new funds are let, the adoption of fund level reporting measures which encourage collaboration between fund managers to develop the deal flow chain/pipeline and encourage progression between the different funding streams.

Strategic impacts, incremental outcomes and wider/regional benefits

7.16 Currently, the Fund of Funds model does not result in any specific economic outputs or outcomes as these are realised at the level of the individual funds. Nonetheless, the flexibility afforded by the Fund of Funds undoubtedly represents a significant incremental outcome which would not have been achieved had Invest NI continued to operate a series of separate, individual funds. It is important to note that, as yet, Invest NI has not been required to utilise any of the flexibilities created through the Fund of Funds although it is anticipated that this will occur in future as legacy returns are realised; the level of incremental outcomes is expected to increase significantly in future. In this context, we conclude that the Fund of Funds has contributed to the achievement of a number of wider and regional benefits including:

- contributing to increasing the scale/quantum of public sector investment in risk capital funds in Northern Ireland; the Fund of Funds has created a robust mechanism to facilitate the long-term management of investment returns and other matters which unlocked Departmental and Ministerial approval for a larger quantum of funding than could have been the case had the funds been operated and managed in silos

- securing new sources of private sector investment as a result of the need to replace EIB investment in the Fund of Funds following the decision not to develop a JEREMIE programme in Northern Ireland

- developing investment and fund management capacity in Northern Ireland; the Fund of Funds approach has engaged local fund managers and investors in the risk capital process and strengthened the capacity and longevity of locally-based fund managers

- building the capacity and capability of the Invest NI's Board around the theme of access to finance through the establishment of the Fund of Funds Committee

- market adjustment; the Fund of Funds is designed to support the adjustment of Northern Ireland's loan and equity investment markets by providing the flexibility to re-allocate resources in response to changes in demand and other market signals.

7.17 The scale and persistence of these impacts will increase over time as the benefits of the flexibilities associated with the Fund of Funds model are realised.

Complementarity with other access to finance/business support initiatives

7.18 By acting as an umbrella for Invest NI's individual risk capital funds, the Fund of Funds is unique in a Northern Ireland context. There are no other programmes or activities in place which seek to address the same issues or opportunities in the area of access to finance. In addition, we conclude that the Fund of Funds is complementary to Northern Ireland's wider innovation and business support 'eco system' by creating a long-term platform for investment for the pipeline of businesses supported through Propel, NISP Connect and related initiatives.

Additionality

7.19 Although the level of additionality associated with the Fund of Funds was not quantified, we conclude that the initiative has demonstrated low levels of deadweight and displacement. At individual fund level, a degree of product market displacement will be present as businesses supported secure market share from other firms who have not benefited from support.

Value for money

7.20 The Fund of Funds demonstrates both **economy** and **efficiency** in the use of inputs/resources to manage the programme. In terms of economy, Invest NI considered a range of options (including both in-house and external management of a holding fund) as part of the casework process. In recommending the preferred option (in-house management based on the successful model adopted by Scottish Enterprise) the casework report concluded that the Fund of Funds approach could realise all of the flexibilities and other benefits inherent in the JEREMIE approach but at a substantially lower cost.

7.21 This point can be developed further in considering the **efficiency** of the Fund of Funds approach. There are no quantifiable outputs associated with the Fund of Funds therefore the assessment of efficiency is based on the costs associated with realising the strategic or wider/regional benefits summarised earlier in section 5.

7.22 Although Invest NI does not allocate a specific budget heading to the Fund of Funds, it is estimated that the overall staffing costs associated with the Fund of Funds, including Board member input, is £80,870 per annum or 0.09% per annum of the public sector capital invested through the Fund of Funds. In contrast, North East Finance has occurred whole life holding fund management costs of £14.5m or some 11.6% of the capital invested in the holding fund. This is equivalent to around £2.9m per annum. Although the level of resource devoted to holding fund management is substantially larger in the projects benchmarked in section 6, there are no significant differences in the general approach to holding fund management.

7.23 The project's **effectiveness i**s related to its impact on longer-term outcomes and to the strategic objectives of Invest NI, DETI and the Northern Ireland Assembly through the Programme for Government. We conclude that the project has demonstrated its effectiveness through its contributions to the objectives and targets set out in the 2011-2015 Corporate Plans of both organisations and makes an additional, direct contribution to Programme for Government targets through the Growth Loan Fund. On this basis, we conclude that, to date, the Fund of Funds has demonstrated clear value for money for the public purse.

Longevity of the Fund of Funds

7.24 Our analysis of the loan/equity finance market in Northern Ireland and overview of the performance of Invest NI's risk capital funds suggests that market failure continues to be present in both investment spaces and will be for some time. It appears unlikely that Northern Ireland's banks will return to SME lending at pre-recession levels for the foreseeable future whilst the equity investment market is subject to longer-term, structural market failures, particularly in relation to seed stage investment.

7.25 The added value of the Fund of Funds model is derived from the flexibilities inherent within this approach. As we highlight earlier, the incremental outcomes associated with the Fund of Funds will increase over time as legacy returns are generated from earlier risk capital funds and/or the need to vire resources between sub-funds arises. For these reasons, we conclude that Invest NI should adopt a long-term approach to the Fund of Funds model and that, whilst subject to regular review, it should remain in operation for at least the next six years (to 2020) coincide with the new European Structural Funds programme period and, subject to further evaluation, roll forward into the following (2020-2026) programme period.

Equalities impacts

7.26 The Fund of Funds initiative was subject to a policy screening process by Invest NI to determine whether an EQIA was required and was 'screened out' as it was not expected to have an impact on any of the Section 75 categories and thus were not subject to EQIA. The evaluation found no evidence that Invest NI delivered the project in a way which is likely to have a detrimental impact on the Section 75 equality of opportunity or good relations categories.

Recommendations

7.27 The evaluation identifies a series of recommendations for Invest NI and other stakeholders that are summarised in table 7.1 below. These relate both to the wider policy environment (identified by the prefix 'P' in parentheses) in which Invest NI's risk capital funds operate and also to specific aspects of the delivery of the Fund of Funds initiative in the future (identified by the prefix 'D').

Table 7.1: Recommendations

No	Recommendation	Justification
1(P)	Invest NI should seek to extend the remit of the Fund of Funds Committee beyond oversight of the performance of the individual funds. Alongside this, the Committee should develop a more strategic role, focusing on longer term demand and supply-side issues.	Stakeholders including Committee members highlighted the need for a more strategic, long-term focus on access to finance for Northern Ireland SMEs.
2 (P)	Working with the Fund of Funds Committee, Invest NI should revise/update the Access to Finance Strategy with a dual focus on stimulating business demand for finance and addressing market failures/gaps in supply. Forthcoming DETI research in response to the recommendations of the EAG report should inform this process.	Stakeholders highlighted the need for a more strategic, long-term focus on access to finance for Northern Ireland SMEs.
3(P)	To support the Fund of Funds Committee in implementing recommendations 1 and 2, Invest NI and DETI should draw together a series of existing indicators reflecting market trends in demand for and the supply of SME finance. These should be presented on a quarterly basis.	Stakeholders highlighted the need for a more strategic, long-term focus on access to finance for Northern Ireland SMEs and a lack of appropriate metrics to inform this.

No	Recommendation	Justification
4(P)	Invest NI should liaise with DETI to ensure that the forthcoming research on venture capital considers the following potential market failures in the medium-term: • later stage equity investment in the £2m-£5m range • investment in MBO/MBI activity • property-related debt, including support for non-Irish banks with a significant property exposure • social enterprise support and the availability of community development finance.	The stakeholder consultation and desk research highlighted a number of potential gaps/market failures across Northern Ireland's loan/equity investment markets.
5 (D)	Within the framework of the existing Departmental and Ministerial approvals for the Fund of Funds, where possible, Invest NI should seek to explore opportunities with DETI and DFP to establish a sustainable revolving fund for risk capital investment. The revolving fund should maintain a public sector funding allocation of around £100m to ensure continuity in the supply of risk capital funding.	Stakeholder consultation and benchmarking highlighted the need to ensure a long-term approach to public sector investment in risk capital which maximises opportunities for re-investment of legacy returns from earlier funds.
6(D)	Linked to the 2014-2020 European Structural Funds programme, if practically possible Invest NI should seek approval to establish a flexible risk capital pot of between £5-10m that could be allocated rapidly to an individual fund in response to market signals. This would reduce the time associated with securing separate approvals to extend a fund.	The benchmarking research highlighted the benefits of retaining flexibility in the allocation of funding in Scotland and North East England.
7 (D)	Invest NI should undertake a more detailed benchmarking exercise with Scottish Enterprise to compare governance structures and staffing resources to deliver the Fund of Funds/holding fund model.	The research suggests that Invest NI is delivering the Fund of Funds model at significantly less cost than comparator organisations – although they may be delivering a larger volume of relevant activity. A more detailed benchmarking exercise would test this assumption and Scottish Enterprise/Scottish Investment Bank is the most appropriate benchmark case study as it did not adopt the JEREMIE approach.
8(D)	Invest NI should undertake an early review of its communications strategy relating to the Fund of Funds. This should include exploring the potential to develop the use of the Invest NI brand as the primary gateway for those businesses seeking access to finance rather than rely on the marketing activities of the individual funds.	The benchmarking exercise highlighted that Finance Wales/Scottish Investment Bank have a much higher profile and brand as a gateway to business finance.

No	Recommendation	Justification
9 (D)	Building on the ex-ante evaluation of financial instruments undertaken by DETI, Invest NI and DETI should liaise concerning the development of the 2014-2020 EU Structural Funds programme and agree the broad allocation of ERDF to be utilised as part of the Fund of Funds. This could include extension of the existing ERDF-supported Co-Investment Fund or the creation of a more flexible funding pot in response to recommendation 6.	Stakeholder consultation highlighted the need to consider this issue.
10 (D)	Building on the material presented in Appendix 1 of this report, Invest NI should develop aggregated KPIs at Fund of Funds level to feed in to the Corporate Plan cycle. These could include target number of investments/deals, amount invested and jobs created, cumulated at Fund of Funds level and reported annually. The GVA target for each fund should be assessed at the end of the 10 year operational period through Post Project Evaluation.	Stakeholder consultation highlighted the need to consider this issue.
11 (D)	Whilst recognising that investment cycles are not always linear, Invest NI should introduce and monitor new reporting measures at fund level which encourage collaboration between fund managers to develop the deal flow chain between the seed, early and development stages of funding	Stakeholder consultation highlighted the need to consider this issue.
12 (D)	Invest NI should support the development of the industry-led Propel Forum which brings together key stakeholders across the investment and innovation communities. Invest NI should monitor the impact of the Forum as • an industry lobbying group • a sounding board to test evolving DETI/Invest NI policies • a mechanism for signposting/referral of investment opportunities.	Stakeholder consultation highlighted the need to consider this issue.
13 (D)	When Fund of Fund Committee members reach the end of their tenure on the Invest NI Board, Invest NI should consider extending their period of appointment to the Committee through the use of existing co-opting arrangements. For the medium/long-term, Invest NI should review the Terms of Reference for the Fund of Funds Committee to ensure mechanisms are in place to retain skills and expertise whilst maintaining an appropriate balance of serving Board members and co-optees.	Stakeholder consultation highlighted the need to consider this issue.

No	Recommendation	Justification
14 (D)	Invest NI should review the engagement of each of the key seed stage/start up business support initiatives with the Invest NI funds to ensure that relevant programme managers/client executives have full awareness of the range of funds available.	Stakeholder consultation highlighted the need to consider this issue.
15 (D)	Invest NI should continue to review the Fund of Funds delivery model every three years, benchmarking the approach against best UK and European best practice. The review should test the costs and benefits of the current approach against those of an independently managed holding fund.	Keeping delivery arrangements under regular review reflects best practice in comparator programmes.