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Northern Ireland Audit Office

Access to finance for small and medium-sized enterprises (SMEs) in Northern Ireland

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
26 September 2017

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K J Donnelly
Comptroller and Auditor General

Northern Ireland Audit Office
26 September 2017

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Glossary

Equity investment	Investment in a company in exchange for shares in the company.
Exits	The redemption by the investor of its equity and other interest in an investee business (or fund).
Financial Transactions Capital	Capital funding provided to the Northern Ireland Executive outside the block grant. It can only be deployed by taking an equity stake in, or by providing a loan to, a private business.
Gross Value Added	Gross Value Added is used in the measurement of productivity and at a company level is expressed as the sum of wages and profits.
Impairments	An accounting principle whereby a fund manager reduces the value of the equity it holds in an underlying business or the value of a loan advanced to a business.
Leverage	Additional funding achieved as a result of an investment being made. This can be at fund level or individual deal level.
Limited Partnership Agreement	An agreement which sets out in detail the legally binding relations between fund investors and the general partner (representing the fund manager).
Mezzanine finance	A hybrid of debt and equity financing.
Proof of Concept	A demonstration in principle with the aim of verifying that some idea, concept or theory has commercial potential.
Seed businesses	Early-stage, high-potential, growth companies.
Small and medium-sized enterprises	Small and medium-sized enterprises ranging from sole operators to businesses with up to 249 employees.
Spin Out	A corporate action whereby a company `splits off' a section of the business into a separate entity.
Subordination	Ranking behind other investors in respect of the return on investment in an equity/debt fund.
Venture capital	A form of financing provided to small, early-stage and growth companies that are deemed to have high growth potential.

Abbreviations

BBA	British Bankers Association
DoF	Department of Finance
EAG	Economic Advisory Group
EIB	European Investment Bank
ERDF	European Regional Development Fund
FTC	Financial Transactions Capital
GVA	Gross Value Added
IREP	Independent Review of Economic Policy
JEREMIE	Joint European Resources for Micro to Medium Enterprises
KPI	Key Performance Indicator
NISPO	Northern Ireland Spin Out Funds
SMEs	Small and medium-sized enterprises

Key Facts

7

FUNDS IN OPERATION

Total investment funding for SMEs of

£181m

£104m

57%

Funded by Invest NI

Total Fund Manager Fees of

£34m

£25m met by Invest NI

Funding Breakdown

GRANTS	£8m
LOANS	£55m
EQUITY	£118m

The strategy funds will operate between

MARCH 2009 and JULY 2024

Executive Summary

Executive Summary

Introduction

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

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

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

Key findings

Developing the Access to Finance Strategy

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

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

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

1 Businesses with 0-249 employees.

2 Early-stage, high-potential growth companies.

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

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

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

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

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

Managing funds

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

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

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

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

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

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

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

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

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

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

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

Measuring and reporting performance

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

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

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

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

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

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

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

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

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

Conclusion on value for money

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

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

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

Recommendations

Measuring SME demand for finance and the extent of market failure

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

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

Structure of funds

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

Availability of funding for programmes

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

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

expenditure which will be required to deliver its operations.

Fund management

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

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

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

Performance evaluation

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

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

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

Part One:
Background

Part One:
Background

SME sector in Northern Ireland

1.1 The SME sector contributes significantly to the Northern Ireland economy. In 2015, there were 117,000 SMEs in Northern Ireland[11], representing more than 99 per cent of all businesses. SMEs provide approximately 75 per cent of all private sector jobs and turnover.

Invest NI's steps to improve access to finance

1.2 Access to finance is critical for the consolidation and growth of SMEs. However, in 2009, commercial lending to SMEs in the UK began to contract considerably due to the global economic crisis.

1.3 The reduction in commercial lending prompted an enhanced government focus on SME funding. In the UK, the Department of Business, Innovation and Skills (BIS) established a portfolio of access to finance programmes for SMEs. In 2012, the Bank of England and HM Treasury introduced the Funding for Lending scheme which incentivises banks and building societies to boost lending to the UK economy.

1.4 Whilst SMEs in Northern Ireland could participate in the Funding for Lending scheme and some of the BIS programmes, initiatives have also been developed locally to assist the sector and address market failure in the local risk capital market. The former Industrial Development Board (IDB) supported a number of investment funds from 1995 and, more recently, Invest NI has introduced an Access to Finance Strategy for local SMEs.

1.5 The strategy comprises a range of venture capital and loan funds and smaller proof of concept grant funds. Between 2009 and 2024, £181 million of funding will be available to SMEs. Invest NI is providing £104 million and its fund managers have also secured £77 million from private investors. To date, £124 million has been allocated to eligible SMEs. In line with Invest NI's strategic objectives, funding is only available to SMEs which are growing or exporting, or have such potential.

1.6 The investment activity exposes Invest NI's funding to high levels of risk, as £55 million of its funding is subordinated to private sector investment. This means that private investors will receive full repayment plus a rate of return before Invest NI recoups any of its investment. Some £30 million of Invest NI support relates to two funds which are providing unsecured finance to SMEs. Invest NI told us that its subordinated investment has been provided with the objective of achieving wider economic policy benefits, rather than commercial gain, which means that it has had to accept higher levels of risk than private investors.

1.7 In addition to the £104 million investment in funds, Invest NI will incur costs of approximately £25 million on fund management fees. Invest NI

11 Businesses with up to 249 employees.

appoints fund managers accredited by the Financial Conduct Authority for each individual fund[12]. Fund managers approve, manage and oversee investments and loans and have significant influence over fund activity and performance. Consequently, Invest NI needs to: ensure that fund managers are capable of delivering high standards of service provision; robustly monitor fund manager performance; and address any areas of under-performance.

1.8 Measurement of the performance and value for money delivered by the strategy will involve a rounded assessment of several key areas. These include stimulation and development of the historically weak local venture capital industry which Invest NI has identified as a key strategic objective. Returns on investments and wider economic benefits achieved, including jobs created, Gross Value Added (GVA)[13] and business turnover are also important indicators. However, as the funds are medium-term or long-term in nature and two of the largest funds will operate until 2023 or later, a complete picture of performance will not be apparent for some time.

1.9 The strategy is providing a continuum or pipeline of funds through which seed and early stage SMEs can enter and potentially progress as they achieve growth. The extent of progression by SMEs through the range of funds will provide a further measure of performance.

1.10 In November 2010, Invest NI established a Fund of Funds model. This acts as a holding vehicle to facilitate central management of the portfolio of individual funds. Invest NI envisages that this model will enable it to react to changes in SME demand and economic conditions, and to reallocate funding flexibly across funds and recycle financial returns into other funds supporting SMEs.

Scope of the study

1.11 This report examines:

- the development and implementation of the Invest NI Access to Finance Strategy (Part Two);
- how Invest NI manages the programme of funds (Part Three); and
- the measurement and reporting of the Strategy's impact (Part Four).

1.12 Our study methodology is summarised in **Appendix 1**. This highlights that our fieldwork included a survey of key stakeholders in the SME field to obtain their views on the Access to Finance Strategy.

12 Invest NI enters into a Limited Partnership Agreement with the fund manager.

13 Gross Value Added is used in the measurement of productivity and at a company level is expressed as the sum of wages and profits.

Part Two:

Strategy development and implementation

Part Two:
Strategy development and implementation

What we examined:

- The extent of SME demand for finance and any funding gaps.
- The steps taken by Invest NI to address funding gaps and improve access to finance for SMEs.
- Future challenges facing Invest NI in delivering its Access to Finance Strategy.

Demand for, and supply of, finance to SMEs

2.1 Regular and reliable information is needed to help stakeholders understand the difficulties faced by SMEs in obtaining finance and the measures required to address these problems.

2.2 In recent years, information on SME demand for finance has improved. The Department for the Economy (the Department) and the Department of Finance (DoF), InterTradeIreland and the Economic Advisory Group (EAG)[14] have all conducted research in the area. This has helped to provide an insight into SME requirements.

2.3 Although research on SME demand has been carried out, there is no formal and structured means of gathering data. In December 2013, InterTradeIreland concluded that the absence of routine measurement represented a significant gap in information. It noted, by way of comparison, arrangements for gathering data in the Republic of Ireland where a twice-yearly survey of SME demand for finance had been undertaken since 2009.

2.4 Until recently there has also been relatively limited data on the supply of finance to SMEs. In July 2014, the British Bankers Association (BBA) began issuing statistics on bank lending to the sector, covering the period from June 2012. This has helped provide a clearer picture on the supply side but there are still some information gaps. For example:

- the BBA data for applications and approvals does not include asset based finance and funding provided through business credit cards; and
- there is no reporting of finance being supplied to SMEs by non-bank sources.

2.5 There are other key indicators of SME financing in Northern Ireland which have not been measured. These include total outstanding credit and net lending to SMEs. InterTradeIreland considers that the absence of analysis of outstanding credit has hampered the development of policy responses to address any local funding gaps.

2.6 Recent demand for finance has been low but a high proportion of SMEs have existing finance in place. Research suggests there is a range of factors contributing to the lower demand for finance. For example, SMEs may

14 An Access to Finance survey covering the period 2007 to 2010 was conducted for the Department and the DoF in 2011. InterTradeIreland carried out several surveys of SME financing needs between 2010 and 2014 and the EAG published a report on access to finance for local businesses in March 2013. In 2014, Analytical Services Unit in the Department conducted a follow-up survey to assess changes since the EAG report was published. The EAG published a further update report in September 2015.

consider the terms and conditions of bank finance too onerous. Other factors include uncertainty over the financial climate, constraints on businesses obtaining finance due to existing property related debt and some SMEs are discouraged borrowers[15].

2.7 On the supply side, the levels of bank lending to local SMEs have increased since 2012:

- The EAG found that only 69 per cent of SME applications for bank finance in 2012 were approved. However, BBA data suggests that bank lending to the sector has subsequently increased, with an approval rate[16] of between 91 per cent and 94 per cent in 2014.
- Between July 2012 and December 2014, total quarterly funding approved by banks increased from £236 million to £408 million. The average level of approval rose from £48,800 to £101,100.

This analysis is consistent with findings from the NIAO survey of stakeholders that bank lending to SMEs has recently improved.

The funding gap in Northern Ireland

2.8 The funding gap is the difference between funding required by the SME sector and that available. An estimate of the size of the funding gap can inform stakeholders of the current and future scale of SME needs and can assist statutory bodies assess whether current policies and programmes are appropriately aligned to these needs.

2.9 In 2013, research estimated that a £10 billion funding gap existed for UK SMEs and forecast that this would rise to £22 billion by 2017[17]. To date, there has been no formal measurement or estimate of the current or potential future funding gap in Northern Ireland.

2.10 The BBA has not published details of the amount of bank funding which was sought but not obtained by SMEs whose applications were rejected. This data would provide a partial measurement of the funding gap in Northern Ireland.

2.11 Research findings[18] suggest that 70 per cent of SMEs whose applications to banks are rejected obtain no alternative finance. Based on these findings, the level of local unmet SME need related to rejected bank applications alone could amount to £92.5 million in 2015. However, when rejected applications from unviable SMEs are taken into consideration, it is possible that this funding gap may have been as low as £23 million.

2.12 In addition to the impact of unviable SME applications, other areas may need to be taken into consideration when estimating the funding gap. For example:

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15 SMEs which informally approached banks about raising finance but were discouraged from borrowing.

16 The EAG and BBA data both report on applications by SMEs which were fully or partially approved.

17 Research commissioned by Department of Business, Innovation and Skills (BIS). This also found that uncertainty over future levels of gross domestic product meant that the funding gap in 2017 could be as low as £6 billion or as high as £39 billion.

18 Research commissioned by BIS in 2013.

Part Two:
Strategy development and implementation

some viable SMEs may be unsuccessful in their efforts to obtain funding from non-bank sources; some may also have viable business propositions, but may have been discouraged from applying for finance; and some viable businesses may consider bank terms too onerous. The current uncertainty over the scale of the local funding gap underlines the need for more robust data to better inform policymakers and stakeholders.

Recommendation 1

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

Investment in venture capital

2.13 Historically, equity and venture capital investment activity in Northern Ireland has lagged behind UK levels. This was reaffirmed by analysis in a review which was completed for the Department in March 2015[19]. Evaluations conducted for Invest NI have also suggested that substantial gaps existed in Northern Ireland for equity investments and venture capital investments. For example:

- in 2012, Invest NI identified a market gap of up to £60 million for individual investments between £450,000 and £2 million alone; and
- in 2014, research[20] concluded that the preference of investors to support larger investments had resulted in support being primarily directed towards established businesses, which had created an equity gap in Northern Ireland particularly for seed or early stage businesses.

2.14 Conversely, the Varney Review on the Competitiveness of Northern Ireland (April 2008) and the Independent Review of Economic Policy (IREP) (September 2009) attributed historically low levels of venture capital activity in Northern Ireland to a lack of demand for this type of finance, rather than a lack of supply.

2.15 Varney found little evidence of market failure in the supply of venture capital to local businesses compared to elsewhere in the UK. The IREP concluded that Northern Ireland had suffered from an insufficient number of suitable deals rather than a limited supply of venture capital.

2.16 Both reviews also considered that the availability of significant levels of public sector funding had potentially discouraged private investment in the local venture capital market. The IREP considered that this may have limited the attractiveness of Northern Ireland as a market for private investors due to smaller potential investment returns. With the exception of seed and early stage businesses, where it

19 Future of Early Stage and Growth Finance in Northern Ireland.

20 Interim evaluation of Invest NI Fund of Funds (May 2014).

acknowledged a supply gap existed, the IREP recommended that Invest NI disengage from direct involvement with venture capital funds and instead act as a facilitator between companies and the venture capital industry.

2.17 However, despite the findings of these reports, Invest NI considered that strong evidence existed of substantial market failure in the local venture capital industry and that public sector intervention was necessary to stimulate this market.

Recommendation 2

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

Invest NI's Access to Finance Strategy

2.18 Prior to establishing the Access to Finance Strategy, the Department and Invest NI supported several funds aimed at developing the local venture capital market and improving access to finance for SMEs. These included Crescent Capital I and II, Viridian Growth Fund and Nitech. The Department and Invest NI contributed £20.9 million of the total £49.5 million funding to these initiatives.

2.19 By the late 2000s, Invest NI had adopted a more strategic approach to its access to finance activities. It established a series of investment funds linked to the stage of development of SMEs and to address gaps in larger scale investment in the local venture capital market.

2.20 Since 2009, Invest NI has established seven interlinked funds:

- **Northern Ireland Spin Out Funds (NISPO)** - comprising four sub-funds with a total of £19.5 million funding between March 2009 and March 2019;
- **Five venture capital, equity and loan funds** - introduced between 2011 and 2013 with total funding of £142.8 million[21] and running until 2023; and
- **Techstart NI** - introduced in July 2014 and effectively the follow-up programme to NISPO, comprising four sub-funds with £30.6 million funding and running until July 2024.

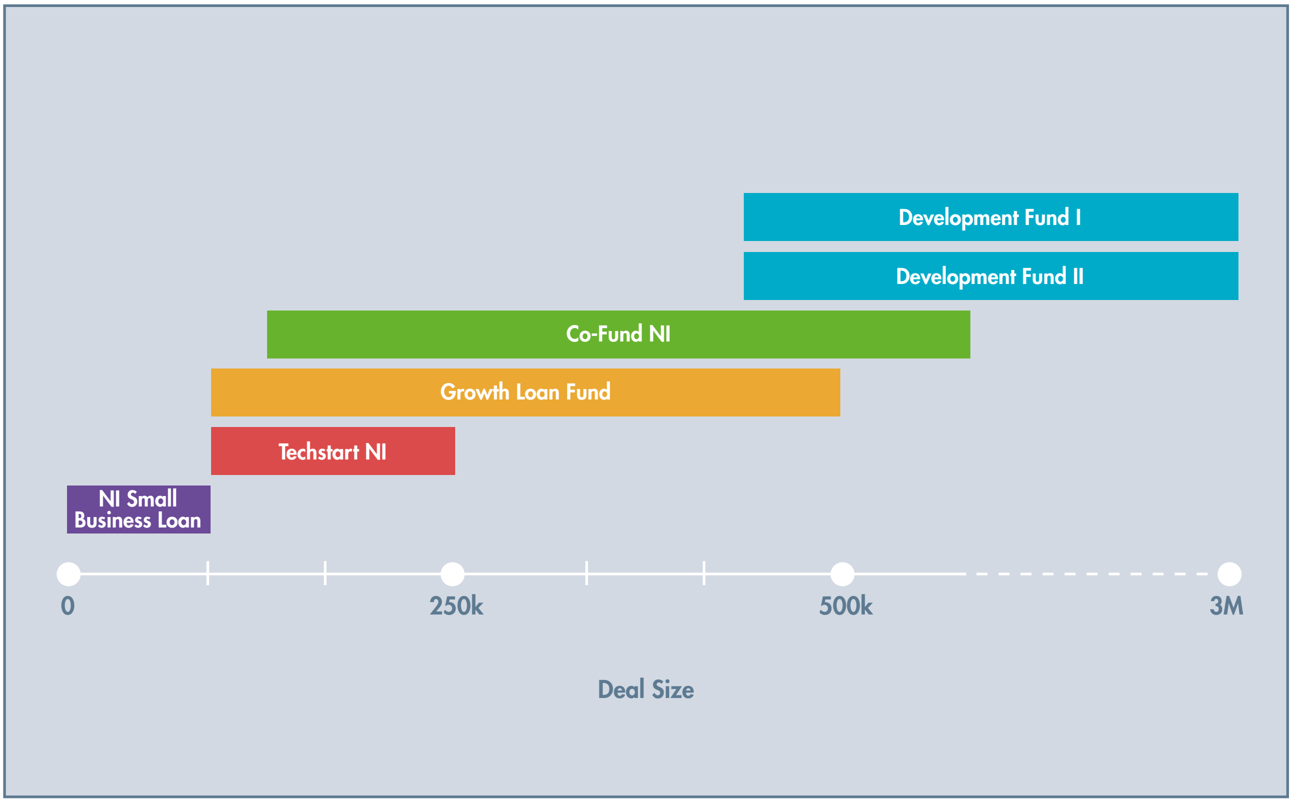
2.21 Total funding available to SMEs is £181 million. Invest NI is contributing £104 million and its fund managers have levered £77 million from private investors (**Appendix 2**). Some £173 million (96 per cent) of funding is provided through venture capital (£48.5 million), loan funds (£55 million) and equity (£69.1 million).

2.22 The strategy provides a continuum or pipeline of funds. Start-up and early stage SMEs are supported through the NISPO and Techstart strands and progress as they achieve growth. Established businesses can access support from venture capital and loan funds (Co-Fund, Growth Loan Fund and Development Funds) (**Figures 1 and 2**).

21 This includes the £11.6 million fees which are scheduled to be paid to the fund managers of the two Development Funds.

Part Two:
Strategy development and implementation

Figure 1: Continuum or pipeline of strategy funds



Source: Invest NI

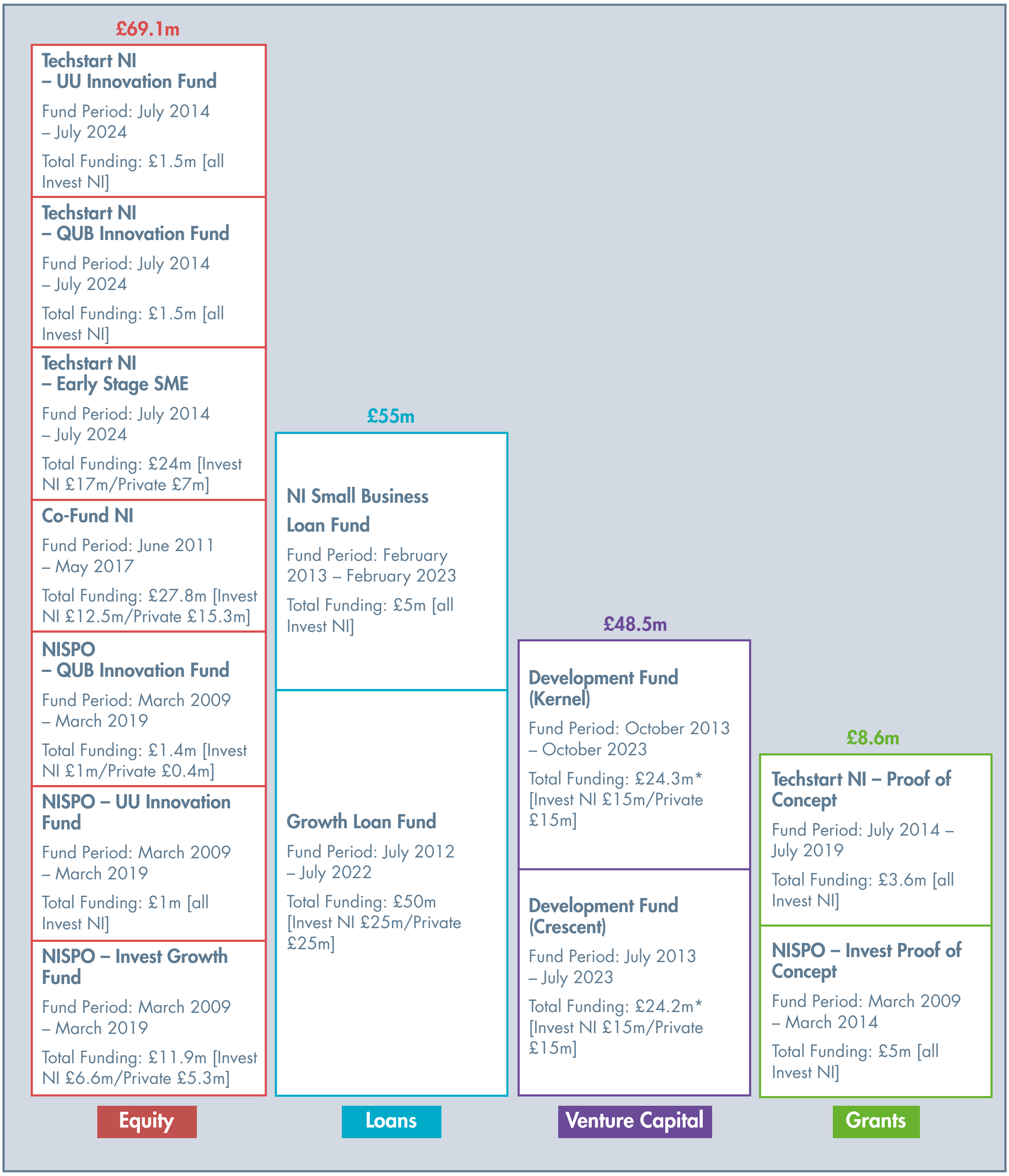
Eligibility for strategy funding

2.23 Funding is only available to businesses which are currently growing or exporting or which have such potential, in line with Invest NI's strategic objectives. Consequently, only a small proportion of SMEs are eligible for support.

2.24 Respondents to our stakeholder survey were divided on the merits of restricting assistance to certain SMEs. Some agreed with targeting support at growth-focused SMEs. However, others highlighted that this precluded companies which required working capital, as well as the construction and retail sectors which are key in employment terms but experience difficulty in securing bank funding.

2.25 Some stakeholders suggested that more could be done to improve access to finance for SMEs, with a particular need for additional sources of mezzanine finance (a hybrid of debt and equity finance). However, the overall view was that the strategy has considerably assisted local SMEs.

Figure 2: Overview of Invest NI Access to Finance Strategy Funds



Note: *Net of fund manager fees - when fund manager fees are included, these funds each have a total value of £30 million.

Source: NIAO based on Invest NI data

Part Two:

Strategy development and implementation

Establishment of the Fund of Funds model

2.26 Establishing a holding fund model to oversee the suite of investment funds offers important advantages. It helps facilitate the re-allocation of resources across funds to address changing market conditions and SME demand and enables any financial returns to be recycled across other funds.

2.27 In October 2010, Invest NI appraised three holding fund options (JEREMIE[22], engaging a dedicated fund manager and an in-house Fund of Funds model). Whilst the JEREMIE model would have enabled Invest NI to secure loan funding from the European Investment Bank (EIB), it was concerned that the complex process to secure this funding could significantly delay the introduction of its proposed funds. Invest NI also concluded that the management costs for the in-house Fund of Funds would be significantly lower than the JEREMIE option. Consequently, Invest NI decided to implement the Fund of Funds model.

2.28 An interim evaluation in June 2014 found that the Fund of Funds model had realised all the benefits of the JEREMIE approach at substantially lower cost. Invest NI estimates that the Fund of Funds lifetime costs will be approximately £5 million, contrasting with anticipated costs of over £14 million for three comparable JEREMIE funds in England.

2.29 The lower costs are primarily because the Fund of Funds is overseen by an in-house Access to Finance Working Group rather than an external holding fund manager as required by EIB for the JEREMIE funds (**Appendix 3**). Invest NI's total fees (including management fees for the individual funds) are also lower (**Figure 3**).

Figure 3: Estimated total management costs for the Fund of Funds and JEREMIE funds

Costs	North East Finance JEREMIE £ million	North West Fund JEREMIE £ million	Finance Yorkshire JEREMIE £ million	Invest NI Fund of Funds[1] £ million
Set up	n/a	1.8	0.5	0
Holding Fund Costs	14.5	14.7	14.2	5.0
Fund Management Fees	32.1	27.7	14.0	29.2
Total	**46.6**	**44.2**	**28.7**	**34.2**
Funds Under Management	124.9	155.2	90.2	142.6
Total costs as % of funds under management	37.3%	28.5%	31.8%	24.0%

Note 1: Excludes NISPO Funds which were operating before the Fund of Funds was established and the Techstart NI Proof of Concept grant fund as the JEREMIE funds do not include this type of grant scheme.

Source: NIAO and Invest NI

22 JEREMIE – Joint European Resources for Micro to Medium Enterprises.

2.30 Whilst the Fund of Funds holding fund costs are significantly lower than the JEREMIE model, Invest NI has not fully costed both options to assess all factors, including interest charges. Under the JEREMIE model, Invest NI could potentially have availed of EIB interest rates which may have been significantly lower than the rates being paid to private investors in the current Development Funds.

2.31 An updated evaluation of the Fund of Funds will be carried out in 2017. This provides an opportunity to establish whether EIB funding is still accessible following the result of the June 2016 referendum and to fully compare the costs and benefits of the Fund of Funds and JEREMIE models.

Recommendation 3

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

Funding arrangements

2.32 For five of the strategy funds, Invest NI's fund managers have levered private investment, and Invest NI has also secured European Regional Development Funding (ERDF) and Financial Transactions Capital (FTC)[23] (**Figure 4**). However, Invest NI was unable to secure

Figure 4: Invest NI funds with ERDF and Financial Transactions Capital funding

Fund	Funding source	Proportion of total fund investment	Proportion of fee payment
Development Funds (both funds)	Private Investment	50%	50%
	ERDF	50%	50%
Co-Fund	Private Investment	50%	n/a
	ERDF	50%	60%
	Invest NI	0%	40%
Growth Loan Fund	Private Investment	50%	50%
	FTC	50%	50%
Techstart NI	ERDF	60%	60%
	Invest NI	20%	40%
	Private Investment	20%	n/a

Source: NIAO and Invest NI

23 Financial Transactions Capital is funding provided by HM Treasury, which is administered in Northern Ireland by the DoF. FTC can only be used as a loan to, or an equity investment in, a private entity. DoF allocate the funding to Northern Ireland departments which are delivering eligible initiatives. Departments are entitled to retain half of any net benefits realised.

Part Two:
Strategy development and implementation

an ERDF contribution for the NISPO programme, and it funded this through a planned £13.6 million contribution from its baseline expenditure[24] as well as an envisaged £5.7 million from private investors.

2.33 Invest NI projects that the Fund of Funds will be 85 per cent externally funded, with 15 per cent coming from its baseline budget. This is broadly similar to JEREMIE funds in Wales and the North East of England. However, the Invest NI expenditure could have been reduced to 8 per cent if ERDF had been utilised for NISPO.

2.34 In Scotland, the advanced nature of the Scottish risk capital market has enabled the Scottish Investment Bank to focus almost exclusively on co-investment. This is entirely funded by private investors, ERDF and baseline expenditure (**Figure 5**).

2.35 If the Northern Ireland market develops to similar maturity as that in Scotland, the potential exists for significant future benefits. For example, Invest NI could adopt an in-house approach to individual fund management and further reduce public funding, including the baseline expenditure required to fund access to finance initiatives.

2.36 Following the result of the June 2016 referendum, the UK Government has provided a commitment that EU funding (which has been a major funding component of Invest NI's access to finance initiatives and other assistance programmes) will be available until 2023. Beyond this guarantee, future UK policy on the use of risk finance funding has still to be developed, meaning that there is a degree of uncertainty over how local access to finance initiatives will be funded in the longer term.

Figure 5: Comparative funding arrangements

Fund	Funding Arrangements				
	Private investment	**ERDF**	**FTC**	**EIB**	**Baseline**
Scottish Investment Bank	75%	15%	–	–	10%
Finance Wales (JEREMIE)	–	40%	–	50%	10%
North East Finance (JEREMIE)	–	35%	–	50%	15%
Invest NI Fund of Funds	37%	48%		–	15%

Source: NIAO and Invest NI

24 Invest NI's total contribution to the Access to Finance strategy comes from three sources. It uses baseline expenditure from its own budget, and has also secured ERDF and FTC.

Recommendation 4

Invest NI should identify the extent of the funding shortfall which is likely to arise following the future loss of EU funding and quantify the level of additional baseline expenditure which will be required to deliver its planned operations.

Re-allocating funding

2.37 A key anticipated benefit of the Fund of Funds was that Invest NI could re-allocate funding flexibly across individual funds in reaction to changing market conditions and SME demand.

2.38 No funding has been re-allocated to date. In practice, funding in most funds can only be re-allocated if a fund manager contract is terminated for non-achievement of investment Key Performance Indicators (KPIs). Invest NI told us that clauses within the Growth Loan Fund contract would potentially enable it to be downscaled and that other fund managers may voluntarily de-commit funding if investment activity is significantly behind schedule.

2.39 Elsewhere in the UK, a number of regional investment funds have successfully re-allocated resources between individual funds. However, Invest NI is unaware whether the contractual arrangements for those funds permit greater flexibility and do not require contract termination to facilitate this.

2.40 The Fund of Funds also enables Invest NI to recycle financial returns across strategy funds. During 2016-17, three exits were realised between the Co-Fund and NISPO funds, generating £2.8 million of returns against an original investment of £1.2 million. These financial returns were recycled in line with ERDF guidance across the strategy funds in the 2016-17 financial year.

Part Three:
Managing the programme of funds

Part Three:
Managing the programme of funds

What we examined:

- The appointment of fund managers.
- The level of fund manager fees and how these compare with industry benchmarks.
- How Invest NI is overseeing the performance of fund managers.

Appointment of fund managers

3.1 Invest NI has appointed fund managers to oversee each fund through competitive tendering (paragraph 1.7). With the exception of the Co-Fund, fund managers are responsible for levering private finance, approving investments, loans and grants, monitoring and managing these, providing advice and support to investee companies and deciding when to exit from investments. Co-Fund investments are identified and led by private investors, and are also approved by an investment committee. The fund manager seeks to ensure that the investors have a strong investment record and are subjecting deals to appropriate due diligence, as well as monitoring subsequent performance. The selection and oversight of fund managers is therefore critical to the success of the funds.

Fund manager fees

3.2 Fund managers will receive £33.9 million in fees for overseeing the seven strategy funds. Invest NI will pay approximately £24.7 million of these fees.

3.3 Overall, Invest NI's fees will equate to 23.7 per cent of its £104 million investment funding. Fees for individual funds range from 13.5 per cent for the Co-Fund and Growth Loan Fund to 32.1 per cent for the NISPO suite of funds.

Fee levels in comparison to industry benchmarks

3.4 The general industry structure for management fees is that fund managers receive:

- an annual fee for fund management and oversight; a standard industry benchmark is that fees for venture capital funds of £25 million or more are approximately two per cent of committed funding per year; and
- a share of fund profits after scheduled distributions have been made to investors.

3.5 The fee structure for Invest NI's investment and loan funds broadly reflect this. An exception is the Co-Fund which has no profit sharing arrangements, as fund investments are identified and led by private investors rather than the fund manager.

3.6 At 1.88 per cent of committed funding per year, Invest NI's overall fee levels are below the 2 per cent industry benchmark. However, the benchmark applies to venture capital and equity funds and Invest NI's total fees for these types of fund are 2.16 per cent per year **(Figure 6)**.

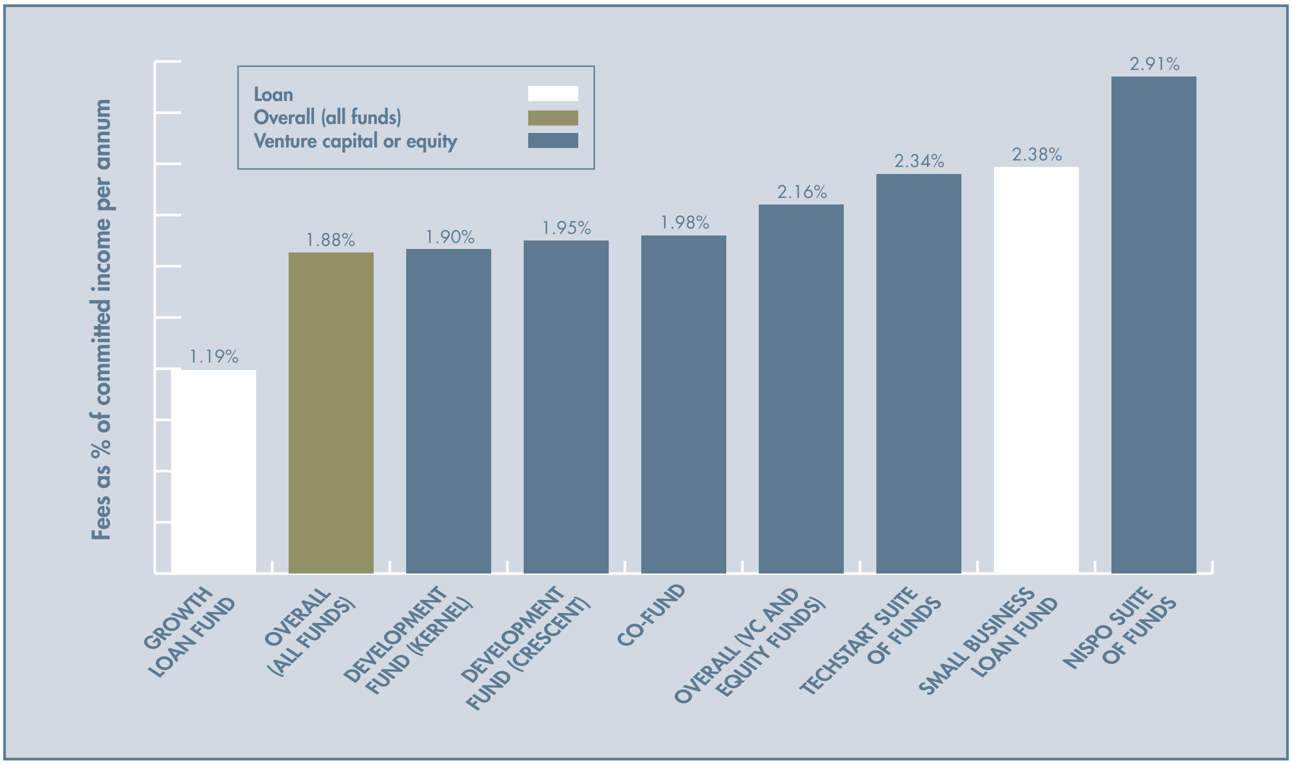
3.7 Invest NI told us that the small size of some strategy funds had created economy of scale issues. Other UK venture capital funds typically involve minimum funding of £25 million. Invest NI has invested between £5 million and £23.6 million in three of its seven funds and the fees for these exceed the two per cent benchmark. Invest NI will pay fees of approximately £13.9 million for these funds, 30 per cent of its £45 million investment.

3.8 Fees for Crescent Capital I and Crescent Capital II, two of the funds supported by Invest NI[25] before the Access to Finance Strategy, were also above the industry benchmark, at 2.5 per cent and 2.3 per cent respectively. Invest NI told us that these funds, with respective investment of £14 million and £22.5 million, were also relatively small scale compared to the industry benchmark.

Recommendation 5

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

Figure 6: Invest NI annual fund management fees as percentage of committed funding



Note: Fees for the Small Business Loan Fund will be higher than 2.38% per annum if the fund does not recycle £3 million of receipts into further loans.

Source: NIAO, based on Invest NI data

25 These funds were established by the Industrial Development Board which was replaced by Invest NI in April 2002.

Part Three:
Managing the programme of funds

Fund manager bonuses and sanctions

3.9 For six of the seven strategy funds, fund managers will receive a share of profits if target levels of financial returns are achieved.

3.10 The bonuses achievable are likely to be comparatively small compared to the fixed management fees. Fund managers will also have to achieve a very high performance to receive any of the bonuses available. This is illustrated by the case example at **Figure 7.**

Figure 7: Bonus levels for the Kernel Development Fund

The Kernel Development Fund is a £30 million venture capital fund. Invest NI's £15 million investment is subordinated to private investments in the fund. This means that Invest NI will not receive any distributions until private investors are repaid their capital investment and receive an annual return of 8 per cent.

For private investors to be repaid their capital and receive their annual return, and for Invest NI to be repaid its capital, the fund needs to achieve an Internal Rate of Return of approximately 4 per cent.

Whilst the fund manager will be actively seeking to maximise returns, they will only be paid a bonus if fund performance achieves or exceeds an Internal Rate of Return of 8 per cent for all investors, including Invest NI.

This would require a significantly higher performance than the -0.9 per cent Internal Rate of Return achieved by the Crescent Capital I fund.

Note - the figures for actual returns will vary depending on the timing of future drawdowns by the fund manager and distributions to fund investors.

Source: NIAO based on Invest NI data

3.11 Whilst the fee structures for Invest NI's funds broadly reflect industry norms, they provide relatively little incentive for fund managers to deliver strong performance outcomes. For example:

- the sanctions available for penalising poor performance are mainly linked to non-achievement of activity based investment KPIs; and
- bonuses for achieving financial return targets are likely to be relatively small and state aid requirements mean that it is not possible to incentivise fund managers to deliver a strong performance for economic benefits, such as increases in employment, gross value added and productivity.

3.12 The fee structure could lead to fund managers focusing primarily on achieving investment KPIs which creates the risk that poor investments could be made. One indicator which could give cause for concern in this regard is the emergence of any significant and unexpected spikes in investment activity.

3.13 Invest NI told us that fund managers are incentivised to achieve strong investment outcomes to enhance their industry reputation and help secure future fundraising and fund management work. We consider that Invest NI, and the Fund Advisory Committees which have been established to oversee each strategy fund, need to address any potential risks arising from significant spikes in investment activity, and confirm that fund managers are appropriately scrutinising and evaluating investment applications.

Recommendation 6

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

Overseeing fund manager performance

3.14 Effective oversight is essential to ensure that fund managers are delivering the required standard of performance and appropriately managing investments and risks. As an investor in the funds, Invest NI cannot influence investment decisions. However, fund managers must report regularly to Invest NI on investment activity, the financial performance of investments and loans and investee company performance, including annual reporting on wider economic benefits achieved. Invest NI also undertakes a detailed annual review of investment performance for each fund.

3.15 Fund Advisory Committees have been established for each fund. These monitor fund performance against stated objectives, review investment performance and ensure funds are complying with the requirements of the Limited Partnership Agreement[26] including the investment policy. The Committees comprise members from Invest NI and the Access to Finance Working Group and, where appropriate, private investors and independent non-executive Board Members.

3.16 Whilst the likelihood of some investment failure is high, particularly in early stage companies, the monitoring by Invest NI and the Fund Advisory Committees aims to ensure fund managers are providing support and taking corrective action when investee companies perform below expectations.

3.17 The terms of fund manager contracts permit fund investors to take action should serious concerns arise over fund manager performance. These could include suspension of funding, termination of the investment period or ultimately contract termination which, depending on the circumstances, could involve payment of compensation.

3.18 Evidence suggests that the fund managers for the Northern Ireland Small Business Loan Fund and Growth Loan Fund have provided a high standard of service. An interim evaluation of the funds completed in July 2016 highlighted that:

- strong and experienced fund management teams were in place;
- the funds were well governed, and

26 A Limited Partnership Agreement sets out in detail the legally binding relations between investors and the general partner (representing the fund manager).

Part Three:
Managing the programme of funds

had robust investment approval processes; and

- SME applicants were satisfied with services provided by the fund managers.

3.19 However, ongoing oversight has identified some areas of concern for other funds. In February 2015, investors notified the fund managers responsible for the two Development Funds that they had not achieved the contractual level of investment activity required in 2014. In each case only two investments had been made against the KPI requirement of four deals. After Advisory Committee discussions with the fund managers, no further action was taken as the investors decided not to take steps which could lead to the fund managers making poor investments.

3.20 The most significant issues which have arisen have related to the fund manager contract for the NISPO programme **(Figure 8)**.

Figure 8: NISPO fund manager performance

Whilst the NISPO fund manager (E-Synergy) had submitted the highest cost of all the tenders submitted, it was awarded the fund manager contract on the basis that it was judged to have submitted the most economically advantageous proposal, taking account of the qualitative, technical and sustainable aspects of its bid.

In overseeing the early stages of the programme, Invest NI was concerned over low levels of investment activity, and in August 2011, it notified E-Synergy that it had failed to achieve the requisite KPIs. As the rate of investment activity subsequently escalated, Invest NI took no further action related to this element of performance.

By September 2014, Invest NI told us that it had identified concerns over other aspects of E-Synergy's performance, and in October 2014, having taken legal advice, it began withholding management fees from the company. E-Synergy contested Invest NI's entitlement to take this action, and issued legal proceedings in November 2014 to have the fees re-instated. As part of a mediation process, Invest NI re-commenced paying fees in March 2015. The resolution of the matter through a settlement meant that Invest NI's entitlement to withhold fees under the Limited Partnership Agreement was never tested in court.

In November 2014, Invest NI initiated legal action with the objective of having the fund manager contract terminated. The subsequent legal process was lengthy and protracted, and ultimately, neither parties' arguments were tested in court, as Invest NI and E-Synergy reached a mutual agreement to settle the dispute in January 2017.

This agreement resulted in E-Synergy voluntarily resigning as the NISPO fund manager in January 2017, and agreeing not to pursue monitoring fees owed to it by investee companies.

Over an eight-year period between April 2009 and January 2017, E-Synergy was paid management fees of £2.75 million under the terms of the original contracts. The mutual agreement resulted in Invest NI paying a settlement fee of £0.45 million to E-Synergy. In addition, Invest NI incurred total legal costs of

£0.24 million in settling the dispute. The NISPO investments have been managed internally by Invest NI since January 2017.

Source: NIAO based on Invest NI data

3.21 Invest NI told us that in all subsequent fund manager contracts, it has included robust termination clauses and has the ability to withhold fees where there are significant performance concerns. Whilst Invest NI has sought professional legal advice and tightened contractual clauses, these have not yet been tested in practice.

3.22 Ultimately, the difficulties with implementing sanctions emphasise the importance of a rigorous appointment process which confirms prospective fund managers can deliver high standards of service provision. Ongoing monitoring must also seek to ensure delivery against performance targets and compliance with contract terms and fund investment policies. Sufficient evidence must be gathered when fund managers fail to meet contractual requirements to enable relevant sanctions to be imposed.

Managing conflicts of interest

3.23 Conflicts of interest can give rise to risks in the governance and operation of investment funds. In February 2016, the Wales Audit Office highlighted concerns over the Welsh Life Science Investment Fund[27]. These concerns included a conflict of interest in the appointment of the fund manager and their subsequent failure to properly notify Finance Wales of conflicts around fund investments.

3.24 It is important that Invest NI's monitoring and oversight of funds ensures that potential conflicts of interest are identified and managed effectively. In appointing fund managers, Invest NI has established procedures aimed at ensuring that potential or actual conflicts in respect of fund managers, members of the Access to Finance Working Group and Invest NI officials are properly declared and managed. Invest NI told us that fund managers have disclosed a number of potential conflicts and these have been managed appropriately. Invest NI's arrangements rely on fund managers complying with their contract terms and self-declaration of potential or actual conflicts, and it does not carry out any testing of investments to establish if any undeclared conflicts have occurred. It considers such tests would not be effective in identifying conflicts or discovering them before they had occurred.

3.25 An example of the potential risks which need to be controlled in these types of funds is evident from the Westminster Public Accounts Committee's report on the Emerging Business Trust (EBT) which was published in May 2006[28]. EBT had been established in 1996 by the former Local Enterprise Development Unit to provide loans and equity to SMEs.

27 Establishment and oversight of the Wales Life Sciences Fund – Auditor General for Wales (25 February 2016).

28 Governance issues in the Department of Enterprise, Trade and Investment's former Local Enterprise Development Unit.

Part Three:
Managing the programme of funds

3.26 The Committee's report highlighted significant conflicts of interest which arose with the operation of EBT. Specifically, it highlighted that the fund had provided support to a company in which the fund manager held shares and directorships. The Committee concluded that such fundamental conflicts of interest could not be managed, but could only be dealt with by being avoided altogether.

Recommendation 7

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

Part Four:
Performance of funds

Part Four:
Performance of funds

What we examined:

- How funds are performing in making investments and allocating funding.
- The performance of investments and potential future financial returns.
- Progress against targets for wider economic benefits.
- The impact of Invest NI's support in helping to develop the local risk capital industry.

Measuring performance of access to finance funds

4.1 Invest NI will commission evaluations which will measure both the interim and final performance of each fund. It will be some time before performance of the funds can be fully measured. The NISPO funds have reached the end of their investment period but investments and loans will continue to be made from other funds until at least 2019. Loan repayments are scheduled until 2022 and exits[29] from venture capital and equity funds will continue until at least 2024 (**Figure 9**).

4.2 We reviewed the progress in key areas which will ultimately determine if the strategy has achieved value for money:

- investment activity and allocation of funding to SMEs;
- the financial performance of investments and loans; and

Figure 9: Investment timeline for funds

Fund	Type of Fund	End of main investment/loan period	Anticipated dates for exits and final loan repayments
NISPO Invest Growth Fund	Equity	2014	2015 to 2019 (exits)
NISPO Proof of Concept	Grant	2014	No repayments
NISPO University Innovation (2 funds)	Equity	2014	2015 to 2019 (exits)
Co-Fund	Equity	2017	Exits managed by private investors
Growth Loan Fund	Loan	2017	2017 to 2022 (final repayments)
Small Business Loan Fund	Loan	2018	2018 to 2023 (final repayments)
Development Funds (2 funds)	Venture Capital	2018	2019 to 2023 (exits)
Techstart Equity Fund	Equity	2019	2019 to 2024 (exits)
Techstart Proof of Concept	Grant	2019	No repayments
Techstart University Innovation (2 funds)	Equity	2019	2019 to 2024 (exits)

Source: NIAO based on Invest NI data

29 The redemption by the investor of its equity and other interest in an investee business [or fund].

- wider economic benefits (including employment, Gross Value Added and productivity) achieved by investee companies.

4.3 We also assessed the strategy's impact to date in stimulating the local risk capital industry and whether Invest NI has clearly articulated what it expects to achieve in this respect.

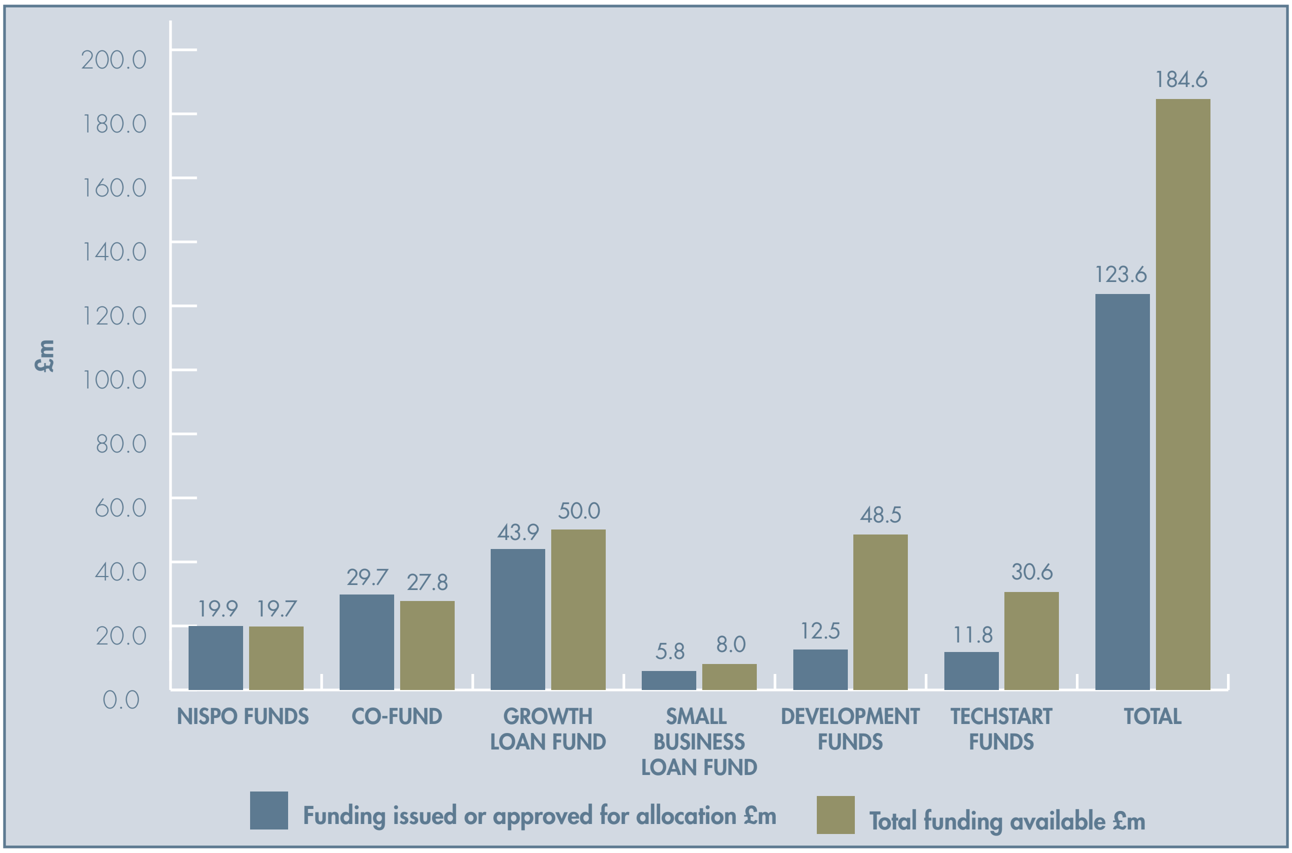
Investment activity and allocation of funding

4.4 One aspect of performance measurement assesses whether funding available is being invested in SMEs by fund managers in line with KPI requirements. The KPIs include the numbers of investments, loans and grants made and the amount of funding allocated to SMEs.

4.5 At March 2017, £123.6 million (67 per cent) of the overall £184.6 million[30] funding available had been issued to SMEs (**Figure 10**). This comprised £67.2 million from Invest NI and £56.4 million of private investment.

4.6 **Figure 11** shows progress against investment KPIs for each fund using a traffic light diagram. Despite strong

Figure 10: Funds allocated to SMEs at March 2017



Note: The funding issued or approved for allocation for the NISPO funds and the Co-Fund reflects the fact that these have secured more private investment than had initially been envisaged. Figures for the Growth Loan Fund reflect loans approved and expected to proceed rather than allocated to SMEs.

Source: NIAO based on Fund Manager data

30 This figure reflects that the Small Business Loan Fund, which initially invested £5 million in SMEs, will recover at least £3 million of this, which will be recycled into the fund to provide further support to SMEs.

Part Four:
Performance of funds

approval numbers, the Growth Loan Fund is currently behind schedule for loan drawdowns. Whilst both the Development Funds are relatively early in their investment cycle, an acceleration in future investment activity will be required to meet their KPIs.

4.7 Although performance against these activity-based measures has been mixed, those which are behind schedule could still be achieved. A lengthy time is often required for equity and venture capital funds to identify a strong investment pipeline and to bring companies to investor readiness and agree investment terms. In addition, follow-on investments increase as the fund portfolios are built up. Consequently, it is not unusual for investment activity to increase in the later stages of such funds. Of key importance is the need to strike a balance between monitoring progress in achieving investment KPIs, without pressurising fund managers to make poor investment decisions.

Figure 11: Progress against investment KPIs

Fund	KPIs achieved or on course to be achieved	
	Number of investments/loans/ grants	Allocation of funding
NISPO Invest Growth Fund		
NISPO Proof of Concept (1)		
NISPO University Innovation Funds		
Co- Fund		
Growth Loan Fund		
Small Business Loan Fund		
Development Fund (Crescent)		
Development Fund (Kernel)		
Techstart SME Equity Fund		
Techstart Proof of Concept		
Techstart University Innovation Funds		

Note 1: NISPO Proof of Concept – The initial fund envisaged allocating grants of £5 million to SMEs. Whilst £5.1 million funding was committed through grant offers, £0.3 million of this was not drawn down, meaning that only £4.8 million was allocated to SMEs.

Source: NIAO based on Invest NI and fund manager data

Financial performance of investments and loans

4.8 Some degree of financial return can be expected from all of the investment and loan funds[31]. Invest NI did not set financial return targets for several funds due to the lack of performance information from similar local initiatives. For these funds, Invest NI anticipates that the Co-Fund and Techstart programme will at least recoup the funding allocated by them. However, it does not envisage that it will recoup the £5 million funding it is providing to the Small Business Loan Fund.

4.9 Targets for the NISPO programme and the two Development Funds envisage these achieving a nil per cent Internal Rate of Return. This would result in the total investment allocated to these funds being recouped. Invest NI has also forecast the potential distributions between itself and private investors from these funds (**Figure 12**)

4.10 Whilst fund managers will be seeking to maximise returns for all fund investors, forecasts for the Development Funds suggest that Invest NI could receive £7.2 million for its £30 million investment and private investors may receive £52.8 million for their £30 million investment[32].

4.11 Private investors would therefore receive 88 per cent of returns generated. Invest NI would recoup around 24 per cent of its investment largely because it has provided subordinated funding. The forecast that Invest NI could receive no return from the Crescent Development Fund reflects the higher annual returns payable to private investors compared to the Kernel Development Fund.

4.12 The uncertainty associated with investment activity and the lack of forecasts for some funds creates difficulties in estimating the total financial returns achievable. However, using the information available, we estimate that:

Figure 12: Financial return and distribution targets/forecasts

Fund	Total investment £m	Total forecast return £m	Invest NI		Private investors	
			Investment £m	Forecast return £m	Investment £m	Forecast return £m
NISPO	12.4	12.4	9.0	9.0	3.4	3.4
Development Funds	60.0	60.0	30.0	7.2	30.0	52.8

Source: NIAO based on Invest NI projections

31 No financial returns will be realised by the two Proof of Concept grant funds.

32 Projections based on final outcomes from Crescent Capital I and projected results from Crescent Capital II, which were broadly similar in nature to the Development Funds.

Part Four:
Performance of funds

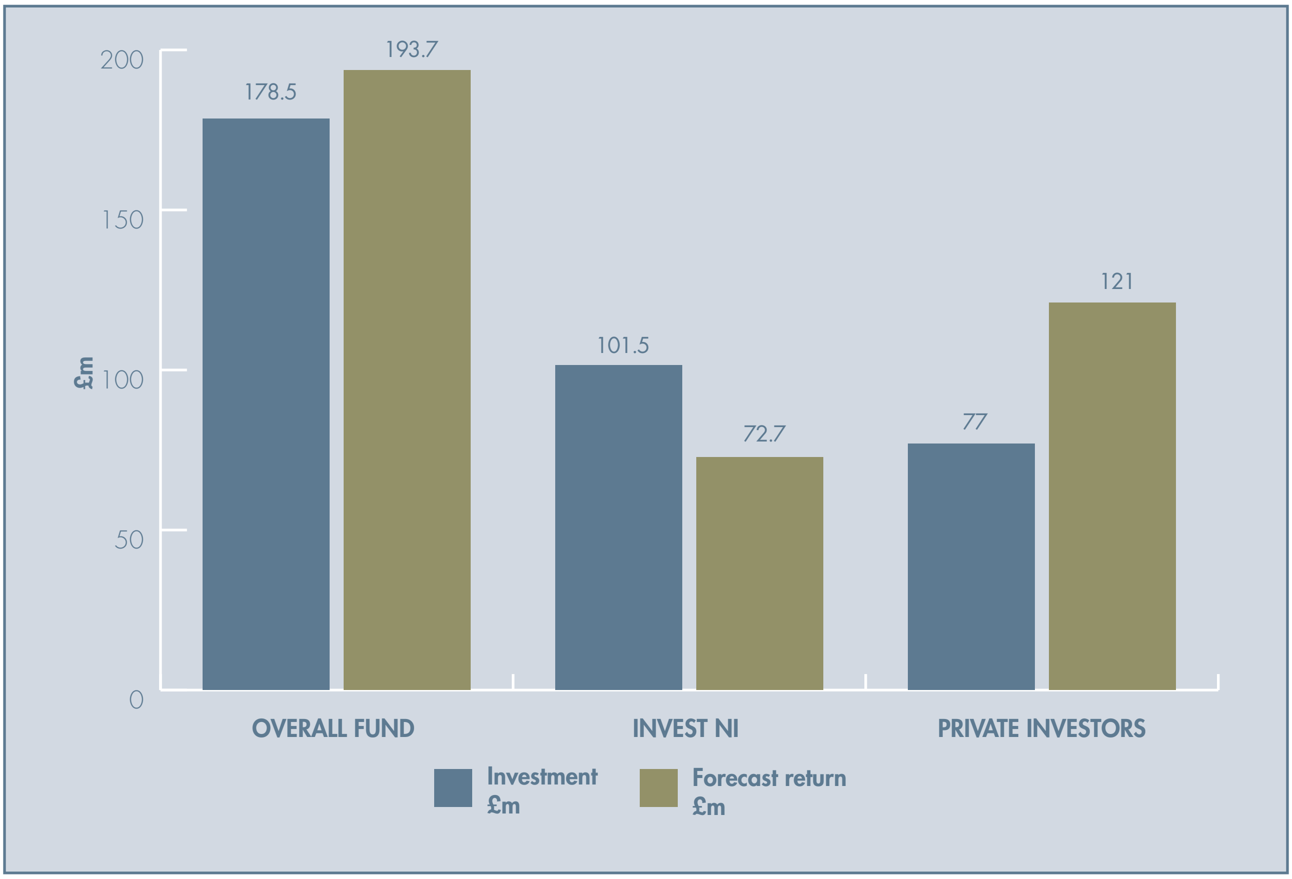
- Invest NI may recoup approximately £72.7 million of its £101.5 million[33] investment, a loss of £28.8 million (28.4 per cent); and
- private investors could receive around £121 million for their £77 million investment, a return of £44 million (57 per cent) (**Figure 13**).

4.13 Financial return targets have mainly been based on recouping funding through achieving a nil per cent Internal Rate of Return. This reflects the lack of available information on performance achieved by similar local funds.

4.14 Invest NI should take account of evolving performance of the funds, as well as outcomes from similar UK initiatives, to ensure that targets for the current funds can be re-calibrated if necessary. Similarly, targets for future funds should be based on robust benchmarks and baselines. This will provide assurance that these are sufficiently challenging and assist measurement of final outcomes.

4.15 Since its establishment in 2002, Invest NI has delivered most of its business support through a range of grant assistance programmes. This form of assistance does not yield any financial

Figure 13: Potential investment and financial returns from the Access to Finance Strategy



Source: NIAO based on information supplied by Invest NI (excludes the Proof of Concept grant funds).

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

returns to Invest NI. In contrast, returns generated from investment and loan funds can be recycled into further initiatives supporting SMEs. However, the substantial fund management costs mean that overheads are likely to be higher than grant programmes. Invest NI has attempted to benchmark costs and benefits of its different assistance methods but told us that this had proved complicated and had not produced any conclusive results.

Fund valuations

4.16 Fund managers report quarterly on the latest valuation of investments. This helps Invest NI to monitor ongoing fund performance. The most recent valuations in the largest venture capital and equity funds show a deficit on Invest NI's investment in most funds (**Figure 14**).

4.17 As none of these funds have yet reached the eighth year of investment when the most significant returns start to materialise, it is too early to forecast final outcomes with any certainty. The valuations of Invest NI's investments in the Invest Growth Fund, Co-Fund and Techstart NI Equity Fund have been revised downward. However, Co-Fund exits may continue until 2026 and 33 of the 36 Invest Growth Fund investments remain active at September 2016. The Techstart NI Fund is at an early stage of investment, having commenced in July 2014.

4.18 The performance of individual companies supported by the earlier funds has been mixed. At September 2016, 30 of the 33 NISPO Invest Growth Fund investments had either reduced in value or remained unchanged, with the value of the other three (including a successful exit) increasing. Despite this, the fund manager forecasts potential for 18 future trade sales and two intellectual property sales. At March 2017, the Co-Fund investments showed £1.97 million of gains across four companies and £3.47 million impairments[34] across 10 companies. Five companies in which

Figure 14: Valuation of Invest NI investments

Fund	Invest NI/Fund investment £m	Valuation		Surplus/(Deficit) £m
		£m	Date	
NISPO Invest Growth Fund	6.6	3.4	Sep 2016	(3.2)
Co-Fund	11.4	9.3	Mar 2017	(2.1)
Development Funds[1]	12.5	12.6	Mar 2017	0.1
Techstart NI Early Stage Equity	5.2	4.6	Mar 2017	(0.6)
Total	**35.7**	**29.9**		**(5.8)**

Notes:

1. Development Funds data reflects both Invest NI and private investment.

Source: NIAO based on Fund Manager data

34 An accounting principal whereby a fund manager reduces the value of the equity it holds in an underlying business or the value of a loan advanced to a business.

Part Four:
Performance of funds

Invest NI had invested £0.63 million had been liquidated. More positively, during 2016-17, the Co-Fund achieved two exits, securing £2.1 million in returns for an investment of £1 million, with potential further deferred income of up to £0.9 million if certain future performance conditions are met.

Performance of loans

4.19 At December 2015, the level of default by SMEs had been significantly lower than forecast within the economic appraisals for the Small Business Loan Fund and the Growth Loan Fund. Total arrears and write-offs were £481,000 for the Small Business Loan Fund at November 2015 and there were £1.8 million of provisions and write-offs for the Growth Loan Fund at September 2015 (**Figure 15**).

4.20 For loans made from the Small Business Loan Fund up to July 2015, Invest NI is projected to incur a deficit of between £0.67 million and £1.29 million. The forecast for the Growth Loan Fund ranges from income of £1.41 million to a £1.7 million deficit[35]. The projected income or deficits will increase as further loans are approved. The economic appraisals for the loan funds forecast that Invest NI would incur deficits of £1 million for the Small Business Loan Fund and £4 million for the Growth Loan Fund (**Figure 16**). The substantial variation in potential financial returns highlights the need for strong fund management to minimise defaults.

Performance of pre-strategy funds

4.21 The outcomes from the Crescent Capital I fund, which was established before the Access to Finance Strategy, also highlights mixed performance of investments (**Appendix 4**). The fund operated between 1995 and 2007. The £14 million funding was financed by Invest NI[36] and private investors, each contributing £7 million.

Figure 15: Loan funds default rates

Fund	Default rate		Arrears £m	Loans written off £m	Total arrears/ provisions and loans written off £m	% of loans in arrears
	Forecast	Actual 2015				
Small Business Loan Fund	22% to 25%	11%	0.323	0.158	0.481	17%
Growth Loan Fund	12.5%	8%	0.788	0.986	1.774	25%

Source: NIAO based on Invest NI data

35 Net of fund manager fees.

36 The fund was established by the Industrial Development Board which preceded Invest NI.

4.22 Crescent Capital I realised total returns of £13 million. This represented a return rate of - 0.9 per cent on its £14 million investment. Invest NI's funding was subordinated to the private investors with the objectives of levering private investment and developing the local venture capital industry. Consequently, the private investors received all £13 million proceeds and Invest NI received no return. Invest NI told us that whilst it had not received a financial return, the fund had helped generate wider economic benefits within investee companies.

4.23 Although the evaluation of Crescent Capital I contained limited analysis of the economic benefits achieved, the evidence available does suggest that two businesses (Andor Technology and Lagan Technology) performed strongly and substantially increased their levels of employment and turnover during the funding period. However, both businesses also received other assistance from Invest NI during this period totalling £3.45 million and £0.45 million respectively, meaning that these improvements would not be fully attributable to Crescent Capital I funding.

Wider economic benefits

4.24 The outcomes from Crescent Capital I help to illustrate how the extent of growth in employment, gross value added and turnover amongst investee companies being supported by the current strategy funds will be important in measuring value for money, particularly as Invest NI may receive minimal financial returns from some funds.

4.25 Invest NI did not set targets for economic benefits for the NISPO funds when it established these in 2009. Its guidance for appraisal at that time did not require such targets. The interim evaluation of NISPO in 2012 concluded that the lack of these measures had reduced Invest NI's ability to ensure that the quality of programme delivery was sustained.

Figure 16: Loan funds forecast returns

Fund	Invest NI		
	Funding £m	Projected returns £m	Projected (deficit) £m
Small Business Loan Fund	5.0	4.0[1]	(1.0)
Growth Loan Fund	25.0	21.0	(4.0)

Note 1: Following recycling of £3.8 million of receipts into further SME loans and payment of £2.3 million in fund management fees.

Source: NIAO based on Invest NI data

Part Four:
Performance of funds

4.26 There has been very limited measurement of economic outcomes from NISPO. The interim evaluation did not assess economic benefits achieved by the Invest Growth Fund and found that SME participants in the other elements had only achieved minimal increases in employment and turnover. Due to the legal process between Invest NI and E-Synergy, Invest NI has not yet proceeded with a further evaluation to measure the economic benefits achieved by NISPO. Invest NI told us that these outcomes will be examined in a final evaluation of the programme.

4.27 Invest NI did establish targets for increases in employment, Gross Value Added and turnover for the funds established after NISPO (**Figure 17**).

4.28 Fund managers report on employment, Gross Value Added and turnover achieved each year. Invest NI reviews this data to assess how individual investee businesses are performing but does not formally measure cumulative performance against the targets for economic benefits.

4.29 The interim and final evaluations which Invest NI will commission for each fund will assess performance in more detail and measure progress against the targets. The evaluations will seek to quantify the benefits specifically linked to the funds, through assessing additionality[37] and deadweight[38] and by discounting the impact of other funding received by assisted SMEs during the investment period. For example, Invest NI provided £5.5 million of other funding to companies which have been assisted by the Co-Fund.

Figure 17: Targets for wider economic benefits

Fund	Period	Employment Target	Gross Value Added Target £million	Turnover Target £million
Co-Fund	2011 to 2017	350	25.9	55.0[1]
Growth Loan Fund	2012 to 2022	2,100	60.0[2]	150[3]
Small Business Loan Fund	2013 to 2023	226	10.3	No target
Development Funds (combined)	2013 to 2023	750	35.0	No target
Techstart NI (combined)	2014 to 2024	916	52.7	No target

Notes: 1. Projected increase in turnover.
2. Annual increase in Gross Value Added by the end of the fund's life.
3. Annual increase in turnover by the end of the fund's life.

Source: NIAO based on Fund Manager data

37 Additionality is the net economic benefit brought about as a result of intervention.

38 Deadweight measures the extent to which a project would have occurred in the absence of intervention.

4.30 Evaluating the funds is difficult at this early stage of their operation and Invest NI is not yet properly sighted on the full extent of economic benefits being realised. To date, the most detailed measurement has been provided by the interim evaluation of the Small Business Loan Fund and the Growth Loan Fund, which estimated the economic benefits achieved by SME participants at December 2015, and projected potential outcomes for these businesses at 2018-19[39]. The evaluation forecast that both funds could generate significant economic benefits. Whilst the targets for the Small Business Loan Fund are on course to be met or exceeded, it is more difficult to currently assess whether the Growth Loan Fund targets will be achieved, given that these were set on an annual basis and because only £21 million of the available £50 million loan funding had been allocated to SMEs when the evaluation was undertaken (**Figure 18**).

Figure 18: Small Business Loan Fund and Growth Loan Fund economic benefits

Northern Ireland Small Business Loan Fund

- an estimated 311 jobs have already been created or safeguarded compared with the target of 226, and this is forecast to increase to at least 619 jobs by 2018-19; and

- between £9.6 million and £21.8 million net additional Gross Value Added is forecast by 2018-19, compared with the £10.3 million target.

Growth Loan Fund

- net additional Gross Value Added of between £134.9 million and £152.9 million is projected at 2018-19, compared with the £60 million annual target by the end of the fund's life; and

- forecast turnover of £880 million to £1.23 billion at 2018-19, compared to the £150 million annual target by the end of the fund's life.

Source: NIAO based on Invest NI data

4.31 The only target currently behind schedule is for jobs to be created by the Growth Loan Fund. The fund is projected to create 675 to 768 jobs by 2018-19 compared with the target of 2,100 created and safeguarded jobs to be achieved at fund closure in 2022. Whilst the employment target was based on the full £50 million of available loan funding being disbursed, only £21 million had been allocated when this evaluation was completed.

4.32 The very high level of performance forecast at 2018-19 was based on a combination of actual results achieved to date and surveying a sample of SME participants. It will be important that Invest NI ensures that the final

39 A survey of supported businesses was completed. Responses were received from 64 Small Business Loan Fund and 47 Growth Loan Fund participants - i.e. 36 per cent and 70 per cent of supported SMEs.

Part Four:
Performance of funds

evaluations of funds measure and gather clear evidence on the actual outcomes achieved between the date of investment and when exits are made from the funds. To provide fully transparent measurement, the evaluations should also report on jobs which have been sustained at fund closure. Where possible, there should also be measurement of wider benefits being achieved outside of investee companies, for example, within supply chains.

4.33 Projections for both funds suggest that most targets were set too low. Invest NI told us that no loan funds were in place locally when these funds were established, and that no specific evidential base was therefore available to assist target setting. However, going forward, Invest NI needs to ensure that future targets are based on robust benchmarks and baselines (paragraph 4.14) and that the results from its programme of evaluations are used to assess and restate targets and performance measures where necessary.

Aggregated targets

4.34 Although a range of targets have been set for individual funds, no aggregated KPIs have been established for the strategy or the Fund of Funds overall. The interim evaluation of the Fund of Funds recommended that Invest NI should develop such targets for its next Corporate Plan period and for the 2015-19 Programme for Government.

4.35 The evaluation estimated that, overall, the Fund of Funds had potential to create or safeguard 5,000 jobs within investee companies and to achieve increased Gross Value Added of £1.07 billion. Invest NI told us that it is currently seeking to develop more holistic and aggregated performance reporting for its access to finance activities. However, the lack of such measures to date means that it is not fully clear what the various funds are expected to deliver as a programme.

4.36 The evaluation also found that only a small number of SMEs had progressed through the investment pipeline from seed and early stage funding to development funding, which had been identified as a key Fund of Funds objective. Invest NI has not completed any further detailed analysis of SME progression through the investment pipeline. It does not consider that this is still a valid performance indicator, given that an element of competition has developed between some of the funds. Instead, Invest NI considers that employment, Gross Value Added and turnover will be key indicators of SME growth.

4.37 In our view, the extent of progression through the investment pipeline remains a valid indicator to help assess the extent to which the supported SMEs are achieving growth.

Recommendation 8

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

Additionality and deadweight

4.38 The measurement of additionality and deadweight is an important aspect of measuring how economic development programmes perform. The evidence gathered for the Crescent Capital I and NISPO funds indicate that these had high levels of additionality and low levels of deadweight.

4.39 However, the interim evaluation of the Small Business Loan Fund and Growth Loan Fund found that both funds demonstrated "somewhat high" deadweight levels at 53.6 per cent and 47.9 per cent respectively. More positively, the evaluation reported that no individual businesses assisted by the Growth Loan Fund had indicated full deadweight[40].

Subordinated funding and development of the venture capital industry

4.40 A key objective of Invest NI's access to finance activity has been to stimulate the local risk capital market and address funding gaps. The £69.5 million of public investment in the Crescent Capital I and Crescent Capital II funds and the Strategy funds have helped lever £77 million private funding. However, to

Figure 19: Subordination of funding

Fund	Funding £ million		Actual or estimated impact of subordination
	Invest NI	Private investors	
Crescent Capital I	7.0	7.0	Private investors received all £13 million proceeds and Invest NI received no financial return. However, Invest NI considers that the fund helped generate wider economic benefits among investee companies.
Crescent Capital II	7.5	15.0	Invest NI envisages receiving a partial return on its investment.
Growth Loan Fund	25.0	25.0	Invest NI forecasts that it may recoup £21 million.
Development Funds	30.0	30.0	Invest NI forecasts that it could recoup £7.2 million and that private investors could receive £52.8 million.

Source: NIAO based on Invest NI data

40 No businesses indicated that they would have taken forward the activities at the same scale and within the timescale regardless of receiving a Growth Loan Fund loan.

Part Four:
Performance of funds

achieve this, Invest NI's funding has been subordinated to private investors (**Figure 19**).

4.41 The Crescent Capital I fund did not recoup any of the taxpayers' investment and a significant level of current public funding is also at high risk, as private investors must recoup their investment and obtain a rate of return before the public sector recoups any funding. Invest NI told us that the high levels of subordination should be viewed in the context of the difficult recent economic conditions which had created difficulties with fundraising. It highlighted the failure to raise sufficient private investment to establish a planned Development Fund in 2011 and the need to provide high levels of subordination to secure the private finance for the current Development Funds.

4.42 In contrast to subordinated funding, £27.6 million of private finance within the NISPO Invest Growth Fund, the Co-Fund and the Techstart NI Early Stage Equity Fund has been secured on terms based on equal sharing of risk and financial returns. The Co-Fund investments are identified by private investors and supported by Invest NI on `co-investment' terms.

4.43 The Co-Fund was successfully launched in 2011, with £12.5 million funding from Invest NI and £15.3 million private investment. However, the August 2012 economic appraisal for the Development Funds ruled out co-investment as an option, as it identified major obstacles to raising private funding for investments below £2 million on co-investment terms. Invest NI therefore opted to provide its £30 million investment in the Development Funds on a subordinated basis. Invest NI told us that the Development Funds were established to address an identified market failure and that a previous procurement process had failed to secure private funding at a reduced subordination level.

Recommendation 9

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

4.44 The funds supported by Invest NI have enhanced the scale of risk capital activity in Northern Ireland. Prior to 2010, there were three local funds with total funding of £39.5 million being managed by eight investment executives. Since 2014, a further six funds have been established with total funding of £163 million and a management team of around 20 investment executives.

4.45 However, Invest NI's support has not yet helped develop the local market to the stage where the need for substantial public intervention is reducing (**Figure 20**). The interim evaluation of the Fund of Funds in 2014 highlighted that a period of 15 years of public intervention was required in Scotland to stimulate an under-developed market and achieve a sustainable mix of investors.

Figure 20: The need for subordination of funding

Since Crescent Capital I was launched in 1995, Invest NI has supported 13 of the 15 other venture capital and loan funds established locally[41]. Invest NI has provided £117 million to these funds, £65.8 million of which was subordinated. The fund managers have levered £136.3 million of private investment for these funds.

Invest NI provided 50 per cent subordinated funding for Crescent Capital I when this was established in 1995. A lower level of 33 per cent subordination was provided for Crescent Capital II in 2004. However, 50 per cent subordinated funding was again required when the Development Funds were established in 2013, as the appointed fund manager had been unsuccessful in fundraising for a similar fund in 2011 which had offered 33 per cent subordination.

Recent appraisals and evaluations of access to finance funds have highlighted that market failure in the Northern Ireland loan and venture capital market will continue for some time.

Source: NIAO based on Invest NI data

4.46 Whilst the Access to Finance Strategy is intended to develop the local venture capital industry, Invest NI has not established any formal medium-term or long-term success criteria to measure the impact of its significant investment in this area. However, it told us that longer term indicators of success would include:

- reduced subordination levels;
- increased private investment leverage; and
- higher financial returns from exits which could be recycled into future risk capital initiatives.

Recommendation 10

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

Reduced market failure for loans

4.47 The interim evaluation of the Small Business Loan Fund and the Growth Loan Fund found that whilst market failure still existed for loan finance in Northern Ireland, it may have reduced since the funds were introduced. It cited recent EAG research findings that SME demand for loans may be modest and that some strategic stakeholders had expressed concern over future demand for the Growth Loan Fund. It recommended that any future appraisals or approvals for the funds should assess demand analysis, and measure prevailing market conditions.

4.48 In view of the potential of the Growth Loan Fund to provide strong financial returns, the evaluation also

41 The two funds not funded by Invest NI were established by the local Universities with funding of £4.7 million.

Part Four:
Performance of funds

recommended that Invest NI promote the fund to the financial investment industry with a view to reducing its 50 per cent stake in any future iteration of the fund and seeking higher private investment than the current 50 per cent ratio.

Value for money

4.49 The interim evaluation of the Fund of Funds concluded that it had demonstrated its effectiveness through contributing to the Department's and Invest NI's objectives and targets and had demonstrated "clear value for money for the public purse".

4.50 However, in our view, a value for money judgement cannot be formed solely on this basis, particularly as the strategy's performance outcomes cannot be meaningfully measured for some time. We consider that outcomes related to financial returns and wider economic benefits, together with the strategy's contribution to developing the local venture capital industry and reducing market failure in this area, will provide a more complete and rounded picture of performance.

Appendices

Appendix 1: (paragraph 1.12)
Study Methodology

1. We completed our review of Invest NI's access to finance programmes after analysing information gathered in the period between October 2015 and December 2016.

2. In completing our review, we:

- reviewed recent research on demand and supply of finance to local SMEs;
- interviewed Invest NI and departmental staff;
- surveyed key stakeholders in the SME field[42];
- reviewed relevant Invest NI and departmental documentation; and
- analysed a range of data from individual loan and investment funds established by Invest NI.

3. We obtained evidence to examine:

- whether clear objectives have been established for individual strategy funds and for the Invest NI Access to Finance Strategy;
- whether the funding provided under the strategy matches identified SME needs;
- SME take up of the funding available;
- whether Invest NI has identified and appropriately managed the key risks associated with the strategy funds;
- whether fund manager contract terms represent good value for money and if fund manager performance is being well managed by Invest NI;
- whether Invest NI has developed a strong performance management framework for the strategy; and
- the strength of performance outcomes and value for money achieved to date.

42 We received survey responses from: Confederation of British Industry (Northern Ireland); Northern Ireland Chamber of Commerce; Institute of Directors (Northern Ireland);University of Ulster SME Centre; InterTradeIreland; and a key individual involved in the local venture capital industry.

Appendix 2: (paragraph 2.21)

Invest NI Access to Finance Strategy funds

Strand	Fund Title and description	Total funding (£million)	Invest NI (£million)	Private match funding (£million)	Fund Period
NISPO*	Invest Growth Fund - Venture Capital for seed/early stage businesses	12.3	7.0	5.3	March 2009 - March 2019
	Invest Proof of Concept Grant for micro-enterprises and SMEs	4.8	4.8		
	QUB and UU Innovation Funds - Equity investment in pre-commercialisation spin-outs	2.4 (1.2 each)	2.0	0.4	
Venture Capital and Loan Funds	Co-Fund NI - Equity holdings in SMEs	27.8	12.5	15.3	June 2011 – May 2017
	Growth Loan Fund - Loans to established growth focused SMEs	50.0	25.0	25.0	July 2012 - July 2022
	Small Business Loan Fund - Loans to start-up and growth focused micro-enterprises and SMEs	5.0	5.0		Feb 2013 - 2023
	Development Fund (1)** - Venture Capital for early stage, high potential SMEs	30.0	15.0	15.0	October 2013 - October 2023
	Development Fund (2)** - Venture Capital for early stage, high potential SMEs	30.0	15.0	15.0	July 2013 - July 2023
Techstart NI	Early Stage Equity Fund - Venture Capital for start-up and early stage technology driven businesses	24.0	17.0	7.0	July 2014 to July 2024
	Proof of Concept Grants to help commercialise technology innovation	3.6	3.6		
	QUB and UU Innovation Funds Equity investment for university start-ups and early stage technology driven businesses.	3.0 (1.5 each)	3.0		
Total		**192.9**	**109.9*** **	**83.0*** **	

* figures for the NISPO funds show the funding allocated to SMEs whilst the other figures reflect the planned available funding.

** the figures for the two Development Funds include £11.5 million of fund manager fees.

*** when the Development Funds fund manager fees are excluded, £104 million of Invest NI funding and £77 million of private investment is available to SMEs.

Source: NIAO, based on Invest NI data

Appendix 3: (paragraph 2.29)
Access to Finance Working Group

The Access to Finance Working Group was established by Invest NI in November 2011. It comprises four Invest NI Board members and two external members with risk capital expertise. It is responsible for:

- approving the overarching Fund of Funds strategy;
- overseeing Fund of Funds performance;
- advising Invest NI's Board on establishing new funds and extending existing funds;
- approving the re-allocation of resources between funds to address funding gaps and fund underperformance; and
- in accordance with DoF approvals and ERDF guidance, determining how legacy funds should be recycled.

Appendix 4: (paragraph 4.21)
Review of Crescent Capital I

1. Several funds operated prior to the Access to Finance Strategy. Crescent Capital I (CCI) was the first of these funds and provided £14 million financed by Invest NI[43] and private investors, each contributing £7 million. The fund operated between 1995 and 2007.

Financial Returns

2. Whilst an overall internal rate of return target was not established for CCI, the fund realised total returns of £13 million. This represented a return rate of - 0.9 per cent on its £14 million investment.

3. Invest NI's funding was subordinated to the private investors, with the objectives of levering private investment and developing the local venture capital industry. Consequently, the private investors received all £13 million proceeds and Invest NI received no return.

	Public Sector £m	Private Sector £m
Investment	**(7)**	**(7)**
Repayment of Capital	-	7
Return on Investment	-	6.024
Total received	-	13.024
Investment profit/(losses)	(7)	6.024

Source: Invest NI

4. Twelve companies were supported by CC1 and achieved a mixed performance. Whilst four delivered a positive internal rate of return and delivered £8.16 million investment profits, one of these did not meet the fund's investment criteria. The remaining eight companies incurred total losses of £5.93 million.

5. A post-project evaluation of CCI concluded that the internal rate of return at - 0.9% was a reasonable performance compared to other UK funds. However, this benchmarked CCI which had closed with funds which were still investing. As venture capital investments can have negative returns until around the eighth year of investment, the comparison was of limited value.

Wider Economic Benefits

6. Targets for economic benefits (increases in employment, Gross Value Added and turnover achieved by investee companies) were not established for the fund, as the economic appraisal guidance in place at the time did not require these.

43 The fund was established by the Industrial Development Board which preceded Invest NI.

Appendix 4: (paragraph 4.21)

7. The subsequent analysis of economic benefits was also limited, with incomplete data gathered for employment and turnover and no measurement of productivity or GVA.

8. The data gathered indicated a mixed performance by investee companies. Two assisted businesses, Andor Technology Limited and Lagan Technology (Lagan), performed strongly. These companies increased employment by 165 (760 per cent) and 167 (640 per cent) and turnover by £23 million and £13.7 million respectively. However, both businesses also received other assistance from Invest NI during this period totalling £3.45 million and £0.45 million, and so these improvements would not be fully attributable to CCI funding.

9. In 2010, Lagan was acquired by the Kana Software Group, which was in turn acquired by the Verint Group (Verint) in 2014. In agreeing the facts of our report, Verint highlighted that the financial statements for Lagan for the period ended April 2010 reported average company employment of 144 (i.e. a reduction of 50 from the 194 recorded in 2009 when the evaluation was completed). It also pointed out that only 114 of the 144 employees were based in Northern Ireland.

10. Invest NI told us that there was no reason to doubt the accuracy of the data gathered by the evaluation in 2009. Invest NI also acknowledged that there had been a staff reduction within Lagan around 2010 which was designed to move the company into profit, and highlighted that company turnover had increased from £15 million to £17 million between 2008 and 2010.

11. Five companies which received £3.4 million investment went out of business during the fund period and another company, which received £1.1 million, subsequently exited Northern Ireland.

NIAO Reports 2016 and 2017

Title	Date Published
2016	
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