



South Yorkshire Investment Fund

EXECUTIVE SUMMARY



The report makes a case for the development of a successor fund in South Yorkshire. The background and history of SYIF 1 is provided, but a large part of the document is dedicated to an evaluation of the Fund. This retrospective is followed by a rationale for a successor fund or SYIF 2.

1. South Yorkshire Investment Fund was created to fill a gap in the market for access to finance. The critical element of the concept is that of creating a fund that takes risks beyond that of the market, but at the same time operates in a commercial manner, sufficient to provide a return on capital that provides sustainability in the long term.
2. All this is made possible by the use of European Regional Development Funding (ERDF). ERDF has allowed a package of commercial finance from Barclays Bank and private equity to be combined to form a Fund of £50m.
3. So far the SYIF has invested £25m and we are confident of full investment and meeting the target returns for investment. Although, the true test of the concept can only be measured over the full ten-year term of the fund. Therefore, the SYIF model provides significant market impact at zero cost to the taxpayer and provides a sustainable source of high-risk finance for regional development and businesses – a perfect solution.
4. The paper argues that SYIF builds on the basic model by integrating the important elements of management development (Money with Management) and improving the way in which the intermediary or professional support system support business (Professional SY). This rich mixture has, over time made a significant impact on the market.
5. Finally, in looking back SYIF provides a natural transition between the history of providing grants to business and the full operation of the commercial market. As the grants are phased out with the reduction of ERDF – the investment fund approach provides a natural stepping-stone to the market.
6. The final part of the paper looks forward and describes a vision in which South Yorkshire will have an Investment Fund that will be a permanent resource for business in the sub-region. The vision is based on the arguments in the paper, reinforced by establishing the alignment between the investment model and national and regional economic strategy. Secondly, in demonstrating the modifications necessary to strengthen the model to fit with this future evolution of the economic agenda.
7. The section concludes by presenting the case for a successor fund, which builds on the success of SYIF 1 and makes improvements designed to strengthen the model for SYIF 2.



South Yorkshire **Investment Fund**

A SUCCESSOR FUND TO SYIF



1. Introduction

- 1.1 The purpose of this paper is to introduce the concept of a successor fund for the South Yorkshire Investment Fund. It is accepted that any new Fund must support and form part of the Investment Planning approach for the period 2008-2013 – delivering the Regional Economic Strategy.
- 1.2 The Paper argues the case for a second or successor fund (SYIF 2) as way of maintaining the momentum of early success created by the existing Fund (SYIF 1). Moreover, it is argued that through the lessons learned from SYIF it will be possible to consolidate and develop the success of SYIF 1.
- 1.3 The vision for the South Yorkshire Investment Fund is by 2013 South Yorkshire establishes a permanent fund for business, owned and driven by the regional partners – independent of Government support. The prize of a sustainable fund for South Yorkshire – differentiates this project with most others in the area of business support.

2. The Background

- 2.1 The South Yorkshire Investment Fund was launched late in 2001 and after a slow start, has now become an established and highly successful player in the regional finance market, with an enviable level of penetration and brand awareness among professional intermediaries, who are the key route to the market.

The Fund lifecycle & structure

- 2.2 The Fund exists as a provider of gap debt and equity finance. That is to say that the Fund fills gaps in the market left by commercial providers of finance and in so doing, allows projects to take place that would otherwise never 'see the light of day'. This market-making role is crucial to the economy of South Yorkshire and its relevance will increase in line with economic growth and the thrust of UK and European policy.
- 2.3 The Fund has a twelve-year life that ends in 2013. During the first seven years, which coincides with the Objective 1 programme, loans and investments are made. In the following 5 years, returns from those loans and investments are realised back into the Fund. During its first investment cycle up to 31st December 2008, the Fund will invest £50m. By 2013 the return made will have a substantial impact in economic terms (jobs, sales and leverage) and the realisation of c. £20m (from successful investment). Of course, at the same time the Fund will also have repaid, with premium, its private sector sponsors, for example the SY Pension Fund, Barclays Bank and DonBAC
- 2.4 South Yorkshire Investment Fund is established as a company limited by guarantee. The Fund is made-up of 3 sub-funds:
- **The Capital Fund** – equity based venture capital (£10m)
 - **The Development Fund** – equity and debt based mezzanine finance (£20m)
 - **The Small Business Fund** – typically unsecured debt based lending to £150k (£20m)

Simply, the Fund, as a whole, must be greater than the sum of each of separate Funds – this is the goal.

- 2.5 From its inception, the Fund's sub-funds have each been separately managed by FSA authorised Fund Managers. The Fund Managers work under the SYIF umbrella and are branded as SYIF – whose role has been to direct and focus all strands of activity. The Fund Managers, who are contracted and directed by SYIF, deliver the investment in business. The project has been made more cost efficient by the Holding Company providing all back-office and marketing services, allowing the investment process to be negotiated at reduced price, but also maintaining a focus on business investment. The use of FSA authorised Fund Managers will continue to be used for SYIF 2 – as it provides the commercial bedrock of the approach.

The Competence and expertise of the Fund

- 2.6 SYIF now has its own wholly owned FSA approved subsidiary that operates the Small Business Fund (debt finance products). At the same time we have forged a strategic partnership with YFM:VF for the equity linked products. Both developments have increased efficiency and effectiveness, through rationalisation and integration and increased business focus which, as illustrated in the evaluation shows that costs have been reduced by 20% since the beginning of the Fund. Critically, the development of the Fund has resulted in the creation of a team of 18 who are specialists in investment finance – without the successor fund this expertise will leave and be lost to the region.

Money with Management

- 2.7 SYIF 1 is not just about investment, but has made the important connection between investment and the need to develop business management. The Fund's Money with Management programme provides each business that the Fund supports with an experienced and skilled mentor or Non-Executive Director who will help them to achieve profitable and sustainable business growth by:

- Providing an objective, dispassionate, critical sounding board to promote effective strategic management.
- Supporting the development of management teams and the individuals within them.
- Enhances the business model, its performance and adds value.

2.8 Businesses that agree to use a mentor or NED benefit from a significant rebate of between 30-80% of the interest charged on their loan and a subsidy of up to £6,000 towards the fees of the mentor or NED selected. The Fund runs a database of mentors called the SYIF Mentorbank that now numbers 480+ members and is probably the largest, most comprehensive and successful service of its kind presently in the region. The programme has been a great success and this is a component we propose to further develop as part of SYIF 2.

Market Making

2.9 Finally, SYIF has a role of market making – as a small business with a core team of 18; it must work through the market intermediaries. Through its lead role in ProSY, SYIF has helped to promote the involvement of the professional network and this is crucial in raising the profile and the intervention of professional advisors to business. SYIF has also enjoyed a close working partnership with Chambers of Commerce and Business Link South Yorkshire, from which, a significant proportion of the Fund's deal flow is derived. These partnerships have enabled other benefits such as the strategic linkage of the Fund with the BLSY grant programme. The ideal outcome of this process is better co-ordinated packages of finance that provide the development headroom for business and provide value for the taxpayer.

2.10 In summary, SYIF has been a key agency in delivering the plans of Regional and Local Government and Yorkshire Forward. SYIF has provided leadership and strategy for the Fund, which has successfully invested £25m and developed a robust portfolio of investment, which is on target to provide a commercial return. In doing so we have developed a strong team of investment specialists whose focus is South Yorkshire, supported by a strong system of management support and which helps to strengthen the way in which businesses are provided with support from the professions and other specialist agencies.

3. An Evaluation of SYIF

Appendix 1 provides an extensive review of the performance of the Fund. In conclusion, albeit very early in a 12 year project, the Fund has been a success in three areas of market impact:

- **Market Making:** There is clear evidence to support a positive effect on the market, through the Fund and its related work in the access to finance market (also see 2.9 above).
- **Financial Performance:** The current forecast is to achieve the original return rates – both in terms of the investment made and, more importantly the return to investors, public and private.
- **Economic Impact:** The Funds are forecast to fully meet the main economic outcomes contracted by Government.

Some of the headline messages are:

- The Fund has provided added value without making significant market distortion and produces a sustainable model.
- Investment Funds take time to launch, probably two/three years before the full momentum is achieved, and businesses plans and financial models needs to take this into account.
- The Fund Management strategy with its commercial discipline has been a success and is an effective and efficient use of public sector resources.
- The cost of Fund Management is an expensive resource, but is a cost effective means of raising the quality of the process and the return to private and public sector investors.
- The integrated model of using finance and management support (Money with Management) has enhanced the product and its effect on the market.

4. The Contribution to existing and future Government

- 4.1 So far the paper has looked back and provided an initial evaluation of the programme. This next section examines some of the emerging policy trends that point towards investment funds as a key mechanism in providing Government support to the business. [Table 1](#) presents this schematically.
- 4.2 The Commission and UK Government have commissioned a major evaluation study of the ERDF Funds, which will be concluded by the end of the year. This reflects the importance placed on the “investment model” by Government. The following points can be made:
- I. That the European Commission are supportive of the investment fund model, in that it provides regional ownership of funds and moves away from a pure grant aid model which is not sustainable. The approach is being recommended across the European Union for the next ERDF programme. There is an acceptance that cost issues need to be addressed as part of any broader roll out.
 - II. The Department of Communities and Local Government have been comfortable with the performance of the Investment Fund concept, particularly when compared to the performance of grant aid schemes.
 - III. The DTIs/Small Business Service simplification process will have a bearing on the way in which the key instruments of business support are developed. It can be argued that the Investment Fund approach, particularly allied to money with management support and market making with business support intermediaries, provides a big impact for little cost. It can also be used more effectively to meet the drive and improve the quality of projects or “investment readiness”.
 - IV. The Northern Way and its focus on knowledge based regeneration means that this will generate a demand for high risk capital, currently only 8% of the total UK private equity investment occurred in the North in 2004 (BVCA). Consequently, there is a need to provide a response to meet this need – investment funds provide a potential solution.
 - V. Yorkshire Forward and Government Office for the Region regard SYIF as a credible success (I would not want to overstate this point – but this was recently endorsed by PMC and the Yorkshire Forward Executive Team) and we have an excellent working relationship with both bodies and this is important in providing strong continuity of strategy.
 - VI. The Yorkshire Forward Regional Economic Strategy and Review of Business Support are crucial in helping to shape the future landscape of business support in the region. It is within this framework that the Investment Fund needs to operate, if it is to meet the expectation of Government. This has been a strong determinant of SYIF policy.
 - VII. SYIF has consulted widely in SY with the full range of stakeholders and there is general support for a Successor Fund on the basis that the Fund will provide a commercial and sustainable fund – under the direction of the sub-regional governance.

Table 1: Government Policy Drivers supporting the Investment Fund Concept

| Strategy | Imperative | SYIF Response |
|---|--|--|
| Yorkshire Forward: Regional Economic Strategy 2006-15 | Improvement of access to finance identified as a central pillar of YF's business competitiveness strategy. | SYIF 2 will provide micro, gap, seedcorn and equity finance, coupled with money with management to strengthen business competitiveness. SYIF will continue to work closely with Business Link, professional intermediaries and other providers to maximise leverage in finance and expertise. |
| DTI: EU Structural Funds - Draft National Strategic Reference Framework | <p>ERDF will embed the five drivers of productivity: competition, enterprise, science and innovation, skills and investment.</p> <p>Programme to target long-term productivity growth to support the Lisbon Agenda.</p> <p>Programme will deliver high impact interventions to maximise value of investment to bring sustainable benefits.</p> | <p>SYIF 1 has demonstrated how the Fund can support growth and productivity gains. SYIF 2 clearly has a pivotal role – directly as an instrument for business investment and to drive enterprise, aspiration and innovation with the use by clients of selected mentors and NEDs.</p> <p>SYIF 2 will target investment at knowledge driven industries, into the science base - through universities and R&D.</p> <p>SYIF 2 will be a commercial revolving fund that will recycle each grant '£'. Benefits will be sustained far beyond the end of the programme.</p> |
| BLSY: Access to Finance Study & Group Findings 2005 & 2006 | Gaps in finance provision exist across the range but there is particular demand for seedcorn, equity and unsecured lending. | SYIF 2 will be configured in line with demand feedback from the study and from experience gleaned in running SYIF1. |

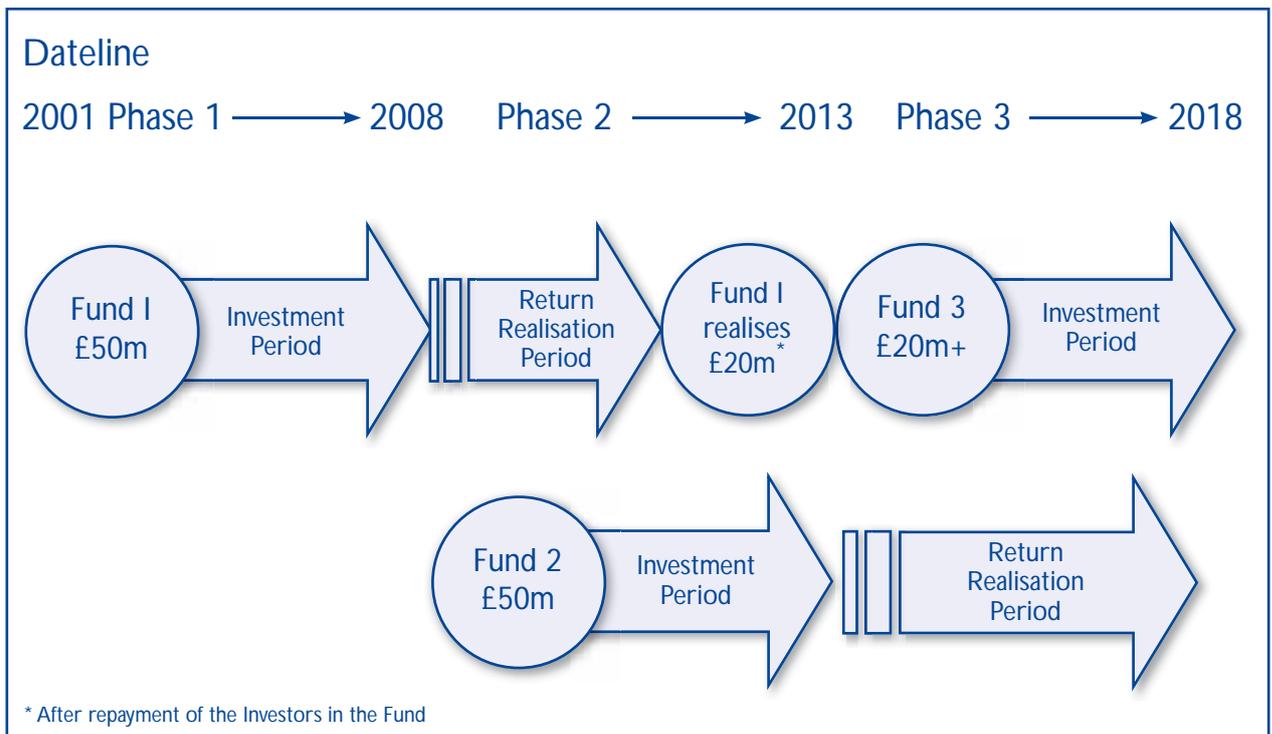
4.3 Consequently, we can propose with some confidence a Successor Fund, which has a proven market – which has increased year on year. The Fund is in line with Government Policy: European, National, Regional and Local and has the support of the business community.

5 The Successor Fund – An outline plan

The rationale

- 5.1 On the basis of the above, the proposal for Successor Fund (SYIF 2) follows the practice adopted by the private market and similar Funds, developed in Wales and Merseyside. The approach has been to raise a new second stage Fund. The proposal is to raise SYIF 2 when the SYIF 1 investment period terminates at the end of the 2008 calendar year. The raising of the new Fund coincides with the start of the next European Regional Development Fund programme period - which will be scheduled for 2007 - 2013. We expect the new Fund to be effective from the beginning of 2009.
- 5.2 Diagram 1 below presents the proposal graphically. The key point to make is that realisation from SYIF 1 will not become available until all the investors have been repaid and this will not be possible until 2010, and a flow of funds sufficient to support investment from the SYIF 1 realisations will not be available until around 2013. Hence, SYIF 2 is required to fill the gap and maintain the momentum of investment. Critically, though SYIF 2 provides the basis of a sustainable fund by 2013 for South Yorkshire's economy and business community.

Diagram 1: The SYIF 2 - Flow diagram of Fund investment and return cycles



The Scale and Focus of the Fund

- 5.3 The size and focus of the Fund will need to be determined more precisely at a date closer to the period of investment. However, a working model is for a Fund of similar size, but slightly different focus – which mirrors the requirements of the latest Operational Plan. The changes also reflect:
- The experience gleaned from SYIF 1 (see Appendix 1 for the evaluation),
 - Market research undertaken by Business Link on behalf of the South-Yorkshire Partnership and several other pieces of research, which indicate changes in the access to finance market.
 - The policy shift towards greater focus on the Lisbon agenda.

- The need to move away from grant-aid to more sustainable forms of financial intervention in the market.

Further market research is planned, building on the Almeida Research undertaken by the Small Business Service. The key area of research and the evaluation is the need to define those areas of market intervention that will provide the most effective impact.

5.4 In order to reflect these changes in the market, there will be differences in emphasis between sub-funds. The most significant of these changes point towards the need:

- To target investment activity towards tackling the Lisbon Agenda
- To provide greater integration & effectiveness of the investment – tailored to the needs of the early stage market; and
- To provide greater efficiency of delivery through driving further business improvement.

5.5 Some suggestions designed to achieve these objectives are as follows:

- Firstly, one of the most important lessons learned from SYIF 1 was that in order to achieve commercial return targets – most pre-revenue investment could not be supported through the mainstream fund. This left clearwater in the market in an area, which is rich in technology based businesses. Our response has been to recommend the creation of a new high-risk **Seedcorn Fund** (Total fund value - £10m) that will invest from £10 - £250k in very early stage or pre-revenue businesses. The fund will concentrate on the vital area of knowledge-based business, so important to economic growth and consistent with meeting the Lisbon Agenda. The fund will support proof of concept and commercialisation of ideas, working with the Universities and incubators to accelerate growth in the sector. To reflect this higher risk investment it is proposed to use the maximum intervention rate available from public funds to support what is pre-competitive investment.
- Secondly, there is a need to build on the foundation of SYIF 1 and provide flexible equity packages that will attack weakness in the market and attract other venture capital into the SY market. We believe that the formation of a single equity fund called the **Equity Fund** (Total fund value - £25m) will effectively simplify the current Capital and Development funds, into one flexible fund. This fund will provide venture and mezzanine finance from £100k - £2.5m.
- Thirdly, we recommend that the successful **Small Loan Fund** be continued. It is our view that to make more impact this Fund should also be more targeted on the start-up market and helping to bridge the gap between the Seedcorn and Equity Fund market segments. The Fund would continue to provide low level, typically unsecured debt finance from £10k – £150k (Total fund value - £15m) – but would also use equity options to compensate for the higher risk lending that has been made. Such a fund fills a vital gap for small businesses that are either unable to find sufficient mainstream finance and/or may have exhausted their allocation of funding under the Small Firms Loan Guarantee Scheme.
- Fourthly, a continuation of **Money with Management** that will use mentors and NEDs to support business growth and secure investments, coupled with more targeted interest rebates and a subsidy that can be used to support professional fees.

5.6 Therefore, the structure of SYIF 2 will be significantly different to that of SYIF 1, but will continue to operate commercially. However, there is a need to emphasis that in taking the Fund into areas of higher risk a consequent reduction in return expectation must also be made. The precise details of this balance between risk and return – will be crucial in determining the best use of scarce resources in the next programme.

5.7 As now, each Fund will operate through the legal structure of a Limited Partnership vehicle and be delivered by FSA authorised Fund Managers – working independently, within investment and operating guidelines set by the investors. We believe the continued focus on commercial investment principles is critical to the quality of investment and in turn the sustainability of the model i.e. a permanent Fund for South Yorkshire. However, equally crucial is the need to create a more innovative model of investment that reaches into areas of the market outside market operation. This balance is the critical ingredient of the SYIF model.

Table 2 Indicative Funding Requirement

| Fund | ERDF £m | Private £m | Total | YF Investment Plan £m |
|-----------------------|---------|------------|-------|-----------------------|
| Equity Fund | 11.25 | 13.75 | 25.00 | Nil |
| Seedcorn Fund | 7.5 | 2.5 | 10.00 | Nil |
| Small Loan Fund | 6.75 | 8.25 | 15.00 | Nil |
| Money with Management | 3.75 | Nil | 3.75 | 3.75 |
| TOTAL | 29.25 | 24.5 | 53.75 | 3.75 |

6. Summary and Recommendations

- 6.1 The paper above proposes that a Successor Fund (SYIF 2) is developed for South Yorkshire using the next phase of ERDF funds available to the region. The paper argues that this is the most effective way of providing access to finance for growing businesses, as it follows market principles and allows the development of a sustainable Fund to be created generating benefits far beyond the lifetime of the ERDF programme. Modifications to the Fund are proposed which would improve its effectiveness in supporting economic objectives, and issues requiring consultation and discussion are raised for Yorkshire Forward and the South Yorkshire Partnership.
- 6.2 The paper recommends the following next step:
- South Yorkshire Investment Fund seeks Government support, through Government Office for the Region, Yorkshire Forward and South Yorkshire Partnership to develop plans for a successor fund as outlined – as part of the Operational Plan for the next ERDF Programme – in line with [Table 2](#) previous.

An Evaluation of Fund Performance

1 Introduction

- 1.1 The headline message is that the Fund has been successfully launched in a difficult market and is now an established part of the local market.
- 1.2 The shorter term is measured by proving that there is a market for the Fund operating on a commercial basis. Having made £28m (including Money with Management) of investment in more than 200 businesses – this suggests that the case has been proven. Moreover, the Fund is broadly on track to achieve its stated aim in the Business Plan (2001).
- 1.3 In the longer-term, the Funds' ultimate success (c. 2012/13) is best judged on its ability to perform commercially – making the market for risk finance & filling gaps in the market. Current projections suggest that the fund will be successful in providing the following:
 - **Market Making:** provided by the way in which the Fund has filled gaps in the market and provides a catalyst for growth in the corporate finance market professions and more general business support.
 - **Financial Returns:** that will service the loan from the Bank and meet the expectations of the private equity and the Government investors.
 - **Economic Impact:** in relation to business success (sales and profits) and jobs – in other words how it meets the objectives of the Government stakeholder.
 - **Operational & Governance:** how the Fund has been established, resourced and managed – with efficiency and effectiveness the benchmark.

2 Market Making

- 2.1 Perhaps, the most challenging issue to emerge from the first four years of the Fund has been to prove the market. There was an initial fear that the appetite for loan and equity finance in SY would be insufficient to support such a Fund. It has been a difficult market in which to develop, particularly with the early market depression around 2002/3, competition from the plethora of grant-aid available and from an increasing risk accepted by the banks (this is good for the market and business) – but as can be seen the Fund, after a slow start has now established itself in the market.
- 2.2 A more detailed analysis shows the following:
 - a) Firstly, in providing a **new source of risk** finance, SYIF has affected the way in which existing market providers behave. The best example of this is the behaviour of banks who are more willing to stretch their risk taking beyond normal standards when working with the Fund – the high levels of leverage exerted by the Small Business Fund – provides a proxy for this effect. It also highlights the point that investment must work with the grain of the market – unlike some of the grant regimes. This is a complicated area to evaluate, because of the complexity of financial mechanisms available to business: private and public. However, what is clear is that the effect has been positive.
 - b) Secondly, SYIF has been part of a necessary process of **shifting the market interventions from grant to investment**. This so called “grant dependency” has grown up over many years of government support and, whilst this is exaggerated, there is no doubt that it has diminished the spirit of enterprise. SYIF I has been introduced into a market in which an estimated £50m of government grants have been distributed since 2001 and therefore to prove the market in these circumstances is an important achievement. There is no doubt that there is a place for grant-aid in the business support market, but it is clear that any displacement

of investment mechanisms by grant aid - as has been evidenced during the past five years, should be eradicated as we move forward.

- c) **The marketing of the fund**, separated as it is from the mainstream of fund management and its traditional relationship marketing approach, has been effective in opening up new and more cost effective channels of marketing. The use of marketing as a discrete element of the fund has allowed a broader marketing approach that has examined price, product and position in a more effective way – this adding more value. Another example is the way in which e-marketing and direct mail have been used to significant effect and how continuous and focused PR has been effective in communicating the main message. The clear lesson in this area is the need to recognise that it takes time to communicate the message – which needs to be constantly reinforced. One illustration of the SYIF effect has been to compare previous rates of publicly supported investment with that going forward: this shows that the YOHEF Fund made a total of investment of around £4m in South Yorkshire – best average of £1.5m per annum – compared to the £7m per annum investment by SYIF.
- d) **The educational effect** on the market, principally with corporate finance – but also with SMEs. This effect is deeper and more sophisticated than simply the provision of a new supply of finance. The SYIF effect has been to raise awareness and commitment to increasing entrepreneurship and the ways in which this can be supported. An example of this concerns the debate on the use of equity v debt finance instruments – this effect is difficult to measure, but qualitatively this is an important cultural change in financial market, which have been traditional, conservative and generally moderate in risk taking. Also the Fund, for the first time in the era of ERDF, has opened the debate on grant dependency – which it is argued has a debilitating effect on market process. This debate has been one in which the fund has worked closely with the RDA and Business Link – to ensure that public sector investment is best used to achieve value for money. Consequently, the Fund has provided a catalysis – in several ways through its presence and action.
- e) **The deal making effect** of the Fund through its investment managers has been significant and is still growing. Although the Fund is not resourced to chase deals and depends on intermediaries to find the deals, the Fund has added value, particularly on the equity side of the house, by working with SME's and their advisors to help shape the best deals for the clients. This role has compensated for the lack of existing deals makers in the market, however, as the Fund has expanded the market, the number of such dealmakers has increased which reinforces the evolving nature of market making in this area.

2.3 Finally, there are two other influences the fund has provided in the way the market performs. These are Money with Management and the development of the professional network through Professional South Yorkshire. Evaluating the effect of these initiatives shows:

- a) **Money with Management** – the use of mentors: This project has already been evaluated early in its development to test the effect on the market. The project provides a tapering 50% subsidy for the use of business-experienced mentors in each of the Funds investments (Non-executive directors are used for the larger equity investments). The impact of the project has been significant in firstly emphasising the importance of management competence in growing a business. Secondly, it provides an opportunity for entrepreneurs to seek support and guidance from a third party – which lessens the isolation often felt by entrepreneurs, but also adds value with new ways of thinking and how this can develop and strengthen the business. Thirdly, mentoring has had an effect on the intermediary market in helping the sector to recognise the importance of professionals developing their skills as mentors – this has been supported by a programme of seminars designed to help both business and has provided cemented further the critical role of the intermediary in the access to finance market. In conclusion, by linking finance to management – there is a win-win to the Fund in protecting the investment and to the entrepreneur in adding value to the business. The most telling metric from the early evaluation was that 85% of SME's questioned said they would continue with their mentor when the subsidy ended.
- b) **Professional South Yorkshire** – this initiative was taken on by the Fund having seen the effect in other areas, like Leeds and Manchester. The goals of the project were to:

- Promote the services provided by professionals in SY.
- Increase the level of business and deals dealt with by the sector.
- Provide a bridge between the professions and public sector initiatives from the RDA and local development agencies.

The Fund has taken on project leadership and supported the project to its current launch as an independent legal entity run by the sector for the sector. The Fund has now become a member of Pro-SY, establishing itself as a formal part of the market. More importantly, the development has fostered close relationships with the sector, better understanding on market position – but MOST importantly a debate about how the sector, particularly in the corporate finance and property area, can do more for existing clients and develop new client relationships.

- 2.4. The impact of this project is one more strand in the way the Fund has influenced the market in South Yorkshire, by the way it has improved the demand side of the market, not by another injection of public sector resource, but by emphasising how the development of the existing market can be improved by focused investment on the supply of services from the private sector.
- 2.5 Finally, it can be shown that not only has the Fund levered in £29m private sector match funding, from Barclays, The SY Pension Fund and DonBAC, but each deal has levered in an average of £4 for every £1 invested by the Fund. This double benefit is important to note – as the region looks forward to a time when Government support will be seriously reduced.

3 Financial Returns

- 3.1 Although it is too soon to accurately forecast the final returns, what can be said is that commercial investment criteria have been maintained. It is estimated that this will result in loss rates within the tolerances of the original model of between 20-25%. At the same time the loan-book for debt finance and the investment portfolio for equity investments are robust and there are good prospects for profitable exits. Therefore, the need to maintain commercial investment principles, but striking the balance between taking risks beyond those normally taken by the commercial market and achieving returns that support sustainability – is the magic formula (which when added to the economic gains provides effective performance at low cost).

More detailed conclusion and most likely outcomes are as follows:

- The financial return provided for investors and debt providers will be achieved, broadly in line with the original plan.
- The most likely outcome demonstrates that the bank will be repaid and that the private investors return expectations will be met, with a residue of around £20m being available in 2013.
- The Fund has maintained rigorous commercial criteria on assessing investments and this has paid dividends in managing the expectation of the market and, critically, the quality of the investments are achieving the balance between taking increased risk, beyond that normally taken by the market, and return which must be sufficient to meet the expectations of investors.
- The cost per for £1 invested must be evaluated across the whole period of the programme, but current projections suggest this will amount to an equivalent of 1.8% of the Fund value per annum or around £900k per annum over the full-life of the project. This compares favourably with investment fund analogues (this additional cost against grant-aid schemes must be adjusted to take account of the nil cost per economic outcome, achieved from the recovery of investments).
- Thus far there is no evidence that the Fund has distorted the market – banks and other financial products have continued to aggressively market – but collaborate when there is a benefit from doing so. The ability to achieve this balance between collaboration and competition is one based on good relationship marketing and being clear on product parameters and differentiation.

- The Fund, working closely with its Fund Managers, has improved the administrative and marketing systems of the Fund forming an integrated brand that provides both clarity of message coupled with an efficiency of delivery. This has resulted in a continuous process of cost reduction, so that the original cost rate has been reduced by 10% over the first four years of the investment programme.
- A total investment of £25m has been made distributed between the Funds as follows: Small Business Fund £11.5m; Mezzanine Finance £8.8m; and Equity £4.7m.
- Future investment rates: The original business plan produced was based on the Merseyside anticipated demand, which with the benefit of hindsight was an unrealistic assumption. As indicated the Fund took time to establish its marketing message and brand. This took 2-3 years to establish and now we have established a more reliable run-rate of £3m for the Small Business Fund and £5-6m for the Mezzanine and Equity Funds, combined. This should provide an outturn between £45m to full investment of the fund – assuming the general trend of increased investment from the Equity linked funds.
- Loss rates: The Small Business Fund which has now built up a large portfolio of 200 transactions – has been intensively reviewed, both by PWC (2003) and as part of the due diligence process involved in the transfer of responsibility to the new FM (2006). This shows that the current provisions are running at 17% (actual capital losses 8%).
- The division between the debt finance and equity products shows, that the market has been easier for the debt market in that this product message is clear and largely acceptable in the small business market – cheap finance with easy conditions.
- The equity-linked products including mezzanine finance have been more difficult to establish – in what is accepted as an unsophisticated market. Equity linked products are much more difficult instruments for smaller businesses to understand and, given the risk are more expensive. Here the importance of the market-making role through education and marketing cannot be understated.
- The Mezzanine and Equity Fund have over time been integrated to provide a flexible higher risk debt-equity package for the market that intermediaries now understand better – which has resulted in increased demand. The key point here is the need for flexibility, but communicated clearly what gap the product is designed to fill in the market.

3.2 In conclusion, it is too early to assess the true financial performance of the Fund, particularly the equity element of the fund, which will depend on exits to achieve target returns. However, what can be said at this stage is that loss rates are being contained within reasonable levels and that the quality of the portfolio is such that one can reasonably expect to achieve target rates of return. The unknown quantity, at the moment, is the level of investment between now and the end of the investment period on 31 December 2008. As indicated above we are confident that the run-rate of investment can be improved and this will result in a full investment of ERDF monies.

4. Economic Impact

- 4.1 The argument used by the Fund has been that successful investment equals successful economic impact. This approach has been taken to maintain the commercial discipline, which is heavily predicated on financial measures of success. However, a review of the metrics demonstrate that apart from the numbers of SME's supported, which appeared to be wildly optimistic (equal to a 40% penetration of the core client group) the metrics are all positive and are on target to achieve those required by Government.
- 4.2 Again, the economic impact of business growth and job creation will be back loaded. The approach taken has been to focus on the simple formula that successful investment leads to economic impact. We have not taken a "bean counting" approach to each investment. Not surprisingly, this low bureaucracy approach has been welcomed by business clients and appears to be delivering the goods as table 3 over demonstrates. If one adds the leverage impact to the contracted measures – one can see a very effective return being provided for the Government and regional investment.

4.3 Some of the detailed points to emerge so far are follows:

- **Cost per outcome:** Two differentiators from the Government supported grant-aid programmes for business are that:
 1. They involve a close working relationship: including monitoring and review as part of the process of investment management; and
 2. Successful investment at a gross level provides a nil cost per outcome – due to the recovery of the original grant (more sophisticated economic analysis still shows that the cost per outcome still outperforms grants).

Finally, initial evidence from Merseyside shows that even when the quantum of grant is compared to investment - the Fund still provides the best value impact.

Table 3: Delivered and Projected Economic Outputs from the programme

| Output | Total Projected Outputs | Target to 31 March 06 | Achieved to 31 March 06 | Achieved % |
|-----------------------------|-------------------------|-----------------------|-------------------------|------------|
| New jobs created | 1,100 | 601 | 883 | 146% |
| Jobs safeguarded | 3,000 | 2,726 | 2,825 | 103% |
| Mentor days assisted | 6,000 | 3,800 | 3,381 | 89% |
| Value additional sales (£m) | 387 | 83 | 79 | 95% |
| New business starts | 50 | 35 | 45 | 128% |
| Businesses advised | 3,000 | 1,800 | 2,008 | 111% |

NB. Growth of Value additional sales (additional sales generated by clients above baseline measured at investment drawdown) will continue to grow at a higher level.

- **Leverage:** The Fund has levered finance from the market at two levels, firstly the level of the Fund, where private investment has been made at £29m, but also the impact from the leverage exerted at the level of the investment – which is equivalent to £4 of leverage every £1 invested (consistent with other Funds). The definition used for leverage has been the more conservative definition of the deal size, rather than the wider definition of all of the finance in the business (there is some discretion in this measure given the judgement of relevance to the SYIF investment made. The breakdown of the samples shows that:

| Fund | Invested | Levered | Ratio |
|------------------------------|----------|---------|-------|
| Small Business Fund | £10.9m | £46.3m | 4.25 |
| Capital and Development Fund | £11.5m | £34.5m | 1:3.1 |

- The impact on **turnover/sales of businesses** involved has been excellent and will provide significant impact. These figures should be back-loaded in the programme due to the growth lag, but to date we are on target to fully achieve the targets set in this area of programme.
- **Jobs:** there is a need to understand that the greater emphasis on knowledge-based businesses the less likely these are to have on job creation, as the emphasis is on capital investment and fewer and better-qualified employees. This said the Fund has been successful in achieving current targets.

4.4 Some other economic impacts have been referenced previously – these are:

- The contribution made as a result of the emphasis on making investments in markets consistent with the Lisbon agenda.
- The development of the professional services sector – which is essential to support a strong knowledge based economy.
- Management development – has been at the heart of the Money with Management programme, both improving the level and intensity of mentoring and the quality of management in SME's.

Operational and Governance

Management – a new model of delivery?

- 5.1 The SYIF model is unusual in relation to the other VCLF models in that it separates back-office functions, like marketing and accounting, from the investment function. Therefore SYIF, as the Holding Company, has responsibility for both Strategic and non-core functions (including Money with Management) leaving the Fund Manager to focus on the issue of investment.
- 5.2 The proposition was that this was a better delivery model, providing greater integration and is more cost effective. The conclusion over time, as convergence and integration of function has occurred, is that the model is more effective, but that the quantum on fee reduction should have been nearer £200k-£250k per annum. The process of achieving this level of efficiency and effectiveness gain has been a process of continuous improvement.
- 5.3 After four years, having taken the Small Business Fund in house and created a strategic partnership with YFM to support the delivery of equity investment - is there has been real progress made in providing a new model of delivery. The qualitative evidence is that an effective balance has been achieved between the demands of the commercial imperatives of investment and the economic objectives of Government. In effect, SYIF have attempted to create a new model – the reality is that it will take longer than four years to fully effect this change.
- 5.4 At a more quantitative level it is clear that:
1. The SYIF Holding company provided the role of a cost effective management agency for government - providing a more effective, focused and efficient means of managing the supply side and providing a cluster of services around the delivery of access to finance;
 2. It is estimated that SYIF model will cost the equivalent of 1.8% of the Fund value, but like Finance Wales supplies a wider range of services for the government customer; and
 3. The model, subject to the efficiency of cost of sales (see point 2) provides a more transparent mechanism for recycling the resources into future regional investment.

Overall, the above suggests that the delivery cost are in keeping with the impact on the market, if one takes a long-term or strategic perspective.

Accounting & Systems

- 5.5 The accounting processes have been a source of issue for the outsourced element of lending and investment, but have been simplified now with the SYIF subsidiary having achieved FSA approval. FSA has created a dual system of accounting between the holding company and the Fund Manager, which has been slowly integrated over time – mainly due to the nervousness of being non-compliant. We now believe that further efficiency gains can be made in this area.
- 5.6 SYIF has made a real effort to develop e-business principles, in an investment culture that is resistant to change. However, the importance of good market intelligence has been accepted and this is an area where the pace of change has now increased. With this will come greater efficiencies and, in some ways a better understanding of the market – as part of the SYIF role of becoming a centre of excellence in the sub-region.

Marketing

- 5.7 As indicated previously, in describing the market-making role of SYIF, good practice and achievement can be identified in this area. Much of this has been about marketing the concept in the market – a challenge which has taken time and on which there is much more to do. For example there is still widespread resistance to equity, which we believe is an impediment to business growth, creating as it does both an over-gearing of debt finance and a demand for grants. SY is an unsophisticated market and the economies success and that of the Fund, depend on this changing.
- 5.8 The marketing strategy of the Fund has been to focus on intermediaries, raising their understanding of the requirements of the Fund, but at the same time spreading the message in the market. SYIF measure the awareness and attitudes to the fund through a tracking study – this provides a rough benchmark of progress. This is complemented by research undertaken in the market. The process and its measurement illustrate the progress made – key account awareness now stands at 93%. The importance of using intermediaries as a quality filter cannot be understated, as the quality of deal flow is critical to managing the operation in a cost-effective way – i.e. more investment managers would be required to deal with the flow and much of this work would be nugatory.
- 5.9 The other points of relevance drawn from marketing of the fund are:
- The educational effect in the market has been seen as part of the market making function see paragraph 2.2c. The point to stress is the importance of raising the profile of finance with businesses and the advisory/intermediary network (private and public) – this has improved during the life of the fund, but needs to improve.
 - The original market analysis used to provide the baseline for operations was insufficient to provide clear segmentation of the market. It is clear that there is a need for better market intelligence of the business market, but it is equally clear that much time could be spent on this aspect of the business, without necessarily improving penetration – the right balance needs to be carefully weighed.
 - The marketing of the fund has used a full marketing mix, including communication, web-based and relationship marketing – critical to the process has been the relationships developed with key intermediaries – this and the understanding of the local market are vital to the Fund making an impact.
 - The positioning of marketing in the Holding Company has created a new approach to marketing investment that has provided dividends beyond the traditional Fund Management approach. It has not been without its tensions, mainly people related, but in part the requirements of FSA compliance, but has provided an opportunity to provide a more systemic – which in the final analysis has provided a more effective and efficient communication.
 - The use of a business development resource has provided mixed returns: the positive in the sense that it has widened our message in the intermediary market, but the negative in the sense that it has been difficult to coordinate effectively the information derived from the process through our Client Relationship Management database. Primarily, through the deep resistance from investment managers to this kind of approach. This is changing, but slowly, but is one way of improving the marketing effort

6. Lessons Learned & Conclusion

Overall, the most important lesson learned has been the time it takes to effect radical change. The introduction of the Fund, with its goal of moving away from traditional grant aid and making a new market, does qualify as a radical change. The corollary of this insight is that it would be a economic loss if having developed the market and the professional capacity to deal with it – continuity was lost.

1. The integration of access to finance services, delivered through a range of different organisations, is difficult to manage – but is worth the effort given the enhanced service it provides.

2. Investment Funds take time to launch, probably two/three years before the full momentum is achieved, and businesses plans and financial models needs to take this into account.
3. The need to clarify the product offer from the outset with clear investment criteria that avoid raising false expectation and provide a quality filter on the applications made to the fund.
4. Related to 3) the most effective financial intervention, particularly that which is supported by Government intervention, happens when it is packaged, balancing the needs with the client with that of the taxpayer.
5. The Fund Management strategy with its commercial discipline has been a success and is an effect and efficient use of public sector resources.
6. The need for equity finance instruments is clear in terms of normal market decision making, but has not been an easy sell to make either to businesses or their advisors.
7. The importance of using intermediaries as the main route to market is critical to the success of making the market.
8. The cost of Fund Management is an expensive resource, but is a cost effective means of raising the quality of the process and provides a significant return to private and public sector investors.
9. The integrated model of using finance and management support (Money with Management) has enhanced the product and its effect on the market.
10. The capacity developed over the period of investment provides a powerful resource in the market – the need for continuity is therefore strong.
11. The Fund has provided added value without making significant market distortion.