Scottish Loan Fund
Strategic Review and Economic Impact Assessment

FINAL REPORT TO

SCOTTISH ENTERPRISE

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A EXECUTIVE SUMMARY

A1 Scope

This document summarises the process, conduct, findings and recommendations from a Strategic Review and Economic Impact Assessment of the Scottish Loan Fund (SLF). The Review was commissioned by Scottish Enterprise (SE) and conducted by Malcolm Watson Consulting (MWC) between September 2016 and February 2017 and covered all of the loans completed between establishment of the SLF in March 2011 and 1st September 2016.

A2 Review Objectives and Process

The main **objectives** of the Review were to:

- Conduct a review of the current market conditions in which the SLF operates and assess whether there continues to be a rationale for intervention through the SLF in its current or amended format.

- Consider evidence of any market adjustment which has occurred in the period since the introduction of SLF, in the context of the niche market within which the SLF operates.

- Assess the net economic impact generated by the completed SLF loans made to 31 businesses in the period to 30th September 2016.

- Review the commercial performance of the Fund and compare actual performance against projections provided in the original Maven tender.

- Assess the value for money produced by the Fund taking account of costs incurred in management by Maven and SIB.

These objectives have been addressed through a research **process** consisting of:

- A review of information on the Fund and its client business performance.

- Consultations with 4 Stakeholders, 6 Limited Partners, Maven, 15 SLF client businesses and 11 SE Account Managers.

- A review and analysis of data and opinion on the market for finance for Scottish SMEs.

A3 FUND ESTABLISHMENT AND LAUNCH

The SLF was established for an initial period of 10 years with the potential for 2 separate one year extensions. The first 5 years would be the "Commitment period" when funds would be deployed across recipient companies, with the remaining 5 years predominantly time to allow loans to be repaid.

In order to attract private sector investment, alongside the Scottish Enterprise/ERDF commitment, an external Fund Manager was required. Maven Capital Partners were appointed as Fund Managers following an OJEU Procurement process.

Following approval by SE and the procurement of Maven as Fund Managers the first call for funds from investors (subsequently Limited Partners in the Fund) closed on 18th March 2011 with total commitments of £94.202m. A second and final call closing in March 2012 brought an additional £18.987m bringing the total Fund value to £113.189. Six commercial Limited Partners (LPs) (4 banks and 2 Scottish Pension Funds) committed £57m of this total to the Fund.

Following launch the first drawdown from the SLF LPs was made on 29th July 2011 and the first loan was completed on 31st August 2011.

A4 FUND ACTIVITY AND PERFORMANCE

An analysis of Fund activity was prepared based on data provided by SIB and Maven. Over the Review period 31 SLF client businesses drew down loans to a total value of £68.9m. Income from these loans totalled £8.1m and the IRR on exited loans at the date of the Review was assessed at 17.6%. Over the Review period 12 of these loans totalling £28.4m were repaid and there were three defaults at net cost of £6.2m.

The run-rate of the Fund has been behind both projections based on market-research and the expectations of stakeholders and LPs. This has been attributed to the launch of an innovative product (with limited awareness amongst potential beneficiaries) in a niche market, and the prevailing difficult economic conditions in the early years of the Fund, combined with the unexpected and ongoing challenges in the oil and gas sector.

SLF client businesses were largely satisfied with the operation of the Fund and the activities of the Fund managers (Maven) at both application and approval stages, and through ongoing loan and relationship management. Maven was valued by many for the insight and assistance provided in areas including accounting procedures, governance and identification of potential Non-executive directors.

The LPs were wholly satisfied with the performance of Maven and in particular the detail of management information provided, and responses to requests and suggestions they made.

A5 MARKET ADJUSTMENT

The Fund was established to address a perceived market failure in provision of mezzanine finance to Scottish SMEs. Initial market adjustment occurred in attracting commercial banks and pension funds to invest in the Fund, although it is apparent that, whilst they anticipated a return on investment, their rationale for involvement included aspects of corporate social responsibility. Market adjustment, in the form of more commercial provision of mezzanine finance to Scottish businesses, has not to date occurred to any significant extent.

It is considered by SIB, Maven, and the Limited Partners that a run rate of c£10m p.a. is representative of the market for the product in Scotland. Most LPs consider that there remains a rationale for provision of a product like SLF in Scotland – but are not planning any new direct provision themselves (Santander currently do offer a product in the market). Moreover at the time of consultation, the LPs appeared unlikely to commit to either an extension of SLF or a successor. This was borne out after the completion of these consultations, with the Fund commitment period closing as expected in March 2017.

A6 ECONOMIC IMPACT

The SLF client businesses are or have been originally headquartered in Scotland and have high concentrations of economic activity and employment within Scotland restricting the potential for leakage of economic benefit outside Scotland. They also have high proportions of sales outside Scotland. Significant proportions of the businesses' competitors are located outside Scotland ensuring limited displacement of economic activity in Scotland.

The primary attraction of SLF was the non-dilution of equity in the businesses, although flexibility on the repayment of capital was also an important consideration for some businesses.

In the absence of SLF funding two-thirds of businesses would not have grown at the same rate as with SLF - with 40% saying they would have contracted and 20% saying they would have grown at a slower rate. The remaining third considered their business would have performed in much the same way in the absence of SLF. No business stated that it would have ceased operating if SLF had not been available.

Two-thirds of businesses consider SLF to have been more or much more important to the development of their business than other support they have received. SLF was reported to be particularly effective in driving growth and facilitating step changes in business development.

The EIA results relate to 21 of the 31 loans made through the SLF over the evaluation period. The loans which have been excluded from the EIA are those where:

- The loan period has been less than one year (4 cases)
- The business is in administration or has been dissolved (3 cases)
- The business has demonstrated significant reduction in revenue over the period up to and during SLF loan (2 cases)
- Efforts to secure consultations with the business or a proxy have not been successful and there is insufficient data from other sources to make a judgement on key determinants of economic impact (1 case)

For the avoidance of doubt it should be noted that the financial performance of all of the cases excluded from the EIA **have** been included in the assessment of the financial performance of the Fund and the associated value for money assessments.

Overall, the assessment suggests a potential economic impact for these 21 cases in **Net Additional GVA terms of £61.6m in monetary values and a £50.4m Net Present Value in 2011** (the year SLF was launched). These benefits have been assessed on loans made between 2011 and 2016 and will persist up to 2026 (10 years from the date of the last loan made in 2016).

This estimated GVA has been generated from loans advanced to a total monetary value of £50.4m. The net value of loans advanced *less* loans repaid is £29m. A Value for Money (VFM) calculation has been prepared based on the total cost of the SLF to the public sector and includes defaults, Fund Management costs and SIB internal management cost. **VFM is currently assessed at a Net Additional GVA to public sector net cost ratio of 2.68:1 – although this is based on capital at risk at the date of the evaluation – and has the potential to will improve as and when outstanding loans are repaid.**

The economic impact model provides for the assessment of gross but not net additional employment. The data indicates **an increase of 505 in the gross employment** within the SLF client businesses over the evaluation period.

A7 CONCLUSIONS

SLF has addressed a market failure and assisted in establishing the potential scale of demand for the Fund at around £10m per annum – around 50% of the run rate and total value of the original 5-year £113m SLF.

The volume of lending has been well behind projections based on market research and expectations of stakeholders and LPs. This is attributed to an innovative product trialling in a niche market in challenging economic times.

LPs and Stakeholders consider there to be a continuing but lower level of demand for a Mezzanine Finance product in this deal space at a rate of c£10m per annum. There is limited evidence, however, of market adjustment to deliver commercial provision of a similar Mezzanine finance product in the Scottish market.

There are significant costs attached to managing a Fund like SLF which suggests that it might be difficult for a lower value Fund operating at £10m pa to cover management costs and provide a commercial return to investors.

The economic impact of the SLF to date has been in line with expectations, given the nature of the intervention and is based mainly on time additionality. There is significant potential for an improvement in VFM as costs are reduced by income and capital repaid at loan maturity. There is also potential for the costs to rise if further defaults occur.

SLF has been shown to address a market need and facilitate economic development. Rapidly growing businesses and effective entrepreneurs require access to a range of financing options as they evolve. The use of mezzanine finance can allow a business to balance the requirements of existing lenders and equity investors with the need to progress the business to a point where it can exploit a market opportunity and/or secure its next round of funding.

Whist the SLF will not be continued in its current format we consider that the facility to provide a mezzanine finance solution should be retained as part of the SIB toolkit of investment support.

A8 RECOMMENDATIONS

In the light of the collective decision of the SLF Stakeholders and Limited Partners not to continue the SLF, our recommendations are generic – and relate *not to the SLF per-se* but to Mezzanine Finance and the design and implementation of stand-alone funds.

In relation to **Mezzanine Finance** we recommend that:

- SIB continues, with others, to promote the concept and facilitate the provision of mezzanine finance in Scotland as an important contributor to the progression and development of rapidly growing businesses.

In relation to **stand-alone investment and loan funds**:

- Research into the anticipated scale and demand for the fund product considers the potential for economic shocks and makes provision in the structure, management, and investing principles of the fund to respond to such shocks.

- The relationship between scale of the fund, investment run rate and costs of third party fund management should be fully reflected in the design and establishment of any fund. Provision for legacy management of investments or loans, beyond the investing/lending phase of the fund, should be fully reflected in assessing management costs and long term returns to the fund.

- The fixed costs of individual investment/loan due diligence and ongoing management is proportionate to the scale of investments and loans. This is likely to require a minimum scale of investment or loan value by the fund, unless arrangements can be put in place to streamline approval and ongoing management costs for smaller loans/investments.

1. INTRODUCTION

1.1. General

This document reports the process, conduct, findings and recommendations from a Strategic Review and Economic Impact Assessment for the Scottish Loan Fund (SLF).

The Review was commissioned by Scottish Enterprise (SE) and conducted by Malcolm Watson Consulting (MWC) between September 2016 and February 2017 and covered all of the loans completed between establishment of the SLF in March 2011 and 1st September 2016.

1.2. The Scottish Loan Fund

The SLF, established in March 2011, is a Scottish Limited Partnership with total contributions of £113m at its final closing in March 2012. The Fund was initiated by the Scottish Government Economic Recovery Plan in response to the 2008 Financial Crisis in conjunction with SE (supported by Highlands and Islands Enterprise (HIE) and the European Regional Development Fund). In total 6 private sector funders invested in the Fund (4 banks and 2 pension funds). The SLF is managed on behalf of the contributors by Maven Capital Partners UK (Maven), who were appointed following a procurement process.

The Fund provides loans of between £250,000 and £5m to businesses located in Scotland. The SLF loans are classified as a form of mezzanine finance. Mezzanine Finance sits between debt and equity financing, and is often used to finance expansion of existing companies. Mezzanine financing operates in a similar way to a bank term loan but ranks behind it from a security perspective. SLF is a flexible form of funding with each facility structured to meet the needs of the company in question. This includes loan terms of between 3 and 7 years, with capital repayment holidays available to help repayments fit with cashflow projections.

The SLF is available to SMEs with an established operating base in Scotland. Sustainable operating profits and positive cash generation are generally required in order to service such a loan and ideally Maven look for annual turnover of £1m in the preceding 12 months of trading.

To comply with ERDF eligibility requirements, and lending policies of the other Limited Partners, loans cannot be made to businesses operating in certain ineligible industry sectors referred to as "restricted sectors". The list of restricted sectors current at the date of this report is included at **Appendix 1** to this report.

SLF Loans are made to facilitate Capital Expenditure, Working Capital, Development Capital and Overseas Market Development. As of September 2016 loans had been made through the Fund to 31 businesses.

1.3. Review Objectives

The main objectives of the Review, as identified in the assignment brief, were to:

- Conduct a review of the current market conditions in which the SLF operates and assess whether there continues to be a rationale for intervention through the SLF in its current or amended format.

- Consider evidence of any market adjustment which has occurred in the period since the introduction of SLF, in the context of the niche market within which the SLF operates.

- Assess the net economic impact generated by the completed SLF loans made to 31 businesses in the period to 30th September 2016.

- Review the commercial performance of the Fund and compare actual performance against projections provided in the original Maven tender.

- Assess the value for money produced by the Fund taking account of costs incurred in management by Maven and SIB.

These objectives have been addressed through research consisting of:

- A review of information on the Fund and its client business performance.

- Consultations with Stakeholders, Limited Partners, Maven, SLF client businesses and their SE Account Managers.

- A review and analysis of data and opinion on the market for finance for Scottish SMEs.

1.4. Review Report Structure

The remainder of this report is structured as follows:

- **Section 2** outlines the Review approach and method.

- **Section 3** traces the rationale for the SLF, its establishment, operation and performance up to the date of the Review.

- **Section 4** summarises our aggregate consultation findings amongst the SLF Client businesses.

- **Section 5** provides our assessment of the potential economic impact from SLF loans made from Fund establishment in 2011 through to September 2016.

- **Section 6** presents our conclusions on the operation of the Fund to date, an assessment of the continuing rationale for public sector intervention in the funding market for Scottish SMEs through the SLF and recommendations for any future operation of the Fund.

2. REVIEW METHOD

2.1. General

In this section of the report we summarise the method used to conduct the Review. This was set out in our response to the Review brief and subsequently adopted without amendment at the Review inception meeting.

2.2. Method

Our method incorporated the following core tasks:

- An inception process to refine the method, access data and conduct initial analysis of data on fund performance.
- A research and design programme including strategic consultations, design of questionnaires and topic guides and review of SIB research into the corporate finance market environment.
- Consultations with SLF client businesses and their SE Account Managers.
- Consultation with the Fund's Limited Partners and stakeholders including SE, Scottish Investment Bank (SIB) and Scottish Government (SG).
- Design and population of a case-by-case Economic Impact Assessment model with assumptions informed by research amongst the SLF businesses and their Account Managers.
- Synthesis of the collective research findings to produce the draft final report. Refinement of the draft report following feedback from SIB and SE to produce the final report.

2.3. Review Research Sources

In the course of the research MWC were variously provided by SIB, SE and Maven with:

- Background papers on the development and approval of the SLF.
- Data on the business performance of the SLF clients based on the most recently available financial reports.
- Copies of the Fund Manager reports.
- SLF client company contact information.

MWC conducted a total of 37 consultations in the course of the research as detailed in **Table 2.1**.

Table 2.1: SLF Consultation Programme			
Consultee Group	**Telephone**	**Face to Face**	**Total**
Stakeholders	-	4	4
Funding Partners	3	3	6
SLF Client Businesses	8	7	15
Account Managers	11	-	11
Fund Manager	-	1	1
All	**22**	**15**	**37**

3. SLF RATIONALE, ESTABLISHMENT & OPERATION

3.1. Introduction

This section of the report traces the evolution of the SLF from rationale through establishment and securing of funding, to activities in the period up to September 2016.

3.2. Rationale and Approval

The concept of a Scottish loan fund to be established and part funded by the public sector emerged during a period which saw severe constrictions in the supply of corporate finance across the range of providers. These constraints had persisted in the wake of the global financial crisis of 2008, as large parts of the UK banking sector were bailed out by the UK Government and were required to re-build their balance sheets and restore liquidity.

The rationale for a Scottish loan fund was set out in a Paper submitted to the Scottish Enterprise Board in March 2010[1]. The paper noted that

"There has been a substantial reduction in the number of banks leading to a substantial reduction in the quantity of debt capital available with the surviving remaining banks deploying more challenging lending criteria. In this environment many companies are struggling to access the debt capital they need to grow their business".

The consequence of these restrictions were assessed in the Paper as having particularly severe implications for higher risk investments in, ambitious, growing businesses:

"There is an increasing gap in the supply of higher risk debt for those firms unable to satisfy the banks' now tighter risk criteria. The drive by banks to repair their own balance sheets together with the impact of further regulation makes it unlikely that they will return to serve that higher risk/return lending market at least in the medium term. The resultant reduced supply of finance is particularly impacting those cohorts of ambitious growth and exporting firms which have most to contribute to our economic recovery and growth.

The response to this restriction in supply was a proposed SIB loan fund pending return to the market by commercial lenders. This fund was intended to facilitate market adjustment by demonstrating viable demand for a higher risk debt product for use by fast growing businesses – characterised as Mezzanine Finance[2].

"The intention of the SIB loan fund is to help speed up this adjustment process by demonstrating to banks and others that there is sufficient viable demand for this type of debt product and sufficient commercial returns to be made to encourage the banks and others to again fill this space in the market. The Fund(s) will operate for a defined period that we will determine in due course but should the market adjustment happen quickly the public sector could make an early exit. Alternatively if the market failure remains beyond the term of the original fund then the proceeds of the first fund can be recycled and used to create further funds until the market adjustment takes place".

[1] Scottish Enterprise Board SE (10)37. March 2010

[2] Mezzanine Finance is a hybrid of debt and equity financing normally used to finance expansion of existing companies. Mezzanine financing is debt capital with rights reserved to the lender to convert into an equity interest in the company under certain circumstances – for example if the loan is not repaid or the business is sold. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies.

Market adjustment would occur in two stages – first through attraction of private sector funding into the SIB loan fund and secondly through demonstration to private sector providers of the viability of lending to the market targeted by the fund leading to their future direct provision to that market.

The economic development impact for the SIB loan fund was summarised in the Paper as being generated from the Fund's capacity to:

- *help viable, ambitious firms in the short/medium term by providing access to commercially priced finance that they couldn't otherwise get;*
- *encourage in the medium/longer term the development of private sector supply of such products.*

These sources of impact, whilst not explicitly stated as two core objectives for intervention, encapsulate the rationale for intervention. They also form the core of this Review which is required to investigate: the scale and additionality of the economic benefits generated through the Scottish Loan Fund's loans to client businesses; and the extent to which market adjustment has occurred in the SLF target market.

3.3. Establishment and Funding

The Scottish Loan Fund was introduced as part of the Scottish Government Economic Recovery Plan in response to the 2008 Financial Crisis. Evidence from the Scottish Government's "Access to Finance" report (and elsewhere) highlighted a growing need to intervene in areas of the loan market where a significant number of growing and exporting businesses were experiencing difficulties in obtaining finance. This evidence gathered through a number of sources, (including the Scottish Government Access to Finance surveys, the Experian analysis of company borrowing and the Rowlands report) all pointed to unmet demand of significant scale. As such the SLF was intended to help support these companies. In addition, a second objective of the loan fund was to help speed up the market adjustment process by demonstrating to banks and others that there is sufficient viable demand for this type of debt product and sufficient commercial returns to be made to encourage the banks and others to again fill this space in the market.

The SLF was established for an initial period of 10 years with the potential for 2 separate one year extensions, the first 5 years would be the "Commitment period" when funds would be deployed across recipient companies, with the remaining 5 years predominantly time to allow loans to be repaid with a limited investment into existing SLF portfolio companies.

In order to attract private sector investment, alongside the Scottish Enterprise/ERDF commitment, an external Fund Manager would be required. The Scottish Government/Scottish Enterprise project team undertook a full procurement process for external Fund Managers to operate the Loan Fund. A notice was published in March 2010 to alert the supply market to the opportunity and an Information Session was held on 17th June 2010 which was attended by some twenty five interested Fund Managers.

A Contract Notice was then published in the OJEU and eleven firms completed Pre-Qualification Questionnaires. Following the evaluation of these, three suppliers were invited to participate in the dialogue stage of the process. Two submissions to this invitation were received, from Maven Capital Partners UK LLP and from one other fund manager. Invitations to submit Best and Final Offers (BAFOs) were issued on 24 December 2010 and the responses received on 7 January 2011. The evaluation process then took place, including further diligence on the assumptions, models and all other aspects of the BAFO submissions. This model detailed for investors a number of metrics including the expected return to investors. Following this evaluation process Maven Capital Partners were appointed external fund managers for the Scottish Loan Fund.

Following approval by SE and the procurement of Maven CP as fund managers the first call for funds from investors closed on 18th March 2011 with total commitments of £94.202m. A second and final call closing in March 2012 brought an additional £18.987m bringing the total Fund value to £113.189.

The Limited Partners in the SLF and their respective contributions are detailed in **Table 3.1**.

Table 3.1: Limited Partner Commitments to SLF At Final Close

Partner	**Funds committed at 31 March 2012**	
	£m	**%**
Scottish Enterprise	55	48%
Clydesdale Bank	5	4%
Strathclyde Pension Fund	10	9%
RBS	11.319	10%
Lloyds	11.319	10%
Santander	9.42	8%
North East Scotland Pension Fund	10	9%
Maven Co-Invest	1.132	1%
Total commitment	**113.19**	**100%**

Following launch, the first drawdown from the SLF was made on 29th July 2011 and the first loan was completed on 31st August 2011.

3.4. Review and Economic Impact Assessment 2014

MWC undertook a Market Review and Economic Impact Assessment of the SLF in 2014. This was undertaken to coincide with, and support, a three year review undertaken by Maven as Fund Managers. The MWC work was commissioned to:

- Consider the progress of the Fund in lending to client businesses.
- Project potential for commitment of the whole Fund by the end of its planned investment period (then March 2016).
- Assess the potential net economic impact of lending to April 2014.
- Re-visit the rationale for the SLF in the context of the then current (2014) SME finance market in Scotland.

The total committed at the time of the review in April 2014 was £39.4m – equivalent to 35% of the £113.2m total fund. Information on total funds expended (i.e. drawn down by SLF clients against the agreed total commitment) showed a total loan value drawn down of £27.2m equivalent to 24% of the Fund value. Projections based on loan run rates (the number and value of loans agreed) and draw-downs (the value of loans taken up by SLF clients) to April 2014 suggested that total funds *expended* by end 2018 would have been c£80m.

The review, and the parallel work undertaken by Maven, resulted in a series of recommendations for implementation over the remaining investing life of the Fund. These were in summary:

- SIB, SE and the other Fund LPs should support, where possible, the Fund Managers in implementing their suggested actions to increase the run rate of enquiries and their conversion into completed loan deals.
- SIB should closely monitor the monthly enquiries, conversions and deal flow based on suitable data submitted by the Fund Managers, and continually update projections against Fund targets up to the end of 2015.
- SE and SIB should also monitor SLF activity to ensure achievement of required eligible ERDF *expenditure* levels.
- The Fund Managers should continue to collect data *as it becomes available* on SLF client turnover, export performance, employment and accounting information required for the calculation of GVA (Employee Costs, Operating Profit, Depreciation and Amortisation).
- SIB should continue to monitor the market for Mezzanine Finance in Scotland to assess whether existing providers are gaining traction or new commercial providers are offering competitor products to Scottish SMEs.

As a result of both reviews a number of changes to the investment policy, as well as some new activities, were proposed, discussed and subsequently agreed by the SLF Investment Committee. These are summarised below:

- Extension of the commitment period.

  The Limited Partners agreed to extend the commitment period by a year to allow for greater deployment of funds, recognising the amount of time it had taken for the product to gain traction in the market.

- Allow an element of "cash-out".

  This increased flexibility to the use of the SLF allowed up to 25% of the loan to be used to support an exit or partial exit for existing investors. This was useful for companies where existing investors were not able to support the ongoing growth of the company, and also allowed the SLF to work more collaboratively with angel investors.

- Remove the alcohol restriction in the investment policy.

At the request of a private sector Limited Partner the SLF investment policy included a restriction on investment in alcohol. This was amended to allow up to 2 investments per year, taking on board feedback that a number of distillers had been in contact with the SLF[3].

- Increased flexibility in turnover criteria.

  In order to ensure that the companies starting discussions with SLF were in a position to service a loan and recognising that company growth can be sporadic, criteria had been included to ensure that the SLF supported companies generating turnover of at least £1m in the preceding 12 months. Flexibility was increased by allowing Maven to support companies which had not actually achieved this level but which had contracts in place giving sight of this turnover level.

It was also agreed that Maven should undertake some enhanced demand stimulation work. As such an external company was engaged by Maven to undertake a review of the market and identify any companies which could potentially benefit from the SLF.

Another aspect which was discussed within the Investor Committee and with Maven as Fund Manager was the possibility of minimising diligence costs. As such Maven entered into discussions with a number of diligence providers and agreed framework rates, as well as agreeing template legals with providers.

3.5. Fund Activity to September 2016

MWC were provided with the Maven Limited Partner's Management Report for the period to end September 2016 and have used the data in this report to conduct a review of Fund Performance.

The key performance data for the Fund is summarised in **Table 3.2**.

Table 3.2: SLF Portfolio Commercial Performance to 30/09/2016

	Number	Value
Loans Committed since Establishment	31	£75,517,500
Loans Drawn Down since establishment	31	£68,851,500
Current Committed Loans	17	£45,862,500
Current Drawn Down Loans	17	£39,196,500
Repaid Loans	12	£28,385,073
Defaults	3*	-£6,193,994
Capital Repaid to Date		£28,385,073
Income Received to Date		£8,140,688
Internal Rate of Return on Exits		17.60%
Default Rate (Defaults as % Total Drawn Down)		9.00%
Total Fund Available for Lending		£113,190,000
Committed Loans as % of Total Fund		66.7%
Drawn Down Loans as % of Total Fund		60.8%

* Includes one loan still recorded as currently drawn and committed where business in administration.

[3] No SLF loans were actually made to businesses producing alcohol.

This analysis shows a total of £68.85m of funds *drawn down* in loans since establishment of the Fund in 2011 in 31 loans. This equates to just under 61% of the total Fund resources available for lending. The level of Funds *committed* at £75.5m equates to two thirds of the Fund resources. On average 91% of committed loan value has been drawn down. We have assessed defaults to September 2016 (where loans have not been repaid or are anticipated not to be repaid) at 9% of the total value of loans drawn down at that date. In the model submitted as part of the procurement process the default rate was forecast to be 10%. This was considered to be within market norms by the diligence providers who reviewed the model on behalf of Scottish Enterprise.

It should be noted that the IRR of 17.6% quoted relates to income and capital receipts on those loans which have been fully repaid at September 2016, and also accounts for defaults. This is above the 10% IRR set for the Fund at its inception. The IRR on the whole Fund can only be assessed at the end of the Fund life (with all loans at maturity) when total income, capital receipts and losses to the Fund over its lifetime are quantifiable. At the close of the Fund it will be possible to fully judge commercial performance against the forecast IRR of 10%.

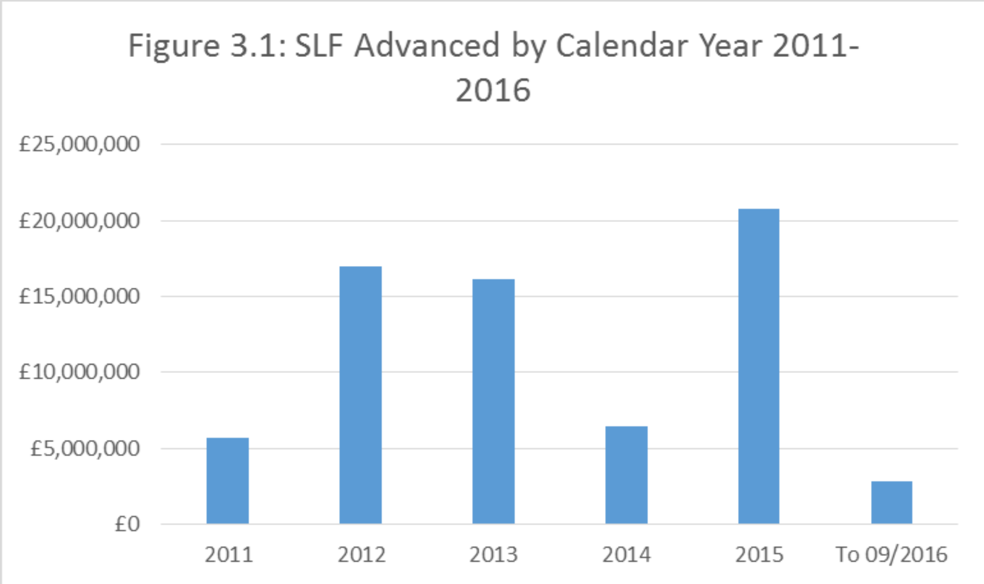
We have conducted an analysis of Fund drawn-down loan values by calendar year which is detailed in **Table 3.3**.

Table 3.3: Scottish Loan Fund Loan Activity Analysis to 30th September 2016 (Drawn down values)

	2011	2012	2013	2014	2015	To 09/2016	All Years
No of Loans	2	6	8	4	9	2	**31**
Total Loan Value	£5,725,000	£17,012,500	£16,130,000	£6,450,000	£20,734,000	£2,800,000	**£68,851,500**
Average Loan Value	£2,862,500	£2,835,417	£2,016,250	£1,612,500	£2,303,778	£1,400,000	**£2,221,016**
Median Loan Value							**£1,700,000**
Largest Loan Value							**£5,000,000**
Smallest Loan Value							**£425,000**

This analysis produces an average drawn down loan value over the period to September 2016 of just over £2.2m with a range of values from £425,000 to £5,000,000 (the ceiling value for individual loans through the SLF). This analysis, and the Median loan value of £1,700,000 suggests that the majority of Loans have been well above the lower limit for the SLF of £250,000.

Figure 3.1 shows the pattern of lending over the life of the SLF to date. It should be noted that the 2016 figure is for lending activity to September 2016.



It is apparent that the value of advances over this time has varied significantly from year to year with the greatest consistency over 2012 and 2013 and a significant spike in 2015. It is likely that the variability in advances reflects in part the niche market within which SLF operates and the relatively small potential client base from which opportunities to lend can arise from.

We also conducted an analysis of the terms of the loans advanced through the SLF and of those instances where, at September 2016, the loan had been repaid early.

The 31 loans arranged through SLF had an average term of 59 months. The longest term arranged was 84 months and the shortest 6 months. Of the 31 loans 9 (31%) had been repaid early as at September 2016. On average these repaid loans had run for 37% of their term and were repaid between 10 and 61 months early. Early repayments were most often the result of acquisition of the borrowing business by a third party or a re-financing of the borrowing business.

3.6. SLF Market Context

On its introduction to the Scottish corporate finance market in 2011 the SLF was an innovative and niche product combining elements of debt and equity provision. At the time of its introduction there was no alternative offered in Scotland by the private sector.

Pre-launch, the Scottish Government and Scottish Enterprise conducted significant market research in the course of designing the SLF, arriving at an estimate of around £20m of demand per annum for the product over a 5 year lending period. This was the basis upon which European Funding was secured and total public sector funding of £55m used to lever in a further £58m of commitment to the Fund from the private sector Limited Partners.

The SLF was launched in the aftermath of the 2008 Global Financial Crisis and entered a Market where traditional bank lending to business was severely constrained as banks were regulated to increase reserves and restore their balance sheets.

Because of the innovative nature of SLF there did not exist a history of lending through mezzanine finance products in Scotland. Today the Scottish market is still sparsely populated with mezzanine finance products, with only one established product being delivered by a commercial provider (Santander) who is also an SLF Limited Partner, but SIB are not aware of any use of the product in the Scottish market.

3.7. Market Adjustment

At conception it was anticipated that SLF might engender market adjustment in two ways.

- The first was to engage private sector investors in the market by becoming Limited Partners in the Fund.

- The second was to demonstrate to a wider group of commercial loan finance providers that a market existed in Scotland for a mezzanine finance product thereby encouraging them to enter this market.

The first of these two forms of adjustment has been achieved through the securing of £58m of commitment to the Fund from the private sector Limited Partners. In our consultations with the LPs we explored their rationale for committing to the SLF. From these consultations it was apparent that the Limited Partners saw the SLF in part as an expression of corporate social responsibility and as a means of committing additional loan finance to the Scottish market within containable levels of risk exposure. They considered that the SLF would probably not generate significant returns but offered a low risk means of contributing additional funds to the corporate debt market in Scotland.

The response of commercial lenders to the opportunities which exist for provision of mezzanine debt in Scotland has been more muted. There is a commercial provider of mezzanine finance in Scotland (Santander) but they have reported that demand has been at a low but steady level.

It is interesting to note that all of our LP consultees considered there remained a case for the provision of a mezzanine product in Scotland (as a niche product for certain businesses at a specific stage in their development) but that none (excluding Santander and the two Pension Funds) had any plans to do so. It was also apparent from our consultations that the LPs were non-committal about their potential involvement in an extended or successor SLF. This should be seen in the context of wider LP considerations around capital adequacy - which relates to the amounts of available capital that Banks or other financial institutions have to hold as required by the financial regulator. This is expressed as a capital adequacy ratio and measures the amount of capital a bank retains compared to its risk. It is an important consideration for the LPs as it is a key measure of the financial soundness of a bank.

Subsequent to these consultations, a joint decision was taken by the LPs not to extend or support a successor Fund.

3.8. SLF Market Reach and Spread

The SLF is a pan-Scotland product available to eligible SMEs in the SE and HIE area. We conducted an analysis of the application of loans by geographic location and business sector. It should be stressed that there was no requirement on the Fund Managers to lend in specific areas and the only restrictions on sector investment related to non-eligible activities as a result of European Structural Fund support to SLF and a small number of specific sector restrictions included by private sector partners for commercial and reputational reasons (see Appendix 1). One example of this was an initial restriction on lending to companies involved in alcohol.

However, this subsequently changed as there was a demand from distillers. The Fund was operated on a commercial basis and tasked with generating returns for the LPs based on viable opportunities.

The loans have been provided to businesses across Scotland operating in a range of sectors as detailed in **Table 3.5**.

Table 3.5: SLF Lending by Sector and Location 2011-2016					
Analysis by Sector			**Analysis by Location**		
Sector	**Loan Value Advanced**	**% Total Advanced**	**Location**	**Loan Value Advanced**	**% Total Advanced**
Oil & Gas Services	£26,975,000	39.2%	Aberdeen	£31,775,000	46.2%
Software	£11,959,000	17.4%	East Lothian	£1,500,000	2.2%
Telecommunications	£7,450,000	10.8%	Edinburgh	£3,575,000	5.2%
Printing	£5,000,000	7.3%	Fife	£3,500,000	5.1%
Shipping	£4,800,000	7.0%	Glasgow	£9,459,000	13.7%
Manufacturing	£4,112,500	6.0%	Highland	£800,000	1.2%
Life Sciences	£2,750,000	4.0%	North Ayrshire	£550,000	0.8%
Educational Supplies	£2,200,000	3.2%	North Lanarkshire	£2,200,000	3.2%
Electronics	£1,680,000	2.4%	South Lanarkshire	£12,992,500	18.9%
Education	£1,500,000	2.2%	Stirling	£500,000	0.7%
Business Services	£425,000	0.6%	West Lothian	£2,000,000	2.9%
Total	**£68,851,500**	**100.0%**	**Total**	**£68,851,500**	**100.0%**

This analysis demonstrates the high proportion (by value) to date of lending which has occurred in Aberdeen (all of which has been in the Oil & Gas services sector with the exception of a shipping business serving the Oil and Gas industry).

3.9. Fund Administration & Management

In the course of our research amongst the SLF Client Businesses and Limited Partners, we asked about their experiences of working with Maven. The findings for each of the Groups are summarised below.

3.9.1. SLF Client Businesses

We asked the client businesses to rate a range of aspects of the SLF application and approval process against other experience they had in applying for and securing finance for their businesses. The results are presented in **Figure 3.3**.

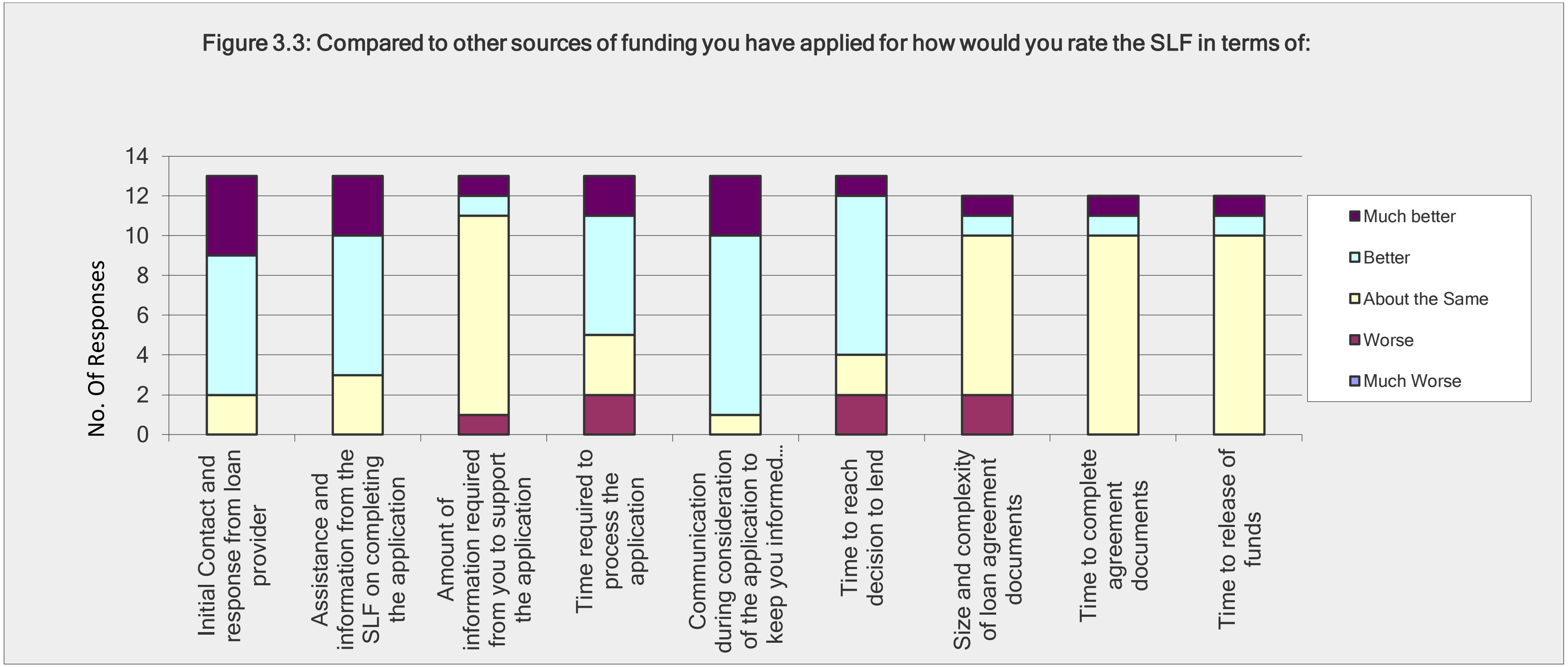


Figure 3.3: Compared to other sources of funding you have applied for how would you rate the SLF in terms of:
No. Of Responses
14
12
10
8
6
4
2
0
Initial Contact and response from loan provider
Assistance and information from the SLF on completing the application
Amount of information required from you to support the application
Time required to process the application
Communication during consideration of the application to keep you informed…
Time to reach decision to lend
Size and complexity of loan agreement documents
Time to complete agreement documents
Time to release of funds
Much better
Better
About the Same
Worse
Much Worse

Analysis of these responses suggests that, for the majority of respondents, the SLF process has been similar to that for other sources of finance they have experienced. Areas where the SLF has been noticeably better include; initial contact and response, communication during consideration of the application and time taken to reach a decision to lend. Areas where it has been perceived by a small minority to be worse are the amount of information required to support the loan; the size and complexity of the loan agreement documents; and the time required to process the loan.

We asked the SLF client businesses if they had any particular issues about the management or administration of their SLF loan. All but one of the businesses reported that they had no specific issues in their relationship with Maven. The exception reported involvement in governance, operational and accounting aspects of their business.

A number mentioned the requirement for regular performance monitoring information but recognised that this was a necessary part of the investment relationship. Several commented that Maven had been challenging in reviewing the performance of their business but summed their approach up as firm but fair. One respondent commented that Maven had been supportive at a time of stress for the business, when loan repayments had been suspended.

We asked the SLF clients to highlight any aspects of their relationship with the Fund Managers which they considered to be good practice. We received positive responses from many of them. The aspects identified as good practice included:

- An application process which was transparent and streamlined. One respondent commented that although the process took several months Maven were clear on the process, stuck to an agreed plan and managed expectations throughout. Two others considered that Maven were strongly committed to both the deal and the business from the outset, and remained focussed on getting to completion.

- Overall, due diligence was considered thorough (and, for a few, took too long) – but generally was reported, by those with experience of due diligence elsewhere, as being more efficient and better packaged.

- Over the course of the loan, high levels of interest in and commitment to the business were reported along with constructive participation by Maven on the Board. This commitment was evident from an early stage with a focus on getting the loan in place. One respondent characterised Maven as being well informed, proactive and adding value to the business.

- Several of the respondents took this question as an opportunity to state that they considered the SLF to be an important part of the business finance landscape in Scotland, offering a form of finance that was not replicated elsewhere.

We also asked for suggestions for the improvement of the SLF and received a number of comments. The most commonly suggested improvement related to the costs of the loans – both in terms of interest rates charged and redemption premiums which are paid as a percentage of capital being repaid. Several respondents made reference to what they considered to be high costs of due-diligence. Two others suggested changes to the scale and scope of SLF loans, stating that there should be provision for SLF to make larger loans; and to lend to non SMEs (the latter not currently permissible due to the State-aid provisions attached to the European Funding component of SLF).

When asked, half of our respondents stated that Maven had assisted their business over and above arranging and managing their SLF loan.

Generally, this assistance had arisen from the input of Maven observers on their Boards - put in place as part of the conditions of the SLF loan. Several characterised their observers as active, engaged and offering insight. There was also a number of instances of Non-Executive Directors being suggested by Maven, and in one case a suggestion (taken up by the business) for a Chairman. None of the responding businesses had Maven provide assistance in helping them find further finance for their business, although one had Maven accompany them to meetings concerning a potential sale of their business.

3.9.2. SLF Limited Partners

In our consultations with the Limited Partners we asked those experienced in working with other Fund Managers to assess the relative performance of Maven in managing the SLF. Three of our respondents considered they had sufficient experience of working with Maven on SLF and another Fund manager to provide a response. Of these three, two considered the overall performance of Maven to have been better than experienced elsewhere and one considered it to have been on a par with other fund managers they used.

When asked to suggest particular good practice displayed by Maven, the Partners identified:

- Excellent, detailed management information packs, allowing the LPs to drill down into individual loan performance where they wished.
- Strong communications and quick and constructive responses to queries and suggestions.
- Good understanding of the corporate finance market and investor network in Scotland.
- A willingness to evolve and improve over the lifetime of the Fund evidenced by the streamlined due diligence process introduced in response to LP suggestions.

We specifically asked the LPs about the rate of draw-down from the Fund. All commented that the level of take up of SLF had been slower and lower than they expected and that it was clear that the Fund would not be fully distributed.

The main reasons the LPs identified for the lower than anticipated take were:

- The innovative nature of the product in the Scottish market place. This resulted in an initial and ongoing need to educate the market (borrowers, other providers of finance and third party advisors) on the nature and application of Mezzanine Finance - which is a novel concept for many businesses.
- SLF operating in a niche market (high growth, high export, limited number of sectors).

- Initial over-estimation of the scale of the market – with several respondents suggesting that the actual run rate of £10m - £11m of loans advanced per annum was now a natural and established level for this type of product within Scotland. Importantly one respondent noted that it might be difficult to maintain this run-rate in the future if the Oil and Gas sector did not recover.

- SLF being launched in the shadow of the 2008 Global Financial Crisis and continuing suppressed demand for corporate finance in the period during which SLF has been in the market.

We asked the LPs about their levels of satisfaction with the returns on their investments in the SLF.

Overall it was considered by the LPs that returns had fallen below expectations. This was widely attributed to the exposure to the Oil and Gas sector where client businesses had been subject to an unforeseen seismic market shock. One of the LPs felt that the run rate and scale of lending both needed to have been much higher to drive returns. It is, however, recognised (as noted in section 3.5) that the current level of return is in excess of the target set at the outset. A final conclusion on returns is difficult to assess at this stage in the life of the Fund).

Several LPs commented on the limited risk spread of the Fund – a function of the small numbers of loans and the concentration of lending in the Oil and Gas sector. The risk spread rendered the overall returns on the Fund vulnerable to failures of individual borrowers. The initial early levels of lending to Oil and Gas businesses was not criticised *per-se* – as the sector was buoyant in the early years of the SLF and offered the greatest opportunity for lending. It was only in hindsight that it could be seen to have contributed to a reduction in returns. One of the LPs commented that Maven had worked hard in later years to redress the balance of lending to the Oil and Gas sector.

Interestingly, one of the LPs commented that none of the commercial lenders had gone into the Fund with the expectation of making a lot of money.

3.10. Fund Management Costs

Maven were appointed as Fund Managers for the SLF after an EU compliant competitive tender process. They have recently provided SIB with an estimate of the total costs of their service provision of c£8.4m - on the assumption that the SLF is not extended beyond March 2017. This is equivalent to 11% of the value of Funds committed under SLF at September 2016.

SIB have provided an estimate of the resource assigned to the management of the SLF and this has been converted to a monetary value of £65,500 per annum using a standard conversion factor supplied by SE. On the same assumption as applied to the costs of the Fund Manager (i.e. that the Fund would not extend beyond March 2017), this would equate to a total cost of £393,000 between Fund Establishment and cessation of lending activity in March 2017. It is recognised that less intensive SIB Management of Maven will be required in the period after March 2017, before all remaining loans mature. To reflect this we have adopted a total figure of £460,000 as the estimated cost of SIB management to the closure of the Fund. This is based on an assumption that, c20% the annual cost of management of Maven by SIB during the active life of the Fund, will be incurred each year for a period of five years from March 2017.

Together, therefore, the costs of management of the SLF by the external Fund Managers and SIB staff is estimated at £8.86m over the lifetime of the Fund.

It is apparent from these costs that the operation of a Fund such as SLF requires intensive input from the Fund Managers and that Funds and associated lending activity have to be of a scale to both recover these costs and provide an acceptable return to investors.

3.11. Conclusions

From our analysis of the SLF's Rationale, Establishment and Operation we conclude that:

- The Fund was established to address a perceived market failure in provision of mezzanine finance to Scottish SMEs.
- Initial market adjustment occurred in attracting commercial banks and pension funds to invest in the Fund, although it is apparent that, whilst they anticipated a return on investment, their rationale for involvement included aspects of corporate social responsibility.
- Market adjustment, in the form of more commercial provision of mezzanine finance to Scottish businesses, has not occurred to any significant extent.
- The run-rate of the Fund has been behind both projections based on market-research and the expectations of stakeholders and Limited Partners. This has been largely put down to the exploration of a niche market with an innovative product, and the prevailing economic conditions in the early years of the Fund, combined with the unexpected and ongoing challenges in the oil and gas sector. The Fund is likely to have advanced less than 65% of its total value of £113m at the end of new lending activity in March 2017.
- It is considered by SIB, Maven, and the Limited Partners that a run rate of c£10m p.a. is representative of the market for the product in Scotland. Most LPs consider that there remains a rationale for provision of a product like SLF in Scotland – but are not planning any new direct provision themselves (Santander currently do offer a product in the market). Moreover at the time of consultation, the LPs appeared unlikely to commit to either an extension of SLF or a successor. This was borne out after the completion of these consultations, with the Fund commitment period closing as expected in March 2017.
- The SLF loans have shown particular concentrations in the Oil and Gas sector (40% by value) and the Software sector (17% by value). The Fund loaned to businesses across Scotland with a concentration of loans to businesses in Aberdeen, driven by opportunities in the Oil and Gas sector.
- LPs considered returns from the SLF to be below their expectations (although SIB considered returns to be on profile with anticipated returns at Fund establishment). Several LPS identified the exposure to the Oil and Gas sector as a contributory factor to this. However, LPs were not critical of the scale of lending to this sector – as it was where most SLF-appropriate deals were available in the early stages of the lifetime of the Fund. More generally, the smaller number of loans than anticipated is considered to have limited returns and heightened exposure to risk for the Fund.

- SLF client businesses were largely satisfied with the operation of the Fund and the activities of the Fund managers (Maven) at both application and approval stages, and through ongoing loan and relationship management. Maven was valued by many for the insight and assistance provided in areas including accounting procedures, governance and identification of potential Non-executive directors.

- The LPs were wholly satisfied with the performance of Maven and in particular the detail of management information provided, and responses to requests and suggestions they made.

- The costs of management of Funds such as SLF are significant, and reflect the expertise and resources required from the Fund Managers. In the case of SLF they will amount to c11% of the Funds committed which SIB considers to be in line with industry standard. Without the appointment of an external Fund Manager, the private sector financial commitment would not have been secured for this new market intervention. These costs need to be provided for out of the returns to the Fund, before distribution to the LPs.

4. BUSINESS CONSULTATION FINDINGS

4.1. Introduction

In this section of the report we summarise the aggregate findings from our research amongst the SLF client businesses. The following subsections report in aggregate the responses to a selection of the questions put to the SLF client consultees. Client-specific responses are applied in our assessments of additionality, displacement and leakage in the course of the EIA assessment reported in Section 5. We have previously reported responses from businesses on the effectiveness and value added by Maven as the Fund Managers in our comments on Fund Management in Section 3.

4.2. Extent of Consultations

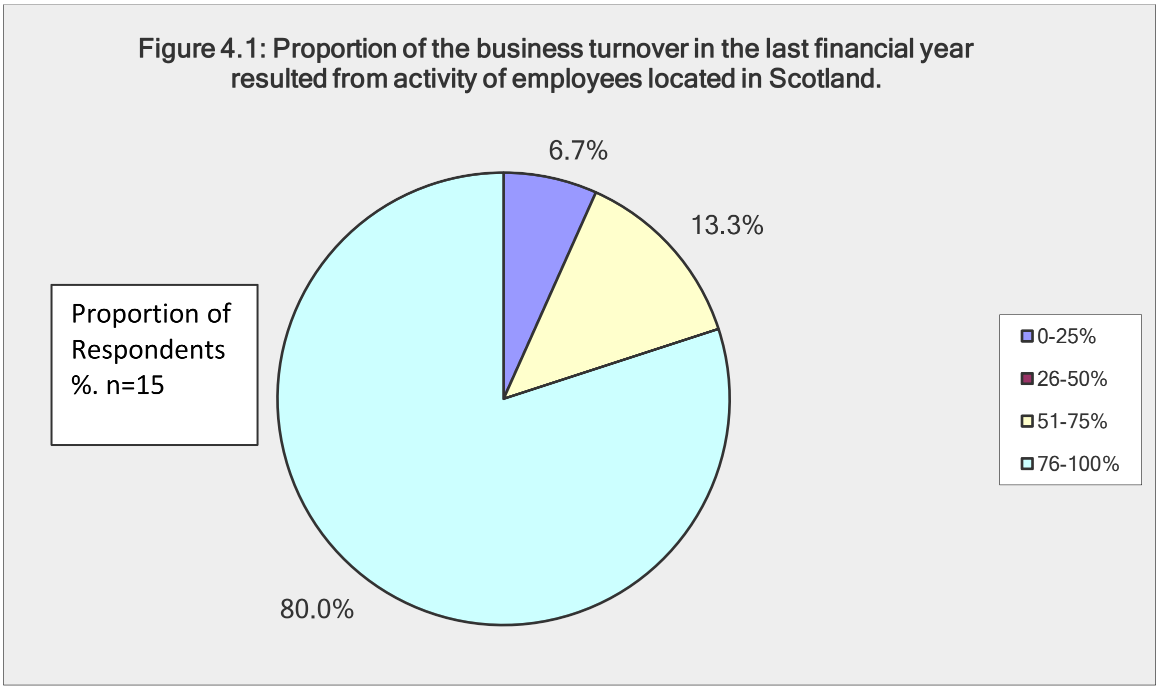
We secured consultations with a total of 15 SLF client businesses – just under 50% of the 31 businesses taking out loans. Consultations could not be undertaken with 3 businesses which were no longer trading at the time of the evaluation and one further business which we were asked not to approach due to prevailing sensitive negotiations at that time. Scottish Enterprise Survey Control restrictions excluded one further business from consultation. Out of a potential 26 businesses available for survey our consultations therefore represented 58% of the available businesses.

The responses reported in the remainder of this Section are from the 15 businesses who responded to requests to complete our survey.

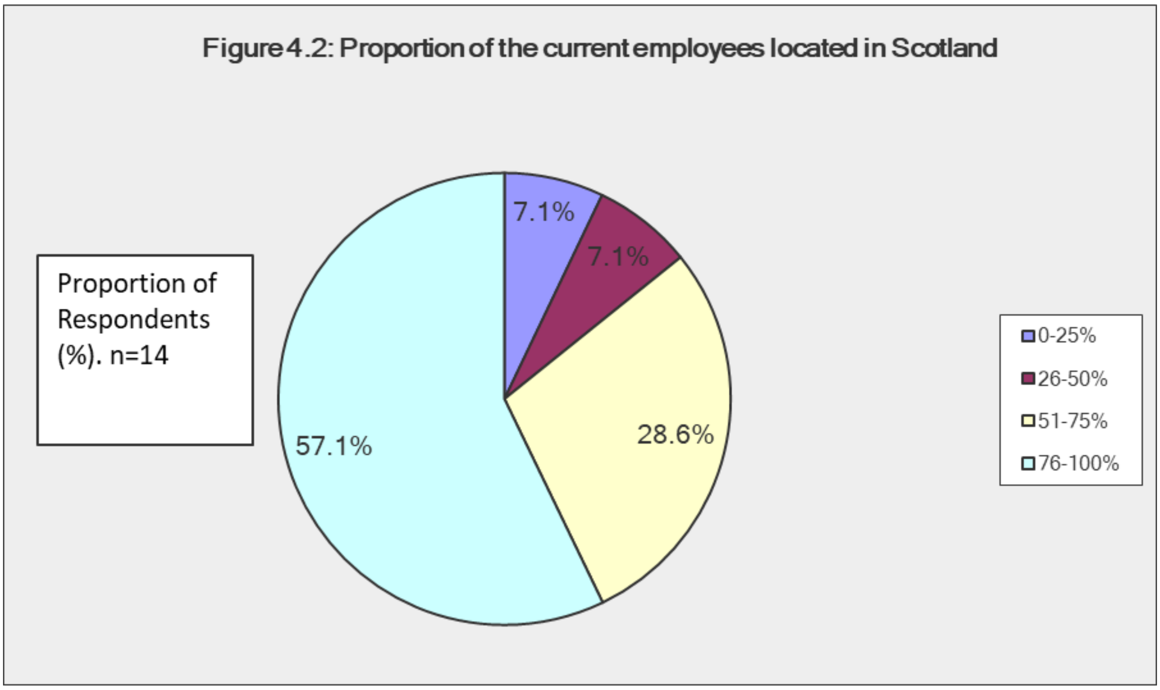
4.3. Business Activity in Scotland

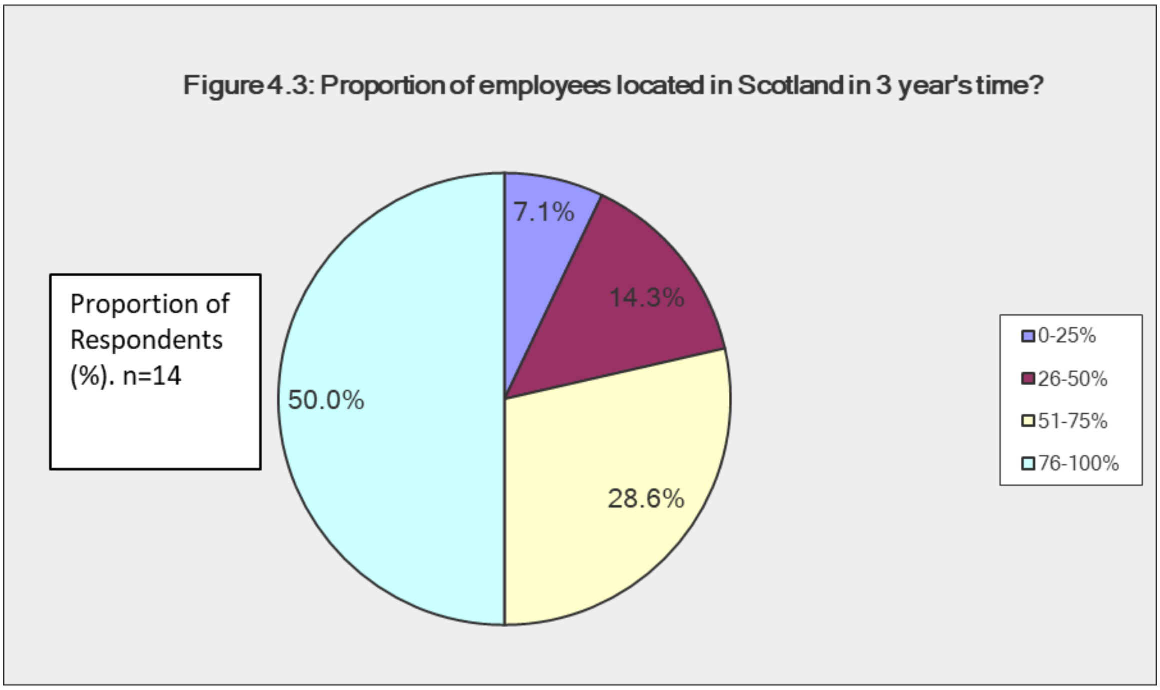
All but one of the 15 SLF client businesses we consulted were headquartered in Scotland. The exception had been acquired by a US business in the period since the SLF loan.

Figure 4.1 demonstrates the intensity of economic activity generated in Scotland with 80% of the consulted businesses generating over 75% of their turnover from employees based in Scotland.



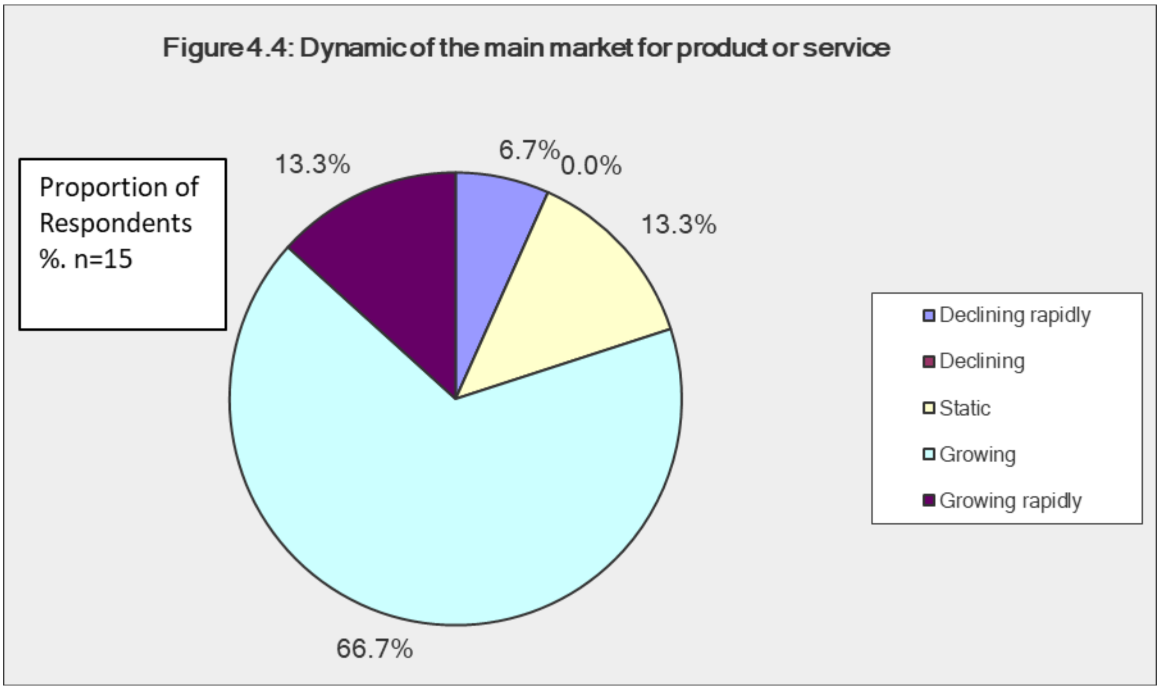
Twelve of the consultees advised on employment in the most recent financial year of 1,247 employees, with a projected increase of 7.1% to 1,334 in the next financial year. **Figures 4.2 and 4.3** record that 84% of businesses currently have more than 50% of their employees in Scotland and that this proportion is projected to reduce only marginally to 79% in three years' time.



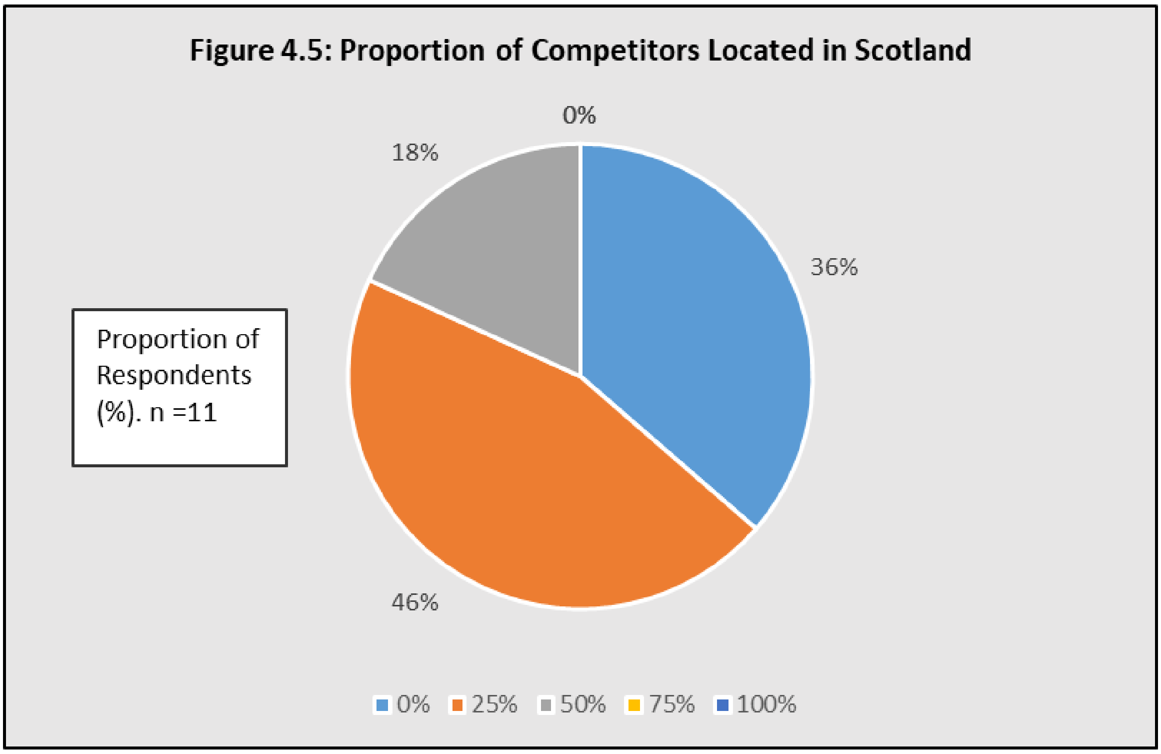


4.4. Markets and Competitors

The growth status of the markets the businesses operate in is an important determinant of the potential for SLF-funded activity to displace other economic activity in Scotland. As **Figure 4.4** illustrates a high proportion (80%) of the businesses we consulted considered their markets to be growing or growing rapidly.

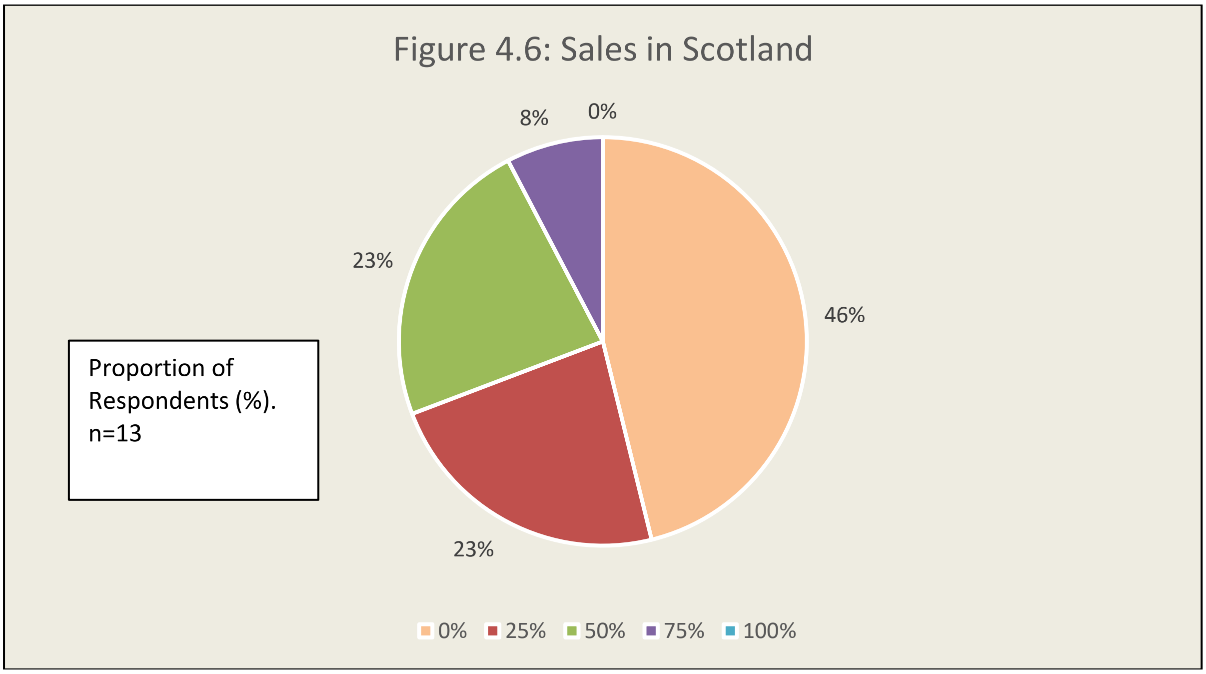


Another key determinant of the potential for displacement is the location of the competitors of the SLF Client businesses and this is illustrated in **Figure 4.5**.



Again this presents a positive picture from the consultees on displacement – with 82% of respondents having 25% or less of their competitors located in Scotland.

We also asked about the proportion of businesses' turnover generated from sales in Scotland. The results are illustrated in **Figure 4.6**.



This suggests the SLF client businesses are significant exporters with two-thirds deriving 25% or less of their turnover from sales in Scotland.

4.5. Attractiveness and Application of SLF

In the course of the consultations the businesses were asked what had attracted them to the SLF as a source of finance for their business. Their responses are detailed in **Table 4.1** (each respondent could select any number of reasons)

Table 4.1: Aspects of SLF Considered Most Attractive to Businesses. (N=14) (Multiple Responses Allowed and Received)		
Answer Options	**Percent of Respondents**	**Response Count**
No dilution of equity	85.7%	12
Flexibility (capital repayment holidays)	28.6%	4
Flexibility (loan term)	7.1%	1
Flexibility (application of funds)	7.1%	1
Involvement of SE or HiE	0.0%	0
Availability at time of application	14.3%	2
Scale of funding available	7.1%	1

It is clear that the SLF characteristic considered most attractive is the non-dilution of equity in the business. This is in line with expectations in cases where companies were in a growth stage and had secured early stage equity - meaning further dilution would be unattractive. Over 85% of the business consulted identified non-dilution of equity as an attraction of SLF. The flexibility of the Product (most notably through capital repayment holidays) was also considered attractive, whilst a small number valued the ready availability of the SLF.

Consultees also provided insight on the application of the SLF funds they borrowed. Whilst many businesses used the loan for a number of reasons the most cited applications were for market development, working capital and capital investment. A quarter of respondents had used the SLF to fund a strategic acquisition of a supplier or competitor.

4.6. Business Performance in Absence of SLF

When we asked these businesses how their business might have performed in the absence of application of the SLF loan we received the responses detailed in **Table 4.2**.

Table 4.2: Business performance in the absence of the SLF loan		
	Response Percent	**Response Count (N=15)**
The business would have performed in much the same way as it has after securing the SLF loan.	33.3%	5
The business would have grown at a slower rate than it has.	20.0%	3
The business would have failed to grow.	6.7%	1
The business would have contracted.	40.0%	6
The business would have failed.	0.0%	0

From this it is apparent that the largest proportion of our respondents (40%) considered that their business would have contracted and a further 20% would have grown at a slower rate. One third of respondents stated that their business would have continued to perform in much the same way as it had with the SLF. When these respondents were asked why they considered performance would not have differed they stated that the business had alternative funding options – albeit less attractive or less appropriate to their funding requirements at the stage of development of their business.

4.7. Actions in Absence of SLF

The alternative actions of the SLF clients, in the event of not receiving SLF, were further explored with each consultee and the responses received are detailed in **Table 4.3**.

Table 4.3: Alternative actions if the SLF loan had not been secured (N=15)

Answer Options	Response Percent	Response Count
Business would not have secured additional funding (SLF was the only available option)	0.0%	0
Business would have continued to investigate additional funding from other sources	80.0%	12
Business would have ceased seeking additional funding (continued to operate)	20.0%	3
Business would have ceased seeking additional funding (ceased operating)	0.0%	0

It is clear from these responses that only a minority of the SLF clients would have ceased to look for additional funds if SLF had not provided support. The majority would have continued to ***investigate*** other potential sources, **but importantly this is not to say that they would have been successful in actually securing all or some of the finance they raised from the SLF.** It is difficult to predict with any certainty whether they would have secured alternative funding. However, the likely growth trajectory of most SLF-eligible businesses would suggest that *over time* it might be likely that alternative funding could be secured. It is on that basis that the Economic Impact Assessment has been calculated for this evaluation where it is assumed that there would be time additionality of between 12 and 36 months depending on individual circumstances.

A minority of SLF client businesses (20%) would have stopped seeking additional funding and in these cases it is assumed that SLF was wholly additional to any uplift in business performance over the period of the loan. None considered that they would have ceased operating in the absence of their SLF loan so there were no cases where SLF prevented a business closure, albeit this is not something that would be expected from this cohort of businesses.

4.8. SLF in Context of Other Assistance

Finally, we asked the businesses about the relative importance of SLF in comparison to other assistance they had received. This question was intended to provide an indication of the potential for dilution of the additionality of SLF – where some of the improvements in performance over the SLF period might have been attributable to other interventions. The responses received are set out in **Table 4.4**.

Table 4.4: Relative Importance of SLF and Other Public Sector Assistance Received (N=14)		
Answer Options	**Response Percent**	**Response Count**
The SLF loan is the only support that I am aware of having received	7.1%	1
The SLF loan was much more important than other support I have received	50.0%	7
The SLF loan was more important than other support I have received	14.3%	2
The SLF loan was equally important to the other support I have received	14.3%	2
The SLF loan was less important than other support I have received	14.3%	2
The SLF loan was much less important than other support I have received	0.0%	0

It is worth pointing out that several of our respondents caveated their responses to this question with the comment that they were recipients of a package of support from SE and SIB which *together* provided them with the capacity to grow.

Two thirds of our respondents considered the SLF to have been more or much important than the other support they had received from public sector sources. We asked for further qualitative commentary from these respondents and recorded feedback including:

- *"SLF more important as it allowed the business to get into a new market with projected additional turnover to Group of £3.5m to £4.0m p.a".*
- *"SLF more critical to taking the business forward. SE Account Management support more targeted and tactical - for example had support for innovation, process reviews, exports and trade show representation".*
- *"SLF facilitated a step change providing financial capacity to drive growth".*
- *"SLF Strategically important in facilitating growth and getting towards a potential sale of the business".*

The respondents who had considered SLF to be equally or less important in developing their business referred to the receipt of an innovation grant and of a previous (but exited) SCF investment as having significant effects on the growth of their businesses.

Respondents also valued Account Management assistance but considered this to be more tactical than strategic – one summed it up by saying:

"SLF gave the business the horsepower to grow. Account Management nice to have - improved managerial capacity but could not have delivered a step change"

4.9. Conclusions

From our analysis of an aggregation of the responses to our SLF Client Business Survey we conclude.

- The businesses are or have been originally headquartered in Scotland and have high concentrations of economic activity and employment within Scotland restricting the potential for leakage of economic benefit outside Scotland. They also have high proportions of sales outside Scotland.

- Significant proportions of the businesses' competitors are located outside Scotland ensuring limited displacement of economic activity in Scotland.

- The primary attraction of SLF was the non-dilution of equity in the businesses, although flexibility on the repayment of capital was also an important consideration for some businesses.

- In the absence of their SLF funding two-thirds of businesses would not have grown at the same rate as with SLF - with 40% saying their business would have contracted and 20% saying they would have grown at a slower rate. The remaining third considered their business would have performed in the same way in the absence of SLF. No business stated that it would have ceased operating if SLF had not been available.

- In the absence of securing SLF 80% of businesses would have continued to investigate other offers of funding and suggested that they might be able to secure an alternative at a future date. However, given these businesses took up SLF and ceased seeking alternatives at that point, there is no means of determining if and when such alternative funding might have been secured. 20% said that they would have abandoned their search. No business considered they would have ceased to operate if they had not secured other funding or stopped investigating other funding.

- Two-thirds of businesses consider SLF to have been more or much more important to the development of their business than other support they have received. However, many appreciate that the package of support, including other SIB investment and SE Account Management support to be part of an holistic approach to driving the development of their business. SLF was reported to be particularly effective in driving growth and facilitating step changes in business development.

5. POTENTIAL ECONOMIC IMPACT OF SLF

5.1. Introduction

In this section of our report we present our assessment of the potential economic impact of the SLF. This assessment reflects performance of the SLF client businesses to date and the projections of performance provided by the businesses in the course of our consultations.

5.2. Factors Influencing Economic Impact

The assessment first required an estimation of the extent of the **additionality** of the SLF (i.e. what happened with SLF that would not have happened at all or in the same timeframe in the absence of SLF being available). Thereafter these additional benefits need to be adjusted to reflect the potential for ***displacement***, ***leakage*** and ***optimism bias***.

5.2.1. Additionality

At the level of **the Fund** we consider there to be ***absolute additionality***. It is clear from our consultations with the Limited Partners and public sector stakeholders that, in the absence of public sector initiative, the SLF as a concept would not have come into being in the wake of the 2008 Global Financial Crisis. The Scottish Government and Scottish Enterprise, through SIB, worked to secure a contribution from the European Structural Funds and to bring commercial lenders in as Limited Partners to the SLF. There was a strong political imperative for assistance in the corporate loan market at the time of establishment and the Limited Partners saw the SLF as a means of committing additional loan finance to the Scottish market within containable levels of risk exposure.

Moreover, the absence of the emergence of any significant commercial competitor mezzanine product over the lifetime of the SLF, suggests that the capacity provided by the Fund over the period 2011-16 would not have been replicated by the market. Consequently there is no evidence of SLF crowding-out the private sector in this market.

For **individual loans**, the level of additionality is dependent upon the **individual circumstances of each business**, any alternative forms of finance potentially available to them at that time, and the length of time the loan was current. We have been able to determine these factors for the majority of cases based on our consultations with the businesses or their SE Account Managers and from data and information provided by SIB and Maven.

Of particular relevance is the fact that the SLF, as with all forms of mezzanine finance, is, by design, intended as an interim form of finance for businesses where:

- Access to conventional loan finance is constrained by short trading histories and/or low asset bases.
- Existing equity investors oppose dilution and are unwilling or unable to increase their commitment to the business.

The relatively high costs to businesses of servicing SLF loans reflects the risks to the Fund of operating in the market. It would be expected that businesses taking up loan offers would have struggled to access other forms of finance. This would tend to suggest relatively high levels of additionality for the SLF – as businesses would choose it only in the absence of lower cost alternatives or to avoid dilution of equity. However there are factors which can dilute this presumption towards a high level of additionality. These tend to occur because:

- The SLF loan was a preferred method of funding because of flexibility of capital repayment terms and a desire to avoid equity dilution - but the business had alternative sources available and would have performed in a similar way using these alternative sources.

- The SLF loan was taken up by a business to address market shocks when revenues (and for the purposes of EIA the associated GVA from wages and profits) were declining or static. In such instances there is no positive change in the performance of the business to attribute to the loan. However, these businesses may not consider they would have failed in the absence of the loan.

- To date four of the SLF loan facilities have been used for a very short period of time, in advance of re-financing or sale, meaning the intensity of assistance may be too low to attribute performance benefits. In the case of acquisitions this is further complicated by absorption of future performance into a larger business unit.

Finally, there are also issues over the ***dilution of the additionality*** of the SLF because of instances of multiple public sector-funded assistance to the businesses taking up the loan. These include:

- 25 of the 30 SLF client businesses being Account Managed by Scottish Enterprise or HIE (1 account managed by HIE), receiving assistance through a wide range of business and staff development support products.

- 8 of the SLF client businesses having previous or co-terminus investment from SIB.

It is likely that these other sources of support will have contributed to the performance of the business over the period the SLF loan was in place. There are, however significant complications in assessing these effects. The SIB investments have mostly been made in the period before the introduction of the SLF, and half of the SIB investments have been realised. It is possible to separate the ***financial performance*** of the SLF loans from other SIB investments from the perspective of SIB - the *loan* return is in the form of interest and capital repaid through. It is much more difficult, and not appropriate, to apportion ***economic*** benefits between SLF and other SIB investment where that investment takes place over a different time frame.

In the case of SE Account Management support there are also challenges both in providing a monetary quantification of the value of that support and in businesses distinguishing between that support and SLF in contributing to their performance.

In our research amongst the SLF client businesses we sought evidence on the relative importance of each form of support in contributing to the performance of their business over the period of the SLF loan. This is reported in **Section 4.8** but we do not consider this to provide a robust basis for assessing and quantifying the relative additionality of each form of assistance.

We have, however, sought to address the potential for dilution of benefits by, for **all** cases:

- Not ascribing absolute additionality to **any** SLF loan – suggesting that in all cases the business would have survived in some form without the loan. We have instead interpreted the business responses to apply time additionality from a minimum of one year to a maximum of three years lag in performance from the SLF advance year. Where businesses have stated that they would have ceased looking for funding and either contracted or not grown we have attributed all uplifts in performance to the SLF loan.

- Limiting the duration of benefits to 10 years from the year of advance of the loan.

- Limiting the period of 100% SLF additionality to the duration of the loan term and providing a decay rate of 20% on benefits after this period.

- In case of early repayment, ending 100% additionality at the year of loan repayment and commencing decay of benefits from this point.

This approach seeks to contain the apportionment of benefits to the period when the SLF is most likely to have influenced the performance of the business. This is consistent with the episodic nature of capital support to businesses and in particular where earlier SIB investment has taken place.

However, the potential for some dilution of benefit attributed to SLF by other SE and SIB activity remains and this should be borne in mind in the interpretation of the results of the Economic Impact Assessment.

5.2.2. Displacement, Leakage and Optimism Bias

Displacement occurs through the potential for the reduction in business turnover of Scottish based *competitors* of the SLF-funded businesses caused by any increase in the turnover of the SLF client business. We have allowed for this by this by asking about the location of the SLF client businesses' competitors, the markets in which they sell their goods and services and about the rate at which the market for their product or service is growing (Reported for all respondents at Section 4.4).

Leakage occurs where the benefits from any increase in business are delivered outside Scotland. We have done this by asking the SLF client businesses about the extent of their employment in Scotland and the amount of turnover generated by employees located in Scotland (Reported for all respondents at Section 4.3).

Optimism Bias is an adjustment to reflect the potential for consultees to over-estimate future performance of the business in the period over which the SLF loan is in place. In practice the level and extent of optimism bias will vary between cases and in the case of shorter term loans made in the early years of the SLF will be redundant as the additional performance will be based on actual performance data. Loans made in the later years of the Fund will be more susceptible to optimism bias given the delivery of benefits is dependent on forecast performance.

It should be noted that another potential dilution of impact – substitution – where businesses actively change their behaviour to access subsidy, is not considered likely to occur in the case of SLF. This is because SLF is delivered on a commercial basis at a premium rate and operates in a market with other corporate finance providers.

5.3. Impact Assessment Method

We have prepared a bespoke economic impact calculator model based on a template prepared by Scottish Enterprise and SIB to estimate the economic effects of capital investment. We have been prudent in our application of the evaluation research findings to this model and have:

- Limited projection of benefits to a period of 10 years from the year in which the SLF loan was advanced.
- Restricted lag effects (where the business reports it would not have grown or have grown more slowly in the absence of the SLF loan) to a period of between one and three years after receipt of the SLF loan, dependent on responses received in consultations.
- Introduced a decay effect (20%) on benefits delivered or projected after the term year of the loan, or the year of repayment, whichever occurs first.
- Excluded cases from the economic assessment where the duration of the loan has been one or less years and the business has been re-financed or sold, reflecting the facilitative rather than strategic nature of the financing. This does not extend to exclusion of the commercial returns on such loans, which are included in assessing the net costs of the Fund used in assessing value for money.
- Derived estimates of deadweight, displacement and leakage from individual businesses' assessments of performance in the absence of the SLF, competitor location, market growth and the location of employees.

The EIA model spreadsheet had been populated on a case-by-case basis and includes a summary for each case of the factors informing assumptions made on additionality, displacement and leakage. Gross Value Added has been assessed using data from the most recently available accounts for each business and is an aggregation of employee costs, operating profit, depreciation and, where reported, amortisation.

5.4. Estimated Economic Impact

The results of our assessment of economic impact are detailed on a case-by-case basis and aggregated in the spreadsheet provided to the client. The headline results for the Fund investments to date are anonymised to preserve commercial confidentiality and presented in **Table 5.1**.

The EIA results relate to 21 of the 31 loans made through the SLF over the evaluation period. The loans which have been excluded from the EIA are those where:

- The loan period has been less than one year (4 cases)
- The business is in administration or has been dissolved (3 cases)
- The business has demonstrated significant reduction in revenue over the period up to and during SLF loan (2 cases)

- Efforts to secure consultations with the business or a proxy have not been successful and there is insufficient data from other sources to make a judgement on key determinants of economic impact (1 case)

For the avoidance of doubt it should be noted that the financial performance of all of the cases excluded from the EIA **have** been included in the assessment of the financial performance of the Fund and the associated value for money assessments.

Table 5.1: Summary Results - Scottish Loan Fund Economic Impact Assessment 2011-2016												
Business Name	**Loan Year**	**SLF Advanced (£000)**	**SLF Repaid (£000)**	**Gross GVA (£000)**	**Net Additional GVA (£000)**	**Gross to Net Ratio (%)**	**Net Additional GVA discounted to 2011 (£000)**	**2016 Gross Employment (FTEs)**	**Gross Employment at Loan Advance (FTEs)**	**Other SIB Investment Current**	**Other SIB Investment Realised**	**SE Account Managed**
Case 1	2013	£2,000	£0	£36,726	£0	0.0%	£0	64	34	Yes		Yes
Case 2	2014	£3,850	£0	£3,176	£0	0.0%	£0	20	13			
Case 3	2011	£4,650	£4,650	£81,450	£0	0.0%	£0	223	213			
Case 4	2015	£3,500	£0	£18,948	£0	0.0%	£0	143	164			
Case 5	2012	£2,100	£2,100	£5,022	£0	0.0%	£0	33	55		Yes	Yes
Case 6	2013	£1,650	£1,650	£30,645	£0	0.0%	£0	0	33			
Case 7	2012	£550	£550	£65,038	£867	1.3%	£698	204	136			
Case 8	2016	£800	£0	£17,702	£383	2.2%	£284	39	39			
Case 9	2015	£5,000	£0	£56,072	£1,422	2.5%	£1,068	95	91			
Case 10	2015	£425	£0	£3,189	£221	6.9%	£164	12	16			
Case 11	2014	£1,500	£0	£34,188	£2,715	7.9%	£2,193	29	11	Yes		Yes
Case 12	2014	£2,000	£0	£37,075	£3,181	8.6%	£2,584	53	35			Yes
Case 13	2013	£3,000	£0	£26,838	£2,447	9.1%	£1,948	38	25		Yes	Yes
Case 14	2013	£1,680	£1,680	£14,340	£1,518	10.6%	£1,305	35	27		Yes	
Case 15	2013	£1,700	£0	£36,471	£4,870	13.4%	£3,795	52	16			Yes
Case 16	2015	£1,500	£0	£6,790	£1,025	15.1%	£765	31	26	Yes		Yes
Case 17	2015	£3,000	£0	£68,593	£10,649	15.5%	£8,238	183	219			Yes
Case 18	2014	£2,200	£2,200	£15,871	£2,510	15.8%	£2,028	89	69		Yes	Yes
Case 19	2014	£750	£0	£10,200	£1,718	16.8%	£1,051	35	43	Yes		Yes
Case 20	2012	£3,563	£3,563	£66,398	£12,526	18.9%	£10,662	450	150			Yes
Case 21	2012	£5,000	£5,000	£65,857	£15,570	23.6%	£13,585	122	30			Yes
21	**-**	**£50,418**	**£21,393**	**£700,588**	**£61,623**	**8.8%**	**£50,367**	**1950**	**1445**	**4**	**4**	**12**

Overall, the assessment suggests a potential economic impact for these 21 cases in Net Additional GVA terms of £61.6m in monetary values and a £50.4m Net Present Value in 2011 (the year SLF was launched). These benefits have been assessed on loans made between 2011 and 2016 and will persist up to 2026 (10 years from the date of the last loan made in 2016).

This estimated GVA has been generated from loans advanced to a total monetary value of £50.4m. The net value of loans advanced *less* loans repaid is £29m.

The economic impact model provides for the assessment of gross but not net additional employment. The data indicates an increase of 505 in the gross employment within the SLF client businesses over the evaluation period.

5.5. Value for Money Assessment

Our assessment of the value for money (VFM) provided by the SLF is based upon:

- The Net Additional GVA (monetary value) reported in **Section 5.4**.
- The net value of loans advanced *less* loans repaid for **all** SLF cases to September 2016 as detailed in **Table 3.2**. This is the value of funds ***at risk*** at that date.
- The Income to the Fund and default costs as set out in **Table 3.2**.
- The estimated costs of managing the Fund as set out in **Section 3.10**. These are estimated by Maven at £8.4m for the period from launch in 2011 to conclusion of new client lending activity in March 2017.
- The proportion of investment in the SLF made by the Public Sector (SE, HIE and European Structural Fund) as set out in **Table 3.1** (48%).
- All benefits being attributed to the public sector partners – based on our conclusion of full additionality at Fund level as set out in Section **5.2.1**.
- The estimated costs borne by SIB in managing the Fund as set out in **Section 3.10**. These are estimated at £460,000 from Fund inception to close.

Our base-case calculation of VFM, based on the foregoing, is set out in **Table 5.2**.

	Table 5.2: VFM Estimate - GVA to Public Sector Cost of SLF at September 2016	
		£(000)
1	Net Additional GVA Estimate	61,600
2	Total Funds Advanced	68,851
3	Total Funds Repaid	28,385
4	Net Funds at Risk September 2016 (2-3)	40,466
5	Income to Fund (Interest and Warrants)	8,100
6	Cost of Defaults	6,194
7	Costs Of Fund Management	8,400
8	Total Cost - Funds at Risk, Defaults, Income & Management Cost (4-5+6+7)	46,960
9	Public Sector Share of Funds at Risk and Management Cost (48% of 8)	22,541
10	SIB Cost of Fund Management	460
11	Total Cost of SLF to Public Sector to Date	23,001
12	£ GVA to £ Public Sector Cost to Date (1/11)	£ 2.68

The VFM generated by the SLF is ultimately dependent upon the *actual cost* of the Fund to SE. As a commercial fund set up to deliver a return to investors the SLF may be revenue neutral or revenue positive to SE. Actual VFM will reflect the performance of the currently outstanding loans in repaying capital and interest and the levels of default or under payment within the SLF client businesses.

5.6. Conclusions on Economic Impact

Economic impact of the SLF to date has been modest. This is primarily down to:

- Impact Estimates being based on time additionality with all businesses stating they would have continued to operate in the absence of securing SLF – and many businesses stating they would have continued to look for alternative sources of finance.
- Exclusion of impacts for cases where the loan has been current for less than one year.

VFM is currently assessed at a Net Additional GVA to public sector net cost ratio of 2.68:1 – although this is based on capital at risk at the date of the evaluation – and has the potential to improve as and when outstanding loans are repaid.

6. CONCLUSIONS & RECOMMENDATIONS

6.1. Introduction

In this section we present our conclusions based on the research conducted in the course of the evaluation.

We would also normally present recommendations on the future operation of an intervention. However, towards the end of the evaluation research period it became apparent that the majority of the Limited Partners had chosen not to commit to an extension or continuation of their SLF engagement. In the light of this the Public Sector Partners elected to close the Fund to new lending. Our conclusions are therefore couched in more generic terms and may be of benefit in the future consideration or design of mezzanine finance interventions.

6.2. Conclusions

Based on the research and analysis conducted in the course of this evaluation we have arrived at the following conclusions.

- SLF has addressed a market failure and assisted in establishing the potential scale of demand for the Fund at around £10m per annum – around 50% of the run rate and total value of the original 5-year £113m SLF.

- The volume of lending has been well behind projections based on market research and expectations of stakeholders and LPs. This is attributed to an innovative product trialling in a niche market in challenging economic times.

- LPs and Stakeholders consider there to be a continuing but lower level of demand for a Mezzanine Finance product in this deal space at a rate of c£10m per annum. There is limited evidence, however, of market adjustment to provide a similar Mezzanine finance product in the Scottish market. This is evidenced by the limited entry to the mezzanine finance market in Scotland by private sector providers and the decision by the SLF Limited Partners not to re-commit to an extension of the SLF. Limited Partners also stated in consultation that they had no plans to enter this market as providers on their own account.

- There are significant costs attached to managing a Fund like SLF which suggests that it might be difficult for a lower value Fund operating at £10m pa to cover management costs and provide a commercial return to investors.

- Financial returns have been behind LP expectations and reflect, in part, over-commitment to Oil & Gas in advance of a significant market shock to that sector. This market shock could not have been foreseen and the scale of lending in advance of the market collapse reflected a rational response by the Fund Managers to where most opportunity for SLF lending existed in its early years.

- The economic impact of the SLF to date has been in line with expectations, given the nature of the intervention and is based mainly on time additionality. There is significant potential for an improvement in VFM as costs are reduced by income and capital repaid at loan maturity. There is however also potential for the costs to rise if further defaults occur.

- There have been several instances of absolute additionality identified amongst the SLF client base where businesses would have ceased seeking additional funding from any source if they had not secured SLF. Other clients have stated that they would have continued to explore alternative sources of funding, although it is not certain that they would have succeeded in securing these. In some cases clients used SLF as a short term form of finance to avoid dilution of equity or facilitate acquisition of a competitor or supplier.

- SLF has been shown to address a market need and facilitate economic development. Young, rapidly growing businesses and effective entrepreneurs require access to a range of financing options as they evolve. The use of mezzanine finance can allow a business to balance the requirements of existing lenders and equity investors with the need to progress the business to a point where it can exploit a market opportunity and/or secure its next round of funding. SLF has provided access to funding for businesses at various stages in their growth cycle to allow them to progress, when other providers of debt and equity were unwilling or reluctant to do so. Given the relative importance of young, growing businesses to the development of the economy, SLF has made an important contribution to economic development in Scotland. The scale of that contribution has been modest to date – but this is in part a reflection of the niche mezzanine finance market space within which SLF operates.

- Whist the SLF will not be continued in its current format we consider that the facility to provide a mezzanine finance solution should be retained as part of the SIB toolkit of investment support.

6.3. Recommendations

In the light of the collective decision of the SLF Stakeholders and Limited Partners not to continue the SLF, our recommendations are generic – and relate *not to the SLF per-se* but to Mezzanine Finance and the design and implementation of stand-alone funds.

In relation to **Mezzanine Finance** we recommend that:

- SIB continues, with others, to promote the concept and facilitate the provision of mezzanine finance in Scotland as an important contributor to the progression and development of rapidly growing businesses.

In relation to **stand-alone investment and loan funds**:

- Research into the anticipated scale and demand for the fund product considers the potential for economic shocks and makes provision in the structure, management, and investing principles of the fund to respond to such shocks.

- The relationship between scale of the fund, investment run rate and costs of third party fund management should be fully reflected in the design and establishment of any fund.

Provision for legacy management of investments or loans, beyond the investing/lending phase of the fund, should be fully reflected in assessing management costs and long term returns to the fund.

- The fixed costs of individual investment/loan due diligence and ongoing management is proportionate to the scale of investments and loans. This is likely to require a minimum scale of investment or loan value by the fund, unless arrangements can be put in place to streamline approval and ongoing management costs for smaller loans/investments.

APPENDIX 1

SLF RESTRICTED SECTORS (Current May 2014)

The SLF is open to all eligible businesses with no sectoral focus meaning we invest in both manufacturing and service businesses. However we are prohibited from providing funding into certain restricted sectors. We are therefore unable to provide funding if your company performs, or operates in, one of the following activities:

- Retail
- Motor vehicles
- Real estate/property development
- Social and personal services
- Pubs, clubs and restaurants
- Local services
- Banking and insurance
- Nuclear decommissioning
- Professional services

Source: SE Website