**CO-INVESTMENT FUND**

**INTERIM EVALUATION – FINAL REPORT**
**December 2016**

**OFFICIAL-SENSITIVE-COMMERCIAL**

Invest Northern Ireland

**December 2016**

**INVEST NI**

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**GLOSSARY OF TERMS**

| | |
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| ASHE | Annual Survey of Hours and Earnings |
| BBB | British Business Bank |
| CFM | Clarendon Fund Management |
| Co-Fund | Northern Ireland Co-Investment Fund |
| DG Research | Directorate-General for Research and Innovation |
| DG Connect | European Commission Directorate General for Communications Networks, Content & Technology |
| EAF | European Investment Funds European Angels Fund |
| EIS | Enterprise Investment Scheme (tax scheme) |
| ESI | East of Scotland Investment Fund |
| ERDF | European Regional Development Fund |
| IRR | Internal Rate of Return |
| IUL | Innovation Ulster Limited |
| KPIs | Key Performance Indicators |
| LCIF | London Co-investment Fund |
| NECOIF | North of England Co-Investment Fund |
| NZSCIF | New Zealand Seed Co-Investment Fund |
| SCF | Scottish Co-Investment Fund |
| SEIS | Seed Enterprise Investment Scheme (tax scheme) |
| SIB | Scottish Investment Bank |
| SIF | Strathclyde investment Fund |
| SME | Small, Medium Enterprise |
| SSF | Scottish Seed Fund |
| SVF | Scottish Venture Fund |
| VFM | Value for Money |
| VC | Venture Capital |

**Terminology**

We frequently find that the terms "group" and "syndicate" and "network" are used interchangeably. In order to distinguish clearly between these different entities, we use the following terminology:

**"Angel" or "Business Angel"** means a private individual who personally invests in entrepreneurial ventures and generally shares his business experience to help the venture grow and succeed.

**"Business Angel Network" or "BAN"** means an organisation which matches Business Angels with entrepreneurs looking for capital e.g. HALO in NI.

**"Syndicate"** – refers to two or more Business Angels acting together to fund a single deal.

**Business Angel Groups** – refers to multiple Business Angels acting with the intention of funding a number of successive and separate deals. These will typically have a Charter and Agreement, as per the HBAN Business Angel Groups. Note: In the context of any future HALO and Co-Fund Programme objectives, Business Angel Groups will be taken to mean ten or more Business Angels acting together with the intention of funding a number of successive and separate deals.

**"Group Syndicate"** means two or more Business Angel Groups acting together.

# EXECUTIVE SUMMARY

## 1. Introduction

Invest NI commissioned Capaxo Ltd and its partners, including independent expert, Nelson Gray, to undertake an independent Interim Evaluation of the Invest NI Co-Investment Fund ("Co-Fund") covering the period from June 2011 to 30th June 2015[1].

Invest NI is committed to actively stimulating and encouraging early stage, high growth businesses in order to develop a world class, knowledge based economy. Its Access to Finance strategy promotes a continuum of funding and a deal flow chain. The Co-Fund is an integral part of this strategy, designed to, in part, fill the recognised gap in the supply of funding of deals of up to £3m. In addition, developing the private business angel investor community (including through the Co-Fund) is a further important element recognised by Invest NI to support business growth and competitiveness, with Co-Fund also to be a mechanism to achieve this objective.

Co-Fund, launched for investments in 2011, is a £12.5m (uplifted from £7.2m in 2014) 6-year fund which is projected to run to May 2017. It is funded through a European Regional Development Fund ("ERDF") budget. It is the first formal co-investment fund in Northern Ireland.

When Co-Fund was conceived, it was seen by Invest NI as a possible bridge between early stage seed funding (as provided by the techstart NI Fund and its predecessor[2]) and Series A funding provided by one of the two Development Funds[3], or other venture fund sources. Co-Fund was subject to a first interim evaluation by Deloitte in February 2014[4] with the outcome being confirmation that the Co-Fund was on track to achieve its investment activity targets and on that basis that there was a rationale for increasing the fund size to £12.5m.

## 2. Aim, Objectives and Targets of Co-Fund

The primary aim of Co-Fund is *"to stimulate more private investment in Northern Ireland companies, who demonstrate high growth potential, are innovative and are export focused*".

The May 2010 economic appraisal, which provided the case for the roll out of Co-Fund in 2011 for six years, identified the following objectives:

- "To strengthen the capability of NI to develop and commercialise new technologies and break into growing sectors and markets"
- "To address imminent gaps in the availability of venture capital in NI by providing a continuum of funds and a deal flow chain across seed, early stage and development capital"

There were no prescriptive objectives around the development of the supply side of the investment market, a key objective of almost all other co-investment funds globally.

The Co-Fund was positioned to typically invest in investment rounds of between £150k and £1m, at a ratio of up to 50% of the investment round on *pari passu* investment terms alongside private sector investors. On a portfolio basis, the target ratio was set at 55:45 private:public. Match funding can originate from business angels (individuals, syndicates or business angel groups), institutions, universities, founders and corporates, as long as the initial match funder is new to the company. The expectation was that the investee company would have already sourced the majority of the private sector funding, including a "Lead Investor" who would be trusted to carry out appropriate levels of due diligence, deal structuring, valuation and post investment support and monitoring. Co-Fund was designed to effectively "pre-qualify" the skills and expertise of the Lead

[1] Where more recent investment activity data exists, it is presented for information purposes
[2] techstart NI is managed by Pentech Ventures, a £17m seed fund investing in the range £50k -£250k
[3] Funds managed by Kernel Capital and Crescent Capital, each £30m fund invests between £150k and £1.2m, initially, with follow on up to a total of £3m (over a series of funding rounds).
[4] Interim Evaluation of the Invest NI Co-Investment Fund, Deloitte, February 2014

Investor and, subject to agreement, follow their investment decision. "Follow on" investments, matching against the private sector, were permitted.
The following targets/ Key Performance Indicators (KPIs) were set for Co-Fund in 2014:

(i) Complete 14 investments per annum;
(ii) Typically operate in the deal range of £150k - £1m, with an average investment of £170k;
(iii) Make investments on substantially the same terms as pre-qualified investors and to contribute no more than 50% of the funding in any one round and to achieve a ratio of 55:45 private to public funding over the portfolio;
(iv) Invest £12.5m over the term and no less than £2m per annum in years 4-6; and
(v) Pre-qualify no less than 12 private investors.

## 3. Operational Performance of the Co-Fund

Following a competitive tendering process, Invest NI appointed Clarendon Fund Management Ltd ("CFM") to manage Co-Fund. CFM is responsible for facilitating investments with ownership of the investment (mostly equity through ordinary share capital) being held by Invest NI. The administration cost of Co-Fund, consisting of CFM costs and Invest NI fully loaded costs, totalled £1.19m by June 2015, and increased to an average of £460k per annum by 2015/6, following an increase in staffing levels within CFM following the uplift in the fund size from £7.2m to £12.5m in 2014.

As of June 2015, there have been 53 Co-Fund investments into 28 companies. CFM has invested £8.0 million, mostly Ordinary Share Capital (£7.42m) but with circa £580k by way of Preferred Ordinary shares and Convertible Loan Notes (reflecting the need to match against investors funding mechanisms). The latter is mainly in respect of investments by US investors. This has leveraged a total of £24.6 million of investment, of which Co-Fund matched against investment of £11.2m. The number of Co-Fund investments per investee company are set out in the following Table:

| Key Co-Fund Investment Data As at June 2015 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Investment Round | No of companies | Total Funding | Total Co-Fund | Pre Q[5] Private Investor funds | Total Co-Fund and Private Matched | % Co-Fund of matched | % CF of total | % of Co-Fund |
| One | 28 | £15,916,824 | £4,859,405 | £7,722,315 | £12,581,720 | 39% | 31% | 61% |
| Two | 15 | £6,568,757 | £2,189,043 | £2,492,671 | £4,681,714 | 47% | 33% | 27% |
| Three | 9 | £2,001,553 | £902,797 | £968,127 | £1,870,924 | 48% | 45% | 11% |
| Four | 1 | £150,000 | £50,000 | £70,000 | £120,000 | 42% | 33% | 1% |
| | | £24,637,134 | £8,001,245 | £11,253,113 | £19,254,358 | 42% | 32% | 100% |
| **Percentage of total funding** | | | **32%** | **46%** | **78%** | | | |

Of the £24.6m raised, private sector funds totalled £16.6m of which £11.2m was matched by Co-Fund.

Investments have been made by Co-Fund in one company through four investment rounds, eight companies through three investment rounds, six companies through two investment rounds and 13 companies through one investment round. Circa 61% of total investment had been in the first round investments with 39% being follow on. There was a strong pipeline at June 2015. Actual Co-Fund investments to end June 2016 (in 32 companies) totals £10.45m.

Co-Fund achieved its first exit in June 2016. A confidentiality agreement is in place surrounding the financial details of the sale; however, Invest NI has confirmed that Co-Fund and the private investors all achieved positive returns on their equity investments. In addition, three portfolio companies have raised additional funds at an uplift in valuation. The June 2016 return by CFM to Invest NI shows the original Co-Fund investment in these four portfolio companies (of £2.496m) being reflected at a £4.030m valuation, representing an increase of £1.533m or 61%.

[5] Investors pre-qualified by CFM as suitable matches for Co-Fund

Countering these positive valuations, there were 14 Co-Fund companies (50% of the portfolio and including four liquidated companies) in NI with valuations below cost at June 2016; which results in an overall portfolio with an estimated–deficit of £1.8m or 19% for the 28 portfolio companies. The Evaluator's view is that this reflects prudent write downs, with no provision for potential uplifts on performing portfolio companies. For the four companies with uplifts, these would need to be achieving uplifts of 4.17 times for the Co-Fund to breakeven financially at the current level of investment (prior to discounting and before any further funding), as compared to the current uplift of 1.61 times. The experience of the Archangels business angel group in Scotland (as per the benchmarking) would be that such returns are possible but cannot be predicted with any certainty. Note that portfolio companies may however require further follow on Co-Fund investment.

Given the limited time the Co-Fund has been investing (from 2011/12 with the longest period of investment being 3.5 years and an average 1.93 year investment period) the low level of exits to date is not unusual. A comparison of Co-Fund to the benchmark data in Section 3 indicates that the UK Angel CoFund has had two exits and the New Zealand Seed Co-Investment Fund has had four, these being launched in 2011 and 2005, respectively.

Positive financial returns on early stage investing typically take a minimum of six years to achieve, with recent evidence suggesting that this is extending to nine or more years. Reviews of other angel investments would suggest that for the Co-Fund a) further exits may not be achievable, or indeed identifiable, for a further three to nine years, and b) of the 28 companies invested in to June 2015, possibly just four will provide 90% of all the capital returned to the Co-Fund.

## 4. Achievement against objectives and targets

Co-Fund has successfully achieved its activity targets set in its Interim Evaluation in 2014, with the revised fund size of £12.5m projected to be fully utilised ahead of the May 2017 target date. There is evidence of:

- *Additional gross export sales of circa £12.3m (para 5.2.2);*
- *Additional gross wages and salaries of circa £3.9m (para 6.2.1);*
- *98.5 new NI gross jobs created and 95 gross jobs safeguarded (para 5.5.2)*
- *Investment focused on R&D*
- *Companies reporting that they are at, or close to, cash breakeven*

There is confidence amongst Investors and companies as to future successful exits and uplifts in valuation (although with funding requirements of up to £24m). While there has been one exit in June 2016, it is too early to tell if such optimism is well founded.

Co-Fund would appear to be achieving against its objectives, providing funding support to enable mainly innovative companies to grow and providing a further choice for accessing finance.

## 5. Co-Fund Management

There has been excellent feedback on the role of CFM as fund managers, in their pre and post investment support. This involvement has been higher than originally envisaged, attributed by CFM to the lacks of skills within the Lead Investors and the inability of the private sector, generally, to actively engage in due diligence, monitoring etc. With the size of Co-Fund increased from £7.2m to £12.5m, CFM resources were increased from two to three investment managers in 2014.

CFM have acted as typical fund managers, interested in achieving a financial return on the fund (although there are no financial return targets). Whilst CFM did not have a formal remit for supply side development, there is recognition that they did undertake some angel development and matching of angels to deals for the greater good of Co-Fund.

In the absence of any specific supply side KPIs, it is unsurprising that CFM have been relatively uninvolved in such activity. That said, across the 28 investee companies, these have attracted 164 business angel investors. However, it is apparent that the level of market development, and the

level of formal syndication (more than one angel working with another angel on a structured basis), in NI is limited.

## 6. Forward Positioning of Co-Fund

A distinction needs to be drawn between how the Co-Fund in NI appears to have been designed originally, and how it has actually been implemented. The original documentation repeatedly refers to the "Scottish model" and the desire to move towards a more delegated investment process as the NI market develops i.e. prequalification of potential angel investors.
In practice, the NI Co-Fund Model has fundamentally differed to the Scottish Model insofar as:

- The Co-Fund prequalification in practice in NI has related merely to qualification under the financial services regulations, and not to skill or capacity as would be the case in, specifically, the Scottish model;

- Co-Fund would appear to have had a less formalised (and measurable) role in developing the skill base of the NI private investor market, with this not being part of the remit at the time of the award by Invest NI. The Co-Fund Management Services Agreement (Schedule 1) would indicate that the Co-Fund manager did not have a responsibility to develop the supply side, stating *"It is anticipated that private investors and/or business angels would have identified and agreed in principle to invest in a potential Co-Investment Company prior to contact with the Manager. However, this will not preclude the Manager from identifying potential co-investment opportunities and introducing them to private investors and/or business angels."*

- Invest NI has separately funded Halo[6] to develop business angel groups and formal syndicates in NI. Halo's remit is to facilitate business angel investment in NI companies. Funded by Invest NI, it also has the remit to develop the angel syndication market and business angel skills in NI.

In forward planning the NI Co-Fund the Evaluation Team has necessarily considered wider benchmarking comparators. The NI Co-Fund can also be compared to the UK Angel CoFund model which is heavily centred on angels. Businesses cannot approach the Fund directly - Angel Syndicates must bring deals to the Fund. The Lead Angel must be approved separately from the Syndicate and the Lead Angel is interviewed by the UK Angel CoFund Investment Committee as part of the pre-qualification and approval process. The UK Angel CoFund has therefore a specific headline objective to seek to increase the quality and quantity of business angel investment activity in the UK.

Both Co-Fund and Halo have, within their terms of reference, an expectation that their operation will assist in the establishment and development of Business Angel groups in NI. Halo has also been subject to a recent formal evaluation[7], and both evaluations have noted that the level of development of Angel groups within NI remains low.

However, Co-Fund, unlike other co-investment fund models, does not have any specific objectives around the development of the supply side of the investment market.

The findings from both evaluations would indicate that there is an immaturity of the local marketplace in terms of supply side investor development, and a cultural reluctance amongst investors to be visible. There is a need to encourage more private sector investors into NI companies, more sharing of deals by the private sector (through syndications) and the formation of business angel groups (similar to the successful Scottish models).

On this basis, the Evaluation Team would query whether the Scottish model is an appropriate structure to aim for at the stage of market development that NI currently finds itself. Furthermore, the view of the Evaluation team is that NI is circa 10 years behind the more developed Scottish co-fund model (on which it is stated to be based).

[6] Halo is part of the NI Science Park, now rebranded to Catalyst
[7] Halo Phase IV Evaluation, - Final, Cogent, March 2016.

## 7. Impact & Additionality of Co-Fund

The net additional wages impact associated with Co-Fund investee companies has been estimated to total £4.312m, or £2.993m[8] when one outlier company is excluded. The Invest NI cost of the Co-Fund has been £9.19m to date. This would indicate that, notwithstanding further CFM fees, the potential need for further Co-Fund funding, the potential for additional employment generation and increases in average salary levels, and the potential for company profits to be earned, the portfolio would breakeven from an economic perspective in 2.1 to 3.1 years (without any discounting of benefits, and based on Invest NI Co Fund costs only)). It is noted that portfolio companies consulted as part of the Evaluation anticipate their NI employment levels to increase by 85% (to 636) in the next three years. Hence the period for the Co-Fund generating an economic return could feasibly be shorter, notwithstanding the fact that some of the investee companies will likely fail whilst others will grow in the interim period.

There is evidence of wider benefits from the Co-Fund including its ability to address the equity gap in NI, and to attract new funding institutions to NI. Other benefits also are CFM's ability to act as a broker and match companies and investors, to open up CFM's networks and skill base to portfolio companies, to create commercial value within companies, to introduce informal groupings of angels to pipeline, and to bring private sector lead Investor skills and expertise to companies (although with no structured transfer of skills). CFM has also added value to investors through for example, working with small groups of investors in portfolio companies to develop capability by mentoring Lead Investors through follow-on round corporate finance fund raising, exit planning, insolvency and HR restructuring.

Overall, Co-Fund is meeting key strategic objectives and market demand (for funding), with additionality deemed to be high (68-71% additional in terms of raising finance and subsequently 76-84% additional in terms of impacts).

## 8. Key Findings and Lessons Learnt during the Evaluation of the Co-Fund

**Strategic Fit and Demand**

**Fit with Access to Finance Strategy** – There is potential for Co-Fund to invest in pre-revenue companies, at a minimum investment of £75k[9], up to investments of £1m (and potentially higher), which highlights the fact that Co-Fund is spanning the full range of the Invest NI Access to Finance continuum. This also demonstrates that the financial instruments launched by Invest NI under its Access to Finance strategy should not be considered as a linear continuum but rather, offering choice to businesses seeking funding. It is also noted that this flexibility is in keeping with other benchmark funds that can fund from pre-revenue to exit.

**Ability to support start-up companies** – Co-Fund's investments should reflect the needs of the private sector. It is therefore right that pre-revenue companies should therefore continue to be eligible.

**Demand and Market Failure** - This Interim Evaluation of the NI Co-Fund would report strong demand for the Co-Fund, with indications that the demand for the current £12.5m fund is likely to exceed funding capacity. The level of funds allocated to a future Co-Fund model in NI should therefore reflect the high level of demand, including demand for maximum funding to increase beyond £1m. There is evidence of market failure, with an inability/reluctance of the private sector to meet the funding needs of the portfolio companies supported by Co-Fund, particularly early stage companies, given their inherent risks. The challenge, however, is for Co-Fund not to "crowd

[8] This was a packaging company where employment fell from 210 to 160

[9] Co-Fund typically operates at a minimum deal size of £150k with 50% funding resulting in a minimum initial investment of £75k

out" the private sector, including the VC and corporate funds who may have significant funding capacity.

There is a recognition, however, that even when there is no/limited evidence of "market failure" within later funding round deals, ie the VCs/corporates could feasibly fill the funding gap, there is still a need for the Co-Fund intervention, owing to its early development stage, to be in a position to demonstrate the success of the co-investment funding model to the private angel market, and that this may best be achieved in some instances by Co-Fund following their money to successful exits.

**Maximum funding limits** - In terms of the limits of Co-Fund investment at £1m maximum per company and/or 10% of all funds, the Evaluation Team note the request by companies for higher levels of funding. Increasing the maximum limits may create opportunities for increased angel investing into good projects, whilst discouraging companies from moving on to VC and corporate funds. Linked to the issue of the maximum fund size is the requirement to maximise the leverage from the private sector, and reduce the public sector contribution. For all upper limits, there should be built in controls and mechanisms around prior approval from Invest NI, with it likely that the absolute legal limits are determined to some extent by absolute fund size.

**Co-Fund KPI targets** – As they currently stand, Co–Fund targets in relation to investment funding inputs do not distinguish between new and follow on funding. It is recommended that such distinctions should be made as part of any future Co-Fund. The target for the number of "new" investee companies should be clearly defined at the outset. Consideration might be given to target ranges to allow for flexibility in deal size, whilst ensuring that the KPIs for "new deals" exclude all, including small, follow on rounds.

**Ability to provide follow-on funding with funds allocated for follow-on -** A co-fund should retain sufficient follow-on funding to support investments and to support co-investment partners of the fund, through to potential positive exit. The minimum follow-on amount for the Co-Fund should be set at 50% of the fund value (this would match that used by the UK Angel CoFund). It should be noted that in a mature market, angels invest around 75% of their cash into existing portfolio companies.

**Ability to provide follow-on funding to maximise the Return from the Investment** - The ability of a co-fund to provide follow on funding, even where the co-fund private sector business angel partners are unable to (ie matching against corporates, institutional investors etc), will have a significant influence on the overall financial performance of the co-fund. A prudent investor will want to maximise the return from "successful" investments by investing more capital in them. Follow on funding will help to protect the overall value of a co-fund, supporting "successes", with these then becoming important marketing tools. However, follow on investments can be considered as having potentially less programme additionality and provide little supply side market development, with the added risk of crowding out the private sector angel investors. The inclination of a normal fund manager would be to follow success, increasing investments in companies that appear to be successful, reducing investment in those that are struggling. For an economic development fund, wishing to "crowd in" the private sector, the considerations are likely to be different. Whilst investing additional capital into successful investments may mean that there will be less capital available to invest into other new companies, (and therefore potentially narrowing the pool of companies able to access overall programme funding), successful exits lead to additional monies being available for recycling and hence may increase the availability of funding for new investment opportunities. It is therefore clear that there are conflicting financial, economic and supply side objectives associated with Co Funds which should be considered and balanced as part of any future Co Fund intervention.

**Matching against EIS/SEIS** - The Evaluation team note that other UK based funds match against EIS investments but that UK Angel CoFund will not match against SEIS[10]. However, given the need to encourage more angel investment in NI, is it recommended that the current matching against SEIS should continue.

[10] EIS and SEIS are UK tax incentive schemes (see para 4.4.3)

**Time period for the Co-Fund** - We note that none of the other benchmarked co-funds are set up on a time limited basis (of 6 years), but equally none of the other funds have a third party acting as a delivery agent, hence Invest NI is restricted by the procurement process for its Co-Fund managers in terms of having a time limited fund.

## Supply Side Development

The supply side development (i.e. development of angel investor market) has not been a key focus to date of Co-Fund in NI. Most co-funds seek to create an angel investment market, with the typical primary objective of co-funds being to alter the behaviour, capacity and capability of potential and existing private investors to invest in businesses with potential for growth and to achieve an acceptable return.

Issues for Co-Fund relate to the extent to which it is developing the supply side of the business angel market or hindering the development of the private sector, given the high level of involvement, pre and post investment, by the current Co-Fund managers. A key challenge going forward is the opportunity to reduce this intensity of resource as the supply side is developed.

**Level of Engagement of the Fund Managers -** The Co-Fund managers are more active than managers in other similar co-funds, and do not require minimum syndicate size to co-invest with, or minimum levels of skill on the part of the Angels. There is limited incentive for the Co-Fund managers not to invest at the maximum public/ private funding ratio or to "crowd in" the private sector.

**Lack of KPIs and clarity on responsibility on supply side market development** - A key issue arising from the Interim Evaluation is for Invest NI to determine the extent to which Co-Fund should focus on supply side development, which would represent a fundamental change in its emphasis. The issue also is one of sustainability: NI has 28 companies and 3 investment managers while the New Zealand Seed Co-Fund has, according to its webiste, 116 companies and three highly skilled professionals with international experience (the website does not specify the level of support resource employed). This reflects the different intervention models in the two regions. Changing the dynamics will require more work by the Lead Investors and less by the Co-Fund managers. Invest NI has tasked Halo with the responsibility to develop business angel groups and formal syndicates in NI. Invest NI needs to determine the respective roles of its delivery agents with an interest in private sector investment, (ie Co-Fund, Halo, techstart NI etc), with the challenge being firstly the development of the Lead Investors and secondly the need to get more individuals into individual deals – with increased syndications and leading to angel group formations.

**Level of Funds Leveraged** – The low level of visible business angel investment in NI, and lack of syndicates and business angel groups, has impacted upon the amount of funding leveraged. The UK Angel CoFund leverages more than two times the Co-Fund investment. The Scottish model has been to establish business angel groups, with a larger grouping of investors able to contribute to larger funding rounds. This is a challenge for NI, with the lack of syndicates and business angel groups resulting in some portfolio companies having an insufficient pool of investors for follow on funding.

**Incentives for Lead Investors** - We note that there is little incentive in NI for individuals to take on the responsibility of being a Lead Investor or to actively form a syndicate or business angel group. There is no grant funding available to help with the costs of group operation. The Co-Fund in Northern Ireland is the only public sector co-fund we are aware of that does not compensate angel partners for bringing deals to the Co-Fund. For example, the UK Angel CoFund pays the angel syndicate a 2.5% to 4% fee for the upfront work they undertake in forming the deal.

**More rigorous challenge of the private investor** - If Co-Fund NI were to move to the UK Angel CoFund model, this could mean that some "good projects" are not funded where the project lacks a sufficiently qualified Lead Investor. Increasing reliance on the private sector'**s capability** would, in the short term, reduce the level of deals completed and cash going into the companies. While the feedback from the investor surveys is that most consider themselves to be sufficiently qualified, the NI angel market is generally un-sophisticated. Lead Investors have no skills in group

formation. It still remains that with angel syndication in its infancy in NI, NI has too few angels investing, too few Lead Investors, no skills in group formation, and the amount of money being invested is too small relative to UK Angel CoFunds.

**Assessment of funding needs** - In other co-funds, the Lead Investor is challenged at the approval stage on the funding needs of the relevant company and the plan for the company going forward, including plans for sales, cash breakeven and/or exit. The Lead Investor will then report to the fund manager on achievements of the company (sales, employment, cash) against their original plan. A similar process should be adopted for NI, with better monitoring of performance against plan and exit planning.

**Assessment of the opportunity for development of Business Angel Groups in NI** – as noted, both Co-Fund and Halo (and indeed techstart NI) have an interest in business angel investment. There is a need for greater understanding of the opportunity for the development of Business Angel groups in NI. A Feasibility Study and Options Analysis should be commissioned by Invest NI to provide a roadmap as to how Angel investment groups could/should be developed in NI over the next 3-5 years. The output from this project would be taken into account as part of a Co-Fund Economic Appraisal and any future tendering for of Co-Fund and Halo programmes. In this way, Invest NI will ensure that the activities it supports are co-ordinated and mutually supportive of common goals.

**Board positions** – the hands-on approach by the Co-Fund managers to date in funded businesses has meant that they are involved at a Board level in almost all companies (albeit mostly at an observer level). Going forward, where the Lead Investor is considered to lack the necessary skills and experience, consideration should be given to the appointment of a Non Executive Director to represent the interests of the private sector, thus reducing the draw upon Co-Fund resources.

**Cooperation amongst stakeholders** – Invest NI should seek to ensure that the objectives and KPIs for Co-Fund going forward are constructed in a manner that supports the desired cooperation between the Co-Fund and stakeholders (such as Halo and techstart NI) who also co-invest alongside private investors, thus better supporting the development of the Angel market in NI. The same applies for objectives and KPIs for all relevant partner organisations within the Invest NI Access to Finance strategy.

**Limitations on matching against founders** - In terms of developing the supply side, most other co-funds would exclude matching against founders as this again limits the opportunity to present projects for angel investment. This needs to be considered as part of an Economic Appraisal for any future Co-Fund.

**Communication** – Co-Fund should continue to host events at which they inform the NI investor and corporate finance communities in NI what their role is, what they are prepared to offer to an investee company and confirm the types of companies they are targeting for investment. There should be transparency over terms by which they match the private investors.

**Economic Drivers**

**Economic targets** - Invest NI has set economic development related monitoring targets (that are not formal KPIs) in relation to turnover, employment and GVA. The Evaluation team note the relevancy of such targets to Invest NI's economic development objectives, whilst also noting that no other co-funds have similar explicit targets. These economic drivers, together with details as to how companies are performing against their original plans, etc, should continue to be reported to Invest NI on an annual basis, on the clear understanding that these are not Delivery Agent "performance" related targets.

**Financial/Commercial Drivers**

**Ability of a Government Fund to become Evergreen** - An issue for a state sponsored co-fund is to achieve a return of its capital, and thereby potentially become evergreen. All of the major co-funds considered in this report have a stated or implied ambition to become "evergreen", although no co-

funds have IRR targets[11]. There is as yet no evidence that an evergreen fund has been achieved. Co-funds do not have the same capability or capacity as, say, a private Venture Capital ("VC") fund to maximise financial returns. The Co-Fund's performance is restricted due to the imposed limitations on investment size, investee eligibility, level of share of ownership, availability of follow on funding, and partner selection and levels of support.

**Demonstration of Opportunity for Commercial returns** - One of the objectives of a co-investment fund, and a specific objective of the UK Angel CoFund, is to demonstrate to the business angel market that it is possible to make a commercial rate of return by investing in companies such as those supported by the co-fund. The ability of a co-fund to provide follow on funding, even where the co-fund business angel partners are unable to, (and matching against VCs. corporates etc) will have a significant influence on the overall financial performance of the co-fund. A prudent investor will want to maximise the return from "successful" investments by investing more capital in them. Follow-on funding will help to protect the overall value of a co-fund, supporting "successes" and has been the rationale for the Co-Fund's continued involvement in two Series B funding rounds to June 2016[12]. The successful exit in June 2016, and the gains realised, will create more funds that can be used used for recycling to fund new opportunities. However, follow on investments can be considered as having less programme additionality and provide little market development. These conflicting objectives need to be considered during the Economic Appraisal, including the assessment of market failure and how it sits vis-à-vis actions to maximise the Co-Fund's success.

**Monitoring**

There is room to improve the monitoring information gathered and provided to Invest NI on economic and financial performance.

**Targets for KPIs** – Invest NI should continue to monitor against specific KPIs on number of new deals, follow on deals, number of new Lead Investors, etc. As noted, economic drivers should continue to be reported to Invest NI for information purposes only.

**Monitoring against Plan and Cash flow requirements** - The Monitoring report to Invest NI could be strengthened with comparison of each companies' performance against their plan and more regular reporting on the key drivers for value creation, i.e. potentially profitability and cash flow. Exit planning could be strengthened, and should be reported on, including expected future funding needs over the lifetime of the investment.

**Resource requirements** - Consideration should be given to ensuring that the Co-Fund managers have an adequate level staff at an appropriate level who can undertake monitoring duties at an appropriate cost level, as well as the use of software solutions available for the monitoring of portfolios.

## 9. Conclusion

Overall, this Interim Evaluation would conclude that there is still a need for a Co-Fund intervention in NI.

As noted above, Invest NI is to determine its future objectives for Co-Fund for demand and supply side intervention. The opportunity to develop the supply side of the market, to encourage more angel investing, to develop Lead Investors, for angels to work together as a formal syndicate, and ultimately form a business angel group, should be further explored.

## 10. Recommendations

The recommendations from the Interim Evaluation of Co-Fund are:

[11] Internal Rate of Return on Investment. It is important to note that references to IRR within other co-funds have been inferred, rather than being an explicit target. For example, the New Zealand co-fund has a requirement to target "return of capital", which implies an IRR of 5%. Evergreen status will then only be possible if the fund is able to achieve a financial return on its exits sufficient to cover its capital losses and its operating costs, together with an amount to cover the devaluation of its capital caused by inflation.

[12] There have been 2 Series B funding rounds, 1 in Jan 2016 and 1 in June 2016

1. Invest NI should consider the opportunity to further develop the supply side of the market (in keeping with other benchmarked co-fund regions) with this having a marked bearing on the direction of any future Co-Fund, including the extent to which there is a more rigorous challenge of the Lead Investor's capability and potential cost implications. This should be explored through a further Feasibility Study and Options Analysis as an interim measure.

2. In the event that Invest NI moves to a co-fund model with a supply side remit, in keeping with benchmarked regions, consideration should be given as part of an Economic Appraisal as to the necessary transitionary period arrangements and the need to financially support Lead Investors if they are to assume the level of responsibility as seen in benchmark regions, to incentivise them to undertake a more proactive role.

3. In the event that the Feasibility Study finds that there is not an appetite to develop the supply side of the market, the Economic Appraisal should consider how the Co-Fund model in NI can be made more sustainable. This should include investigating how best to manage the Co-Fund manager's level of hands on involvement in existing portfolio companies in line with existing contractual terms/investee company needs, and also how to reduce the Co-Fund manager's hands on involvement in future portfolio companies.

4. Consideration should be given as to how the Co-Fund can increase the capability of Lead Investors and increase their appetite for involvement in investee companies (or where there is scope to introduce Non Executive Directors, as paid for by the companies). The role of the Lead Investor should be more clearly defined as part of any future Co-Fund, setting out roles and responsibilities.

5. Going forward, the Co-Fund's database of prequalified angels should be used to ensure that angels benefit from investor training programmes, by Co-Fund and/or others, subject to the relevant consents on the part of the angels.

6. Co-Fund investments should continue to be market led and reflect the interest of the private sector, including in pre-revenue companies.

7. Consideration should be given as part of the Economic Appraisal as to the level of Co-Fund total finance to be retained for follow-on funding, reflecting the balance required between protecting fund investments and securing successful exits, demonstrating the commercial returns to be made from investment in companies such as in the Co-Fund portfolio, as well as avoiding crowding out the private sector.

8. The funding needs of the company, to reach exit or cash breakeven, and defining targets for sales and cash generation (internally generated through sales or externally raised), should be clearly defined at the approval stage and as part of the assessment of the investment partners, to ensure that there is capacity and/or a plan to provide follow on funding at the levels required.

9. The Economic Appraisal should further consider:

   - The appropriate size of any future Co-Fund.
   - The appropriate number of deals, including a "range" for "new" investments.
   - The rationale for maintaining the minimum investment round at £75,000, and if this limit should be introduced for follow on investments also.
   - The scope to increase the maximum funding per company above £1m, subject to recognition that any one investment should not exceed 10% of the Co-Fund.

10. Any future Co-Fund should:

    - Consider the objectives of the Co-Fund, including which institutions it is appropriate to invest alongside, having regards to additionality and the need for co-terminus private angel investment so that supply side objectives are also met.

- Continue to restrain from matching solely against the founders of a company.
- Continue to match against EIS and SEIS, subject to the Lead investor investing a minimum amount (relative to a limit of £40k in UK Angel CoFund).

11. The Co-Fund should continue to improve its monitoring and reporting processes.

12. Any new Co-Fund should have activity KPIs relating to the number of new investments per annum, the number of new Lead Investors (as defined by UK Angel CoFund), the classification of investors (privates, institutions, NI/other locations etc), the mix of public to private investment, number of follow on rounds.

13. Co-Fund managers should report annually to Invest NI against activity KPIs, the position of portfolio companies against their original plan (e.g. sales, employment, cash position) and an annual updated position on funding needs to cash breakeven and/or exit. Reporting requirements should reflect investment levels.

14. Consideration should be given as part of the Economic Appraisal as to the preferred option regarding how best to cater for the fund management aspects of the current Co-Fund portfolio post the end of the current Co-Fund funding period.

# 1 INTRODUCTION AND BACKGROUND

## 1.1 Introduction

Invest NI commissioned Capaxo Ltd and its partners, including independent expert, Nelson Gray, to undertake an independent interim evaluation of the Invest NI Co-Investment Fund ("Co-Fund") covering the period from June 2011 to 30th June 2015.

Invest NI is committed to actively stimulating and encouraging early stage, high growth businesses in order to develop a world class, knowledge based economy. Its Access to Finance strategy promotes a continuum of funding and a deal flow chain. The Co-Fund is an integral part of the strategy, designed to, in part, fill the recognised gap in the supply of funding of deals of up to £3m. In addition, developing the private investor community (including through the Co-Fund) is a further important element recognised by Invest NI to support business growth and competitiveness, with Co-Fund also to be a mechanism to achieve this objective.

Co-Fund, launched for investments in 2011, is a £12.5m (uplifted from £7.2m in 2014) 6-year fund which is projected to run to May 2017. It is funded through a European Regional Development Fund ("ERDF") budget. It is the first formal co-investment fund in NI.

When Co-Fund was conceived, it was seen by Invest NI as a possible bridge between early stage seed funding (as provided by the techstart NI Fund and its predecessor[13]) and series A funding, which could possibly be provided by one of the two Development Funds[14], or other venture fund sources. Co-Fund was subject to a formal interim evaluation by Deloitte in February 2014[15] with the outcome being confirmation that the Co-Fund was on track to achieve its investment activity targets and that there was a rationale for increasing the fund size to £12.5m.

## 1.2 Aim, Objectives and Targets of Co-Fund

***Aim and Objectives of Co-Fund***

The primary aim of Co-Fund is *"to stimulate more private investment in Northern Ireland companies, who demonstrate high growth potential, are innovative and are export focused"*.

The economic appraisal that was completed for Co-Fund identified the following objectives:

- "To strengthen the capability of NI to develop and commercialise new technologies and break into growing sectors and markets"
- "To address imminent gaps in the availability of venture capital in NI by providing a continuum of funds and a deal flow chain across seed, early stage and development capital"

There are no prescriptive objectives around the development of the supply side of the investment market, a key objective of almost all other co-investment funds globally, other than a general expectation that *"as Halo[16] angels become more sophisticated and syndicated, the Co-Fund manager will become less involved in deals"*[17] and that *"it will be important for the appointed fund manager to work closely with the Halo business angel network and with the NISPO fund managers"*[18].

The Terms of Reference for this Interim Evaluation of Co-Fund (Aug 2015) noted that the Co-Fund model was based upon the co-investment scheme in Scotland, where this supply side objective of developing business angel groups and formal syndicates forms a key objective of the fund.

***Co-Fund Targets***

[13] techstart NI is managed by Pentech Ventures, a £17m seed fund investing in the range £50k -£250k
[14] Funds managed by Kernel Capital and Crescent Capital, each £30m fund invests between £150k and £1.2m, initially, with follow on up to a total of £3m (over a series of funding rounds).
[15] Interim Evaluation of the Invest NI Co-Investment Fund Deloitte, February 2014
[16] Halo is the private business angel network in NI, delivered by the NI Science Park and funded by Invest NI
[17] Submission to Invest NI Board for Co-Investment Fund, May 2010, page 9.
[18] Submission to Invest NI Board for Co-Investment Fund, May 2010, page 10, NISPO, being the predecessor to techstart NI.

Monies available for investment by Co-Fund was increased to £12.5m in 2014, as part of an Addendum. As at 30th June 2015, over £8m of the fund had been invested, leaving £4.5m to be invested over the remaining 23-month investment period. The following updated Key Performance Indicators (KPIs) were set for Co-Fund at the time of the fund size increase:

(vi) Complete 14 investments per annum;
(vii) Typically operate in the deal range of £150k - £1m, with an average investment of £170k;
(viii) Make investments on substantially the same terms as pre-qualified investors and to contribute no more than 50% of the funding in any one round and to achieve a ratio of 55:45 private to public funding over the portfolio;
(ix) Invest £12.5m over the term and no less than £2m per annum in years 4-6; and
(x) Pre-qualify no less than 12 private investors (ie additional 6 from 2014).

The Addendum also sought to quantify potential economic impacts for the Co-Fund.

***Co-Fund Terms***

The Co-Fund invests in investment rounds of typically between £150k and £1m, and will invest at a ratio of up to 50% of the investment round on *pari passu* investment terms alongside private sector investors. On a portfolio basis, the target ratio is 55:45 private:public.

*"The 55:45 ratio makes the deal "commercial" with the private money leading the deal, setting the price and contributing more than the public sector"*[19].

This ratio should be interpreted as the ratio over the life of the investment, and not the expected ratio on a deal by deal basis, increasing to 50% in the latter rounds of funding.

## 1.3 Delivery of the Invest NI Co-Fund

Following a competitive tendering process, Invest NI appointed Clarendon Fund Management Ltd ("CFM") to manage Co-Fund through a 'Management Services Agreement'. CFM is responsible for facilitating investments with ownership of the investment (mostly equity through ordinary share capital) being held by Invest NI.

## 1.4 Summary of the Co-Fund Activity

In total, 53 deals were completed to end June 2015, covering 28 investee companies and with £8m invested. It is noted that for co-funds benchmarked (see section 3), multiple follow on rounds of investment are normal practice and demonstrate good investment practice. From July 2015 to June 2016, there was a further £2.406m of investment, including into four new companies. Total investment at end June 2016 totalled £10.88m. A pipeline of deals continues to exist and CFM estimate that the current £12.5m fund could be fully invested ahead of the May 2017 target.

[19] Casework Submission: Co-Fund Uplift, page 8.

## 1.5 The scope, purpose and objective of the Interim Evaluation of the Invest NI Co-Fund

The scope of the interim evaluation of the Invest NI Co-Fund is set out in Appendix I.

The methodology followed is summarised as follows:

- Desk top review of strategic context and the Co-Fund database;
- Benchmarking with other Co-investment models as per Appendix II;
- Consultations with participant company representatives and investors, key stakeholders as per list at Appendix III (findings from company and investor consultations at Appendix V and VI respectively);
- Review of Co-Fund Portfolio as per Appendix IV and Additionality and GVA at Appendix VIII;
- Analysis and synthesis of findings and conclusions.

The evaluation covers the period of operation of the Co-Fund to June 2015. However, where more recent investment activity data exists, it is presented for information purposes.

# 2 ECONOMIC AND STRATEGIC CONTEXT

## 2.1 Introduction

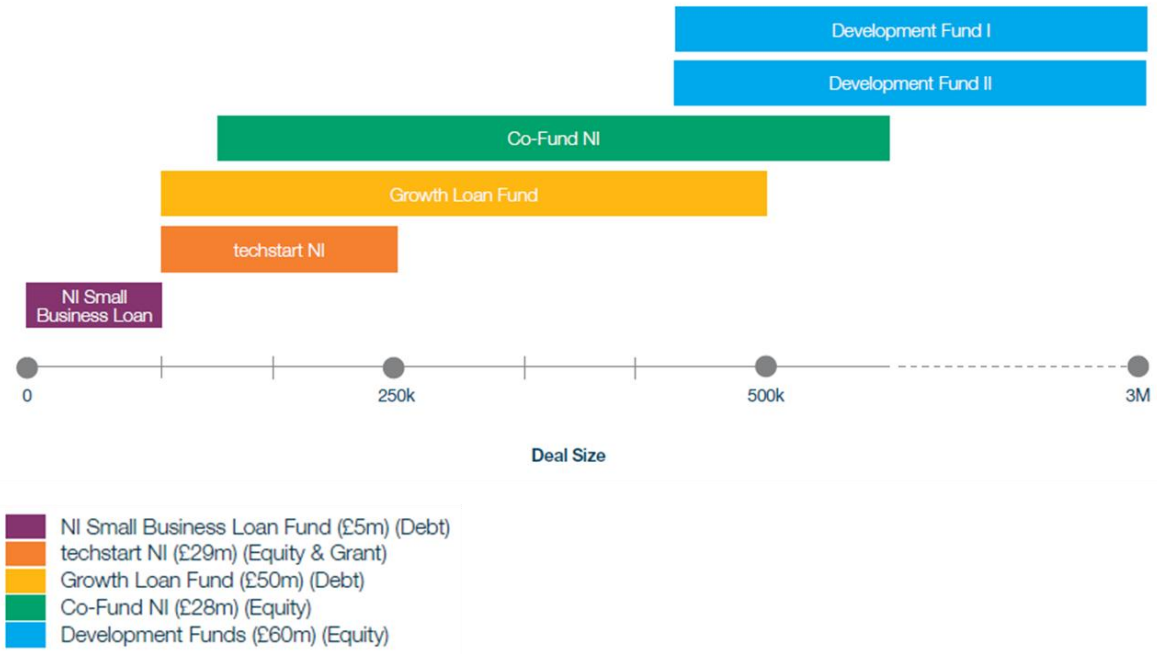
Section 2 is concerned with an assessment of the economic and strategic context in which the Co-Fund was launched and continues to operate.

## 2.2 Strategic Context – Access to Finance and Angel Activity

### 2.2.1 Government Intervention in providing Access to Finance

Encouraging the growth of early stage and high growth potential innovative businesses by way of funding and other forms of support is considered to be central to the aim of growing the NI economy. Invest NI has acknowledged that if NI is to develop a strong, knowledge based economy, then it must put in place appropriate structures to help provide funding and other support for early stage technology (in the widest sense) and growth companies in NI. To this end, Invest NI has established a range of funds to address the equity funding gap in NI, which have been consolidated into Invest NI's Access to Finance Strategy (launched in 2011), i.e. a "Fund of Funds" valued at £170 million. These provide early stage and development funding for SMEs. Co-Fund was designed to sit as follows within the Access to Finance Solutions:

A Risk Capital funding continuum – from £1k start up capital to £3m development capital:




The Invest NI Access to Finance Solutions include the following:

| Invest NI Funds and delivery partner | Details |
|---|---|
| Loan funds – delivered by Enterprise NI/UCIT for NI Small Business Loan Fund and Whiterock Capital for Growth Loan Fund | Invest NI has a NI Small Business and Growth Loan Fund (lending per business up to £50k and £1m respectively) |
| NISPO (£7m fund to 2014) and techstart NI (£13m fund from 2014) - delivered by Pentech from 2011 | Early stage seed funding up to £250k. No requirement for private/match investment.<br>Provide separate seed funding into University spin-outs through QUBIS (Queens University) and Innovation Ulster (University of Ulster) |
| Co-Fund (£12.5m fund from 2011) - delivered by CFM from 2011 | Funding for companies with high growth potential, innovative and export focused. Matches private equity funding. Deal size now typically £150k to £1m, although |

| Invest NI Funds and delivery partner | Details |
|---|---|
| | with the potential to fund companies up to £1m, or up to 10% of the total fund |
| Development Funds – delivered by Crescent Capital and Kernel (two £30m funds (each)) from 2013 | Follow on funding for deal sizes typically £450k to £2m |
| Halo – delivered by NI Science Park from 2007/8 | Facilitates business angel investment in NI companies. Funded by Invest NI, it also has the remit to develop the angel syndication market and business angel skills in NI |

The Access to Finance Solutions follow on from previous supports by Invest NI including previous Crescent Capital I and II Development Funds (up to 2005 and 2015 respectively) and the Viridian/NITEC Funds (established in 2001 and 2003), the latter also been more akin to the Development Funds.

While not stipulated at its inception, it had been envisaged that companies seeking funding would move along the "funding escalator" i.e. Co-Fund would follow on from techstart NI (and its predecessor) and be a source of funding before the Development Funds.

Co-funds are a relatively new approach by governments to addressing the funding gap that is encountered by entrepreneurial businesses. They operate on the basis of 'picking partners' (rather than 'picking winners'), investing alongside private investors, mainly business angels, thereby leveraging their networks and experience and minimizing the public sector's transaction costs. That given, the existence of the Co-Fund in NI to support high growth, technology focused businesses fits well with a range of EU, UK and NI strategies, aims and objectives.

At an EU level, the European Commission has expressed a general policy in favour of promoting VC funds in the European Community as a means of helping businesses become involved in R&D and innovation based activities. This is reflected in the EU2020 strategy which has set targets (covering the period of 2014-2020) to improve access to finance in order to enhance levels of R&D, therefore increasing levels of productivity within businesses in the EU. DG Research and DG Connect will shortly be announcing a new pan European Angel co-fund for ICT firms, specifically targeted at encouraging cross border syndicated/group angel investment. Benchmarking details are included in Section 3.

At a UK level, the Co-Fund is consistent with developments in the UK where access to finance barriers still exist for SMEs, due to the lasting impacts of the economic downturn, and the inherent risks associated with early stage technology companies that creates a barrier in accessing traditional bank finance. The UK Angel CoFund was launched in November 2011, initially capitalised at £50m and increased to £100m in 2014. The London Co-investment Fund was launched on 4 December 2014, a £25m fund to be invested alongside six preselected investment partners into companies based in London, while the Scottish Co-Investment Fund ("SCF") has been relaunched in 2015 (further details in Section 3).

In NI, the current role of Halo is particularly important for Co-Fund. The main objective of the Halo programme is to stimulate the growth of technology based, high growth potential SMEs in NI. Invest NI (in its Terms of Reference for the Evaluation of Halo in August 2015), notes that a significant body of research exists which suggests that there is a recognised gap in the continuum of the supply of equity and debt finance for start-ups and early growth businesses of this nature. The research suggests that this gap has emerged due to a combination of structural market failures relating to the demand for, and supply of, finance. The Halo programme seeks to help address this market failure by bringing together Business Angels[20] and early stage companies with high growth potential. Such Business Angel networks have existed for decades in certain countries such as the USA, Scotland and England. Invest NI targets for Halo for the period 2011/12 to 2015/16 included the following:

| Target | 2011/12 | 2012/13 | 2013/14 | 2014/15 | 2015/16 |
|---|---|---|---|---|---|
| Angel investment | £1.125m | £1.15m | £1.2m | £1.2m | £1.3m |

[20] High net-worth individuals who invest (either individually or with other angels as part of a 'syndicate or angel group') in an entrepreneur/business and provide ongoing advice and expertise.

| | | | | | |
|---|---|---|---|---|---|
| Deals | 10 | 10 | 10 | 10 | 11 |
| Leveraged investment | £2.25m | £2.3m | £2.4m | £1.2m | £1.3m |
| EIS[21] or other angel Fund | 1 | 1 | 1 | 1 | 1 |
| Funds raised in the EIS Fund | £250k | £250k | £250k | £150k | £150k |
| Deals invested by the Fund | 4 | 4 | 4 | | |
| Angel members of Halo | 150 | 175 | 200 | | |
| % Angels outside NI | | | | 15% | 15% |
| Companies pitching (incl. virtual) | 30 | 30 | 30 | 30 | 32 |
| Angel networking events | 5 | 5 | 5 | | |
| PR articles or broadcasts | 20 | 20 | 20 | | |
| New syndicates/groups formed | 1 | 1 | 1 | 1 | 1 |

Halo has therefore been charged with raising angel investment and developing business angel groups and formal syndicates in NI. Performance against targets (as per the 2015 Evaluation findings) is:

| Target | May 11-Apr 12 | May 12-Apr 13 | May 13-Apr 14 | May 14-Apr 15 | May 15-Sept 15 | Total |
|---|---|---|---|---|---|---|
| No of deals | 9 | 15 | 15 | 13 | 4 | 56 |
| Value of deals | £405k | £2.658m | £1.32m | £2.535m | £715k | £7.63m |
| Range in deals made | £25k-£100k | £15k-£550k | £30k - £395k | £30k-£500k | £30-£375k | £15k-£550k |
| Average deal size | £45k | £177.1k | £88k | £195k | £178k | £136k |

Halo has three angel groups, although none are operating effectively. Halo has recently been evaluated by Invest NI, with the evaluation noting the high level of business angel investment but the early stage in the development of business angel groups and formal syndicates.

Both Halo and Co-Fund therefore have an interest in business angel investment; however, Co-Fund, unlike other Co-Investment fund models, does not have any objectives around the development of the supply side of the investment market, and this responsibility for the development of angel groups and formal syndicates has lied with Halo. Halo has been separately evaluated and the format of a Halo intervention going forward will be subject to separate Economic Appraisal.

At a local NI level, the Co-Fund was also aligned with the NI Programme for Government 2011-2015, specifically Priority 1 which had in place targets to increase levels of investment in the NI economy. Invest NI supports, including the Co-Fund, have a particular focus on supporting high growth businesses which have the potential to compete in global markets and help promote a competitive, outward looking economy.

### 2.2.2 Market Development of Angels in Northern Ireland

Internationally most co-funds seek to create an Angel investment market where previously there was none. Therefore, while co-funds do provide funding to companies, their typical primary objective is to alter the behaviour, capacity and capability of potential and exiting private investors in such a way that they will operate in a manner that supports the economic development objectives of the fund sponsors (i.e. Invest NI).

In the case of Scotland, there are now some 20 angel groups and a sophisticated business angel sector. The Scottish Co-Fund (SCF) III funds (see section 3) has 14 pre-qualified lead partners. The New Zealand Seed Co-Investment Fund ("NZSCIF") has 13 active partners while the UK Angel CoFund has invested alongside 14 non prequalified formal angel syndicates and 25 informal syndicates. The Scottish fund has been operating since 2004, but was preceded by more hands on funds launched in 1999. The New Zealand fund was initiated in 2005, and began investing, having spent some time establishing the infrastructure of pre-qualified investment partners, in 2007. The UK Angel CoFund is much more recent, commencing operations in November 2011, with a first

[21] Enterprise Investment Scheme - a Fund consisting of monies introduced by individual Angels administered by NISP and managed by a suitably qualified individual. The Fund invests in a number of companies and therefore any Angel investing in the Fund, has their investment effectively spread over a number of businesses.

investment in March 2012, but operates in a much larger and more developed market than NI. The majority of its investments have been made in London and the South East. The above demonstrate that building a local angel investment community is a long term project.

By comparison, the Angel market in NI remains relatively underdeveloped. In 2010 what looked like the first angel group formed within Halo around a £500k+ angel investment. However, most of its members stepped back from making further investments, often stating that they wanted to 'see how this one went' before making more investments. Given the relatively small size of NI as a region, this was an early indication of the cultural problem and education gap that exists in the NI angel circles, with a reluctance by the private investors to attract attention to their investment decisions or capacity to invest.

Since then, a number of angel master classes have been run by Halo, often featuring some of the most experienced angels across the world. John Huston, Bill Payne, David Rose (USA) and Nelson Gray (Scotland) are examples. As noted, Halo now has three angel groups, although all still, in reality, at fairly early stages, and a fourth one just launching. Overall, the level of Angel investing through Halo over the last three years has been in the range of 13 to 15 deals annually, with Halo investments ranging from £1.3m in the year to April 2014 to circa £2.5m in both 2013 and 2015. When speaking to angels, the sentiment is that whilst there is recognition that the most effective investment strategy is to work in angel groups and syndicates, the collective experience of actually doing this remains low in NI.

Much work remains to be done in NI to arrive at the point that the majority of deals are completed by relatively fixed angel groups, and not by solo angels or a couple of investors coming together around one specific deal. This lack of recognisable angel groupings makes it difficult for companies to fulfil the Co-Fund objective of having sourced the majority of the private sector funding before approaching NI Co-Fund, thus placing more onus on the Co-Fund managers to bring a deal together.

As noted in para 4.3.1, Co-Fund's investment of £8m has leveraged £24.6m of funding to June 2015, including institutional funding. The Co-Fund is co-investing with a range of private sector investors, not just business angels.

## 2.3 Operational Fit of the Intervention and Complementarity with other Invest NI programmes

The profile of companies invested in through Co-Fund in NI suggests that some have availed of more than one Fund of Fund initiative, from the early stage techstart NI funding, through to Development funds. This is indicative of the profile of companies, with many being early stage pre-revenue companies and others being more mature, in existence in excess of five years.

As per para 2.2.1, it had been envisaged that companies would move along the funding escalator, reflecting greater funding needs as companies became more mature. There has not, however, been the "structured" progression envisaged, evidenced by the fact that there has been follow on into Co-Fund from existing Viridian/NITEC and E Synergy investments, previous development funds, a follow on from the Growth Loan Fund, plus Co-Fund has invested alongside techstart NI and has matched against QUBIS and Innovation Ulster. The level of interaction with other Invest NI and publicly funded initiatives (both previous ones such as Viridian/NITEC and E-Synergy) and currently, is set out in the Table below:

| Invest NI interaction with Co-Fund investee companies | No of companies (not mutually exclusive) |
|---|---|
| Viridian/NITEC | 3 pre Co-Fund |
| E Synergy | 4 pre Co-Fund |
| Crescent Capital development funds | 4 pre Co-Fund, including 1 matched with Co-Fund |
| techstart NI | 1 alongside Co-Fund |
| Kernel | 1 Post Co-Fund where Co-Fund did not participate, follow up being planned with Co-Fund participating |
| QUBIS | 7 (mix of pre Co-Fund and matching including one spin in) |
| Innovation Ulster | 2 pre Co-Fund including 1 matching |
| Growth Loan Fund | 1 (1 pre Co-Fund and a number applied but not yet progressed) |
| NI Small Business Loan Fund | 1 |

Previous investment through Invest NI-supported institutional funds prior to Co-Fund is estimated to be in excess of £4m, mainly in 3 heavily funded companies. The 28 companies have also benefitted from Invest NI grant funding of circa £5.5m from 2011, including £3.3m of Grant for R&D, reflecting the innovative nature of the companies and stage of development. Finally, with there being 9 spinouts from NI universities, a number have also received Proof of Concept funding from Invest NI (not included in the £5.5m above).

The following is noted in respect of the Invest NI initiatives:

- The Invest NI continuum of funds currently involves four delivery agents (excluding loan funds). Benchmarks and latest best practice would suggest that other regions provide funding from one single source. Scottish Enterprise reorganised its Venture Fund in 2015 and provides funding from £10k to £2m from one fund. "Competition" comes from the multiple private lead investors who are able to draw on the fund.

- Invest NI has created competition across its funds in the sense that companies have a degree of choice as to who they can approach. Co-Fund is therefore spanning the full range of the Access to Finance continuum, and the financial instruments under Access to Finance should not be considered as a linear continuum but rather, offering choice to businesses seeking funding; an example of this being one company where the company accessed Co-Fund, then development capital and is planning to access Co-Fund again; and a further company where an applicant to Co-Fund was rejected and subsequently secured development funds.

  The fund management remuneration terms differ between funds – techstart NI and the Development funds have a "carried interest" while Co-Fund does not. There may therefore be a potential disincentive on the part of fund managers to allow companies to move between funds, particularly from the earliest stages to later stage investors. Fund managers could be reluctant to pass "their" companies on to be managed by other later stage investors, if this will affect their carried interest or their management fees. Consideration should be given by Invest NI as to whether or not carried interest is an appropriate form of incentive for early stage fund managers, although, as noted, this is not an issue for Co-Fund.

## 2.4 Consideration of the validity of the rationale and need for the intervention (original and ongoing)

### 2.4.1 Need and Demand for Co-Fund

The Evaluation Team are of the view that an intervention is necessary on the demand side (ie demand for funds from companies) as there is no evidence that the private sector is yet willing to come forward to the extent necessary to fill funding gaps. The reasons are complex: the size of the private sector within NI remains small, and unsophisticated in its organisation; Halo acts as a network, but is still relatively young and is still working to develop angel groups and syndicates that invest on a consistent basis; there is a lack of examples of successful exits that might encourage private individuals to become investors within NI; private individuals who have the capacity to become investors have largely derived their wealth from traditional sources, in particular property

development, and they are somewhat risk averse when considering entering business sectors within for example technology or the life sciences where they have no personal experience or reference points.

Consultations with 19 private/Lead investors in the 28 companies invested in by Co-Fund to June 2015, indicates that only six would have invested in the absence of Co-Fund, although a further six stated that they "weren't sure" if they would have invested, including four "institutional investors":

| Investment without Co-Fund | Yes | No | Not sure | Total |
|---|---|---|---|---|
| Institutions | 2 | 0 | 4 | 6 |
| Private angels | 4 | 7 | 2 | 13 |
| **Total** | **6** | **7** | **6** | **19** |
| **%** | **32%** | **37%** | **32%** | **100%** |

Seven private angels stated that they would not have invested without Co-Fund and therefore Co-Fund provides immediate cash to allow companies to develop in the short – term.

As at June 2015, £8m had been invested of a £12.5m fund, increased to £10.4m at end June 2016 and with a strong pipeline. There therefore continues to be strong demand for Co-Fund. The Economic Appraisal for the establishment of Co-Fund also focused on creating deal flow for larger commercial funds which may in time generate commercial returns and substantial, non-monetary costs and benefits[22]. The experience to date is that there has been one follow up investment by the Development Funds (with a follow up planned) but also that there is follow up funding being negotiated outside of NI, whereby the companies are getting access to new networks as well as money.

The view of the Evaluation Team is that the market will likely remain in a developing state for a number of years.

Consideration has been given to the impact on demand of equity crowdfunding platforms, such as Syndicate Room and Crowdcube. The view of the Evaluation team is that these are not well used outside of London, are not particularly useful for knowledge intensive businesses (which over 50% of the Co-Fund portfolio are) which can be complicated to explain to the crowd investors and which need a lot of follow on funding.

There was originally considered to be a need by Invest NI for an intervention to develop the supply side of private investors. This need still exists, but the Co-Fund investment focus has been on addressing demand side funding shortages, not supply side development issues, with this responsibility resting with Halo. The Evaluation Team are of the view that that NI is some 10 years behind the Scottish industry in terms of supply side development and further intervention is necessary (and more similar to where the East of Scotland and West of Scotland was in 1999). It is recommended that a feasibility study should be completed to determine how supply side developments should be incorporated into any future Co-Fund.

Overall, there continues to be a need for the Co-Fund intervention. The rationale is that providing additional funding to companies will give them more time to be successful. It must also be recognised however that funding more companies will also result in more companies failing, simply because of the high percentage of all funded companies that do fail, as borne out in the benchmarked funds (Section 3).

### 2.4.2 Market Failure

A 'market failure' describes a situation where the market alone would not efficiently organise allocation of goods and services.

At this stage, there is evidence of market failure (at demand and supply side) to support the strategic rationale for a future Co-Fund programme, namely:

[22] Submission To Invest NI Board For Co-Investment Fund Date: 25th May 2010, page 13.

- There is risk aversion on the part of the private sector to fill the funding gaps identified by companies[23];
- The supply side of the market has not been developed in any meaningful way to encourage groups of investors to invest alongside each other and reduce the overall level of risk to the private sector;
- Linking both is coordination failures – Lack of information in relation to the rewards from investing alongside a co-fund (with Co-Fund having just achieved its first exit in June 2016).

A key issue for Invest NI going forward will be the extent to which it will seek to continue to focus on the demand side i.e. with cash for companies being the primary objectives, or the extent to which it will move more to a market development supply side development model.

## 2.5 Summary of Findings

In conclusion, Co-Fund is an important element of the funding continuum that exists in NI in its ability to de-risk funding for the private sector and match fund against them and institutional investors. The key issue is the need to further develop the supply side. This is a matter for consideration by Invest NI for any new Co-Fund and is considered further in Section 7.

[23] The British Business Bank: Small Business Finance Markets 2015/2016

# 3 BENCHMARKING

## 3.1 Introduction

Detailed benchmarking has been undertaken by Nelson Gray of Co-Investment funds worldwide. Details are included in full in Appendix II. The latter in particular sets out the investment process adopted.

## 3.2 Benchmarks of Co-Investment Funds

### 3.2.1 The UK Angel CoFund

The UK Angel CoFund was launched in November 2011 with a loan from the Regional Growth Fund (RGF) (15 year term non-subordinated loan) and support from the British Business Bank (BBB) who provide fund administration services. It was initially capitalised at £50m. This was increased to £100m in 2014. The Fund is able to invest amounts of between £100k and £1m in SMEs alongside syndicates of Business Angels, on an up to 50:50 ratio. The minimum deal size is £200k (a contribution from the Fund of £100k), though the target is to provide £100k against a £300k deal; size, keeping the fund's share in a deal they support well below the 49% limit.

The UK Angel CoFund had its first investment in March 2012, but operates in a much larger and more developed market than NI. The majority of its investments have been made in London and the south east – London dominates both the applications to the fund (44%) and the completed deals (37%). There has been just one investment completed in NI.

The UK Angel CoFund is managed within the British Business Bank (BBB) by four staff with the assistance of an external law firm for legal document review.

The UK Angel CoFund is heavily centred on angels although it also matches corporates and institutions. Businesses cannot approach the fund directly - angel syndicates must bring deals to the Fund; syndicates are considered (approved) on a deal-by-deal basis; once an initial review is passed, the Syndicate (not the company) submits an investment paper template provided by BBB which provides an overview of the business. Angel Syndicates become partners of the Fund by having a deal approved. They are not "pre-approved" or pre-qualified as is the case with the Scottish SCF. The UK Angel CoFund has invested alongside 14 non prequalified formal angel syndicates and 25 informal syndicates. A fund investment committee comprising independents approves or rejects the deal. Additionally, the Lead Angel must be approved separately from the syndicate and the lead angel is interviewed by the fund investment committee as part of the pre-qualification and approval process. This person fills the role of leading negotiations, due diligence on the quality and growth prospects of the company and post-investment monitoring. Investee companies must meet the European Commission's definition of SME.

The UK Angel CoFund has a specific headline objective to seek to increase the quality and quantity of business angel investing in the UK. The fund only invests in deals that are "new" for angels, and the fund reserves 100% of capital for follow-ons.

Just 18% of companies brought to the fund by angels make it through the due diligence review to the Investment Committee. Of these, 85% are approved for investment. The fund pays the angel syndicate a 2.5% fee for the upfront work they undertake forming the deal.

The UK Angel CoFund has specific targets (set out on a month by month basis) for the number and value of investments made. Initially it also had specific KPIs in relation to the number of jobs created, but these have now been dropped (as there are no longer ERDF monies invested). The primary focus is now on ensuring that the fund achieves a commercial rate of financial return in order to demonstrate to potential new private sector investors that it is possible to achieve attractive financial returns acting as a business angel. The fund may not hold more than 30% of a company's equity. Successful applicants have come from a broad range of sectors, including medical equipment (23%), software (15%) and financial services (online) (12%).

As at October 2015, the actual average investment contribution across 100 investment rounds has been £275,000, attracting an average private sector match of £1.72m, a match ratio of 1:4.26. This has been invested in 59 companies, meaning that each company has received an average total funding of £2.45m. As at October 2015, the UK Angel CoFund was ahead of its KPIs having invested £27.5m against a target of £27m and created 1,800 jobs against a (now not binding) KPI of 800. It is considered too early to assess the UK Angel CoFund's impact on increasing the quality and quantity of business angel investing in the UK. As noted, there are no specific targets regarding return on investments.

| Benchmark to UK Angel CoFund | NI Co-Fund (June 2015) | UK Angel CoFund |
|---|---|---|
| Launch year | 2011 | 2011 |
| Level of co-fund funding to date | £8.0m | £27.5m |
| Private sector total match funding | £16.6m | £117.2m |
| Leverage rate | 2.08 | 4.26 |
| No of investee companies | 28 | 59 |
| No of funding rounds | 53 | 100 |
| Average co-fund funding per company | £285,759 | £466,101 |
| Average co-fund funding per round | £150,967 | £275,000 |
| Match ratio (public to private) | 1:2.07 | 1:4.26 |
| No of failures | 4 | 10 |
| No of exits | 1 | 2 |
| Investments held above costs | 4 (at June 2016) | 16 |
| Investments held below cost | 9 | 14 |
| Fee to Lead Investor | No | Yes – 2.5% |
| KPIs – No & value of deals | Yes | Yes |
| KPIs -Jobs created | No | No – did previously |
| KPIs – IRR | Yes- at 0% | No |

On the face of it, 14% of the NI fund investments are held above cost, and 27% of the UK Angel CoFund investments are held above cost. The funds are operating in quite different markets and the levels of investment being made are significantly different. Fundamentally, the UK Angel CoFund is operating in much larger deals where it is clearly possible to significantly increase value faster. It is also likely that, because of the size of the deals and the speed at which their companies are developing, they are having follow-on rounds of more significance, and are therefore able to claim an increase in valuation when a transaction actually takes place. The fact that only four companies are held at an increased value within the NI Co-Fund does not mean that only four companies have increased in value. Valuations would only be recognised once a transaction takes place with a third party agreeing to pay a higher price. Valuation is really only of any significance at an exit event. Until then any company that is presently being held at an increased value, really only represents the fact that someone has been willing to pay an increased share value on a follow-on round at that moment in time, could end up being valued at zero. Companies are as susceptible to down rounds as they are up rounds.

NI deals are much smaller – yet, while salary costs are typically lower, it is not substantially cheaper to start a globally focused start up in NI than the rest of the UK. The challenge for NI is to source additional funding, with UK funds leveraging more than two times the Co-Fund investment. The Scottish model is to establish syndicates with a larger grouping of investors able to contribute to larger funding rounds.

### 3.2.2 The Scottish Co-investment Fund (SCF I & SCF II) (to May 2015)

The Scottish Co-investment Fund ("SCF") was established in 2003 and has been capitalised twice, initially £60m and then a further £67m, partially funded by the European Regional Development Fund. It was managed by the Scottish Investment Bank ("SIB"), part of Scottish Enterprise. SCF provided equity financing (very occasionally convertible loans) of between £100,000 and £1m into company financing deals of up to £2m. This total amount could be allocated in multiple rounds. SCF investment partners include private angels, private offices, corporate investors and venture funds. Each partner receives an annual investment allocation in advance, based on its anticipated investment levels against which it can draw down. In Scotland, there are now some 20 angel groups and a sophisticated business angel sector.

Between 2003 and 2013, SCF I and SCF II invested in total £103m and leveraged a further £190.8m of private sector investment.

SCF forms contractual partnerships with VC fund managers and angel groups who apply to be partners. Deals are sourced by partners and SCF co-investments alongside negotiated terms.

In terms of SCF performance up to 31st March 2013, the key statistics are as follows, together with KPI targets:

| Benchmarking to SCF | NI Co-Fund | SCF Performance 2003-2013 |
|---|---|---|
| Year of launch | 2011 | 2003 |
| Level of co-fund funding | £8.0m | £103m |
| No of investee companies | 28 | 241 |
| No of funding rounds | 53 | 661 |
| Total ERDF | £8.0m | £21.9m |
| Private sector total match funding | £11.2m | £190.8m |
| Average co-fund funding per company | £285,759 | £427,386 |
| Average co-fund funding per round | £150,967 | £155,825 |
| Match ratio (public to private) | 1:2.07 | 1:2.35 |
| Fee to Lead Investor | No | Yes |
| KPIs – No & value of deals | Yes | Not public |
| KPIs – IRR | Yes- at 0% | Not public |

When ERDF funding was being applied for during the establishment of SCF in 2004, the application included an investment return target of 20%. This target is not reported against however, and is much larger than any other funds implied IRR (typically 5% - 7%).

### 3.2.3 Scottish Seed Fund (SSF) (to May 2015)

SSF was launched in November 2006 as a £14m fund to address the equity gap for businesses in the £20,000-£250,000 range for start-up and very early stage companies that seek to grow. Under SSF, private investor partners were not pre-qualified or allocated funding in advance; the company must have arranged private investors before the fund was approached. The SSF did act as lead investor and conducted its own due diligence. SSF was managed by SIB and was the subject of a formal economic impact review in 2013[24]. The SSF was rolled into the Venture Fund under the SIB fund reorganization of 2015.

The public objectives of SSF do not specifically state an intention to increase the capacity (though as noted below, the fund has encouraged an increase in private sector funding) or capability of the supply of private sector capital, or an increase in the capability of the demand side. It is clear from the architects of the fund however that these were in practice the primary objectives in establishing the fund.

The formal review reported that SSF provided £6.7m funding for 83 different businesses, and that this has levered in some £14.5m from other funding sources, primarily business angels and VCs, a leverage ratio of 1: 2.2. The total amount invested via SSF was, therefore, £21.2m. SSF only invested £6.7m of its £14m fund; demand was low because most Scottish deals were structured at a higher investment value than that covered by the seed fund, and the majority of angel investors moved to be members of formal angel groups who were partners to the SCF, which gave them access to larger amounts of co-investment funding, without having to have each individual deal scrutinised by Scottish enterprise (SCF approved the investment partners, not the individual investments).

Applicants were Lead Partners who were subject to a detailed due diligence. Companies must have been incorporated, fall within the European Commission's definition of an SME and operate in an approved business sector. The recipients of SSF were 49% in Digital Media & Enabling Technologies, 19% in Life Sciences, and 32% spread relatively evenly over Energy, Food and Drink, Construction, Chemicals, Financial Services, Textiles, Aerospace and Forest Industries (i.e. c4% each).

[24] Economic Impact of the Scottish Enterprise Seed Fund. Final Report, PACEC, April 2013.

The annual survival rate of companies receiving SSF was 95% over the first three years (after 3 years 72 out of 83 survived)[25]. Up to March 2011 there had been three income returns from SSF shares totalling £285k. These arose from investments totalling £250k, which represents a return of 14%. In each case the returns were made after one year. There are no known KPIs.

### 3.2.4 Scottish Co Fund III (SCFIII) and Scottish Venture Fund (From May 2015)

The ERDF Programme, which part funded the SCF II, came to an end in 2015. SIB took this opportunity to carry out an assessment of all of their funds operations and delivery in response to changing market needs to ensure future delivery built on what had worked well, whilst improving the fund based on lessons learned to enable future fund activity to be as streamlined and flexible as it needed to be. This resulted in a restructuring of the Scottish Seed Fund (SSF) and the Scottish Venture Fund (SVF), and the launch of a new Scottish Coinvestment Fund (SCF III).

The Scottish Seed Fund (SSF) was rolled into the Scottish Venture Fund (SVF). As a result, the range of investments completed by the SVF has been extended to invest primarily equity of £10,000 up to £2 million, as part of a total deal size ranging from £20,000 to £10 million. SVF is also a co-fund, investing alongside private sector investors on equal terms, up to a maximum of 50% of the total funding package on a commercial basis. SVF differs from SCF III principally in that SVF co-investment partners are not pre-qualified, but are considered, along with the quality of each deal, on a deal by deal basis. Under SVF, SIB does not act as a Lead Investor, but may conduct its own due diligence (this is discretionary, based on an assessment by SIB as to the quality of due diligence that has already been carried out and the due diligence activities that are necessary in each individual case).

In this regard it is the closest Scottish co-fund operationally to the NI Co-Fund. SIB will carry out a full due diligence of the investment opportunity for SVF investments. In addition, they say they will take into consideration the deals "potential economic benefits to Scotland". The Fund will pay the investment partner a 2.5% - 3% fee on successful completion for the upfront work they undertake forming the deal.

The changes in operation for SCF III include lowering the minimum amount that can be invested by the Fund, increasing the maximum amount and increasing the overall deal size. Specifically, the minimum Scottish Enterprise investment from the SCF III will be reduced from £100k to £10k and the maximum cumulative investments into any one company led by Accredited Partners will rise from £1m to up to £1.5m on a cumulative basis. The maximum deal size for SCF investments will rise from £2m to £10m. Fund Partners are obliged to enter into a Co-Investment Partnering Agreement, an extensive 43-page document setting out the partners' duties and obligations as an investment partner. This includes that the Partner undertakes to "exercise that degree of skill and care as a reasonably experienced and diligent private equity investor would normally take in selecting, investigating and managing each Investee Company and in negotiating the detailed terms of each Co-investment", and goes on to list specific requirements relating to Due Diligence, Co-investment Terms, Investment Documentation, Fees, Conflict of Interest and the Partners obligations in regard to the on-going monitoring of investments. It is noted that these are co-investment funds where the deal sourcing and investment decisions are delegated to the partners of the fund. As a result, "competition" is built into the system at the partner level, and there is no need to have multiple funds or fund managers. Having a single fund manager, even without recourse to multiple fund partners, introduces significant economies of scale, as a single fund manager will be able to follow the company have a deep understanding of the company and considerable time effort and expense will be saved by the company in trying to find follow-on funders in competition with all other companies seeking funding at that time. There are no known KPIs.

Twice per year, the SCF III Partner must provide SIB with a report setting out for each investment:

- The Partner's view on current valuation;
- Trading summary and outlook;

[25] See Scottish Enterprise Seed Fund Final Report Jan 2015 – para 2.2.13

- Progress against original investment plan and current year budget;
- Management and board changes since last meeting;
- Anticipated changes required to management or the board in next twelve (12) months and explanation on how these positions will be filled;
- Funding outlook;
- Exit planning and return expectations

The above should be considered for the monitoring requirements of a future Co-Fund. The SIB are sent the same information that all other investors receive and as set out in the investment agreement.

### 3.2.5 The New Zealand Seed Co-Investment Fund

The New Zealand Seed Co-Investment Fund (NZSCIF) commenced operations in July 2005 and the first co-investment partnerships and first investment were announced in January 2007 (18 months later), having spent some time establishing the infrastructure of pre-qualified investment partners up until 2007.

It is a NZ $40m (£20m) fund operated by New Zealand Venture Investment Fund, a Government entity. The overall objective of the fund is to support the development of New Zealand's market for angel equity finance. This is set out in the policy documents underpinning the fund:

- Develop greater professional capacity in the market for intermediating funds between investors and newer technology-based firms;
- Increase the depth in the specialist skills needed to assess and manage early-stage technology-based investment;
- Increase the scale and enhance developed networks for early stage investment;
- Catalyse investment that would not have occurred without the programme; and
- Minimise fiscal risk and cover costs (the Fund does not have a specific financial return (e.g. IRR) target). The Fund pays a fee to its partners on completion of a deal of an average of 4%.

The core focus of and aim of the fund is the development of investors and their capabilities in the NZ market. The cash investment in the companies is a by-product of this.

The fund has an annual budget of $100k for market development initiatives[26] and a fund of up to NZ $8 million per annum for passive investment by the Crown in seed and start-up investments alongside pre-qualified angel investment partners. The fund can invest up to NZ$250k (£130k) into a new investment proposed by investment partner, on an up to 1:1 match funding basis. As at 30 June 2014, private sector was matching SCIF investment across the SCIF portfolio at a ratio of greater than 4:1[27].

The fund may only hold a maximum of 35% ownership of any investee company (with the exception of co-investments in companies originated by Crown Research Institutes or universities). NZSCIF has the ability to participate in "follow-on" investments in the same investee company for a further NZ$250k – and so up to a total investment limit of NZ$750k per company. Only 4 companies have received more than NZ$500k. While no minimum investment amount applies, SCIF will usually only consider a co-investment where its investment will be at least NZ$25k.

The NZSCIF does not conduct deals with individual investors. Instead investment partners, who may be angel networks, angel funds, etc., are "pre-qualified" by NZSCIF. The fund then relies on the Partner's investment skills and judgement for individual investments.

[26] This figure will not include any personnel costs for the fund for example. The money is used to primarily to provide some sponsorship for events, notably the annual Business Angel conference, to provide some payment to subsidise angels travelling internationally two conferences, in particular the American ACA and Asian conferences, and to pay the travel and accommodation costs of invited international experts. Given the attractiveness of New Zealand, it is relatively easy to persuade international experts to attend for expenses only.
[27] NZSCIF Briefing for Incoming Minister, October 2014

NZSCIF is the most active of all funds in seeking to improve the skill levels of potential and existing Angel Partners, with the establishment of the New Zealand Angel Capital Association, and sponsorship to enable international Angel experts to spend time in New Zealand to provide skill transfer, and for New Zealand Angels to attend international conferences and workshops.

Angel networks or funds are pre-qualified as investment partners. The fund then relies on partner investment skills and judgement. Partner qualification is rigorous; after which, few investments brought by partners are turned down. The Fund participates as a passive investor. A committee exists, which ensures that the company is at the appropriate stage (seed/start-up), there are no conflicts of interest and that the investment falls within an eligible industry.

Post investment, for each investment the fund appoints an "Investor Representative" to ensure that its investment interests are properly represented at the company board. This person is usually, but not always, one of the other participating investors in the investment. The Investor Representative must sign a standard Investor Representative letter which outlines their obligations to the Fund in that role. Standardised quarterly company reports need to be provided to NZSCIF, the format of which has been developed over the years. These reports provide quarterly highlights, "key flags" such as changes to the board, legal proceedings, any material change to type of business being carried out, plans for capital raising, expected future flags, and cash position.

The most recent publicly available performance data is as of June 2014[28].

| Benchmark to New Zealand co-fund | NI Co-Fund | NZ co-fund (shown in Sterling)[29] |
|---|---|---|
| Launch year | 2011 | 2005 |
| Level of Co-fund funding to date | £8.0m | £15.3m |
| Private sector total match funding | £16.6m | £16.4m |
| No of investee companies | 28 | 113 |
| No of funding rounds | 53 | n/a |
| Median average of investments | 18 months | 36 months |
| Average co-fund funding per company | £285,759 | £135,463 |
| Average co-fund funding per round | £150,967 | n/a |
| Match ratio (public to private) | 1:2.07 | 1: 1.07 |
| No of failures | 4 | 14 |
| No of exits | 1 | 4 (total £2.1m)- 13.5% of capital invested |
| Investments held above costs | 1 | Not Known |
| Investments held below cost (incl liquidated) | 9 | 28 (24.8% of portfolio) |
| Fee to Lead Investor | No | Yes – typically 4% |
| KPIs – No & value of deals | Yes | No |
| KPIs – IRR | Yes- at 0% | No |

NZSCIF investment modelling shows that the return on government investment of NZ$40m will be in the range 0.80x–1.5x capital by 2026. These values are very conservative, reflecting the markedly higher risk profile of pre-seed and seed stage investments. The fund expects that 90% of its positive return value will be produced by just 10% of exits achieved.

NZSCIF, which made its first investment in 2007 anticipates reaching an evergreen state by the beginning of 2019. It has an implied investment return target of around 5% IRR[30].

[28] New Zealand Venture Investment Fund, Investment Report, November 2014
[29] 1 NZD to GBP = 0.5154 - http://www.exchangerates.org.uk/historical/NZD/28_06_2014
[30] Evergreen status will be possible if the fund is able to achieve a financial return on its exits sufficient to cover its capital losses and its operating costs, together with an amount to cover the devaluation of its capital caused by inflation. The determining factors are therefore the skill of the funds partners in selecting "good" investments and steering them to profitable exits, and the cost structure of the fund. All of the major funds considered in this report have a stated or implied ambition to become "evergreen". There is as yet no evidence that this has been achieved.

### 3.2.6 Other Co-Funds

New structures and forms of Co-Investment funds are being launched on a regular basis. Most recently within the UK, the London Co-investment Fund ("LCIF") was launched on 4 December 2014. Managed by Funding London and Capital for Enterprise, it is a £25m fund to be invested alongside six preselected investment partners into companies based in London. It is interesting to note the inclusion of Crowdcube, an equity crowdfunding platform as one of the preselected co-investment partners. In Europe DG Research and DG Connect will shortly be announcing a new pan European Angel co-fund for ICT firms, specifically targeted at encouraging cross border syndicated angel investment.

Co-investment funds are rare in the USA. Ohio has a scheme by which the state will place cash into an angel fund, providing a 2X support for the funds placed there by angel investors. The angels then have complete freedom as to how to invest this money going forward. This model is not applicable in the UK as it would require the business angels to be regulated by the financial conduct authority. The Evaluators are not aware of any other state doing this. More typical state support within the USA for angel activities is to provide tax incentives against local state tax. Around 50% plus of the states in the United States have some form of local tax incentive for angel investing.

In Canada, Québec has had an angel co-investment fund at the state level supporting the Québec angels, more or less on a delegated basis. The National Association of Angels in Canada is presently lobbying the national government for the introduction of an angel co-investment fund.

## 3.3 Benchmark Evaluations of Angel Funds – Archangels Evaluation

While interest in the use of co-investment funds as a tool for economic development has increased significantly in recent years, the majority of schemes are relatively new and have not yet been subject to economic impact assessment. Much of the literature relating to other funds that is in the public domain consists largely of descriptions of the fund size, operating method, application process and input measures, including the amounts invested. It is therefore extremely difficult to obtain reliable bench mark data. A proxy measurement may be taken from the returns from organised angel groups. Only one Angel group, the Scottish group Archangels, has had an evaluation of financial performance[31]. Archangels was established in 1992 and is one of 22 angel groups in Scotland with a combined 1,100 individual investors.

In terms of Archangels' performance up to 2015, the key statistics are:

| Components | Archangels Performance 1992-2015 (23 years) |
|---|---|
| Companies invested | 80 |
| Total investment | £90m – average size from £50k to £2m |
| Support to pre revenue companies | 25% of current portfolio to pre revenue companies |
| Return by exit proceeds or dividend | £100.4m on investment of £36.6m |
| Current Active Portfolio | 22 companies with book value of £37.9m and investment of £38.6m |
| Employment | Created 2,955 jobs |
| GVA (based on 2012 data) | £7.12- £8.99 for every £1 invested |
| Turnover | £14.34- £20.39 for every £1 invested |
| Failures | 44% of number of companies invested in but 14.9% of monies invested |
| Average investment period | 8 years for sold investee companies<br>3.66 years for failures |
| Exits | 18 exits (3 IPOs, 1 MB) and 14 trade sales) of which 12 remain in Scotland, 3 moved abroad and 3 dissolved. Of 12 in Scotland, generate revenues of £587m and created minimum 240 net jobs |
| 10 year returns to 2014 | 20.9% for 10 year period |

[31] Archangels: Impact evaluation of activities, 1992-2015, Hunter Centre for Entrepreneurship, University of Strathclyde, 2015.

## 3.4 Lessons learnt from the benchmarking exercise

The SCF and NZSCIF examples can be used to benchmark the future aspirations for the Co-Fund. While both funds have been subject to formal assessment and potential comparative data is therefore available, they do not operate on the same basis as the Co-Fund at present. Both of these funds preselect and "audit" investment partners for their Funds prior to those partners submitting any potential investment. The funds do not do any due diligence or deal structuring on the deals brought to them by their approved partners.

In both cases, the fund manager assesses whether the angel applicant to the fund has the necessary skills and knowledge to become a partner and will be able to carry out sufficient due diligence to support the investment (formal assessment versus informal "opinion"). Once a partner has been approved, and brings forward a deal, the funds do not do further due diligence, or indeed review the due diligence done on any individual deal.

The ability of these funds to operate in this manner reflects the level of development and structure of the angel markets they serve and it may be an aspiration for the Co-Fund to move in the direction of these more established funds. This level of development has been achieved as a direct result of the objectives of the co-funds to be key players in the development of supply side skills and capacity. Invest NI should undertake a feasibility study to ascertain the feasibility of moving to operating in a similar fashion to more established co-funds, with more angels in deals, more Lead Investors etc.
Scottish Angel angel groups have experienced an average of 6 investment rounds per company.

Moreover, although economic development lies at the heart of all public sector intervention, there is significant variance as to the extent to which this is specifically measured for each fund. The formal assessments of the SCF and SSF report largely against such economic development targets, though these measures are not set as formal KPIs, the UK Angel CoFund to a lesser, and reducing, extent, and the NZ Co-Fund not at all (no formal economic development targets were set for this fund, which is focused exclusively on Angel market development).

We note the widely differing investment return "inferred" targets set for co-funds (for example an IRR of 20% for the SCF and around 5% for the NZ co-fund). There are however no explicit IRR targets. We note also the Archangels evaluation and its comments on timescales for return on investment and achieving economic impact, typically 8 years from the date of first investment.

## 3.5 Conclusion

The above highlights key benchmarks for Co-Fund, with key differences including the levels of investment, the assessment of investment partners, the monitoring and performance targets, the payments to lead investors and the general level of sophistication of the benchmark co-funds.

# 4 OPERATION AND DELIVERY

## 4.1 Introduction

Section 4 is concerned with an assessment of the operation and delivery of the Co-Fund. Section 4 includes the following:

| Para | Details |
|---|---|
| 4.2 | The delivery model for Co-Fund |
| 4.3 | The Investment Portfolio and Pipeline |
| 4.4 | Effectiveness in managing and delivering Co-Fund |
| 4.5 | Progress against Action Plan |

## 4.2 The Delivery Model for Co-Fund

### 4.2.1 Co-Fund Operation

The process outlined initially for the operation of the Co-Fund was based upon the ultimate objective of deals being "private-investor" and "market led", with a relatively passive involvement from CFM as the Co-Fund manager. The proposed delivery approach was to be as follows:

- Where new private investors were considering an investment but faced a funding gap, the private investors would approach Co-Fund who would assess whether the investors were "sophisticated" and/or "high net worth" (as defined by the Financial Services and Markets Act 2000[32]).
- The Co-Fund managers would assess the extent of the funding gap for deals brought forward.
- The private investors would undertake the detailed due diligence and determine the company valuation.
- The Co-Fund managers would not undertake due diligence for each investment, but would provide a challenge function that the lead private investor (Lead Investor) had carried out sufficient due diligence to support the investment decision.
- While it was anticipated that private investors and/or business angels would identify and agree in principle to invest in a potential Co-Investment company prior to contact with the Co-Fund manager, this would not preclude the Co-Fund manager from identifying potential co-investment opportunities and introducing them to private investors and/or business angels[33].
- While the role of the Co-Fund manager is not to promote investments and must not provide investment advice, the manager may facilitate an investment led by private investors and/or business angels[34].

It was anticipated that CFM initially would be more "hands on" and assess private investor syndicates and specific investments on a deal by deal basis, but, over time, would move to a position where the Co-Fund had a number of "pre-qualified" partner syndicates, thus delegating responsibility to the Lead Investor. {Note – there was no distinction between syndicates or business angel groups}. The Co-Fund documentation specifically states that the desire is for Co-Fund to move towards the "Scottish Co-investment model". To do this however, there is a need for the investment supply side to be adequately developed. The implication is, therefore, that the Co-Fund, or some other intervention,, should be helping with this supply side market development in tandem. As noted below in para 4.2.4, the current model of delivery (with no onus on the Lead

[32] the Financial Services and Markets Act 2000 defines "sophisticated" as an individual for whom at least one of the following applies: Is a member of a network or syndicate of business angels and have been so for at least the last six months; has made more than one investment in an unlisted company in the two years prior to the date below; is working, or has worked in the two years in a professional capacity in the private equity sector, or in the provision of finance for small and medium enterprises; is currently, or has been in the last two years a director of a company with an annual turnover of at least £1 million.

[33] Co-Investment Fund Management Services Agreement, page 33.
[34] Co-Investment Fund Management Services Agreement, page 33.

Investor to have the skills or experience to support the company's growth) is unlikely to have any significant impact on this objective of moving the Co-Fund managers to a less involved role in terms of actively managing investment deals.

Moreover, initially it was anticipated that the Co-Fund would "*provide assistance and support, where required, to help facilitate the investment process, without leading deals and making investment recommendations*". While the Co-Fund managers are not presently making investment recommendations, as a result of the relatively low skill base of the Lead Investors, they are having to take a more active educational and exemplar role in the deal making process.

Even in the "relatively passive" role envisaged, CFM was expected to have to:

- Assist the private investors with setting out term sheets, discussing valuation principles and providing guidance on due diligence and investment process (the Co-Fund did not set out to do its own due diligence, but expected all due diligence done by the private investors to be shared and would comment on it and guide suggested additional work).
- Work with investee companies and investors, post investment, to plan for follow on investment rounds.

The review of the processes adopted by CFM reflects the fact that no two deals are similar. Of the investee companies surveyed as part of the evaluation, CFM has acted as a broker between the company and its private investors for three of the 28 companies, applying significant resources to "work deals up". Moreover, CFM has had a hands on role post investment, with attendance at board meetings of investee companies. CFM is acting as an observer and attending Board meetings in all but one of its investee companies (excluding those in liquidation), with the justification being the need to stay close to companies to be aware of and support future investment rounds. This role is discussed further in section 7.

### 4.2.2 Eligible companies

Eligible companies for the Co-Fund were to meet the following:

- Must be a SME with operations substantially based in NI;
- Must not be in prohibited EU sectors and generally be in manufacturing or tradable services;
- Must demonstrate the existence of a funding gap in a proposed investment. Companies must have tried, and been unable, to raise all required funding from private sources before applying to Co-Fund;
- Must already have sourced the majority of the private sector funding (including a "Lead Investor"). The Co-Fund will effect introductions to private investors to help companies fill out the balance of investment rounds where necessary, but will not make introductions to effectively the first private investor.

As noted above, CFM has funded three companies where it has acted as facilitator between the companies and private investors. In these instances, the company has contacted CFM directly without having match funding in place. CFM have then made introductions to private investors and facilitated the investment.

### 4.2.3 Eligible Investment Partners

Co-Fund was permitted from the outset to co-invest (and match) alongside Universities, individual Angels, syndicates of Angels/business angel groups, founders plus corporate and institutional investors.[35]

Once a co-investment partner, who is new to the company, has been identified, the Co-Fund could match not just that new investor's contribution to a round, but also all other contributions to a round, for example including the founders, providing all are investing on the same terms. The

[35] Co-Fund management service agreement (page 10) sets out the definition of private investors

exception to this are funds from other Invest NI equity investment vehicles, which cannot be matched.

While the Co-Fund is not exclusive to business angel led deals, it was expected that a high proportion of deals would be co-investment with business angels[36]. This would reflect the position in Scotland with SCF, which can also invest with Venture Funds, but where the majority of the deals and the majority of the funding is alongside Angel investors. Nearly all of this Angel funding is provided through Formal Angel Groups in Scotland, of which there are over 20. This differs to NI where the angel syndication industry is in its infancy.

### 4.2.4 Pre-Qualification of Private Investors

CFM are required to prequalify 12 private investors by 2017[37]. The Deloitte interim evaluation noted that:

*"The benchmarking undertaken as part of this evaluation has illustrated the importance and benefits of pre-qualification of investment partners. It allows the fund operator to undertake a passive role in the investment and reduces the due diligence process, both of which reduce the costs associated with the deal.*
*The qualification and education/experience of an increased number of private investors will allow the investor market to mature and develop and will be vital for future deal flow[38].*

At present, however, the Co-Fund managers prequalify to the extent that they confirm that the business angel investors meet the minimum legal requirement to act as angel investors under the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001, i.e., confirming that they fall under the definition of either a "Sophisticated Investor" or a "High Net Worth Investor", tests that can be passed by individuals who have never actually made an angel investment[39]. These legal definitions are not intended to assess competency as an investor. Qualification merely enables an individual to receive financial promotions that have been approved by a firm regulated by the Financial Conduct Authority ('the FCA') and whose content may not conform to FCA rules.

Technically, CFM considers that the "pre-qualification" stage is met once CFM confirm that the private investors falls under the Sophisticated Investor or High Net Worth Investor definition. However, they note that, in reality, CFM is including some assessment of who the investors are and how active they have been in carrying out due diligence, and this is discussed internally before proceeding with any deals and, in majority of cases, documented in the Co-Fund investment papers. CFM also state that they have tried to step back from deals where they do not feel there is a real Lead Investor, and as such there is an element of pre-screening but that this is not formalised.

It is normal practice with other co-funds to have a formal process for assessing the capacity and competency of their co-investment partners, in particular to identify the Lead Investor who can be trusted to carry out appropriate levels of due diligence, deal structuring, valuation and post investment support and monitoring. Working with such skilled individuals reduces the burden on the co-fund managers, allowing more deals to be considered, and companies to receive greater support post investment, without increasing the co-fund's overhead costs.

The Evaluation team's view is that there is a delicate balance to be achieved between the CFM fund managers continuing to provide relatively intensive "deal making support" in order to get deals done and companies funded who would otherwise not receive investment, while at the same time not displacing the need for the private sector to be adequately upskilled over the medium to long term, resulting in the NI private investor sector never achieving the required skill base.

[36] Submission To Invest NI Board For Co-Investment Fund Date: 25th May 2010, page 8
[37] The original target was 6 as per para 1.2 with a further 6 to be qualified post the 2014 Evaluation and in the period to 2017
[38] Deloitte interim evaluation, 2014, page 57.
[39] One of the tests to qualify as a "sophisticated " investor is to have been a member of a network or syndicate of business angels for at least six months before the date of self-certification, however there is no requirement for the individual, or any other members of the syndicate to have actually made an investment, or indeed read a business plan.

On a separate note, the Co-Investment Fund Management Services Agreement, page 37, states that an investor and/or business angel who is a member of the Halo business angel network in NI shall not be counted towards the target for 12 prequalifying private investors. Given the educational element needed in developing Lead Angel abilities, it may be that this should be reconsidered to allow Halo and the Co-Fund managers to work more closely together to develop a pool of suitably skilled and qualified investors.

### 4.2.5 The Role of the Lead Investor

The intention, when establishing the Co-Fund, was that while "ultimately" it would be the private sector bringing forward the deals, it was seen as necessary that there would be a "professional" fund manager who would facilitate the deal making process in the initial stages. The Management Services Agreement (Schedule 1 para 2) notes that the Co-Fund manager will not be precluded from identifying potential co-investment opportunities and introducing them to private investors and/or business angels. This reflects the position in Scotland in 1999, when Scottish Enterprise launched the Strathclyde Investment Fund ("SIF") and the East of Scotland Investment Fund ("ESI"), precursors to the SCF.

Both of these Scottish funds were actively managed by professional fund managers as it was recognised that there was, as now in NI, few private sector investors or organised syndicates or angel groups. The SIF and ESI fund managers were, however, specifically charged with educating and developing the supply side, and worked closely with LINC, the Scottish Angel Capital Association (and equivalent to Halo), to do this. This supply side development work facilitated the launch of the SCF structure, utilising the increased supply side lead investor skills generated.

Owing to the early stage of development of private sector investment in NI, CFM, as the Co-Fund manager, continues to face a situation where most of the deals presented to them have not managed to source the majority of the required private sector funding. As with many other co-funds, including, for example, the UK Angel CoFund, they continue to have difficulty in finding suitably experienced private investors to act as Lead Investors. Because of this continuing NI supply-side market failure, CFM have remained more involved in the deal making process and post investment support role than was anticipated at the time of the Co-Fund launch.

### 4.2.6 CFM Resources and Approvals

CFM won the tender to deliver the six year Co-Fund on the basis of the employment of two full time investment executives. This was based on managing a portfolio of 18-22 new investments and 26-30 follow on investments with a fund of £7.2m. At the end of year three of the investment period, the number of investee companies was already at 21, with the continuing need for follow on funding, and a strong pipeline in place. With the Co-Fund investment potential increased to £12.5m, plus higher than anticipated CFM input both pre and post investment, and additional monitoring requirements for Invest NI and ERDF, a case was made in 2014 for additional CFM resources. An additional investment executive (plus admin) was subsequently employed by CFM to support both investment and portfolio management.

This has resulted in additional funding being agreed, with additional management fees of £432k agreed for years 4-6, representing an increase in overall management fee of 44% as compared to the original contract award value (i.e. from £1,170k to £1,689k). The Co-Fund now has three full-time fund managers.

In terms of approvals, Co-Fund has an Investment Committee comprising CFM management based in Belfast, the CFM Non Executive Chairman, and the CFM Non Executive Director, the latter being an ex-CEO of Yorkshire Fund Management Group.

Proposed co-investment projects do not require specific consent from Invest NI unless they fall outside Co-Fund's specific investment remit (e.g. >25% equity position or the investment is over £500k). CFM presents a varied level of detail (and notice) to Invest NI prior to each investment drawdown but there is regular pipeline dialogue and review at quarterly meetings.

## 4.3 The Investment Portfolio and Pipeline

### 4.3.1 Investment Activity and profile of investee companies

As of June 2015, there has been 53 investments into 28 companies. CFM has invested £8.0 million, mostly Ordinary Share Capital (£7.42m) but with circa £580k by way of Preferred Ordinary shares and Convertible Loan Notes (reflecting the practice of (largely) matching the terms and financial instruments used by investors)[40]. The latter is mainly in respect of investments by US investors. This £8.0m Co-Fund investment has leveraged a total of £24.6 million of investment into the 28 companies, of which Co-Fund matched against £11.2m and a further £5.3 million was not matched. The total amount leveraged by Co-Fund is therefore £16.6m. Details on the Co-Fund portfolio are included as Appendix III.

Companies are shown by number of investments:

| Investment | No of companies | Total Funding | Total Co-Fund | Pre Q Private Investor funds | Total Co-Fund and Private Matched | % Co-Fund of matched | % CF of total | % of Co-Fund |
|---|---|---|---|---|---|---|---|---|
| One | 28 | £15,916,824 | £4,859,405 | £7,722,315 | £12,581,720 | 39% | 31% | 61% |
| Two | 15 | £6,568,757 | £2,189,043 | £2,492,671 | £4,681,714 | 47% | 33% | 27% |
| Three | 9 | £2,001,553 | £902,797 | £968,127 | £1,870,924 | 48% | 45% | 11% |
| Four | 1 | £150,000 | £50,000 | £70,000 | £120,000 | 42% | 33% | 1% |
| | | £24,637,134 | £8,001,245 | £11,253,113 | £19,254,358 | 42% | 32% | 100% |
| | **Percentage** | **Total Funding** | **32%** | **46%** | **78%** | | | |

The above includes 1 company with 4 investment rounds, 8 companies with 3 investment rounds, 6 companies with 2 investment rounds and 13 companies with 1 investment round. Circa 61% of the total £8.0m investment at June 2015 had been in first round investments, with 39% being follow on.

The overall ratio of private to public matched funds on a portfolio basis is 58:42.
In terms of its level of shareholding, excluding the four liquidations – see below, Invest NI holds more than 20% in 4 companies, where total investment was £1.63m (average £408k), and holds less than 10% in 10 companies where total investment was £3.07m (average £307k).
The range of investment is shown:

| (£) | Total Co-Fund investment | No of companies | Average investment Co-Fund | Largest £ | Smallest £ |
|---|---|---|---|---|---|
| Investment one | 4,859,405 | 28 | 173,550 | 334,844 | 75,000 |
| Investment two | 2,189,043 | 15 | 136,815 | 470,000 | 14,268 |
| Investment three | 902,797 | 9 | 100,311 | 190,903 | 14,999 |
| Investment four | 50,000 | 1 | 50,000 | 50,000 | 50,000 |
| | 8,001,245 | 28 companies | £285,759 | | |
| | | 53 investments | £150,967 | | |

The average Co-Fund round investment is £151k, and has ranged from £75k to £334K for a first round investment and from £14k to £470k for follow on investment.

With the Co-Fund launched in 2011, investments in new companies, by year, have peaked in 2014/15:

| Co-Fund | 2011/12 | 2012/13 | 2013/14 | 2014/15 | 2015/16 – 3 months | Total |
|---|---|---|---|---|---|---|
| New companies | 3 | 8 | 7 | 9 | 1 | 28 |
| Investment | £488,875 | £1,671,405 | £2,259,780 | £3,161,024 | £420,170 | 8,001,245 |
| % total | 6% | 21% | 28% | 40% | 5% | 100% |

Note that the 2015/16 data above represents three months to June 2015. In the full year to June 2016, Co-Fund has invested £2.4m, including follow-ons and investment into four new companies

[40] CFM notes that the Co-Fund is a discretionary fund and that it has the discretion to change the terms it offers from that of the private investors (a similar approach is adopted by UK Angel CoFund)

Investment to June 2015 can be set out, by year, by new and follow on investment:

| Co-Fund | 2011/12 | 2012/13 | 2013/14 | 2014/15 | 2015/16 (3 months) | Total |
|---|---|---|---|---|---|---|
| Initial investment | 488,875 | 1,300,500 | 1,279,957 | 1,625,083 | 164,999 | 4,859,414 |
| Follow on | - | 370,905 | 979,823 | 1,535,941 | 255,171 | 3,141,831 |
| Total Investment | 488,875 | 1,671,405 | 2,259,780 | 3,161,024 | 420,170 | 8,001,245 |
| % Initial | 100% | 78% | 57% | 51% | 39% | 61% |

As at 30 June 2015, there have been four liquidations with the Co-Fund investment in these being £467k. This includes one of the three companies where the private investors were introduced by CFM (with total investment by Co-Fund of £201k). Of the £8.0m investment by Co-Fund, an uplift in valuation had been recorded in one company at June 2015[41] and, excluding the liquidations, there had been write-downs of £1.3m in a further five companies where the Co-Fund investment was £1.8m.

Note that as of June 2016, Co-Fund have recorded uplifts in valuations of £1.533m for four companies, including one successful exit in June 2016.

At 30th June 2015, the Co-Fund portfolio was valued at £6.4m, a write down of £1.6m, with write downs considered annually by CFM. At June2016, the level of net write downs against the portfolio of 28 companies has increased slightly to £1.8m.

Positive financial returns on early stage investing typically take a minimum of 6 years to achieve, with recent evidence suggesting that this is extending to 9 or more years. It is therefore not surprising to find that the Co-Fund has just recently recorded a positive financial return. It is noted that many of the companies are however in existence for 5+ years (two are well established packaging companies) and this may impact upon the timing of exits.

As a comparator for early stage funding, the NZSCIF, which made its first investment in January 2007, only showed a positive financial return (i.e. holding value plus capital returned to date exceeding the amount invested) for the first time in June 2014, and this was for a very modest amount (see para 3.2.5). The UK Angel CoFund, in its first exit, achieved an aggregate return of £1.086M on its original investment of £383K, equating to a money-multiple return of 2.84x for the fund and its angel co-investment partners. Details of the return on the NI Co-Fund exit have not been disclosed but Invest NI has confirmed that Co-Fund and the private investors all achieved very positive returns on their equity investments.

[41] See para 5.3.1, there have been 3 uplifts in late 2015/early 2016

There has been investment by Co-Fund into a range of sectors[42]:

| | No of companies |
|---|---|
| Social Media | 4 |
| Enterprise Software | 3 |
| Consumer Products | 4 |
| ICT Security | 2 |
| Biotech | 3 |
| Digital Market Places | 6 |
| Industrial/packaging | 3 |
| Medtech | 3 |
| | 28 |

**Sectoral distribution** – The Co-Fund has so far assisted eight broad sectors including high capital intensive and IP-rich (3 biotech) and low capital intensive ~ low barriers to entry (4 social media, 6 digital market places of which 2 have liquidated). All of the portfolio companies would have aspirations for export sales, although 2 related companies in the packaging sector are mainly NI focused (the first investment was in an established, packaging company, acquired under distressed sale conditions, which was also in receipt of Invest NI "Buying time" assistance as part of this restructuring, and where the Co-Fund matched against investment in new technology). It is evident that Co-Fund investments have, so far, been reflective of the "emerging" sectors in the current market, with a high proportion of companies in social media and digital market places receiving assistance, but with a broad spread in biotech, manufacturing, medtech, ICT, Enterprise software etc. 4 of the 6 digital market place companies have had their value written down and 2 are liquidated at June 2015 (with 4 liquidations in total).

**Sub regional distribution of Co-Funds** – While Co-Fund is seeking to support companies with high growth potential, not focused on regional distribution, it is noted that there is a reasonable sub-regional distribution of funds; of the 28 investee companies, 10 are located outside of Belfast.

**Level of Innovation** - Investee companies are largely innovative, with 18 of the 28 receiving Invest NI Grant for R&D support during the investment period.

**Ageing of companies** - The investee companies are predominantly very young, with the majority being circa 1 to 3 years in existence, although there are 6 companies in existence over 10 years, including the mature packaging company referred to above.

### 4.3.2 The Profile of Investees

Across the 28 investee companies, funding was leveraged from business angels, founders/management, QUBIS and Innovation Ulster Ltd ("IUL"), techstart NI, and seven Institutional Funds/corporates/syndicates from the UK and US. Details of investments in each company by institutions, corporates and syndicates, and the number of private investors per company, are set out in Appendix IV (c).

For the private investors, there were four investors who acted as Lead Investor for two companies each, with there being evidence of loose syndicates forming, including being facilitated by Co-Fund. This included one company which had pitched at Halo but had an unrealistic valuation of £4m. CFM followed up with the company and appointed Corporate Finance advisors who were able to get the valuation down to £800k. CFM then proceeded to successfully source private investors, including those introduced initially to the company by Halo. A number of these private investors (who considered themselves to be a "loose grouping" of investors), have since been looking at other potential Co-Fund projects.

The 28 deals attracted 164 private business angel investors, 22 founders/existing management, 17 corporates, 13 Venture Capital ("VC") funds plus QUBIS and IUL. Of the total of 218 investors, 139 were from within NI and 79 were from outside of NI:

[42] The sector analysis is as supplied by CFM and does not refer to SIC codes

| | NI | RoI | GB | Europe | USA | RoW | Totals |
|---|---|---|---|---|---|---|---|
| **Private Investors** | 103 | 11 | 43 | 2 | 2 | 3 | 164 |
| Investment Amount (£) | 4,317,507 | 704,526 | 1,743,550 | 28,270 | 8,252 | 313,639 | 7,115,744 |
| **Founders/Management** | 17 | - | 3 | 2 | - | - | 22 |
| Investment Amount (£) | 839,876 | - | 134,709 | 104,344 | - | - | 1,078,929 |
| **Corporates** | 10 | 3 | 1 | 2 | - | 1 | 17 |
| Investment Amount (£) | 928,085 | 510,170 | 500,000 | 485,000 | - | 25,000 | 2,448,255 |
| **VC Funds** | *7* | - | *3* | - | 3 | - | 13 |
| Investment Amount (£) | 1,291,893 | - | 2,054,175 | - | 166,459 | - | 3,512,527 |
| QUBIS | *1* | | | | | | 1 |
| across 6 companies (£) | 759,989 | | | | | | 759,989 |
| IUL | *1* | | | | | | 1 |
| across 2 companies (£) | 124,547 | | | | | | 124,547 |
| **Total Investors** | **139** | **14** | **50** | **6** | **5** | **4** | **218** |
| **Total Investment** | **8,261,897** | **1,214,696** | **4,432,434** | **617,614** | **174,711** | **338,639** | **15,039,991** |

1. The above table is not definitive as it includes funds that have not been matched against, i.e. techstart NI, and excludes debt funding. Hence, the above does not tally with the total non-Co-Fund investment introduced of £16.6m as per para 4.3.1.
2. Seven NI funds have invested across nine companies, e.g. Halo EIS has invested in two companies, Crescent Capital in two companies.
3. Six of the ten corporates in NI are individuals that have used companies as an investment vehicle.

In total, 36% of investors, representing 45% of the amounts invested, came from outside NI.

Co-Fund has therefore been instrumental in introducing new institutions into NI, although there is little evidence that these relationships are being developed and further new deals presented to them. This in turn again highlights the mixed responsibilities, with Co-Fund having played a role in introducing new investors but Halo being responsible for angel syndication.

Consultation was undertaken by the Evaluation Team of the Lead Investors (N=16 representing 19 companies and 218 total investors) with these being the Lead Investor in the companies at the time of the initial Co-Fund investment, and with 8 of these representingy Corporate investors, VC Funds, and QUBIS. These Lead Investors would indicate that almost all have experience in investing in companies, with only two indicating that they had only ever invested in one company (although 13 had only invested in one Co-Fund supported company). Moreover, only one (n=16) indicated that they were, at this time, a private business angel with no linkages with other investors, formal or informal. Consideration of the backgrounds of the Lead Investors indicate that a large number (11 out of 16) previously/currrently ran their own business, with these having a broad range of sectoral and business experience.

All 16 currently sit on the Board of the portfolio companies, with all stating that they are very active (11) or reasonably active (5) in provding direction to the investee companies.

### 4.3.3 Pipeline and investments since June 2015

In reporting to Invest NI on performance to 31st June 2016, CFM noted the investment of £2.406m since June 2015 (including investment of £525k in four new companies and £1.881m in follow on funding). There was circa £1.1million in the pipeline of which £575k was projected to be in 4 new companies. Completion of these deals would bring the Co-Fund investment portfolio to the £11.5m:

| (£) | Total Co-Fund Investment June 15 | No of investments June 15 | Total Co-Fund Investment June 16 | No of investments June 2016 | Total Co-Fund Investment Proj May 16 | No of investments Proj Aug16 |
|---|---|---|---|---|---|---|
| First round inv | £4,859,405 | 28 | £5,384,405 | 32 | £5,959,405 | 36 |
| Follow on | £3,141,840 | 25 | £5,023,509 | 45 | £5,618,749 | 48 |

| (£) | Total Co-Fund Investment June 15 | No of investments June 15 | Total Co-Fund Investment June 16 | No of investments June 2016 | Total Co-Fund Investment Proj May 16 | No of investments Proj Aug16 |
|---|---|---|---|---|---|---|
| Total | £8,001,245 | 53 | £10,407,914 | 77 | £11,578,154 | 84 |
| Average investment per company | £285,759 | | £325,247 | | £321,615 | |

## 4.4 Effectiveness of CFM in Managing and Delivering Co-Fund

### 4.4.1 Marketing and Promotional activities engaged in

Feedback from companies and investors alike would indicate that most became aware of Co-Fund and CFM from general knowledge of the fund managers and a variety of business networks. CFM updated the Co-Fund website in 2015 and has a number of case studies circulated to Invest NI which are also to be uploaded to the website. CFM also has regular update meetings with a range of partners including Halo, the Universities, Corporate Finance advisers, and other Invest NI-backed fund managers. With CFM continuing to provide a brokering service to companies, there are regular meetings with business angels to discuss the Co-Fund pipeline, as well as resources used to build Series A relationships.

Finding and assessing suitable private sector partners for a Co-Fund is largely about personal relationships and networks; conventional marketing is not generally appropriate. CFM have demonstrated evidence of wide networks and, with the strong demand that exists, the marketing activity is considered to be appropriate. CFM has stated that at the point when there is a significant exit to announce, or other such major milestone, that marketing of the same will be critical to publicly demonstrate the financial commercial value and economic benefits arising from private angel investment and thus promotion of the Co-Fund's ability to match against private investors and achieve successful outcomes. We note that the sale of one of its portfolio companies, in June 2016, is prominent on the Co-Fund website.

### 4.4.2 Range of investments

Details on investments are set out in para 4.3.1 above. The following is noted:

**Number of investments** – the number of businesses invested in at June 2015 is high at 28 – however in comparison with other co-funds (see section 3), the individual deal size and the Co-Fund's ability for follow on is relatively low (although the average investment per company has increased from £285,759 at June 2015 to £325,247 at June 2016). This is discussed further in section 7.

**There are 8 sectors supported** – including high capital intensive and IP-rich (3 biotech) and low capital intensive low barriers to entry sectors (4 social media, 6 digital market places of which 2 liquidated) – which suggests that Co-Fund is market led and reflecting the interest of the private sector.

**Early sight of funding needs** – While there has been follow on investment in 15 companies by June 2015, it is not clear as to the extent to which the initial investment was only made where there was clear sight of follow on funding needs. CFM has stated that it seeks to set aside follow on funding for companies, and to provide funding to key milestones, rather than make significant investments in the initial round(s).

**Matching -** Co-Fund can match against all investors, including founders, as long as the initial Co-Fund deal involves a new private/institution. Match funding can come from institutions only, with no requirement for private business angel investor funds to be introduced.

**CFM as broker** - There have been 3 investments by June 2015 where CFM brokered the deals, with some evidence of CFM developing informal syndicates. It is as yet unclear if these informal syndicates will do additional investments into new companies together.

**Support focused on the private investor** - CFM have suggested that, in some instances, they have backed a private investor with whom they have prior knowledge even where there are some initial concerns over valuations and company strategy. There has also been follow on funding (albeit small amounts <£15k) where Co-Fund has matched a private investor in a "failing company" where this was previously agreed and the focus was on preserving the relationship with a "serial" private investor. CFM has justified such investments in order to ensure that such private sector investors continue to engage with Co-Fund and investments across a range of company portfolios.

**Stage of development of eligible investment** – There is some deliberation by CFM as to the targeted stage of company development and the level of their investment in start-ups[43]. This raises queries as to what extent this should be at the discretion of the fund managers and to what extent investment should be simply market driven.

**Valuations** – Four portfolio companies are showing an increase in valuation to at end June2016 (one at end January 2016), although several companies have had multiple rounds of funding. This suggests that companies receiving follow on funding are not doing so against preserved increases in value. There is no reporting by CFM as to the extent to which: original valuations were too high; companies are failing to make progress gains compared to their business plans; or companies are maintaining valuation levels so as to secure smaller follow up funding in order to reach key milestones.

### 4.4.3 Basis for investment {in line with contractual terms}

Although stated as investing on a *pari passu basis,* the Co-Fund also states that it will *"to the extent possible, follow the terms of the private investors including the structure and price of any investment"*. This discretion enables CFM, as fund managers, to adjust the terms the Co-Fund invests on to ensure close alignment of interest between Co-Fund and the private sector, alignment that could be distorted if, for example, the private sector investors were benefiting from significant tax relief on their portion of the investment[44].

There is one instance where Co-Fund adopted the same terms as the institutional investor (rather than the privates). While Co-Fund would state that it provides "discretionary" funding, and that the privates benefitted from tax relief, one of the private investors was unable to avail of such tax relief and therefore considered himself to be disadvantaged. The Evaluation team would note that other funds reserve the right to be discretionary (with UK Angel CoFund not matching Seed Enterprise Investment Scheme ("SEIS") investors) and that its approach is consistent with other funds.

Co-Fund can, and has, participated in follow on funding into the companies it has invested in. To do so, however, it must again be following private sector investors. This is in contrast to the SCF, where Scottish Enterprise can continue to invest, using funds other than from within SCF, to make follow on investment, even if the private sector is not able to do so (for example the angel investor has no funds to do so). This enables the SCF (Scottish Enterprise) to preserve the value of its investment in appropriate circumstances.

With follow on investments as low as £14k in 2 instances, the approach adopted by Co-Fund could suggest a lack of strategic investment. These low-level investments would generally be for project-specific reasons (to address a short term funding challenge, honour commitment to Lead Investor to match an investment where the Lead Investor had proceeded to advance funds to the investee company) and all would be approved in advance with Invest NI. Follow on funding can therefore be in support of short term as much as long term milestones.

[43] The target company development stage is not specified in any of the Co-Fund documentation

[44] Angel investors in the UK can benefit from tax discounts of over 50% on their investments under the SEIS and EIS schemes. This substantially reduces the risk of investment for the private sector in comparison to the fund.

The Co-Fund deal size range is stated to be "typically" £150k to £1m, which, based on a deal size range of 50% of £150k, has facilitated investments of £75k. Invest NI has increased the maximum investment per company to £1m (from £720k). Four companies had initial investments below £100k. As of June 2015, just 5 companies have received total funding of more than £500k, with 3 companies having investments at circa £700k. These include 2 inter-related printing companies, where the combined investment was £970k.

Feedback from a number of companies and investees is that the ceiling of £1m should be extended to £2m plus, with one noting that "the limit of £1m is not consistent with the ambition to build larger companies of scale, with higher profiles". This assumes that the Co-Fund has a responsibility to continue to fund companies, (and does not recognise the role of the NI Development funds). The Evaluation team would contend that a bigger issue is that the angel investor base within each deal is too small to have a meaningful follow on, although the ability to match against institutional investors would mitigate against such concerns.

### 4.4.4 CFM engagement with participating businesses and private investors

In terms of its engagement with participating business and private investors, the following is noted:

**Pre-Qualification** – There is no Pre Qualifying process for Lead Investors within the meaning used by other co-funds (although CFM is meeting all existing KPIs in regard to the present understanding of "prequalification" for the NI Co-Fund).

**Due diligence** – there is evidence of CFM conducting due diligence even when this is done by another institutional investor, which is contrary to other co-funds. Other co-funds would tend to ask their investment partners to do any additional due diligence considered necessary, not do it themselves. This largely reflects some justified concerns by CFM as to the level of due diligence conducted by the private investors, but is not always scaled back where the investor (private or corporate) does undertake an appropriate due diligence process.

**Co-Fund Managers Involvement in "sophisticated" investments** – The consultations would suggest that, despite the focus by most co-funds on a "passive" role by the fund manager, CFM, by contrast, provides the same relatively high level of resource input into all portfolio companies (with variations based on company needs and challenges), i.e. through sitting as observers on the Boards, even when the companies have other "sophisticated" private/institutional investors. This is likely to reflect a number of different factors, from a perceived lack of comfortableness in the competence of the Lead Investor, to companies valuing the input of CFM into Board discussions.

**CFM overall input** – there is a high level of ongoing input by the CFM fund managers, pre and post investment, which is unlikely to be sustainable as the portfolio increases without the addition of more fund management resource, at an extra cost. There are now 3 fund managers for Co-Fund. The £100m UK Angel CoFund, with a present portfolio of 59 companies, operates with a staff of 4. The £20m NZSCIF, now with a portfolio of 130 companies (113 at June 2014), has a staff of 3. Each of these funds relies, to a greater extent, on the private sector investors, particularly in relation to post investment support and monitoring. Each would place a far greater emphasis on ensuring that the proposed private sector investor has the necessary skills to be supportive before committing to a deal. Where there was a "good" company, but a poor private sector co-investor, the deal would not proceed, and the company would likely be advised to find an alternative private investor. Within the NI Co-Fund, it is more likely that the deal would proceed, with the Co-Fund manager filling the skills gap. In discussion with CFM, they would concur with the view that the current model is not scalable (based on their current level of involvement). This issue of scalability can therefore only be addressed by improving the capacity and capability of the private sector investors, and specifically the encouragement and development of more skilled Lead Investors.

**Co-Fund's ability to sit as directors** – Co-Fund managers now have a remit to sit as directors on the Board of portfolio companies and do so for 1 company (without remuneration). CFM regularly attend Board meetings for 22 out of the currently portfolio of 24 Companies (excluding liquidations). The Co-Fund managers state that in over half of these companies (given the amounts

invested/absolute shareholding/level of involvement) they are probably falling into a shadow director position.

**Satisfaction with Co-Fund and CFM -** The feedback from both companies and investors on the role of Co-Fund and CFM is extremely positive, with all company respondents (n=22) stating that they are satisfied or very satisfied with Co-Fund and would recommend it to other companies and all investor respondents (n=15) stating Co-Fund's overall value to the private/institutional equity market to be good or very good. Comments on CFM reflect the appreciation for their hands on role and support and include:

*"The CFM guys are really good, diligent and supportive. They are well connected and have introduced the company to potential customers."*
*"CFM are very professional, very approachable and are available at all times".*
*"CFM have major expertise, plenty of local knowledge with a very 'hands on ' approach".*
*"Reliable, professional investing partner."*
*"No doubt that deals are only closing because of CFM."*
*"CFM have played an important role in pulling deals together and creating a loose syndicate".*

### 4.4.5 Financial Management and Output Monitoring arrangements

The Invest NI Co-Fund is funded 100% by European Regional Development Fund (ERDF) funding. We note that Co-Fund is meeting ERDF requirements.

As noted in para 4.2.6, Co-Fund resources were increased in September 2014. Total CFM costs are circa 11% of total funds invested as at 30th June 2015:

| Co-Fund | 2011/12 | 2012/13 | 2013/14 | 2014/15 | 2015/16 (3mths) | Total |
|---|---|---|---|---|---|---|
| Investment | £488,875 | £1,671,405 | £2,259,780 | £3,161,024 | £420,170 | £8,001,245 |
| CFM fee (incl VAT) | £115,000 | £138,000 | £203,000 | £360,000 | £97,200 | £913,200 |
| % | 24% | 8% | 9% | 11% | 23% | 11% |
| Invest NI fully loaded cost | £79,241 | £61,550 | £61,877 | £55,153 | £17,924 | £275,746 |
| Total Costs | £683,116 | £1,870,955 | £2,524,657 | £3,576,177 | £535,294 | £9,190,191 |

Invest NI internal costs for administering and managing the Co-Fund totalled £275k as at the end of June 2015. The above would indicate that the total cost of Co-Fund to 30th June 2015 is £9.190m.

Investment monies are transferred directly to the investee company from Invest NI (via solicitors) and are not handled by CFM.

In addition to monthly statistical reporting, CFM reports formally and meets with Invest NI on a quarterly basis, with details of total investments, valuations and write downs, the investment pipeline, progress against KPIs as per the targets in para 1.2. There is an annual report prepared that sets out the company information on turnover, FTE employees, net profits and GVA[45].

The Evaluation team would note:

- The Monitoring report to Invest NI could be strengthened with comparison of each companies' performance against their plan;
- Exit planning could be strengthened, and should be reported on, including expected future funding needs over the lifetime of the investment.

## 4.5 Progress against the Action Plan (as per 2014 Evaluation)

Details of progress against the Action Plan prepared following the 2014 Interim evaluation of Co-Fund is as follows, with the main issue relating to monitoring:

[45] Calculated by CFM as net profit/(loss) plus wages

| No. | Recommendation | Status per Evaluation Team |
|---|---|---|
| 1. | Continue the operation of the Co-Fund over the remaining term of the contract (until June 2017) at a minimum. | Ongoing |
| 2. | Increase the upper investment limit of the fund into the deal range of the Development Funds by 2014. | Co-Fund has the potential to fund to £1m, up from £720k |
| 3. | Increase the size of the Co-investment fund (resulting in a pro rata increase in the management fee as per terms and conditions of contract) | Increased from a £7.2m fund to a £12.5m fund, with the CFM fee increased from an annual fee of £138k to an annual fee of £388k |
| 4. | Seek to pre-qualify a further 6 private investors prior to contract completion in 2017. | In the period from May 2014, there were 8 investments with a total of 37 new private investors. These would have been "pre-qualified" as per the CFM definition. CFM has had no role in the development of the skill base of investors |
| 5. | Improve Operation of the programme through establishing enhanced monitoring and reporting processes – with better systems to record information from the companies – requiring bi-monthly updates from the companies (for example: companies upload the information on the website rather than CFM seeking the information) by 2015. | Co-Fund is requesting this additional information but note that it is not fully completed by companies and lacks real commercial updates. This should be addressed going forward.<br>Monitoring reports could be enhanced further with details of actual versus planned progress.<br>With high level of follow on required, this should also facilitate the receipt of monitoring information |
| 6. | Establish and implement a communications strategy to educate and inform businesses and investors on equity finance and the various options available by June 2014 (Invest NI responsibility). | This recommendation (for Invest NI) is partially accepted - the communications strategy and subsequent action plan could be improved but also needs to take into account the equity funding available through the other funds within the access to finance suite. Guidance is awaited from DETI[46]. In the meantime, Invest NI continues to actively promote the funding continuum and the Invest NI Corporate Finance team are engaged with Comms with regard to developing a suitable Comms strategy in a budgetary constrained environment. |
| 7. | CFM – Establish and implement a communications plan (to include an enhanced website) in order to increase awareness of the Co-Investment Fund by June 2014 | The website has been updated. Planned communications around 30th deal, first successful exit (this now being effected) |
| 8. | Invest NI to liaise with DETI colleagues to discuss the additional work incurred with the ERDF reporting requirements which are over and above the original contract terms and its potential impact on the management services fee | Uplifted fees in place |

[46] The DETI commissioned report "Research into the Future of Venture Capital, Private Equity, and Growth Finance in Northern Ireland" was published in March 2015 and DETI are currently considering the best way to take forward the recommendations therein which will likely involve a working group with representation from Invest NI.

## 4.6 Conclusion

Overall, the review of Operation and Delivery would indicate that CFM has a hands on role for the delivery of Co-Fund, with resources increased beyond that originally envisaged of a relatively passive role. Overall the role of Co-Fund differs from those benchmarked in section 3:

- It is not operating overtly as a supply side support measure.
- It does not place specific responsibilities/requirements upon the private sector investors.
- It does not assess the capability or capacity of the private sector investors.
- It is managed by professional fund managers at a deal level, who are making investment manager type decisions, rather than delegating these decisions largely to the private sector.

This in large measure reflects an unsophisticated private investor base in NI, although Co-Fund has also matched against institutional funds. The current delivery model creates challenges in ensuring sustainability and scalability. This is discussed further in section 7.

# 5 PERFORMANCE & IMPACT

## 5.1 Introduction

Section 5 is concerned with an assessment of the performance and impact of the Co-Fund. Section 5 includes the following:

| Para | Details |
|---|---|
| 5.2 | Economic performance of companies invested in through Co-Fund |
| 5.3 | Financial performance of Co-Fund |
| 5.4 | Wider impact of Co-Fund |
| 5.5 | Extent to which Co-Fund is meeting its stated aims, objectives and targets |
| 5.6 | Assessment of the impact in increasing/stimulating equity investment and addressing barriers to finance |

## 5.2 Economic performance of companies invested in through Co-Fund

### 5.2.1 Economic Performance as per Monitoring reports

The economic impact analysis for Invest NI evaluations would generally consider gross and net impacts, considering gross GVA and employment, taking account of deadweight and displacement.

For the purpose of the Interim Evaluation of Co-Fund, the Evaluation Team would note that investee companies are, in general, young pre-revenue/pre-profit companies and very little of their GVA impact potential will have, as yet, materialised. In addition, if the target of the Co-Fund is to support technology companies[47], it must be appreciated that very many of them will not trade profitably whilst held within the Co-Fund. Profitability is not the primary indicator of value within such companies in their early years. The specific value drivers for any individual company will depend upon the industry sector. For example, the value driver of an Internet company may be the number of users or the number of "hits". The value of a life science company is likely to be based upon its patent portfolio and the specific data proof points it obtains from different stages of its clinical development.

CFM prepared a report for Invest NI in November 2015 that sets out investee company information in relation to current turnover, FTE employees, net profits, employment costs and GVA[48]. This is summarised below and includes a scenario where the four largest companies by turnover value are excluded for illustrative purposes[49]:

| Investee Company data | Investment Amount (At June 2015) | 31 Oct 2015 FTE employees | Most recent full year Turnover | Most recent full year EBITDA | Full year Employment costs | Most recent full year GVA |
|---|---|---|---|---|---|---|
| | £'000 | | £'000 | £'000 | £'000 | £'000 |
| Companies – all | 8,001 | 359 | 28,444 | -5 ,900 | 12,317 | 6,417 |
| Companies - excluding 4 largest by turnover | 6,331 | 137 | 4,680 | -6,346 | 5,092 | -1,254 |

The table above excludes the four investee companies that have been liquidated to date.

FTE employment and salaries above include non NI staff, although, as noted below, non-NI staff represents a small proportion (8%).
Based on CFM data, there are seven companies with turnover in excess of £500k, ten companies with a positive GVA (based on a combination of wages & salaries and EBITDA), and three companies report a positive profit position (i.e. EDITDA).

[47] The Co-Fund objective, as per para 1.2, include to strengthen the capability of NI to develop and commercialise new technologies and break into growing sectors and markets.
[48] Prepared to 31st October 2015 and calculated by CFM as net profit/(loss) plus employment costs, with data taken from 2014 and 2015 statutory accounts, management accounts etc with estimations made where data was incomplete.
[49] Including a packaging company in East Belfast, invested in in 2011/12 and while the turnover and employment has fallen from levels pre investment, this remains a substantial employer in the area (with over 150 staff). This one company accounts for 46% of total turnover and employment of companies within the Co-Fund portfolio.

### 5.2.2 Turnover and Employment Performance as per the Evaluation Team

Note that as part of the evaluation Co Fund I, companies were asked to provided details of their turnover and exports sales at the point of investment and their current position, as part of a survey.
Separately, at a later stage as part of the Evaluation, an exercise was completed to estimate the cumulative annual turnover effects associated with the Co Fund. This latter exercise was completed using supplementary turnover information available to the Evaluation Team for a small number of companies, which in some instances differed marginally to those totals provided as part of the company survey. It is noted that the 'At Investment', 'Current', and 'Increase from Base to Current' totals used in the Table here are based on the self-completed company survey data, whilst the 'Cumulative Increase' estimates (as set out later in this section) have utilised the more detailed annual turnover totals available that for some individual companies, and assume a build-up in annual sales. The self-reported export levels have been applied to the cumulative totals.

Accordingly, on the basis of an average investment period across the 28 companies of 1.93 years (with the period of investment by Co-Fund ranging from 3.5 years to a few months), the change in turnover, export turnover and employment has been estimated by the Evaluation team, taking account of the responses from company survey consultations, and information from Co-Fund (where gaps existed).

The increase is estimated as follows[50]:

| Excludes four liquidated companies | Total Gross Sales | Gross Export sales outside NI | Gross Export sales outside UK | Total FTE employment | NI FTE employment[51] | Estimated NI salaries[52] | Estimated salaries by CFM |
|---|---|---|---|---|---|---|---|
| | £'000 | £'000 | £'000 | | | £'000 | £'000 |
| At investment | 22,935 | 8,220 | 1,466 | 311 | 305 | 6,996 | n/a[53] |
| Current | 28,157 | 16,928 | 7,118 | 383.5 | 353.5 | 9,636 | 12,317 |
| Increase from base to current (not cumulative) [54] | 5,222 | 8,708 | 5,651 | 72.5 | 48.5 | 2,640 | n/a |

The difference in current salaries between the level estimated by CFM (£12,317k) and that estimated by the Evaluation Team (£9,636k) reflects a number of factors, including the fact that CFM includes all remuneration and employer costs (likely to be an additional 20% of costs, for employers NIC, pension, other benefits and non NI staff), whilst the Evaluation Team's estimates relate to NI staff salaries only and does not include employers' costs (see para 6.2.1).Other contributory factors to differing totals include timing of data collection, use of estimates where gaps exist, and self reported errors by companies reporting as part of the evaluation. It is noted that four companies reported that they were generating profits during the consultations, compared to three reported based on the CFM assessment, although this may reflect changes in profitability from when both sets of data were collated.

Current NI FTE employment is noted at 353.5. These figures include all companies. When the one large packaging outlier is excluded (with 210 staff at commencement and 160 staff currently), there were 95 NI FTE jobs at investment, 193.5 currently, hence 98.5 new jobs and 95 jobs

[50] Note that there were some supplementary turnover figures presented by companies post the analysis of the survey responses – these are reflected above, with there being some marginally differences to the turnover detail presented in Appendix VIII
[51] These figures include all companies. When the one large packaging outlier is excluded, there were 95 NI FTE jobs at investment, 193.5 currently, hence an increase of 98.5 and 95 jobs safeguarded.
[52] See detail in para 6.2.1
[53] Information was not collected by CFM on salary costs at the date of the investment
[54] There was a fall in total local sales, which is consistent with the fall in sales of the large packaging company – see para 5.5.3

safeguarded. Similarly, when the outlier is excluded from total gross sales, turnover at investment is stated at £2.935m and currently at £15.157m, an increase of £12.222m.

In terms of salaries, the Archangels Evaluation report (para 3.3) notes that early stage, high risk companies are not typically well-paying employers relative to the skill levels of their staff (although typically above the NI average median as per para 6.2.1) – they have to manage cash flow carefully and are focused on developing their unique selling point in the products or services that they are trying to sell. However, the Archangels' experience is that companies start to increase their employees' salaries significantly as they grow. The NI experience is that technology companies[55] incentivize their senior staff through share option schemes in the earlier years. This suggests that Co-Fund has the potential to grow the number of high-value added jobs within NI over a longer period of time.

In considering the increase in sales, the cumulative increase in total sales and export sales is estimated, (taking into account the increase from the base, year on year). As noted above, information is taken from actual company accounts for four companies and estimated for a further 12 companies reporting turnover in 2015 (and assuming a build up in annual sales). The results are shown inclusive and exclusive of one large company which reported a fall in total and export (outside of NI) turnover:

| Excludes four liquidated companies | Total Gross Sales | Gross Export sales outside NI | Gross Export sales outside UK | Total Gross Sales excluding outlier[56] | Gross Export sales outside NI excluding outlier | Gross Export sales outside UK excluding outlier |
|---|---|---|---|---|---|---|
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| At investment | 22,935 | 8,220 | 1,466 | 2,935 | 2,220 | 1,466 |
| Current | 28,157 | 16,928 | 7,118 | 15,157 | 13,028 | 7,118 |
| Increase from base to current[57] | 5,222 | 8,708 | 5,651 | 12,222 | 10,808 | 5,652 |
| Cumulative increase | 2,566 | 12,325 | 9,644 | 19,566 | 17,425 | 9,644 |

The above would indicate total export sales of £12.325m attributed to the Co-Fund companies. Forecast turnover and employment was also provided as per the company consultations (see Tables below). There were no responses from 2 companies. The results shown are inclusive and exclusive of 2 outliers (two companies with significant growth forecasts where they are forecasting turnover growth of a factor of 10 times and employment of a factor of 2 times – and independent of the company historically reporting a fall in sales):

| Includes two outliers | Total Gross Sales | Gross Export sales outside NI | Export sales outside UK | Total Gross FTE employment | NI Gross FTE employment |
|---|---|---|---|---|---|
| | £'000 | £'000 | £'000 | | |
| Current | 28,157 | 16,928 | 7,118 | 383.5 | 353.5 |
| Forecast in one year | 90,600 | 76,079 | 26,913 | n/a | n/a |
| Forecast in 3 years | 277,544 | 258,676 | 188,695 | 800.5 | 671 |

| Excludes two outliers | Total Gross Sales | Gross Export sales outside NI | | Export sales outside UK | Total Gross FTE employment | NI Gross FTE employment |
|---|---|---|---|---|---|---|
| | £'000 | £'000 | | £'000 | | |
| Current | 24,261 | 13,071 | | 6,729 | 356.5 | 343.5 |
| Forecast in 1 year | 37,100 | 23,079 | | 11,613 | n/a | n/a |
| Forecast in 3 years | 84,144 | 66,776 | | 40,295 | 686.5 | 636 |

Note that the companies are forecasting minimal increases in non NI employment.

[55] As per para 1.2, Co Fund's objective was to strengthen the capability of NI companies to develop and commercialise new technologies.
[56] The outlier in this instance is one large company reporting a historical fall in sales
[57] Referred to in footnote 54 above - There was a fall in total local sales, which is consistent with the fall in sales of the large packaging company – see para 5.5.3

For many companies, they are at an early stage of development, with R&D and early commercialisation ongoing for many (ranging from proof of concept R&D for a number of early stage companies, to continued commercialisation for more established companies), and salary levels maintained to preserve cash flow.

It is recognised that there are significant limitations associated with the projections above, given the nature of the intervention and companies involved. Notwithstanding this, it is noted that the majority of projected employment in three years' time, (ie 636 jobs) is projected to be NI based.

The feedback from consultations was that 38% of companies considered that they were performing the same or better than expected at the time of original investment, with 62% not performing as well as expected. For some, significant commercial benefits have been realised including additional sales, development of strategic partnerships, greater penetration of export markets etc. Comments from companies:

*"The company has now moved to a profitable monthly trading position each month, with cash in bank circa £150k".*
*"Revenues are materially up, staff increased to 8 in NI and 18 outside NI, break even achieved".*
*"The company is performing better and got costs down, has secured the top 3 City of London financial clients and is close to breakeven. There is greater emphasis on recurring deals".*
*"The Company is currently operating at 25% above target. In the last 12 months, the Company has secured work with the 3 top academic clinics in the US as well as top clinics in the UK"*
*"The company has been able to partner with some major customers, is working with major retailers, has business opportunities coming from the Gulf countries such as Kuwait, Qatar and also from Asia, and is currently establishing a satellite office to connect with China trades".*
*"The company is finalising licensing agreements and has 30-40 potential orders".*
*"The company has established relationships with UK, US and China and has started to generate revenues".*
*"The company has established partnerships with significant companies overseas, in the US, Netherlands and Japan".*
*"A contract is being negotiated in the US - a 10 year contract worth up to €30 million".*
*"The company is selling demonstration products (at £30k to £50k). More focus now on product sales with contracts under negotiation"*
*"There is still 12-24 months of R&D but the Company has secured a major US food manufacturing customer. Has 20 customers with recurring subscription revenues".*

## 5.3 Financial Performance of Co-Fund

### 5.3.1 Potential Exits

The Terms of Reference had requested that consideration be given to the assessment of the financial impact (financial return) of the Co-Fund through discussions with investees, clearly separating actual and anticipated impacts.

There was one successful exit in June 2016. Details have not been disclosed, but feedback from Invest NI is that this has been a positive exit. There have been no dividends paid to investees to date across the portfolio. Given the limited time the Co-Fund has been investing, the limited financial returns are not unusual. Positive financial returns on early stage investing typically take a minimum of 6 years to achieve, with present evidence suggesting that this is extending to 9 or more years. It is therefore not surprising to find that the Co-Fund has to date recorded just one positive investment exit.

Wiltbank's studies have demonstrated that cash returns in an Angel investment portfolio are highly concentrated in winners; 90 percent of all the cash returns are produced by 10 percent of the exits[58]. The implication for the Co-Fund is that a) further exits may not be achievable, or indeed

[58] See "Angel Investors Do Make Money, Data Shows 2.5x Returns Overall", Oct 13, 2012 by Robert Wiltbank, PhD, http://techcrunch.com/2012/10/13/angel-investors-make-2-5x-returns-overall/

identifiable for a further three to nine years b) of the 28 companies invested in to date, just four will likely provide 90% of all the capital returned to the Co-Fund.

IRR targets for other co-funds are reported on in Section 3. Overall, it is considered by the Evaluation Team to be too early to report on potential IRR targets for the NI Co-Fund (see para 6.2.3). The IRR on the June 2016 exit has not been disclosed although Invest NI report a positive return.

Both companies and investors were questioned in relation to the exit strategy in place for the company and the responses are set out in the Tables below. Caution should be exercised in assigning any degree of reliability to the data provided during the consultations. Experienced investors know that it is virtually impossible to predict which companies in a portfolio will prove to be the winners, and that entrepreneurs and company managers are inevitably over optimistic.

| Potential Exit | Company respondents | Investor respondent |
|---|---|---|
| Trade sale | 17 | 13 |
| Stock exchange flotation | 3 | 1 |
| VC/Private Equity Buy Out | 3 | 3 |
| Potential Strategic partner | 2 | 1 |
| Don't know | 0 | 2 |
| Too early to tell | 0 | 1 |
| Liquidated | 0 | 1 |
| **N=** | **21** | **19** |

The estimated timing of the exit was also provided:

| Potential timing of the Exit of Co-Fund | Company respondents | Investor respondent |
|---|---|---|
| Less than 1 year | 2 | 3 |
| 1 – 2 years | 2 | 3 |
| 2-4 years | 12 | 8 |
| 5-7 years | 2 | 1 |
| Over 7 years | 0 | 0 |
| Don't know | 3 | 3 |
| Liquidated | n/a | 1 |
| N= | 21 | 19 |

As would be expected, the majority of respondents are positive as to the potential for a successful exit. The types of forecast exits vary, with trade sales to US partners, including strategic partners, being the most widely cited. 11 companies project that valuations will be £5 m+ in 2/3 years, with 7 companies projecting valuations of over £10 million.

In total, 14 of the companies (n=22) anticipate requiring further investment prior to exit by Co-Fund, with the level of additional cumulative funding estimated by 12 of these to range from a cumulative £17.9m to £24.1m.[59] This will have implications for any future Co-Fund. It is noted that in late 2015/early 2016, three portfolio companies have raised additional funds at an uplift in valuation, with one company having exited in June 2016 at a positive uplift in valuation. The June 2016 return by CFM to Invest NI shows the original investment on these four portfolio companies (of £2.496m) being reflected at £4.030m, an increase of £1.533m or 61%. The overall portfolio is estimated at a deficit of 19% for the 28 portfolio companies. The Evaluator's view is that this reflects prudent write downs with no provision for potential uplifts on all performing portfolio companies.

As previously stated, there has been one exit to date, which is not surprising given that Co-Fund made its first investment in 2011/12, with the longest funding period being four and a half years and with the average investment period for the portfolio companies being 1.93 years. This makes it challenging to assess the financial performance of the Co-Fund, with there being no disclosure of

[59] This represents an overall fund requirement. CFM have since estimated there to be a requirement of £3m from Co-Fund which will provide sufficient funding to the existing Co-Fund I portfolio throughout the life of Co-Fund II.

the return on the exiting company and there being inherent difficulties in "projecting" returns (i.e. 62% of companies note that they have performed below plan).

Only one benchmarked Angel fund (Archangels) has had an evaluation of its financial performance[60], with details set out in Section 3.

Of Co-Fund's remaining 24 companies (at June 2015), 14 (n= 22) state that they require follow on funding (and hence investment by Co-Fund could be significantly higher).

The value of Co-Fund can be demonstrated through the case study on Cirdan Imaging:

**Cirdan Imaging** designs, manufactures and supplies innovative medical imaging solutions for the detection and treatment of cancer in surgery, radiology and pathology. The founder, Dr Hugh Cormican, was previously founder of Andor Technology and has many awards and accolades. Pre Co-Fund - there were 3 fund raising rounds supported by the co-founders and staff, and used for R&D and staffing costs. Co-Fund's investment enabled Cirdan to become a spin-in into QUBIS, matching QUBIS and a small number of independent privates. A follow up round was particularly instrumental in funding the acquisition and then integration, commercialisation when Cirdan acquired the IP and assets of the Centricity Laboratory Division of GE Healthcare IT in collaboration with Kainos Software Limited in Belfast in Oct 2013. The responsiveness of Co-Fund was key to enabling the deal to happen. The Company exports globally and have offices in Canada and Australia.

Published sales to date are in excess of £3m with the staff complement having grown from 6 staff pre Co-Fund to 30 currently, including 21 in NI.

Cirdan did consider VC development funds at the time of the initial investment but didn't progress with these as the fit wasn't considered by management to be right at this time - they had anti-dilution clauses that were not appropriate for seed capital.

Since Co-Fund, Cirdan has raised further funding from the Kernel development fund and has closed
a Series B funding round in Qtr 1 2016 (circa £3.5m) with Kernel, Co-Fund and Kainos participating.

Kainos' investment (for a 10% shareholding) will enable the two companies to work closely together for their mutual benefit and it is envisaged that Cirdan could become an important reseller of Kainos' Evolve solution in the US, Canada and Australia. As part of this development, Cirdan has entered into a five year Evolve SaaS agreement carrying an annual license fee and additional potential revenue depending on platform usage. The continued involvement of CFM and expertise they bring is considered by the founders to be invaluable.

## 5.4 Wider Impact

### 5.4.1 Role in developing the Skill base of the NI Investor Market

The Co-Fund has had a limited reported role in developing the skill base of the NI investor market, with 25% (n=16) of investors stating that they have increased their general knowledge of angel investing as a result of being involved with the Co-Fund. Moreover, Co-Fund would appear to have added value to investors, for example, working with small groups of investors in portfolio companies to develop capability by mentoring NEDs and Lead Investors as well as support through follow-on round corporate finance fund raising, exit planning, insolvency and HR restructuring.

### 5.4.2 Role in addressing the Equity Gap

The Co-Fund's impact is more immediately apparent in the extent to which it has addressed the "equity gap" for NI portfolio companies, with over 40% of surveyed companies (n=22) noting that

[60] Archangels: Impact evaluation of activities, 1992-2015, Hunter Centre for Entrepreneurship, University of Strathclyde, 2015.

Co-Fund provided access to angel and VC investment that would not otherwise have been accessible.

Co-Fund's main reported benefits are:

- It has enabled investors to undertake larger funding rounds and to make follow-on funding arrangements. The Co-Fund has provided 'stretch funding' to enable more rapid access to larger amounts of funding in an equity gap ranging from £200,000 to at least £2m. Feedback from companies indicates that this has facilitated more rapid R&D and commercial development than would otherwise take place;
- It has helped to attract new institutional and corporate investors to NI as per para 4.3.2;
- It has facilitated QUBIS to introduce a spin in company (with IUL already an investor in a Co-Fund supported company);
- CFM has used its experience and significant networks to build Series A funding relationships (although none completed to date).
- The confidence of the private investors has been raised, with two thirds of investors (n=15) stating that as a result of working with the Co-Fund, they as Lead Investor, are more likely to be a Lead Investor again in a Co-Fund in NI, or other deals, and 45% of private investors (n=11) more likely to invest with the same syndicate members in another deal as a result of having completed this investment.

*"Co-Fund was able to fill out a round. The round wouldn't have closed without Co-Fund. It would not have been practical or realistic to raise £500k from private investors in NI. Having a small number of investors plus Co-Fund enabled this deal to get completed".*

*"Having the Co-Fund involved in a deal gives confidence about raising required future rounds of funding".*

The comfort that Co-Fund and CFM brings to private investors was also noted:

- 87% stated that with Co-Fund match funding, private investors have been able to spread available investment funds across more companies, reducing risk;
- 67% stated that having the Co-Fund involved in a deal gives confidence about raising required future rounds of funding;
- 87% stated that the Co-Fund has helped to address the gap in equity funding in NI.

*"There is a need for investors to spread risk and Co-Fund facilitates this".*
*"CFM have major expertise, plenty of local knowledge with a very "hands on approach".*
*"Reliable, professional investing partner".*
*"No doubt that deals are only closing because of CFM".*

An alternative argument is that Co-Fund could be mitigating the need for angels to build large syndicates or angel groups.

### 5.4.3 Networks and skill base available to Portfolio companies

The feedback from the company and investor engagement highlights the value that CFM and Co-Fund has brought to its portfolio companies:

- The CFM team is highly regarded, the skill base is considered to be sound and their input at a strategic level is valued[61];
- It has trusted CF advisers that it can use to help challenge company valuations and other impediments to securing investments for good companies;

[61] There is no suggestion that there are conflicts of interest arising, although CFM is likely to be acting as shadow directors as per para 4.4.4

- It is well networked and seeks out business development and funding opportunities, with a number of customer gains arising from CFM introductions;
- It has developed some informal angel grouping to which it is continuing to present pipeline projects for funding;
- It has provided support to companies in developing their management teams (see 5.4.5):

*"The company now has the perfect MD with perfect experience to match with company, CFM was key in sourcing him".*

*"There is a PR benefit by association with the Co-Fund and the team at CFM. Investors take confidence that the company has secured a reputable investor such as the Co-Fund, it provides a backdrop of due diligence that a private investor relies on. In other words, private investors take comfort in the fact that the Co-Fund has invested because they see the CFM team as professional investors. This is also important for follow on funding".*

The above feedback would emphasise the fact that the CFM team are seen as 'professional investors' rather than fund managers.

The Evaluation team would also note that these informal angel groupings are "hidden" and only accessible through CFM as fund managers. Other funds would make the investors, or at least a representative, more public – so expanding the "visible" sector of the market.

### 5.4.4 Co-Fund Role in creating Commercial Value

In terms of the value of the portfolio, four companies have had a value increase since its initial investment (only one at June 2015).

At the time of the establishment of the Co-Fund, it was envisaged that a key benefit of Co-Fund would be its ability to create dealflow for larger commercial funds which may, in time, generate commercial returns and substantial non monetary costs and benefits. It is noted that despite the relatively young age of the portfolio, with the average investment period being 1.93[62] years, the 24 companies still trading in the portfolio, at June 2015, have increased total gross turnover and export turnover by £5.2m and £8.7m respectively (see para 5.2.2)[63], with the creation of 98.5 gross jobs and 95 jobs safeguarded (see para 5.5.2), these being above the NI average salary levels (see para 6.2.1).

For the surveyed companies:

- 55% reported an increase in R&D and Innovation within the company; and
- 73% reported further development and growth of the company.

Further growth in turnover and employment is envisaged.

Co-Fund has also been instrumental in attracting 5 non NI investment funds to its portfolio companies and has already secured follow on investment from one of the NI Development funds. Further funds and strategic partners are being pursued by portfolio companies.

[62] Assuming those less than one year = one year
[63] The growth in export sales exceeds that of local sales, with local sales having fallen

### 5.4.5 Other Benefits to companies from private investor engagement

The Co-Fund has brought wider benefits to companies from their engagement with private investors who might not have otherwise invested and brought the Lead Investors' expertise to the companies/boards. The companies surveyed (n=22) indicated that these derived benefits from:

- Investors[64] consulting/advising, serving as a sounding board (77%)
- Investors assisting with evaluation/recruitment of management team members and staff (50%)
- Investors assisting in development of new products or services (45%)
- Investors assisting in sales and marketing effort (41%)
- Investors providing strategic support in short-term crises and problems (73%)
- Investors providing support in the development of Company's strategy (82%)
- Investors providing access to networks (potential other investors, potential other board members, management team members, service providers, customers, suppliers or corporate partners) (73%)
- Investors embedding knowledge, experience and disciplines into start up and early growth stage companies (64%)
- Improved image: the presence of the private investor providing confidence in the investee company (68%)

There are three instances where the Lead Investor has gone on to act as CEO or Executive Chairman, and five instances where the Lead Investors have been instrumental in changing the management team, with resultant company benefits. Feedback provided includes:

*"QUBIS has been able to share their experiences of other spin out companies. As a Spin in to QUB, it is also easier to have a relationship for research contracts with QUB".*

*"Have an excellent Lead investor, who has key linkages and has floated a number of key medtech firms. Sales and Marketing and Strategy skills have been transferred from the Lead investor. The investments prior to Co-Fund did not make a noticeable difference, but the investment supported by Co-Fund has made a considerable difference by attracting this knowledgeable Med Tech fund to NI".*

*"Private investor has helped in developing business plan and strategy. One investor is looking to secure a business deal with the Company".*

### 5.4.6 Development of the Business Angel model and Informal syndicates

The Evaluation Team note that Angel activity is at a very early stage of development in NI, with few Angels and very few potential Lead Investors/Angels. As per para 2.2.1, Halo now has three angel groups, although all still, in reality, are at fairly early stages, and a fourth one is just launching. None of these are really active or doing deals.

This has resulted in CFM having to take a more active role in identifying angel investors (albeit limited) than anticipated. There is evidence that Co-Fund has started to make some inroads also into facilitating informal groupings or syndicated deals, although not yet business angel groups, with a number of existing Co-Fund Lead Investors already looking at Co-Fund pipeline deals together. There are still no effective Business Angel Groups operating in NI.

As per earlier, we note that there are no Co-Fund prescriptive objectives around the development of the private angel investment market (a key target of most other co-funds). We note that the Deloitte 2014 report suggested that[65]:

[64] Investors in this section excludes the fund managers
[65] Deloittes used the terminology of Syndicate to refer to Business Angel Groups – hence their comment has been paraphrased

*"Despite not being responsible for developing Business Angel Groups it will be important that CFM continue to foster and strengthen links with Halo in order to support Halo's development and delivery of private investors and business angel groups."* We note the Invest NI response that responsibility for development of business angel groups continues to lie with Halo.

While the initial proposal for the establishment of the Co-Fund did anticipate that fund managers would be more active in the investment process within NI than was characteristic in other co-funds in other more developed regions, it was also anticipated that as Halo angels become more sophisticated and syndicated, the Co-Fund manager would become less involved in deals. It was considered important for the appointed Co-Fund manager to work closely with the Halo business angels[66], with one of the non-monetary benefits arising from Co-Fund identified as "its ability to strengthen the NI business angel network". The Co-Fund would *"accelerate the development of Halo, the NI business angel network"*[67]. As noted above, there is some evidence that the NI business angel network, while still in its infancy, is starting to develop; there is less evidence however that Co-Fund and Halo are working efficiently and effectively together.

It will be appropriate to ensure that the objectives and KPIs for any Co-Fund going forward are constructed in a manner that supports the desired cooperation between the Co-Fund and Halo (and any other interested stakeholders such as techstart NI who also co-invest alongside private investors) for the development of the Angel market in NI. SCF for example has a specific objective of *"increasing the number of fund managers operating in the "equity gap"*. The nature of the selection criterion of investment partners for the SCF significantly favours those who are members of formalised angel groups, which encourages new angels to join such organisations in order to access the fund. The synergy between SCF and formal angel groups is credited with creating the "distinctive" Scottish market where "*deals are larger, there is more co-investment activity, more follow-on investing and larger investee companies*"[68].

[66] Submission to Invest NI Board For Co-Investment Fund Date: 25th May 2010, page 9.
[67] Submission to Invest NI Board For Co-Investment Fund Date: 25th May 2010, page 4.
[68] Annual Report On The Business Angel Market In The United Kingdom: 2008/09, BIS, 2010, page ix.

## 5.5 Extent to which Co-Fund is meeting its stated aims, objectives and targets

### 5.5.1 Assessment against KPI targets

An assessment of Co-Fund's performance against the KPI targets set by Invest NI would indicate that all are being meet or exceeded. It is noted that all were investment activity related targets, namely:

| Original Key Performance Indicator | Update on Progress at March 2014 | Revised Key Performance Indicator | Progress against revised targets at June 2015 | Performance against targets |
|---|---|---|---|---|
| **To complete eight investments per annum (to new companies and follow on)** | Completed 25 investments. Includes 18 companies and seven follow on deals.<br><br>Equates to 25 deals in 2 yrs and 10 months which is ahead of target (8 pa equates to 23 in 2 yrs and 10 months) | **To complete 14 investments per annum for the last 3 years (June 2014 to May 2017) (to new companies and follow on)** | Completed 53 investments across 28 companies.<br><br>Four have gone into liquidation.<br><br>Year to June 2015 - 23 investments, with seven new investments and 16 follow on investments<br><br>Includes follow on (£14k) in (now) liquidated company | On target |
| **To typically operate in the deal size range for Co-Fund monies of £250,000 to £450,000. This will include an average deal size of £150,000 per annum.** | Average size of the Co-Fund investment completed: £176,802[69]<br><br>Range of total deals completed (including Co-Fund and private sector): from £100k to £2m with an average of £448,988 | **To typically operate in the deal size range for Co-Fund monies of £150,000 to £1,000,000. This will include an average deal size of £170,000 per annum. (Invest NI consent over £500k)** | Year to June 2015 – Total funding of £7.7m, with deal range from £28k to £1.1m. Average deal size £336k.<br><br>Co-Fund investment totals £2.66m, with range from £14k (for a follow on) to £300k. Average Co-Fund investment of £116k. | Variation from target |
| **To make investments on substantially the same terms as pre-qualified investors participating. To contribute no more than 50% of the funding and no less than the ratio of 55:45% private to public funding in** | Deals completed have not exceeded the 50% ratio. The public sector ratio contribution ranges from 18% to 50% with the majority (16 out of 25) of the completed deals being between 45% and 50%.<br><br>Average public sector contribution across the all deals is 39% and private sector contribution is 61%. | **To make investments on substantially the same terms as pre-qualified investors participating. To contribute no more than 50% of the funding on an individual deal basis and no less than the ratio of 55%:45% private to public funding in each year (on an aggregate basis).** | Mainly pari passu but one exception where Co-Fund matched the terms of the institutional investors and not privates.<br><br>Deals completed in year to June 2015 have not exceeded the 50% ratio. As per para 4.3.1, the overall ratio of private to public matched funds on a portfolio basis is 58%:42%.<br><br>The public sector ratio contribution ranges from 5% to 50% with 12 out of 23 of the completed deals being between 45% and 50% and 15 out of 23 being between 40% and 50%. There were 7 deals where the ratio was less than 40%. Lowest contribution was £50k against a £1m follow on deal. | Variation from target on terms<br><br>On target for public:private |

[69] Co-Funds only

| Original Key Performance Indicator | Update on Progress at March 2014 | Revised Key Performance Indicator | Progress against revised targets at June 2015 | Performance against targets |
|---|---|---|---|---|
| **each year.** | | | | |
| **To invest £7.2million over the term and no less than £1million per annum by way of investment and follow on investment as required** | After 2 years and 10 months, the Co- Fund has invested £4.420m - which equates to approximately £1.56m per annum.<br><br>(On a pro rata basis of £1.2m per annum the expected level of investment at this stage would be £3.4m).<br><br>Investment to date is split £3.069m in initial investments and £1.351m in follow on investments. | **To invest £12.5million over the term and no less than £2million per annum in each of Years 4 – 6 by way of investment and follow on investment as required** | Total invested at June 2015 was £8.0m.<br><br>Year to June 2015 - Co-Fund investment totals £2.66m. Investment split £1.4m new investments and £1.2m follow on.<br><br>Actual deals and pipeline deals at June 2016 would bring total investment to £11.5m. | On target |
| **To pre-qualify no less than six private investors as pre-qualified investors over the term. At least three will be qualified in the first two years of the term.** | At May 2014, CFM indicated that they have over 30 pre-qualified investors who are non-Halo | **To pre-qualify no less than a further six private investors as pre-qualified investors over the remaining three years.** | CFM have confirmed that they have met target. In the period from May 2014, there were eight investments with a total of 37 pre-qualified private investors. | On target |

Key Commentary:

- The Co-Fund is generally achieving or on target for its stated target KPIs
- Variations are in respect of pari passu terms and deal sizes, although CFM would state that Co-Fund is a discretionary fund.
- As per para 6.2.3, Internal Rate of Return ("IRR") targets are at 0% (a definition of IRR is included as Appendix VI). It is considered by the Evaluation Team to be too early to report on actual IRR achieved.
- There are no KPIs around private angel investor supply side development (capacity or capability).
- The KPIs do not include any measurement of the increase in syndications or the sophistication of private sector angels

### 5.5.2 Assessment against Other Targets introduced in 2014

Additional monitoring criteria/measurements were introduced by Invest NI in 2014, with these being recorded for Invest NI purposes only and not used to drive the performance of the Co-Fund managers. These were based on an increased fund size of £12.5m:

- Jobs created/ safeguarded: between 233 and 427 (mid point 330)
- Additional turnover of between £28m and £82m (mid point £55m)
- Target: Additional GVA of £16.4m to £35.3m (mid point £25.9m)

The Evaluation team has not been presented with the detail to determine the period the monitoring criteria refers to, or if these are reported gross or net, although the Economic Appraisal prepared for Invest NI in 2014 would indicate that projected activity levels have been benchmarked against the SCF[70].

Achievements to date at a gross reporting level are noted as per para 5.2.1 and 5.2.2, namely:

| Measure | Target[71] | Gross Performance | Status |
|---|---|---|---|
| Employment - Jobs created/ safeguarded | Between 233 and 427 | Excluding one outlier where there were 50 gross jobs lost (from 210 to 160):<br><br>98.5 gross jobs created; 95 gross jobs safeguarded<br>Total 193.5 jobs created and safeguarded | On course to be achieved if the majority of jobs are assumed to be safeguarded are included and including outlier |
| Additional turnover | Between £28m and £82m | The portfolio companies reported additional sales of £2.566m (£19.566m additional sales when outlier is excluded) and additional external and export sales of £12.325m (£17.425m excluding outlier) | Early progress against target |
| Additional GVA | Between £16.4m and £35.3m | Additional GVA (as measured by W&S only) of £3.957m before deadweight or £2.993m net of deadweight (see para 6.2.1) | Early progress against target |

When the one outlier is excluded, there were 95 NI FTE jobs at investment, 193.5 currently, hence an increase of 98.5 new jobs and 95 jobs safeguarded.

We note that other co-funds do not have explicit/public targets associated with employment, turnover and GVA. UK Angel CoFund has recently dropped their jobs target (as it is no longer ERDF funded). NZSCIF never had such targets. The 2008 assessment of SCF tried to calculate economic impacts, but does not set them against any targets that had been set for the co-fund (section 2).

In any event, the Evaluation team's view is that such assessment is limited by the early stage of the Evaluation given the average age of the Co-Fund investments. This is discussed further in section 7.

[70] As per Economic Appraisal Uplift "Net additional economic impact of SCF (based on investment of £33.6m): Employment: current 449-644 jobs; and future 176-505 jobs which equates to between 625 and 1149 jobs. Given the COIF (£7.2m), the pro rata equivalent is: between 134 and 246 jobs."
[71] It is not clear if this is a gross or net target

### 5.5.3 Assessment against Aims and Objectives

The primary aim of Co-Fund is *"to stimulate more private investment in Northern Ireland companies, who demonstrate high growth potential, are innovative and are export focused"*.

The economic appraisal that was completed for Co-Fund identified the following objectives:

- "To strengthen the capability of NI to develop and commercialise new technologies and break into growing sectors and markets"
- "To address imminent gaps in the availability of venture capital in NI by providing a continuum of funds and a deal flow chain across seed, early stage and development capital"

Co-Fund is investing cash into companies and meeting demand side requirements for cash. There is evidence of:

- Additional external and export sales of £12.325m (£17.425m excluding outlier)
- Investment in a range of sectors
- Investment focused on R&D

There is evidence of growth, innovation and export potential within some, but not all, portfolio companies, although for some it is too early to tell. Four companies have failed (which is to be expected – as per para 3.2.5, for the NZSCIF, there are 14 failures and 28.4% of portfolio companies are held below cost) and one investment is in a packaging company which has seen significant decline, albeit recent recovery to circa pre-investment levels. Other companies reported on the investment in technology and commercialisation of such technology, including Cirdan (whose case study is included in para 5.6) Overall, the view of the Evaluation team is that the demand side aims and objectives are being met, including the development and exploitation of new technologies.

In assessing the performance of the Co-Fund and CFM's overall performance, the following is also noted:

- Co-Fund can match against all other sources of private funds, providing at least one is a new investor to the company in the initial investment. There is no restriction on follow on funding, as long as the matching funds qualify. There is no imperative to specifically match against private angels. Of the seven new deals in the year to 30th June 2015, four were solely matched with Institutional/corporate investors from UK/US.
- There is some complementarity with other Invest NI funding initiatives; of the 13 deals (including seven follow-ons) completed by Halo members in the year to April 2015, just two were match funded by the Co-Fund, while only one of the 10 equity-based techstart NI deals have been matched by Co-Fund.
- CFM is also being active in originating deals and matching deals to investors (three of the 28 deals were organized by Co-Fund).
- There is a lack of clarity as to the purpose and value of the pre-qualification process for the investors, a process which does not assess capacity or skill. There is no focus (or remit) on developing the supply base or skill base of private angels. There is no focus on developing "Lead Investors", a key component of other co-funds. There are a significant number of investments by Co-Fund (circa 70%) that originate from the company rather than the private investor.
- Investment decisions are made for a variety of reasons – ranging from CFM being presented with a good company, or good investor skills but there can be a mismatch in investment principles (ie CFM match funding where a concern exists that the valuation too high but the company/Lead Investor is well regarded). There have been investments where the level of deal size appears to be meeting a short term rather than a strategic need.
- As at November 2015, Co-Fund had had 54 "informal applications" and made investments into 29 companies (of the 54 applications). There would appear to be a lower percentage of applications being presented by UK Angel CoFund for approval (the approval panel sees just 18%

of applications, and approves 85% of those it does see)[72]. However, caution is noted as the above may not necessarily be comparing data of equal standing, and the two co-funds may record an "application" at different stages of contact. Given the close nature of the market in NI, there are more informal approaches to the Co-Fund which are not recorded, and as a result inappropriate applications are not formally recorded as applications.

- CFM resources are heavily involved in post investment development and monitoring, in part as a result of a lack of lead private angels. Typically, they provide a comparable level of post investment involvement in each company (quasi Director status), even where the Lead Investor is sophisticated or an Institutional investor.
- There is evidence of good work by CFM in networking (business development and funding).
- There is evidence of funding taking place that does not conform with the concept of the NI Access to Finance funding continuum - in one instance Co-Fund invested alongside techstart NI, there have been four investments into Crescent Capital companies, and there was one investment alongside a Kernel backed company in January 2016. Co-Fund is therefore spanning the full range of the Access to Finance continuum; discussions with Invest NI would indicate that the financial instruments under Access to Finance should not, in reality, be considered as a linear continuum but rather, offering choice to businesses seeking funding.
- There is little evidence of the acceleration of the NI business angel network as it impacts upon Co-Fund (which would allow the role of CFM to decrease) although there is some evidence of informal syndication groups forming. However, overall, the supply side development is not clearly set out and while this is not formally an aim (that is not being met); this would be a typical aim of other co-funds.

## 5.6 Assessment of the impact in increasing/stimulating equity investment and addressing barriers to finance

In the funding period from 1st July 2015 to 30th June 2016, there has been limited funding available for new investments from the Co-Fund. There has been investment of £525k into four new companies (22% of total investment in the period), with 78% of funds being follow on funding of the existing portfolio. There were 20 follow on investments between June 2015 and June 2016. This is not unusual for co-funds at the early stage of the funding market. Both the SCF and the NZSCIF now see 75% of their funding go into follow on rounds. Angel investors would normally be advised to reserve a similar level as their initial investment for follow on support. The UK Angel CoFund reserves half of the fund value for follow on.

Earlier sections of the report set out the successes of Co-Fund to date in providing access to finance, with Co-Fund achieving and exceeded its KPIs, and actively working a pipeline, in part facilitated by CFM and its matching of companies (with better defined valuations) and investors, and the accessibility of Co-Fund in matching against institutions, corporates etc.

Whilst c60% of companies invested in by June 2015 were pre-revenue, we note that CFM had been, more recently, considering more discretion around support for pre revenue deals and potentially focusing on revenue generating projects, which would align to the funding continuum as envisaged by Invest NI and included in para 2.2.1. While CFM qualify this by saying that each deal will be subject to assessment of the investor and company, and indeed more recent investments continue to be pre-revenue, it is noted that Co-Fund investments should be market led and reflect the interest of the private sector, including in pre-revenue companies.

Despite this, there is still a limited number of skilled private investors in NI and the NI Lead Investor market has not developed sufficiently and not to the extent envisaged in the Addendum to the Economic Appraisal in 2014. Moreover, Lead Investors are not pre-qualified in relation to skill, competency or capacity to support a deal. The Evaluation team's view is that while a number of the portfolio companies have attracted Lead investors who have the necessary skills and experience (including institutional investors), this lack of proactive development of the private equity market will mean that it is unlikely that the NI Angel market will be developed to the extent that Invest NI can reduce funding to the Co-Fund in the foreseeable future.

[72] UK Angel Co Fund have a more formal process for recording applications than Co-Fund hence these are not like for like comparisons,

It is also noted that Co-Fund in NI is the only major co-fund not to provide a "deal fee" payment to the private sector on completion of an investment. These completion fees are usually in the range of 2.5% to 4% of the value of the co-funds' investment. These fees have proved to be of significant importance in assisting Angels to form and operate formal syndicates and angel groups, and are an incentive for individuals to take on the onerous responsibilities of a Lead Investor.

The need to stimulate and support more syndication is particularly relevant where private investors are only willing to invest small sums (i.e. £10k), with one company noting *"Our experience is that local investors who typically invest 10k or less are unwilling to lead a deal."* The challenge is therefore to have more angels in syndicates, to join/form business angel groups and to have more lead angels.

An alternative for governments who wish to support the development of angel groups would be to pay a grant directly to the groups to help cover their operating expenses[73]. The advantage of doing so via a co-fund is that the level of support will be directly related to their actual level of investment activity. The payment of such fees also makes it easier for the co-fund to impose requirements relating to the quality of deal preparation, due diligence and post investment monitoring and support requirements onto its co-investors, all of which also helps to improve the skill base of the private sector. The European Investment Funds European Angels Fund (EAF) does not pay a fee to the Partner, but will share investment-related costs on a pro-rata basis, and does pay a 'Carry' to the Partner on a successful exit. The DG Research and DG Connect (European Commission) pilot European Cross Boarder Co Investment Fund[74] (to be launched 2016) will pay a fee to the private investors for "scouting, screening and due diligence of the company".

As noted earlier, NI is still not seeing syndicates being developed at the levels envisaged, there are no effective business angel groups in NI, and therefore there is limited access to follow on funds. The SCF experience is that there are typically 6 rounds of follow on funding until exit. This could become a challenge for the NI portfolio companies where there are insufficient funds available from the private investors (and insufficient angels in a syndicate) to bring deals to a satisfactory exit. While Co-Fund is matching against institutional funds, the experience of the Evaluation team is that Institutions and corporates will not do the volume of deals that angels will do. Notwithstanding this, there does appear to be a willingness amongst portfolio companies to engage with follow on VCs at an earlier stage than, say, in Scotland. This is evidenced by the number of portfolio companies (currently 14) seeking follow on funds of up to circa £24million. The ability to raise this level of follow on funding has however not yet been demonstrated.

As a further difficulty, working relationships across Invest NI "Fund of Funds" can be challenging, with different funds being managed on different criteria, with two having "carried interest", unlike Co-Fund, which doesn't. CFM appears to be proactively seeking to work alongside its "Fund of Fund" partners, although there may not always be an alignment of interests, for example in the declared support for pre-revenue companies. Other benchmarked co-funds such as SCF do not have similar issues, with all funding managed centrally. This is a management issue which Invest NI acknowledges and is considering the implications of.

Halo has responsibility for syndication but CFM would query if Halo have access to appropriate angel investors with follow on funds (Halo is perceived as operating in the £50-100k deal size though actual average across 13 deals in the year to April 2015 was £192k provided by Angels). Going forward, CFM should ensure that it opens its database of prequalified angels to enable them to benefit from Halo investor training. Opportunities for angel investing come in NI from various sources, including Co-Fund, Halo, techstart NI etc. Closer working relationships and introductions to suitable angels, should be encouraged.

We note that the UK Angel CoFund will not match against SEIS element of an investment as the 50% tax deduction for the private angel investor is seen to make alignment of interest with the fund

[73] In Scotland, LINC, the Angel Association, (see Appendix 2), provides ERDF backed financial support to Scottish angel groups, with the condition that they develop their operations to a standard sufficient for them to qualify as Scottish Co Fund partners, and complete a target number and value of deals each year.
[74] HORIZON 2020 – Work Programme 2014-2015, Access to Risk Finance, Equity Facility window, 3.1

difficult. NI is however so far behind in the development of the private equity market (with a lack of syndicates/groups etc) that this is unlikely to be an option.

The engagement with companies and investors has highlighted a number of areas for addressing or considering going forward, namely:

- **Transparency of roles** - Co-Fund should consider hosting events whereby they inform the NI investor community in NI what their role is, what they are prepared to offer to an investee company and confirm the types of companies they are targeting for investment. There should be transparency over terms by which they match the private investors. CFM would note that they extensively marketed the Co-Fund principles when it was initially launched through a programme of events, and continues to do so on an on-going basis primarily through regular one-on-one meetings with the investment community and Corporate Finance community.

- **Targeted support** - The Co-Fund needs to be more selective because there are less funds available. There is a perception that Co-Fund doesn't support pre revenue companies (although the investment statistics indicates that Co-Fund has, including recently, funded pre-revenue companies) but Co-Fund needs to support these and derisk for the private sector.

- **Level of funding -** The challenge for companies is in raising £2m plus. Consultees have queried if Co-Fund should be a larger fund and invest up to £2m (although, as per para 4.4.3, the issue is that the angel investor base within each deal is too small to have a meaningful follow on). Moreover, if the funding cap increased to £2m, to keep a 10% limit on any one company the minimum fund size could potentially need to be £20m. There is also support for more money to be made available for 1st time investments. The potential for Co-Fund to invest from pre-revenue companies to investments up to £2m highlights the fact that Co-Fund is spanning the full range of the Access to Finance continuum, and that the financial instruments should not be considered as a linear continuum but rather, offering choice to businesses seeking funding. It is also noted that this flexibility is in keeping with other benchmark funds that can fund from pre-revenue to exit.

- **Tax benefits -** Excluding institutional investors, 25% of Lead Investors stated that they would cease to make angel investments in the absence of tax relief and 58% would scale back investment.

- **Co-Fund representation on the Board** – some companies stated that Co-Fund should consider a seat on the Board, as its skills are valued and its use of voting rights could be beneficial in driving company growth, where other investors/Directors are less hands on and slow at decision making. This would be contrary to other co-funds where the fund managers would be more hands off. This is considered further in section 7. While their participation at board meetings is welcomed, other more experienced investors noted that they, and the companies they have invested in, do not need as much of a hands on role from the Co-Fund managers.

## 5.7 Conclusion

The above would indicate the Co-Fund is performing well, is meetings its KPIs, has a portfolio of companies that are demonstrating growth in export sales and NI employment, has had one successful exit and reported uplifts in valuations across four companies. It is providing a choice to companies seeking funding and has brought value to companies and investors. The current focus is on follow on investment, with limited investment in new companies, reflecting the fact that the Co-Fund is coming to a close and has circa £11.5m of its £12.5m fund invested or earmarked for investment.

# 6 RETURN ON INVESTMENT & VALUE FOR MONEY

## 6.1 Introduction

Section 6 is concerned with an assessment of the Return on Investment and Value for Money from the Co-Fund. Section 6 includes the following:

| Para | Details |
|---|---|
| 6.2 | Consideration of the GVA return on investment |
| 6.3 | Economy, efficiency and effectiveness of Co-Fund |
| 6.4 | Assessment of Value for Money |
| 6.5 | Equality |

## 6.2 Consideration of the GVA return on investment

### 6.2.1 Calculation of GVA as per the Evaluation team

Consideration has been given to the economic impact (through the Gross Value Added – GVA) of the investment made by Co-Fund on the NI economy, although recognizing the very early stage of the funding cycle. As agreed with Invest NI, this economic impact assessment has largely focused on the wages impact on NI as it is the Evaluator's view that it is too early for the Co-Fund's full GVA impacts to have materialised, given the early stage in the company development process in many cases, and the fact that many companies are not yet trading profitably. The GVA calculation details are as per Appendix VIII. Consultations with 24 of the 28 companies invested in by Co-Fund to June 2015 indicates that circa 60% were pre-revenue and only one was profit generating at the point of investment. This Evaluation has confirmed that only 4 are currently profit generating.

As such, the GVA impact assessment has focused on the increased wages contribution brought about as a result of new jobs generated through the investments made, albeit at a relatively early stage in the investment process for some.

There were 98.5 new jobs and 95 jobs safeguarded (in NI).

The GVA calculation (based on W&S from new jobs only) is calculated using information from 1) all Co-Fund assisted companies and 2) excluding one significant outlier which shed 50 jobs or one-quarter of its workforce over the Co-Fund assistance period. GVA is therefore calculated as follows:

| GVA from new jobs created | All Co-Fund Companies | All Co-Fund Companies – excluding outlier |
|---|---|---|
| Gross NI Wages – base at point of assistance | £6,996k | £2,897k |
| Gross NI Wages – current (2015) | £9,636k | £6,116k |
| Additional Accumulative Gross NI Wages since assistance[75] | £3,957k | £5,346k |
| Additional Net NI Wages net of deadweight | £2,993k | £4,312k |

In overall terms, gross wages from new jobs in funded companies have increased by an estimated £3.9m over the funding period[76]. When the significant outlier is excluded, this increase is £5.3m (as wages in the significant outlier fell considerably over the assistance period).

When deadweight[77] is taken into consideration, the figure of £3.9m falls to £2.9m (based on an overall self-reported deadweight level of 24%). Excluding the significant outlier, additional wages and salaries, net of deadweight, falls from £5.3m to £4.3m (based on an overall self-reported deadweight level of 21%). Following discussions with Invest NI, the Evaluator has not taken displacement effects into account. This again reflects the largely early stage in the company

[75] This is an accumulative position and takes account of the increase year on year from the base year investment
[76] Note: 1 full year of assistance has been assumed for those companies where assistance has taken place within the last year
[77] Based on the evaluation survey of assisted companies

development process and feedback from the companies themselves, demonstrating very limited competition for their products/services within NI[78].

The above table reflects the GVA impact assessment from the new jobs generated. When new and safeguarded jobs are considered, the impact on the GVA is significant:

| 98.5 new jobs and 95 jobs safeguarded | All Co-Fund Companies | All Co-Fund Companies – excluding outlier |
|---|---|---|
| Gross NI Wages – base at point of assistance | £6,996k | £2,897k |
| Gross NI Wages – current (2015) | £9,636k | £6,116k |
| Additional and safeguarded Gross NI Wages since assistance | £33,512k | £14,402k |
| Additional and Safeguarded Net NI Wages net of deadweight | £30,143k | £11,989k |

{note that the deadweight percentage changes when the safeguarded jobs are included, due to the impact of the self reporting of deadweight and variations by companies}

In overall terms, gross wages from new and safeguarded jobs in funded companies, after deadweight, has increased by an estimated £30.143m over the funding period. When the significant outlier is excluded, this increase is £11.989m.

Consideration has also been given to the average wages generated by assisted companies compared to the NI average. The average annual wage (full-time equivalent) among companies funded through Co-Fund currently amounts to £31,500 (exclude the large outlier company and £27,250 including this), being above the NI private sector average of £22,630[79]. Average annual full-time wages in Co-Fund assisted companies are high when reviewed against sectoral median averages in NI[80]. For example, median wages in Co-Fund assisted companies in the Professional, Scientific & Technical services sector are £33,917 compared to a NI sectoral median of £25,986. They are also comparatively higher across all parliamentary constituencies with the exception of Foyle and Newry and Armagh.

### 6.2.2 Economic Return on Investment

As noted above, the additional wages impact associated with investee companies to date (net of deadweight) amounts to £4.312m, or £2.993m when an outlier company is included. As per Appendix VIII, the annual average increase in net wages from the base to current levels is £2.176m excluding the outlier and £1.776m including the outlier.[81]

As per para 4.4.5, the total cost of Co-Fund, including CFM costs, Invest NI fully loaded costs and the investments made, totals £9.19m.

The current level of wage effects, assuming no growth in employment or salary levels, would yield an economic Return on Investment breakeven point of 2.1 to 3.1 years down the road (prior to any discounting, and based on Invest NI Co Fund costs only). It is recognised however, that in the interim, the likelihood is that some companies will grow significantly and others will fail.

It is noted that companies anticipate their NI employment to increase by 85% (to 636) in the next three years. Hence the period for the Co-Fund generating an economic return could be shorter than that stated above, albeit there is a perceived requirement for further follow on funding.

[78] The exception is the packaging company referred to in para 4.3.1 where there will be some displacement to be expected
[79] Annual Survey of Hours and Earnings (ASHE) 2015
[80] See Appendix VIII
[81] Note that the average years is 1.93 years, assuming 1 year even for those investments less than a year – adjustment is also made for deadweight

### 6.2.3 Financial Return on Investment

There was one successful exit in June 2016. Details have not been disclosed, but feedback from Invest NI is that this has been a positive exit. There have been no dividends paid to investees. It is too early to assess the financial return on the total investment. In addition to the exited company, as per para 5.3.1, three additional portfolio companies have raised additional funds at an uplift in valuation. The June 2016 return by CFM to Invest NI shows the original Co-Fund investment in these 4 portfolio companies (of £2.496m) being reflected at a £4.030m valuation, representing an increase of £1.533m or 61%.

The overall portfolio is estimated at a deficit of 19% for the 28 portfolio companies at June 2015 (the evaluation period). The Evaluator's view is that this reflects prudent write downs with no provision for potential uplifts on performing portfolio companies.

A comparison of Co-Fund to the benchmark data in section 3 indicates that UK Angel CoFund has had 2 exits and the NZ Co Fund has had 4, with one for Co-Fund NI:

| Components | NI Co-Fund 2011-2015 | Archangels Performance 1992-2015 | NZSCIF (2005-2014)[82] | UK Angel CoFund 2011-2015 |
|---|---|---|---|---|
| Companies invested | 28 | 80 | 113 | 59 |
| Average co-fund funding per company | £285,759[83] | | £135,463 | £466,101 |
| Exits | 1 exit – positive return | 18 exits | 4 (total £2.1m)- 13.5% of capital invested | 2 – 1st exit had money-multiple return of 2.84x on investment of £383k |
| 10 year returns to 2014 | n/a | 20.9% for 10 year period | n/a | n/a |

Co-Fund had invested £10.4 m by June 2016. There were 20 follow on investments between June 2015 and June 2016 and investment in four new companies. There were 14 companies with valuations below cost at June 2016 (including the four liquidated companies). For the four companies with uplifts and in which there was total investment by Co-Fund of £2.49m, these are now valued at £4.03m, an uplift of 1.61 times. These four investments would need to be securing uplifts in value of 4.17 times for the Co-Fund to breakeven at the current level of investment. The experience of Archangel would be that such returns are possible but cannot be predicted with any certainty. The details of the exit achieved by Co-Fund have not been made public to determine how close this is to an uplift of 4.17.

The Co-Fund has a target Internal rate of return (IRR) of 0%. Although the Casework Submission: Co-Fund Uplift document states at page 39 that *"not making a return would not be considered a failure for this type of fund"*, this is not the experience of the Evaluation Team, with the key issue not being the return to government but that success of co-funds is demonstrated to the private investors. The SCF has a target IRR of 20% as set out in its initial ERDF funding application (although it did not report against this), and a specific objective of "*demonstrating to potential investors that returns could be made by investing in the "equity gap" thereby stimulating the growth of the venture capital industry*". The UK Angel CoFund, while not having a target IRR, does have a target that the co-fund will be a demonstrator to angel investors that it is possible to make a commercial return from this class of investment. NZSCIF has a IRR target of at least the return of capital, to support aspirations for the achievement of an evergreen status. This gives an implied IRR of around 5% based on recovering operating costs and maintaining fund value, post an allowance for inflation. There is no evidence that these IRR "targets" are being achieved.

[82] Shown in Sterling
[83] As per para 4.3.3, Note that para 5.5.1 refers to one year only

### 6.2.4 Achievement of Evergreen Status /Benchmark Returns against Formal VC

The ability of a co-fund to achieve commercial market rates of return, and thereby potentially become evergreen is inhibited by the level of limits set on it by the government establishing the fund. Co-funds do not have the same capability or capacity as a private VC to maximise financial return. The co-fund's performance is restricted due to the imposed limitations on:

- Its limits on investment size;
- Investee eligibility;
- Level of share of ownership;
- Availability of follow on funding; and
- Partner selection and levels of support.

The ability of a co-fund to provide follow on funding, even where the co-fund private sector business angel partners are unable to, and matching is against corporates, institutions etc, will have a significant influence on the overall financial performance of the co-fund. A prudent investor will want to maximise the return from "successful" investments by investing more capital in them. Whilst investing additional capital into successful investments may mean that there will be less capital available to invest into other new companies, (and therefore potentially narrowing the pool of companies able to access overall programme funding), successful exits lead to additional monies being available for recycling and hence may increase the availability of funding for new investment opportunities. These conflicting objectives need to be considered during the Economic Appraisal, including the assessment of market failure and how it sits vis-à-vis actions to maximise the Co-Fund's success.

It is also important that such restrictions on the actions of the Co-Fund are taken into account when making performance comparisons with purely private sector manged funds.

The target of an evergreen co-fund is therefore highly unlikely under the current model of limited/no supply side development, and lack of sufficient follow on funding in NI (and, in the view of the Evaluation team, is an aspirational target anyway). There are no known evergreen co-funds at the present time. The NZSCIF, which made its first investment in 2007 anticipates reaching an evergreen state by the beginning of 2019, and based on anticipated exits in the next 3 to 4 years. This has yet to be achieved.

Clarity of the definition of "evergreen" would be required should this ambition be formalised. For example, in the event that the NZSCIF were to become evergreen from 2019, this would only mean that the co-fund had sufficient profits being returned to it from successful exits to enable it to continue to re-invest into new companies. The amount of funding available would not necessarily be sufficient to meet demand for new or follow on investments, especially give the NZ government's increasing programs to encourage more new startups.

## 6.3 Economy, efficiency and effectiveness of Co-Fund

Consideration is given to the economy, efficiency and effectiveness with which public funds have been used on the Co-Fund.

In terms of economy – ('doing things at the right cost'), Invest NI has implemented a robust Economic Appraisal process to assess, amongst other things, the reasonableness of cost components including the need for the uplift in the Co-Fund manager's fees (see para 4.2.6). The Co-Fund managers were appointed under a competitive tendering process, with uplifts justified and appraised. As such, it is the Evaluation Team's view that Invest NI has made appropriate efforts to ensure that the Co-Fund was delivered at least cost to NI. However, looking forward, the Evaluation Team are of the view that in respect of any future potential Co-Fund, that consideration should be given to the level of involvement of the Co-Fund managers and their ability to be more "hands off" post investment.

In terms of efficiency, ('doing things the right way'), **as** noted previously, the NI Co-Fund is operating in substantially different ways to other co-investment funds, with Co-Fund managers much more active and involved, both in the deal making process, and in companies post-

investment. As a result, the Co-Fund is structured in a manner that requires three highly experienced commercial fund managers. We note that there are 3 fund managers for Co-Fund, based on 28 companies in its portfolio at June 2015. The £100m UK Angel CoFund, with a present portfolio of 59 companies operates with a staff of 4. The £20m NZSCIF, with a portfolio of 130 companies (116 in June 2014), has a staff of 3. Other co- funds do not therefore require the same level of skill or expense as the NI Co-Fund because of the delegation of the detailed fund management activity to their co-investment partners, and, rather than paying salaries or management fees, they pay much smaller one-off deal fees. Because of the additional overhead costs included within the NI Co-Fund as a result of its operating structure and practice, it is likely that, on a deal by deal basis, the costs are higher than those incurred by other co-funds (where monitoring is not done by a professional fund manager). The detailed operating costs of these other co-funds are however held confidentially and salary details are not available to allow any further comparison.

Notwithstanding this, individual investments made by Co-Fund have been subject to due diligence by CFM in many cases, or following discussion of the due diligence process adopted by the Lead Investor. A formal approval process is in place and parameters set as to when Invest NI consent is required. The feedback from companies and investors report a high level of satisfaction with Co-Fund managers. The current "hands on" approach by Co-Fund managers is understandable but not sustainable. Co-Fund will need to assess its level of future involvement with companies on a case per case basis.

With regard to effectiveness ('doing the right things'), Co-Fund is meeting its aims and objectives. Co-Fund is well on its way to achieving the deal activity targets set in 2014 (see para 5.5.1), with the revised fund size of £12.5m projected to be fully utilised ahead of the May 2017 target date. There is evidence that commercial success has been achieved for a small number of companies, although many companies are still at an early stage in their development and four have gone into liquidation.
A key issue, however, is the extent to which Co-Fund should have had objectives around supply side business angel development. While the challenges are acknowledged, this will be an issue for any future Co-Fund.

## 6.4 Assessment of Value for Money

Consideration is given to the extent to which the Co-Fund represents good Value For Money (VFM) and appropriate use of public funds across the full spectrum of relevant VFM indicators. Value for money is considered against relevant indicators:

| Summary of Value to Money | |
|---|---|
| **VFM Indicator** | |
| **Strategic Fit** | The focus for the NI Executive is on strengthening the economy, with investment in innovative companies being key to driving productivity and economic growth. Allied to this, the Co-Fund is clearly aligned to the focus of the NI Economic Strategy and NI Innovation Strategy, a key part of the Invest NI Access to Finance Strategy, and addressing funding gaps in NI companies seeking to develop and commercialise new technologies and break into growing sectors and export markets. |
| **Need & Market Failure** | Demand for Co-Fund has been high, with £8.001m invested to June 2015, increased to £8.88m by end Oct 2015, and, was £10.4m at end June 2016. In terms of market failure:<br>• An intervention is necessary on the demand side as there is no evidence that the private business angel sector or indeed institutional investors are yet willing to come forward, to the extent necessary, to fill funding gaps of NI companies;<br>• This market failure on the demand side is attributed to a range of issues including the quality of projects being presented, size of the private sector, risk aversion of the private sector;<br>• On the supply side, most co-funds seek to create an Angel investment |

| Summary of Value to Money | |
|---|---|
| **VFM Indicator** | |
| | market where previously there was none. The typical primary objective of co-funds is to alter the behaviour, capacity and capability of potential and exiting private investors to invest in businesses that have potential for growth and an acceptable return.<br>• This Evaluation has noted that NI is some 10 years behind the Scottish industry in terms of the supply side development;<br>• The supply market will likely remain in a developing state for a number of years.<br>Where Invest NI is seeking to develop the supply side through business angel groups or formal syndicates and development of lead investors, more needs to be done, and further intervention is necessary. There needs to be clarity as to how Co-Fund will work with other relevant interventions to achieve this objective. |
| **Additionality** | In terms of their ability to access funding in the absence of the Co-Fund, feedback from company respondents would suggest that additionality is high and that Co-Fund is 68-71% additional in terms of raising finance and 76-84% additional in terms of impacts. |
| **Displacement and complementarity** | Displacement is likely to be low or non existent. 91% of company respondents noted that 76%+ of competitors are outside of NI, with evidence of a global customer and competitor base. This reflects the largely early stage in the company development process and feedback from the companies themselves, demonstrating very limited competition for their products/services within NI[84]. £8.001m of Co-Fund funding has leveraged £24.6m of total funds into 28 companies. |
| **Economy Efficiency and Effectiveness** | The Co-Fund is performing well in terms of economy, efficiency and effectiveness as per para 6.3 above, albeit with a higher resource cost than original envisaged. Targets on input do not distinguish between new and follow on funding. The current delivery model is not sustainable and needs to be addressed, including through the development of the business angel supply side. |
| **Cost effectiveness** | The comparison to UK Angel CoFund (para 3.2.1) would indicate that NI deals are much smaller, with UK funds leveraging more than 2 times the Co-Fund investment (1:4.26 versus 1: 2.08 in Co-Fund NI). |
| **EET** | The average age of investments in the 28 companies is 1.93 years. While there has been one (undisclosed) exit to date, it is too early to assess a financial return on investment. There were 14 companies with valuations below cost at June 2016 and four with uplifts in valuations (including the exit). For the four companies with uplifts, these would need to be securing uplifts of returns of 4.17 times for the Co-Fund to breakeven at the current level of investment, as compared to the current uplift of 1.61 times, on the basis of the current valuations. The experience of Archangel would be that such returns are possible but cannot be predicted with any certainty. |

Overall, there is considered to be progress on all Value for Money indicators. However, the model is not scalable, with this to be considered for any future programme.

## 6.5 Equality

This section of the report provides an Equality assessment of the Co-Fund.
As a recognised public authority, Invest NI has an obligation, under Section 75 of the NI Act 1998 to provide equal opportunities for all in relation to nine categories: religious belief, political opinion, racial group, gender, marital status, age, persons with a disability and those without, persons with dependents and those without and sexual orientation. On recognition of the obligation to provide

[84] The exception is the packaging company referred to in para 4.3.1 where there will be some displacement to be expected

equality of opportunity, Invest NI's website (www.investni.com) outlines the following equality statement:

*"Invest NI is committed to achieving a successful economy in Northern Ireland which provides equal opportunities for all citizens. The organisation works to fulfill its responsibilities across the spectrum of Government policy relating to Equality, the Lifetime Opportunities - Anti-Poverty and Social Inclusion Strategy and Human Rights."*

Invest NI details in its Equality Scheme how it continues to meet its Section 75 responsibilities through its arrangements for monitoring any adverse impact of policies on the promotion or equality of opportunity. The Evaluation Team's review of the programme's activities indicates that the programme is available to all eligible businesses and investors.

# 7 SUMMARY OF KEY FINDINGS

## 7.1 Introduction

It is difficult to compare the NI Co-Fund with any other co-fund:

- It is not operating overtly as a supply side development support measure.
- It does not place specific responsibilities/requirements upon the private sector investors.
- It does not assess the capability or capacity of the private sector investors.
- It is managed by professional fund managers at a deal level, who are making investment manager type decisions, rather than delegating these decisions largely to the private sector.
- It is the only co-fund not to pay the private sector any form of fee.
- It has economic development targets relevant to Invest NI, with no KPIs in place for supply side development.
- It is the only benchmarked co-fund delivered by the private sector.

Key findings are noted below.

## 7.2 The Challenges in Developing a NI Local Angel Investment Community

The size of the private investment sector within NI remains small, and unsophisticated in its organisation. Halo acts as a network, but is still relatively young, and is still working to develop angel groups and formal syndicates that invest on a consistent basis. The immaturity of the local marketplace, also, in part, reflects the cultural reluctance amongst NI investors to be visible.

There is a lack of examples of successful exits that might encourage private individuals to become investors within NI. Private individuals, who have the capacity to become investors, have largely derived their wealth from traditional sources, in particular, property development. It is unsurprising that they are somewhat risk averse when considering entering business sectors within, for example, technology or the life sciences sectors, where they have no personal experience or reference points.

In the case of Scotland, there are now some 20 angel groups and a sophisticated business angel sector. The Scottish (SCF III) funds has 14 pre-qualified lead partners. The NZSCIF has 13 active partners while the UK Angel CoFund has invested alongside 14 non prequalified formal angel syndicates and 25 informal syndicates. The Scottish co-fund has been operating since 2004, but was preceded by a more hands on fund launched in 1999. The NZSCIF was initiated in 2005, and began investing in 2007, having spent some time establishing the infrastructure of pre-qualified investment partners. The UK Angel CoFund is much more recent, commencing operations in November 2011, with a first investment in March 2012, but operates in a much larger and more developed market than NI. The majority of its investments have been made in London and the south east of England. The point that is being emphasized is that building a local angel investment community is a long term project.

There is room for further clarity in relation to Co-Fund's role regarding the development of the supply side business angel sector and indeed the extent to which it should be matching against VC institutions (where there will never be the need for co-terminous "supply side" development). The overall view is that even when there is no evidence of "market failure", ie the VCs could fill the funding gap, there is a need for Co-Fund to demonstrate the success of the co-investment funding model to the private angel market, and that is best achieved by Co-Fund following their money to successful exits.

## 7.3 Lack of Objectives around the Development of the Supply side of the Investment market

There were no objectives set by Invest NI for Co-Fund for the development of the supply side of the investment market. As noted in section 3, and in more detail in appendix II, the fundamental objective of most co-funds around the world is to help the development of the supply side, increasing the capacity and capability of the private investor base. Public sector cash is certainly invested in companies in the short term, but this is not the primary objective of co-funds. Rather,

the primary objective of other co-funds is to stimulate the private sector to become suppliers of capital over the long term. The impression has been given that the NI Co-Fund was intended to be a supply side intervention. It has been stated that it was modelled on the Scottish co-fund, and that, while the Co-Fund managers may initially need to be more active than in Scotland, due to the undeveloped nature of the NI market, it was anticipated that as the NI market developed, the Co-Fund managers would be able to step back. This has not been the case to date, as seen in the lack of supply side targets set for the Co-Fund managers.

The NI Co-Fund is unique in that it is managed by professional fund managers. No other co-investment fund is presently structured in this manner. Other co-investment funds are centrally managed by government agencies, who to varying extent, delegate the investment decisions to their private sector "partners". Other co-fund managers do not themselves seek out investments, structure deals, or generally carry out their own due diligence. They do not appoint themselves to company boards or become engaged in strategy and other commercial advice to the investee companies. The co-funds' objective is to increase the skill and capacity of the private sector to take on all of these activities.

The original concept of the NI Co-Fund was that the fund managers would be actively involved at the beginning, but would ease off as the market develops. Fundamentally, the market has not developed. A contributory factor, but not the only factor, in this is that the market has not had to develop, because the fund managers have continued to do all the work. The fund managers have not required to the private sector to do the work, nor have relied on the private sector to bring them the deal flow. Increasing reliance on the private sector will in the short term reduce the level of deals completed and cash going into the companies. The level to which this delegation is to be pushed can only be determined as a policy matter by Invest NI.

By appointing professional fund managers to manage the Co-Fund, without setting specific supply side development targets, it is perhaps inevitable that CFM have acted as "fund managers". It is also somewhat reinforcing, that, because they are not specifically building up the supply side (skill base), they are as a result having to spend more time in being hands-on. This is also linked to the other KPIs and expectations placed on the Co-Fund regarding the level of investment being made. However, if they were to rely more on the supply side, this could, at least in the short term, reduce the volume of funding going into companies as a result of those companies not being able to find private sector investors with the necessary skills. These are important considerations for Invest NI in developing a new supply and demand focused Co-Fund scheme.

## 7.4 The Level of Interaction with Halo in their role of supply side development

In terms of working alongside Halo, feedback from CFM is that they consider Halo deals to be too small and that they try to attract a different type of investor, specifically investors with larger sums to invest. CFM appear not, in the case of Halo, following or supporting the market. Within the general parameters set, for example investment size or sector, other co-funds would allow the private sector to identify appropriate investment opportunities. If the Co-Fund was acting specifically to develop the supply side, it would support Halo deals, with the intention of assisting Halo members to increase the size and sophistication of their investments.

## 7.5 The Role of Co-Fund in Developing the NI Business Angel market

The issue of pre-qualification centres on the fundamental objectives set for Co-Fund by Invest NI. If Co-Fund is focused on the provision of finance to companies, positioned as a solution to the "finance gap" in the short term, then the skill base of the co-investment partners is relatively irrelevant. The fund managers will still need to verify that their co-investment partners are either "sophisticated" or high net worth individuals as defined by the legislation, as this is a legal requirement placed upon all companies raising funding.

If the intention is to use the co-investment fund as a tool to improve the capability of the local Angel investment market, consideration should be given to moving more towards the processes used by other co-investment funds to validate the ability of the co-investment partners to assess and support investee companies over the long term. Appendix II provides a number of case studies

setting out the requirements that other co-funds have of their partners, with the Scottish co-fund probably being the most rigorous (see appendix II page 35).

When deciding the future remit of Co-Fund, Invest NI will need to recognise that increasing the rigor with which co-investment partners are selected is likely to reduce the number of companies that will, in the short term, be able to secure funding through the Co-Fund. Companies may well be declined funding by Co-Fund based on the quality of their private sector investors, rather than the perceived quality of the underlying investment proposition. The investment committee for the UK Angel CoFund, for example, has no direct contact with the companies into which investment is being considered. Rather than interview the entrepreneurs, the UK Angel CoFund committee interviews the prospective angel investors to ascertain whether they have the skills and capacity necessary to make an appropriate investment decision and to support the company going forward. If, for example, the investor is considered not to have carried out appropriate levels of due diligence, is unable to support the company going forward and represent the co-fund post investment, or is deemed to have conflicts of interest with the investment interests of the UK Angel CoFund, the investment will be declined. Development of the supply side may therefore have implications for meeting demand-led objectives of the Co-Fund.

## 7.6 The Role of Co-Fund in Brokering deals and Hands on Involvement

It is noted that CFM has acted in a number of instances as a broker between the company and its private investors, while sitting as observer on company Boards. As noted elsewhere, this is the only co-fund where professional fund managers have been appointed to administer the co-fund. The appropriateness of this level of activity by CFM is dependent upon the objective set by Invest NI for the Co-Fund. If Co-Fund is intended to act as a supply side market development instrument, then, in comparison to the majority of other co-investment funds, this level of involvement by CFM would be seen as inappropriate, as it is “leading” the market, rather than following and supporting the market. On the other hand, if the primary objective is to supply capital to companies, then CFM would appear to be undertaking activities that the private sector are unable or unwilling to take. It is reiterated that CFM have no supply side objectives and are operating in line with the remit within their contract with Invest NI.

Whilst authorised legally, we note that CFM are prohibited under the terms of their appointment as fund managers from giving “investment advice” and appear to operate within this remit.

If the intention of Co-Fund is to provide short-term financial support for companies, then it would appear that because of the undeveloped nature of the NI private sector market, and the inability or unwillingness of the private sector to become more hands-on, it is necessary for CFM to undertake the current level of work. If the intention of the Co-Fund is to provide a stimulus for the long-term development of a sustainable local private sector market, then, while delivered with the best of intentions, the additional involvement by CFM may be solving a short term issue, but is not contributing to the development of a long-term solution. A key change going forward therefore would be on the Co-Fund managers withdrawing hands-on activity delivered by themselves, and instead emphasise a support role for the private sector undertaking the activities,

Where Invest NI is minded to develop the existing co-investment fund into a more traditional fund model, that of supply side development, then the role of the Co-Fund manager will change under the next contractual period, and a critical part of their role will be the mentoring and support of other investors, and by necessity, to invest in companies that they themselves may otherwise have declined. For example, it will be necessary for them to make investment decisions at a deal level, not at a portfolio level (i.e. they will follow the market, rather than choosing investments that give them a balanced portfolio). Rather than making specific investment decisions regarding what they believe will be a successful investment and what they would put the funding into, they would likely have to address the questions used by the UK Angel CoFund investment committee:

i. Does the investment opportunity appear to offer a commercial return, relative to the risk, that an experienced wealthy private investor might consider reasonable;
ii. Has, based on the evidence provided, an appropriate level of due diligence been carried out for the specific investment proposed; and

iii. Are the terms and structure of the investment proposed appropriate and does the Co-Fund have alignment of interest with the other investors in the round.

## 7.7 Sophistication and Skill Base of the NI Business Angel Market

Investors, and particularly, Lead Investors, are required to be sophisticated to warrant co-investment by the Co-Fund. It should be noted that this is not a test of investment competence. It is perfectly possible to be classified as a sophisticated investor yet never have read a business plan, never conducted due diligence and never actually invested in a company. The relevance of this for the NI Co-fund is that it is the only co-fund that does not place a competency test upon the private sector co-investors. All of the other co-funds assess the competency and capacity of the co-investors to adequately support the company and in the best interests of the co-fund, prior to accepting them as co-fund partners. This assessment may be in advance of assessing individual deals, as in the case of the Scottish co-fund, or on a deal by deal basis, as for the UK Angel CoFund.

The NI Co-Fund makes no assessment of the capacity of the co-investors or therefore their ability to properly assess a company prior to investment or support post-investment. As a result, the NI Co-Fund managers have had to take a more active role pre-and post-investment that would be considered appropriate with any other co-fund.

As part of their remit to improve the capabilities of the supply side, the other co-funds effectively require the private sector to improve its skill base in order to be able to access the co-investment funds. This acts as an incentive to inexperienced investors to join with more experienced investors, notably by joining established groups and syndicates. This facilitates the spreading of knowledge and best practice. In contrast, for the purposes of meeting their target, the NI Co-Funds managers are specifically prohibited from including members of Halo within their number of prequalified "sophisticated investors", thus acting as a barrier to the increase in capacity of Halo members.

## 7.8 The Appropriateness of the Targets set and Targets for IRR

Unlike most other co-investment funds, the NI Co-Fund has a hard target in relation to the number of deals to be completed within a period (although the UK Angel CoFund does have such a target).

Co-Fund has a target to complete 14 investments per annum.[85]. Based on the Co-Fund size, and the specified investment range, it is not an unreasonable number for the Co-Fund to invest in, while appropriately managing its portfolio. Whether these will turn out to be "excellent investments" from a financial perspective will only be ascertained at the point the Co-Fund achieves an exit. Whilst it is difficult to predict winners with any level of certainty, it is likely that providing additional funding to companies will give them more time to be successful. It must also be recognised however that funding more companies will also result in more companies failing, simply because of the high percentage of all funded companies that do fail.

All of the investments completed by the Co-Fund are required to have private sector co-investment, and therefore the private sector co-investment partners presumably believe that they will make a financial return from the commitment of their funds. Given that the public sector typically only provides funding to a co-investment fund because there is a perceived funding gap, a market failure, it must however follow that there is not sufficient confidence within the private sector to provide all of the funding necessary. Indeed, the need for the private sector to invest alongside the public sector mitigates against the risk of Co-Fund investing in businesses that have limited prospects or would not merit investment if targets were not requiring to be met.

Invest NI also set "monitoring criteria" around employment and turnover in its last appraisal process, although these are specifically not KPIs for the Co-Fund managers.
One of the objectives of a co-investment fund, and a specific objective of the UK Angel CoFund, is to demonstrate to the private sector that it is possible to make a commercial rate of return by investing in companies such as those supported by the fund. The UK Angel CoFund therefore has a specific target, to obtain a commercial rate of return, as one of its selection criteria for the

[85] The original target was 8 for a £7.2m fund (based on the original Economic Appraisal). The Co-Fund was subsequently increased by 75% to £12.5m and the investment target similarly increased by 75% from 8 to 14.

projects it supports. It should be noted that this is not a specific requirement of the NI Co-Fund, whose establishment documentation sets an IRR of 0%. It is however implied that this is a requirement, and has been part of the rationale for the Co-Fund's continued involvement in Series B funding rounds, alongside the need to demonstrate positive returns to the private sector[86].

## 7.9 The Rationale for Follow on Investment

Multiple follow-on rounds of investment are normal, and show good investment practice. To take an early stage technology company to market and achieve cash flow breakeven is likely to take many years and significant amounts of capital.

A good investment strategy is to ensure that the company sets out the measurable milestones, and sets out the sources of funding it anticipates using for raising the next rounds of funding. This ensures that the milestone that is met using the first investment is actually seen as being of value by the next round funder. Typically, companies would be encouraged to raise funding that would last them around 18 months. Given that technologies are rarely at cash breakeven when they are subject to an exit event, and that it may be anticipated that it will take up to 9 years to achieve an exit event, it may be anticipated that a company might require five or more rounds of funding. The Scottish technology company, Optos, that was successfully floated on the main London market, some 15 years after launch, required some 16 rounds of funding overall.

## 7.10 The Responsibility for monitoring the Investment

It is normal practice for investors to stay "close to their companies", often taking up non-executive director positions. Most other co-investment funds rely upon their investment partners, ie Lead Investor, to undertake this role. Investors will therefore have in place suitable review structures to ensure that there is an appropriate challenge process and that, when considering follow-on funding, the company has clearly met its milestones to date.

Where a non-executive director is considered appropriate by an investor, particularly a co-fund, such directors would often be appointed from an independent panel. The co-fund managers themselves do not usually have the capacity to be involved in every one of the boards of companies they have invested in. Such directors would normally be paid for by the company, and the funding provided to the company would be adjusted to take into account this additional cost. This additional funding cost should be justified on the basis of the "added value" that such an independent non-executive director would provide.

In terms of extracting appropriate monitoring information, all investors tend to find that it is difficult to get information from companies on a consistent and timely basis. Generally, the companies see the provision of such information as an overhead that adds no value to their operations. Chasing up such information and ensuring it is presented in a useful format is a significant resource drain for the investors. Going forward, consideration should perhaps be given to ensuring that the Co-Fund managers have an adequate level of less experienced staff who can undertake this largely clerical operation. Alternatively, increasingly there are software solutions available for the monitoring of portfolios, and it may be that implementing a standard platform such as Seraf[87] would be appropriate.

## 7.11 The Appropriateness of targets for turnover, jobs created and GVA

The majority of other co-investment funds, and indeed most venture funds, do not specifically track turnover, job numbers or GVA by investee. Funds are "balanced" based on the percentage of their investment capacity that is allocated to any one company. One would expect good practice to be that no one investment should receive more than 10% of the total investable funds of a fund in order to mitigate the risk of failure of any one investee company.

Co-funds tend not to monitor the values of turnover, employee numbers or GVA as these are not the prime drivers of a company's value. The specific value drivers for any individual company will

[86] There have been two Series B funding rounds, one in Jan 2016 and one in June 2016.
[87] Seraf-Investor.com

depend upon the industry sector. For example, the value driver of an Internet company may be the number of users or the number of "hits". The value of a life science company is likely to be based upon its patent portfolio and the specific data proof points it obtains from different stages of its clinical development.

## 7.12 Payments made to the Lead Investors

The NI Co-Fund is the only co-fund not to pay the private sector investors for finding, structuring, negotiating and then monitoring the investments made. The typical fee paid is between 2.5% and 4% of the amount invested by the co-fund. As noted previously, this is also the only co-fund that employs professional fund managers. The other co-funds delegate the fund management activities to their investment partners. Fund managers of commercial (and most public sector) venture funds are paid a fund management fee equivalent to 2.5% of funds, per annum (not one off on each investment) and in addition seek a carried interest payment. Thus the economics of a standard co-investment fund is that the fees paid to the partners who effectively do the bulk of the investment work, amount to 2.5% of the co-fund's value. This compares favourably to a standard venture capital model where the co-fund manager receives 2.5% of the co-fund value per annum, with a typical co-fund having a life of 10 years. The investment fee paid to the co-fund partners is also often seen as a critical element of inducement to persuade private sector investors to enter the early stage investment space. They have been critical in the development of formalised angel groups and syndicates in Scotland and New Zealand.

# 8 CONCLUSIONS, LOOKING FORWARD AND RECOMMENDATIONS

## 8.1 Conclusion

A key focus of this Evaluation of the Northern Ireland Co-Fund is the assessment of the outcomes, value for money and wider economic benefits gained from the delivery of Co-Fund from June 2011 to June 2015 and the extent to which objectives have been met.

## 8.2 Performance of the Co-Fund

Co-Fund, launched for investments in 2011, is a £12.5m (uplifted from £7.2m in 2014) 6-year fund which was projected to run to May 2017. It is funded through a ERDF budget. It is the first formal co-investment fund in NI. It is delivered by CFM.

As of June 2015, there has been 53 investments into 28 companies. C0-Fund has invested £8.0 million, mostly Ordinary Share Capital (£7.42m) but with circa £580k by way of Preferred Ordinary shares and Convertible Loan Notes (reflecting the need to match against investors). The latter is mainly in respect of investments by US investors. This has leveraged a total of £24.6 million of investment, of which Co-Fund matched £11.2m. Companies are shown by number of investments:

| (£) | No of companies | Total Funding | Total Co-Fund | Pre Q Private Investor funds | Total Co-Fund and Private Matched | % Co-Fund of matched | % CF of total | % of Co-Fund |
|---|---|---|---|---|---|---|---|---|
| Investment one | 28 | 15,916,824 | 4,859,405 | 7,722,315 | 12,581,720 | 39% | 31% | 61% |
| Investment two | 15 | 6,568,757 | 2,189,043 | 2,492,671 | 4,681,714 | 47% | 33% | 27% |
| Investment three | 9 | 2,001,553 | 902,797 | 968,127 | 1,870,924 | 48% | 45% | 11% |
| Investment four | 1 | 150,000 | 50,000 | 70,000 | 120,000 | 42% | 33% | 1% |
| | | 24,637,134 | 8,001,245 | 11,253,113 | 19,254,358 | 42% | 32% | 100% |
| | | | 32% | 46% | 78% | | | |

The above includes 1 company with 4 investment rounds, 8 companies with 3 investment rounds, 6 companies with 2 investment rounds and 13 companies with 1 investment round. Circa 61% of total investment had been in the first round investments with 39% being follow on. There is a strong pipeline and £10.4m has been spent by June 2016, of which 52% is first round investment in 32 companies and 48% is follow on investment.

Match funding can originate from business angels (individuals, syndicates or business angel groups), institutions, universities, founders and corporates, as long as the initial match funder is new to the company.

## 8.3 Determine the extent to which the principle objectives and targets of the intervention have been met

Co-Fund is meeting its aims and objectives in terms of providing access to funding to companies, a number of whom who are, in turn, demonstrating that they are innovative, with high growth potential and export focused.

Co-Fund is spanning the full range of the Invest NI Access to Finance continuum. Invest NI has noted that the financial instruments available under Access to Finance should not be considered as a linear continuum but rather, offering choice to businesses seeking funding. This flexibility is in keeping with other benchmark funds that can fund from pre-revenue to exit.

Co-Fund is well on its way to achieving the targets set in 2014 (see para 5.5.1), with the revised fund size of £12.5m projected to be fully utilised ahead of the May 2017 target date. There is evidence of:

- Additional gross external and export sales of circa £12.3m (para 5.2.2);
- Additional gross wages and salaries of circa £3.9m (para 6.2.1);
- 98.5 new NI gross jobs created and 95 gross jobs safeguarded (para 5.5.2)

- Investment focused on R&D
- Companies reporting that they are at, or close to, cash breakeven

There is confidence amongst Investors and companies as to future successful exits and uplifts in valuation (although with funding requirements of up to £24m). Although there has been one company exit in June 2016, it is too early to tell if such optimism is well founded.

Targets for input do not distinguish between new and follow on funding. Invest NI has set monitoring targets (that are not KPIs) in relation to turnover, employment and GVA. The Evaluation team would query if the targets set are meaningful (no other co-funds have similar targets).

There is evidence of wider benefits including the Co-Fund's ability to act as brokers for match companies and investors, to address the equity gap in NI, to open up CFM's networks and skill base to portfolio companies, to attract new funding institutions to NI, to create commercial value within companies, to introduce informal groupings of angels to pipeline, and to bring private sector Lead Investor skills and expertise to companies.

Moreover, Co-Fund would appear to have had a less formalized (and measurable) role in developing the skill base of the NI private investor market but has added value to investors for example, working with small groups of investors in portfolio companies to develop capability by mentoring NEDs and Lead Investors as well as support through follow-on round corporate finance fund raising, exit planning, insolvency and HR restructuring.

As per earlier, we note that there are no objectives for Co-Fund around the development of the private angel investment market (a key target of most other co-funds). Instead, Halo is responsible for the development of business angel groups and formal syndicates in NI. A key issue, therefore, is the extent to which Co-Fund should have had objectives around supply side business angel development, having regards to the role of Halo, the immaturity of the local marketplace, the cultural reluctance amongst investors to be visible, and therefore the impact of prescriptive formalised structures around angel group.

The NI Co-Fund is consistent with developments in GB, where barriers still exist, due to the lasting impacts of the economic downturn, continuing to restrict access to finance for SMEs and the inherent risks of early stage technology companies that creates a barrier in accessing traditional bank finance. There are various co-funds globally, and schemes differ in design, primarily concerning whether they are assessing investors or deals. The UK Angel CoFund was launched in November 2011, initially capitalised at £50m and increased to £100m in 2014. The Scottish SCF has been relaunched in 2015, with the first Scottish co-fund being launched initially in 2003. A new pan European Angel co-fund for ICT firms is to be launched.

The intervention by Invest NI is meeting key strategic objectives and market demand (for funding), with additionality deemed to be high. Issues for Co-Fund relate to the extent to which it is developing the supply side of the business angel market. Linked to the latter is the high level of involvement, pre and post investment, by the CFM fund managers, and the opportunity to reduce this as the supply side is developed.

### 8.4 Determine the extent to which the intervention represents good Value For Money (VFM) and appropriate use of public funds

In terms of economy – ('doing things at the right cost'), Invest NI has made appropriate efforts to ensure that the Co-Fund was delivered at least cost to NI. However, looking forward, the Evaluation Team are of the view that, in respect of any future potential Co-Fund, that consideration should be given to the level of involvement of the Co-Fund managers and their ability to be more "hands off" pre and post investment.

In terms of efficiency, ('doing things the right way'), we note that there are three fund managers for Co-Fund, with a higher staffing level than benchmarked funds, although this is balanced by the fact that Co-Fund NI does not pay a fee to its Lead Investors and that the NI market may not be sufficiently sophisticated for the private sector to take the lead in all appropriate investments. The

current “hands on” approach by Co-Fund managers is understandable but not sustainable. Co-Fund will need to assess its level of future involvement with companies on a case per case basis. The preference would be for Invest NI to set a clear guideline that the role of the Co-Fund is to review deals brought to it, not to create deals, and that the Co-Fund managers are not to become involved as non-executive directors (shadow or real), unless they receive a fee for doing so (as one would expect all other non-executive directors to receive). Where they believe due diligence has been inadequately performed, rather than carrying out additional due diligence themselves, they should require this to be done by the potential angel investors, and then review the results. They should “mentor” rather than “do”. An increased part of their function should be to “crowd-in” as many additional private sector investors as possible. They should not automatically provide 50-50 matching, but rather seek to bring in a higher proportion of the private sector. The impact of this however must be recognised, in that deals will likely take longer to happen, and deals will end up not being done, because the quality of deal structuring and due diligence by the inexperienced Angels will be inadequate. A transition period may therefore be appropriate.

With regard to effectiveness ('doing the right things'), Co-Fund is well on its way to achieving the deal activity targets set in 2014, with the revised fund size of £12.5m projected to be fully utilised ahead of the May 2017 target date. There is evidence of some commercial success amongst portfolio companies, although many companies are still at an early stage in their development.
The additional wages impact of funded companies has been calculated at £4.312m excluding one outlier company and £2.993m including the outlier. The total cost of Co-Fund, including CFM costs, Invest NI fully loaded costs and the investments made, totals £9.19m. This would indicate that, notwithstanding further CFM fees, additional employment and increases in average salary costs, the portfolio would breakeven in 2.1 to 3.1 years at an economic level. It is noted that companies anticipate their NI employment to increase by 85% (to 636) in the next three years. Hence, and notwithstanding the requirement for additional follow on funds, the period for the Co-Fund generating an economic return could be shorter.

There was one successful exit in June 2016. Details have not disclosed, but feedback from Invest NI is that this has been a positive exit. There have been no dividends paid to investees. It is too early to assess the financial return on the total investment. In addition to the exited company, as per para 5.3.1, three additional portfolio companies have raised additional funds at an uplift in valuation. The June 2016 return by CFM to Invest NI shows the original Co-Fund investment in these 4 portfolio companies (of £2.496m) being reflected at a £4.030m valuation, representing an increase of £1.533m or 61%.

The overall portfolio is estimated at a deficit of 19% for the 28 portfolio companies. The Evaluator’s view is that this reflects prudent write downs with no provision for potential uplifts on performing portfolio companies.

A comparison of Co-Fund to the benchmark data in Section 3 indicates that UK Angel CoFund has had two exits and the NZSCIF has had four, as compared to one exit for Co-Fund in NI:

There were 14 Co-Fund companies with valuations below cost at June 2016, including the four in liquidation. For the four companies with uplifts and in which there was total investment by Co-Fund of £2.49m, these are now valued at £4.03m, an uplift of 1.61 times. These four investments would need to be securing uplifts in value of 4.17 times for the Co-Fund to breakeven at the current level of investment. The experience of Archangel in Scotland (as per the benchmarking) would be that such returns are possible but cannot be predicted with any certainty.

Given the limited time the Co-Fund has been investing (from 2011/12 with the longest period of investment being 3.5 years and an average 1.93 year investment period), the low number of exits to date is to be expected. Positive returns on early stage investing typically take a minimum of six years to achieve, with recent evidence suggesting that this is extending to nine or more years. Reviews of other angel investments would suggest that for the Co-Fund, exits may not be achievable, or indeed identifiable for a further three to nine years. Of the 28 companies invested in to date, possibly just four will provide 90% of all the capital returned to the Co-Fund.

The view of the Evaluation team is that NI is circa 10 years behind the more developed Scottish co-fund model (on which it is stated to be based). Much has been done to date. Consideration now

needs to be given by Invest NI to the extent to which the model can further evolve and thus become more sustainable.

## 8.5 Findings and Lessons Learnt during the Evaluation of the Co-Fund

**Strategic Fit and Demand**

**Fit with Access to Finance Strategy** – There is potential for Co-Fund to invest in pre-revenue companies, at a minimum investment of £75k[88], up to investments of £1m (and potentially higher), which highlights the fact that Co-Fund is spanning the full range of the Invest NI Access to Finance continuum. This also demonstrates that the financial instruments launched by Invest NI under its Access to Finance strategy should not be considered as a linear continuum but rather, offering choice to businesses seeking funding. It is also noted that this flexibility is in keeping with other benchmark funds that can fund from pre-revenue to exit.

**Ability to support start-up companies** – Co-Fund's investments should reflect the needs of the private sector. It is therefore right that pre-revenue companies should therefore continue to be eligible.

**Demand and Market Failure** - This Interim Evaluation of the NI Co-Fund would report strong demand for the Co-Fund, with indications that the demand for the current £12.5m fund is likely to exceed funding capacity. The level of funds allocated to a future Co-Fund model in NI should therefore reflect the high level of demand, including demand for maximum funding to increase beyond £1m. There is evidence of market failure, with an inability/reluctance of the private sector to meet the funding needs of the portfolio companies supported by Co-Fund, particularly early stage companies, given their inherent risks. The challenge, however, is for Co-Fund not to "crowd out" the private sector, including the VC and corporate funds who may have significant funding capacity.

There is a recognition, however, that even when there is no/limited evidence of "market failure" within later funding round deals, ie the VCs/corporates could feasibly fill the funding gap, there is still a need for the Co-Fund intervention, owing to its early development stage, to be in a position to demonstrate the success of the co-investment funding model to the private angel market, and that this may best be achieved in some instances by Co-Fund following their money to successful exits.

**Maximum funding limits** - In terms of the limits of Co-Fund investment at £1m maximum per company and/or 10% of all funds, the Evaluation Team note the request by companies for higher levels of funding. Increasing the maximum limits may create opportunities for increased angel investing into good projects, whilst discouraging companies from moving on to VC and corporate funds. Linked to the issue of the maximum fund size is the requirement to maximise the leverage from the private sector, and reduce the public sector contribution. For all upper limits, there should be built in controls and mechanisms around prior approval from Invest NI, with it likely that the absolute legal limits are determined to some extent by absolute fund size.

**Co-Fund KPI targets** – As they currently stand, Co-Fund targets in relation to investment funding inputs do not distinguish between new and follow on funding. It is recommended that such distinctions should be made as part of any future Co-Fund. The target for the number of "new" investee companies should be clearly defined at the outset. Consideration might be given to target ranges to allow for flexibility in deal size, whilst ensuring that the KPIs for "new deals" exclude all, including small, follow on rounds.

**Ability to provide follow-on funding with funds allocated for follow-on -** A co-fund should retain sufficient follow-on funding to support investments and to support co-investment partners of the fund, through to potential positive exit. The minimum follow-on amount for the Co-Fund should be set at 50% of the fund value (this would match that used by the UK Angel CoFund). It should be

[88] Co-Fund typically operates at a minimum deal size of £150k with 50% funding resulting in a minimum initial investment of £75k

noted that in a mature market, angels invest around 75% of their cash into existing portfolio companies.

**Ability to provide follow-on funding to maximise the Return from the Investment** - The ability of a co-fund to provide follow on funding, even where the co-fund private sector business angel partners are unable to (ie matching against corporates, institutional investors etc), will have a significant influence on the overall financial performance of the co-fund. A prudent investor will want to maximise the return from "successful" investments by investing more capital in them. Follow on funding will help to protect the overall value of a co-fund, supporting "successes", with these then becoming important marketing tools. However, follow on investments can be considered as having potentially less programme additionality and provide little supply side market development, with the added risk of crowding out the private sector angel investors. The inclination of a normal fund manager would be to follow success, increasing investments in companies that appear to be successful, reducing investment in those that are struggling. For an economic development fund, wishing to "crowd in" the private sector, the considerations are likely to be different. Whilst investing additional capital into successful investments may mean that there will be less capital available to invest into other new companies, (and therefore potentially narrowing the pool of companies able to access overall programme funding), successful exits lead to additional monies being available for recycling and hence may increase the availability of funding for new investment opportunities. It is therefore clear that there are conflicting financial, economic and supply side objectives associated with Co Funds which should be considered and balanced as part of any future Co Fund intervention.

**Matching against EIS/SEIS** - The Evaluation team note that other UK based funds match against EIS investments but that UK Angel CoFund will not match against SEIS[89]. However, given the need to encourage more angel investment in NI, is it recommended that the current matching against SEIS should continue.

**Time period for the Co-Fund** - We note that none of the other benchmarked co-funds are set up on a time limited basis (of 6 years), but equally none of the other funds have a third party acting as a delivery agent, hence Invest NI is restricted by the procurement process for its Co-Fund managers in terms of having a time limited fund.

**Supply Side Development**

The supply side development (i.e. development of angel investor market) has not been a key focus to date of Co-Fund in NI. Most co-funds seek to create an angel investment market, with the typical primary objective of co-funds being to alter the behaviour, capacity and capability of potential and existing private investors to invest in businesses with potential for growth and to achieve an acceptable return.

Issues for Co-Fund relate to the extent to which it is developing the supply side of the business angel market or hindering the development of the private sector, given the high level of involvement, pre and post investment, by the current Co-Fund managers. A key challenge going forward is the opportunity to reduce this intensity of resource as the supply side is developed.

**Level of Engagement of the Fund Managers -** The Co-Fund managers are more active than managers in other similar co-funds, and do not require minimum syndicate size to co-invest with, or minimum levels of skill on the part of the Angels. There is limited incentive for the Co-Fund managers not to invest at the maximum public/ private funding ratio or to "crowd in" the private sector.

**Lack of KPIs and clarity on responsibility on supply side market development** - A key issue arising from the Interim Evaluation is for Invest NI to determine the extent to which Co-Fund should focus on supply side development, which would represent a fundamental change in its emphasis. The issue also is one of sustainability: NI has 28 companies and 3 investment managers while the New Zealand Seed Co-Fund has, according to its webiste, 116 companies and three highly skilled professionals with international experience (the website does not specify the level of support

[89] EIS and SEIS are UK tax incentive schemes (see para 4.4.3)

resource employed). This reflects the different intervention models in the two regions. Changing the dynamics will require more work by the Lead Investors and less by the Co-Fund managers. Invest NI has tasked Halo with the responsibility to develop business angel groups and formal syndicates in NI. Invest NI needs to determine the respective roles of its delivery agents with an interest in private sector investment, (ie Co-Fund, Halo, techstart NI etc), with the challenge being firstly the development of the Lead Investors and secondly the need to get more individuals into individual deals – with increased syndications and leading to angel group formations.

**Level of Funds Leveraged** – The low level of visible business angel investment in NI, and lack of syndicates and business angel groups, has impacted upon the amount of funding leveraged. The UK Angel CoFund leverages more than two times the Co-Fund investment. The Scottish model has been to establish business angel groups, with a larger grouping of investors able to contribute to larger funding rounds. This is a challenge for NI, with the lack of syndicates and business angel groups resulting in some portfolio companies having an insufficient pool of investors for follow on funding.

**Incentives for Lead Investors** - We note that there is little incentive in NI for individuals to take on the responsibility of being a Lead Investor or to actively form a syndicate or business angel group. There is no grant funding available to help with the costs of group operation. The Co-Fund in Northern Ireland is the only public sector co-fund we are aware of that does not compensate angel partners for bringing deals to the Co-Fund. For example, the UK Angel CoFund pays the angel syndicate a 2.5% to 4% fee for the upfront work they undertake in forming the deal.

**More rigorous challenge of the private investor** - If Co-Fund NI were to move to the UK Angel CoFund model, this could mean that some "good projects" are not funded where the project lacks a sufficiently qualified Lead Investor. Increasing reliance on the private sector**'s capability** would, in the short term, reduce the level of deals completed and cash going into the companies. While the feedback from the investor surveys is that most consider themselves to be sufficiently qualified, the NI angel market is generally un-sophisticated. Lead Investors have no skills in group formation. It still remains that with angel syndication in its infancy in NI, NI has too few angels investing, too few Lead Investors, no skills in group formation, and the amount of money being invested is too small relative to UK Angel CoFunds.

**Assessment of funding needs** - In other co-funds, the Lead Investor is challenged at the approval stage on the funding needs of the relevant company and the plan for the company going forward, including plans for sales, cash breakeven and/or exit. The Lead Investor will then report to the fund manager on achievements of the company (sales, employment, cash) against their original plan. A similar process should be adopted for NI, with better monitoring of performance against plan and exit planning.

**Assessment of the opportunity for development of Business Angel Groups in NI** – as noted, both Co-Fund and Halo (and indeed techstart NI) have an interest in business angel investment. There is a need for greater understanding of the opportunity for the development of Business Angel groups in NI. A Feasibility Study and Options Analysis should be commissioned by Invest NI to provide a roadmap as to how Angel investment groups could/should be developed in NI over the next 3-5 years. The output from this project would be taken into account as part of a Co-Fund Economic Appraisal and any future tendering for of Co-Fund and Halo programmes. In this way, Invest NI will ensure that the activities it supports are co-ordinated and mutually supportive of common goals.

**Board positions** – the hands-on approach by the Co-Fund managers to date in funded businesses has meant that they are involved at a Board level in almost all companies (albeit mostly at an observer level). Going forward, where the Lead Investor is considered to lack the necessary skills and experience, consideration should be given to the appointment of a Non Executive Director to represent the interests of the private sector, thus reducing the draw upon Co-Fund resources.

**Cooperation amongst stakeholders** – Invest NI should seek to ensure that the objectives and KPIs for Co-Fund going forward are constructed in a manner that supports the desired cooperation between the Co-Fund and stakeholders (such as Halo and techstart NI) who also co-invest alongside private investors, thus better supporting the development of the Angel market in NI. The same applies for objectives and KPIs for all relevant partner organisations within the Invest NI Access to Finance strategy.

**Limitations on matching against founders** - In terms of developing the supply side, most other co-funds would exclude matching against founders as this again limits the opportunity to present projects for angel investment. This needs to be considered as part of an Economic Appraisal for any future Co-Fund.

**Communication** – Co-Fund should continue to host events at which they inform the NI investor and corporate finance communities in NI what their role is, what they are prepared to offer to an investee company and confirm the types of companies they are targeting for investment. There should be transparency over terms by which they match the private investors.

**Economic Drivers**

**Economic targets** - Invest NI has set economic development related monitoring targets (that are not formal KPIs) in relation to turnover, employment and GVA. The Evaluation team note the relevancy of such targets to Invest NI's economic development objectives, whilst also noting that no other co-funds have similar explicit targets. These economic drivers, together with details as to how companies are performing against their original plans, etc, should continue to be reported to Invest NI on an annual basis, on the clear understanding that these are not Delivery Agent "performance" related targets.

**Financial/Commercial Drivers**

**Ability of a Government Fund to become Evergreen** - An issue for a state sponsored co-fund is to achieve a return of its capital, and thereby potentially become evergreen. All of the major co-funds considered in this report have a stated or implied ambition to become "evergreen", although no co-funds have IRR targets[90]. There is as yet no evidence that an evergreen fund has been achieved. Co-funds do not have the same capability or capacity as, say, a private Venture Capital ("VC") fund to maximise financial returns. The Co-Fund's performance is restricted due to the imposed limitations on investment size, investee eligibility, level of share of ownership, availability of follow on funding, and partner selection and levels of support.

**Demonstration of Opportunity for Commercial returns** - One of the objectives of a co-investment fund, and a specific objective of the UK Angel CoFund, is to demonstrate to the business angel market that it is possible to make a commercial rate of return by investing in companies such as those supported by the co-fund. The ability of a co-fund to provide follow on funding, even where the co-fund business angel partners are unable to, (and matching against VCs. corporates etc) will have a significant influence on the overall financial performance of the co-fund. A prudent investor will want to maximise the return from "successful" investments by investing more capital in them. Follow-on funding will help to protect the overall value of a co-fund, supporting "successes" and has been the rationale for the Co-Fund's continued involvement in two Series B funding rounds to June 2016[91]. The successful exit in June 2016, and the gains realised, will create more funds that can be used used for recycling to fund new opportunities. However, follow on investments can be considered as having less programme additionality and provide little market development. These conflicting objectives need to be considered during the Economic Appraisal, including the assessment of market failure and how it sits vis-à-vis actions to maximise the Co-Fund's success.

**Monitoring**

There is room to improve the monitoring information gathered and provided to Invest NI on economic and financial performance.

[90] Internal Rate of Return on Investment. It is important to note that references to IRR within other co-funds have been inferred, rather than being an explicit target. For example, the New Zealand co-fund has a requirement to target "return of capital", which implies an IRR of 5%. Evergreen status will then only be possible if the fund is able to achieve a financial return on its exits sufficient to cover its capital losses and its operating costs, together with an amount to cover the devaluation of its capital caused by inflation.

[91] There have been 2 Series B funding rounds, 1 in Jan 2016 and 1 in June 2016

**Targets for KPIs** – Invest NI should continue to monitor against specific KPIs on number of new deals, follow on deals, number of new Lead Investors, etc. As noted, economic drivers should continue to be reported to Invest NI for information purposes only.

**Monitoring against Plan and Cash flow requirements** - The Monitoring report to Invest NI could be strengthened with comparison of each companies' performance against their plan and more regular reporting on the key drivers for value creation, i.e. potentially profitability and cash flow. Exit planning could be strengthened, and should be reported on, including expected future funding needs over the lifetime of the investment.

**Resource requirements** - Consideration should be given to ensuring that the Co-Fund managers have an adequate level staff at an appropriate level who can undertake monitoring duties at an appropriate cost level, as well as the use of software solutions available for the monitoring of portfolios.

## 8.6 Conclusion

Overall, this Interim Evaluation would conclude that there is still a need for a Co-Fund intervention in NI.

As noted above, Invest NI is to determine its future objectives for Co-Fund for demand and supply side intervention. The opportunity to develop the supply side of the market, to encourage more angel investing, to develop Lead Investors, for angels to work together as a formal syndicate, and ultimately form a business angel group, should be further explored.

## 8.7 Recommendations

The recommendations from the Interim Evaluation of Co-Fund are:

1) Invest NI should consider the opportunity to further develop the supply side of the market (in keeping with other benchmarked co-fund regions) with this having a marked bearing on the direction of any future Co-Fund, including the extent to which there is a more rigorous challenge of the Lead Investor's capability and potential cost implications. This should be explored through a further Feasibility Study and Options Analysis as an interim measure.

2) In the event that Invest NI moves to a co-fund model with a supply side remit, in keeping with benchmarked regions, consideration should be given as part of an Economic Appraisal as to the necessary transitionary period arrangements and the need to financially support Lead Investors if they are to assume the level of responsibility as seen in benchmark regions, to incentivise them to undertake a more proactive role.

3) In the event that the Feasibility Study finds that there is not an appetite to develop the supply side of the market, the Economic Appraisal should consider how the Co-Fund model in NI can be made more sustainable. This should include investigating how best to manage the Co-Fund manager's level of hands on involvement in existing portfolio companies in line with existing contractual terms/investee company needs, and also how to reduce the Co-Fund manager's hands on involvement in future portfolio companies.

4) Consideration should be given as to how the Co-Fund can increase the capability of Lead Investors and increase their appetite for involvement in investee companies (or where there is scope to introduce Non Executive Directors, as paid for by the companies). The role of the Lead Investor should be more clearly defined as part of any future Co-Fund, setting out roles and responsibilities.

5) Going forward, the Co-Fund's database of prequalified angels should be used to ensure that angels benefit from investor training programmes, by Co-Fund and/or others, subject to the relevant consents on the part of the angels.

6) Co-Fund investments should continue to be market led and reflect the interest of the private sector, including in pre-revenue companies.

7) Consideration should be given as part of the Economic Appraisal as to the level of Co-Fund total finance to be retained for follow-on funding, reflecting the balance required between protecting fund investments and securing successful exits, demonstrating the commercial returns to be made from investment in companies such as in the Co-Fund portfolio, as well as avoiding crowding out the private sector.

8) The funding needs of the company, to reach exit or cash breakeven, and defining targets for sales and cash generation (internally generated through sales or externally raised), should be clearly defined at the approval stage and as part of the assessment of the investment partners, to ensure that there is capacity and/or a plan to provide follow on funding at the levels required.

9) The Economic Appraisal should further consider:

- The appropriate size of any future Co-Fund.
- The appropriate number of deals, including a "range" for "new" investments.
- The rationale for maintaining the minimum investment round at £75,000, and if this limit should be introduced for follow on investments also.
- The scope to increase the maximum funding per company above £1m, subject to recognition that any one investment should not exceed 10% of the Co-Fund.

10) Any future Co-Fund should:

- Consider the objectives of the Co-Fund, including which institutions it is appropriate to invest alongside, having regards to additionality and the need for co-terminus private angel investment so that supply side objectives are also met.
- Continue to restrain from matching solely against the founders of a company.
- Continue to match against EIS and SEIS, subject to the Lead investor investing a minimum amount (relative to a limit of £40k in UK Angel CoFund).

11) The Co-Fund should continue to improve its monitoring and reporting processes.

12) Any new Co-Fund should have activity KPIs relating to the number of new investments per annum, the number of new Lead Investors (as defined by UK Angel CoFund), the classification of investors (privates, institutions, NI/other locations etc), the mix of public to private investment, number of follow on rounds.

13) Co-Fund managers should report annually to Invest NI against activity KPIs, the position of portfolio companies against their original plan (e.g. sales, employment, cash position) and an annual updated position on funding needs to cash breakeven and/or exit. Reporting requirements should reflect investment levels.

14) Consideration should be given as part of the Economic Appraisal as to the preferred option regarding how best to cater for the fund management aspects of the current Co-Fund portfolio post the end of the current Co-Fund funding period.