FIN(4)FW007
Finance Wales Inquiry
Response from Morgan Cole LLP

I wish to provide some brief thoughts having read the above review by Professor Dylan Jones-Evans.

I am a Welsh corporate finance lawyer practising in Swansea and Cardiff for nearly 20 years and have been a partner at Morgan Cole for the last 12 years. I am currently head of the firm's Business Services Practice Area.

My practice in all that time has been concerned with the strategic development of Welsh based businesses of all sizes from start-ups to major nationals such as PHS, with transactions normally involving debt and/or equity funding and investment.

I should state at the outset that Morgan Cole is a panel firm for both Welsh Government and, separately, for Finance Wales.

I confess I was somewhat concerned at certain of the conclusions of the report and would like to make the following brief points:

1. As a preliminary point, it was unfortunate that the report was compiled by Professor Jones-Evans who is well known in the professional services community as having previously been a board member at Finance Wales and that the decision was taken not to retain his services in that position. I am not aware that he made any public comment regarding the terms upon which Finance Wales made loans to SMEs during his tenure. I have no doubt that the Professor's conclusions have been objectively reached, but perception is important as you will undoubtedly appreciate.

More substantively:

2. The Welsh private sector economy currently includes a substantial number of long standing SMEs whose owner-managers are over 55. As these owners look to retire (and we are regularly dealing with those who wish to do so), there are effectively two options for ownership succession: sale to a larger competitor or sale to an existing or incoming management team. The former carries a high risk of the business being relocated outside of the region to generate synergy benefits for the purchaser. Hence, it is important that every opportunity is provided for the retiring owner to achieve a sale to the business' management team, buy-in candidates or another local competitor. This not only preserves the employment in the region of the relevant employees, but also injects more energy and (in all likelihood) a higher degree of entrepreneurism and growth ambition into its ownership and management.

The short position is that such MBO/MBI transactions are highly unlikely to be funded through high street bank debt and that support from Finance Wales (often in the form of a combination of debt and equity) is the best and most likely funding option. It is not in the best interests of the Welsh economy to be deterring owner managers from discussing management buyout and buy-in transactions with Finance Wales based on a somewhat bizarre conclusion that its funding is unduly expensive (the conclusion which makes the headlines read by owner-managers). I was delighted to hear of the proposed buyout fund as part of FW's funds under management as well-managed funding to support credible buyouts will be very important in the coming years. The conclusions of this report do nothing to assist FW in promoting access to this fund for buyout and buy-in teams.

3. As to the cost of Finance Wales's lending, it is disappointing that the following context points were not made in the report:

(a) FW's debt is usually either subordinated to existing bank debt or totally unsecured. Rates of interest of between 8-11% for such risky mezzanine debt is, frankly, as cheap as are available anywhere. By way of comparison, venture capital mezzanine debt and preference share coupons in recent years have ranged between 10 to 15% (and often at the higher end of that range).

(b) Regardless of whether FW could lawfully offer lower rates, it would be uneconomic to do so and would justifiably result in the high street banks concluding that such unfair competition constrains their ability to conduct commercial lending business in the region. This would be entirely counterproductive to the Welsh economy as FW has insufficient funds to accommodate the region's entire commercial borrowing requirement.

(c) Much of FWs funds are invested in the form of equity, preference shares and loan notes with interest and/or preferred dividend payments being "rolled up" and only actually paid or redeemed when en exit is agreed. The structure of the funding will invariably be designed to ensure that (based on the business's plan) the equity holders (which may or may not include FW) should generate a healthy return even after accounting for such "rolled up" interest/dividend payments. If this were not the case, the other proposed equity holders would be unlikely to accept the proposed funding structure.

4. The professional community in Wales by and large welcomes the fact that FW operates as a professional investor, looking to make a return on its investments in order to continue its investments in the regional economy and ensuring that SMEs in the Welsh economy which it supports embrace the financial and management disciplines which are more likely to ensure their success. Its processes and investment parameters are well understood and the professional community therefore finds it easy to refer potential investments to FW. I cannot see how a new Development Bank of Wales (variations on which theme have recently been promoted by the Welsh

Liberal Democrats and the Welsh Conservatives) would be in a position better to deliver a combination of the venture capital funding options offered by FW and the secured secured debt funding options offered by the high street banks. I fear this would be a very expensive and time consuming distraction without significant benefits and one we can ill afford at present. Enhanced promotion of FWs funding options and resources, together with a campaign of education about owner-manager succession options, would in my opinion offer a more successful outcome, certainly in the short to medium term.

There are various other recommendations of the report with which I do agree, notably the need to generate a greater level of business angel investment (particularly at the higher end to complement FW investments where, say, £3m+ would be the optimum investment required to really enable the business to take off) and the need to provide much better quality access to help to make businesses "Investment ready" (and to provide an honest assessment if the business is not likely to be suitable for angel or FW investment).

However, dismantling the region's principal SME venture finance investor which is the envy of other regions (and indeed has been asked by other regions to manage its regional investment funds) at a time when it is essential that we focus on ensuring SMEs know and understand the availability of FW to support their growth and succession plans would in my view be highly damaging.

I hope the above assists in this debate and would be happy to discuss further.

Yours sincerely

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on behalf of Morgan Cole LLP | Solicitors | Corporate