

Archwilydd Cyffredinol Cymru
Auditor General for Wales

The Welsh Government's funding of Kancoat Ltd



WALES AUDIT OFFICE
SWYDDFA ARCHWILIO CYMRU

I have prepared and published this report in accordance with section 135 of the Government of Wales Act 2006.

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What this review is about

- 1 Kancoat Ltd (Kancoat) was a limited company set up in early 2012 to take over the operation of a metal-coil-coating production line at the Alcoa site on the Waunarlwydd estate in Swansea. The line processed pre-lacquered steel and tinplate strip for the manufacture of can components. These components, known as can stock, include ring pulls, aerosol caps and can ends. At the time, there were no other volume producers of pre-lacquered strip in the UK.
- 2 Although the Welsh Government provided Kancoat with a funding package for acquiring a coil-coating line and operating the line totalling £3.4 million, its business venture failed and the company went into administration in September 2014.
- 3 Shortly afterwards, the Auditor General for Wales received correspondence raising questions about the:
 - a value for money of the financial support package that the Welsh Government had made available to Kancoat, and
 - b the transparency of Kancoat's relationship with another company called Coilcolor Ltd (Coilcolor).
- 4 At our request, the Welsh Government's Internal Audit Service (Internal Audit) initially considered these matters as part of its review of Welsh Government compliance with its own policies and procedures in supporting Kancoat. Internal Audit concluded that whilst the Welsh Government had complied with its policies and procedures in so far as these were relevant, it needed to introduce additional procedures to address commercial loans and property transactions used in the Kancoat support package.
- 5 Risk management was not explicitly part of the scope of Internal Audit's review, but their working papers noted some issues regarding the management of risk by the sponsors of the project within the Welsh Government's Economy, Skills and Natural Resources Group¹. We were also aware of other instances when companies in receipt of Welsh Government financial support had gone into administration. These factors, taken together, led the Auditor General to conduct an external audit review of the Kancoat case.
- 6 This report sets out a factual account of the key matters relating to the Welsh Government's financial support package for Kancoat and presents these in the wider context of the Welsh Government's approach to supporting businesses in Wales.
- 7 **Appendix 1** sets out our audit approach and methods.

¹ In February 2016, the Welsh Government restructured, one of the groups established was Economy, Skills and Natural Resources.

Key findings

- 8 As part of its wider role in promoting Welsh economic development, the Welsh Government provides a range of financial and non-financial support to businesses in seven key industrial sectors, including the advanced materials and manufacturing sector (paragraphs 1.1 to 1.14).
- 9 The Welsh Government provided Kancoat, a company operating within that sector, with financial support worth £3.4 million to purchase and operate a metal-coil-coating production line. This support package was intended to enable Kancoat to secure a sub-lease on its business premises, purchase the coating line, restart manufacturing and weather a period of difficult trading (paragraphs 2.1 to 3.3).
- 10 The scale of the Welsh Government's support package increased between August 2013 and February 2014, and eventually comprised:
 - a property support: a lease commitment of £1.4 million (to be offset by an equivalent level of income from the sublease – paragraphs 3.4 to 3.11);
 - b Repayable Business Finance² offered on a non-repayable basis of £0.7 million (paragraphs 3.12 to 3.34); and
 - c commercial loans of £1.3 million (paragraphs 3.35 to 3.50).
- 11 As a result of Kancoat going into administration in September 2014 the 'cost per job created/safeguarded' was nearly three times higher than the Welsh Government's original expectation in the context of its assistance to the project via Repayable Business Finance (paragraphs 3.51 to 3.56).
- 12 As at the end of June 2016, Kancoat owes the Welsh Government nearly £2.6 million in repayment of the financial support that it has received (Exhibit 16). Based on the likely proceeds from the sale of the coating line meeting the lower end of the market valuation available at the time the line was purchased, the maximum potential irrecoverable loss to the public purse is currently estimated to be £1.5 million (paragraphs 3.57 to 3.59).

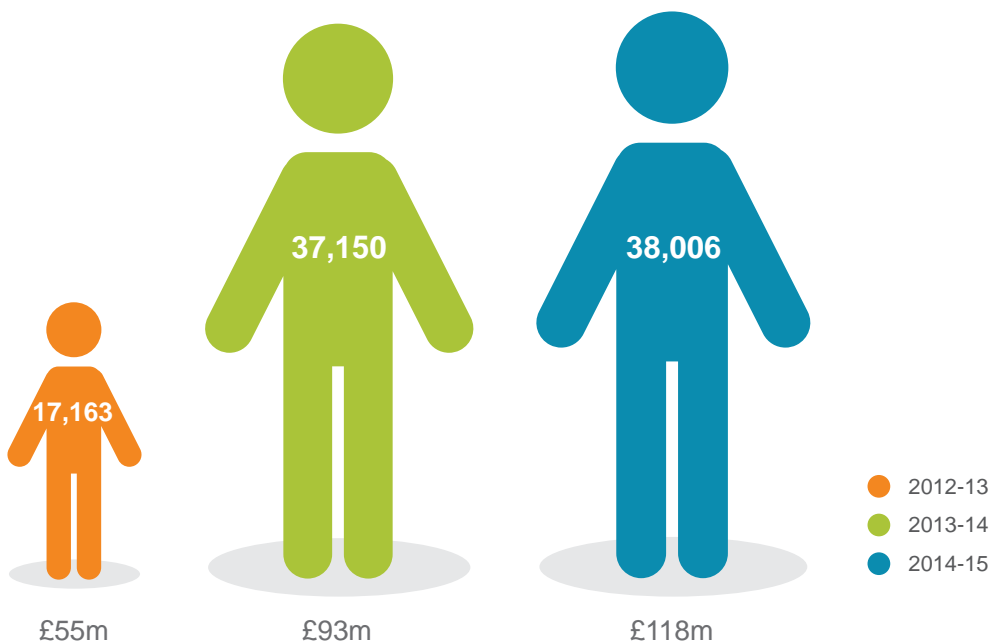
² See Exhibit 3 for Repayable Business Finance definition.

Part 1

How the Welsh Government supports the 'Advanced Materials and Manufacturing' business sector

- 1.1 The Welsh Government's Economy, Skills and Natural Resources Group operates eight Sector Teams providing financial and non-financial support to businesses:
- a Energy and Environment
 - b Construction
 - c Creative Industries
 - d Advanced Materials and Manufacturing
 - e Financial and Professional services
 - f Information and Communications Technologies
 - g Life Sciences
 - h Tourism
- 1.2 Between 2012-13 and 2014-15, the Welsh Government reports that it has provided some £266 million of financing to businesses operating in these eight sectors, creating or safeguarding over 90,000 jobs as shown in **Exhibit 1**.

Exhibit 1: Jobs created or safeguarded and the value of financial support provided by the Welsh Government



Note
The Welsh Government's definition for 'safeguarded' jobs is: The number of permanent full time equivalent paid jobs in a business which would have been lost and have therefore been safeguarded through Welsh Government support. In addition, European Union State Aid rules require that any jobs created or safeguarded remain in place (as part of conditions of support) for five years for large companies, and for three years for SMEs.

Source: Welsh Government data

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- 1.3 There is an established process for evaluating and approving applications for financial support. An Investment Panel meets weekly to consider applications for support that are put forward by each of the Sector Teams. The case papers that must be completed to support each application being presented to the panel are set out in [Exhibit 2](#).

Exhibit 2: Case papers necessary for Investment Panel decision

Documents details
All documentation supporting the application is presented and the application signed by the applicant.
A financial due diligence appraisal.
Investment Advisory team will undertake a quality assurance role on sectors cases with the exception of the tourism sector, which undertakes its own quality assurance.
A fully completed appraisal document.
Head of Sector recommendation to support.
Confirmation by Senior Finance and Performance Manager that budget approval has been given.

Source: [Welsh Government](#)

- 1.4 The Investment Panel comprises at least one member of the Group's Corporate Leadership Team, together with senior members of the Management Team. A member of the Investment Advisory Team chairs the panel and undertakes the secretariat role. A minimum of four members must be present for the panel to be quorate, and the member attending from the sector sponsoring the application is precluded from voting on the outcome. The Investment Panel presents recommendations for consideration to the Minister via a 'Ministerial Advice Folder'.

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- 1.5 The appraisal document presented to the Investment Panel ensures that the project meets the Welsh Government's own 'Value for Money' guidelines. These guidelines are based on a cost-per-job calculation, which was £24,638 (based on 70 per cent of the average salaries of £27,375, plus 20 per cent uplift for the jobs being located in a tier 1 area).
- 1.6 All investment decisions involve a degree of risk and this is particularly the case for start-up companies with no previous track record and limited working capital. In Wales, the five-year survival rate for new businesses from 2008 to 2013 was 42.5 per cent. This is slightly higher than the UK-wide survival rate of 41.3 per cent for the same period.
- 1.7 The Welsh Government's risk appetite can be high when trying to support and promote the Welsh economy. Officials refer to their role as 'lender of last resort', stepping in where the commercial finance market is unwilling to do so at a reasonable lending rate. In many cases, applicants presenting themselves to the Welsh Government for financial support will often have tried but failed to secure sufficient backing from private-sector finance sources.
- 1.8 In November 2011, in response to the economic downturn the Minister announced the first round of the Wales Economic Growth Fund which was an economic stimulus package aimed at supporting businesses that were able to bring forward investment ready projects. As the economy improved the number of Repayable Business Finance applications increased.
- 1.9 Repayable Business Finance offers 'discretionary' financial support to eligible businesses. This aims to help fund capital-investment and job-creation projects throughout Wales. The key objectives of this type of financial support are to:
 - a encourage new investment which increases competitiveness and productivity, especially within the Assisted Areas;
 - b help create and/or safeguard better skilled jobs; and
 - c develop key sectors in Wales.
- 1.10 Of the £266 million of financial support provided to the eight sectors over the three-year period 2012-13 to 2014-15, around £166 million (62 per cent) was Repayable Business Finance. However, some £154 million of this Repayable Business Finance support (93 per cent) was actually made available to companies (including Kancoat) on a non-repayable basis.

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- 1.11 Welsh Government officials told us that Repayable Business Finance can be deemed non-repayable in either of the following circumstances:
- a A mobile project, which would include inward investment. Mobile projects only become repayable if key targets are not met, for example: the number and quality of jobs, longevity of project, etc.
 - b With Ministerial approval and in 'exceptional circumstances', it is possible for the scheme to be offered on a non-repayable basis. An example of this was during the delivery of the Wales Economic Growth Fund, under which approval was given for Repayable Business Finance applications to be considered on a non-repayable basis.
- 1.12 During the same period, the Welsh Government advanced £38.5 million in commercial loans to 17 businesses including Kancoat.
- 1.13 The Welsh Government has made recoveries from 54 of the 1,110 companies which received financial assistance (4.9 per cent) in the last five years. The reasons for grant funding recovery in these 54 cases are: liquidation (35 cases); administration (14 cases); and failure to deliver the required outputs (five cases). In those five cases, the new jobs created by the companies concerned were not maintained for the necessary three to five years specified within the Welsh Government's funding conditions. In financial terms, the amount targeted for recovery from these 54 cases is £11.2 million out of £337.3 million awarded (3.3 per cent).
- 1.14 Kancoat's application was to the Advanced Materials and Manufacturing Sector Team and so this report focuses on the financial packages that are available to companies operating within that sector as shown in [Exhibit 3](#).

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Exhibit 3: Financial packages available to the Advanced Manufacturing and Materials sector

Type	Detail
Repayable Business Finance	<p>Economic Renewal: A new Direction' published by the Welsh Government in July 2010 sets out the approach for discretionary support to businesses. One of the main sources of funding is through Repayable Business Finance which offers financial support to eligible businesses. It aims to help fund capital-investment and job-creation projects throughout Wales.</p> <p>Repayable Business Finance is provided as a grant and the level of support is negotiable but must always be within State Aid ceilings and no more than is necessary to enable the project to go ahead. Any funding support made is 100 per cent repayable unless it is a mobile project ie, the project could be undertaken outside of Wales or there are exceptional circumstances where it can be considered on a non-repayable basis.</p> <p>Notwithstanding the above all funding offered under the Repayable Business Finance scheme is 100 per cent repayable, should the agreed terms and conditions of support not be met.</p> <p>European State Aid cover for Repayable Business Finance is provided by the current General Block Exemption regulations that came into force on 1 July 2014 (GBER).</p> <p>Specifically: Repayable Business Finance for capital investment projects is provided through the Welsh Government Capital Investment and Employment Aid Scheme (State Aid reference SA 39086).</p>
Commercial loan	<p>Loans made available on commercial terms and in compliance with the provisions of sections 60(1) and 70 of the Government of Wales Act 2006 and sections 1(2)(a), 1(3)(b) and 1(7)(d) of the Welsh Development Agency Act 1975.</p>
Property solution – Head lease	<p>It is not financial support but a means of enabling the company to secure possession of premises that was essential for its business, and was delivered on commercial terms.</p>

Source: Welsh Government

Part 2

Kancoat – a business supported by
the Welsh Government

- 2.1 Kancoat was established to take over the operation of a metal-coil-coating production line at the Alcoa site on the Waunarwydd estate in Swansea. The production line had been in situ for many years and a brief history of its ownership is set out below, with further details of the key events in [Appendix 2](#).

The Waunarwydd metal-coil-coating line

- 2.2 The coil-coating line was originally in use by Alcoa Manufacturing (GB) Ltd (Alcoa), the owners of the Waunarwydd site. With the support of a £350,000 grant from the Welsh Government, a company called Falcon Steel Ltd negotiated a lease for use of part of the site with Alcoa in 2009. However, Falcon Steel Ltd was unable to make a commercial success of the line and transferred both the lease and ownership of the line to Falcon Holdings UK Ltd in 2010. Both companies went into administration in 2011.
- 2.3 Coilcolor Ltd (Coilcolor) which was an established coil coater in Newport, set up a new company, Coilcolor (West) Ltd in December 2010 to take over the lease with Alcoa and the ownership of the coating line from the administrator of Falcon Holdings UK Ltd. Coilcolor also planned to relocate as a sub-tenant to the Waunarwydd site in 2012 since the development of housing on the land surrounding its Newport site would make its continuing operations and potential for future growth difficult.
- 2.4 A picture of the coating line can be seen in [Exhibit 4](#).

Exhibit 4: The coil-coating line at Waunarwydd Industrial site, Swansea



Photo: Kancoat Ltd

- 2.5 A condition of the site lease Alcoa entered into with Falcon Steel and Coilcolor (West) Ltd was that a standing prohibition on the processing of aluminium on the site until 1 January 2018 would remain extant. This meant that only steel or other substrates such as tinplate could be processed by the existing machinery on the line until that date. Coilcolor's intention was that, if it could agree an earlier date for aluminium processing with Alcoa, it would operate the line and develop specialised markets to which the line was suited. Coilcolor's business strategy was therefore to remove the threat of another competitor buying the site and operating the facility.
- 2.6 Coilcolor (West) Ltd continued to negotiate with Alcoa over the terms of its lease but failed to obtain Alcoa's agreement to lift the restriction for processing aluminium on the site any earlier than 2018. In June 2011, Coilcolor therefore approached the Welsh Government at both official and Ministerial level to seek assistance in securing Alcoa's consent to the removal of the restriction.
- 2.7 In December 2011, the Minister for Economy, Science and Transport wrote to the Alcoa Board requesting that the company continue to negotiate with Coilcolor (West) Ltd. In doing so, the Minister made it clear that she did not want the Welsh Government to intervene in any commercial negotiations between Alcoa and Coilcolor (West) Ltd. The Minister also provided an assurance to Alcoa that, where possible, the Welsh Government would continue to support Coilcolor's plans for its operations at Swansea.
- 2.8 However, by July 2012 Coilcolor (West) Ltd had accrued £200,000 in debt plus interest to Alcoa in respect of payments due under its lease. The title of the coil-coating line had transferred to HSBC finance under a pre-existing charge. The subsequent decision to close Coilcolor (West) Ltd was taken to allow a new company to take over production at the line and reach wider markets than the Coilcolor brand could facilitate.

The establishment of Kancoat, its ownership and business plan

- 2.9 Despite the setbacks outlined above, the owners of Coilcolor itself were keen to maintain production at the line and sought to attract other investors to fund either it, or a brand new company to continue production based on a different business model.
- 2.10 Coilcolor, together with two other investors (Building Products Offshore Fze and BLF Investments Limited) therefore established a new company called Kancoat Ltd to take the business forward. Kancoat's Managing Director had 20 years of relevant industry experience, and the company was supported by another highly experienced consultant and advisor. There was also a workforce on hand with experience of operating the line.
- 2.11 Kancoat was incorporated as a private limited company on 6 March 2012, with an initial share capital allocation of one ordinary share allocated to Coilcolor. Its sole Director was a Director of Coilcolor between 1 May 2011 and 31 March 2012. Although there was a short overlap in tenure it was always the intention by Kancoat's director to resign from Coilcolor as soon as Kancoat was formally incorporated.
- 2.12 On 15 August 2013, Kancoat adopted 250,000 preference shares³ and 250,100 ordinary shares⁴ as its share capital; split equally between Building Products Offshore Fze and BLF Investments Limited. However, in order to demonstrate the independence of Kancoat from the existing owner of the coil-coating line, Coilcolor itself did not take an equity shareholding in the company as it had originally intended.
- 2.13 Kancoat's business plan was to purchase the coil-coating line from Coilcolor (which would also involve settling the charge over the line by HSBC Asset Finance) and take over the lease with Alcoa. Coilcolor, which at the time was operating in Newport with 50 employees and a turnover of over £12.5 million, was expected to be Kancoat's major customer for its first year of trading (as set out in Kancoat's business plan). Coilcolor and Kancoat would operate totally autonomously, with no common executive directors.
- 2.14 Kancoat's business plan was incremental. Initially, it expected to supply Coilcolor as its main customer, but it hoped to expand its customer base and attract new investors as confidence grew in its successful operation of the line. The Directors of Coilcolor have since told us that they do not recognise the expectation that it would be Kancoat's main customer for the first year of trading. Kancoat, as set out in its business plan, expected that the most lucrative phase of the venture would begin in 2018 with the lifting of the Alcoa-imposed aluminium processing restriction.

³ Preference shares; a share which entitles the holder to a fixed dividend, the payment of which takes priority over that of ordinary share dividends.

⁴ Ordinary shares; a share entitling its holder to dividends which vary in amount and may even be missed, depending on the profits of the company.

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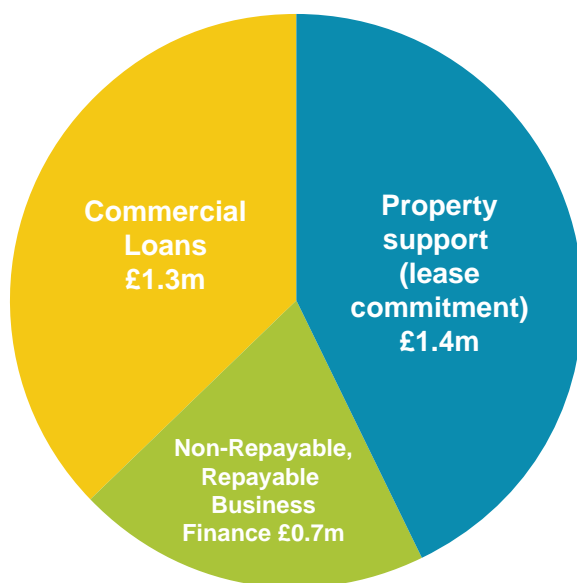
- 2.15 The coating line itself had been independently valued for Coilcolor in March 2011 at a £5 million market value 'in situ', and at £1.25 million based on its piecemeal disposal. Kancoat intended to purchase the line from Coilcolor at an agreed price of £2.5 million, adapt the building and then re-commence production at an estimated total cost of £7.1 million. This figure included the cost of the lease with Alcoa, capitalised over a 10-year period.
- 2.16 As Kancoat was a new and untested company, which had close links with Coilcolor and Coilcolor (West) Ltd, Alcoa was not prepared to enter into a lease with it directly. However, Alcoa indicated that it was prepared to lease the site to the Welsh Government so that in turn the Welsh Government could sub-let the site to Kancoat.
- 2.17 In light of the earlier correspondence between the Minister and both Alcoa and Coilcolor, officials looked at how the Welsh Government could do two things:
- a support Kancoat's wish to use the Alcoa-owned site; and
 - b provide business finance for Kancoat's purchase and subsequent operation of the coil-coating line.
- 2.18 Kancoat asserted that the Welsh Government's assistance would help it bring back into operation a state of the art production line, whilst creating 32 jobs over three years and safeguarding one further job in an economically important area.
- 2.19 Although the Kancoat business plan was inherently high risk given the nature of new start-up companies and the previous history of the line, Welsh Government officials told us that they had considered it carefully. They thought it worth taking the risk subject to securing appropriate security over the coil-coating-line fixed asset, as this had a resale value. In addition to this the company's medium to longer-term prospects were assessed as promising providing Kancoat could secure new investors and expand its customer base in the lead up to being able to process aluminium from 2018 onwards.
- 2.20 Kancoat's business plan was consistent with market opportunities and conditions at the time and was strategically sound provided it could meet the particular challenges associated with the first few years of trading. Welsh Government officials also told us that they considered that the company's management capacity and experience was good.

Part 3

Kancoat's support package from the Welsh Government between August 2013 and February 2014

- 3.1 Between August 2013 and February 2014, the Welsh Government provided Kancoat with a package of support valued at £3.4 million comprising three main elements as set out in [Exhibit 5](#).

Exhibit 5: Welsh Government provided three types of support to Kancoat



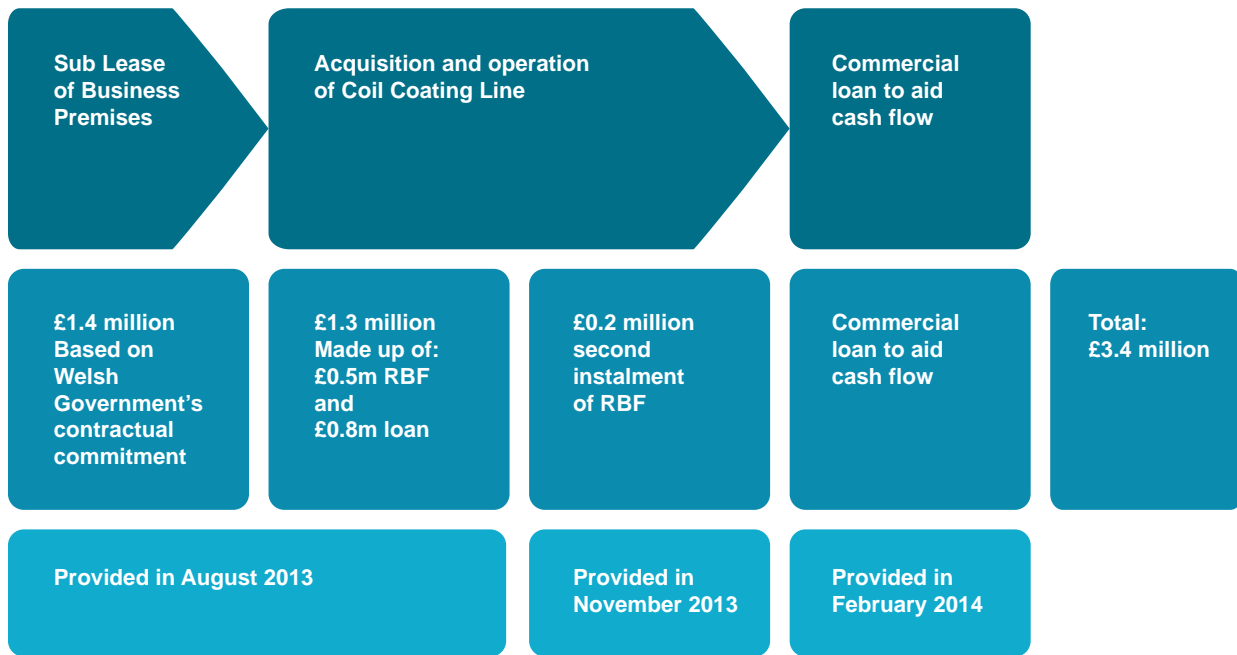
Note

The £1.4 million is over a five-year period, up to the first break clause in August 2018; it includes an eight-month rent-free period in the first year.

Source: Wales Audit Office analysis

- 3.2 This support package enabled Kancoat to:
- secure a sub-lease on its business premises (see [paragraphs 3.4 to 3.11](#));
 - purchase and restart manufacturing at the coil coating line ([paragraphs 3.12 to 3.44](#)); and
 - weather a period of trading difficulty with a commercial loan ([paragraphs 3.45 to 3.50](#)).
- 3.3 [Exhibit 6](#) shows how and when these elements came together.

Exhibit 6: The timing of Kancoat's support package



Note

The £1.4 million is over a five-year period, up to the first break clause in August 2018, it includes an eight-month rent-free period in the first year. The lease agreement also provides for remediation and separation works that may be necessary at the appropriate time.

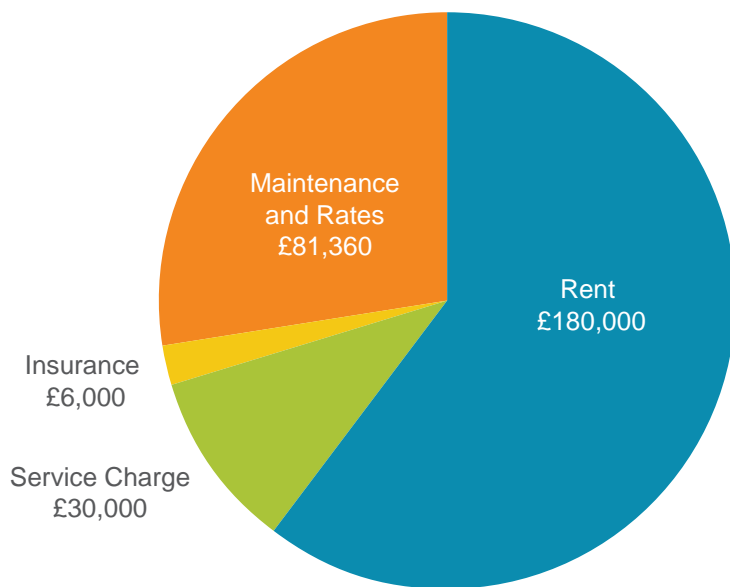
Source: Wales Audit Office analysis

The Welsh Government secured a lease with Alcoa

- 3.4 The Welsh Government's Property Infrastructure Team was tasked with securing the accommodation required by Kancoat by undertaking head lease negotiations with Alcoa. Kancoat was an Advanced Materials and Manufacturing-led project, one of the key sectors the Welsh Government was supporting. The Sector Team therefore viewed the provision of financial support for the company and its business proposal as contributing to the Programme for Government's goals of creating growth and sustainable jobs.
- 3.5 The Welsh Government did not have a formal policy and procedure for approving leases (or other property interventions) jointly with other investment decisions, where a company was requesting property and financial support at the time of the negotiations, but has since developed one⁵. The negotiations took place at the same time as, and solely as a consequence of the Investment Panel discussing the approval of a Repayable Business Finance application (paragraphs 3.12 to 3.34) and as part of that approval it was suggested that the Welsh Government should only enter into a lease with Alcoa if it included a two-year opt-out clause, to help manage the uncertainties associated with the future success of Kancoat.
- 3.6 Welsh Government officials negotiated directly with Alcoa, initially requesting a two-year break clause, however, this request was unsuccessful. After further negotiations officials secured 'break clauses' either five or 10 years into the lease (in 2018 and 2023 respectively), providing there is no sub-lease in place at that time. The lease for the premises housing the metal-coating line commenced in August 2013, coinciding with Kancoat's purchase of the coating line from Coilcolor, expiring in February 2029.
- 3.7 The annual cost of the lease agreed between Alcoa and the Welsh Government is £297,360 and comprises rent, service charges, insurance, maintenance and rates, as shown in Exhibit 7.
- 3.8 The Property Leadership Team considered the lease terms agreed with Alcoa to be the best they could achieve, supported by independent market valuations undertaken.

⁵ Now all proposals to secure leases or other property solutions for companies which are also seeking other forms of financial support must be considered by the Investment Recommendation Panel (with the benefit of appropriate advice from the Property Leadership Team), which makes a formal recommendation to the Minister having taken into account the results of due diligence.

Exhibit 7: Breakdown of the Welsh Government's annual lease costs of £297,360



Source: Welsh Government analysis

The sub-lease between the Welsh Government and Kancoat

- 3.9 As soon as the Welsh Government agreed the lease with Alcoa it granted a sub-lease of the premises to Kancoat. The terms of this sub-lease are substantially the same as those agreed between the Welsh Government and Alcoa, except that Kancoat did not benefit from any opt-out provisions in years five and 10 (ie, Kancoat was contractually committed to the full 16-year term of the lease until February 2029).
- 3.10 Kancoat was required to pay the full cost of the lease to the Welsh Government under its sub-lease (ie, £297,360 per annum). However, to date Kancoat has only paid the Welsh Government a total of £13,166, as shown in [Exhibit 8](#).

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Exhibit 8: Lease payments made by Kancoat Ltd

Repayment of:	£
Service charge for August 2013	3,002
Insurance and rent for August 2013 to May 2014	10,164
Total	13,166

Source: Welsh Government

3.11 Unless a new tenant can be found to sub-let the premises, the Welsh Government will be liable to Alcoa for the remaining lease costs until it is able to exercise its break clause in 2018. These liabilities will amount to just under £1.4 million, as shown in [Exhibit 9](#).

Exhibit 9: Lease payments due from Kancoat Ltd

Year commencing	Sub-lease payment due to Welsh Government from Kancoat, £	Payments made by Kancoat, £	Cumulative balance of unpaid sub lease costs, £
2013	177,360	13,166	164,194
2014	297,360	–	461,544
2015	297,360	–	758,914
2016	297,360	–	1,056,274
2017	297,360	–	1,353,634

Note

In the first year a rent-free period of eight months was awarded to Kancoat, and the lease agreement also provides for any remediation and separation works necessary.

Source: Welsh Government

Kancoat initially intended to seek £3 million of Welsh Government assistance

- 3.12 Coilcolor had offered the line for sale to Kancoat for £2.5 million. The proposed terms were that £1.5 million would be paid upfront and the balance of £1 million could be paid back over two years under a loan agreement.
- 3.13 Kancoat found that it could not raise the £1.5 million from private capital finance to purchase the line. It was a new start-up company proposing to operate a production line that had failed on two previous occasions. Kancoat had secured £500,000 of working capital from its two private investors, but this was sufficient only to cover operating costs.
- 3.14 In April 2013 Kancoat approached Finance Wales PLC to discuss potential sources of finance. Discussions between the two parties culminated with an application for an investment of £325,000 which was subsequently declined by Finance Wales because of the unacceptably high level of risk that it associated with this start-up project, particularly in the first year of trading.
- 3.15 Whilst discussing the offer of a sub-lease with officials from the Welsh Government's Property Team, Kancoat also sought to secure additional financial support from the Welsh Government's Advanced Materials and Manufacturing Sector Team to aid its purchase and reinstatement of the metal-coil-coating line from Coilcolor. The coil coating line in operation is shown in [Exhibit 10](#).

Exhibit 10: The coil-coating line in operation



Photo: Wales Audit Office

- 3.16 In April 2012 Kancoat suggested that they would seek financial support in the region of £3 million from the Welsh Government. Welsh Government officials have told us that it was made clear that a formal application for this amount would not be approved because both the risks and the forecast 'cost per job created' were too great. The Director of Kancoat believes that the company was initially encouraged by the Welsh Government to apply for a higher level of funding towards capital costs and understood that cost per job and value for money were not criteria that were being applied at this time.

Kancoat's formal application for £1.8 million of Repayable Business Finance was rejected

- 3.17 Kancoat subsequently submitted a formal application to the Welsh Government for £1.8 million of Repayable Business Finance on 9 May 2012. The funding sought was towards a project capital cost of £6.7 million and the creation/safeguarding of 33 jobs. The Welsh Government turned down this application on the basis of poor value for money, with the 'cost per job created' too high at £54,545.
- 3.18 Instead, the Welsh Government invited Kancoat to re-submit its application to seek £500,000 of Repayable Business Finance. This figure was the maximum funding level that could be approved by the Investment Panel at the time, as all applications over £500,000 required approval by the Wales Industrial Development Advisory Board (WIDAB)⁶.

Kancoat's revised application for £500,000 Repayable Business Finance was approved

- 3.19 Towards the end of May 2012 and shortly after the rejection of the first formal application for £1.8 million of support, Kancoat submitted a revised formal application for £500,000 Repayable Business Finance, towards the cost of the project. As part of the revised terms of the application, Coilcolor would provide private-sector capital of £2.5 million; Kancoat was expected to make an immediate payment of £1.3 million to Coilcolor with the balance being repayable over two years.
- 3.20 The Welsh Government's financial due diligence reviewer who examined the application concluded that:
'with the exception of Coilcolor Ltd [Welsh Government] have no financial information as to the financial or otherwise standings of the other two shareholders. Building Products Offshore Fze would appear to be the name of a UAE business, however, internet searches do not find an entity of this name, we do not have a CV for [the Kancoat Managing Director].'

⁶ As noted in paragraph 3.28, the threshold for WIDAB approval was increased in January 2013 to £1 million.

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- 3.21 We have, however, seen documents provided by the Director of Kancoat that more details of the two private investors were available at the time than that which was made available for the purpose of the due diligence review. The Director is of the view that the Business Development Manager overseeing this application was aware of the background and experience of these investors.
- 3.22 The financial due-diligence reviewer had concerns about Kancoat's financial projections as set out in its business plan. From the year ended 31 March 2018 onwards, the plan projected an increase of £500,000 in forecast turnover due to the ability to process aluminium at the site from 2018 onwards. However, in reviewing the breakdown of this increase in the monthly sales of processed aluminium, the additional £500,000 of income did not allow for any increase in raw-material costs. This led the reviewer to place a high degree of scepticism on the resultant projected increase in gross profit margin from 15 per cent to 31 per cent.
- 3.23 The Welsh Government Business Development Manager responsible for supporting this project told us that customers would have been expected to provide their own aluminium-based raw materials for processing, and that this addresses the observation made by the due-diligence reviewer in his appraisal.
- 3.24 On 5 November 2012, the Welsh Government sent an offer letter to Kancoat approving its application for £500,000 of Repayable Business Finance, but on a non-repayable basis, since Kancoat's owners had made it clear they would not be able to agree to an offer of repayable finance. Such an arrangement was not unusual at the time since, as explained in [paragraph 1.10](#), the majority of Repayable Business Finance approved by the Welsh Government in this period was actually non-repayable.
- 3.25 The Director of Kancoat has told us that he became unhappy with how the Welsh Government was dealing with Kancoat's request for financial support and what he saw as inconsistent messages being given about what could be provided in support to the company. He complained about the position and in his view this resulted in a series of further discussions and the consideration of the subsequent formal application for Repayable Business Finance. Welsh Government officials state that the further discussions and the consideration of the subsequent application for Repayable Business Finance arose because of a change in Kancoat's business plan which is considered next.

The Welsh Government subsequently increased its approval of Repayable Business Finance to £778,000

- 3.26 Between October 2012 and January 2013 market conditions for Kancoat suddenly improved. Kancoat informed the relevant Welsh Government Business Development Manager that a major supplier of coated aluminium had relocated to Europe, and this resulted in new customers approaching Kancoat as an alternative supplier for can stock some 12 months earlier than anticipated. This scenario contrasted with Kancoat's previous business plan, which had set out an intention to rely on revenue from one single customer, Coilcolor, for the first year of trading.
- 3.27 In addition to the above, changes in circumstances prevented Coilcolor from relocating its business to Swansea as planned.
- 3.28 Due to Kancoat moving into a new market and Coilcolor being unable to relocate to Waunarlwydd, it was anticipated that Coilcolor would reduce the amount of finance it was prepared to advance to Kancoat for the completion of the purchase of the coil-coating line. Therefore, in order to meet the new customer needs and to get the line into operation earlier than initially anticipated, Kancoat increased its application for Repayable Business Finance from £500,000 to £990,000. This coincided with the threshold for WIDAB approval of Repayable Business Finance applications increasing from £500,000 to £1 million, and so Kancoat's revised application only required Investment Panel approval, rather than WIDAB consideration.
- 3.29 The Welsh Government's due-diligence review prepared in respect of the previous application was also updated to take into account the changes in circumstances. The conclusions of this review, dated 21 February 2013, were as follows:
'The business plan appears weak and inconsistent. The inherent risks associated with Kancoat as a start-up remain. The replacement of the Coilcolor Group and the loss of their participation and guarantee leave the risks identified as essentially unmitigated. The proposal involves the WG taking on a significant landlord risk in addition. The project was identified as high risk in the initial assessment. The revised proposal and developments surrounding this have increased the level of risk rather than mitigated it.'
- 3.30 The Investment Panel considered the revised application for £990,000 of Repayable Business Finance on 12 March 2013. The Panel noted that, based on the Kancoat's latest proposal for the creation of 31 jobs and one safeguarded job, £788,400 was the maximum amount of funding that could be awarded⁷.

⁷ The £778,400 of funding created a higher cost per job than the Welsh Government's value-for-money guidelines.

- 3.31 At this time, officials in the Welsh Government's Property Team were still negotiating the terms of the lease with Alcoa. Members of the Investment Panel were therefore concerned about the potential £4.8 million Welsh Government liability for lease payments over a 16-year lease term should Kancoat, a high-risk venture, fail and no other companies come forward to take on the sub-lease for the site. The Panel's recommendation was therefore to reject the new application, but it also concluded that the existing offer of £500,000 could remain available to Kancoat.
- 3.32 The Investment Panel met again a week later on 19 March 2013 to consider the Kancoat application again, paying particular attention to the risks associated with entering into a 16-year lease with Alcoa. The Panel agreed to recommend to the Minister the offer of '£788,400 non-repayable business finance with a steer to the Property Leadership Team to make a commercial decision on the property aspect'.⁸
- 3.33 The Minister approved the Kancoat application for Repayable Business Finance, on a non-repayable basis due to 'exceptional circumstances', which took into account Alcoa's restriction on the use of the site until January 2018 (see [paragraph 2.5](#)) and the start-up nature of the business.
- 3.34 The Welsh Government paid two Repayable Business Finance instalments (of £500,000 and £200,000) totalling £0.7 million to Kancoat on 1 August and 27 November 2013 (see [paragraphs 3.12 to 3.34](#)). The first instalment of £500,000, together with a loan from Coilcolor of £1.2 million, was used by Kancoat to purchase the coil-coating line from Coilcolor for £2.5 million; the balance of £0.8 million having to be made up from private sources on a commercial basis (see next section). The second instalment of £200,000 was paid following a site visit by Welsh Government officials, as they assessed that the terms of the offer letter had been complied with. However, the Welsh Government did not release the £88,400 balance, as in the meantime Kancoat had requested additional investment from the Welsh Government. This issue is considered in the next section of the report.

The Welsh Government's approval of a £0.8 million commercial loan

- 3.35 In light of the changes in circumstances set out above the financing of the purchase of the line was revised. Coilcolor required an initial payment of £1.3 million from Kancoat and the remaining balance of £1.2 million would be repaid over two years. The £1.3 million up-front payment would be made up of the application of £500,000 Repayable Business Finance together with a commercial loan requirement of £800,000, the changes in funding requirements for the purchase of the line are set out in [Exhibit 11](#).

⁸ The Panel also suggested that the Welsh Government should only enter into the lease with Alcoa if it included a two-year opt-out clause, to help manage the uncertainties associated with the future commercial success of Kancoat, detailed in paragraphs 3.5 and 3.6.

Exhibit 11: Changes in funding requirements for purchasing the line

Detail	First requirement, £	Second requirement, £	Third requirement, £
Coilcolor	2,500,000	1,200,000	1,200,000
Commercial Loan (commercial lender)	0	800,000	0
Commercial Loan (Welsh Government)	0	0	800,000
Repayable Business Finance	0	500,000	500,000
Total	2,500,000	2,500,000	2,500,000

Source: Wales Audit Office analysis

- 3.36 Kancoat had obtained an offer of commercial finance in the form of a secured loan of £800,000 over five years from a merchant bank. This offer was conditional upon the Welsh Government entering into a 'step-in agreement', obligating the Welsh Government to guarantee the loan and becoming directly liable for any outstanding loan debt in the event of a default by Kancoat.
- 3.37 In order to remain supportive of the project whilst complying with its internal legal advice in respect of providing guarantees, the Welsh Government explored the option of instead lending £800,000 itself to Kancoat on a commercial basis.
- 3.38 For the Welsh Government officials who appraised this proposed loan to Kancoat, a key factor was the value of the coating line as security. They were aware that a third-party company which had marketed the line in November 2011 on behalf of Coilcolor had placed a value of around £3 million on the metal-coating line for resale as an operational asset. One of Alcoa's competitors had also expressed an interest in buying the line around this time for £3.74 million, but no firm offer for this amount was actually received.

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- 3.39 The Welsh Government officials therefore recommended that either the terms of the security should be negotiated to allow the coating production line to be sold 'in situ' as an operational asset (as opposed to breaking it up into parts or scrapping), or else that some other form of security or guarantee should be sought from Kancoat. The financial due diligence officer also recommended that the Welsh Government may wish to consider undertaking an independent valuation of the coating line, to ensure valuation figures previously obtained by Coilcolor remained valid.
- 3.40 However, no further asset valuation was obtained as Welsh Government officials decided that the valuation of between £1.25 million and £5 million obtained by Coilcolor in March 2011 remained sufficiently current to be relied upon to support the purchase of the line at £2.5 million and to cover the Welsh Government's exposure to any potential loss. A best-case resale of the line 'in situ' at £5 million would enable the Welsh Government to recoup all of its contributions to facilitate the acquisition of the line by Kancoat. Conversely, a worst case 'piecemeal' disposal of the line at £1.25 million would leave Welsh Government with a potential irrecoverable loss of some £1.5 million (as at August 2013).
- 3.41 The Welsh Government therefore granted the commercial loan of £800,000, and secured its investment in the coating line via the 'Deed of Priority' set out in [Exhibit 12](#).

Exhibit 12: Deed of priority over Kancoat's assets

Priority	Over
1 Welsh Ministers	The first £800,000 plus interest and charges
2 Alcoa Manufacturing GB Ltd	The next £200,000 plus interest and charges, which related to the Coilcolor arrears on the line
3 Welsh Ministers	Priority without limitation on subsequent amounts
4 Alcoa Ltd	Priority without limitation on subsequent amounts
5 Coilcolor Ltd	Priority without limitation on subsequent amounts

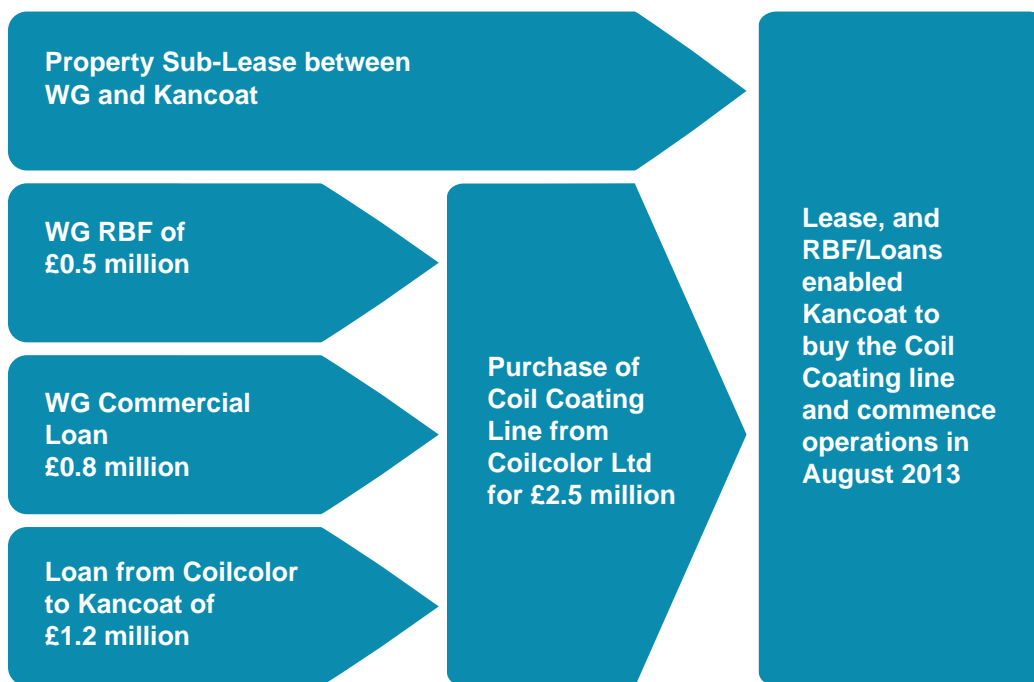
Note

In order to fund the acquisition of the coating line, Coilcolor had obtained finance from a commercial bank. This bank funding was secured on various assets to include the coating line, Coilcolor (West) Ltd defaulted on its payments to the bank, which resulted in arrears of £200,000.

Source: Welsh Government

3.42 Kancoat accepted the commercial loan offer of £800,000 on 1 August 2013, and purchased the metal coating line from Coilcolor for £2.5 million on 15 August 2013, as summarised in [Exhibit 13](#).

Exhibit 13: Completion of purchase of the coil-coating line and the start of Kancoat's operations



Source: Wales Audit Office analysis

3.43 To date, Kancoat has made seven repayments totalling £121,923 against this £800,000 commercial loan, leaving an outstanding balance (including both principal and interest debt) of £955,677 due to the Welsh Government, as shown in [Exhibit 14](#).

Exhibit 14: Commercial loan payments due to the Welsh Government from Kancoat Ltd

Financial Year	Commercial loan payments due to Welsh Government £	Payments made by Kancoat £	Cumulative balance of unpaid loan instalments £
2013-14 (one month after drawdown)	125,720	121,923	3,797
2014-15	215,520	–	219,317
2015-16	215,520	–	434,837
2016-17	215,520	–	650,357
2017-18	215,520	–	865,877
2018-19	89,800	–	955,677

Source: Wales Audit Office analysis

3.44 At the time the loan of £800,000 was advanced, the Welsh Government did not have a formal policy and procedure for assessing and approving loans to businesses. The Welsh Government told us that it has since addressed this gap by ensuring that:

- a all commercial loans are subject to Investment Panel consideration;
- b Senior Management Team ratify any recommendation by the Investment Panel for commercial loans above £1 million;
- c the monitoring of loans is undertaken by a Central Monitoring Team;
- d a separate appraisal in addition to the Ministerial Advice Folder for the Minister must be undertaken; and
- e loan applicants are more thoroughly assessed for their ability to repay.

The Welsh Government provided a further loan to Kancoat to help it overcome unforeseen operating difficulties

- 3.45 In early 2014, some five months after the completion of the deal to secure the lease with the Welsh Government and purchase the coil-coating line from Coilcolor, Kancoat experienced operating difficulties. These difficulties led to further discussions with Welsh Government officials regarding the provision of additional financial support.
- 3.46 Unforeseen difficulties with Kancoat's main UK supplier of steel coil meant that Kancoat considered it had no alternative other than to seek new suppliers in France and Korea. The consequent two-month lead time for the product led to delays in the receipt of income against the sales forecast in the business plan. In addition, both overseas suppliers demanded payment in advance. These two factors, taken together, created a significant cash-flow problem for Kancoat. Kancoat sought finance from other commercial sources, including an additional application to Finance Wales and the Enterprise Finance Guarantee scheme – a UK Government lending scheme intended to help smaller viable businesses who may be struggling to secure finance, by facilitating bank loans of between £1,000 and £1 million – but was unsuccessful.
- 3.47 Kancoat officials projected that without an immediate injection of £500,000, the firm would be unable to purchase raw materials in order to meet its order book and would cease trading. The 12 jobs already created would be lost, together with the further 20 jobs expected to be created over the next three years. Closure would also result in Kancoat defaulting on its loan from Coilcolor, the Welsh Government's commercial loan of £800,000, and its obligations under the sub-lease agreement.
- 3.48 Welsh Government officials examined and accepted Kancoat's revenue and cash-flow projections when considering whether to provide a further short-term loan of £500,000 to the company. However, this second commercial loan was conditional on Kancoat being up to date with its lease payments to the Welsh Government. By January 2014, Kancoat had made seven repayments totalling £121,923 against its first £800,000 commercial loan. However, it had not made any payments under its sub-lease from the Welsh Government, other than a contribution of £13,166 towards service charges and insurance (see [Exhibit 8](#)).
- 3.49 The Welsh Government approved the second loan and advanced it on 14 February 2014, despite Kancoat still not having made any further payments against its lease obligations⁹. The award of the second commercial loan of £500,000, secured on the same terms, did not provide the Welsh Government with a commensurate level of security given Kancoat's weak trading situation at the time, as the existing Deed of Priority was not amended.

⁹ Although Kancoat had not satisfied the pre-payment condition, Welsh Government Officials informed us that the central finance do not identify a company being in arrears until the Welsh Government has issued three reminder notices. Consequently, Kancoat was not in arrears at the time of the second loan.

- 3.50 In March 2014, in light of the ongoing cash flow difficulties that Kancoat was experiencing, the Welsh Government also granted it a 90-day 'payment holiday' on both the first commercial loan and its rental payments under the sub-lease.

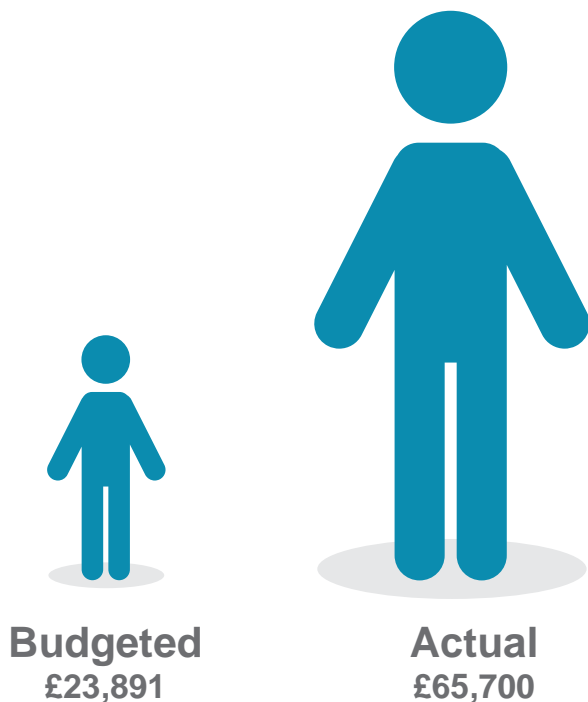
Despite the Welsh Government's increased financial support, Kancoat went into administration in September 2014

- 3.51 In [paragraph 3.17](#), we note that in May 2012 the Welsh Government was not prepared to consider an initial application by Kancoat for Repayable Business Finance of £1.8 million on the basis that the risk was too great. However, over the life of the project, the Welsh Government has committed some £3.4 million towards the cost of Kancoat's business venture. Of the £1.3 million commercial loans that are repayable, only £135,000 has been remitted by Kancoat to the Welsh Government. Coilcolor representatives have advised us that the amount outstanding to Coilcolor Ltd when Kancoat went into receivership was actually £1,409,731.
- 3.52 Despite receiving the second commercial loan of £0.5 million in February 2014 from the Welsh Government, and the 90-day repayment holiday granted in March 2014, Kancoat was unable to operate as a viable business and by July 2014 its owners were looking to sell the business.
- 3.53 Negotiations with a consortium based in Russia, which had expressed an interest in the acquisition of circa 70 per cent of Kancoat for between £1.5 million and £3 million and potentially the purchase of the Waunarlyydd site from Alcoa, did not lead to a satisfactory outcome. Kancoat's sole Director resigned on 24 July 2014 and the company went into administration on 15 September 2014.
- 3.54 In January 2015, Welsh Government officials referred Kancoat to Finance Wales to see if it could provide the company with any assistance. Despite Finance Wales introducing three sets of potential investors to Kancoat, none of these decided to invest.
- 3.55 At the time of publishing, Kancoat's administrator has not received any bids for the steel-coating line. Alcoa has recently offered the whole of its Waunarlyydd Industrial Park for sale and Welsh Government officials informed us it has received an expression of interest for both the plant and the site as a whole from a high-profile, well-regarded company with significant steel assets.

The Welsh Government faces a potential irrecoverable loss of £1.5 million arising from its financial support for Kancoat, and the actual 'cost per job created' was nearly three times higher than originally expected

3.56 Welsh Government officials considered that supporting Kancoat would contribute to the Programme for Government's goals of creating growth and sustainable jobs. The project was expected to create some 32 new jobs over three years and safeguard one other job, in an economically important sector. In the event, as a result of Kancoat going into administration, the project created 12 jobs and the actual 'cost per job created' was nearly three times higher than the Welsh Government's original expectation, as shown in [Exhibit 15](#).

Exhibit 15: Expected cost per job against the actual cost per job created/safeguarded



Source: Wales Audit Office analysis

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- 3.57 Welsh Government officials told us that if the Kancoat application were received now, given the higher volumes of applications and fewer funds available to the Welsh Government, they thought it very unlikely that such an application would be successful.
- 3.58 In total, the Welsh Government provided financial support worth £3.4 million to Kancoat. Of this, £700,000 was in the form of non-repayable Repayable Business Finance. When Kancoat entered administration, it had made loan repayments to the Welsh Government of £121,923, and the remaining £2.6 million of financial support became immediately due for repayment.
- 3.59 On the basis that the coating line can be disposed of at the lower end of the market valuation obtained by Coilcolor in March 2011 at £1.25 million ie, piecemeal disposal, the first £800,000 of any sale receipts will be payable to the Welsh Government and the next £200,000 is payable to Alcoa. The maximum potential loss to the public purse is therefore currently estimated to be some £1.5 million, as shown in [Exhibit 16](#). It is important to stress that it is only possible to provide an estimated figure on the loss here and the final figure could be significantly different depending on the key factors such as the scrap value of steel, and what a potential buyer may pay for the site if it can be sold on or the site re-let.

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Exhibit 16: Potential maximum irrecoverable loss for the Welsh Government

Welsh Government financial support provided:

• Commercial Loan #1	800,000
• Commercial Loan #2	500,000
• Non-repayable Repayable Business Finance #1	500,000
• Non-repayable Repayable Business Finance #2	200,000
• Property support (lease commitment) up to five-year break clause	1,400,000
Total Welsh Government financing	3,400,000
Less: Commercial loan repayments by Kancoat	(121,923)
Less: Non-repayable Repayable Business Finance	(700,000)
Less: Insurance and service charge paid	(13,166)
Balance due for repayment to the Welsh Government	2,564,911
Less: Potential proceeds from piecemeal disposal of the coil-coating line	(1,250,000)
	1,314,911
Plus: 'Deed of Priority' liabilities owing to Alcoa (see Exhibit 12)	200,000
Welsh Government potential maximum irrecoverable loss	1,514,911

Note

The Property Support total will only arise if Kancoat's business fails and the under lease was terminated on the first day of the term. Although Kancoat has been in administration since September 2014, the business continues to exist as a legal entity and it remains to be the under tenant of the premises. Therefore, any liability to pay business rates to the Rating Authority remains with it and not the Welsh Government. The administration period has been extended to September 2016 and on the assumption that Kancoat's under lease will be terminated at that time, the Welsh Government's maximum exposure to such costs would be for 23 months (until the Welsh Government's break date in August 2018).

Source: Wales Audit Office analysis

Welsh Government lessons learnt after providing financial support to Kancoat

- 3.60 The Welsh Government's Director of Sector and Business has recognised that Kancoat was a particularly complex case and commissioned a lessons-learnt exercise by the Head of Monitoring, Financial Due Diligence and Investment Advice.
- 3.61 The lessons learnt review recognised that there was a need to ensure that the scrutiny that was applied to Business Finance applications should be applied to other forms of funding such as commercial loans. In June 2014, a revised Financial Approval process was presented to the Corporate Leadership team, which incorporated the need for commercial loans to in future follow the departmental Financial Approval process.
- 3.62 As a result of that review, and as part of the department's continuous improvement, Welsh Government officials informed us that a number of key changes in procedures have since been implemented:
- a the consideration of commercial loans now forms part of the Financial Approval process and are subject to Investment Panel recommendation before Ministerial approval is sought;
 - b Senior Management Team must now ratify any recommendation by the Investment Panel for commercial loans above £1 million;
 - c as part of the Financial Approval process a standalone appraisal of all projects involving commercial loans must be undertaken;
 - d the monitoring of loans has moved to the Central Monitoring team, an agreed departmental protocol has been established to provide clarity on areas of responsibility;
 - e loan applicants are more robustly assessed for their ability to repay by undertaking appropriate Financial Due Diligence;
 - f a standardised approach to risk assessment has been introduced to ensure consistency across funding schemes;
 - g where multiple interventions are being considered (ie, financial support and property solutions) they are now considered by a single body (Investment Panel) with appropriate advice from the Property Leadership Team;
 - h the introduction of a standardised appraisal document has ensured a consistent approach to project appraisal is applied across funding schemes;

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- i improvement in management information by driving increased and improved use of the department's Customer Relationship Management (CRM) system; and
- j centralised the issue of award letters to a single team: this has improved customer service and ensured that conditions of award are more consistent and robust.

Appendices

Appendix 1 - Our audit approach and methods

Scope

We conducted an audit review of the financial support that Kancoat Ltd received from the Welsh Government, and considered this within the wider context of the Welsh Government's support for businesses in Wales that operate within the 'advanced materials and manufacturing' sector.

Our audit set out to establish the underlying facts in respect of concerns that had been raised in correspondence with the Auditor General. We have not sought to form evaluative conclusions from our work or to make specific recommendations; rather, the report sets out the facts of the matter for consideration by the Public Accounts Committee of the National Assembly for Wales.

Methods

In undertaking the review we gathered documentary evidence from the Welsh Government and Kancoat's administrator between November 2015 and February 2016.

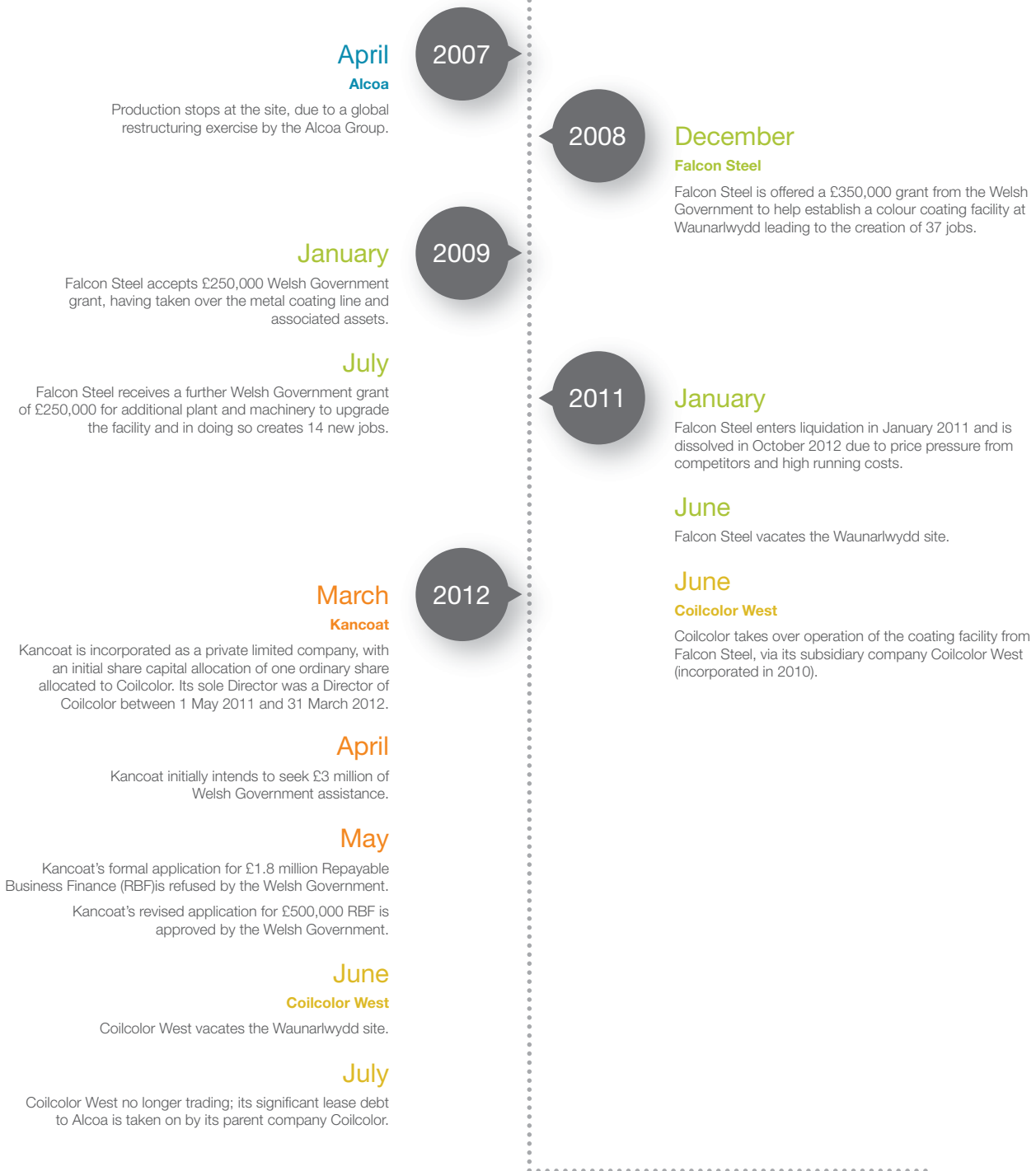
In particular, we examined documents held by the Welsh Government's Internal Audit Service, which set out the scope and findings of its review of the Welsh Government's compliance with its internal policies and procedures in respect of the sub-lease, the Repayable Business Finance and the two commercial loans made to Kancoat.

We interviewed relevant Welsh Government officials, and undertook a site visit to Waunarlwydd accompanied by Kancoat's administrator.

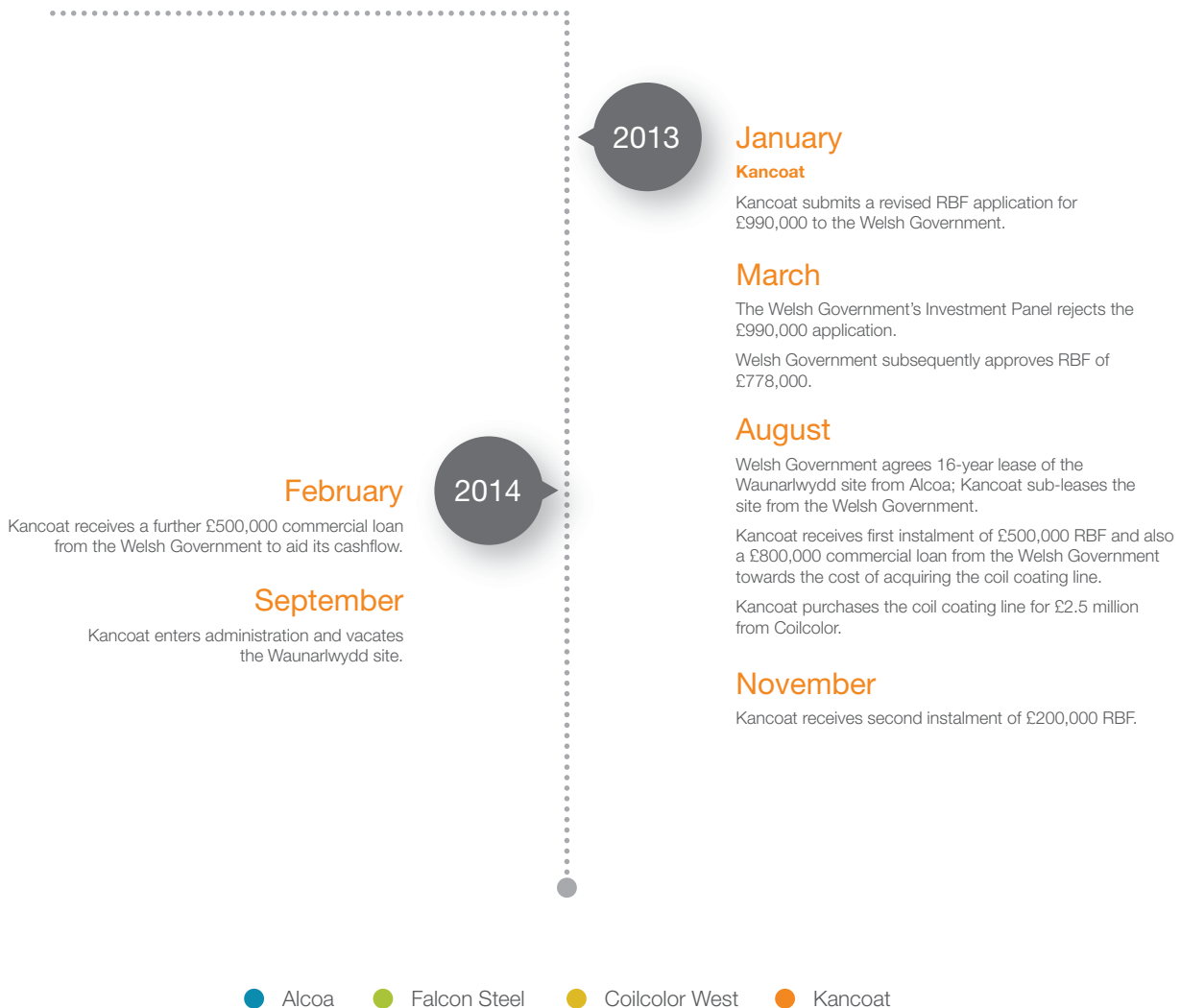
Prior to publication, we agreed the factual accuracy of our report with the Welsh Government and the named third parties.

Appendix 2 - Timeline of key events

Timeline



● Alcoa ● Falcon Steel ● Coilcolor West ● Kancoat



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