European Investment Bank
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# Using Financial Instruments for SMEs in England in the 2014-2020 Programming Period

## A study in support of the ex-ante assessment for the deployment of EU resources

Annex Two – Area Overviews

**East Midlands**

January 2015

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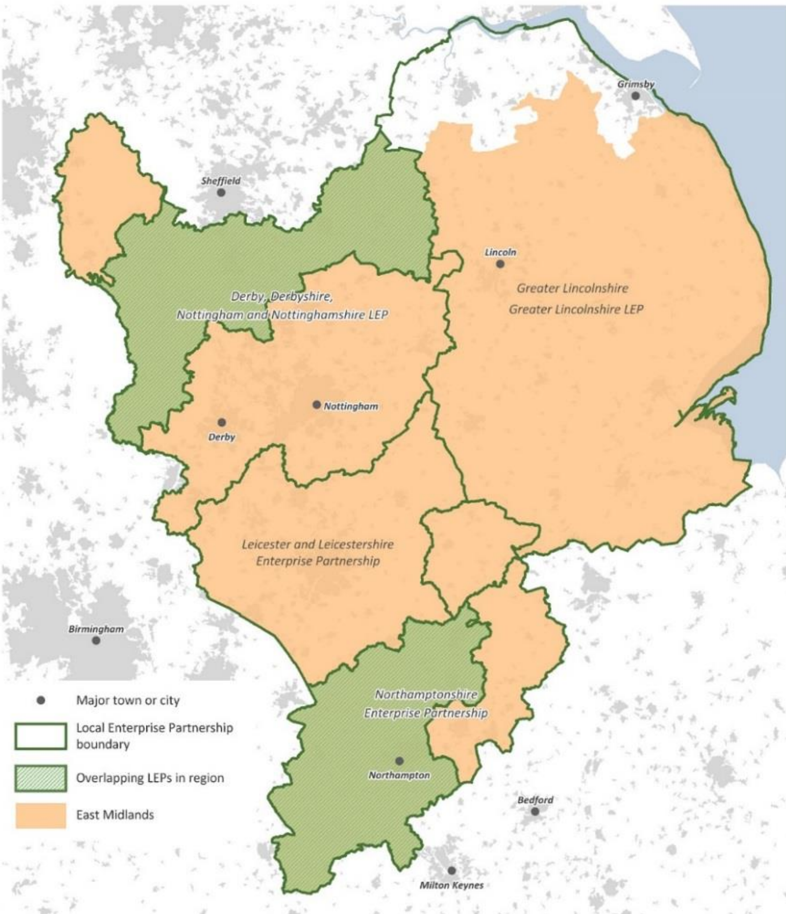
# Area Overview: East Midlands

This section provides an overview of the SME finance market in the East Midlands, evidence on market failures and the implications for the overall scale and shape of market failures that could reasonably be addressed by future ERDF backed interventions for the 2014-20 programme period. **In order to interpret the overview it is necessary first to review the main ex-ante assessment block one summary report, which outlines the assessment framework which is used**. These sections provide the theoretical basis for the market assessment framework used to assess the finance gap and the portion thereof that is accounted for by market failure.

This section applies this assessment framework to the region and the overall conclusions and implications of this process are summarised at the end of the section. There are various limitations in the published data sets which are used to inform this assessment and various forms of uncertainty, all of which must be borne in mind in interpreting the assessment.

## 1.1 Economic Geography

The East Midlands is home to 4.6 million residents, 2 million jobs, and 314,000 SMEs (84,000 of which have employees).[1] Total Gross Value Added in the region in 2012 was £79.7 billion, equivalent to £17,400 per head of population. This is low in comparison to the England average of £21,900 and still behind the average of £19,100 when London is removed from the analysis.




There are six Local Economic Partnerships (LEPs) either wholly or partially located in the East Midlands region. These are:

- D2N2, covering Derby, Derbyshire, Nottingham and Nottinghamshire.
- Greater Lincolnshire LEP, covering Lincolnshire, North Lincolnshire and North East Lincolnshire.
- Leicester and Leicestershire LEP, covering Leicester and Leicestershire.
- Northamptonshire LEP, covering Northamptonshire.
- South East Midlands LEP, covering Aylesbury Vale, Cherwell, Kettering, Northampton, Bedford, Corby, Luton, South Northamptonshire, Central Bedfordshire, Daventry and Milton Keynes.

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[1] Source: BIS Population Estimates. Note: This includes sole traders and businesses that are not registered for VAT or PAYE. This data is not available at a sub-regional level.

- Sheffield City Region LEP, covering Barnsley, Bassetlaw, Bolsover, Chesterfield, Derbyshire Dales, Doncaster, North East Derbyshire, Rotherham and Sheffield. This LEP extends partly into the East Midlands region.
- Greater Cambridge and Greater Peterborough LEP also extends partly into the East Midlands region.

The region has a complex economic geography and does not function as a single economic area. Different parts of the region have functional economic relationships with areas beyond the regional barriers. The southern part of the region is part of a wider functional economic area encompassing parts of the East and South East of England. This part of the region extends into the ‘Innovation Triangle’ around Cambridge, Oxford and London. The western part of the region, in which manufacturing and engineering are important sectors, shares much in common with the West Midlands and the north western areas of the region look to Yorkshire and Humberside.

The D2N2 LEP area is the largest LEP area in the region in population terms, containing 2.1 million residents. The area contains 60,000 enterprises, of which 59,700 are SMEs.[2] It contributes £37 billion in annual GVA, the second highest of all the LEPs in the region.

There are 1.4 million residents in Greater Cambridge and Greater Peterborough LEP, with 53,000 enterprises of which 52,800 are SMEs. It contributes £30 billion in annual GVA. Note that this LEP area overlaps with the other regions (the East of England).

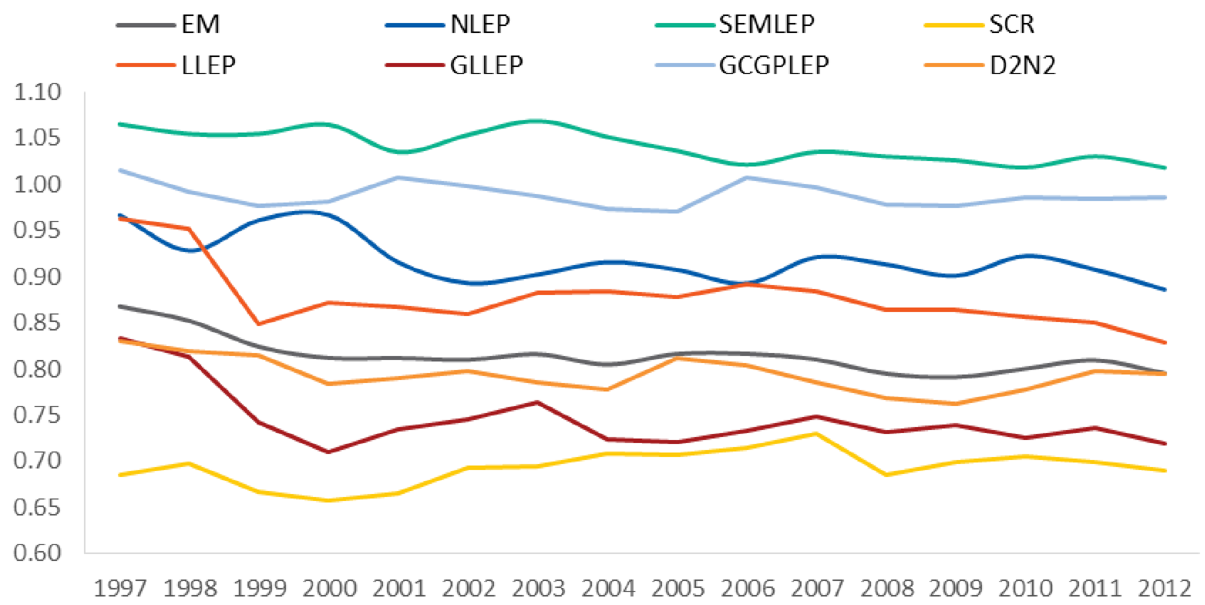
Greater Lincolnshire LEP is home to 1.1 million residents and 33,300 enterprises, the majority of which (33,200) are SMEs. It contributes £16.5 billion in annual GVA. Note that this are overlaps into the Yorkshire and Humber region.

Leicester and Leicestershire LEP contains 995,000 residents, 33,000 businesses of which 32,900 are SMEs. The area contributes £18 billion in annual GVA.

Gross value added (GVA) per head of the population has increased in nominal terms from £11,300 in 1997 to £17,500 in 2012. Compared to the national average, GVA per head for the region has been consistently lower through the period (1997 to 2012) and the gap has actually grown. Within the region, compared to the national average there is substantial variation in performance. GVA per head for SEMLEP has been consistently higher than both the national rate and the regional rate throughout the whole period, reflecting its close proximity to the southern regions of England. GVA per head for Greater Cambridge and Greater Peterborough LEP has been in-line with the national rate and has been consistently higher than the rate for the region.

[2] Source: ONS Business Counts. Note that this data source is the only one that can be used to understand the business base at a sub-regional level. It covers both enterprises and local units (which include multiple branches of the same enterprise). We have quoted the enterprise figures above. The data does not include businesses that are unregistered for VAT/PAYE. For these reasons the SME figures quoted at LEP level differ from the regional figures from BIS Population estimates cited above.

*Figure 0.1: GVA per Head (England=100) - 1997-2012*




*Source: Office for National Statistics*

## 1.2 Policy

The main economic development issues in the region are concerned primarily with job and GVA creation. As with other regions, the focus on creating private sector employment and rebalancing the economy is a key theme for all of the region's LEPs. In many of the regions LEP areas, particularly those to the south of the region, there is a focus on innovation led growth and a desire on the part of the LEPs to build upon key knowledge assets.

LEP strategies also reflect the importance of advanced manufacturing in the region, the presence of a number of OEMs (including Rolls Royce and Bombardier) and thee need to facilitate supply chain development.

A summary of key priorities and actions identified by the LEPs is set out below. This points to investment needs across innovation-led businesses as well as more generally to support business growth in the region.

| **SME Competitiveness Priorities of LEPs in the East Midlands** | | |
|---|---|---|
| **LEP** | **Relevant Priorities and Strategic Themes** | **Key Sectors and Assets** |
| D2N2 | • Private sector job creation<br>• Innovation led growth central to the strategy<br>• Maximising benefits of OEMs in the LEP area (Rolls Royce, Toyota, Bombardier)<br>• A2F identified as a central part of aspirations around business competitiveness and innovation<br>• Activities to stimulate increased levels | • High productivity, advanced manufacturing (transport related). Toyota, Bombardier and Rolls Royce are key drivers<br>• But lower value added manufacturing to the north<br>• Life sciences, particularly medical technologies and pharmaceutical manufacturing (Bio City and Medi, city). Nottingham is the focal point for this activity. Nationally significant cluster.<br>• Tech cluster in eastern and southern Nottinghamshire (Vodaphone, Timico)<br>• Low carbon economy (building upon OEMs, particularly |

| | | |
|---|---|---|
| | of enterprise. | Toyota and Rolls Royce) plus research expertise in transport technologies and duel fuels<br>• University of Nottinghamshire School of Mechanical Materials |
| GLLEP | • Growth in strategic sectors is identified as a key priority.<br>• Expansion of the business base and growth of existing SMEs is highlighted as central to deliver of aspirations. | • Engineering and manufacturing to the west, Agriculture, food and tourism to the east<br>• Agri-food<br>• Manufacturing<br>• Visitor economy<br>• Health and care<br>• Port and logistics<br>• Low carbon (particularly offshore wind, linked to Marine Energy Park and range of other investments in the offshore wind sector. |
| Leicester and Leicestershire LEP | • Activities to improve business competitiveness and growth<br>• Innovation support<br>• Sector development around knowledge assets | • Loughborough University Science and Enterprise Park<br>• MIRA technology park<br>• Leicester University expertise in space science and genetics and medical and health research<br>• Transport sector R&D at MIRA technology park and enterprise zone<br>• Logistics<br>• Manufacturing |
| Northamptonshire LEP | • Activities to stimulate business base growth and productivity improvement<br>• Development of important supply chains in the LEP (particularly logistics and motorsports)<br>• Exploiting exports | • Predominantly rural economy<br>• Some growing towns but polycentric economy<br>• High performance technologies network (includes Mercedes, AMG, Cosworth) (linked to motor sport specialism)<br>• Logistics<br>• Food and drink |
| SEMLEP | • Private sector job growth<br>• Enterprise<br>• Enhancing SME competitiveness (access to finance identified as a barrier to growth)<br>• Strengthening and exploiting innovation assets<br>• Activities to increase exports<br>• Attracting inward investment | • Position on the innovation triangle<br>• High performance technology (precision engineering – motorsport valley important here)<br>• Manufacturing and advanced technology<br>• Cultural and creative sectors |

*Source: LEP Strategic Economic Plans*

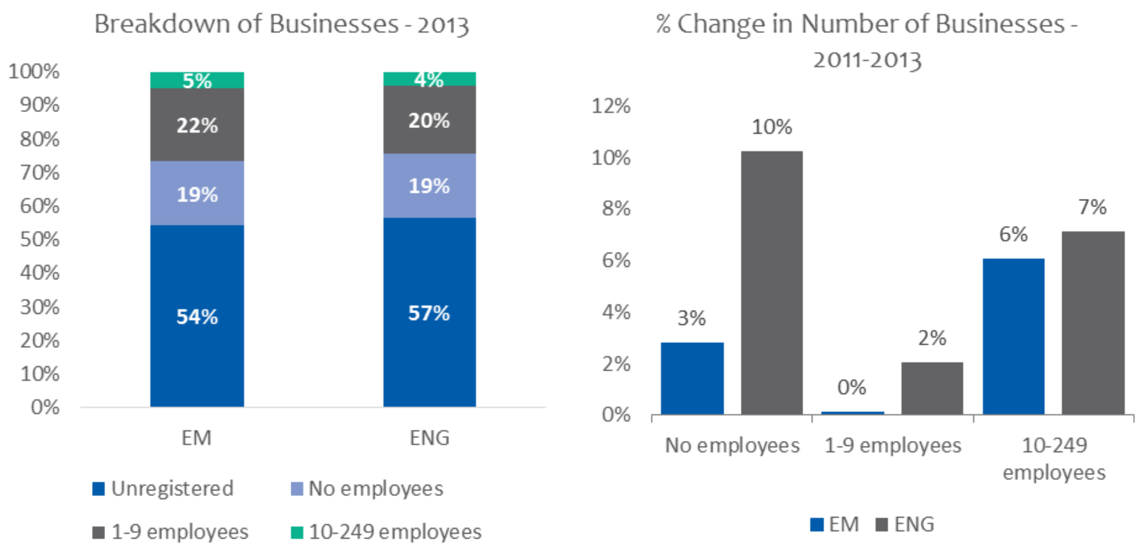
## 1.3 Business Demography Trends

### 1.3.1 Business stock

The East Midlands is home to 313,900 SMEs, of which 298,400 (95%) are microbusinesses (less than 10 employees), 13,300 are small (10-49 employees) and 2,200 are medium sized firms (50-249 employees). Of the microbusiness stock, 170,500 are unregistered for VAT/PAYE and 59,700 are single person firms.

The current size band structure of the SME stock in the region is broadly similar to the national breakdown. In the past three years, growth in all size bands for the SME stock has lagged behind the national growth rate, particularly for businesses with no employees where the growth rate has been 7 percentage points lower than the national rate. Notably the stock of microbusinesses with employees has remained the same over the past three years.

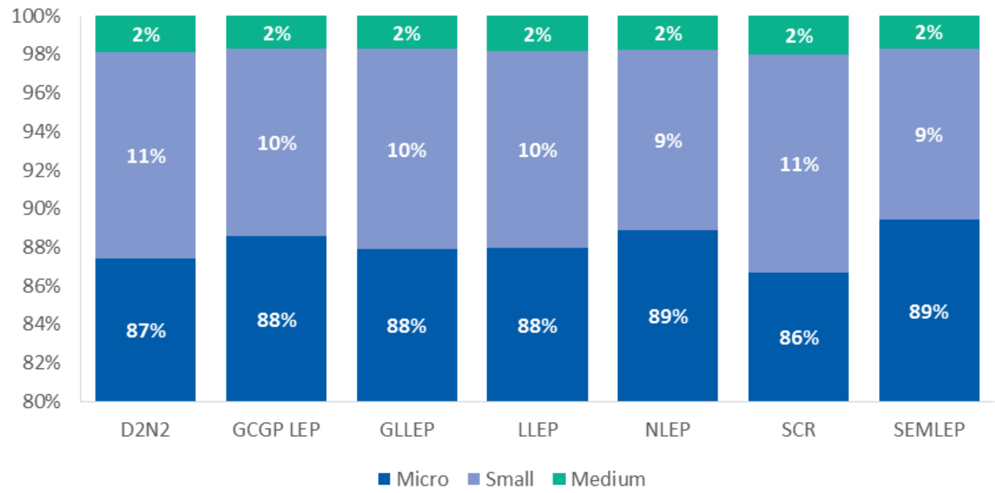
Figure 0.2: Composition (%) of SME Stock in 2013 and change 2011-2014




*Source: BIS Business Population Estimates 2011-2013*

There are some interesting differences in the size band structure of the LEPs business bases. In particular, the LEP areas to the south of the region (South East Midlands, Northamptonshire and Greater Cambridgeshire and Peterborough) have business bases that are slightly more weighted towards microbusinesses, reflecting the more R&D intensive and dynamic nature of the economies of these LEP areas. Conversely, LEP areas with a more traditional, manufacturing based economy have slightly greater representation of larger SMEs, in part reflecting the historical dominance of larger employers in these areas and tendency towards lower rates of enterprise and slightly less dynamism in the economies of these areas.

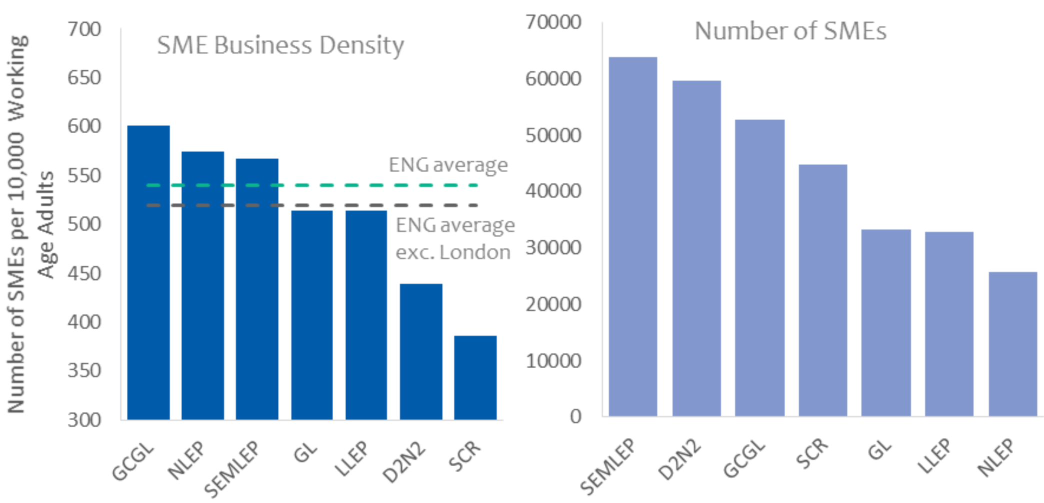
Figure 0.3: Breakdown of SMEs by Size – 2013




*Source: ONS Business Counts*

This is picture is also reflected in the varied business densities in the region's LEPs. Overall the region's business density[3] is 8% lower than the England average but this masks some substantial variations between LEPs. Business density in the southern LEP areas is greater than the England average. SME business density is the lowest in D2N2 and the Sheffield City Region, to the north of the region.

Figure 0.4: SME Business Density, and Number of SMEs - 2013




*Source: ONS Business Counts*

Over the period 2011 to 2013, there has been growth in the SME business base in all LEP areas, although there is variation with regards to the extent of this growth. In all size bands there has been higher than both regional and national average growth in Lincoln and Lincolnshire LEP (LLEP), particularly for medium sized businesses. Growth in microbusinesses has been particularly strong in Northamptonshire

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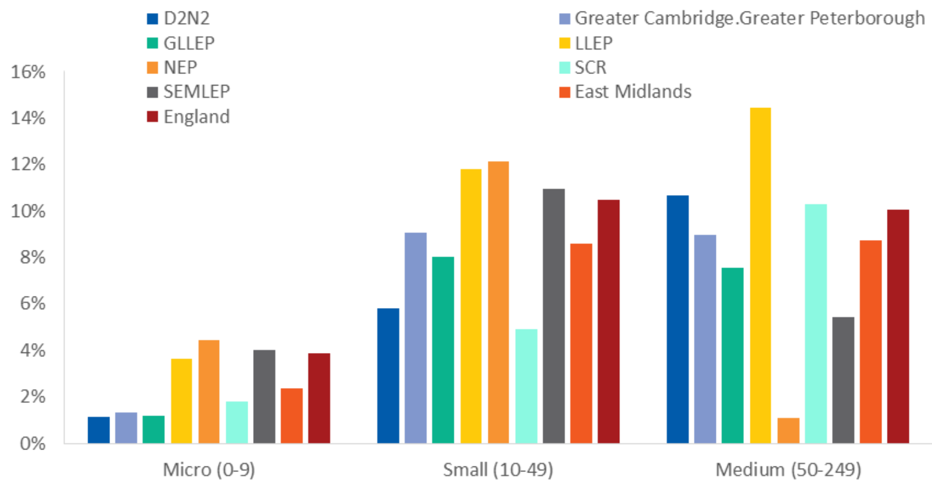
[3] The stock of SMEs compared to the working age population

LEP and LLEP whereas for D2N2 LEP growth has been stronger for larger SMEs. For the region overall however, growth in all size bands has been lower than the national rate.

Figure 0.5: % Change in Number of Businesses 2011-2013




*Source: ONS Business Counts*

The sectoral breakdown of the region's business base, varies substantially by LEP area. Manufacturing is particularly important in the region. Broadly speaking, there is a focus on land based industries and food manufacturing to the east of the region, with engineering (automotive, rail and aerospace in particular) being more prevalent to the west of the region (reflecting the presence of some OEMs and their supply chains in these areas.

Professional services dominate in the region's main urban centre of Nottingham, Leicester and Derby. In the region there is a high concentration of microbusinesses operating in the professional, scientific and technical sector, as well as the construction sector. There is some variation by LEP area however; for example 12% of micro businesses in the GLLEP operate in the agriculture, forestry and fishing sector. 18% of microbusinesses in SEMLEP operate in the professional, scientific and technical sector.

### 1.3.2 Business Starts

In 2012 around 16,600 new businesses formed in the region. At 57 new businesses per 10,000 working age adults, this is 18% below the England average, or 7% below the national average once London is removed. A large proportion of these new businesses were formed in SEMLEP and in D2N2LEP. When adjusted for the working age population, the start-up rate is highest in SEMLEP and Northamptonshire LEP, both in-line with the national average, whereas all other LEP areas have a start-up rate below the national average.

Although the region's start up rate is low, the volume of start-ups has been increasing and was much higher in 2012 than 2009 (there was a 12% increase in the number of new starts in this period). There has been an increase in the number of start-ups in all LEP areas. Northamptonshire, South East Midlands and Lincoln and Lincolnshire LEPs have seen substantial absolute increases in the number of business starts but all LEP areas apart from SEMLEP still lag behind the England average start up rate.

*Table 0.1: Business Starts in North East and its LEP Areas, 2010-12*

| | Business Starts | Business Starts per 10,000 Working Age Population (2012) |
|---|---|---|

| | 2010 | 2012 | Abs Change | | Number | England=100 |
|---|---|---|---|---|---|---|
| Derby, Derbyshire, Nottingham and Nottinghamshire LEP | 6415 | 6815 | 400 | 6% | 50.1 | 72 |
| Greater Cambridge and Greater Peterborough LEP | 5,330 | 5,545 | 215 | 4% | 63.2 | 90 |
| Greater Lincolnshire LEP | 3,545 | 3,840 | 295 | 8% | 59.4 | 85 |
| Leicester and Leicestershire LEP | 3,365 | 3,965 | 600 | 18% | 61.9 | 89 |
| Northamptonshire LEP | 2,720 | 3,095 | 375 | 14% | 69.2 | 99 |
| South East Midlands LEP | 6,990 | 7,890 | 900 | 13% | 70.6 | 101 |
| Sheffield City Region LEP | 5,085 | 5,375 | 290 | 6% | 46.3 | 66 |
| Total East Midlands | 14,860 | 16,625 | 1765 | 12% | 57.1 | 82 |

*Source: ONS Business Demography*

### 1.3.3 High growth firms

Given the difficulties in defining and measuring high growth firms, there is little data available. However, the Business Growth Fund has commissioned research on high growth firms, using data from Experian UK of company accounts. It defines high growth firms as of those that have revenues of between £2.5m and £100m, have had 33% increase in turnover over three years, as well as 10% year-on-year growth for a minimum of two of these years.

The latest report found that 22.9% of businesses with a turnover between £2.5 million and £100 million in the region fall into this high growth category. This ranks the region 2nd out of 9 English regions (although for 2013 the data conflates the East Midlands and West Midlands), although this is a slight fall in the proportion of high growth firms compared to the previous year. In 2013 the proportion was higher than the national rate, although the gap has closed compared to the previous year.

*Table 0.2: High Growth Firms as a % of all Businesses, 2011-13*

| | 2011 Population of High Growth Firms | Regional Rank (2013) | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| East Midlands | 194 | 2nd* | 16.0% | 23.3% | 22.9% |
| England | 4,044 | | 16.9% | 20.9% | 22.0% |

*Source: BGF Growth Companies Barometer. **
*Data for 2012 and 2013 groups the West Midlands and East Midlands together*

### 1.3.4 Innovation activity

The East Midlands performs strongly on a range of innovation indicators. The region has approximately 7,800 businesses defined as innovations active. This represents 49% of the business with at least 10 employees in the region and is above the UK average of 44% and the highest rate for all regions.

There have been 71 university spinouts in the East Midlands since the year 2000, representing 7% of all spinouts in England, the second lowest of all regions. It is also the second lowest when compared with the size of the working age population in the region. The University of Nottingham accounts for around half of the total spinouts in the region, followed by Loughborough University which accounts for 25%. This activity is an important source of early stage businesses with growth potential and a need for seed and early stage venture capital finance.

R&D expenditure, in particular that related to the private and university sectors, is one driver of the spin-out and creation of companies and the demands for early stage risk finance. Expenditure on research and development has increased from £1.2 billion in 2001 to £1.6 billion in 2012, a 36% increase.

### 1.3.5 Enterprise indices

Alongside the data on start-up rates presented earlier, a number of indices provide an insight into the enterprise performance and conditions in the region.

The Global Entrepreneurship Monitor (GEM) provides frequent updates on the scale of early stage business activity, based on a survey of adults. Total Entrepreneurial Activity (TEA) measures the proportion of the working age population that is in the process of setting up a business or involved in a business which has been operational for less than 42 months (three and a half years). It is a commonly used indicator for assessing the extent of early stage commercial activity in an economy.

Using pooled data for 2008-13 at a regional level[4] suggest that the East Midlands performs poorly on entrepreneurial activity. The region scores higher than average for only one indicator (intending to start-up in three years) and for overall TEA ranks the lowest of all regions. Indeed, the region ranks the lowest of all regions on most indicators.

*Table 0.3: Measures of Entrepreneurial Activity, 2008-13*

| ***Highlighted cells shows above average results*** | TEA | % of Opportunity E'preneurs | Stages of Entrepreneurial Activity | | | | High Growth Entrepreneurial Aspiration[5] | |
|---|---|---|---|---|---|---|---|---|
| | | | Intend to Start-up in Next 3 yrs | Nascent E'preneurs | New Firms | Est. Firms | All TEA | Est. Firms |
| London | 8.2% | 6.6% | 8.2% | 4.2% | 3.8% | 5.3% | 22.8% | 6.3% |
| East of England | 7.6% | 6.2% | 4.4% | 3.8% | 3.7% | 6.1% | 16.0% | 5.7% |
| South East | 6.9% | 5.5% | 5.3% | 3.1% | 3.6% | 7.6% | 19.0% | 4.2% |
| South West | 6.9% | 5.4% | 4.6% | 3.1% | 3.4% | 7.5% | 9.6% | 2.5% |
| Yorkshire & Humber | 6.9% | 4.8% | 4.4% | 2.9% | 3.8% | 6.2% | 10.8% | 3.5% |
| North West | 5.9% | 4.3% | 4.0% | 3.0% | 2.8% | 5.7% | 14.4% | 5.0% |
| West Midlands | 5.9% | 4.2% | 6.0% | 2.7% | 3.1% | 5.6% | 16.5% | 5.1% |
| North East | 5.8% | 4.6% | 4.0% | 2.8% | 2.8% | 4.2% | 10.8% | 3.6% |

4 Pooling was necessary due to sample sizes at a regional level.

5 % of firms looking to create 10 jobs and employment growth over 50% in the next five years.

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| East Midlands | 5.2% | 3.8% | 5.3% | 2.5% | 2.6% | 5.9% | 14.7% | 2.0% |

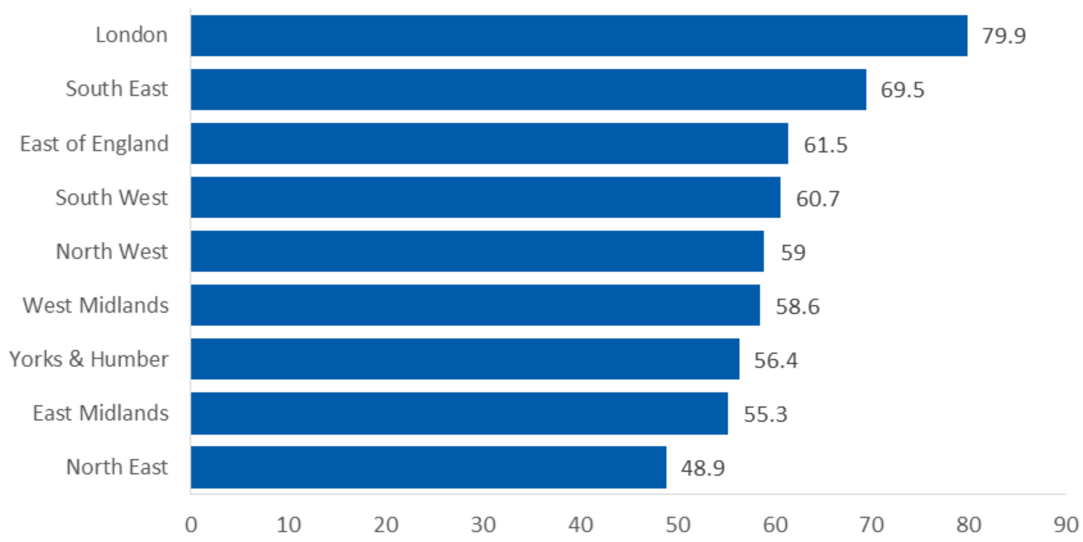
*Source: Global Entrepreneurship Monitor 2008-2013, bespoke regional analysis.*

The Santander Enterprise Index is an annual ranking of "the UK's regional entrepreneurial ecosystems." It uses a methodology developed by the Global Entrepreneurship and Development Institute (GEDI) to create an index for each of the UK regions, examining performance against 15 pillars of entrepreneurship. The index uses survey data on people's attitudes, abilities and aspirations with regard to enterprise and then weights these against objective measures of socio-economic infrastructure (broadband connectivity and transport links to other markets) which provide an enabling environment for enterprise.

The latest ranking for 2014 is consistent with the findings of the GEM, with the region performing relatively poorly compared to other English regions, although it still ranks within the top 50 of the 125 EU regions considered.

The region scores 42.2 on aspiration, the second lowest of all the regions (compared to 77.7 in London), 61.6 on attitude (second lowest) and 62.1 on ability (second lowest) and therefore overall ranks the second lowest of all regions in England (higher than only the North West).

Figure 0.6: Santander Enterprise Index Score - 2014




*Source: Santander Enterprise Index 2014*

## 1.4 Demand for and Take-up of External Finance

### 1.4.1 Survey evidence

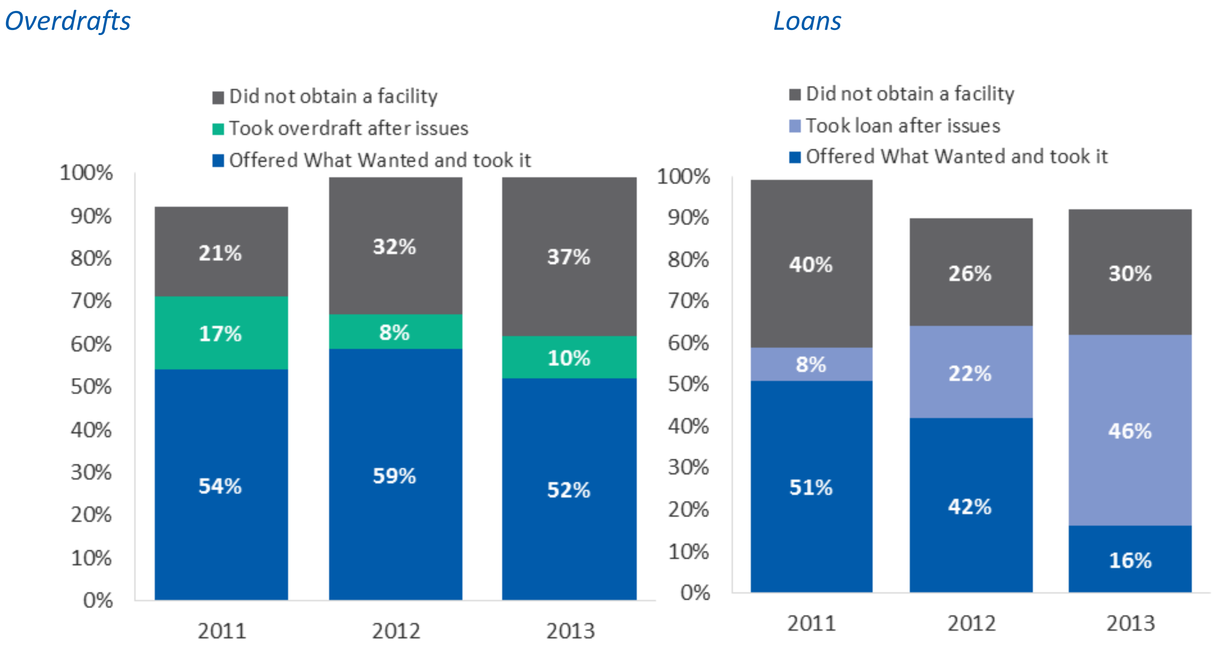
As was set out in the main market assessment section of the report, the BIS Small Business Survey provides insights for the UK as a whole on the demand for different types of finance by region, but unfortunately it is not available regionally. The SME Finance Monitor – set up by the Business Finance Taskforce in 2010 - does provide some insight into the demand for finance from SMEs in the regions and the extent to which they are successful in obtaining the finance they are looking for. This only covers debt finance, so in looking at equity finance it is only possible to infer messages from the national SBS survey evidence. Also data is not available sub-regionally, although consultations were undertaken with business and financial sector representatives.

The data indicates that a substantial proportion (40%) of SMEs in the East Midlands had sought finance of some sort[6] in the East Midlands in the five years preceding the survey. The proportion of firms that are classed as a "permanent non-borrower" (meaning that they have not used external finance in the last five years, have not attempted to borrow over the past 12 months, and have no inclination to borrow in the next three months) was slightly greater at 42% than the national average of 40%. It should be noted that this difference is not statistically significant, once survey margins of error are taken into account.

8% of SMEs applied for a new overdraft or loan facility or sought to renew an existing facility. The number of SMEs successful in their application for overdrafts has increased over the period 2001-2013, however a greater proportion of SMEs have reported issues[7] in their application before approval. The data does not provide conclusive information in relation to the success rates for loan and overdraft applications but it does suggest that for overdrafts, a greater proportion of businesses are having difficulties each year (although there is no overall change in the proportion who go on to secure an overdraft)

On the one hand, it suggests that a larger proportion of East Midlands businesses experience difficulties in accessing finance, but the overall proportion who take-up loans / overdrafts is broadly the same as the England average.

Figure 0.7: Overdraft and Loan Applications in the East Midlands - 2011-2013




*Source: SME Finance Monitor 2011-2013.*

*Notes:1) data for 2013 has small sample sizes and so should be treated with caution 2) the residual proportion is "took another form of financing"*

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[6] Bank overdraft, Credit cards, Bank loan/Commercial mortgage (these three form the core product category), Leasing or hire purchase, Loans/equity from directors, Loans/equity from family and friends, Invoice finance, Grants, Loans from other 3rd parties, Export/import finance.

[7] Issues is defined by BDRC as "something that needed further discussion before a loan or overdraft facility was agreed, typically the terms and conditions (security, fee or interest rate) or the amount initially offered by the bank"

The regional data only covers debt finance, so in looking at equity finance it is only possible to assess at the national level. The only data provided in the BIS SBS is on the proportion of SMEs that were looking for equity investment. This highlights that only a small proportion actively seek out this type of finance, and that this has remained stable over time (standing at 2% in 2012, 2010 and 2008). Less than 1% were seeking mezzanine finance. This partly reflects the more niche nature of equity and mezzanine finance but also probably illustrates the lack of awareness amongst SMEs of this type of finance. The latest survey also shows an emerging awareness of alternative sources, including 1% who are aware of peer to peer/crowdfunding.

Unfortunately the survey evidence does not allow the separate review of the extent to which SMEs seeking this type of finance were successful in obtaining it.

LEPs in the East Midlands carried out an SME Access to Finance survey in Autumn 2014. The survey elicited 192 responses and echoed some of the findings of the national survey data. The main findings of the survey are:

- Access to finance identified frequently by respondents to the survey as a barrier to growth
- Three quarters of survey respondents had sought to access to finance of some type. This exceeds the level set out in the SME Finance Monitor but this could be because the survey was distributed by LEPs amongst businesses they had already engaged with (a good proportion of these were engaged with grant and loan programmes).
- The survey echoes the evidence from the SME Finance Monitor and suggests that a substantial proportion (42%) were unable to secure the finance they sought and a further 29% only able to secure part of the amount.
- The survey also provides some evidence that inability to access finance has stalled some growth projects and / or reduced levels of growth in some businesses.
- The survey also provides evidence of substantial demand for smaller amounts of finance. Around half of the respondents who had sought finance were looking for less than £50k and 65% were looking for sub 100k.
- A reasonable proportion of survey respondents highlight a need for investment readiness support to help them to access finance.

### 1.4.2 Theoretical Unmet demand

Whilst the BIS SBS survey provides data that can be used to assess the extent of unmet demand from SMEs, this data is not available for the regions. However, the results of the UK level survey can be applied to the East Midlands' business base to provide indications of the number of SMEs in different size bands that may be struggling or unable to obtain the finance they are looking for, and hence the value of unmet demand. The important caveats attached to this analysis are presented at the end of this section.

The analysis indicates that, assuming the experience of SMEs in the region is similar to those in the UK as whole:

- In 2012 there were around 20,000 SMEs in the region looking for external finance (15,000 of these were microbusinesses)
- Of the SMEs who had sought finance, more than 9,000 had difficulties of some sort in obtaining it
- 6,400 SMEs were unable to obtain any of the finance they were looking for, and 1,200 received some, but not all of what they were seeking (the national data indicates that the likelihood of successfully obtaining finance varies directly with business size).
- 4,300 SMEs had a need for finance did not apply, for the reason that they thought they would be rejected (there is no further detail available from the survey on why they thought they would be rejected).

Table 0.4: Illustrative Analysis of SMEs' Experience in Accessing Finance in the East Midlands, using Survey Data

| | Total | Looking for finance | Had difficulties | Unable to obtain any finance | Obtained some, but not all finance | Discouraged from applying because thought would be rejected |
|---|---|---|---|---|---|---|
| Micros (1-9) | 68,100 | 15,000 | 7,500 | 5,200 | 900 | 3,800 |
| Small (10-49) | 13,300 | 4,200 | 1,700 | 1,100 | 200 | 500 |
| Medium (50-249) | 2,200 | 800 | 200 | 100 | 50 | 50 |
| All SMEs | **83,600** | **20,000** | **9,400** | **6,400** | **1,200** | **4,300** |

*Source: Regeneris Consulting calculations, using data from BIS Small Business Survey 2012 and BIS Business Population Estimates for 2013.*
*Note: Figure are rounded so may not sum to the totals.*

It is then possible to use data from the survey on the amount of finance being sought by businesses of different sizes to generate **indicative estimates** on the scale of unmet demand. This analysis shows that total unmet demand in the region could be of the order of around £1.2bn in one year. It is not possible to determine from this type of analysis how much of this is from SMEs that had viable business plans (and hence constitutes a market failure). However, Regeneris Consulting have set out below scenarios on the proportion of firms that were viable serve to illustrate the potential scale of market failure. For example, even if only 10% of these were viable, this would imply a finance gap of less than £5 million for microfinance, around £70 million for small loans sought by microbusinesses and around £60 million for small and medium sized SMEs[8] . **This is unmet demand in addition to that which is already being met by the private sector and publicly backed initiatives.**

The survey implies that this unmet demand has grown over time, although this is of course based on national rather than regional data.

The survey does not provide data that allows the split the unmet demand for larger amounts of finance between debt and equity finance. The SBS Survey reports that around 2% of SMEs overall are looking for equity finance. However, this does not necessarily accurately represent the proportion (of SMEs or deal values) that are best suited to equity finance, given the nature of their investment projects. Data presented by the British Business Bank suggests that around 4% of the value of finance to SMEs is in the form of equity.

Using SBS data which allows for the size of the SME and variations in the amount of finance sought by type of finance, around 8% of this overall unmet demand is likely to be accounted by equity finance (and 82% by debt finance and a further 10% by other forms of finance). This would imply a total unmet demand of around £10 million per annum for equity and £110 million if 10% of propositions are viable, in

[8] Note that in effect this is the gap over and above that which is already being addressed by local and national public sector backed initiatives.

addition to that which is already being met by the private sector and publicly backed initiatives (see 5 below for details of many of these initiatives)

Table 0.5: Illustrative Analysis of Unmet Demand (£millions) for Finance from SMEs in the East Midlands, using Survey Data 2012/13

| | Micros (1-9) | | Small (10-49) | Medium (50-49) | All SMEs |
|---|---|---|---|---|---|
| | Seeking Micro - finance (up to £25k) | Seeking larger amounts | | | |
| - those that obtained none of the finance they were looking for | £30 | £630 | £370 | £210 | £1,240 |
| - those that obtained some, but not all, of the finance they were looking for* | £0 | £30 | £20 | £20 | £70 |
| Total unmet demand | £40 | £660 | £390 | £230 | £1,310 |
| Scenarios for % that are viable | | | | | |
| 10% | £4 | £70 | £40 | £20 | £130 |
| 20% | £7 | £130 | £80 | £50 | £260 |
| 30% | £11 | £200 | £120 | £70 | £390 |
| 40% | £14 | £260 | £150 | £90 | £530 |

** Assumes that these firms obtained 75% of what they were looking for.*
*Source: Regeneris Consulting calculations, using data from BIS Small Business Survey 2012 and BIS Business Population Estimates for 2013.*
*Note: Figures are rounded so may not sum to totals.*

In interpreting this analysis a number of caveats must be applied and limitations acknowledged:

- The data is based on a single survey of businesses undertaken in the UK in 2012. Since this is a sample survey the results are subject to sampling error, even at the UK level. Regeneris Consulting have not been able to access any data from the 2014 survey as it will not be published until spring 2015. Finance market conditions in 2014 will inevitably be different from those in 2012.
- Regeneris Consulting do not know from the survey whether businesses in the East Midlands were more or less likely to be successful in obtaining finance than those in the UK as a whole.
- Although the survey reveals the proportion of SMEs that seek different types of finance, it does not allow the separate analysis of unmet demand for these different types of finance.
- The analysis presented above only covers SMEs with at least one employee – it does not include sole traders or businesses unregistered for VAT/PAYE. Regeneris Consulting do not have any data on these businesses' experiences of seeking finance, but they account for 74% of all SMEs in the region. Including this could increase the finance gap, although the vast majority of these will have more modest finance requirements linked to growth plans.
- Similarly, this does not cover the experiences of early stage, pre-revenue businesses and then the demand for and unmet requirement for seed and start-up funding.

Whilst this analysis points to a very large level of theoretical unmet demand for finance, this calculation needs to be treated with considerable caution and should not be confused or conflated with a sensible investment range within which ERDF backed FIs should be operating, for different parts of the market i.e. the types of finance they require. There are very good reasons for this in particular:

- The calculation is based on national survey evidence, which does not provide a robust evidence base in its own right to draw sound conclusions about demand which goes unmet or is met by existing public sector backed schemes
- Experience suggests that much of this unmet demand does not arise due to market failure (as opposed to inadequate business plans), although the evidence about how much is unclear
- If the public sector chooses to use the available ERDF resources to provide finance to SMEs, it needs to do so on the basis of the absolute and comparative economic impacts and value for money it can secure (there are of course other competing demands for the scarce ERDF resources).

### 1.4.3 Evidence of unmet demand from existing interventions

In addition to the theoretical exercise above, the experience of existing ERDF and other public sector backed interventions in the SME finance market can provide insight into the level of demand for various segments of the market, including an additional insight into that which is unmet. There are few existing interventions in the region upon which to draw as most of the ERDF backed access to finance projects have been relatively small scale and focused upon grants.

ERDF investment in a regional CDFI scheme provides some insight into unmet demand for microfinance. The total fund was £1.6m of which £980k was ERDF. The full £1.6m was invested (at an average annual rate of £400,000) and the fund performed well against businesses assisted and jobs created targets which suggests that there are viable propositions in this area.

Evidence from consultation with stakeholders is helpful here and points to:

- Microfinance: The lack of provision of microfinance in the region is thought to be particularly acute. This is linked to the relatively underdeveloped nature of the CDFI sector but some consultees also highlight issues associated with investment readiness within the microbusiness sector.
- Larger amounts of debt: Consultees' views on the balance between demand for and supply of debt does not differ substantially from the national picture. Smaller established SMEs in particular (but also medium sized firms) tend to find it more difficult to access debt finance. This is partly related to their ability to leverage assets but also related to a more general tightening of lenders' criteria, particular in relation to exposure to particular sectors and the tendency for banks to manage this process through credit scoring, rather than detailed appraisal of business plans. Consultees suggest that the most substantial problems are concentrated in the £50k to £100k range. But also in instances on larger amounts (>£200k).
- Early Stage and Expansion Equity: Consultees describe a picture of very poor mainstream and public-backed provision in this area and indicate that the lack of anchor funds in the region has contributed to a particular shortage of Angel activity.

Partners in the East Midlands commissioned a market intelligence study on access to finance and business needs. The study focused primarily on debt but provides some helpful insights which echo the findings of consultations and the analysis of theoretical unmet demand. The key findings of this study are summarised below:

- In a survey of 530 businesses in the region, a quarter of respondents identified inability to access finance as a barrier to growth. The majority of these were SMEs with fewer than 10 employees. This echoes the conclusion drawn from national datasets that smaller SMEs experience the greatest challenges in accessing finance.
- 20% of businesses in the region had sought loan finance in the previous five years. Interestingly, this is a much smaller proportion than suggested by the SME Finance Monitor Survey, although this could simply reflect differences in survey methodology (particularly the approach to sampling of the phrasing of questions).
- The outcomes that survey respondents report paints a slightly more negative picture than the SME Finance Monitor data and suggests that 45% of those who sought finance did not secure any funding. This is 15 percentage points greater than suggested in the SME finance monitor. Analysis of the regional survey by business size reflects the national picture than smaller firms tend to find it more difficult to access debt finance.
- The majority (60%) of businesses responding to the survey were looking for small amounts of loan finance (less than £50,000) and three quarters of survey respondents were looking for less than £100,000.

- The report concludes that there is a strong need for funding for micro-businesses for sums less than £50,000 as well as provisions for riskier and / or new businesses entering the market. The analysis of stakeholder consultation echoes points above in relation to investment readiness.

### 1.4.4 Summary of Demand Indicators

An overall summary of the demand indicators outlined in this section is provided below.

| | |
|---|---|
| **Microbusinesses and start-ups** | • Substantial and growing stock of microbusinesses<br>• Start-up rate below national average but increasing<br>• Relatively poor performance on enterprise indices (GEM and Santander)<br>• Theoretical unmet demand over and above existing private and public backed provision = £4m for microfinance and around £70 million for small loans sought by microbusinesses (if 10% of unmet demand is viable and constitutes market failure). |
| **Early stage growth businesses** | • Strong performance on some innovation indicators and increasing spend on R&D in the region<br>• But lagging performance on spin-outs considering knowledge assets in the region |
| **Established SMEs[9]** | • Smaller pool of established SMEs of which a % will be established >7 years<br>• Strong performance on high growth indicators<br>• Potential increase in demand given growing stock of SMEs and returning confidence<br>• Theoretical unmet demand over and above existing private and public backed provision of £160m per annum, assuming that 10% of unmet demand is viable. Majority accounted for by debt, but still significant equity component. |

## 1.5 Supply of External Finance

The key trends in the supply of finance by market segment, using publicly available data are summarised below. A summary table of the relevant sources of supply is provided at the end of this section.

### 1.5.1 Debt

As noted in the main market assessment, there has been an unprecedented shift in the landscape for bank debt for SMEs in the UK, with a vast reduction in the availability of credit following the financial crisis as banks have been rebuilding balance sheets. Although the precise dynamics vary from one bank to another, and some are more active in lending than others, to a large extent these trends are national (or indeed international) in scope, and hence affect SMEs in all of the English regions.

Nonetheless, it is worth briefly reviewing the available regional data for the East Midlands. Sub-national data on bank debt was not available until the Business Finance Taskforce started to record lending to

[9] Regeneris Consulting would caveat that defining an established SME as one with 9 or more employees is one of several possible ways of defining established SMEs as distinct from microbusinesses and early stage ventures. Others could include using the age of the business. However, there is a lack of data available to do this.

SMEs from Q3 2011. So whilst this data does not reveal anything about the period before this it does indicate the more recent trend (and only covers 60% of the SME lending market).

The data for the East Midlands presents a slightly contrasting picture to the national data, in that it implies that between Q3 2011 and Q4 2014, the total stock of term loans held by businesses in the East Midlands increased by 2%, while it decreased by 2% nationally in the same period. Interestingly, much of the increase in the stock of term loans in the East Midlands occurred amongst small businesses. However, the longer term trend implies that although there are quarterly fluctuations, the overall stock of term loans held by businesses in the East Midlands has remained reasonably stable since Q3 2011. At the same time, there has been a fall in the number of loan facilities approved in the region. This points to an increasing trend in the size of approved loan facilities.

Overall, this means that the value of loans and overdrafts per SME in the East Midlands is:

- For loans for small businesses, £5,900 compared to £7,300 for England as a whole.
- For loans for medium sized businesses, £12,000 compared to £11,300
- For overdrafts for small businesses £1,900 compared to £2,100 for England as a whole.
- For overdrafts for medium sized businesses £2,800 compared to £2,200 for England as a whole.

This suggests that small businesses in the East Midlands find it more difficult to access debt finance than the England average, whilst medium businesses (turning over more than £2m per year) might experience less severe challenges. However, it is important to note that this data source presents only a partial picture. On balance, it provides some evidence that SMEs in the East Midlands, particularly smaller ones, might struggle to access finance. This conclusion is echoed in evidence from consultations with banks and the professional advisory community where there was a general consensus that, like elsewhere, businesses in the East Midlands have suffered from the general tightening up of bank finance around the financial crisis. Consultees felt that this was primarily affecting businesses which did not have access to an asset base, or those without a strong trading track record, rather than businesses in particular sectors, although the desire on the part of banks to limit their exposure in certain sectors viewed as risky was also highlighted as a relevant, albeit lesser important factor.

Although some consultees in the region suggests that there are some signs of banks returning to slightly greater levels of lending to the SME market, there was no sense amongst consultees that banks pre-recession lending practices were set to return. Most consultees suggested that the main gap for term loans was for relatively small loans (up to £100k), although some smaller amounts were also highlighted.

The UK Government has been active in trying to stimulate the flow of lending to SMEs in recent years. The main initiatives have included:

- Funding for Lending: The message from consultations appears to have been that Funding for Lending has not had any noticeable impact on the supply of debt to SMEs, and that lending has been focussed on mortgages.[10]
- Enterprise Finance Guarantee (EfG). Data on the EfG suggests a relatively strong take up of the scheme in the East Midlands to date. The value of EfG-backed loans in the region equates to around £31 million per annum on average over the period. This equates to £380 per SME, which is slightly higher than the England average. The average value of loan backed by the scheme in the region is around £100k, showing that the

[10] Unfortunately the data on the scheme is not split between lending to businesses and lending to individuals, so it is not possible to verify this using performance data.

scheme has been focussed on smaller amounts of debt, but at somewhat higher levels than what would constitute a micro or small loan.

- The Business Finance Partnership and the British Business Bank Investment Programme provide funding to non-bank channels to invest in small and medium sized businesses.[11] The average value of investment through these schemes (£125k) is much lower than the England average of £200k although the overall volume of investment is lower. Investments made through these schemes equate to £300 per SME located in the region, much lower than the national average of £500.
- The Start-up Loans initiative, set up in 2012 to help 18-30 year olds (and since expanded to cover all ages), has had very little impact in the East Midlands. The latest statistics show that on average around £2.3 million per year has been invested through the schemes in the East Midlands. This equates to just £28 per SME, which is very low compared to the national average of £70.

Alternative sources of debt funding have had a role to play in getting debt out to SMEs in the East Midlands. The rise of debt-based alternative sources in the UK is well documented and set out in the main report. This may be playing a role in filling gaps at the lower end of the SME debt market, with the average size of loan raised in the UK being £73,000 in 2013 and 33% of borrowers believing they would be unlikely to get funds from elsewhere.

There is not regional data on P2P business lending, but it has reportedly had some take up in the East Midlands. However, it remains small in the context of overall lending. As set out in the main report, the future role of these sources of funding is unclear.

CDFIs also provide an important source of supply of debt finance in many regions but the sector is relatively underdeveloped in the East Midlands. In total, just 93 loans were made by CDFIs in the East Midlands in 2013, with a total value of around £1m (an average value of around £11,000). This represents just 1% of the number of business loans disbursed by CDFIs in the UK and 2% of the value.

It should also be noted that there is considerable provision of RGF funded grants in the region. Many of these are providing sizeable grants to SMEs. This provision is patchy but includes the schemes set out in the table below.

Table 0.6: Summary of RGF Funded Provision in the East Midlands

| | Fund Size (£m) | Investment Size | Area Covered | Finance Type |
|---|---|---|---|---|
| Lincoln Growth Fund | £1 | Max £50k | Lincolnshire | Grant |
| Global Derbyshire | £3 | Max £75k | Derbyshire | Grant |
| High Performance Technologies R&D Investment Programme | £4 | Up to £1m | Northamptonshire and South East Midlands | Grant |
| Investment for Growth | £7 | Max £500k | D2N2 | Grant |
| Derby Enterprise Growth Fund | £20 | Min £50k | Derby | Grant and Loan |

[11] The Business Finance Partnership ran until April 2013 and the Investment Programme has superceded it. The Investment Programme makes some money available to equity investors as well as lenders.

### 1.5.2 Early stage finance

As was noted in the main market assessment, the available data on the supply of early stage finance is limited in so far as much of the investment activity in this area is informal (through angel investors and associated networks) and therefore not wholly captured in published statistics.

The available evidence points to a very low overall level of early stage equity investment in the East Midlands. The average annual value of investment (in the region of £19 million) represents approximately £230 for every SME in the region, this is very low in comparison to the national figure of £360 per SME. It is also important to note the average size of investment in the region is slightly larger than the national average (£1.1m) and currently stands at £1.5m. This could indicate that national market failures in this area could be more pronounced in this region, but the consultations.

The only major regional public sector initiative in this area is the Lachesis fund. This was originally set up as a University Challenge Fund in 1999 with the objective of funding spin out companies. It subsequently received £2m of ERDF investment from the 2007-13 ERDF programme but no new investments were made using the ERDF funding. The fund is now in the process of being closed down.

A number of national initiatives have also had a significant impact on the early stage funding landscape in the East Midlands. These include:

- **The Angel Co-Fund.** This £100m Fund was launched in November 2011 with a grant from the Regional Growth Fund. The aim has been to invest between £100k and £1 million in high potential businesses, and to leverage significant co-investment from business angels. It invests in both early and later stage businesses. The latest monitoring data indicates that just £2.3 million (including investment by co-investors to the ACF) has been invested in the East Midlands, in just two companies. This represents very small proportion (2%) of the total national investment made by the fund. Regeneris Consulting do not have access to regional data on leverage but at the national level to date £3.80 has been levered in from business angel syndicates for every £1 invested by the ACF itself. At this stage it is clearly too early to judge the level of returns – the data available to us is at the national level, which states that one exit has been achieved at a 3 times return.
- **Enterprise Capital Funds** were originally set up in 2005 as a government-backed scheme with the aim of investing up to £2 million in early stage companies. ECFs operate as private companies that back private capital with Government-guaranteed leverage. The limit on the amount that ECFs could invest into any one fund was £25m, which has recently been increased to £50m. The ECFs are typically UK-wide Funds, although regional funds have been supported. The latest monitoring data shows that eight investments have been made in the East Midlands to date, with a value of £10 million (including co-investment). This represents around 4% of the total investment made to date and is very low in comparison to the size of the region's business base. Annual investment represents £16 per SME in the region, just over half of the national average.
- **UK Innovation Investment Fund**. This Fund provides capital for existing venture capital funds, with a total capital of £330 million (of which £150m has come from the UK Government and £180 million has come from the private sector). It is targeted at small businesses with growth potential and new ventures in the digital, life sciences, clean technology and advanced manufacturing sectors. Regional data is not available for this fund.
- **Aspire Fund**. No regional data is available.
- **Tax incentives.** Collectively tax incentives are the biggest intervention in the UK equity market by value. The Enterprise Investment Scheme (EIS) provides 30% tax relief for investors making an investment of up to £1m in any tax year. SEIS is a derivative of EIS, which aims to encourage seed investment in early stage companies. Investors receive tax relief of 50% on investments up to £100k and Capital Gains Tax exemption on any gains in SEIS shares. ONS data based on HMRC returns shows that between 2009 and 2012, a total of £44m has been invested through the EIS scheme in the East Midlands. This represents an average annual investment rate of around £15 million. The average annual investment represents just £175 per SME employer in the East Midlands, which is particularly low when compared to the England average of £650. This reflects the consensus view from consultees that the volume of Angel activity is particularly low in the region.

Again, alternative funding sources have also played a role in this market, including equity based crowdfunding platforms. These are much smaller in scale than P2P platforms: the latest review of the

UK market found that equity based crowdfunding amounted to £28 million nationally, representing very strong growth from the estimated £4m in 2012 (the average amount of money raised was £199,000). The data suggests that crowdfunding has not had particularly strong penetration in the East Midlands to date. Annual levels of equity based crowdfunding represent £15 per SME in the region (very low compared the national average of £26. Similarly, reward-based crowdfunding (where individuals donate to fund a project with the expectation of a non-financial reward in the event of its success) is not particularly active in the region. Annual investment here represents £20 per SME in the region, compared to £35 nationally.

Whilst these platforms may play some role in early stage finance in the region, the view – supported by consultations across the country – is that they are very unlikely to serve all of the needs of early stage companies. Some of the consultees have made the point that mechanisms are well suited to project finance but much less well suited to building new, innovative businesses, given the need for a longer term commitment of funds through several rounds of funding and the potential for significant dilution for the initial investors. Further, given that these forms of financing are at an embryonic stage there remains potential for significant levels of write offs to come through from the investments made to date, which would impact on the reputation of the platforms.

### 1.5.3 Expansion equity

The BVCA also publishes data on later stage growth deals completed in the East Midlands (privately and publicly backed). According to this data the level of investment fluctuates substantially each year. The average annual value of investments made (over the past three years) was £28m each year. This is the lowest level of all English regions apart from the East of England. On average, just 13 companies in the region received expansion equity investment each year (over the past three years). The lowest volume of deals in all English regions.

While there are currently no public-backed funds operating in this area, there are a number of UK wide initiatives supporting this activity. These include the following.

- **The Business Growth Fund (BGF)** was set up in July 2012 and is backed by a syndicate of banks with £2.5 billion of capital – it focusses on growth equity and mezzanine finance, offering £2m-£10m. It is designed to be an evergreen fund. Published data on the Fund's portfolio indicates that £23 million investment has been made across three businesses in the East Midlands to date. The average investment size of £7.6m is large compared to the national average of £5.6m although for the East Midlands this is based on a very small number of deals.
- **Enterprise Capital Funds** can also invest in later stage businesses. The latest monitoring data was presented earlier under the early stage section.

An overall summary of the key sources of supply of finance to SMEs is provided below. It should be noted that there are significant overlaps between the sources (for example, EfG backed lending is a subset of total SME lending; some funding sources will have provided co-investment for others; data on equity investment includes ERDF-backed investment). Nonetheless, it gives a useful summary picture of the supply side in the East Midlands.

*Table 0.7: Summary of Key Sources of SME Finance Supply in East Midlands*

| | Average annual value of Investment, £m | Average value of investment made, £000s (England avg in brackets) | Value per SME (England average in brackets) | % change in value 2011-13 (England avg in brackets) |
|---|---|---|---|---|
| **Debt** | | | | |
| Lending to Small Businesses: Term Loans (BBA data) | £495 | £81 (£82) | £5,900 (£7,300) | -23% (-11%) |
| Lending to Medium sized businesses: Term Loans (BBA data) | £1,007 | £270 (£295) | £12,000 (£11,300) | -21% (1.5%) |
| Lending to Small Businesses: overdrafts (BBA Data) | £158 | £16 (£16) | £1,900 (£2,100) | -41% (-25%) |
| Lending to Medium sized businesses: overdrafts (BBA) | £232 | £89 (£81) | £2,800 (£2,200) | 20% (-5%) |
| Enterprise Finance Guarantee backed lending (Business Bank) | £32 | £103 (£100) | £380 (£340) | NA |
| Start-up Loans (Business Bank) | £2.3 | £5 (£9) | £28 (£70) | NA |
| Business Finance Partnership & Investment Programme (Business Bank) | £25 | £124 (£207) | £300 (£500) | NA |
| **Equity** | | | | |
| Early stage equity investment (BVCA Data) | £19 | £1,500 (£1,100) | £230 (£356) | -63% (24%) |
| Expansion equity investment (BVCA Data) | £28 | £2,200 (£4,800) | £338 (£584) | -55% (-62%) |
| Angel Co-Fund (Business Bank) | £0.8 | £1,100 (£1,800) | £10 (£30) | NA |
| Enterprise Capital Funds (Business Bank) | £1.3 | £1,300 (£1,300) | £16 (£30) | NA |
| Enterprise Investment Scheme (HMRC Data) | £15 | £200 (£340) | £174 (£650) | 38.4% |
| Business Growth Fund | £13 (relates to 2014, no investment in 2013) | £7,600 (£5,600) | £99 (£77) | 22% |
| Equity-based crowdfunding | £1.2 | NA | £15 (£26) | NA |
| ERDF backed equity | £0.5 | NA | £7 (£60) | 99% |

*Source: BBA, BVCA, NESTA, HMRC, BGF. Note: a detailed explanation of the sources and coverage of the data is provided in Appendix*

### 1.5.4 Performance of ERDF backed funds

The East Midlands lacks the same track record of a number of other regions in delivering large scale public backed SME finance interventions over the last two decades, however there have been a small number of ERDF backed interventions:

- The Lachesis Fund: This is a technology focused fund which invests in very early stage businesses. This fund was originally established in the 1990s and received investment through the 2007-13 ERDF programme. Unfortunately, it was unable to make investments and the ERDF portion of the investment was withdrawn.
- Regional CDFI Fund: ERDF provided £1m to be used by the region's CDFIs to invest in SMEs. The project size was modest (it represented an average annual investment of £500k, of which £250k was ERDF) but all of the funding was committed and the project performed fairly well against its jobs created target (but less so against GVA targets).

It is worth noting here that the East Midlands Development Agency set up two regional equity funds using Single Programme funds. The Early Growth Fund was a £5million fund set up to invest in start-up and early-stage businesses. The fund was managed by Catapult Ventures and could invest up to £400k (including follow-on investment) in early stage businesses. This fund is now closed for new investment. There was also a £30m Regional Venture Capital Fund set up in 2002 which was able to make investments between £100k and £500k. There is no evaluation evidence available for these funds.

## 1.6 Implications for Future Public Sector Backed Funds

This section brings together the results of the preceding analysis to draw out the high level implications for future public sector backed SME finance FIs during the 2014-20 programming period in the East Midlands region.

This has been informed by the area based market assessment framework presented in the main summary report. This is summarised in 8 below. The overall conclusions follow on from this table, providing partners in the region with an indication of the potential scale at which ERDF backed FIs could operate, including the indicative ranges for the different types of finance.

The assessment has been informed by two workshops held with partners in the East Midlands, the second of which discussed the conclusions and recommendations. **The final two steps of the assessment framework, will be completed as part of the block two element of the ex-ante assessment**.

*Table 0.8: Summary of Area Assessment Steps for the East Midlands*

| | Microloans | Early Stage VC | Debt for Growing, Established SMEs | Expansion Equity for Established SMEs |
|---|---|---|---|---|
| Step 1 - Demand and Supply Characteristics | • Substantial stock of microbusinesses<br>• Positive demand indicators (incl growing microbusiness base and increasing start-up rate)<br>• But poor performance on enterprise indicators overall<br>• Region's micro and small firms does less well than many regions in accessing bank finance and experienced greater falls in lending/overdrafts (2011-13)<br>• In addition, fairly modest provision of local grant and loan schemes and underdeveloped CDFI sector compared too many other regions, with little ERDF backed activity.<br>• Relatively low take-up of Business Bank's Start up Loans | • Indicators present a mixed picture<br>• Strong performance on some innovation indicator and increasing R&D spend<br>• But spin out activity from the HE sector is relatively modest and does not reflect the region's knowledge assets<br>• Very low (and falling) levels of early stage investment into companies in the region, although consultations pointed to stronger levels of activity to south of region and in some hot spots elsewhere<br>• Proximity to major centres of venture capital activity in London and South East (and possibly Birmingham) could be masking true picture, although evidence mixed on this point<br>• Little track record of public sector backed activity, although a number of pan East and West Midlands FIs | • Smaller pool of SMEs in this segment. In the region of 15,500 SMEs > 9 employees<br>• Small and medium sized SMEs in region appear to fair better in accessing loans and overdrafts but consultations confirms still affected by retrenchment of high street banks and shift to higher value loans<br>• Potential for demand to increase given growing stock of SMEs and returning confidence<br>• Limited role of public sector initiatives operating in this space in the region, the exception being national Business Bank schemes and RGF funded grant provision. | • Strong presence of high growth firms in the region, although<br>• Substantially lower investment levels than the England average and a very acute drop between 2007 and 2013<br>• National economic conditions have stifled demand but consultations suggest confidence now returning<br>• Very limited public sector backed provision historically, although proximity to major finance centres in London and South East (and to some extent Birmingham) is a relevant consideration for parts of the region<br>• Consultations point to significant equity aversion in the region (linked to general lack of supply of finance of this type); but not dissimilar to some other regions (e.g. Yorkshire and Humber) |
| Step 2 – Unmet Demand | • National evidence of growing difficulties experienced by micro-businesses in obtaining finance, confirmed in the region through consultations.<br>• Existing schemes are filling some but not all of the gap and suggests little contribution from regional or national public sector backed schemes<br>• Evidence from consultations suggests that the gap is focused around smaller amounts of finance (c£20 to £30k) but this rises to larger amounts where banks or public sector banks FIs reluctant to lend (£70-£100k)<br>• Assessment of theoretical unmet demand over and above what private | • Evidence does not point to major levels of unmet demand, unlike in other some other regions, but this could reflect in part gaps in the evidence base<br>• A range of indicators drawn upon suggest low demand / supply equilibrium in region; that is, lack of public sector backed FIs and hence no stimulation of awareness and demand for type of finance within region<br>• This situation could vary within the region however and hence ned for caution in drawing firm conclusions<br>• Nationally, there is evidence of unmet demand for pre-commercialisation | • Evidence from consultations echoes the national picture – despite a better position in some regards, a substantial portion of SMEs have problems accessing debt (particularly smaller firms)<br>• National evidence suggests the gap is in the £80 to £300k area (and hence overlapping to some extent with the microloans space), although consultees in region suggest this is more likely to be focused around the £200k area<br>• Theoretical unmet demand of around £40m per year for established SMEs over and above | • Indicators of potential demand are strong but take up is very low<br>• It is not clear if constraints are on the supply or demand side<br>• Consultees suggest that lack of providers active in the region is reflected in low awareness and take-up<br>• Theoretical unmet demand for growth equity of up to c£10m per annum over and above what provided by private and public sector (assuming that 10% of rejected firms had solid business plans) |

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| | and public sector providing of £4m per year for microfinance and £70m per year for larger amounts (if only 10% of rejected firms had solid business plans). | and early stage investments of up to £500k in first rounds | what private and public sector currently providing (assuming that 10% of rejected firms have solid business plans).<br>• Lack of region specific public backed FIs targeting this part of the market means gap in evidence base around scale and nature at which market failure exists and ability to delivery VFM for public sector's investment | |
| Step 3 – Market Failure | • National evidence points to existence and persistence of market failure in this space<br>• Consultations indicate that smaller businesses are disproportionately affected by contraction in bank lending and increasing loan sizes<br>• Limited public sector backed provision in the region to date means that evidence on which to judge success of provision in targeting this market failure is limited<br>• But as a whole similar situation to Yorkshire and Humber or West Midlands might hold, although could be some variation across region given variation in underlying strength of economies | • There is little doubt national market failures apply in this part of the market in the East Midlands (i.e. investors prefer larger deals and are cautious at early stage given risk and possibility of slow exit)<br>• The market failure case is potentially exacerbated by the weak supply side in the region, with a limited track record of public sector backed initiatives (with the exception of the national Business Bank schemes)<br>• But proximity to finance markets and intermediaries in and around London and the extension of the region into the so-called Research Triangle might mask true patterns | • Strong evidence at a national level of market failure in this area, having increased as a consequence of the financial crisis, increased regulation of the high street banks and changing bank behaviour<br>• Consultations suggest that the picture in the East Midlands more or less reflects national trends and that SMEs in the region have continued difficulties accessing debt finance | • National market failures (whereby transaction costs lead to an equity gap for smaller amounts) apply here<br>• But also potential for a lack of awareness of the benefits of this type of finance |
| Step 4 – Persistence of Market Failure | • Banks not expected to return to pre-crisis lending practices for this part of the market<br>• Demand for finance from start-ups and microbusinesses unlikely to reduce, if anything will increase as economy recovers<br>• Patchy supply and no major investments expected<br>• Market failure likely to persist, as well as the associated finance gaps affecting this part of the market | • No sign of investors changing preferences so national market failure unlikely to change<br>• Evidence suggests that there is scope for demand to increase in the region (and exacerbate the market failure) | • Strong evidence that market failure is likely to persist given likelihood of increasing demand as confidence returns and SMEs implement stalled growth plans<br>• Uncertain extent to which banks likely to re-enter this part of market, but pre-crisis practices of banks unlikely to return | • Evidence suggests that market failure case will persist<br>• Improved economic conditions likely to support demand (but the data does not necessarily present a coherent picture) |

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| Step 5 – Specific Economic Development Priorities | • SEPs seeking to deliver private sector employment growth via interventions focused on business competitiveness and growth.<br>• A focus on start-up and enterprise within Strategic Economic Plans, but as part of a wide ranging strategy to support business growth<br>• **Analysis to be further tested and reviewed as part of Block two work** | • Stronger focus of the LEPs in the more southerly part of the region may stimulate demand for early stage VC, but needs to be linked to other forms of R&I and business support activity if to be successful<br>• Other LEPs place less emphasis on this area<br>• **Analysis to be further tested and reviewed as part of Block two work** | • Strong focus on growing the established business base within all SEPs<br>• Commitment to revenue funded support services to assist businesses to develop growth plans and enhance their investment readiness<br>• **Analysis to be further tested and reviewed as part of Block two work** | |
| Step 6 – Delivery Capacity | • The region lacks the track record of delivering JEREMIE funds and other ERDF backed interventions and hence little existing delivery infrastructure upon which to build<br>• Also, unlike other regions which have been more proactive in previous programme periods, this lack of track record of ERDF backed FIs will not have helped to build up awareness of finance options and investment readiness, and hence a pipeline of investible projects; in general this is more important for larger amounts of debt, mezzanine and equity finance<br>• Limited experience of delivering ERDF backed FIs in the region has not always been positive. For example the Lachesis fund failed to invest the ERDF capital available to it.<br>• Particular lack of track record in delivering public sector backed equity based instruments at scale, with implication that the region may lack the awareness of the criteria which underpin these funds and possibly the networks and relationships which these funds helps to build up (although this may be less important in parts of the region if there is a strong body of financial intermediaries and investors, although the evidence is mixed on this point)<br>• **Analysis to be further tested and reviewed as part of Block two work, as potential investment strategy and delivery options are developed.** | | | |