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

Block One – summary findings

Final Report

January 2015

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Version	Date issued	Scope
Version 1	4-12-14	Includes first full drafts of Sections 1, 3, 4, 5, 6, 7, 8 and 9. Excludes 2 (policy), regional overviews, lessons learnt, additional resources and overall conclusions
Version 2	19-12-14	Addresses EIB comments on v1 Adds sections on policy, lessons, added value Moves area assessment framework to just before the area profiles.
Version 3	13-01-15	Updated conclusions and addition of section 11 and area overview annex (separate document)
Version 4	6-02-15	Amended for comments from DCLG GDTs, BBB and BIS

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Glossary of Terms

Beneficiary	A public or private body responsible for initiating or both initiating and implementing operations; and in the context of State Aid schemes, the body which receives the aid; and in the context of financial instruments it means the body that implements the financial instrument or the fund of funds as appropriate
Business Angels	Individuals who make equity investments in businesses in their early stage with long term growth potential. Typically risk investment
Early-stage capital	Equity based investment which is typically made in pre-revenue or other young businesses
Final recipient	A legal or natural person receiving financial support from a financial instrument
Financial instrument	European Union measures of financial support provided to address one or more specific policy objectives of the Union. Such instruments may take the form of equity or quasi-equity investments, loans or guarantees, or other risk-sharing instruments, and may, where appropriate, be combined with grants
Fund of funds	An overall fund set up with the objective of contributing support from a programme or programmes to several financial instruments
Funding agreement	Contract governing the terms and conditions for contribution from ESIF programme to financial instruments. This will be established between a Managing Authority and the body that implements the financial instrument
Fund managers	Refers to the firms appointed to manage an investment fund, making loans and equity investment with SMEs and managing the portfolio on an on-going basis or to the point of closure
Holding Fund	The body which is set up to oversee a fund of funds, typically receiving and responsible for the ERDF grant, setting the overall investment strategy, and monitoring overall investment, financial and economic impact performance
Loan	An agreement which obliges the lender to make available to the borrower an agreed sum of money for an agreed period of time and under which the borrower is obliged to repay that amount within the agreed time
Leverage effect	In the ESIF context the leverage is the sum of the amount of ESIF funding and of the total additional public and private resources raised divided by the nominal amount of the ESI Funds contribution
Management costs and fees	Management fees shall refer to an agreed price for fund management services provided established via a competitive market process, where applicable. Management costs and fees shall be based on a performance based calculation methodology
Mezzanine finance	A hybrid of debt and equity finance having a higher risk than senior debt and a lower risk than common equity. Also known as quasi- equity, this can be structured as debt, typically unsecured and subordinated and in some cases convertible into equity, or as preferred equity
Local Enterprise Partnerships	Business led partnerships tasked by the UK Government to coordinate economic development in defined local areas
Operation	A project, contract, action or group of projects selected by the managing authorities of the programmes concerned, or under their responsibility, that contributes to the objectives of a priority or priorities; *in the context of financial instruments, an operation is constituted by the financial contributions from a programme to financial instruments and the subsequent financial support provided by those financial instruments*
Pre-match funding	The combination of ERDF with another source of private and/or public sector funding to provide a larger pot of money for investment with SMEs
Venture capital	Relatively high risk post start-up equity based investment

1 Introduction

1.1 Delivery of the ERDF Programme 2014-20

The UK Government is intending to deliver the ERDF programme 2014-20 for England through the Local Enterprise Partnerships (LEPs), alongside aspects of the ESF and EAFRD programmes. The thirty nine LEPs in England are responsible for the development of strategic economic development plans for their areas, as well as defining how they propose to invest the European Union Structural Investment Fund (ESIF) resources to achieve their strategic plans.

The LEPs responsibilities, as set out by the UK Government, for identifying investment priorities extend to determining the use of financial instruments (FIs) to address business competitiveness (and other) objectives set out in the ERDF Operational Programme. However, the development of these proposals is subject to the requirements of Article 37 of the Common Provisions Regulations, which require the Managing Authority to ensure that an ex-ante assessment of any proposed FIs is undertaken, prior to the Managing Authority making programme contributions to FIs.

The European Investment Bank (EIB) has been appointed by the Department for Communities and Local Government (DCLG) to provide analysis and guidance to support the requirements of an ex-ante Assessment. In line with Article 37 and recently published European Commission guidance, the assessment consists of two building blocks and will consequently follow a two stage process. Block 1 consists of a market analysis to inform judgements about the market need and the financing gap, whilst block 2 consists of the development of the investment strategy, delivery approach and management of proposed FIs. EIB is being assisted by Regeneris Consulting and the European Investment Fund (EIF) in carrying out the assessment. This summary report covers block 1 only, with the block 2 work due to commence in February. The full version of the report will be provided upon completion of block 2.

1.2 Block 1: Market Analysis

This block consists mainly of the following analysis:.

- In order to build the strategic framework for FIs, it is necessary to take into account the national, regional and local context underpinning the public sector's involvement in the provision of finance for SMEs. This needs to be informed by a thorough analysis of the demand and supply of finance to start-ups and SMEs, including the identification of market failures or sub-optimal investment situations for which FIs can be appropriate.
- This analysis then informs an assessment of the market gaps and the manner in which these may change over time - a key aspect of the case for public sector intervention. This needs to also be informed by an assessment of the fit and consistency with existing support measures, the consistency with lessons from existing and previous interventions and the ability to secure added value over the current arrangements and value for money.
- Consideration of the lessons learnt for delivery and management and how they will be applied to the new FIs or to the potential continuation of the existing FIs, taking into account also the experience with similar instruments implemented elsewhere.
- Linked to the above, the assessment must also undertake an initial assessment of the appropriateness of different types of FIs and the type and level of financing needed given the market gaps and needs identified. The analysis investigates the complementarity, value added, fit and consistency of the proposed FIs with respect to other public interventions in the same market, e.g. existing grant or publicly supported FIs, including those involving other EU funds. This also involves an assessment of the potential combination of the FIs with grants or other

instruments such as interest rate subsidies or guarantee fee subsidies. All of these tasks will feed into Block Two and will be informed by it in an iterative manner.

- It should also consider the potential to lever in other private and public sector resources, as well as the overall scale of economic results the intervention could achieve, given its underpinning objectives, approach and resources.

1.2 Key Aspects of the Approach

There are a number of challenges in undertaking the assessment which have required a distinct approach. A number of important considerations are noted below.

1.2.1 Assessing the Finance Gap

It is not possible to directly observe or measure the finance gap affecting SMEs or the part of this gap caused by market failure (as opposed to unviable businesses or investment propositions). An assessment of the finance gap therefore needs to draw on a range of sources concerning the demand and supply of finance to SMEs, although the availability of this data is patchy (although improving) and many of these sources are not very well suited to this task. In this way it is possible to use a variety of sources to indicate a range of the potential finance gap.

1.2.2 Spatial Focus of the Assessment

For these reasons, it is necessary that the assessment is focused at an all-England (or in some instances UK level due to the availability of data) and regional level (i.e. NUTS1) within England. Given the availability and robustness of sub national data, it is not realistic or particularly meaningful to undertake this particular assessment at a lower spatial level. However, where it is possible to undertake robust analysis of either demand or supply factors or policy considerations at a lower spatial scale, this has been done in a selective and appropriate way.

It also needs to be borne in mind that the EU is seeking ERDF[1] backed FIs which provide finance to SMEs to have sufficient scale in order to ensure delivery efficiency and effectiveness. The lessons from the previous programming period clearly point to the importance of achieving scale of intervention in achieving this. This points to the need for many (but not necessarily all) LEPs collaborating in the delivery of SME finance FIs.

1.2.3 Involvement of the LEPs and their Partners

Despite the primary focus of the assessment being at a regional level, the assessment has closely involved the LEPs and their partners from an early stage in order to understand the experiences of SMEs locally. This has been achieved through running two consecutive workshops in all regions, which all LEPs were encouraged to attend. This has also helped to ensure that the LEPs have realistic expectations of the assessment and the process has helped all parties to work towards a sensible

[1] In the current programming period all types of ESIF can be allocated to a FI, although we are primarily concerned with ERDF in this assessment. Whilst we often refer to ERDF backed FIs, there is the potential to use other ESIF resources for this purpose.

approach to assessing the case for ERDF backed FIs. Another key LEP role is to advise on where RGF bids and Local Growth Fund deals may be overlapping and potentially overcrowding the market.

There have also been over 100 consultations with business representatives, finance intermediaries, and private and public sector backed finance providers to inform the consideration of demand and supply factors. Careful consideration was given as to how best to target the available resource for consultations in order to ensure it effectively fed into the preparation of a robust evidence base. In some regions this involved the consultants attending additional workshops arranged by local partners in the regions.

1.2.4 Focus of the Assessment

Leaving aside the spatial dimension noted above, the finance market for SMEs can be analysed in various ways, including by the various types of finance and stages of development of SMEs. For the purposes of this report, the assessment has focused upon:

- Finance for microbusinesses – this is defined as businesses with less than 10 employees and covers debt finance for start-ups (but excluding equity for early stages businesses which is covered below), microfinance (typically defined as up to £20-£25,000) and small loans (defined as being up to around £70-£80,000).

- Risk capital for early stage businesses – this category covers pre-start-up and early stage businesses with high growth potential (both pre-revenue and early revenue businesses), which typically require high risk venture capital investment from £0.2m to £2m. These businesses are harder to define in terms of their size – whilst they may be unincorporated, have no employees or have fewer than 10 employees when they are supported, they are distinguished by their potential for rapid growth in turnover and employment terms.

- Debt for established SMEs – this category covers established SMEs (typically with more than ten employees and established for more than two years) which seek to use debt based finance to support relatively low risk growth.

- Risk capital for established SMEs – this category covers established SMEs (again, typically with more than ten employees and established for more than two years) with their aspiration for finance to achieve more rapid growth or major events (such as management succession). This may include a mix of equity and quasi- equity finance.

Whilst this approach to structuring the assessment has a good fit with the focus of the current (and previous) ERDF programme for England, there are inevitable overlaps in this categorisation and the available data does not always neatly fit this categorisation. The analysis in Chapters five to eight highlights any particular issues which need to be noted.

2 Policy Context Summary

2.1 Introduction

This section briefly sets out the range of EU, UK and sub-national policies which are relevant to the conduct of the ex-ante market assessment and the design and delivery of SME finance FIs.

2.2 UK Government Policy

The challenges of the ability of new, growing and established SMEs to secure the finance they require through the markets in the UK has long been recognised[2], accompanied by a good understanding of the market failures and associated demand side reasons for this. There has been a wider range of policy measures put in place to address these issues, with a number of long running initiatives.

The onset of the last recession and the associated financial crisis led to a range of additional interventions being introduced, as well as a commitment by Government to re-examine the causes of the shortcomings in the provision of finance to SMEs and the potential for more effective measures to address them.

The British Business Bank represents a major development in this regard, coordinating an intelligence-led, national and flexible approach which is intended to work alongside the private sector in addressing major market gaps. Major schemes run by the Business Bank which provide debt and equity finance to SMEs include Enterprise Finance Guarantee, Enterprise Capital Schemes, UK Innovation Investment Fund, the Angel Co-investment Fund, and the Business Finance Partnership. The Enterprise Investment Scheme and the Seed Enterprise Investment Scheme are HMRC operated tax relief schemes which aim to encourage private investment in SMEs.

2.2.1 Sub-national Economic Development

LEPs have been given the responsibility of developing economic strategies for their areas, including the use of ERDF and some other ESIF resources. The LEPs have been given clear guidance by DCLG on the design of SME finance FIs where they are seeking to use ERDF, including the importance of achieving scale to ensure efficient delivery, cross boundary collaboration and an underpinning justification.

There continues to be a recognition in UK Government of the role which ERDF backed SME finance instruments can play in addressing market failure and the ability for these to be more closely targeted at specific issues facing SMEs in different geographical areas.

2.3 European Policy

The European Structural and Investment Funds for 2014-20 have ten policy priorities which are intended to be the focus of the Operational Programmes developed for each individual Fund: research and innovation; ICT; business competitiveness; low carbon economy; climate change adaption; environmental protection; sustainable transport; employment; skills; and social inclusion.

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[2] As far back as the MacMillan Report in 1931, and in the Radcliffe (1959), Bolton (1971), Wilson (1979) and Cruickshank (2000), the weaknesses in the provision of debt and equity finance to SMEs has been recognised.

In designing the new ESIFs, and the associated Common Provisions and Fund specific Regulations, the European Commission has the clear intention of ensuring there is a greater concentration of resources on fewer priorities. The selection of which is clearly linked to the economic challenges of the target area, the interventions and instruments implemented should be able to secure more effective impacts and value for money for the EC and Member States, including the development of more effective performance management frameworks.

The European Commission is extending the use of FIs during the 2014-2020 programme period. The ESIF policy framework emphasises the need for more use of financial instruments in 2014-2020, particularly in a context of fiscal retrenchment, across all ESIF priorities. In October 2013 the European Council set a specific target of doubling amounts of ESIF support delivered to SMEs through financial instruments in programme countries. The benefits associated with the use of FIs are viewed by the European Commission to be[3]:

- Leverage of resources and increased impact of ESIF programmes
- Efficiency and effectiveness gains due to revolving nature of funds, which stay in the programme area for future use for similar objectives
- Better quality of projects as investment must be repaid
- Access to a wider spectrum of financial tools for policy delivery & private sector involvement and expertise
- Move away from "grant dependency" culture
- Attract private sector support (and financing) to public policy objectives.

2.3.1 State Aid Rules

New State Aid guidance was issued by the European Union[4] in 2014 covering Regional Aid, RD&I and the most commonly used sections of the new General Block Exemption Regulation (GBER) such as access to finance for SMEs. The updated GBER has a number of implications for SME finance delivered through the new ESIF programmes including:

- Allowing larger amounts of investment per SME and allowing support for MBO (under specific circumstances)
- Requiring lower amounts of private sector leverage required at the level of the deal
- Providing more scope to support mid-caps (up to 500 employees) and in some instances larger companies
- Making fewer distinctions between assisted and non-assisted areas
- Restricting risk capital investment to SMEs which having been operating for more than seven years.

A number of these changes will have implications for ERDF backed FIs, in particular providing them with greater flexibility to invest larger amounts of finance in growing businesses and across geographies. However, the seven year rule will have implications for the extent to which businesses can be supported through risk capital.

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[3] Ibid. Page 4.

[4] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:209:0001:0045:EN:PDF

3 The Finance Gap and Market Failures Summary

The current market assessment focuses on the provision of finance to SMEs. The question is whether the market, without public intervention, will provide sufficient, too little or too much finance and, as a result, business growth and wealth creation are constrained. A market failure which results in too little finance being provided will generate unexploited gains from trade – in this case there are loans, equity and other investments which would be profitable to both firms and investors that for some reason are not made.

Market failure in its own right does not provide a sufficient argument for the public sector to intervene. Intervention will generally involve some distortion of markets and reduction in economic welfare (not least through taxation needed to fund it) against which the benefits need to be weighed. **Public intervention to address a market failure in the supply of finance to SMEs may improve economic welfare, but only if the benefits outweigh the costs of the intervention.**

There is extensive and convincing evidence in the literature identifying the existence and nature of market failures in the provision of finance to SMEs. These failures do vary in their nature between firms in different stages of development and types of finance. Although, these are typically structural market failures, their severity can vary across an economy as large and as diverse as England's.

The nature of market failures and the so-called finance gap has important implications for any market assessment which is undertaken. Demand for finance from SMEs rises as the rate of return required from finance providers decreases (e.g. interest rates on loans fall). **There is in principle no effective limit to demand from firms for credit.** In some instances, for example, the public sector has sought to estimate the size of the market for FIs through survey evidence of the numbers of firms seeking or rejected by mainstream finance. This has sometimes been presented as an estimate of the size of the 'finance gap'. This type of analysis has limited practical value in its own right and has the potential to be seriously misleading.

The size of the market of a public sector led FI, is the amount of finance that could be extended by the fund given any level of return sought, but only in those parts of the market in which the private sector will not invest for reasons of market failure. It is therefore highly dependent on the rate of return sought and the specific investment and pricing strategy which a fund may adopt. **The size of the market for a new fund is therefore subject to a large degree of uncertainty.**

Consequently, the existence of firms rejected by mainstream finance providers (due to information failure), whilst clearly a necessary condition, is not a sufficient condition for market failure and therefore for intervention in the market. Evidence of the finance gap and the optimum size of FIs should be drawn from a variety of sources, including very importantly the insight gained from operating these funds in the same or similar markets.

4 UK and Regional Economic Performance and Prospects Summary

4.1 Economic Growth

Economic Growth has recovered since the recession with GDP rising by 1.8% in 2013 and forecasts from the OBR suggesting around 2.7% for 2014. Regional growth measured by GVA per head was estimated at £21,900 for England with London showing the highest and the North East the lowest. Forecasts show strong economic growth in 2015 and 2016 across the selected forecasting organisations, largely due to increased consumer spending. UK growth projections are particularly positive when compared to global projections, with concerns about weak European and Chinese growth.

The overwhelming message from indicators is that there is a strong recovery nationally and that this is likely to continue. There is some regional disparity in the recovery with London performing consistently well in terms of growth and areas in the North appearing to struggle with unemployment and inactivity. Despite these regional disparities, each region is experiencing a strong individual recovery. Looking forward, there is a clear consensus that the UK's recent growth is robust and is showing good signs for the future.

For SMEs the outlook is, as ever, unclear and dependent on many different factors but surveys indicate a steady level of confidence and an overall expectation of growth. This expectation of growth could be the boost that is needed to take up any future slack in the labour market.

4.2 Implications for FIs

Stronger investment, economic growth and employment growth have shifted the economy out of the recession and the recovery is expected to continue in the next two years. Business investment is becoming stronger and is expected to catch up to consumer demand, with tentative signs that established businesses are seeking to implement their previously stalled investment plans and this is feeding through into stronger demand for external finance.

The volume of SMEs has grown, which is likely to **stimulate the demand for external finance** to support working capital requirements and increasingly their growth aspirations. **There has been particularly strong growth in the volume of start-up businesses which has implications for the nature of external finance that will be required in the next two to three years.**

5 Debt Finance for Microbusinesses in England

5.1 Introduction

Microbusinesses are typically defined as being those businesses which employ less than 10 people, while for the purposes of this analysis, a start-up business may be either pre-start up, in the process of setting up or within its first year of operation. These businesses typically have a requirement for very small amounts of finance, including microfinance as well as small loans. This section does not refer to the need of start-ups and young businesses for specialist forms of investment such as seed or early stage venture capital.

Microfinance has been defined by the EU as loans with a value of below 25,000 Euros[5]. Firms in this category tend to share distinctive characteristics:

- Many are self-employed people with no or few employees. The latest UK Department of Business Innovation and Skills (BIS) estimates on the business population show that 78% of private sector businesses in this size category are sole traders and a further 3% have only one employee[6].
- They tend to be focussed on the provision of goods and services primarily to local markets. As such, these firms tend, generally speaking, to be engaged in relatively lower value-added activities and to be skewed towards the provision of local services, often in consumer-facing sectors.

Many of these enterprises do not have growth aspirations or create additional jobs. At the lower end of the scale micro-enterprises are lifestyle businesses. Consequently, many do not require or seek external finance. It is common for self-employed business owners to make use of informal and personal sources of finance (friends and family, credit cards etc.) before seeking finance from external sources. Those that do seek external finance tend to do so in order to fund working capital or fixed capital investment, and to seek £5k or more[7].

Given their characteristics, micro-enterprises seeking external finance face a particular set of issues. Essentially the problems experienced by SMEs in general in obtaining finance are particularly acute amongst microbusinesses and start-ups. They are particularly likely to lack collateral to offer as security against a loan, and they often do not have a track record in running a business. Compared to larger SMEs they sometimes lack the financial and business management and planning skills typically required in order to have a good chance of securing commercial finance. Some individuals who have previously been out of work and are seeking capital to set up a business may also suffer from a chequered credit history. All of these factors increase the actual and perceived risk associated with providing finance to these entrepreneurs.

From the point of view of banks, the costs of administering loans to this class of firms are high relative to the small loan size. Typically the level of risk and average failure rates of the investments cannot be adequately priced through interest rates so as to yield a commercially acceptable rate of return. The consultations and various reports also suggest that the reputational risks to banks from charging the interest rates required to make an acceptable return on capital are too high[8]. It is important to note,

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[5] European Commission (2004) *Microcredit for European Small Businesses*. In practice there is some flexibility on this definition, since this threshold was set 10 years ago.
[6] BIS Business Population Estimates
[7] BIS Small Business Survey 2012.

[8] DWP (2012) DWP Credit Union Expansion Project: Feasibility Study Report

therefore, that even in a well-functioning market, the private sector (i.e. principally banks) tends to avoid providing finance to this class of enterprises for the reasons cited above.

5.2 Demand

5.2.1 Microbusinesses

According to BIS Business Population estimates, there are currently an estimated 4.6 million microbusiness in the UK and 4.1 million in England, representing 95% of the total business base in both areas. Micro-business account for 32% of employment and 18% of turnover in England.

In terms of sectors, as a percentage of total employees a large proportion of microbusiness operate in sectors that service local markets, such as agriculture, and service activities such as personal and leisure services. A large proportion of microbusiness also operates in construction and education.

Not all of these sectors are eligible for ERDF. Sub-sectors within retail, tourism, manufacturing, and business and professional services are ineligible for ERDF backed funding. Using ONS Business Count data[9], this equates to around 26% of microbusinesses in England. There is regional variation in this proportion, with a greater than average proportion of microbusinesses in the North East and Yorkshire and Humber ineligible for ERDF backed funding (32% and 30%). London has the lowest proportion of microbusinesses ineligible for ERDF backed funding, around 21% of microbusinesses.

Microbusinesses uniformly account for close to 95% of the total business base across all of the regions[10]. There are approximately 800,000 microbusinesses in London, more than in any other region, closely followed by the South East where there are approximately 750,000 microbusinesses. The North East has the least number of microbusinesses of 130,000.

The BIS Business Population data only has time-series data at regional level from 2011. However, data at a UK level shows fluctuating but consistently positive annual growth in the number of microbusinesses between 2000 and 2013. This includes an average annual growth in the wake of the financial crisis of 2.9% from 2009 to 2013.

In total there has been net growth over the period 2001-13 of 1.4 million business (+43%), with the rise in microbusinesses as a proportion of the overall business base from 94.3% to 95.4%. If microbusinesses were to continue to grow at this rate, there would be an additional 990,000 microbusinesses across the UK in 2020. **This growth in microbusinesses would, in normal circumstances, be expected to lead to an increase in the demand for external finance amongst these businesses**.

The 2012 Small Business Survey states that 22% of microbusinesses in the UK have sought external finance in the last 12 months, with 7% seeking finance more than once. The mean average amount applied for was £210,000, compared to £364,000 for small business and £1,983,000 for medium sized businesses. The survey also provides reasons for not applying for finance and the barriers to obtaining finance. The main reasons given for not applying for finance were:

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[9] ONS Business Count data differs from BIS Business Population Estimates in that it only includes business registered for VAT/PAYE. However ONS data allows analysis by 4 digit SIC codes, which have been used to define ineligible ERDF sectors.

[10] Based the BIS Business Population (2013) which incorporates microbusinesses not registered for VAT or PAYE. Microbusinesses account for around 40% of the registered business base (i.e. where these businesses are excluded).

- That the businesses did not want to take on additional risk (56%)
- They thought it would be too expensive (52%)
- The uncertainty due to current economic conditions (47%).

Importantly for the assessment of the finance gap, 46% of those that did not apply for finance thought they would be rejected and therefore did not apply. This compares to 43% for small businesses and just 23% for medium sized businesses[11].

The survey found that microbusinesses which *did* seek finance **encountered greater difficulties in obtaining finance** compared to small and medium sized businesses. Two thirds (66%) of microbusiness applicants obtained all that they needed, compared to 71% of small businesses and 85% of medium sized businesses. A little less than a tenth (7%) obtained some but not all of the finance they required, whereas 23% obtained no finance.

5.2.2 Business Starts

In 2012 there were 240,000 new enterprises formed in England, an increase of approximately 30,000 over the previous three years (around 15%). This increase is similar for all regions with a few exceptions. The increase for London over the past three years is 29%, whereas Yorkshire and The Humber (6%), the West Midlands, and the East of England (8%) all experienced an increase significantly below the average.

London had the highest number of start-ups at 65,000 new enterprises in 2012, over 20,000 higher than the South East and double the amount of the other regions. Taken as a proportion of the working population, London still has the most start-ups, followed by the other southern regions. The North East in particular has low start-up rate, less than half the rate of London's both in absolute value and as a proportion of the working population. Indeed, the England wide average start-up rate as a proportion of the working age population falls by 10% when London is removed.

5.3 Supply

5.3.1 Debt Finance

Given the risks and returns associated with microfinance, and the fact that microbusinesses are much less likely to have assets and a track record, this is not a market that high street banks typically operate in without public support or subsidy or the anticipation of developing a long term relationship with a dynamic entrepreneur.

Typically the level of risk and average failure rates of the investments cannot be adequately priced through interest rates so as to yield a commercially acceptable rate of return. The consultations and various reports also suggest that the reputational risks to banks from charging the interest rates required to make an acceptable return on capital are too high. It is important to note, therefore, that **even in a well-functioning market, the private sector (i.e. principally banks) tends to avoid providing finance to this class of enterprises** for the reasons cited above.

[11] Note: Small businesses are defined as those employing between 10-49 people. Medium sized businesses are defined as those employing between 50-249 people.

5.3.2 Personal Finance

Young microbusinesses also make use of a range of other sources to fund themselves, including informal arrangements with friends and family, and personal credit sources such as credit cards. There is less data on these sources, but the SME Finance Monitor does provide data on the use of these sources. The 2014Q2 survey found that:

- 13% of UK sole traders and 22% of those with 1-9 employees use personal credit cards
- 13% of UK firms with 1-9 employees and 6% of sole traders use loans and/or equity from family and friends.

Whilst there is limited data on the average amounts of finance involved, anecdotal evidence suggests that the overall volume of finance accounted for by these sources are substantial.

5.3.3 Community Development Finance Institutions

Community Development Finance Institutions (CDFIs) operate in a range of markets not covered by mainstream banks, including microloans, social enterprises and community loans. The sector is independent and self-regulated, funded by a number of sources including ERDF, local government, national government and donations.

CDFIs have experienced substantial growth in the UK since the 1990s, partly driven by the Phoenix Fund, a UK Government initiative that aimed to support the development of the sector. The sector is still very small in relative terms, with 39 CDFIs providing finance to businesses across the UK. However, in the last year there has been a significant increase in the amount lent to businesses and the number of businesses receiving funds. £52m was lent to SMEs in 2013, an increase of 72% from 2012. This has helped to create over 8,300 new businesses. The Community Development Finance Association (CDFA)[12] reports that the demand for lending has more than doubled since 2012 as the credit crisis reduced the availability from other sources, with the number of enquiries increasing from 12,900 to over 28,000.

The CDFIs have substantial reach in the country, offering both higher value and volume of loans. This has particularly been the case in Yorkshire and the Humber and the North West. According to the CDFA this is largely due to the Business Enterprise Fund (BEF). Established in 2004, the BEF "*supports new and young businesses in West and North Yorkshire with finance when they require it, and operates in some of the most deprived communities in the country*." In the Yorkshire and Humber region, a region with a particularly high penetration rate for CDFI investment, the number of businesses supported increased from 435 to 1,374 between 2011 and 2013.

5.3.4 Credit Unions

Credit unions are mutual organisations set up as community-based organisations for the benefit of a particular group or community that share a common bond (e.g. living or working in a certain area, belonging to a particular organisation). The use of credit unions has been growing strongly in England over the last 9 years, although loan values clearly remain small relative to the overall market.

[12] CDFA (2013) Inside Community Finance

5.3.5 Asset Backed Finance

Asset-backed finance is less relevant to microbusinesses than larger SMEs due to their lack of assets, but it is nonetheless an available option for some. Data from the SME Finance Monitor shows that 10% of UK firms with 1-9 employees make use of leasing or hire purchase. [13]

5.3.6 UK Government Schemes

In response to the identified gap in funding for microbusinesses, a number of national initiatives have come forward in recent years in the UK.

The **Start-up Loans** initiative is a £152 million scheme introduced in 2012 and set to run to 2015. It is targeted at 18-30 year olds in England and aims to help young entrepreneurs to start businesses, by providing them with low cost, unsecured loans (charged at 6 % p.a. over five years), as well as free business planning and access to expert business mentors. In June 2013 the scheme was extended to entrepreneurs of any age and in October 2013 was extended to Wales. As of 2013 10,000 businesses have been backed by Start-up Loans, with £51m having been lent to businesses with an average loan size of £5,700. London and the North West account for over half of the allocated loans, with the rest of the regions accounting for between 6-8%[14].

The **New Enterprise Allowance (NEA)** was set up in August 2011 by the Department for Work and Pensions (DWP). It is designed to support those out of work for six months or more who want to start their own business. The scheme provides beneficiaries with mentoring to help them develop a business plan and provide business advice in the early period of trading. Participants are provided with access to a start-up loan of up to £1,000 and also a weekly allowance worth £1,274 over 26 weeks.

By March 2014, the scheme had resulted in:

- around 2,000 new businesses being set up each month – around 46,000 in total
- 10,610 businesses being started by people aged 50 or over
- 8,590 disabled people starting their own business[15].

5.3.7 Regional JEREMIE Funds and other ERDF Schemes

Provision of microloans has been a focus for some of the key publicly backed initiatives at a sub-national level. Although, the scale of intervention varies across the regions.

Two regional JEREMIE funds have set up specific microfinance funds. The £6.5 million fund in the North East has proved popular with strong demand from microbusinesses and has invested £3.97 million up to September 2014 (61% of the total fund).

The smaller £3 million Micro Loan fund in the North West only started investing in mid 2014 and had made three investments by averaging £36,000 by October 2014. Finance Yorkshire does not run a specific microfinance fund, but these businesses can secure funding through the £27 million Small

[13] Note: Data only available at national level

[14] note: the latest available data provided by the Business Bank shows that by January 2015 £128m had been lent to c. 24,000 businesses

[15] https://www.gov.uk/government/collections/new-enterprise-allowance-campaign

Business Loan Fund which has invested £24 million to date and is understood can make minimum investments of £15,000.

The largest investment in ERDF backed microloans has been in Yorkshire and Humber, primarily through the £37 million CDFI Social Enterprise Fund which had invested just over half its available funds (£18.9 million) by 2014Q2 to 684 SMEs with an average investment of £24,000. The fund started investing in 2011 and will run into 2015. The remaining finance aimed at microbusinesses in the region have been channelled through the Key Fund for SMEs and Social Enterprises. In addition, £2 million in ERDF backed finance has also been invested in the West Midlands through three separate funds.

Table 5.1: ERDF Backed Regional Microloan and CDFI Schemes (£ millions)

	Fund Name(s)	ERDF Grant	Total Investment to Date	Total Lifetime Investment	Time Period
North East	JEREMIE Microloans	2.5	4.0	6.5	2010-14
North West	JEREMIE Microloans	1.5	0.1	3.0	2014-15
South West	South West Micro Credit	0.8	1.1	1.5	2010-15
Yorkshire & Humber	CDFI Soc. Ent. Fund, Key Fund for SMEs & Soc. Ent	20.2	21.5	40.1	2011-15 (CDFI) and 2011-13 (Key)
West Midlands	1830 Small Bus Loans, WS Loan Fund, Stoke & Staffs Bus. Loans	3.0	2.0	6.0	2012-14 (1830), 13-15 (WS Loan Fund & Stoke & Staffs)
Total		**27.9**	**28.6**	**57.0**	

Source: ERDF Monitoring Data to 2014Q2

5.3.8 Local Schemes

There are a large number of public schemes operating at a local level across the country (in some instances using Regional Growth Fund resources), targeting the provision of finance to microbusinesses (either in the form of loans, soft loans or grants). There is no single source which maps all of these schemes out, although the analysis underpinning the area overviews has outlined this provision where the information has been available to the assessors.

5.3.9 Conclusions

The available evidence presented in the literature indicates **the presence and persistence of market failure in the provision of small amounts of finance to start-ups and micro-businesses** in the UK and across its regions. The extensive consultations confirm the presence of this market failure in all regions of England, including **unmet demand in excess of the current private sector and public sector backed provision.**

There is clear evidence from the available surveys that micro-businesses encounter more difficulties in obtaining finance than larger SMEs (owing in large part to a comparative lack of collateral and/or track record). They have also struggled disproportionately in the wake of the financial crisis to secure finance from commercial banks - many are not applying for finance as they assume they will be rejected, and the average size of loan to small businesses has increased, revealing banks' preference for typically larger loans. **These trends are likely to continue, at least in the short to medium term.**

The UK government has invested in a number of schemes to provide finance to start-ups alongside ERDF backed measures. However, while this represents a sizeable investment, the Start-up Loans Fund and New Enterprise Allowance only account for two sections of a far larger market place. While regional

ERDF-and other public sector backed local funds are delivering more across the regions, this is not consistent across England and is fairly modest compared to the potential need caused by market failure.

These points combine to make a **strong case for a continuation of publicly backed investment in micro and start-up finance in the future.** Although the evidence on the precise scale of the overall gap or the finance range where the failure is concentrated is tentative, it suggests that gaps are concentrated around the £5,000 area for microfinance and up to £70-80,000 for small loans.

6 Risk Finance for Early Stage SMEs in England

6.1 Introduction

This section looks at the market for **early stage equity finance** which for the purposes of this assessment includes investment **pre-start-up through to tranches of investment and follow-on as businesses start to secure revenue**. Early stage equity finance is sought by a wide range of ventures but is primarily sought by those characterised as being at least one of the following:

- Technology or science-focussed: a significant proportion of early stage investment is sought by firms operating in medical sciences and medical technology, ICT, electronics and advanced engineering, where investment in research and development pre-start is often required.
- Research-intensive: research commercialised through spin-out firms, commercial licensing deals and joint ventures via universities and large firms forms a significant part of the demand for early stage equity finance, often requiring early stage investment in order to develop a technology, good or service to a point at which they are commercially viable.
- Innovative and growth-oriented: in addition there are early stage firms which are neither R&D nor technology focussed but which are implementing or developing some form of new process, product or service that is likely to see them grow significantly over a relatively short time span.

Each of these types of ventures can require access to external finance during various stages of their development in order to progress through to commercialisation and early growth. Grants can be needed to finance initial development and proof of concept. As the venture moves to a start-up stage significant amounts of up-front cash are required. Since the venture is pre-revenue at this stage, debt finance is generally inappropriate since the enterprise is yet to generate the cash flows required to service debt. Hence, equity investment has a major role to play in supporting ventures at a start-up and early stage to move towards commercialisation and thus to generate benefits for the economy.

These types of ventures at this early stage are typically by their nature high risk propositions, offering the potential for high return. The term "Valley of Death" is often used to describe the period in between a start-up receiving an initial capital injection and revenue generation. At this stage, significant capital and operating expenditure is incurred in setting up operations and hiring staff, whilst revenues are yet to come through. It is at this point that the venture is most vulnerable and when it can be difficult to attract sufficient funding, due to the market failures described in an earlier section, private venture capital funds tend to focus on less risky, larger deals at the later stages. Consequently, there is a role for publicly backed venture capital funds to support firms through this stage in their development.

6.2 Demand

It is in practice very difficult to assess the number of early stage ventures that exist and which require this type of finance. Many early stage ventures are yet to register as businesses and so are not picked up by publicly available datasets. On top of this, data on the stage of development a particular business may be operating at is hard to come by and the types of ventures to which early stage finance flows cut across various sectors.

The GEM data provides measures of the prevalence of entrepreneurial and early stage business activity. As a result it also provides an insight into the likely demand for early stage finance. This shows a stable rate of activity up to 2010 but an increase in 2011 to 2013 which reflects partly an increase in those entrepreneurs that have been pushed to consider starting a business post-recession as the labour markets tighten. Rates are also found to be higher on average across the Southern regions.

6.2.1 Innovation in SMEs

The extent to which young businesses are innovation active is another indicator, albeit indirect, of the potential need for early stage risk finance. The proportion of UK businesses defined as *innovation active*[16] by the BIS Innovation Survey (2012)[17] stands at around 44%. By business size, small businesses have a lower rate of innovation at 43.1%, compared to medium sized business with a rate of 50%. A fifth (21%) of businesses in the UK introduced new or significantly improved products or processes in 2012, with product innovation 8 percentage points higher than process innovation. Again, compared to medium and large businesses, small business had the lowest rate of both product and process innovation.

6.3 Supply

The supply of early stage finance is divided between research intensive technologies and more generally innovation focussed growth companies. It is not always easy given the data available and the cross over between these investment areas to estimate the scale of these individual sub-markets. Moreover, a significant proportion of financing activity is informal and therefore not picked up in many statistical sources. However, the following analysis provides a strong indication of the market space in which various suppliers are operating and the relative supply of early stage finance across sectors.

Data from the British Venture Capital Association (BVCA) suggests the supply of early stage equity finance has fluctuated notably from year to year. However these fluctuations owe in large part to a relatively small number of very large deals which can skew the data when looked at on an annual basis. For example, there are significant increases in the value of early stage investment in 2000 and 2006 which are not accompanied by corresponding rises in the number of investments made. As such, these stand as clear outliers amongst the longer term trend.

Whilst investment levels follow the economic cycle to some extent, the annual level has typically been within the range £300 to £400 million since 2000 and investment has sustained and indeed grown through the recession and since.

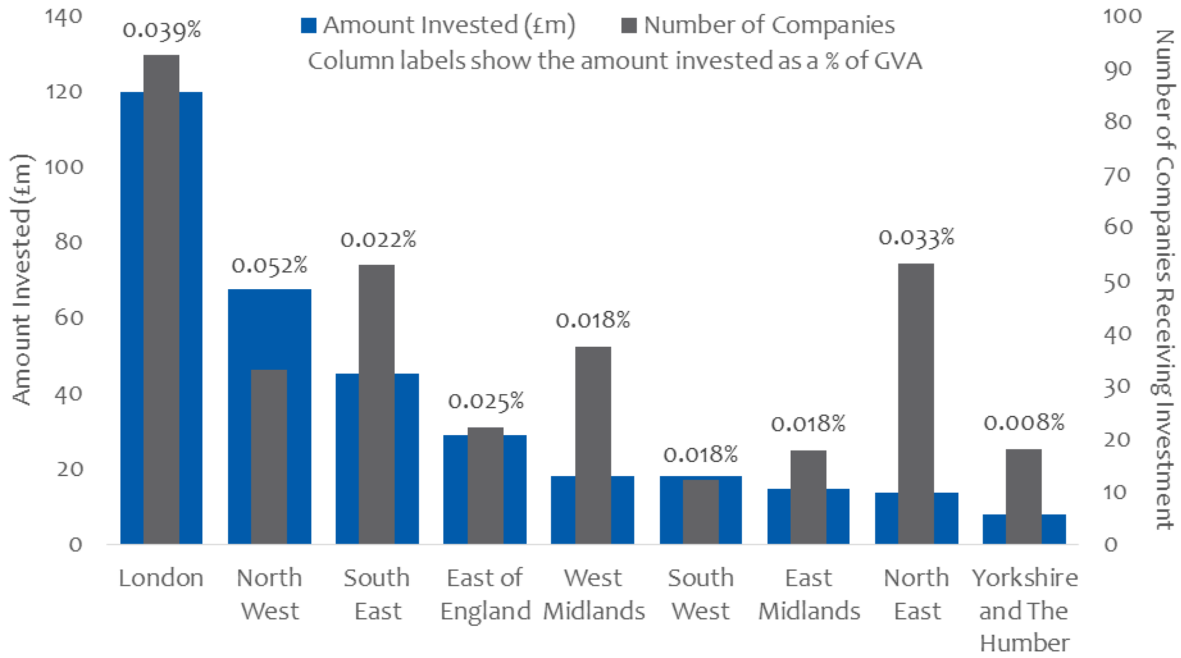
It is important to note that this data is presented in nominal terms and so where the value of investment has remained stable, when adjusted for inflation, a real terms fall is implied. It is also important to note that while BVCA data picks up investment both by private and publicly backed venture capitalists, it excludes significant amounts of angel investor activity.

London and the North West have received the largest amounts of early stage investment in absolute terms compared to other regions in the three years to 2013, reflecting a strong mix of research intensive sectors and strong investor presence in some regards. However, investment of £176 million in the North West in 2013 stands well above the £13 million invested in each of the previous years and it is not likely that this rate of investment can be sustained. While the North East received the second lowest level of early stage investment, when taken as a percentage of annual GVA, this places it third among the

[16] Engaged in either 1) introduction of a new or significantly improved product or process 2) innovation projects not yet complete 3) new and significantly improved forms of organisation, business structures or practices and marketing concepts or strategies.
[17] Data not available for England

regions. Yorkshire and Humber has seen the lowest early stage investment over the last three years – despite registering £15 million in investment in 2012, only £4 million was made in both 2011 and 2013.

Figure 6.1: Early Stage Investment - Annual Average, 2011 to 2013



Source: BVCA Private Equity and Venture Capital Report on Investment Activity, 2012

Venture capital is seen as the main source of funding for high potential, risky early stage firms in key growing sectors such as technology and physical and life sciences. These sectors are often the most innovative and where the largest investment gains are to be made, from advances in science and new technology with potentially wide reaching commercial applications.

6.3.1 Business Angels

Business angels, investing as individuals or as part of a syndicate, are an important source of finance for early stage businesses. Typically they provide finance as firms approach the point of commercialisation, when gains are potentially at their highest.

More than simply providing the finance, many business angels take an active involvement in investee businesses as board members or advisers and can themselves act as an important resource for ventures. Often having set up or managed a business previously, they can hold significant experience in particular sectors and established relationships with potential buyers, suppliers and collaborators.

The Enterprise Investment Scheme (EIS) was set up in 1994 by HMRC and looks to stimulate investment by private individuals, including business angels, by offering tax breaks. The EIS has been designed to encourage investment in higher risk early stage ventures in particular and the British Business Angels Association have recommended even higher rates of tax relief for early stage investments.

HMRC data shows the spread of EIS stimulated investment across the regions and reveals a strong concentration in London and to a lesser degree, the South East. This fits with the messages coming from the discussions with financial intermediaries across the Northern regions in particular, where the presence of business angels is seen as less prominent and scattered when compared to London and the South East.

Data from a survey of 62 business angels conducted by The UK Business Angels Association and Deloitte LLP shows that angels invested more capital in 2013 than in previous years, with the vast majority (83% of all angel capital) invested in early stage ventures and in the digital and internet sectors. London and the South East attracted the most investment, accounting for 54% of all investment, with the South West and the Midlands attracting 13% and 11%.

6.3.2 Crowdfunding

Crowdfunding has been described as "the collective effort of individuals who network and pool their money, usually via the Internet, to support efforts initiated by other people or organisation."[18]

It presents a particular opportunity for many early stage and R&D intensive ventures that may not be able to access finance through traditional sources. Delivering co-ordinated finance alongside others in this way can reduce the risk often associated with early stage investments and allow those investments to progress through developmental stages and towards commercialisation.

There are over 450 crowdfunding platforms and the model through which each operates varies. For instance, Crowdcube allows users to invest small amounts and acquire shares directly in start-up companies whilst Seedrs pools funds to invest in new businesses. Other crowdfunding sites include Crowdfunder and Kuber Ventures.

2014 NESTA research divides the crowdfunding market into three distinct types:

- **Donation-based crowdfunding:** sees investor's pool money with no return, financial or otherwise, expected. The market for donation based crowdfunding grew by 77% between 2012 and 2014. However, in 2014 it accounted for an estimated £2m of the crowdfunding platform, the lowest of any type. The average amount raised in the UK since 2011 is £6,102.
- **Equity-based crowdfunding:** where investors pool to secure equity. Of all of the crowdfunding models, equity crowdfunding is the most tightly focussed toward the early stage market. Equity crowdfunding became a far more established source of finance in the last two years. It has grown by almost 620% to reach £28 million across the UK between 2012 and 2013, and by the end of 2014 is predicted to further increase to £84 million. Furthermore, it has proven elsewhere to be a highly successful model for supplying finance; over the last seven years in Australia 83% of firms receiving it are still in business. This is significantly higher than for firms receiving other sources of finance and high also when considering a significant proportion of firms are likely to be in an early stage of development. Since 2011 the average deal size for an equity based crowdfund campaign is around £199,095.
- **Reward-based crowdfunding:** where investors stand to gain a non-financial return such as goods and services. It has emerged as an innovative means for pre-start up and newly formed businesses to generate finance while undertaking pre-market testing. Reward-based crowdfunding has also emerged as a significant source of finance in recent years. After a substantial increase of around 400% between 2012 and 2013 from £4.2 million to £21 million, it is predicted to increase to around £26m by the end of 2014. Since 2012, the average size of a reward based fundraising campaign is £3,766.

[18] Dylan Jones-Evans (2013) 'Access to Finance Review; Stage 1'. University of Wales.

Government Interventions

There are several major public investments channelling finance towards research and innovation at the UK level:

The £150 million **UK Innovation Investment Fund (UKIIF)** was established in 2009. It uses a fund-of-funds model to channel investment to businesses with high growth potential in priority sectors (including digital technologies, life sciences, clean technology and advanced manufacturing) at all stages of development. The UKIIF has raised additional private investment of £180 million.

The £100 million **Business Angel Co-Investment Fund**, funded by the Regional Growth Fund, set up in 2012 and managed by the British Business Bank invests between £100,000 and £1 million alongside business angel syndicates. In its first year it has delivered £24 million of investment to 18 firms at an average of £1.3 million per firm. Three quarters of this has been leveraged from business angels. It is able to invest up to 49% of any one investment round. Investment decisions are made by the independent Investment Committee of the Fund, based on the detailed proposals put forward by business angel syndicates.

The **Seed Enterprise Investment Scheme (SEIS)** was set up in 2012 and helps small early stage companies to raise equity finance by offering tax reliefs to investors. Investors can receive 50% relief on income tax on up to £100,000 per year as well as exemption from capital gains tax on proceeds from the sale of the investment. Any one company can only raise a total of £150,000 under SEIS. However no detailed data is available to show what the scale of SEIS investment has been.

Innovate UK (previously known as the **Technology Strategy Board (TSB)**) provides seed funding and funding for start-ups and small businesses looking to implement innovative processes or products in order to grow. Funding is delivered through a number of programmes which look to promote collaboration on innovative projects between businesses, public sector organisations and academia, or to deliver funding through competitive application, typically as a grant. In 2014-15 Innovation UK has a £536 million budget, a £96 million increase on 2013.

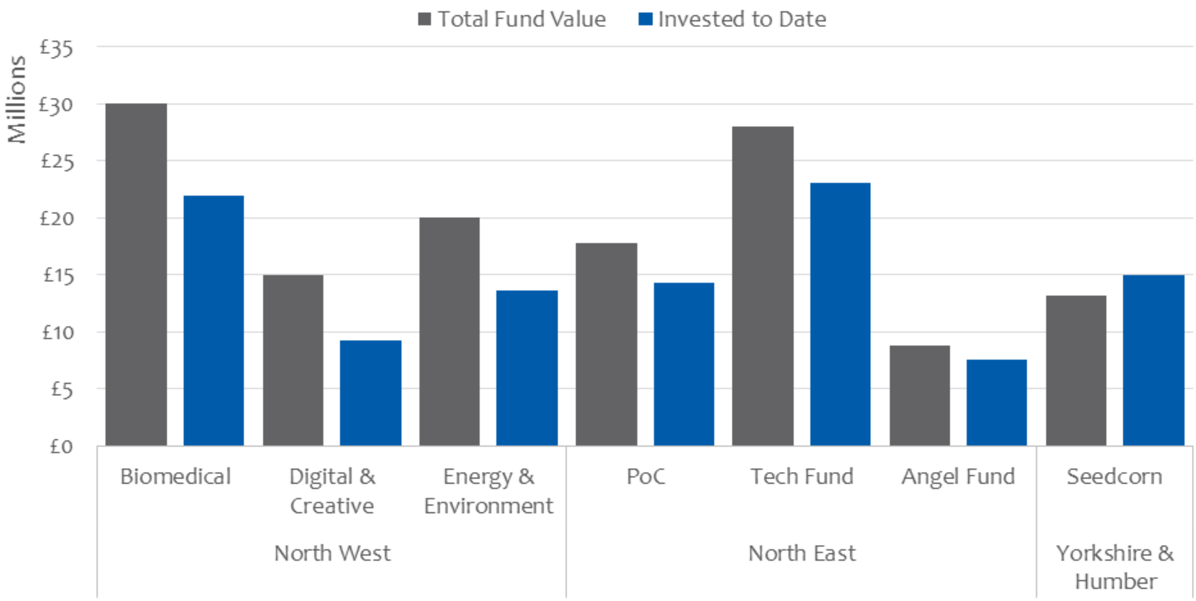
As of October 2014 the UK government has proposed legislation which will require the largest UK SME lenders to forward on details of SMEs they reject for finance to platforms that will help them link up with alternative lending opportunities.

6.3.3 JEREMIE and Other ERDF Backed Projects

ERDF is an additional source of public sector funding for early stage venture capital, although not all English regions chose to use it for such in the last programme period. The regions which have used it include the three northern English regions.

Across the three existing regional JEREMIE funds, more than £134.5 million is being directed through funds providing early stage type investments over the five year investment period. At £65 million, the largest commitment has been in the North West, where three sector specific funds have been set up alongside a larger £30 million venture capital fund (although the latter has more typically invested in later stage deals). To date the three JEREMIEs have invested just over £103 million across these funds collectively. While both having invested just under £45 million each to date in early stage ventures, the North West fund has done so at a faster rate than the North East (£12.8 million annually versus £10.0 million), having started investing around a year later in 2011. The Yorkshire and Humber Seedcorn fund has invested at a rate of £3.75 million annually.

Figure 6.2: Regional JEREMIE Funds, Early Stage Investment to Date against Lifetime Fund Value



Source: Latest JEREMIE Quarterly Progress Reports

Note: for the YH Fund the latest quarterly report made available to us is for June 2014; for NE it is September 2014. The NW Fund has provided a breakdown of investment by sub-fund as of November 2014.

ERDF has also financed early stage investment in some other regions through specific financial instruments, including the East of England through its £44 million Low Carbon Innovation Fund and in the West Midlands through its Advantage Funds.

Table 6.3: ERDF Backed Regional Early Stage Funds (£ millions)

	Fund Name(s)	ERDF Investment	Total Investment to Date	Total Lifetime Investment Target	Time Period
North East	JEREMIE POC, Tech and Angel Funds	20.8	45.0	54.5	2010-14
North West	JEREMIE D&C, Biotech, E&E Funds	32.5	44.8	65.0	2011-15
East of England	Low Carbon Innovation Fund	20.5	43.9	44.2	2010-15
Yorks & Humber	JEREMIE Seedcorn	5.0	13.2	15.0	2011-14
East Midlands	The Lachesis Fund	0.9	2.2	2.2	2009-12
West Midlands	Mercia, Adv.Media Prod, Adv. Early Equity, Adv. Early Growth	10.8	28.5	36.0	2012-15 (Mercia), 09-15 (Media), 10-13 (Early Equity), 10-15 (Early Growth)
Total		**90.4**	**177.6**	**216.9**	

Source: ERDF Monitoring Data to 2014Q2

Note: Funds have been split by finance type but there may be some overlap. For instance, many funds offer a mix of early and later stage or expansion finance as well as a mix of equity, debt and/or mezzanine finance.

6.4 Implications for FIs

Demand for early stage equity finance is hard to gauge with the data that is available. However, measures of entrepreneurial and innovation activity and spend on R&D do provide a good indication of where there is a strong presence of individuals and businesses that are most likely to seek early stage equity finance.

While many of these sources confirm the existence of a strong concentration of activity (and growth in that activity) in London and the South East, they also point to a large proportion of innovation active businesses in the South West, East Midlands and North East when taken as a proportion of the overall business base.

On the supply-side, BVCA data shows the annual level early stage equity investment to have typically been within the range of £300 to £400 million from 2000 onwards and investment has sustained and indeed grown through the recession and since. This said, the data also shows that investors have typically looked to invest larger amounts and consultation with financial intermediaries suggests that **commercial investors remain highly cautious when it comes to the earliest-stage higher risk ventures**. As a result, it appears that this is where the largest gap in finance exists.

The government has created a number of schemes designed to encourage and provide more early stage investment – most notably the UK Innovation Investment Fund, the Angel Co-investment Fund, the Enterprise Investment Scheme and the Seed Enterprise Investment Scheme. These have indeed encouraged notable sums of investment, but have gone only a small way to address the regional imbalances in that supply.

A number of early stage funds have been created under the regional JEREMIE schemes. Demand for these has typically been strong (but slow to build up in some instances) and they have gone some way to addressing the gap for early stage risk finance in these regions.

The assessment suggests a lot of effort and resources in the UK as a whole and across many regions, which has stimulated the demand for early stage funding (although this has been dampened in part by the recession). Whilst the UK Government and a number of regions have put a lot of effort in stimulating private sector provision as well as delivering public sector backed funds both nationally and regionally, **the evidence points to strong demand which is outstripping the supply of finance in a number of regions**. As the economy strengthens **this demand is expected to increase** and many LEPs will need to be able to respond to this through the prioritising and targeting of FIs on this part of the market.

7 Debt Finance for Established SMEs in England

7.1 Introduction

For the purposes of market segmentation, the focus here is **on the requirements of non-micro SMEs** (those employing 10-249 employees as the best measure of an established SME) for **external debt** based finance. However, a definition based on employment or turnover size will capture early stage businesses, although their need for finance will differ. This is reflected in the following analysis as far as possible.

Established SMEs require external finance for a variety of purposes including funding company expansion, renewal or acquisition of new assets and working capital. Loans remain the dominant form of external finance for SMEs, taking the form of term loans and overdrafts. Term loans are suited to firms that have an established trading record - evidenced through demonstrable regular cash flows and profits - and are therefore likely to be able to service regular interest and capital repayments. Term loans are typically used to finance the purchase of capital assets such as machinery, equipment and property. They can also be used to finance working capital, although overdrafts and other instruments (e.g. invoice discounting) are sometimes also appropriate. Overdrafts attached to a current account are generally used to provide a working capital buffer.

As has been widely documented in the academic and Government literature, despite their need for external finance, **established SMEs in the UK experience more difficulties than larger businesses** in accessing bank debt. Lenders prefer to use data on the potential investee's track record and credit rating along with security provided by SME assets to inform their lending decisions in order to reduce risk and avoid costly due diligence procedures. Even established SMEs can struggle to provide the necessary assurances or collateral and hence many struggle to obtain the finance they seek. As highlighted below, these issues have been magnified by the financial crisis and the regulatory pressures on banks.

7.2 Demand

There are no definitive sources of data on demand for debt finance from established SMEs. However, the size of the market can be inferred using data on the business base, along with the results of available survey data regarding the experiences of SMEs.

There are approximately 185,000 established SMEs in England, representing around 4.3% of the total business base. They account for 27% of employment and 30% of turnover in England. There has been an increase of 18,000 established SMEs in the last 3 years since the recession (2011-13).

The latest survey evidence from the BIS Small Business Survey[19] suggests that 24% of all SMEs sought external finance of some form in the previous 12 months, slightly less compared to 2012 (2 percentage points less). Of these seeking finance, a little less than a half (47%) of SMEs had difficulty in securing finance from the first source approached, 4 percent lower than in 2010.

[19] Department for Business Innovation and Skills, Small Business Survey 2012. Note that this at a UK level.

Well over a half (56%) of SMEs that applied for finance stated the main reason was to acquire capital or for cash flow reasons. 23% applied to purchase capital equipment or vehicles. Small and medium sized businesses were more likely than micro businesses to seek finance to acquire equipment or vehicles. Small and medium sized businesses were less likely to seek finance for working capital/cash flow reasons compared to micro-businesses, in part reflecting their more established cash flows. Looking at trends over time, for all SMEs the need for finance for working capital and cash flow has increased by 21 percentage points since 2006 possibly as a consequence of the economic recession and falling turnover. The need for finance for capital equipment or vehicles, to buy land or buildings, and to improve buildings has decreased since 2006 possibly reflecting the stalling of investment plans linked to the deterioration in economic conditions.

For all SMEs, the average amount of finance sought was £294,000, an increase of £57,000 (24%) since 2006 (although a significant part of this increase will be accounted for by inflation). Larger SMEs tended to apply for more finance, with small businesses applying for an average of £346,000 and medium sized businesses applying for £1.98m. The greatest proportion of SMEs applied for £25,000 or less (46% of all SMEs) whereas 11% applied for £250,000 or more. Compared to 2006, over time a greater proportion of SMEs have applied for lower amounts of finance; 32% applied for £25,000 or less and 15% applied for £250,000 or more in 2006.

Assessing the outcome of applications, 16% of small businesses and 8% of medium size businesses[20] were unable to obtain any finance, a fall compared to 2010. A further 5% and 4% of small and medium businesses obtained some finance, but not all that they needed. Overall, overdraft applications were more successful than loans, with 58% of SMEs[21] receiving the offer they wanted and taking it, compared to 39% for loans. This paints a slightly different picture to bank data which suggests a higher drop off in the stock of overdrafts than loans.

In contrast to the BIS Small Business Survey, the SME Finance Monitor provides a regional breakdown of loans and overdrafts[22]. Data is provided on the overall success rate of overdrafts and loans, but also on whether applicants received the offer they wanted and took it, or whether the loan or overdraft was taken after issues[23].

The overall success rate for overdraft applications was higher than that of loan applications in 2013, for all SMEs in England. Looking at trends over time, the number of successful applications for both overdrafts and loans has fallen since 2011. For loans, the proportion of SMEs reporting "issues" before the loan was granted has increased by 9 percentage points since 2011, a greater increase than that for overdrafts (3 percentage points). **For both overdrafts and loans, the proportion of unsuccessful**

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[20] Small businesses are defined as those with 10-49 employees. Medium businesses defined as those with 50-249 employees.

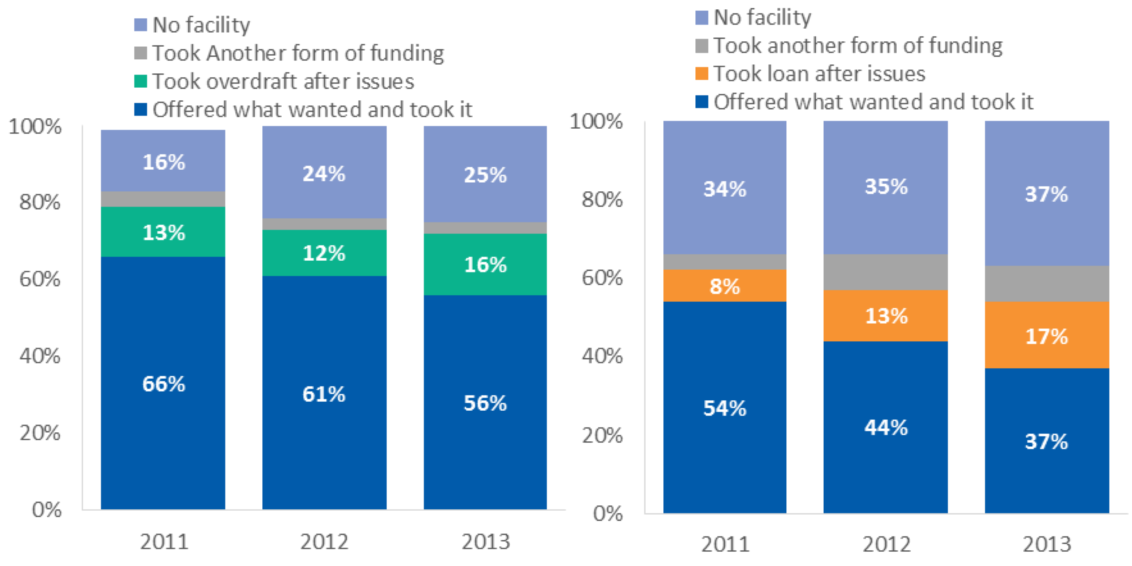
[21] Note that this includes micro-businesses.

[22] BDRC Continental, April 2014. SME Finance Monitor 2013: Annual Report. Note: survey does not provide a breakdown by size of SMEs. For data on applications of loans and overdrafts, data is still being gathered and so figures are based on small samples and should be treated with caution.

[23] "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".

applicants has increased since 2011, reflecting the continuation of very tight credit conditions facing many SMEs in the UK.

Figure 7.1: Outcome of Overdraft and Loan Applications for all SMEs in England - 2011-2013



Source: SME Finance Monitor Annual Report 2011-2013. Note: figures for 2013 are based on small sample sizes and so should be treated with caution

Looking specifically at whether applicants received and accepted the offer they wanted (i.e. took a facility without any issues), 40% of SMEs in London received and accepted the overdraft they applied for, statistically significantly lower than all other regions. For both loans and overdrafts, the rate for SMEs in the West Midlands was statistically significantly higher than rates in other regions. SMEs in the East Midlands had the lowest rate of receiving and accepting the loan offer they wanted. Banks tend to operate in a similar way across the English regions and whilst some of these inter-regional differences may be explained by differences in local demand or supply conditions or behaviour, not all of the differences are statistically significant.

Data from the 2012 Small Business Survey identifies the main reason given for having difficulties obtaining finance[24] was that SMEs did not meet lender's criteria (38%). 9% of SMEs cited a poor credit history which was lower for small and medium business (5% and 4%) than for micro businesses (10%). 15% of medium sized businesses stated having insufficient or no security as a reason, a higher rate than both small and micro businesses. This may be due to the higher amounts applied for compared to smaller and micro businesses, and so a greater importance is placed on security. This information is not available on a robust basis for the regions.

[24] Department for Business Innovation and Skills, Small Business Survey 2012. Note that this at a UK level.

7.3 Supply

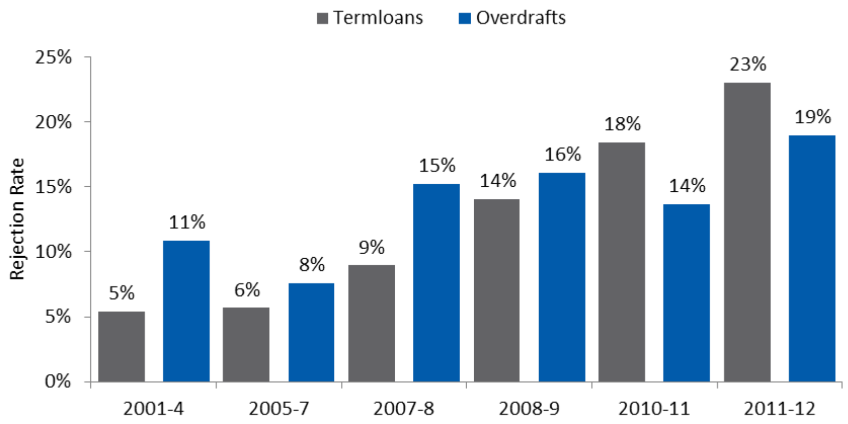
7.3.1 Bank Lending

Overall for England from Q2 2011 to Q2 2014, the total stock of loans to small and medium sized businesses fell by 2%, from £82 billion to £80.5 billion[25]. In 2014, the total stock of loans to small businesses was valued at £29 billion, whereas for medium sized business the total value was £51 billion.[26] This decreased by 0.4% for small businesses, whilst for medium businesses there was a reduction of 2.8%.

In April 2013, BIS published an independent analysis of changes in lending to SMEs from 2001-12, using data from SME surveys. One of the areas examined was rejection rates for applications for bank debt (including new facilities and renewals of existing facilities). Figure sets out the rejection rates over time.

This suggests an upward trend in rejection rates for term loans, supporting the more anecdotal evidence on bank behaviour reported by SMEs and in the press and is consistent with the data on lending to SMEs. The data shows a rise in the rejection rate from around 5% in the period up to 2007-8 to 18% in 2010-11 and then 23% in 2011-12. The rejection rates for overdrafts are more volatile, but they do suggest a rise over this period, albeit a less pronounced rise versus term loans. It is also worth noting here the anecdotal evidence that some banks have purposefully been discouraging SMEs from applying from loans or overdraft renewals, which may skew the official data on rejections.

Figure 7.2: Rejection Rates for Term Loans and Overdraft Applications made by UK SMEs



Source: BIS (2013) Evaluating Changes in Bank Lending to UK SMEs

Another indicator examined in the BIS analysis was banks' margins on their loans and overdrafts. Margins have increased significantly since the financial crisis for both term loans and overdrafts, as banks have been under pressure to repair balance sheets and increase their capital ratios.

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[25] Data from BBA Lending Statistics. Note that small businesses are defined as those that have less than £2m annual debt turnover, whereas medium sized businesses are defined as those that have an annual debt turnover of between £2m and £25m.

[26] According to BBA lending statistics.

7.3.2 Peer-to-Peer Lending

P2P lending is predominantly delivered via online platforms which allow investors to channel funds to investees without going through a traditional financial intermediary such as a bank. Typically investors are able to either select investments directly or are able to select parameters within which they want any investment to be channelled (sector or type of business/project in which the investment will be made, terms of investment etc.).

Across the UK the number of P2P lending platforms and volume at which they are lending has increased significantly in the wake of the financial crisis. Loans totalling £1.6 billion have been made through P2P platforms since 2007/8.[27] In 2014 alone the volume of P2P loans had doubled in the first half of the year. In comparison to bank lending however, this is still a relatively small amount (loans totalling £89 billion have been made since 2011 by high street banks).[28] Thus P2P lending is only around 2% the size of high street bank lending.

7.3.3 Asset Finance

Asset backed finance is an option suitable for financing the purchase of tangible assets such as equipment, plant and machinery. It works through the use of hire purchase agreements (where the firm uses the asset in return for a deposit and interest payments), operating leases (where the lessee borrows the asset, providing periodic rental payments to the lessor) and finance leases (the same as an operating lease but the lessee effectively assumes ownership of the asset). It differs from a straight loan in that the finance is either wholly or predominantly secured on the asset that is being financed rather than other sources of security. Asset finance is provided by specialist finance companies and by departments of banks.

7.3.4 Factoring and invoice discounting

Factoring and invoice discounting or invoice trading are other forms of asset-based finance, secured on the basis of current, rather than non-current, assets (i.e. invoices). A firm can strengthen its working capital position through factoring or invoice-discounting.

At the end of 2013, the Asset-based Finance Association[29] reported that its members had 43,400 UK clients using factoring or invoice discounting, amounting to £18.6 billion in factoring and £236 billion in invoice discounting business. The data show that the use of invoice discounting in particular has been growing since the financial crisis . Initial data from 2014 shows that this trend is likely to continue. This is supported by data from the 2012 Small Business Survey for the UK, which showed that of those firms seeking finance, 6% were seeking factoring or invoice discounting, compared to 3% in 2010 and 1% in 2007/08.

7.3.5 UK Government Schemes

There has been considerable effort on the part of the UK Government to attempt to increase the flow of debt finance to SMEs, in recognition of the critical role that SME finance plays in economic growth

[27] http://www.p2pmoney.co.uk/statistics/size.htm
[28] According to BBA lending statistics, 2011 - Q2 2014

[29] Note: data available at national level only.

and the constraints experienced in recent years. These interventions have taken a variety of forms, including loan guarantees by the Government to high street banks and reductions in the cost of borrowing for banks.

The key interventions are as follows:

The **National Loan Guarantee Scheme**. Introduced in March 2012 and now withdrawn, this took the form of Government guarantees on unsecured borrowing by banks, enabling SMEs to borrow at a cheaper rate. Banks were expected to pass on the entire benefit to small businesses by offering cheaper loans. Participating banks included Bank of Scotland, Barclays, Lloyds TSB, Lombard, NatWest, RBS, Santander and Ulster Bank.

The scheme was eligible to small and medium sized businesses. Whilst operational, over 28,000 loans had been offered under the NLGS by the banks who signed up to the scheme, making loans with a total value of over £5.2bn at a cheaper rate than they would have otherwise received.

The **Enterprise Finance Guarantee (EFG) Scheme**. Commencing in January 2009, the scheme provides a 75% loan guarantee for lending to SMEs lacking the security or track record for a commercial loan. It is available to SMEs with less than £41 million in turnover on loans between £1,000 and £1m repayable between 3 months and 10 years. The business pays a 2% p.a. pro-rata premium to BIS towards the cost of providing the guarantee and is responsible for 100% of the loan. It is delivered through 46 accredited lenders (including some of the UK's high street banks, Community Development Finance Institutions and invoice finance providers). At its inception the EFG scheme was expected to account for 1-2% of all lending to SMEs. An evaluation was carried out in 2013[30]. The key findings were as follows:

- Additionality: The vast majority (83%) of users indicated that they would not have been able to obtain a loan without EFG, indicating limited duplication of provision elsewhere and a high level of overall additionality. This compares to 70% and 76% found within the 1999 and 2006 evaluations of EFG predecessor, the Small Firms Loan Guarantee scheme. Survey analysis and use of control groups show that businesses receiving finance generated employment and sales growth comparable to other borrowers, indicating that the scheme had the desired effect of removing the barrier to growth presented by poor access to finance.
- Economic Effectiveness: over two to three years the scheme contributed strongly to the local economy, creating 6,500 net additional jobs (around one job per business supported) which has generated £567 million in GVA (£84,400 per business) against an operating cost of £178 million.

Overall in England as of Q3 2014, there have been approximately 22,800 loans drawn with an approximate value of £2.3 billion. In terms of the number of loans, the northern regions dominate in terms of their share, with the North West having the highest number of loans both offered and drawn per 10,000 businesses. Looking at the absolute value of loans, they are higher in the south compared to the north. The North East has a large number of lower value loans, with the average value drawn a quarter of the average value drawn in London.

Funding for Lending was introduced in August 2012, following the National Loan Guarantee Scheme, and is aimed at reducing the cost of credit and boosting the demand for, and supply of, finance to both households and businesses. It allows banks and building societies to borrow at cheaper rates from the Bank of England for periods of up to four years. Participating banks can borrow up to 5% of their stock

[30] BIS 2013, Economic Evaluation of the Enterprise Finance Guarantee (EFG) Scheme.

of existing lending to the economy. That is, for every pound of additional lending an institution advances, an additional pound of access to the scheme will be permitted for that institution. For institutions maintaining or expanding their lending the fee will be 0.25% on the amount borrowed.

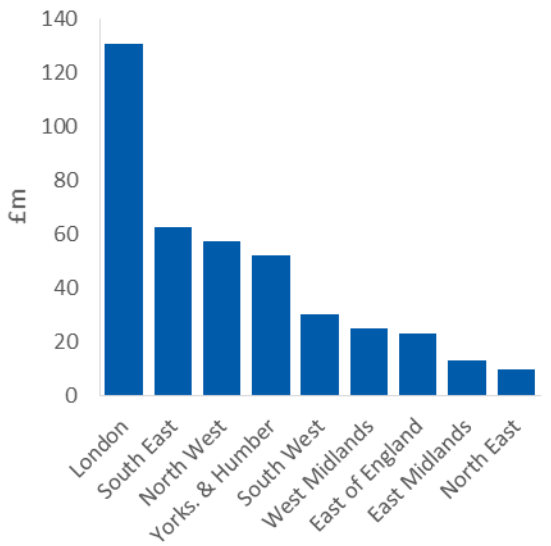
Evidence picked up from consultations with banks and stakeholders suggests that whilst the scheme has enabled some cheaper loans to be made, the bulk of this has benefited firms that banks would have invested in anyway – it has not had a fundamental impact in opening up loan finance to other firms. Thus the funding has been used as a price discounter, enabling banks to keep existing business, rather than to open up lending to firms on the margin.

In November 2013, it was announced that the scheme would cease to be available to households and would therefore only be available for funding for SMEs. It remains to be seen what impact this will have on lending to SMEs.

The **Business Finance Partnership** is a British Business Bank scheme to make capital available to small businesses in the UK through non-bank lenders (such as peer-to-peer lenders, supply chain finance lenders, asset finance lenders and debt and mezzanine finance funds). The government has invested £1.2 billion in the scheme, with an equal amount matched by private sector investment. The scheme is now closed to new applicants, however the money invested in the scheme is still being lent out. So far, approximately £425 million has been lent out to SMEs in the UK.

The **Investment Programme** is a new British Business Bank scheme which builds on the Business Finance Partnership to provide capital to existing lenders who lend to small businesses. Around £18 million has been lent to SMEs so far in the UK.

Figure 7.3: Business Finance Partnership Lending, English Regions, 2012-2014

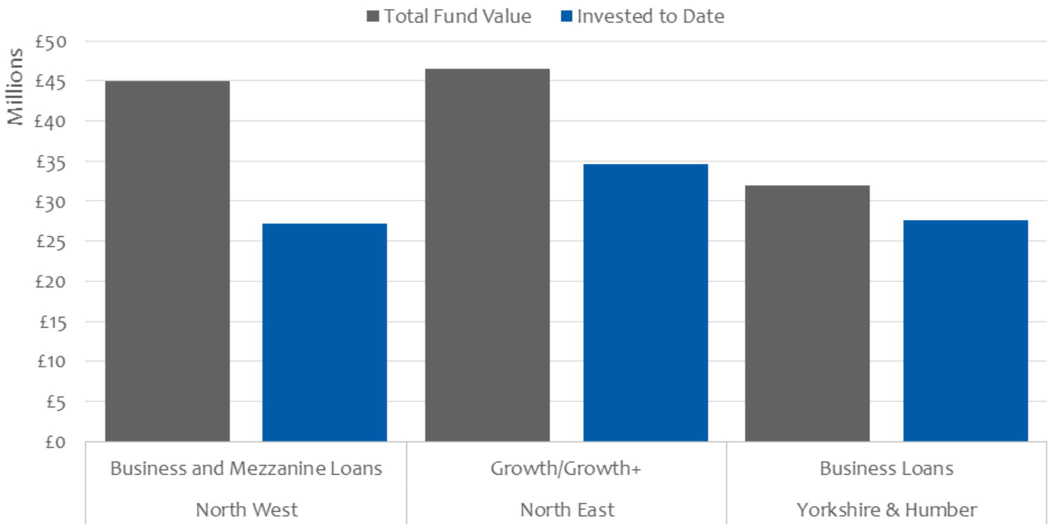


JEREMIE and other publically funded schemes

ERDF is an additional source of financial support for lending to SMEs. Unlike many of the other public sector backed schemes noted above, the initiatives funded through the 2007-13 programmes were spatially targeted.

Each of the current regional JEREMIE funds have invested large amounts in debt finance for established SMEs to date - £89.5 million in total or £23.4 million annually. In Yorkshire and Humber, the vast majority of its business loans fund has been invested in just three and half years.

Figure 7.4: Regional JEREMIE Funds, Investment to Date against Lifetime Fund Value



Source: Latest JEREMIE Quarterly Progress Reports

Note: for the YH Fund the latest quarterly report made available to us is for June 2014; for NE it is September 2014. The NW Fund has provided a breakdown of investment by sub-fund as of November 2014.

No significant ERDF backed debt based FIs have been funded outside of those regions where JEREMIE funds are operating (in part due to the challenges of securing match funding for these particular instruments). The South West Loan Fund has provided the largest scale of finance and investment at £11 million spread over four years but had invested all funds in 2013.

Table 7.5: ERDF Backed Regional Loan Funds for Established Businesses (£ millions)

	Fund Name(s)	ERDF Investment	Total Investment to Date	Total Lifetime Investment Target	Time Period
North East	JEREMIE Growth and Growth +	17.7	34.7	46.5	2010-14
North West	JEREMIE Business and Mezz Loans	22.5	27.1	45.0	2011-15
South West	South West Loan Fund	6.8	11.0	11.0	2009-13
South East	South East Sustainability Loan Fund	2.0	1.7	4.0	2010-15
Yorks & Humber	JEREMIE Business Loans	10.6	27.7	32.0	2011-14
Total		**59.5**	**102.1**	**138.5**	**0**

Source: ERDF Monitoring Data to 2014Q2
Note: Funds have been split by finance type but there may be some overlap. For instance, many funds offer a mix of finance, equity and/or mezzanine finance. Related to this the JEREMIE Growth and Growth+ funds in the North East are also included in Table 8. below.

7.3.6 Implications for Future FIs

The available evidence points to a **marked decline in the provision of debt to established SMEs**, which in part reflects a dampening of demand due to the recession but also a sharp reduction in the availability of finance through the banks as they have rebuilt their balance sheets (shaped by new EU and UK legislation).

While there are signs that the lending behaviour of banks is starting to change, the consensus view from the market and stakeholder consultations is that it will not return to pre-crisis levels in the short to medium term, if at all. **SMEs will continue to face more stringent and demanding tests of their credit worthiness.**

UK Government initiatives have played a role in stimulating increased lending across the English regions in the aftermath of the recession, as have ERDF backed provision in some specific regions. Both traditional and new alternative sources of finance have helped to fill part of the gap left by the changing behaviour of the high street banks, although some of these sources are still modest in scale and not suitable for the riskier parts of this market. New initiatives announced in the Autumn Statement 2014 will help to encourage the growth of these new alternative sources, as well as extending debt based public sector backed schemes to encourage bank lending (such as EFG).

There is strong evidence from the SME surveys of **substantial unmet demand from established SMEs for debt financing and the persistence of market failure across England's regions**. There is evidence that the market failure is less marked above £300k, but this has been impacted by the changing behaviour of banks and is arguably higher now in some locations. This may also vary to some extent between regions, but there is limited evidence of how this varies in practice. Also, as the economy recovers, SMEs are likely to expand and re-invest at an increased rate, stimulating demand for debt.

The implication of this for the design of future funds is that this part of the market has grown in recent years, is likely to continue to grow as the economy strengthens, and that it is likely to persist. **There is a strong case for allocating a higher proportion of resources to this type of finance** (providing there is the flexibility to reallocation is changes in the market require this). Whilst other additional sources of supply are emerging and the overall effect is uncertain, there are good reasons to assume that they will not remove the need for a more active approach on the part of ERDF backed FIs in this part of the market.

8 Risk Finance for Established SMEs in England

8.1 Introduction

Risk capital, also known as development or growth capital, **is a form of finance more suited to established SMEs that are seeking to expand significantly.** It is used by established SMEs to fund a variety of growth activities, including increases in capacity, service and product development, and entry into new markets, as well as major changes in ownership.

Some elements of the finance may come in the form of debt, but here **the focus is on the provision of equity and mezzanine capital.** Typically, as the term suggests, risk capital involves a higher level of risk than term lending. Whilst it is aimed at businesses with an established trading and profits record, there is an element of risk to the growth plans (for example, entering a new market or making an acquisition). The highest risk propositions tend to attract pure equity funding, whilst for less risky proposals mezzanine finance can be appropriate. Mezzanine comes in several different forms and there are various models and definitions used. Often it works through the provision of a loan but with an equity element, so that the investor can share in any upside benefit, but the business does not have to give away as much of its value as in a pure equity deal.

The British Private Equity and Venture Capital Association (BVCA) provides a useful summary of the range of different uses for equity finance – see Table 8.1 below. We have highlighted the role of expansion capital within this.

Table 8.1: Stages of Business Development Suitable for Equity Finance

Venture Capital	Late Stage Venture	Financing provided to companies that have reached a fairly stable growth rate; that is, not growing as fast as the rates attained in the early stage. These companies may or may not be profitable, but are more likely to be than in previous stages of development.
Expansion	Expansion	Sometimes known as 'development' or 'growth' capital, provided for the growth and expansion of a well-established company which is trading profitably. Capital may be used to finance increased production capacity, market or product development, and/or to provide additional working capital.
Replacement Capital	Replacement Capital	Minority stake purchase from another private equity investment organisation or from another shareholder or shareholders.

Source: BVCA Investment Activity Report 2012

There is a substantial literature on failures in the market for equity growth capital. As with debt finance, information failure is again the key issue. Here, rather than a lack of security or track record of the investee, the key issue cited is one of asymmetric information and the related transaction costs. The costs of due diligence associated with the deal process do not vary significantly with the size of the investment. Hence investors tend to focus on larger deals as the transaction costs are proportionally lower and the rewards higher. This leads to an equity finance gap for those deals that fall below the threshold.

Also the Rowlands Review of Growth Capital in 2009, found evidence that business owners may be averse to giving away a stake in their business, thus reducing demand for growth capital even in situations where it may be appropriate. The review concluded that given these issues there had been a steady movement upwards in the size of deal sought by investors, and that there was a gap for companies looking for anything between £250k and £2m and £10m in growth capital (this is in addition to the finance gap at the seed, start-up and early stage phases). This is bounded at the lower end by the investments by business angels and at the upper end by MBOs/MBIs and private equity transactions.

8.2 Demand

As noted earlier, there are currently an estimated 185,000 established SMEs in England (defined as those employing 10-249 employees), representing around 4.3% of the total business base. Equity finance tends to be suitable for a small minority of firms that have good long term growth potential but a high level of risk associated with their business plans.

The UK wide Small Business Survey found that only 2% of businesses seeking external finance were looking for equity funding, and between 0 and 0.5% were seeking mezzanine (this is likely to include very few firms seeking early stage risk capital). This has been fairly constant over time, according to previous iterations of the survey going back as far as 2006/07.

The need for businesses to secure equity investment linked to management succession is a common issue amongst mature SMEs and the ageing of the workforce will drive greater demand for business succession in the near future. A 2004 study by the Small Business Service[31] highlights that "*one-third of UK SME owners have been identified as 'vulnerable' to age-related transfer failure, and this vulnerability affects an increasing proportion of the SME owners*". Indeed, the latest BIS Small Business Survey for 2012 found that 14% of respondents across the UK were considering transferring ownership of their business over the next five years.

Access to replacement finance is a major barrier to effective succession. Generally, larger businesses (£20m plus turnover) have tended to be able to source the finance they need for their transactions (typically in excess of £5 million in value), as the deals are attractive for private equity companies and debt funders. Smaller firms, however, face more difficulties as existing management teams face difficulties in securing finance due to a lack of, or unwillingness to provide the necessary security required and the transaction values are not attractive to private equity financiers or venture capitalists. With the shift in banks' and venture capitalists' attitude to risk, this has widened the finance gap for these smaller deals.

8.3 Supply

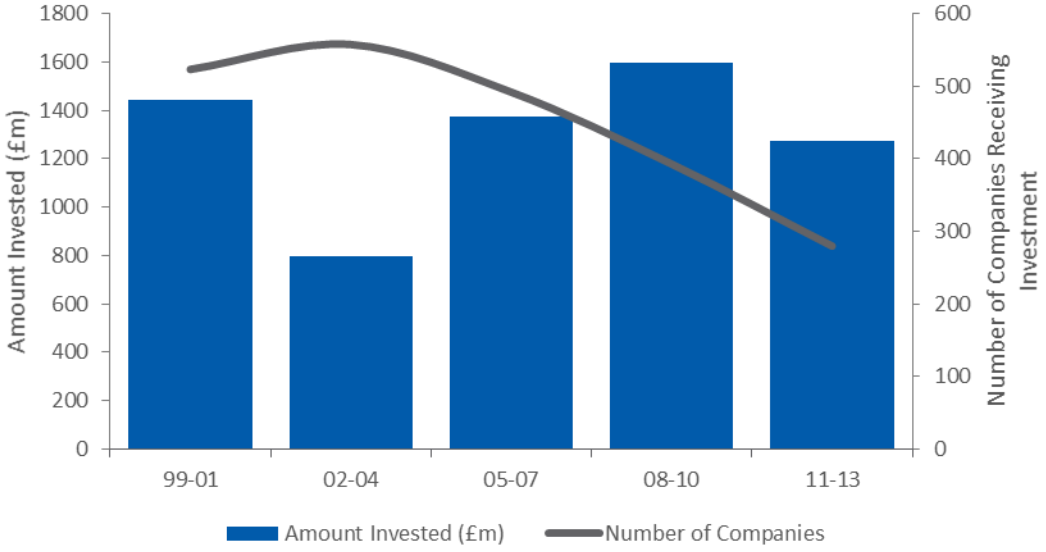
8.3.1 Private Equity Investment

The BVCA collects data on investments made by its members and records the number and value of expansion equity investments by UK region. These figures include both privately and many publicly backed funds. Expansion equity investment in the UK since 1998 has fluctuated substantially over the

[31] Small Business Service (2004). *Passing the Baton: Encouraging Successful Business Transfers.*

period. In the last few years, both the amount invested and the number of companies receiving investment has fallen significantly, particularly after 2008 and the recession from a three year annual average of £1.6 billion between 2008 to 2010 to £1.2 billion for the period 2011 to 2013. This is due to firms scaling back investment plans and cancelling or delaying risky expansion projects until the economy recovers, but also because of higher investment per firm, which is a concentration effect as part of venture capitalists' strategy of managing their risks and costs.

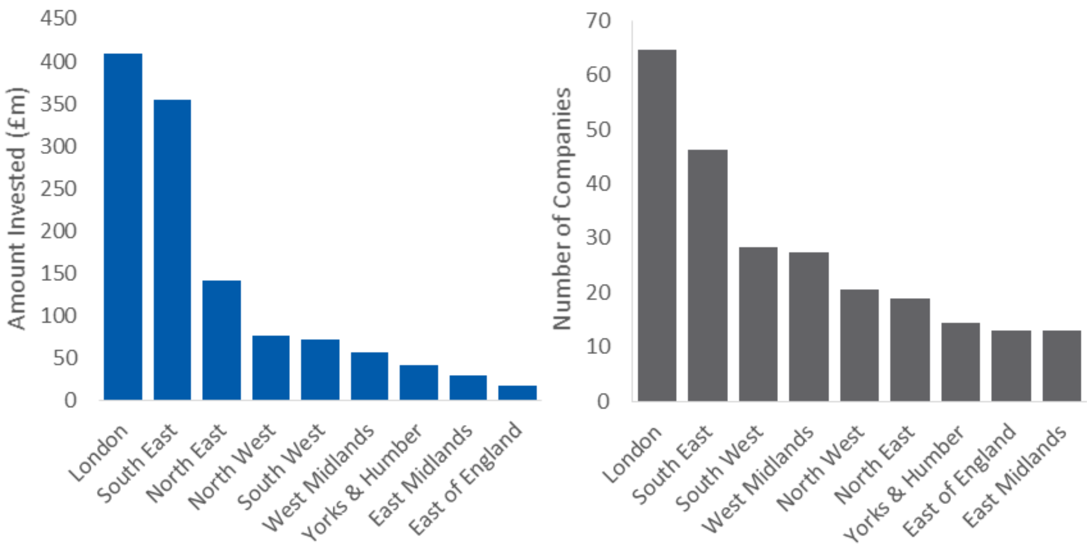
Figure 8.2: Annual Average Expansion Equity Investment in the UK, 1999-2013



Source: BVCA Private Equity and Venture Capital Report on Investment Activity, 2013, 2012 and 2007

Over the period 2011-2013, London and the South East receive the largest average amount of expansion equity investment both in value and in the number of companies receiving investment. This reflects the higher business densities in these regions. The lowest amount of expansion equity investment is in the East of England, with an annual average of only £17 million.

Figure 8.3: Expansion Equity Invested and Number of Companies Receiving Investment, English Regions, Three Year Annual Average 2011 to 2013



Source: BVCA Private Equity and Venture Capitalists Report on Investment Activity 2013

Looking at the level of investment against the scale of the regional economies, the level of expansion equity has been highest in the southern regions, particularly London and the South East, although the North East is the exception[32]. It is evident from Figure 8.3, that there are regions with large economies that are not getting a share of venture capital.

The effect of the recession on the expansion equity market comes into focus when looking at the change in the amount invested. During the recession period (2007-2009), four of the nine regions experienced negative growth in the expansion equity market. From 2010 to 2013, all nine regions experienced negative growth in the market, showing the market has yet to recover. As mentioned earlier, a likely reason for this is that firms have been scaling back investment plans following the recession. For the whole period (2007 to 2013) only in the South West, the West Midlands and the North West has there been positive growth in the amount of expansion equity invested. The largest growth has occurred in the North West, with an increase of £22m from 2007 to 2013. In the South West, it has risen by £23m from £20m to £43 million, whereas in the West Midlands investment has risen by only £2m to £41m.

8.3.2 UK Government Schemes

As well as intervening in the debt market, the UK Government has developed schemes to boost the level of equity investment in the UK. The relevant schemes include:

Enterprise Investment Scheme. Launched in April 2012 by HMRC, this offers tax relief to individual investors to buy equity in small companies. A small company is defined as having fewer than 250 employees and less than £15 million of assets. Individuals can invest up to £1 million in shares and receive

[32] The figure for the North East is heavily influenced by a large amount of expansion equity investment in 2012. Excluding this figure from the annual average, the value for the North East changes to 0.08%, more in line with the England average.

up to 30% of the investment as relief against income tax. Capital gains tax liability on disposal of an existing asset can be deferred if reinvested in EIS shares. Profit on the sales of shares can be exempt from capital gains tax. Losses arising on disposal of shares can be set against income tax as an alternative to being relieved against capital gains tax.

Venture Capital Trust Scheme. This helps small companies (defined as above) to raise equity indirectly through the acquisition of shares in a VCT. Investors in VCTs are eligible for tax relief. Maximum investment in VCT shares is £200,000 per annum. Investors qualify for relief against tax income at 30% of the level invested. Shares must be held by the VCT for at least five years. Dividends from shares are exempt from income tax and there is an exemption from capital gains tax on disposal of shares.

In 2008, The Institute for Employment Studies (IES) undertook econometric analysis on behalf of HMRC to test the effect of both of these schemes on a number of areas of business performance while controlling for other external influences. The results are summarised below:

- Business Type: Investments from VCT in Business Services firms were associated with higher fixed asset formation while both schemes generate higher employment in the sector. Firms operating across multiple sectors generate both higher sales and employment as a result of support received. Firms in 'other services' performed poorly in comparison. Older firms have been better placed to generate higher asset accumulation, employment and profit margins.

- Productivity: EIS investments tended to be associated with lower gearing and higher labour productivity, while significant effect on labour productivity was found among VCT investments.

- Profitability: No significant impact on profits was evident although testing was subject to data limitations.

- Capacity Building: VCT scheme and especially EIS are associated with growth in fixed assets, employment and sales.

Business Growth Fund: Officially launched in May 2011, BGF is Britain's largest investor of equity in established and growing SMEs (typically with a turnover between £10-100m), with £2.5bn of capital available. It is funded by five of the UK's main banking groups and is entirely independent of the government. BGF provides growth capital and typically invests around £2-10m for a minority equity stake and a seat on the directors' board of the company. BGF invests from its own balance sheet and so can offer long term funding, and further funding as the company grows. It has made more than 70 investments, providing over £400m of new capital to UK Companies[33].

The SME finance monitor provides data on the awareness of a variety of support initiatives for SME finance, including The Business Growth Fund. Of all SMEs in England, 15% were aware of fund, higher than the rate for Scotland, Wales and Northern Ireland. SMEs in the East of England were the most aware of the fund (19%), where SMEs in the South East of England were least aware of the fund (10%).

In 2013, the UK government announced policy to allow individual savings accounts (ISAs) to hold shares of companies listed on the Alternative Investment Market (AIM), as well as shares traded on other small company stock markets in Europe. This was designed to stimulate investment in smaller companies and provide a larger pool of funding for growing businesses. The latest data available from the London

[33] Barclays and BGF Entrepreneurs Index Volume Five, November 2014.

Stock Exchange[34] shows that there were 1096 companies listed on the AIM, with 879 of these from the UK. £4.85 billion has been raised in the past year on the AIM.

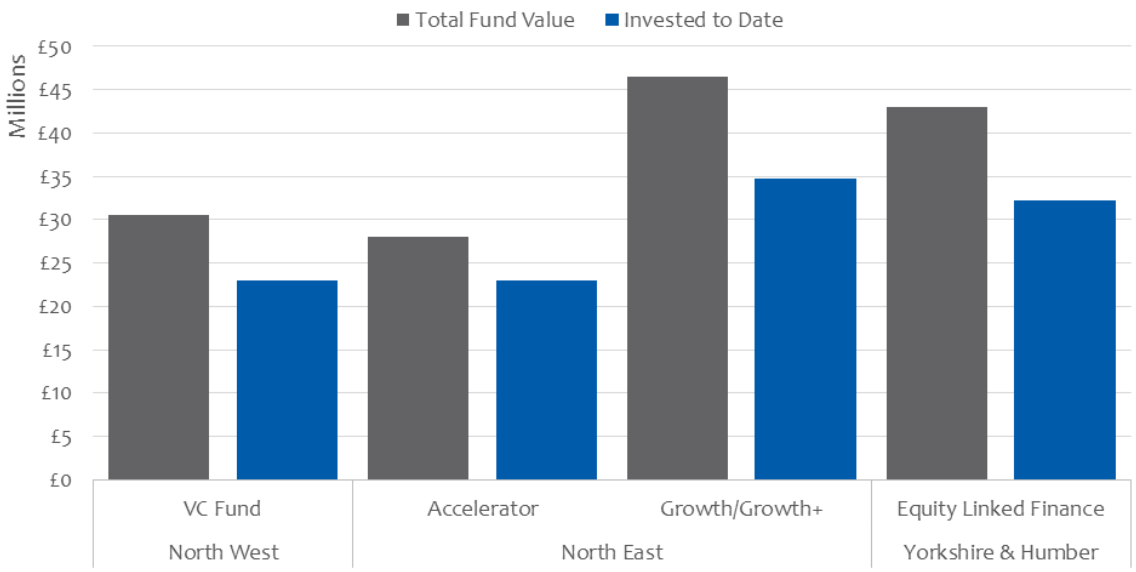
There are other UK level interventions in the early stage equity market, notably the UK Innovation Investment Fund and the Regional Growth Funded Business Angel Co-investment Fund. These are covered earlier in section 6.3.

8.3.3 JEREMIE and Other ERDF Backed Funds

ERDF has been an important source of expansion equity investment in some of the English regions. The largest funds providing this type of finance are operating in the North East, North West and Yorkshire and The Humber.

Almost £150 million is being made available through the three existing regional JEREMIE projects, through sub-funds providing expansion equity (alongside debt). Of this, £105 million has been invested to date – the largest proportion of which has been channelled through the North East fund where two major expansion sub-funds have been created.

Figure 8.4: Regional JEREMIE, Expansion Focussed Sub-Funds: Investment to Date against Lifetime Funds Available, £m



Source: Latest JEREMIE Quarterly Progress Reports
Note: for the YH Fund the latest quarterly report made available to us is for June 2014; for NE it is September 2014. The NW Fund has provided a breakdown of investment by sub-fund as of November 2014.

As is the case for debt finance, there is little in the way of ERDF-backed equity finance FIs for established and expanding businesses outside of the three JEREMIE funds. The largest investment having been the £13.2 million made through the London SME Investment Fund.

Table 8.5: ERDF Backed Regional Expansion Equity Funds (£ millions)

[34] London Stock Exchange AIM Market Factsheet, 2014 to October.

	Fund Name(s)	ERDF Investment	Total Investment to Date	Total Lifetime Investment Target	Time Period
North East	JEREMIE Accelerator Fund, Growth/Growth+[35]	20.8	45.0	54.5	2010-14
North West	JEREMIE VC & Mezz Fund	32.5	44.8	65.0	2011-15
Yorks & Humber	JERMIE Equity and Yorkshire Content Funds	20.5	43.9	44.2	2010-15
London	London SME Invest. Fund	5.0	13.2	15.0	2011-14
West Midlands	Adv. Growth Equity Fund[36]	0.9	2.2	2.2	2009-12
Total		**90.4**	**177.6**	**216.9**	

Source: ERDF Monitoring Data to 2014Q2

Note: Funds have been split by finance type but there may be some overlap. For instance, many funds offer a mix of finance, equity and/or mezzanine finance.

8.4 Implications for FIs

There is significant existing evidence at the UK level (e.g. Rowlands Review) **of the existence and persistence of an equity gap affecting established SMEs** which are seeking finance to grow or need investment to facilitate succession.

As is the case for early stage venture capital investment there is less evidence available about this finance gap from surveys of SMEs than for debt finance. In the UK, SBS survey suggests around 2% of businesses seeking external finance were looking for equity funding and when this is adjusted for the amounts of finance sought it is likely to be nearer 6-8%.

The evidence suggests that **the finance gap is structural and long term**, but when compared to markets for debt has been less affected by the recession. Much of the impact has been on the demand side, with evidence of firms postponing major investment projects. As the economy picks up, **demand for finance to support larger scale and on balance more risky expansion activity is likely to increase**. However, this is likely to be a steady increase which may take time to build up.

However, some venture capital funds in the regions have withdrawn or moved away from particular types of higher risk investment activity. It is unclear whether this situation is changing as the economy starts to grow again, but the likelihood is that these investors will move back into the market more slowly than they withdrew.

The public sector is active in addressing this equity gap at a national level through the British Business Bank and through ERDF backed interventions which are spatially targeted and concentrated in particular regions. Whilst this provision is important in helping to address the gap, the evidence points to the penetration of these activities being less in the economies more distance from London and the South East.

[35] The Growth and Growth+ Funds provide a mix of finance for established businesses and have also been incorporated into the equivalent table in Section 7 on ERDF-backed provision of Debt for established SMEs.

[36] Or Exceed Midlands Advantage Fund

In terms of the key implications for the design of the future funds, the evidence points to a **persistence (and arguably an increase) in the need for equity finance in the part of the market accounted for by market failure**. However, there is likely to be variations between regions, given underlying variation in demand and supply conditions. There is a lot of uncertainty in this regard and these factors need to be carefully considered at a regional level.

The evidence points to the gap being up to levels of finance between £2-3 million, although this varies to some degree between regions, types of SMEs and the purpose of the investment.

9 Lessons Learnt from Previous Programme Periods

9.1 Introduction

This section examines the lessons which have emerged from the review and evaluation of ERDF backed across England and other parts of the UK, as well as the other parts of European Union where they are directly relevant to development and delivery within England.

Key sources include:

- Evaluations of ERDF backed SME finance FIs, including the mid-term evaluation of the three JEREMIE funds in the North of England[37] and other available evaluations of ERDF schemes funded through the 2007-13 programme (although the number is currently limited) and other selected evaluations from outside England which are judged to be rigorous (including for example the mid-term evaluations of Scottish Enterprise Venture Fund and Seed Fund)[38] [39]
- Meta evaluations of interventions providing finance to SMEs, in particular a review of FIs by the Centre for What Works
- Overarching reviews of the effectiveness of the use of ERDF backed SME financial instruments, including the Court of Auditors[40] and the UK's National Audit Office[41].

Overall, the use of financial instruments to deliver SME finance in the UK has been positive, but there are important lessons both from within the UK and elsewhere in the European Union.

9.2 Justification for the Use of Financial Instruments

Added Value of FIs

The overwhelming evidence from the evidence collected through audits, reviews and evaluations of these financial instruments used to provide finance to SMEs in response to market failure, is that they can be very effective and efficient instruments in achieving their underlying goals. However, they are amongst the most complex ERDF backed instruments, with significant risks if not implemented in a well-planned and delivered in an appropriate manner. The following chapter provides more information on the value added that the instruments can provide, whilst the specific lessons are explored below.

Need to Balance Economic Development and Finance Goals

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[37] Mid Term Evaluation of the English JEREMIE Funds, commissioned by the Holdings Funds, 2013

[38] Economic impact of the Scottish Venture Fund: final report, Scottish Enterprise, 2013

[39] Economic impact of the Scottish Enterprise Seed Fund: final report, Scottish Enterprise, 2013

[40] Title March 2012)

[41] Improving access to finance for small and medium sized-enterprises. Report by the Controller and Auditor General. National Audit Office. 29th October 2013

SME finance initiatives, in general, serve to address both gaps in the provision of finance and a range of economic development priorities including stimulating enterprise, research and innovation, employment and regeneration. There is often a misunderstanding or lack of clarity around these two dimensions to these instruments. In developing new funds, it is important to ensure the relationship between these two dimensions are absolutely clear, as they have a direct and very important influence on ways in which finance is targeted at SMEs and the rates of return which can be expected. The evidence suggests that clarity in these aspects provides a stronger foundation for successful delivery and achievement of the underlying goals. There is merit in using tools such as intervention logic chains to ensure this clarity.

Need to Avoid a Funding Hiatus

Although not specific to the justification for FIs, most of the current ERDF backed venture capital and loan funds will be reaching the end of their investment periods by the end of 2014 although some continue into 2015. Although most LEPs and their local partners which wish to use ERDF backed FIs have been proactive in defining their needs and local priorities, it is important that this progress is continued and that the risk of a hiatus in investment activity is minimised. Some of the current Funds or legacy bodies will be receiving legacy income from previous funds which could be utilised to support investment in the interim period if necessary, but this could divert important resources from other sources.

9.3 Market Assessment and Business Planning

Importance of the Ex-ante Assessments

Drawing on the experience over the last two programming periods, the EC has clearly identified the need for the Managing Authorities to include an ex-ante assessment of the suitability and appropriateness of financial engineering instruments in the new ERDF programme for England. The Court of Auditors has in particular been critical of the shortcomings in defining correctly the financing gap of the beneficiary SMEs when designing the programmes. This aspect of the ex-ante appraisal is important in informing the development of the specific proposals which the LEPs will take forward, as well as the decision making of DCLG and the PMC.

Accounting for Uncertainty

There are few ERDF backed projects where the robustness of the market assessment and business planning is so important to successful delivery. The ex-ante assessment will provide some but by no means all of the information that partners require. This has a number of implications including the need for partners to fill any key gaps which persist following the completion of the assessment and which have a direct bearing in the design of the investment strategy. The other is the need to recognise that the market assessment can only be a guide to the gap which public sector should be using ERDF to address and it is important for flexibility to be built into the design and delivery of the FIs which enable delivery to be adjusted if circumstances change over time.

Rigorous Investment Planning

Related to this, in order to ensure a rigorous business and financial planning process, it is essential that review is built in at key points in the development and implementation of the project (in addition to the contribution which the EIB or other major funders can provide in this regard). This is particularly important earlier in the process when key decisions are taken about the design of the project. It also occurs again through the involvement of major external funders and the procurement of fund managers, with each stage offering a further opportunity to test underpinning business plan assumptions and deliverability considerations.

Need for Realism

Whilst it is important for SME finance FIs to be of sufficient scale to achieve efficiency and effectiveness in delivery (and this is outlined further below), there is nevertheless the need for realism in terms of the time it takes to set-up schemes and commence investment, as well as the scale of potential demand which exists. Whilst these matters can be tested during the business planning process, it is important to be realistic.

9.4 Fund Design

FI Models

The mid-term evaluations of the current JEREMIE fund of funds model in England and Wales concluded that the approach provides a good model which can and should be replicated in the next programming round. For reasons of efficiency and effectiveness, these funds should in most instances be a minimum of £100m in size (and the EIB has clearly indicated its desire for this to be a minimum investment threshold for funds it invests in). By implication, the funds would need to cover large geographical areas, with sizeable business bases. In most if not all instances, this will require LEP areas to collaborate across their areas, with the merits of the proposed area being clearly justified in market and delivery terms through the business planning process.

The three English JEREMIE funds have established themselves in their northern regions, in terms of valuable skills and expertise, market profile and awareness, and investment infrastructure. There is a very strong rationale for successor funds in these areas building on this expertise and infrastructure, including the ability to develop and implement new funds more quickly and cost-effectively. The recent mid-term of the Northern Ireland fund of funds scheme also supported this conclusion '*We conclude that the implementation of the Fund of Funds model has created a robust, long-term platform for the management of Invest NI's risk capital funds, creating the framework to manage the funds flexibly and to address reinvestment and other opportunities as they emerge*'[42].

The existing JEREMIE funds have tested a range of different approaches delivering investment to SMEs from which partners developing successor funds can learn a great deal. Whilst there will continue to be scope for tailoring these delivery approaches to local circumstances, it is paramount that the preferred approach can be delivered cost-effectively (well within recommended cost norms). The mid-term evaluation and the pan European review of these instruments by the Court of Auditors concluded that adopting more simplified investment, fund management and corporate service strategies and structures is one way of achieving this efficiency. This points to having a maximum of 4-5 funds of a minimum size and not using sector specific sub-funds unless there is a very good case for doing so.

As noted earlier, the proposed mix of sub-funds or finance products within a fund of funds needs to reflect the finance gaps and be shaped in part by the underpinning economic development priorities. However, it is also important that the number and mix ensures:

- That SMEs are able to access the finance they need and have a degree of choice in doing this;

[42] Interim evaluation of Invest NI Fund of Funds, Invest Northern Ireland, June 2014

- The viability of the financial instrument, in terms of servicing the match funding requirements if this is used, early returns to cover holding fund and fund management costs; and
- The scope to deliver sufficient economic development impacts and legacy to provide value for money to the public sector.

There are lots of trade-offs in this regard and project developers need to demonstrate that they have robustly assessed this through the market assessment and their business planning.

Where a fund of funds approach is adopted, there may be a case for delivering small amounts of additional finance to SMEs outside of this FI structure. This could be due to this finance having a risk profile which is not entirely compatible with that the fund of funds, or a preference amongst local partners to adopt a more localised approach. This could include CDFIs targeting social enterprises or start-ups and micro-businesses more generally, for example. Experience from the Northern regions (and Wales and Northern Ireland) suggests this can work in a sensible manner, although there is the need to clear about the rationale for this approach and its effect on the overall effectiveness of delivering the FIs.

Evaluation evidence suggests other delivery models which are not based on the fund of funds approach may be more appropriate in other areas where partners wish to adopt, for example, a smaller scale or more focused approach. The mid-term evaluations of the Scottish Enterprise sponsored Venture Capital and Seed Fund conclude that the co-finance models operate effectively. Potential delivery models will be assessed in more detail as part of the block two phase of the ex-ante assessment.

Cross Area Delivery

Irrespective of which fund model is adopted, if the approach involves collaboration amongst multiple LEPs across a range of economic areas, it is important to consider how the provision will be marketed to and ensure effective take-up and appropriate market penetration spatially. This may require the establishment of local offices in more peripheral areas or other arrangements in order to promote take-up, subject to the cost-effective of the arrangements.

The experience of all four JEREMIE funds in the UK has been that the penetration of the business base can be lower in areas which are more peripheral (e.g. parts of North Lincolnshire in the case of Yorkshire and Humber, and Teesside in the case of the North East).

Match Funding

Project developers need to explore the range of potential options for match funding ERDF contributions into these financial instruments. This will include the EIB, the high street banks, private sector equity, institutional investors and ERDF legacies from previous funds. They need to be able to demonstrate that all reasonable funding options have been considered, clearly set out the reasons for pursuing their preferred matched funding route and justify any preferential returns associated with this.

However, as we note elsewhere in this report, it is important to note that the realistic alternative funding options may be limited in practice, especially if the aim is to secure a large scale fund of funds approach. The co-financing model offers the opportunity implement single finance or fund FIs (e.g. equity funds) in the absence of large scale matched funding, securing much of the necessary match funding at the level of investment in SMEs. Whilst this model is less helpful for debt orientated funds, these have been delivered in a limited number of instances through private sector match funding from high street banks or other institutions (e.g. Invest NI Fund of Funds in Northern Ireland). However, this approach is generally not replicable due to the reluctance of the private sector to match fund these schemes.

Revenue Funding

Unlike for the ERDF backed financial instruments supported in the 2007-13 period, there is no ready source of revenue grant funding which can be used as a contribution towards the set-up and operational costs of the funds. Project developers need to carefully consider the manner in which they can secure the substantial resources (including development expertise) required to develop, set-up and meet the holding fund costs and management fees of these funds. This could include the legacies which have been returned (or predicted to be returned) from previous Single Programme and ERDF backed funds, liaising with the British Business Bank and DCLG respectively (given their responsibilities for the oversight of these respective legacies). They will also need to demonstrate how the operational costs will be funded throughout the fund life and that the associated risks have been carefully considered.

ERDF Draw Down

Unlike the previous programming period, it is now clear the new ERDF guidelines will not allow for the full draw down of the committed ERDF to the successor funds, with capital grant instead being drawn down in tranches in line with investment performance. Project developers must carefully consider the implications of this change in terms of the ability to meet the holding fund and fund management operating costs. They may need to be prepared to vary existing structures if necessary to accommodate this change.

State Aid Considerations

State Aid is an important factor in determining the scope of the funds to invest with SMEs, as it can impose a range of restrictions in terms of the proposed investment strategies. The new General Block Exemption Regulations (GBER 2014) provide some helpful additional flexibility (e.g. finance for SME succession, provision of working capital as part of a finance package), but also imposes a few additional constraints (e.g. limitations on risk capital investment to SMEs over seven years of age). It is important that project proposers are clear on the implications of these changes for their ability to meet the needs of SMEs, but also how it affects the potential demand. The ex-ante assessment may provide some of this intelligence, but by no means satisfy all requirements.

9.5 Delivery of FIs

Need for Flexibility

The involvement of the LEPs in the design and development of the successor funds is an advantage in that it offers the potential to more closely reflect the local needs of SMEs in the design of these funds. However, it also brings potential risks. It is important to avoid undermining the overall flexibility and cost-effectiveness of funds which operate cross border through imposing onerous restrictions or constraints on investment. If localised investment targets are to be set (at a LEP level), they need to reflect the balance of the availability of ERDF resource contribution whilst responding flexibility to the overall pattern of demand.

The fund of funds model provides important flexibility to move resources between sub-funds in response to changes in market need and opportunity and the performance of the sub-funds (as North East Finance has been able to do in its current fund through a retained pot for future deployment). It is very important that all project developers consider how they can secure this flexibility, effecting changes with minimum cost and disruption. The EC's intention of tranching the payment of ERDF into funds will also provide a further opportunity for switching resources to where it is most needed by sub-funds.

Brand Identity

The evaluation of the JEREMIE funds and previous SME finance initiatives has demonstrated the benefits of developing a strong brand identity and coordinated marketing for public sector backed finance advice and provision. Where these brands exist already, the partners involved in designing the new delivery arrangements need to build on these approaches and the awareness where they are proving successful. Where they don't exist, they should pursue consider the merits of these coordinated approaches in collaboration with partners across boundaries, in particular where this may make sense in terms of larger area identities.

Procuring Fund Managers

Securing fund managers who have the appropriate expertise and will deliver high quality fund management services is vital to the success of FIs. Project developers need to be aware of the strict procurement rules, but also have a well-defined strategy which sets out how they will use the procurement process to ensure they secure the skills they need and to deliver value for the funders. This may include building on the expertise and knowledge that already exists amongst Fund Managers in the region and/or drawing in new expertise which is not currently available. A lesson from the North East and North West JEREMIE funds is the creation of a framework panel for fund managers for the larger funds with multiple sub-funds.

Alignment of Public Sector Backed FIs

Proposals for new ERDF backed funds at a sub-national level need to be carefully aligned not only in terms of the finance gap but also the national initiatives under the British Business Bank (including their increased resources announced in the 2014 Autumn Statement). There is a need to ensure complementarity rather than duplication in these activities, although based on the Business Bank's current strategy and the delivery of schemes which operate on a national basis there may be little overlap at the regional level. The potential to join up the marketing of the respective offers across these providers should be exploited, including cross referral where appropriate.

In addition, there is a need to ensure that the funds are aligned with other parts of the local business support network (but also national initiatives delivered locally), especially in terms of providing SMEs with investment readiness and post-investment support. The linkages need to be clearly set out in project proposals.

Performance Monitoring

The European Court of Auditors[43] set out the need for a small number of measurable, relevant and specific performance indicators for financial instruments, covering the investment, financial and economic performance of the programmes. These measures need to be suitable and tailored to the specific characteristics of the debt and equity instruments used, rather than adapted form measures used for grant based initiatives. There is also the need for a considerable degree of consistency in the defining and measurement of these measures within the ERDF programme as a whole, to allow comparability between FIs. The ECA also suggests fixing contractually binding minimum leverage ratios and leverage dispositions for the respective holding fund or funds.

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[43] http://eca.europa.eu/portal/pls/portal/docs/1/13234738.PDF

Similarly, the National Audit Office[44] has in the past been critical of BIS's approach to the setting of objectives and targets for a range of SME finance initiatives in the UK and the basis for monitoring and disseminating progress.

9.6 Management and Governance

The operational management of FIs (as opposed to investment undertaken by fund managers) requires a high level of expertise and a considerable level of resource, especially for the larger and more complex funds (such as the JEREMIE funds). Whilst the approach and extent of the responsibilities can vary, there is a need to ensure these activities are adequately resourced, especially during the investment period (subject to ensuring value for money is attained).

Drawing on Best Practice Guidance

There is extensive and helpful guidance on the governance arrangements for investment funds, including HMG and BVCA guidance. The available evaluation evidence points to the importance of having a separate management board and an investment advisory group (which advises on the overall investment strategy), although there can be some value in common membership between the two.

Balancing a Public and Private Sector Ethos

Whilst being wholly funded by public money, the JEREMIE funds are managed by the private sector. This brings challenges of governance and accountability, with the need to balance the responsibilities of public sector funding with a commercial ethos. This is an important principle in ensuring that the funds both establish and maintain credibility with the private sector, and that they deliver the objectives set by their core funding partners. It is important that there are cleared and shared understandings of fund structures and objectives from the outset, and that these are fully reflected in reporting arrangements.

Involvement of National Public Sector Agencies

The British Business Bank brings expertise and Government money to the SME finance markets. This has been a major resource commitment by the British Business Bank and demonstrates the desire of Government to see these structures succeed. It is important to build on this expertise and the continued input of the Bank as partners design and implement future FI arrangements.

Performance Management

Whilst instilling a performance management culture is critical to the success of the funds, it needs to achieve a good balance between ensuring fund managers deliver against key targets while avoiding any excessive interference with their delivery. Project developers need to carefully consider how they can best achieve this, including governance and management structures and the systems and processes they put in place. This needs to be explicitly addressed in the preparation of the business plan, the procurement process and the development of systems.

[44] Improving access to finance for small and medium-sized enterprises, National Audit Office, December 2013 http://www.nao.org.uk/wp-content/uploads/2013/10/10274-001-SMEs-access-to-finance.pdf

9.7 Conclusions

Two decades experience of designing, implementing and closing ERDF backed SME finance FIs has provided a range of important lessons. In summary, the key points are:

- **The need to be clear on the purpose of the proposed FI, including the mix of finance and economic development goals**
- **To understand the needs of the market and the manner in which this varies between different types of SMEs (including being proactive in filling these gaps where they may constrain the understanding of market needs)**
- **To draw on the experience and resources of a wide range of partners nationally, regionally and locally**
- **Although there are benefits in range of different delivery models, the evidence points to very important advantages of the fund of funds model given the current policy emphasis on more efficient and effective delivery**
- **Be realistic about project development and delivery, including not underestimating the complexity of SME finance projects, and balancing ambition and realism**
- **In talking decisions about FI design and delivery, be aware of the cost and performance implications of these decision**
- **Ensure a performance management culture which can drive performance and reward it is an appropriate way.**

10 Added Value of ERDF Backed Financial Instruments

10.1 Introduction

This section considers the scope for the use of ERDF backed SME finance FIs to add value in delivering the ERDF programme, as well as other relevant policy objectives. This includes the potential to add value through:

- **Securing greater economic impact and value for the public sector's contribution**
- **Use of additional resources available for delivery**
- **Consistency and complementing other priorities within the ERDF programme or other ESIF programmes**
- **Consistency and complementing other EU, national and sub-national policies and programmes.**

10.2 Potential Sources and Types of Added Value

Providing Much Need Finance

The fundamental objectives of the ERDF backed SME finance FIs is to provide finance which SMEs are unable to secure due to a range of market failures. The financial crisis of the late 2000s has extended these markets failures, arguably both in the absolute finance gap and the range of finance which SMEs are unable to secure.

The overwhelming evidence from a range of evaluations of the non-grant based SME finance FIs which have been implemented over the past decade is that they have been effective in this specific goal of providing finance to SMEs. Indeed, the Mid Term Evaluation of the northern JEREMIE funds[45] concludes that the funds have played a very significant role in providing finance to SMEs, most of which would not have been forthcoming in such challenging economic and market conditions.

High Levels of leverage.

A marked feature of many SME finance FIs is their ability to lever in substantial additional investment, both in the creation of the fund (drawing in institutional investors such as the EIB in the case of JEREMIE) and also through individual investments in SMEs on a deal-by deal basis (as gap funders, these FIs typically, although not always, invest alongside other funding partners such as banks, venture capitalists, factoring companies etc.).

Developing Financial Expertise in the Regions

The ERDF backed FIs also potentially play another important role in terms of the scope to draw financial market and investment expertise which would not otherwise be in the regions. Many of the regions outside of London and South East, aside from some clusters in the major regional centres, have lacked sufficient expertise in more specialist forms of finance and investment. This has been one of the factors which have limited the access to these types of finance for these areas and in some regards counts as a market failure.

The larger funds, especially the funds of funds, have enabled indigenous fund managers to grow, often recruiting expertise from outside their own regions, as well as drawing new fund managers into the

[45] The Mid Term Evaluation of the English JEREMIE Funds, The JEREMIE Holding Funds, 2013

regions. For example, Finance Wales, an experienced fund manager, now runs public sector backed funds in the North East and North West. The North East has recruited specialist early stage fund managers from outside the region to run a number of the JEREMIE funds and the evaluation pointed to the potential for these managers to remain in the region in the future irrespective of the availability of ERDF backed funding.

There is a requirement for a great deal of expertise and professionalism in designing and delivering the larger public sector backed instruments. The emphasis which the EU and UK Governments have placed on more effectiveness FIs has helped to ensure that some of the hard lessons from previous activity are learnt and acted upon. The involvement of the EIB in a number of these funds, but also a number of other private sector investors, has helped to ensure more rigour in design and delivery.

Stimulating Private Sector Provision

Linked to the above point, the available evaluation evidence also points to the role that the ERDF backed FIs can play in stimulating a more active private sector investors, including angels and venture capitalists, in the regions in which they operate. This occurs for a number of reasons, including the scope of ERDF backed funds to create new opportunities for coinvestment, some of which will be attractive to investors both in and outside the region. The involvement of the public backed funds helps to reassure the private sectors, as well as helping to share risk. At a very practical level, the fund managers running ERDF backed funds in the regions often have connections with other investors outside the region with whom they can propose coinvestment or even promote deals which they would not be able to invest in themselves.

On this point, the mid-term review of the Northern JEREMIE funds concluded "*the funds have played a role in stimulating a more active private corporate finance sector in the regions (especially in the North East), but this has been less than might have occurred if the market conditions were less challenging*" (during the recession, that is).

There is the potential for the ERDF backed FIs to displace or crowd out private sector investment activity. The evaluation evidence in England over two programme periods, although subject to a range of limitations in its coverage of this particular issue, suggests that whilst crowding out may occur it is largely at the margins. The mid-term evaluation of the JEREMIE funds pointed to not only fairly limited displacement of the private sector investors, but much less scope for this to occur given the economic climate. The findings also point to the importance of a well-designed investment strategy, the role of State Aid rules and practical deliver rules which help order to promote additionallity.

Driving Economic Impacts

ERDF backed SME finance FIs can be used to achieve a range of desirable economic development impacts, through addressing market failure in the provision of finance to SMEs and stimulating the awareness, demand for finance and investment readiness of SMEs.

The mid-term evaluation of the Northern JEREMIE programme provides the most comprehensive and consistent analysis of the emerging gross and net additional economic impacts of these funds mid-way through their investment periods. It reaches the following conclusion:

"The analysis of the SME beneficiary survey has also informed an initial assessment of the emerging net additional economic impacts (allowing for finance deadweight and economic displacement) and the associated value for money. The limitations of the analysis and the survey data it uses need to be borne in mind and hence the estimates should be interpreted with caution. The analysis indicates that the unit costs

associated with the achievement of job creation and gross value added are reasonable at this stage in the life of the funds, but offer considerably better value for money than grant finance or soft loans".

The available evidence on the extent to which these instruments achieve other economic development objectives such as stimulating research, innovation and enterprise activity more generally is also positive. However, these goals are achieved more effectively where FI activity is accompanied by other measures (e.g. business support) to stimulate demand side awareness and capacity.

Although the evidence is generally positive a review by the Centre for What Works notes the gaps in the evidence: *"While most programmes appear to improve access to finance, there is much weaker evidence that this leads to improved firm performance. This makes it much harder to assess whether access to finance interventions really improve the wider economic outcomes (e.g. productivity, employment) that policymakers care about.[46]"*

Legacy Returns

One of the key strengths of using ERDF backed FIs to provide finance to SMEs rather than grant mechanisms (of soft loans for that matter) is the potential to secure so called legacy returns for the public sector investment of revenue and capital grant. The real advantage of this is that the legacies can be recycled into future SME focused FIs and hence support additional and on-going investment with SMEs.

The FI models which have been developed over the past decade have been designed specifically to deliver these legacies. However, the ability to secure these legacies will depend upon the nature of the model, the underpinning investment strategy, the economy cycle in which investment occurs and the effectiveness of fund management activity.

Whilst the earlier funds operating in previous programming periods have been criticised by the modest or lack of legacies, these periods have been an important learning period for project developers and delivery agencies in the UK. Indeed the UK has set the pace in Europe in aspects of these instruments.

The current experience in the 2007-13 ERDF programme period is on balance more positive despite the impact of the recession delaying progress, although it is still early days in the realisation period of the equity backed FIs. The current projection is for legacy returns of £350 million, with over a half of this accounted for by the three JEREMIE funds. Although positive, this data needs to be treated with caution at this stage as it is still fairly early days and has not been subject to rigorous independent examination.

Demand Side Effects

The general conclusion is that the ERDF backed FIs help to secure a range of demand side benefits, including raising awareness of the range and relevance of finance options available to them, helping to raise investment readiness and ensuring effective business management. Although there is limited survey evidence to demonstrate the extent to which these effects are realised, the anecdotal evidence from our consultations is supportive.

The experience of North East Finance suggest that the investment readiness activity which has been run alongside the JEREMIE programme has been important to ensuring a flow of good investment ready

[46] http://whatworksgrowth.org/policy-area/access-to-finance/#.VJPaxnpAMg

propositions (although restricted to smaller enterprises which have less experience and management expertise in-house. NEF is keen to run a similar programme in the new programme period.

The extent of finance awareness and investor readiness can be an issue where areas have not previously been proactive in running SME focused FIs or related business support initiatives. This is the case to some extent in the East Midlands region and is one reason for an interest in pursuing these interventions alongside any FIs which may be implemented.

Consistency with Other Interventions

The approach to the delivery of sub-national economic development has been devolved to the LEPs in England. As noted earlier, these have been tasked with developing comprehensive economic strategies for their areas, including the plan for the ESIFs. The guidance which DCLG has provided to the LEPs covers the development of their plans for the use of SME finance FIs, including the need to coordinate these to the plans of their neighbouring LEPs, as well as the measures they pursue around business, enterprise, and research and innovation more generally.

Whilst the consistency of these plans will need to be thoroughly tested as their detailed plans become clear, DCLG has tested this through their initial review process. Our review of the LEPs plan in each of the area reviews suggests that in general there is good consistency in all regards.

A similar issue of consistency arises with the other SME finance initiatives which are promoted by the British Business Bank. The Bank is very active in supporting the delivering of a range of debt and equity products through the private sector, and additional support was announced in the Autumn Statement 2014. Many of these interventions operate at a national level and are not specifically targeted or allocated sub-nationally. This helps to promote consistency between ERDF backed provision and minimise potential overlaps, especially in the areas which pursue more active use of ERDF to support FIs.

There has continued to be a use of mostly small FIs at a local level, often managed through local authorities, with a particular focus on microfinance, small loans or grants. Although there is not a complete picture of how many of these schemes exist or the precise basis of their operation (unless they are ERDF backed), our understanding is that the overlap between them and the larger ERDF backed regional schemes is limited. They can be important in filling localised gaps which these regional schemes would struggle to address.

More recently, a number of RGF backed schemes have emerged, operating at a regional or LEP level. A number of these are large in their overall scale, the amounts of finance available to individual SMEs, and hence the potential overlap with ERDF backed instruments. The area overviews suggests that many of these are filling gaps which ERDF backed activity is currently not addressing and will cease investing in the next 2-3 years (depending upon the precise arrangements and proposals for use of legacies). Clearly, the investment strategies for the new ERDF funds need to take account of these factors.

11 Overview of Finance Gaps and Need for Intervention

This section draws together the analysis from the preceding chapters, as well as the recommendations in the area overviews, in order to set out the emerging conclusions about the scale at which ERDF backed finance should be provided to SMEs in England through FIs.

11.1 Market Failures and the Finance Gap

Sections five to eight analysed the demand and supply conditions affecting microloans, early stage risk capital, and debt and equity for established growing SMEs, based on desk based analysis and extensive consultations. The analysis concluded that:

- **There are significant structural market failures affecting parts of the finance market for SMEs**
- **Whilst these market failures vary across England to some extent (for example, access to private venture capital can be better for some classes of SMEs in London and the South East for example), they nevertheless exist and restrict access to finance for start-ups and growing SMEs across England as a whole**
- **The financial crisis has exacerbated these issues facing SMEs, especially in terms of the behaviour of the high street banks which have both reduced their lending overall and concentrated on lending larger amounts to less risky SMEs as part of their strategy of rebuilding their balance sheets**
- **Survey evidence points to SMEs in England experiencing more difficulties in securing the finance they need for working capital and new investment over the past 3-4 years**
- **As the economy recovers, the evidence points to an improvement in the level of business start-up, the growth of existing SMEs and indeed an upswing in business confidence, which is feeding into a greater demand for external finance**
- **As a consequence there is a substantial finance gap affecting SMEs even allowing for the range and scale of public sector backed initiatives that are operating in this space (although many of the existing ERDF backed schemes have now or will cease investing in 2015).**

Drawing on existing survey evidence, our analysis points to around **£1.6 billion per year of theoretical unmet demand for external finance from SMEs, assuming on a fairly cautious basis that 10% of the businesses seeking and unable to secure finance are viable.** This is unmet demand for finance over and above what the private sector and public sector backed providers (including ERDF backed schemes) are already providing to start-ups and SMEs. Our best estimate is that between 8-10% of this finance is equity based, although quasi equity such as mezzanine finance will be in addition to this.

To put this in context, the ERDF backed FIs which have been financed through the 2007-13 programme are forecast to make total investments with SMEs of around £650 million (up to the end of 2015) or an annual average of c£110 million based on an indicative six year investment period. Whilst ERDF is making an important contribution in addressing this potential gap, it is clearly on a fairly small contribution.

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. The reasons for this include:

- 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).

It should also be borne in mind that there are various national, regional and local public sector initiatives that are already targeting part of the market where market failure occurs and where we presume the best economic returns and VFM can be secured, although some of these are time limited and in the case of ERDF backed schemes most will cease prior to the next round of ERDF backed FIs.

The sub-national assessment work undertaken to date has been informed by extensive analysis of existing data and consultations with business and finance representatives across the regions. This has been informed by an area assessment framework, set out in Annex Two, which has been applied as consistently as possible across the nine English regions, although in practice there are significant variations in the available evidence which is a vital part of the assessment across the regions. Once completed as part of block two, the area assessments set out in the annexes will identify a sensible investment range within which ERDF backed FIs should be operating.

Annex One - Comparison of the Penetration of SME Finance by Region

The purpose of this section is to provide a comparison of take-up of SME finance by region. Although the finance types cannot be organised on exactly the same basis as the categorisation of finance used in section 5-8, we have benchmarked by broad debt and equity based finance types.

The provision of finance is benchmarked against the size of the SME base and Gross Value Added. In doing so, the limitations of the analysis should be borne in mind, for example:

- The annual average is based on the last three full years (2011-13), although the timing of the period does vary to some degree by finance type due to the availability of the data
- The benchmarking of the regions on the basis of regional GVA and the SME base is only intended to be indicative and may be influenced more in some regions than others by the performance of these bases (e.g. GVA is London is heavily influenced by the performance of non-SMEs based in the region)
- For some types of finance there is not a clear cut distinction between debt or equity provision – for example, some forms of equity finance also includes significant amounts of debt finance.

In absolute terms, the volume of debt based investment is largest in London, representing just under a quarter of all debt investment in England. Compared to the GVA of each respective region, the highest rate is in the South West. The North East and the East Midlands also have notably higher volumes of debt finance compared to their economies in comparison to the national rate. In comparison to the SME base in each region, the North East and South West have an investment rate far higher than the national rate. The East of England has a notably lower rate, 50% lower than the national rate.

Table 0.1: Regional Benchmarking of Take-up of Private and Public Sector Backed Debt Finance by SMEs

	Average Annual Investment, £m	Average Annual Investment (£) per £1m of GVA	Investment per SME (£)
North East	1,150	26,950	31,900
South West	3,500	34,360	31,000
London	5,550	17,970	29,450
East Midlands	1,900	24,080	22,950
Yorkshire and Humber	2,050	21,770	22,500
West Midlands	2,100	21,340	21,250
North West	2,650	20,320	21,700
South East	3,050	15,130	16,800
East of England	2,600	22,390	13,050

England	24,350	20,770	23,600

Note: a detailed coverage of the sources and coverage of the data is provided in the Appendix. Figures may not sum to England total due to rounding.

The overall volume of equity investment is substantially lower than that of debt finance. London has the largest average annual investment, followed by the South East, reflecting both strong demand and the presence of substantial private sector provision. Taken together, they represent 65% of the total average annual equity investment in England. Compared to both the size of the economy and the business stock in each region, investment is highest in the North East, double the national investment rate.

Table 0.2: Regional Benchmarking of Take-up of Private and Public Sector Backed Equity Finance by SMEs

	Average Annual Investment, £m	Average Annual Investment (£) per £1m of GVA	Investment per SME (£)
North East	180	4,340	5,660
London	980	3,160	5,190
South East	540	2,670	3,030
North West	220	1,680	1,740
South West	140	1,360	1,190
West Midlands	120	1,260	1,140
Yorkshire and Humber	100	1,080	980
East of England	110	**910**	910
East Midlands	70	**850**	910
England	2,330	1,980	2,420

Note: a detailed coverage of the sources and coverage of the data is provided in the Appendix. Figures may not sum to England total due to rounding.

Overall, the take up of British Business Bank schemes is higher than the take up of ERDF backed schemes. Compared to the GVA of each respective region, Yorkshire and Humber has the highest average annual investment of British Business Bank backed finance, with the North West the only other region with an investment rate higher than the national average. Compared to the SME base in each region, all of the northern regions as well as London have an average investment rate higher than the national average. The East of England has the lowest investment rate, 40% lower than the national average.

Looking at the investment of ERDF backed finance, the volume of investment and the investment rate in comparison to the GVA and size of the business base in each respective region is highest in the northern regions, primarily due to the JEREMIE funds operating in these regions. Notably, ERDF backed finance has had little penetration in the East Midlands and the South East.

Table 0.3: Regional Benchmarking of Take-up of British Business Bank and ERDF Backed Finance by SMEs

	British Business Bank			ERDF		
	Avg Annual Investment, £m	**Avg Annual Investment (£) per £1m of GVA**	**Investment per SME (£)**	**Avg Annual Investment, £m**	**Avg Annual Investment (£) per £1m of GVA**	**Investment per SME (£)**
Yorkshire and Humber	£106	£1,140	£301	£21	£223	£59
London	£245	£793	£292	£3	£9	£3
North West	£134	£1,028	£280	£28	£212	£58
North East	£34	£820	£254	£31	£750	£232
South East	£165	£815	£209	£-	£-	£-
East Midlands	£61	£771	£196	£1	£7	£2
West Midlands	£69	£703	£183	£15	£156	£40
South West	£83	£812	£177	£2	£24	£5
East of England	£72	£618	£142	£3	£24	£5
England	£1,000	£852	£235	£104	£89	£24

Note: a detailed coverage of the sources and coverage of the data is provided in the Appendix. Figures may not sum to England total due to rounding. In some instances, the data is too small to be reported

Annex Two - The Assessment Framework

11.2 Finance Gap Assessment Framework

11.2.1 Introduction

It is important to be clear on the framework which will be used to assess the finance gap and associated market failures before commencing the detailed assessment. The framework and thus the method used needs to flow logically from the theoretical market failure arguments that underpin the rationale for public sector intervention in the SME finance market.

The challenges of the assessment include:

- The inability to directly and reliably observe the finance gap and in particular the part of this gap that is due to market failure
- The limitations of the published data available on the demand and supply of external finance for SMEs at a regional and sub-regional level within the UK
- The economic geography of finance markets and the complexity with which these operate across the UK and regional and sub-regional economies
- The scope which public sector agencies have to prioritise different parts of this finance gap given their local economic development priorities, as well as their attitude to risks and returns (which, for example, tend to be higher for early stage finance than debt)
- The dynamic nature of finance markets and the difficulties of predicting the nature and scale of gaps in provision over the period in which any SME Finance Funds will run
- The uncertainty on future economic performance of the UK and its regions.

Acknowledging these challenges, the framework set out below draws on economic theory focused on the provision of finance to SMEs, as well as published guidance on the assessment of the finance gaps.

In this instance, the core requirements for the assessment are:

- Whilst recognising the limitations of focusing on any particular spatial scale, the main focus of the analysis will be at a regional level. However, where appropriate, the analysis will draw out factors which are relevant to the potential form of intervention at a lower spatial scale.
- A consistent assessment approach across regions, allowing for the differing evidence base between regions.
- Given the analysis of the finance gap, a quantification of scale and type of finance which ERDF backed instruments should be targeting, allowing for the considerable uncertainty and range of other factors which will influence this.
- Distinguishing the need for finance by stage of finance as far as is practical and appropriate, in particular debt for micro- businesses, early stage risk finance and both debt and equity investment for growing, established SMEs.

11.2.2 Finance Gap Framework

The market assessment framework is based on market failure theory in SME finance. The framework has three conditions, which need to be met in order to make the case for the existence and scale of market failure in each market segment over the timescale being considered (2014-20):

- **Condition 1:** Evidence of unmet demand, that is, that there are a significant number of SMEs that are failing to secure the finance they are seeking from mainstream sources or are discouraged from seeking finance due to the expectation of refusal. This is a necessary condition for market failure, but is not sufficient, since a certain proportion of SMEs will always fail to obtain finance as their business plans are unviable (i.e. the risk of failure would be too high to justify publicly funded support for them). Unmet demand can be demonstrated through recent survey evidence of SMEs and consultations with advisers and finance providers.
- **Condition 2:** Evidence of value for money from public sector led interventions. This requires that, on average, the returns from investing in a sub-set of this class of firms can under reasonable assumptions be expected to justify the costs – that is, they offer good value for money for the public sector. This takes in both pure financial returns and the wider economic development returns (for example, in the form of net additional GVA or softer measures such as enhanced innovation). The balance between the financial and economic returns will vary by market segment. For instance, it can be expected net financial returns to be negative for microloans but positive economic development outputs may outweigh this. Some insight into this can be gained by considering the performance of existing funds operating in the regions.
- **Condition 3:** Evidence of persistence of conditions 1) and 2) over the period of the ERDF backed interventions. Finally, if it is evident that these two conditions are currently met, it needs to be examined whether the conditions can reasonably be expected to continue to hold over the investment period being considered. This is largely a matter of judgement, drawing on the views of a range of stakeholders on future demand and supply, as well as macro-economic forecasts where available.

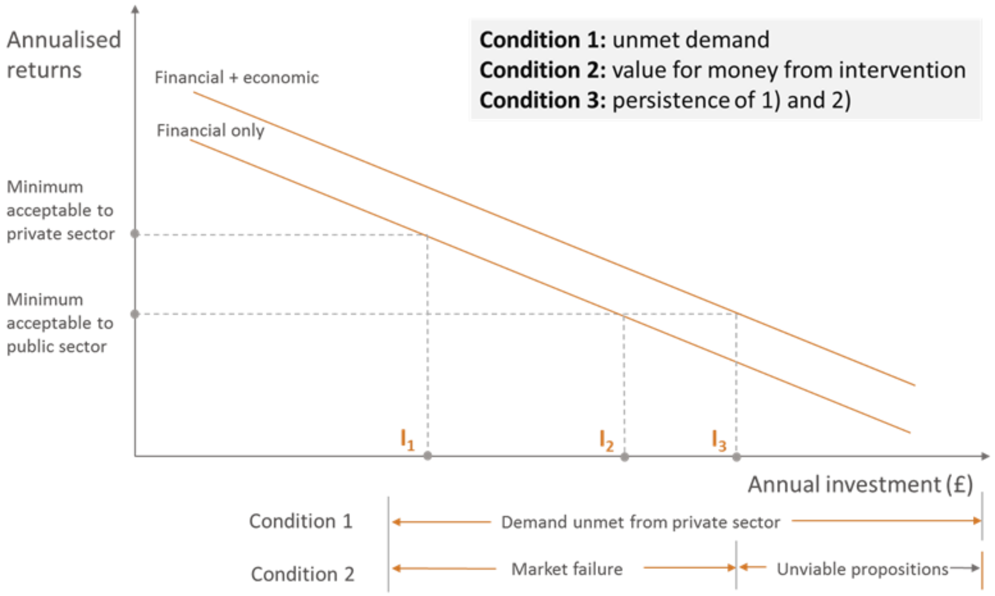
This framework is summarised in Figure A2.1 below. Annualised returns on investment are shown on the vertical axis and the value of investment made on the horizontal. The general assumption is that there are diminishing returns: as more money is invested it will be increasingly difficult to find good quality propositions, so overall returns fall.

The challenge is therefore to estimate, given the prevailing behaviour of the private sector, how large this area of market failure is. If condition 2 is met then this effectively gives a lower bound –the scale of market failure is at least as large as this level of investment. Testing at what point I3 would be reached is much more a matter of judgement and building on the experience of existing funds where possible.

Under a perfect information scenario, the private sector invests up to the point I1, where the financial returns are at least equal to their minimum acceptable rate of return. Since information is imperfect and asymmetric, in practice at somewhere to the left of this point firms find it difficult or impossible to secure the external finance they need from mainstream sources, as private providers start to ration credit around this point. Any point to the right of I1 is therefore demand unmet by the private sector (Condition 1 in the framework). This can often be inferred from surveys of SMEs, although this evidence source is more extensive for debt finance than venture capital.

From a cost-benefit point of view, the public sector is interested in investing in order to secure the wider economic development benefits, as well as some level of financial return for a legacy fund. Once point I2 is reached, the financial returns alone from further investment are below the minimum acceptable return to the public sector. At any point to the right of this, there is therefore a net financial cost to the public sector. But assuming that further economic benefits can be secured from further investment at an acceptable cost to the public sector, there is a market failure rationale for further investment. Therefore, the public sector may invest up to the point I3, where the sum of the financial and economic returns is equal to the minimum acceptable return to the public sector. Further to the right of I3, the investments will not represent value for money for the public sector under normal circumstances. On this definition, this portion of unmet demand does not represent market failure and is not therefore part of the target market for a publicly backed Fund.

Figure A2.1: Illustration of Market Failure Conditions



Source: Regeneris Consulting

11.2.3 Operationalising the Framework

Translating this framework into a useful tool which can address the requirements or principles set out in paragraph 1.4 is challenging. It requires a series of practical steps, as outlined below. Each step will draw on the preceding evidence collected, analysed and presented in the main body of Part B of the report, presenting the conclusions in a summary format.

11.2.3.1 Step 1 - Analysis of Demand and Supply Characteristics

The main chapters of the market assessment and the area overviews will analyse the variation in the economies across England, including the various factors which shape the demand and supply of external finance amongst SMEs. Factors which contribute to important variations at a sub-regional level will also be considered, such as sectoral strengths, enterprise activity or high levels of business R&D and innovation.

This analysis will draw on:

- Analysis of business demography data and other relevant datasets (e.g. R&D and spin-out activity)
- Analysis of the supply of finance by stage of development and type of finance
- Consultations with LEPs and the business and financial communities.

11.2.3.2 Step 2 – Analysis of Unmet Demand

As outlined earlier, this will draw on recent survey evidence of SMEs' finance requirements and consultations with business representatives, financial advisers and finance providers.

Whilst national SME finance surveys are published, these sources do not in their own right provide a robust evidence base at a regional level (and certainly not a sub-regional level). This can be supplemented by ad hoc regional and sub-regional SME survey evidence where it is available, although this will inevitably raise issues of the robustness and consistency of this data.

Also, availability of survey evidence is generally much greater for loan and overdraft finance, as opposed to equity, mezzanine and some other types of finance where the published survey evidence is patchy. The pattern of demand for early stage and expansion equity investment is generally more uncertain and variable over time and hence harder to predict.

Nevertheless, discussions with both private finance providers and public sector backed funds can provide a useful insight into the observed demand for these types of finance and the quality of these propositions, as well as the extent to which there could be latent demand which does not materialise for various reasons (particularly a lack of supply).

The approach to quantifying the unmet demand will follow as far as practical the GAFMA guidance, at least for loan finance for which it is more appropriate. We expect to be able to arrive at estimates using a combination of:

- BIS Business Population estimates (available regionally from 2011 to 2013)
- BIS Small Business Survey (a survey every two years of UK SMEs, available at the UK level only from 2008 to 2012. The sample size for the 2012 survey was 5,700, of which 4,800 had at least 1 employee)
- SME Finance Monitor (available regionally from 2011 to 2013, with the UK sample size for the 2013 survey being 20,000).

11.2.3.3 Step 3 – Assessing Market Failure and VfM from Public Sector Interventions

The underlying purpose of this step is to draw conclusions about the nature and scale of viable SMEs and their investment propositions within the overall unmet demand segment, i.e. those which fail to secure funding due to market failure. There are two mains ways of assessing this:

- Consultations with private sector finance providers and intermediaries about the extent to which viable SMEs and related investment propositions fail to secure the necessary finance at an acceptable price and associated terms and conditions
- Examining the performance of public sector backed SME finance schemes – both through ERDF and other funding streams – including their financial and economic performance. Although drawing on a complex set of metrics, this will provide an indication of the extent to which these schemes are able to address market failure and secure value for money to the public sector (a combination of financial and economic development returns) given their particular investment strategies.

Step 3 clearly draws on diverse sources of evidence and whilst it will draw on quantitative evidence, this aspect of the assessment will be more qualitative in its nature.

11.2.3.4 Step 4 – Analysis of Potential for the Persistence of Market Failure

This is largely a qualitative analysis of whether any observed unmet demand and market failure can reasonably be expected to continue to hold over the investment period being considered. This is largely a matter of judgement, drawing on the analysis of demand and supply conditions, emerging plans for private or public sector backed SME finance and other relevant initiatives, and the views of a range of stakeholders.

11.2.3.5 Step 5 - Review of Economic Development Priorities

Steps 1-4 will provide a broad indication of the scale and nature of the finance gap and the part of this gap accounted for by market failure. The review of the local economic development priorities undertaken within step 5 will identify whether there is a strategic case for the public sector targeting any particular part of this investment space. For example, a particular LEP or grouping of LEPs may have identified a particular sector or business cluster as a priority due to the opportunities for securing economic growth. These LEPs may have investment plans to stimulate the growth of the sector or cluster, which in turn may stimulate demand for finance.

The merits of specifically focusing a public sector led financial instrument upon these particular priorities would need to be considered alongside the merits of a more generic market-focused approach. It should be borne in mind that some specific priorities of this nature may have a different risk and reward profile to a more generic approach, which may in turn have implications for the deliverability and value for money of public sector interventions.

11.2.3.6 Step 6 – Capacity to Deliver

Taken together, steps 1 to 5 will provide a clear indication of the optimum scale and nature of an ERDF backed FIs at the regional level and, where practical, variations at a sub-regional level.

However, the ability to deliver this particular scale or type of SME finance needs to be carefully considered in light of:

- previous and current investment readiness activity with SMEs
- the track record of public sector led SME finance schemes, including the benefits this may bring in terms of raising awareness of these sources and mode of operation amongst SMEs
- the capacity of the private sector financial community.

For example, a region which has not previously benefited from a major ERDF backed SME finance fund will need to carefully consider the implications of this both for the scale, nature and investment profile of a future fund. This will pick up on any important sub-regional points, for example around the LEP groupings that are in place and their scale.

The analysis in steps 1-6 will be brought together for each region and type of finance in the structure set out in the structure shown below.

	Micro loans	Early Stage VC	Debt for Growing, Established SMEs	Expansion Equity for Established SMEs
Step 1 - Demand and Supply Characteristics				
Step 2 – Unmet Demand				
Step 3 – Assessing Market Failure				
Step 4 – Persistence of Market Failure				
Step 5 – Specific Economic Development Priorities				
Step 6 – Delivery Capacity				
Proposed ERDF backed Scale and Mix of Investment				

Annex three provides the area overviews for each of the nine English regions.

Annex Three – Area Overviews

Separate document

Annex Four – Consultees and Workshop Attendees

Region	Consultees	W0rkshop Attendees
East England	• Penny Lord, New Anglia Growth Accelerator • Francesca O'Brien, Syndicate Room • Gill Praynell, Cambridge Chamber of Commerce • Penny Wright, Low Carbon Innovation Fund (Adapt Group) • New Anglia Capital • Donna Cooper, Finance East –	• Alastair Rhind, New Anglia LEP • Andy Luff, Hertfordshire LEP • Paul Witcombe, Hertfordshire LEP • Paul Keegan, South East LEP • Ross Gill, Kent County Council (South East LEP area) • Penny Wright, ADAPT GROUP) • Grant Peggie, British Business Bank • Martin Haindl, DCLG • Simon Hannah, DCLG
East Midlands	• Steve Blount, Chair of Regional Risk Finance Forum • Paul Stevenson, SME Banking Manager, Lloyds TSB • Jonathan Lowe, Catapult Ventures Group • Peter Douglas, Business Finance Services • Kevin Kaley, Thincats • Mark Payton, Mercia Fund • Tim Powell, Minerva Business Angel Network • Tony Petersen, UK Export Finance • Richard Hallsworth, Nicholsons • Gerald Couldrake, Howes Percival	• Barrie Egan, EMB (Consultant) • Anthony Barber, EMB (Consultant) • Corin Crane, Leicester and Leicestershire Enterprise Partnership • Samantha Harrison, Greater Lincolnshire LEP • Sue Tilley, North East Leicestershire LEP • Matthew Wheatley, D2N2 LEP • Sajeeda Rose, Northamptonshire LEP • David Miles, BBB • Hanne Hoeck, DCLG • Pete Holmes, BIS (or his deputy Will Morlidge) • Patricia LLopis, EIB • Graham Cope, EIF
London	• Sue Terpilowski, FSB • - Laurie Wiseman, East London Small Business Centre • - Simon Menashy, MMC Ventures • - Mark Burrows, Foresight Group • - Maggie Rodriguez-Piza, Funding London • - Catherine Glossop, GLA Innovation • - Valerie Jolliffe, Javelin Ventures	• Simon Menashy, MMC Ventures • Nicholas Nicolaou, GLE oneLondon • Valerie Jolliffe, Javelin Ventures Ltd • Peter Chapman, MMC London Fund Advisory Committee • Mark Burrows, Foresight Group • Laurie Wiseman, East London Small Business Centre • Darrel Connell, Foresight Group • Jenny Tooth, UK Business Angels Association • Kenroy Quellenec-Reid, Greater London Authority • Frank Lee, European Investment Bank • Maggie Rodriguez-Piza, Funding London

North East	Regeneris Consulting drew on the findings of a series of stakeholder workshops led by consultants to the JEREMIE 2 Project Team, as well as consulting with members of the JEREMIE 2 Project Team. Each workshop contained a mix of attendees including SME business representatives, corporate finance advisors and finance providers. Regeneris attended two of these sessions as an observer and was provided with notes from the other sessions. The workshops were as follows: • Newcastle, 12/11/14 (attended) • Sunderland, 17/11/14 • Northumberland, 18/11/14 • Durham, 19/11/14 • Stockton, 20/11/14 (attended) • Hartlepool, 21/11/14	• Grant Peggie, BBB • Judith Dibley, BBB • Emily Smith, EIB • Frank Lee, EIB • Iain Derrick, DCLG • Chris Taylor, DCLG • Andrew Mitchell, NE Finance and JEREMIE 2 Project Team • Estelle Blanks, NE Finance and JEREMIE 2 Project Team • Jason Hobbs, NE Finance and JEREMIE 2 Project Team • Alastair Smith NE Finance and JEREMIE 2 Project Team • Linda Edworthy, Tees Valley Unlimited (TVU) • Stephen Catchpole, TVU • Kay Goodinson, NEA2F and J2 team • Michael Karim, NE LEP • Helen Golightly, NELEP • David Smith, NELEP • Simon Goon, Durham County Council/Business Durham
North West	• Jonathan Diggines – Enterprise Ventures • Penny Attridge – Spark Impact • Gary Guest - FW Capital • Adam Workman - 350 Investment Partners LLP • Fred Mendelsohn - AXM Venture Capital • David Martin - Business Finance Solutions • Mark Hughes – Manchester Growth Company • Andy Thomas – Maven Capital Partners • Jerry Scriven - Daresbury Company Solutions • Graham Bond – Baker Tilly • Melanie Yeomans – Ward Hadaway • Mark Rahn – MTI Ventures • Simon Graindorge – IP Group	• Mark Basnett, LCR LEP • Martin Kelly, Lancasahire LEP • John Holden, New Economy • Simon Nokes, New Economy • Francis Lee, C&W Lep • David Read – CLG • Cliff Maylor - NWBF • Rachel Brosnahan – NWBF • Rob Johnson – Cumbria Chamber of Commerce • Sean Davies – Manchester CC • Andy Walker – Lancashire CC • Emily Smith, EIB • Frank Lee, EIB
South East	• Adam Stronach, Harwood Hutton • - Graham Ballantyne, RBS • - Toby Furnivall, Money and Co • - Kevan Jones, FSE • - Charles Breese, Larpent Newton	• Dawn Pettis, Oxfordshire County Council • Richard Byard, Oxfordshire County Council • Heather Dean, Buckinghamshire Business First • Adam Stronach, Harwood Hutton • Derek Beard, Handelsbank • Andrew Clark, Natwest • Eileen Modral, Oxford Innovation • Shyam Chand, DCLG • Guy Lachlan, Jones & Cocks and Bucks TV LEP

		• Patricia Llopis, European Investment Bank • David Priseman, Money & Co • Toby Furnivall, Money & Co • Richard Armitage, Natwest • Stephen Bateman, Santander • Peter Hopkinson, Invent Network • Ian Wenman, Oxfordshire LEP
South West	• Ewan McClymont, Bishop Fleming • Rob Perks, Wessex Chamber (delivery body for Wiltshire Growth Hub) • Rob Guy, Outset Finance Plymouth • Chris Burt, South West Investment Group (SWIG) • Ian Girling, Dorset Chamber of Commerce • Kim Conchie, Cornish Chamber of Commerce • Matt Giles, Get Set for Growth (investment readiness service) • Ann Vandermeulen, Federation of Small Businesses • Robert Davy, Bishop Fleming • Edward Tellwright, Swain - Business Angels and Company Investment.	• Emma Buckman, Heart of the South West • Mike Curran, Gfirst • Antony Corfield, West of England • Steve Ford, Cornwall & The Isles of Scilly • Nicky Pooley, Cornwall & The Isles of Scilly • Len Smith, Cornwall & The Isles of Scilly • Judith Haan, Cornwall & The Isles of Scilly • Julian Head, Swindon & Wiltshire • Giles Thomas, Dorset • Lyn Gardner Dorset • Tim Wheatley, DCLG • Ian Whale, DCLG • Paul Wilson, DCLG
West Midlands	• Paul Heaven, Blue Sky Consulting and GBSLEP • Tim Powell, Minerva Business Angel Network • Tony Stott, Midven • Nick Wright, Catapult Ventures Group • Sue Summers, Finance Birmingham • Steve Walker, Aston Reinvestment Trust • Paul Kalinauckas, BCRS Business Loans • Mark Payton, Mercia • Chris Brown, CBD Finance • Alison Bradley, Central Finance • David Neate, Springboard Corporate Finance • Paul Halford, Regional Director, NatWest • Andy Youngman, Regional Director, Lloyds • Kevin Kaley, Thincats	• Gary Spence, Marches LEP • Judith Wright, DCLG • Norman Price, Chairman of Regional Finance Forum and Cross LEP Sub-Group • Paul Hodgkinson, Stoke on Trent and Staffordshire LEP • David Hope, Coventry and Warwickshire LEP • Daniel Carins, Black Country LEP • Gary Woodman, Worcestershire LEP • Jonathan Dixon, BBB • Paul Brown, Black Country LEP • Paul Heaven, Blue Sky Consulting (Cross LEP representation/GBSLEP) • Graham Cope, EIF • Patricia Llopis, EIB • David Miles, BBB
Yorkshire and Humber	• Simon Pringle, BDO • Arthur Foreman, Finance for Enterprise • Andrea Copley, Irwin Mitchell • Keith Williams , UK Steel Enterprise • Anthony Winn, Handlesbanken • Alex McWhirter, Finance Yorkshire • Rory Earley, Finance Yorkshire Board Director and SME Finance Expert • Alex McWhirter, Finance Yorkshire	• Peggy Haywood, DCLG • Joanna Rowell DCLG • Heather Waddington, Leeds LEP • James Farrar, YNY LEP • James Trowsdale, Humber LEP • David Hewitt, Sheffield LEP • Alex McWhirter, Finance Yorkshire • Sean Hughes Finance Yorkshire • Sam Tarff, the Key Fund

	• Sean Hughes Finance Yorkshire	• Sally Joynson, Screen Yorkshire • Hugo Heppell, Screen Yorkshire • Julia Chapman, Partnership Investment Fund • Stephen Waud, BE Fund • Colin Mellors, York University • Rob Pearson HCA • David Miles, BBB • Emily Smith, EIB