Using Financial Instruments for SMEs in England in the 2014-2020 Programming Period

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

Annex Two – Area Overviews

West Midlands

January 2015

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Version	**Date issued**	**Scope**
Version 2	2-02-15	Revised following comments of GDTs

Area Overview: West Midlands

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

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

1.1 Economic Geography

The West Midlands is a large region of 5.6 million residents, 2.4 million jobs and 380,000 businesses. The region's business base is made up predominantly of SMEs (378,000) and 26% of these (99,000) have employees[1]. Its total Gross Value Added in 2012 was £98.3 billion (by way of comparison the GVA of the North West is £130.6m and the East Midlands is £ 79.7m), equivalent to £17,400 per head of population, which compares to an England average of £21,900.

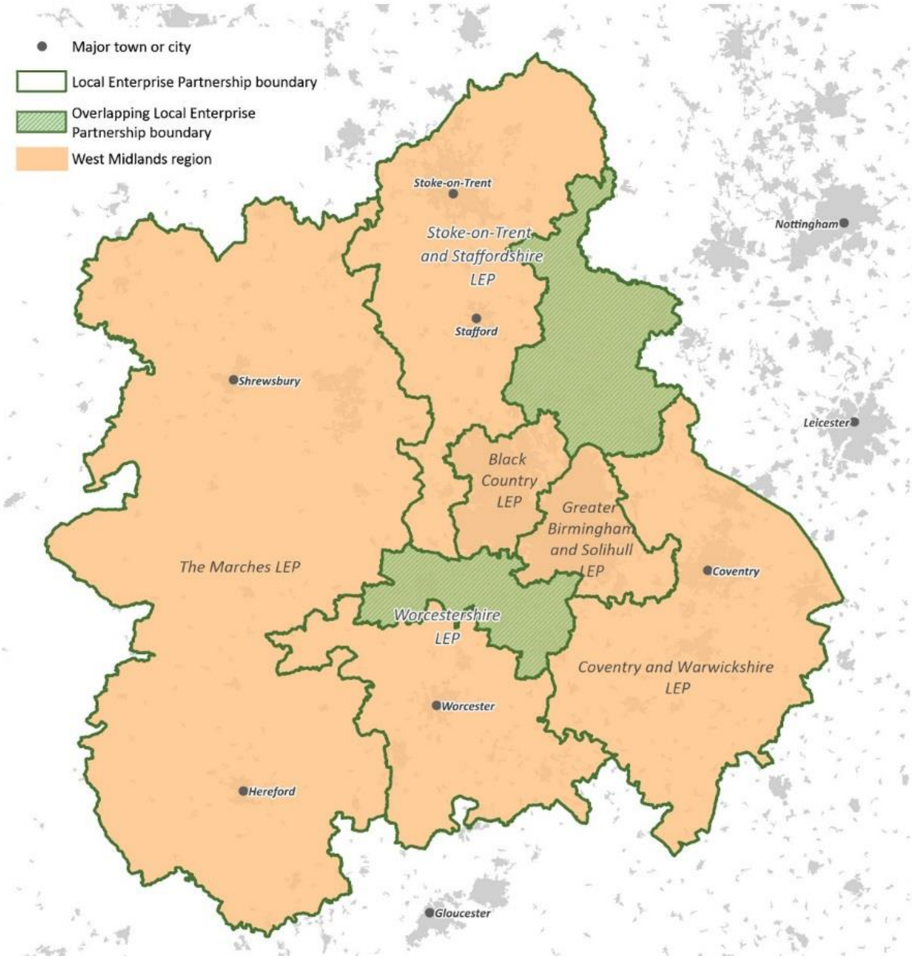
Strategic economic development policy in the region is led by six Local Enterprise Partnerships (LEPs):

- Greater Birmingham and Solihull LEP, covering the local authority areas of Birmingham City, Bromsgrove, Cannock Chase, East Staffordshire, Litchfield, Redditch, Solihull, Tamworth and Wyre Forest.
- Worcestershire LEP, covering the Worcestershire County Council area and the six district councils of Worcester City, Bromsgrove, Redditch, Malvern Hills, Wyre Forest and Wychavon.
- Black Country LEP, coving the boroughs of Dudley, Sandwell, Walsall and the City of Wolverhampton.
- Coventry and Warwickshire LEP, covering the district of North Warwickshire, Nuneaton and Bedworth, Coventry, Rugby, Warwick and Stratford-on-Avon
- Stoke on Trent and Staffordshire LEP, covering Cannock Chase, East Staffordshire, Lichfield, Newcastle-under-Lyme, South Staffordshire, Stafford, Staffordshire Moorlands, Stoke-on-Trent and Tamworth
- The Marches LEP, covering Herefordshire County, Shropshire and Telford and Wrekin.

It should be noted that there are some overlaps between the LEP areas and that the districts making up the LEP areas are not exclusively located in the West Midlands region. This is illustrated in the map overleaf.

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

Figure 0.1: Local Economic Partnerships in the West Midlands Region



Greater Birmingham and Solihull LEP (GBSLEP) has particular economic importance for the region, containing 1.9 million residents and 55,000 enterprises, of which 54,000 are SMEs (larger than any other LEP area in the region)[2]. It contributes £37 billion in annual GVA, with the main economic centre being Birmingham accounting for just under half of the business base in the LEP area (49%).

While GBSLEP is clearly an economic focal point for the region, the other LEP areas make substantial contributions:

- There are 570,000 residents in the Worcestershire LEP area, with 22,000 enterprises, most of which are SMEs (21,900). The area contributes £9.4 billion in annual GVA.
- Black Country is the second largest LEP in the region in population terms containing 1.2 million residents. There are 26,600 enterprises in the area, of which 26,500 are SMEs. The area contributes £17 billion in annual GVA.

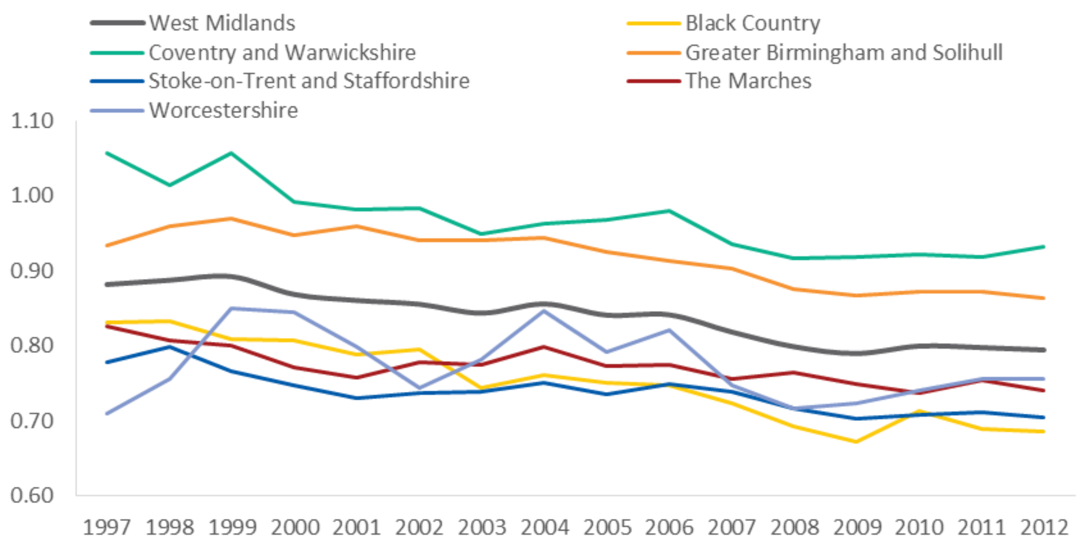
[2] Source: ONS Business Counts. Note that this data source is the only one that can be used to understand the business base at a sub-regional level. It covers both enterprises and local units (which include multiple branches of the same enterprise). Regeneris Consulting have quoted the enterprise figures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

- Coventry and Warwickshire LEP contains 880,000 residents, 30,000 enterprises, the majority of which are SMEs (29,900). The area contributes £18 billion in annual GVA, with the main economic centres of Stratford-on-Avon and Warwick accounting for 47% of the businesses base in the area.
- There are 1.1 million residents in the Stoke-on-Trent and Staffordshire LEP area, containing 33,400 enterprises, of which 33, 3000 are SMEs (the second highest amount in the LEP area). It contributes £17 billion in annual GVA.
- The Marches LEP is the smallest LEP in the region in terms of population, containing 660,000 residents, 27,800 enterprises of which 27,600 are SMEs. Shropshire account for over half of the businesses in the area (52%), followed by Herefordshire which accounts for 35% of businesses. Annual GVA in the area is £11 billion.

In absolute terms, GVA per head of population has been increasing in recent years. Between 1997 and 2012 GVA per head increased from £11,500 to £17,400. But, as Figure 0.2 shows, the increase in the region has not kept pace with that occurring nationally. For the West Midlands as a whole, and each of its LEPs, the gap with national GVA per head has been widening. For the region overall, GVA per head is currently 21% below the national average, or 9% below the national average when London is excluded.

GVA per head in Coventry and Warwickshire LEP and in Greater Birmingham and Solihull LEP areas has been consistently higher than the regional average, reflecting the importance of higher value added activities to the economies of these LEP areas (including for example, motor vehicle and advanced manufacturing activities, and business and professional services sectors respectively).

Figure 0.2: GVA per Head (England=100) - 1997-2012



Source: Office for National Statistics

1.2 Policy

This section provides a short summary of the main economic development issues and corresponding priorities set by the LEPs in the region. The focus here is upon the priorities proposed for business competitiveness and SME finance. The analysis seeks to draw out the important economic drivers in each of the LEP areas.

The main priorities and interventions that are relevant to SME competiveness are set out in Table 0.1. The strategic reflect the varying local economic contexts across the West Midlands' LEPs but there are a number of themes which are common in all parts of the region. In particular:

- The need to create employment and GVA: this reflects the long term trend for GVA per head in the region to be behind the England average and the continued widening of the gap.
- Supply chain development to support growth: particularly related to advanced manufacturing and engineering
- Innovation and R&D: priorities here encompass the full spectrum of innovation related activities from more generalised process innovation and productivity improvement through to R&D intensive and tech focused activities to generate spin out companies.
- Enterprise and start-ups: There is a strong innovation and technology flavour to many of the priorities in this area, although some LEP areas also prioritise the development of an entrepreneurial culture and stimulating business start-ups more generally
- Focus on growth sectors: The importance of priority sectors in driving growth is recognised in all of the strategy documents and each LEP area has identified the key sectors around which they expect future growth to focus. These are summarised below. The advanced manufacturing sector stands out as being particularly important, with automotive, aerospace and aeronautical sectors highlighted as being key strengths and sources of growth.

The range of interventions that emerge from these strategies could, of themselves stimulate demand for finance of different types (and indeed some of the interventions will contribute to the supply side), although there is limited detail on these interventions at this time.

LEP Area	Advanced Manufacturing	Business, Prof and Financial Services	Digital and Creative	Life Sciences / Health and social	Low Carbon / env. tech	Defence and Security	Visitor Economy
Greater Birmingham and Solihull							
Stoke-on-Trent and Staffordshire							
Coventry and Warwickshire							
The Marches							
Black Country							
Worcestershire							

It is important to note that, across the LEPs in the West Midlands, there is strong evidence of cross LEP working, particularly in the area of access to finance. The LEPs have formed a cross LEP working group to explore joint approaches to A2F interventions and there is agreement across all of the SEPs that there is scope for a joint intervention on A2F.

Table 0.1: Priority Sectors in LEP Strategic Plans

SME Competitiveness Priorities and Key Interventions of West Midlands LEPs			
LEP	**Innovation and R&D**	**Growth of Established SMEs**	**Start-ups and enterprise**
Black Country	• Support projects focused on increasing SME demand and capacity for innovation • Product and process innovation to respond to new market opportunities • New science, technology and prototype centre providing managed workspace and laboratory and testing space • Aspiration to become UK centre of excellence for light rail innovation • Smart specialisation focused upon Aero, Auto and Construction sectors	• Access to finance intervention specifically for capital investments in plant, machinery and property. £15million fund. • Programme of grants to business owners to install smart grid technologies and local energy storage systems • Business support investments focused on business growth and improved productivity. Growth Hub. • Various A2F programmes inc grant and loan schemes planned.	• Support for new business creation, particularly linked to innovation. • Enterprise support programmes linked to actions around employment and employability Aim to increase the number of births by 1,500 per year
Coventry and Warwickshire LEP	• Growth through innovation and R&D • Aspiration to become a centre of excellence in Advanced Manufacturing and Engineering • Support for sector growth in Digital/ICT Services and Health technologies • Strengthen the location of Coventry and Warwickshire as a Rural Growth Hub • Targeted investment programme supporting innovation / KT and exchange in less R&D and innovation active firms • Innovation programme for rural growth.	• Support for advanced manufacturing and engineering identified as a key priority • Local business growth programme offering support in access to finance, marketing strategy, exploiting ICT, management development and workforce expansion. • Remove barriers to growth for SMEs in priority growth sectors • Targeted energy efficiency advice to maximise SME competitiveness • Some grant and loan schemes identified.	• Business start-up and sustainability programme focused on confidence, knowledge and skills • Tailored support for businesses in their first three years of trading. • Focus on increasing start up rate and reducing business failure rates
Greater Birmingham and Solihull	• Aston and University of Birmingham are particularly important. University Enterprise Zone is a key intervention • Life sciences campus • Support for collaborative research projects between firms, knowledge base and public sector • Support businesses to commercialise R&D • Physical innovation infrastructure (including incubator space)	• Focus on key growth potential sectors. • Support for a fund of funds • Development of Growth Hub and associated business support delivery • Specific Growth Hub offer for mid and large sized advanced manufacturing and engineering firms • Advanced manufacturing and engineering recruitment and training centre	

Stoke on Trent and Staffordshire	• Facilitating better use of knowledge by helping businesses to commercialise R&D and innovation. • Applied materials research and innovation centre • Centre of Excellence in Energy Security and Renewable Energy • Investment readiness support • Innovation networks • Collaborative research and knowledge transfer programmes • Innovation vouchers and commercialisation support	• Aligned around a growth hub model • Supporting businesses to increase exports • Targeted assistance to develop and grow important businesses in priority sector. • Improve access to investment for businesses with growth ambitions. • Support for West Midland's fund of funds. Activities to build upon existing loan fund mechanisms in the LEP area and include business angel investment projects.	• Early stage support and mentoring • Enterprise networks • Social enterprise support programme • Enterprise incubation centres
The Marches	• Interventions to accelerate R&D and innovation in the advanced manufacturing supply chain and particularly the automotive supply chain • R&D and innovation support programmes • Development of R&D campus facilities • Targeted access to finance initiatives	• Development of a Growth Hub focused in particular on advanced manufacturing and engineering • Coaching and mentoring to support business growth reflects skills emphasis of • Development of a Growth Hub • Grants of up to £50,000 available to support SME competitiveness • Extension of Craven Arms business park	• Supporting enterprise and access to employment is a specific priority • Enterprise is identified as a key focus for the Growth Hub.
Worcestershire LEP	• Innovation support programme to facilitate links between business opportunities and R&D capacity • Centre of excellence in technology to include incubator and lab space, business support services and specialist training facilities. • Establish a virtual innovation hub and explore feasibility of a physical innovation hub • Innovation fund to make finance available for proof of concept and implementation of new innovative processes. C £1m. • Centre of Excellence for Horticulture and Centre for Agriculture Innovation	• Structured programme of tailored business support with additional provision for new and growing enterprises and Low Carbon Businesses • Provision of grant support to expanding businesses • Support for JEREMIE fund in the West Midlands • Growth Hub to provide an integrated business support offer targeted towards identified growth sectors • Business engagement • Priority sectors are agri-tech, advanced manufacturing and cyber security / defence IT • Low carbon business support programme	• Growth hub to encompass support for start-ups • Business incubators to support development of high tech start-ups (see centre of excellence in technology)

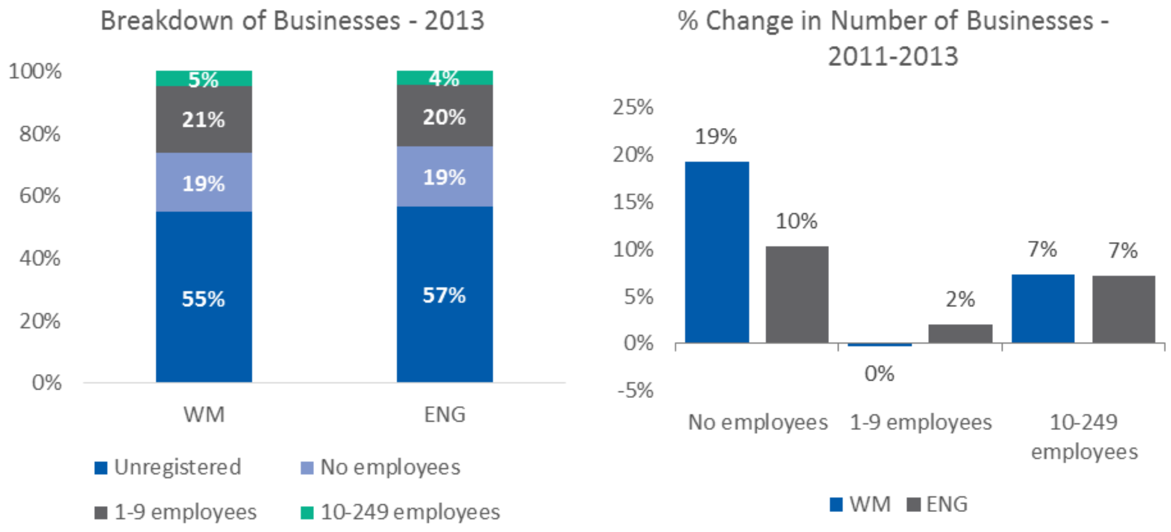
1.3 Demography Trends

1.3.1 Business stock

The West Midlands is home to 378,800 SMEs, of which 360,600 (95%) are microbusinesses (less than 10 employees), 15,600 are small (10-49 employees) and 2,600 are medium sized firms (50-249 employees). Of the microbusiness stock, 208,000 are unregistered for VAT/PAYE and 72,200 are single person firms.

The current size band structure of the region's SME base is broadly similar to nationally but there are some interesting recent trends. In particular, it is notable the number of single employer businesses (both registered and unregistered) in the region has increased by a much greater proportion than nationally. At the same time, the number of larger microbusinesses (with up to nine employees) has declined slightly.

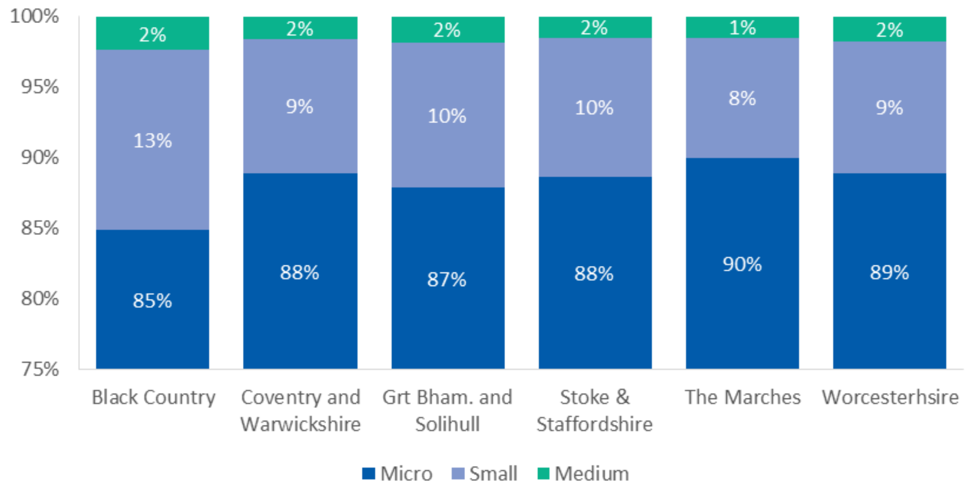
Figure 0.3: Composition (%) of SME Stock in 2013 and change 2011-2013



Source: BIS Business Population Estimates 2011-2013

There are some interesting differences in the size band structure of the LEP areas business bases. Most notably the Black Country's business base is made up of slightly larger SMEs. This is most likely a reflection of the historical importance of large employers in this area and the way that this might be reflected in enterprise performance and activity. Conversely, the Marches business base is slightly more weighted towards micro businesses than in other areas, reflecting the more rural nature of the economy here.

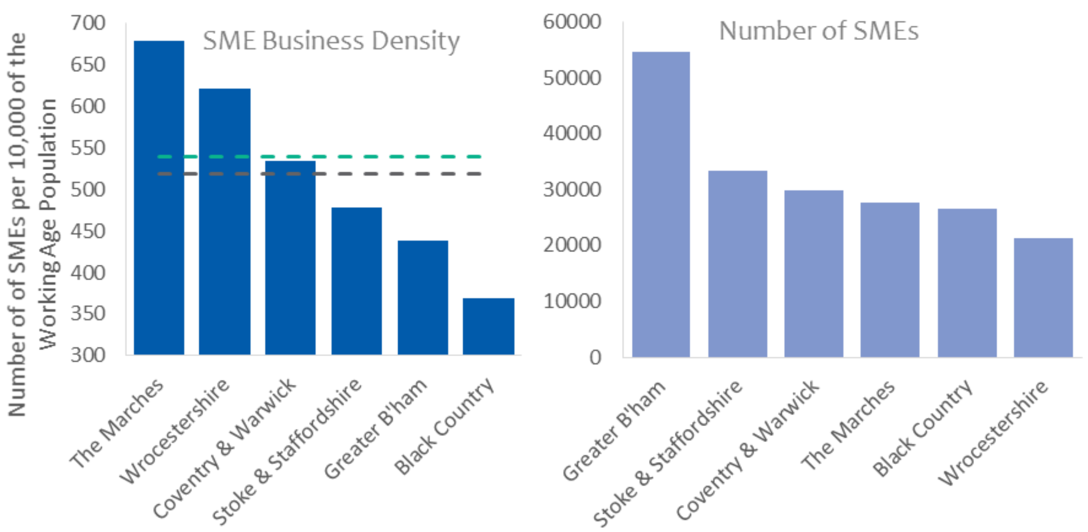
Figure 0.4: Breakdown of SMEs by Size – 2013



Source: ONS Business Counts

SME business density in the West Midlands region is 20% lower than the national average (or 8% lower when London is excluded). This represents a gap of 60 businesses per 10,000 working age residents. This average masks important differences by LEP area. The Marches and Worcestershire LEP have a much higher business density than the England average (although it is worth noting that this reflects the relative low population density in these areas, more than a large concentration of SMEs). The largest concentrations of SMEs in absolute terms are, unsurprisingly in the Greater Birmingham and Solihull LEP (reflecting the importance of the major city of Birmingham). The other LEPs have roughly similar sized SME bases in absolute terms.

Figure 0.5: SME Business Density, and Number of SMEs, 2013

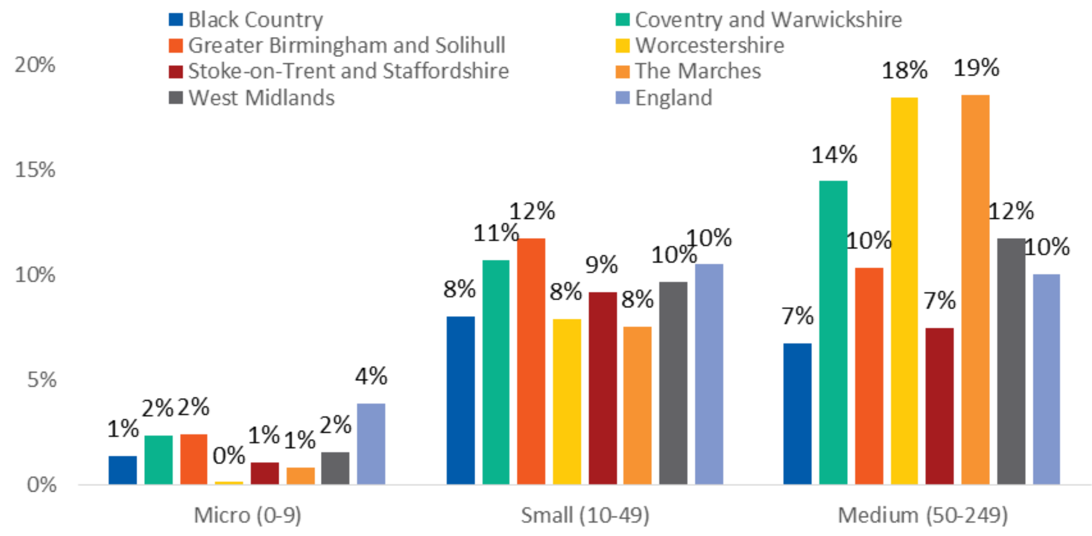


Source: ONS Business Counts

For micro-businesses, growth in the LEP areas is lower than the national growth rate. This may seem contradictory to figure 1.3 which shows strong growth in single person microbusinesses. However the data for the LEP breakdowns does not cover unregistered firms (unlike data for the region as a whole). The rate of growth for small business is varied in the region.

Only in Greater Birmingham LEP and Coventry and Warwickshire LEP is the growth rate higher than the national average, whereas growth in LEP areas without a major urban centre falls behind the national rate (The Marches LEP and Worcestershire LEP). For medium sized businesses, there is significant growth rate in The Marches LEP and Worcestershire LEP, higher than both the regional and national rate. However these are two LEP areas with the smallest business bases and so this may be reflected in the figures (i.e. modest absolute growth is reflected by large percentage changes).

Figure 0.6: % Change in Number of Businesses 2011-2013



Source: ONS Business Counts

In the region there is a high concentration of microbusinesses operating in the Professional, scientific and technical sector followed by the construction sector. There is some variation by LEP area however; for example as a percentage of the SME stock in the area, 20% of microbusinesses in The Marches LEP operate in the agriculture, forestry and fishing sector. For small and medium sized businesses, there is a high concentration of firms in the manufacturing sector, particularly evident in Black Country LEP. This is driven by the presence of large firms such as Jaguar Land Rover and thus there is a strong base of manufacturing supply chain firms in the region.

Similarly, the financial and professional services sector is very important in Birmingham, as it is a major economic centre.

1.3.2 Business Starts

In 2012 around 19,700 new businesses formed in the region. At 55 per 10,000 working age adults, this is 21% below the England average, or 10% below the England average once London is removed.

The majority of these new businesses were formed in Greater Birmingham and Solihull LEP, but when adjusted for the working age population the start-up rate is highest in Coventry and Warwickshire LEP. For all LEP areas, the rate is below the national average, however Coventry and Warwickshire LEP and Worcestershire LEP have the highest start-up rates and are nearest to the national average. When removing London from the rate, these two LEPs have rates above the national average (6% and 1% respectively).

The volume of start-ups has increased for all LEP areas, most notably for Coventry and Warwickshire LEP where there has been an increase of 18%. In The Marches LEP and Black Country LEP there has been the lowest rate of increase of only 2% and 4% respectively.

Table 0.2: Business Starts in the West Midlands and its LEP Areas, 2009-12

		Business Starts			Business Starts per 10,000 WAP (2012)	
	2009	2012	Abs Change		Number	England=100
Black Country	3,270	3400	130	4%	47.4	68
Coventry and Warwickshire	3,050	3,610	560	18%	64.8	93
Greater Birmingham and Solihull	6,815	7,305	490	7%	58.8	84
Stoke on Trent	3,270	3,475	205	6%	49.8	71
The Marches	2,160	2,210	50	2%	54.0	77
Worcestershire	2,015	2,185	170	8%	61.8	88
West Midlands	18,245	19,650	1405	8%	55.2	79

Source: ONS Business Demography

1.3.3 High growth firms

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

The latest report found that 23% of businesses with a turnover between £2.5 million and £100 million in the Midlands[3] fall into this high growth category, ranking the 2nd region overall. Although a slight fall (0.4 percentage points) from the previous year, since 2011 as a whole there has been a strong increase in the proportion of high growth companies. In the last 2 years the proportion has been higher than the national proportion.

Table 0.3: High Growth Firms as a % of all Businesses, 2011-13

	2011 Population of High Growth Firms	Regional Rank (2013)	2011	2012	2013
West Midlands	249	2nd*	15.0%	23.3%	22.9%
England	4,044		16.9%	20.9%	22.0%

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

1.3.4 Innovation activity

The West Midlands has approximately 8,200 enterprises defined as innovation active, representing 43% of the business base with at least 10 employees in the region. This is slightly below the UK average rate of 44%, and ranks the region 5th in England. Compared to the UK rate, the gap is accounted for by

[3] The East and West Midlands are combined in the report.

product innovation, rather than process innovation as the region has the second lowest rate of firms that are defined as product innovators[4].

R&D expenditure, in particular that related to the private and university sectors, is one driver of the spin-out and creation of companies and indeed the demand for early stage risk finance. Expenditure on research and development has increased steadily between 2001 and 2012, from £1 billion to £1.8 billion, an increase of 80%. This increase was particularly pronounced for private expenditure in the last few years, increasing by 65% between 2010 and 2012. Data for the latest year shows that of total R&D expenditure, 80% (1.46 billion) came from the private sector, whereas around 20% (£353 million) came from the higher education sector.

There have been around 90 university spinouts recorded since the year 2000, representing 9% of all spinouts in England. Taking into account the working age population, the region has a higher than national average rate. The three universities of Warwick, Birmingham and Aston account for around 74% of all spinouts in the region.

1.3.5 Enterprise indices

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

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

Table 0.4: Measures of Entrepreneurial Activity, 2008-13

Highlighted cells shows above average results	TEA	% of Opportunity E'preneurs	Stages of Enterpreneurial Activity				High Growth Entrepreneurial Aspiration[5]	
			Intend to Start-up in Next 3 yrs	Nascent E'preneurs	New Firms	Est. Firms	All TEA	Est. Firms
London	8.2%	6.6%	8.2%	4.2%	3.8%	5.3%	22.8%	6.3%
East of England	7.6%	6.2%	4.4%	3.8%	3.7%	6.1%	16.0%	5.7%
South East	6.9%	5.5%	5.3%	3.1%	3.6%	7.6%	19.0%	4.2%
South West	6.9%	5.4%	4.6%	3.1%	3.4%	7.5%	9.6%	2.5%
Yorkshire & Humber	6.9%	4.8%	4.4%	2.9%	3.8%	6.2%	10.8%	3.5%
West Midlands	5.9%	4.2%	6.0%	2.7%	3.1%	5.6%	16.5%	5.1%
East Midlands	5.2%	3.8%	5.3%	2.5%	2.6%	5.9%	14.7%	2.0%
North West	5.9%	4.3%	4.0%	3.0%	2.8%	5.7%	14.4%	5.0%
North East	5.8%	4.6%	4.0%	2.8%	2.8%	4.2%	10.8%	3.6%

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

[4] Source: BIS UK Innovation Survey. It must be noted that this presents a partial picture, as firms with at least 10 employees (which the survey is based upon) accounts for only 5% of the total business base (including unregistered businesses) in the West Midlands.

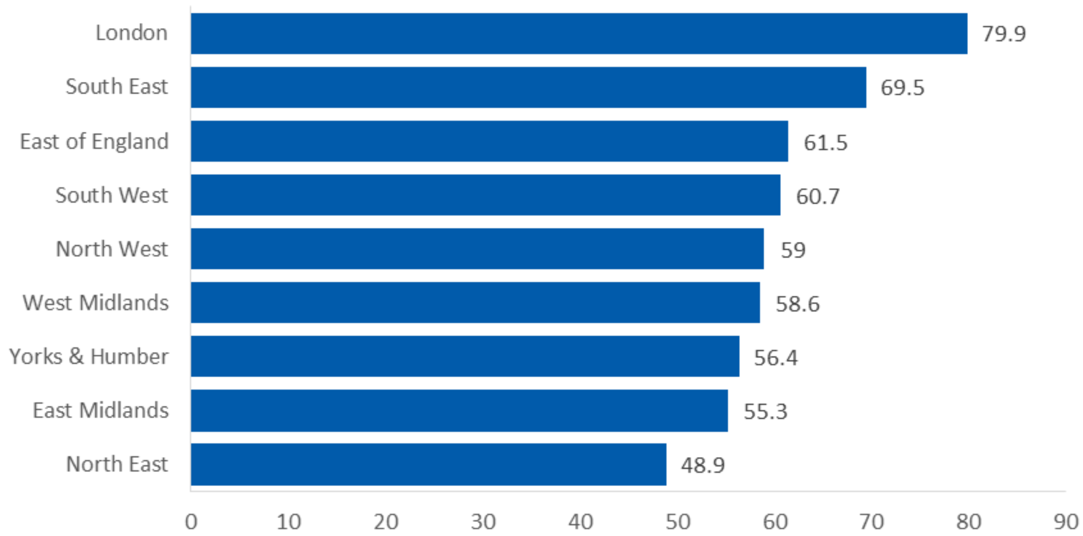
[5] % of firms looking to create 10 jobs and employment growth over 50% in the next five years.

Using pooled data for 2008-13 at a regional level suggests that the region performs relatively poorly on indicators, and has a below average TEA rate. The indicators that are above average relate to future intent, for example the region has the second highest rate (second only to London) for working age adults intending to start-up in the next three years, suggesting that there is good potential in the region for future start-ups and entrepreneurial activity.

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

The latest ranking for 2014 supports the findings of the GEM, which shows that the West Midlands performs relatively poorly compared to other English regions, although it still ranks within the top 40 of the 125 EU regions considered. The analysis suggests that important factors driving the West Midland's score on the index revolve around its performance on indices of attitude, abilities and aspiration. In particular the region scores 48 on aspiration compared to 77.7 for London (the top performing region). However, this is a broad trend, with a middle group of regions (including the West Midlands, as well as the South West, the North West and Yorkshire and the Humber) that all lag behind London in this aspect. The report emphasises that a lack of entrepreneurial aspiration serves as a "bottleneck factor" preventing some UK regions from realising their full economic potential.

Figure 0.7: Santander Enterprise Index Score - 2014



Source: Santander Enterprise Index 2014

1.4 Demand for and Take-up of External Finance

1.4.1 Survey evidence

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

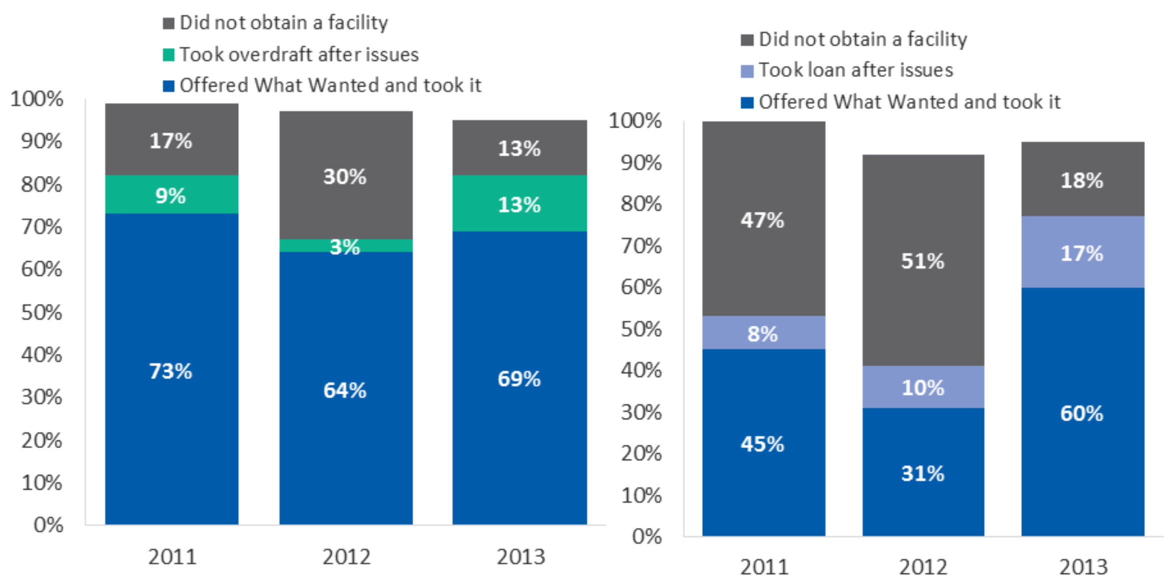
It is important to note that the regional breakdown of this dataset is subject to substantial margins of error, due to the limited regional samples collected. While it can provide some insight into the picture regionally, it is difficult to identify trends or draw strong inferences when margins of error are factored into the assessment. While the data should be treated as indicative only, it can help to highlight some interesting patterns in the demand and supply of finance.

The regional analysis of SME respondents in the West Midlands in 2013 indicates that 39% of respondents in the region had used finance of some sort in the past five years, whilst 58% had not used finance at all over this period. Just under a third (30%) of SME respondents had used either an overdraft, loan or credit card during this period.

A substantial proportion of SMEs (43%) were classed as a "permanent non-borrower" (PNB), meaning that they have not used external finance in the last five years, have not attempted to borrow over the past 12 months, and have no inclination to borrow in the next three months. This is slightly above the England average of 40%, but given the margins of error around this survey data should not be interpreted as being statistically significant. For the West Midlands this proportion has varied since 2011, falling in 2012 but rising again in 2013.

Figure 0.8: Overdraft and Loan Applications in the West Midlands - 2011-2013

Overdrafts *Loans*



Source: SME Finance Monitor 2011-2013.

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

The survey data indicates that 8% of SMEs in the West Midlands applied for a new overdraft or loan facility or sought to renew an existing facility. Figure 0.8 summarises the outcomes that these SMEs reported. For overdrafts, the survey suggests that the majority of these SMEs (69%) were able to access the overdraft that they sought. The proportion of SMEs who were unable to access an overdraft facility fluctuates annually and once the margins of error around survey data is taken into account there is not overall trend here. The most recent data suggests that around 13% were able to secure what they wanted after some negotiation, leaving 13% that were unable to access an overdraft facility. However, the proportion in the previous year was much higher.

The latest data for loans shows that 60% of SMEs seeking one were able to access what they wanted, a substantial increase on previous years (although it is unclear whether this trend can be sustained). Regional data from the SME Finance Monitor is drawn from limited sample sizes and is therefore subject to large margins of error. This, together with the tendency for results to fluctuate annually make it difficult to interpret this dataset. While it is difficult to interpret, the data suggests that success rates for both loans and overdrafts for SMEs in the West Midlands are statistically significantly higher than elsewhere, although it is difficult to see why this would be the case given the way in which banks work nationally.

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

1.4.2 Regional Survey Evidence

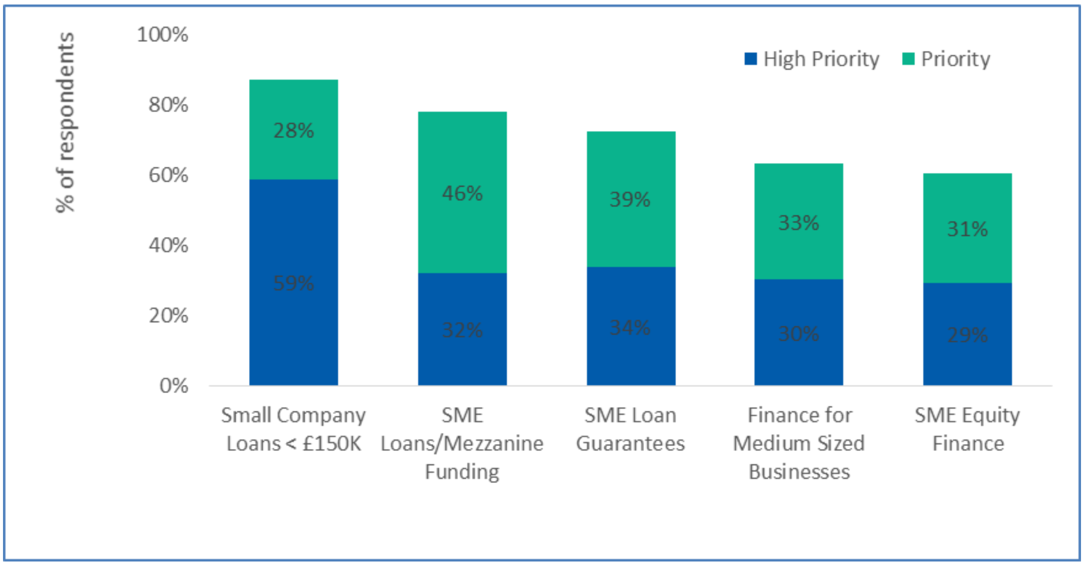
Partners in the West Midlands have undertaken a number of surveys to explore demand for and take up of external finance. The most recent survey was undertaken in October / November 2014 and attracted 109 respondents from the following groups:

- Corporate advisors (41% of the sample)
- Funding provider (42% of the sample)
- Public body (17% of the sample)

An earlier survey, carried out in September 2014, sought to capture responses from SMEs in addition to the groups above. SMEs represented less than 25% of the overall survey sample (70) so their responses cannot be robustly analysed in isolation.

The most recent survey (Oct / Nov 2014) focused primarily on those involved in the provision of SME finance (in both policy terms and those who’s roles put them directly in contact with SMEs seeking finance) to give their views on the priority that should be attached to different regional public sector interventions.

Figure 0.9: Responses to "Are Regional Public Sector Interventions required in the following financial areas?"



Source: Cross LEP SME Finance Survey, October/November 2014

Respondents were asked to prioritise between the finance types set out in the chart above. Within each of the finance types they were then presented with a set of options for the purpose and, in some cases, the amounts of finance which should be a priority. The responses highlight a substantial appetite for a greater supply of all of the types of finance that the survey asked about. All five types of finance were identified as a priority by at least 60% of respondents.

Small debt finance (sub £150k) is viewed as a particularly high priority. The vast majority of respondents identified this area as either a priority. Subsequent questions which sought further detail on the purpose of small loans required were asked again on the basis of prioritisation. Loans for SME expansion were most frequently identified as a priority (by 90% of respondents) with loans for skills development, research and innovation and business start-up all being highlighted by substantial proportion of respondents (circa 70%).

Other survey findings relate to:

- Loans / mezzanine finance: The majority of respondents saw loans/mezzanine finance for expansion as priority within the SME loans / mezzanine funding category. A substantial proportion also highlighted loans for research and innovation, MBO/MBIs as well as loans to support inward investment and relocation.
- SME Loan Guarantees: this area was frequently prioritised although it is not clear in what way this provision would need to be distinct from national guarantee schemes. The responses indicate that most respondents see this as most relevant to micro businesses. The view that further provision is needed in this area echoes that expressed by numerous consultees that EFG might not be fully meeting the needs of businesses in the region.
- Finance for medium sized businesses: This encompasses debt and equity. The frequency with which this was prioritised by respondents highlights a strong view that the finance gap in the West Midlands extends beyond smaller businesses.
- Equity: Although a smaller proportion of respondents highlighted SME Equity Finance this category is still prioritised by 60% of respondents. For the respondents who highlighted this category, the majority (89%) indicated that early stage growth equity (<£500k) was a priority. A similar proportion (83%) highlighted start-up equity (<£250k as a priority).

1.4.3 Theoretical Unmet demand

Unfortunately, whilst the SBS survey provides data that can be used to assess the extent of unmet demand from SMEs, this data is not available for the regions. However, the results of the UK level survey can be applied to the West Midland's business base to provide indications of the number of SMEs different sizes that may be struggling to obtain the finance they are looking for, and hence the value of unmet demand. The important caveats attached to this analysis are presented at the end of this section.

Assuming the experience of SMEs in the region is similar to those in the UK as whole, this analysis suggests that:

- In 2012 there were around 23,600 SMEs in the region looking for external finance, of which 17,700 were microbusinesses. Some of these microbusinesses will have been seeking microfinance; others will have been looking for larger amounts.
- Of these, nearly half (47%) had difficulties of some sort in obtaining this finance
- 7,600 (32%) of SMEs obtained none of the finance they were looking for, and 1,400 received some, but not all of what they were seeking (the national data indicates that the likelihood of successfully obtaining finance varies directly with business size with micros having the most difficulties and these easing with size increases).
- 5,100 SMEs that had a need for finance did not apply, for the reason that they thought they would be rejected (there is no further detail available from the survey on why they thought they would be rejected). The majority of these were micro businesses.

Table 0.5: Illustrative Analysis of SMEs' Experience in Accessing Finance in the West Midlands, using Survey Data

	Total	Looking for finance	Had difficulties	Unable to obtain any finance	Obtained some, but not all finance	Discouraged from applying because thought would be rejected
Micros (1-9)	80,500	17,700	8,900	6,200	1,100	4,500
Small (10-49)	15,600	5,000	2,000	1,300	300	500
Medium (50-249)	2,600	900	300	100	50	50
All SMEs	**98,700**	**23,600**	**11,100**	**7,600**	**1,400**	**5,100**

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

It is then possible to use data from the survey on the amount of finance being sought by businesses of different sizes to generate **indicative estimates** on the scale of unmet demand in addition to that being provided by the private sector and existing public sector backed FIs. This analysis shows that total unmet demand in the region could be of the order of £2.1 billion in one year. It is not possible to determine from this type of analysis how much of this is from SMEs that had viable business plans or investment propositions (i.e. those that, as a class of firms, could be supported in such a way that the financial and economic returns to the public sector from doing so would represent value for money, and hence constitute market failure).

To illustrate the potential scale of the market failure, Regeneris Consulting have set out in Table 0.6 scenarios on the proportion of firms that might have been viable. For example, if 10% of the firms which sought but could not access finance were viable, this would imply a finance gap of:

- £4m per year for microfinance (i.e. up to £25k)

- £80m per year for microbusinesses seeking larger amounts of finance (typically less than £80,000)
- £80m per year for small and medium firms seeking larger amounts of finance.

It should be noted that this is, in effect, the gap over and above that which is already being addressed by publicly backed initiatives, although these are time limited so the theoretical gap could increase when these schemes come to an end. The survey data implies that the unmet demand has grown over time although this is, of course, based on national rather than regional data.

Table 0.6: Illustrative Analysis of Unmet Demand (£millions) for Finance from SMEs in the West Midlands using Survey Data 2012/13

	Micros (1-9)		Small (10-49)	Medium (50-49)	All SMEs
	Seeking Micro - finance (up to £25k)	Seeking larger amounts			
- those that obtained none of the finance they were looking for	£40	£750	£430	£240	£1,460
- those that obtained some, but not all, of the finance they were looking for*	£0	£30	£20	£30	£80
Total unmet demand	£40	£780	£450	£270	£1,550
Scenarios for % that are viable					
10%	**£4**	**£80**	**£50**	**£30**	**£150**
20%	£8	£160	£90	£50	£310
30%	£13	£230	£140	£80	£460
40%	£17	£310	£180	£110	£620

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

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

Using the SBS data survey (which allows for the size of the SME and variations in the amount of finance sought by type of finance), we estimate that around £13m of the £150m unmet demand (calculated on the basis of 10% of propositions being viable) would be accounted for by equity based investment. However, there is the need for caution here as the estimation method will estimate the unmet demand in this part of the market

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

- The data is based on a single survey of businesses undertaken in the UK in 2012. Since this is a sample survey the results are subject to sampling error. Regeneris Consulting have not been able to access any data from the 2014 survey as it will not be published until spring 2015. Finance market conditions in 2014 will be different from those in 2012.
- Regeneris Consulting do not know from the survey whether businesses in the West Midlands were more or less likely to be successful in obtaining finance than those in the UK as a whole. While some datasets appear to suggest that West Midlands firms have been more successful, the evidence is not conclusive. The differences between regions are explained by differences in the size and structure of the business base rather than the demand for finance.
- Although the survey reveals the proportion of SMEs that seek different types of external finance it provides only very limited information on the unmet demand for these different types of finance.
- The analysis presented above only covers SMEs with at least one employee. It does not include business with no employees or businesses unregistered for VAT/PAYE.
- Regeneris Consulting do not have any data on these businesses' experiences of seeking finance, but they account for 74% of all SMEs in the region. Including this could increase the finance gap, although the vast majority of these will have modest finance requirements linked to growth plans.
- Similarly, this does not cover the experiences of early stage, pre-revenue businesses and the demand for and unmet requirement for seek and start-up funding.

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

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

1.4.4 Evidence of unmet demand from existing interventions

In addition to the theoretical exercise above, the experience of existing ERDF and other public sector backed interventions in the SME finance market can provide insight into the level of demand for various segments of the market, including an additional insight into that which is unmet. Regeneris Consulting provide a detailed discussion on the performance of these initiatives in the analysis of the supply side in section 1.5. However, here it is worth reflecting upon the evidence of demand noted from the consultations and performance data:

- **Microloans:** Some CDFIs are reporting very strong increases in demand (in total terms and for levels of finance sought) and the data available for some of the CDFIs which have received ERDF funding suggests that conversion rates have been high (between 9% and 14% of initial inquiries have been converted to loan offers overall). Unfortunately, there is no information routinely collected about the extent to which those rejected might have had viable business propositions.
- **Larger amounts of debt:** Consultees' views on the balance between demand for and supply of debt does not differ substantially from the national picture. Smaller established SMEs in particular (but also medium sized firms) tend to find it more difficult to access debt finance. This is partly related to their ability to leverage assets (or, in the case of manufacturing firms, the way that these assets are treated by lenders) but also related to a more general tightening of lenders' criteria, particular in relation to exposure to particular sectors and the tendency for banks to manage this process through credit scoring, rather than detailed appraisal of business plans. Consultees suggest that the most substantial problems are concentrated in the £80k to £120k range. But also in instances larger amounts (>£200k).
- **Early Stage Equity:** Although data on conversion rates is not available, consultation evidence points to low conversion rates for some of the early stage equity funds in the region. The consensus view is that there is

sufficient unmet demand to allow fund managers to be selective and that this leads to some viable propositions being unfunded. This does not reflect the experience of all funds.

- **Expansion Equity:** Consultees suggest that as the supply side here is constrained, there is significant unmet demand which extends well beyond that suggested in the analysis of unmet demand above. Although data is not available on conversion rates of existing expansion equity funds in the region, recent work completed by Blue Sky consulting indicates that conversion rates are particularly low in the region's equity funds. Although precise figures are not available, the analysis suggests that between 2% and 5% of applicants secure investment and that a substantial proportion of those which do not are viable. The report draws upon interviews with fund managers in the region and concludes that the low conversion rates are a product of high levels of demand and limited supply, which has enabled fund managers to be selective.

1.4.5 Summary of Demand Indicators

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

Microbusinesses and start-ups	• 360,000 microbusinesses in region (72,000 have no employees) • Some growth in the stock of microbusinesses but start-up rate below national average • Relatively poor performance on enterprise indices (GEM and Santander) • Mixed performance of micro-loan funds but on balance evidence suggests strong demand • Theoretical unmet demand over and above existing private and public backed provision = £40m per year for microfinance, or £4m per year if 10% of unmet demand is viable and constitutes market failure.
Early stage Growth businesses	• Proportionally fewer product and process innovators • But, increasing R&D spend and reasonable performance on spin-outs • University of Warwick, Aston and Birmingham account for majority of spin outs • Some innovation intensive sectors
Established SMEs[6]	• Smaller pool of established SMEs (c18,000), of which a % will be established >£7 years • Strong performance on high growth indicators • Theoretical unmet demand over and above existing private and public backed provision of £160m per annum, assuming that 10% of unmet demand is viable. Majority accounted for by debt, but still significant equity component.

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

1.5 Supply of External Finance

1.5.1 Trends in supply

The key trends in the supply of finance by market segment, are summarised below, using publicly available data. In the discussion reference is made to the performance of current publicly backed instruments where data is available.

1.5.1.1 Debt

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

Nonetheless, it is worth briefly reviewing the available regional data for the West Midlands. Sub-national data on bank debt was not available until the Business Finance Taskforce started to record lending to SMEs from Q3 2011. So whilst this data does not reveal anything about the period before this it does indicate the more recent trend (although it should be noted that this does not cover the full SME lending market). The data for the West Midlands suggests that the stock of term loans in the West Midlands has remained broadly stable during this period, with some quarter by quarter fluctuations. At the same time, the total stock of overdrafts has declined very slightly by 1% (or £12 million).

The Business Taskforce data paints a picture of stability in the supply of debt finance to SMEs in the West Midlands which does not reflect national trends. Nationally, there has been a substantial decrease in the value of overdrafts (the value of overdrafts has decreased by almost 20%, or £2.2 billion in the period covered by this dataset). And the UK the stock of term loans fell by 3.5% between Q3 2011 and Q4 2014. The value of overdrafts and loans has remained broadly stable in the West Midlands in this period. It should be noted however that this does not reflect the view of consultees that there has been a marked shift from overdrafts to other forms of debt finance (although it could simply reflect that this shift took place before 2011 in the West Midlands).

It is important to bear in mind that while the overall stock of term loans has been broadly stable in the West Midlands, the absolute number of approved loan facilities has been falling. In the period covered by this dataset, the number of approved facilities has fallen by almost 1,700 (a decrease of 40%). This has affected both smaller and medium businesses[7] although the trend has been slightly more pronounced amongst smaller firms. Here the number of approved loan facilities dropped by 43%, compared to 31% for medium firms. This points to an overall **trend towards an increase in the size of loans** which mirrors the trend which has occurred nationally. Consultations suggest this could be linked to a tendency for banks to continue to lend to existing customers with better risk profiles as well as a desire on the part of banks to manage their risk by focusing lending activity on a smaller number of businesses that are deemed to be less risky.

Based on 2013 lending figures, the value of new term loan lending per SME in the West Midlands was:

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[7] Small businesses are defined as those with less than £2 million annual debit turnover, whereas medium businesses are defined as those that have between £2m-£25 million annual debit turnover.

- Slightly above the national average for small businesses at £8,000 per SME in the region compared to £7,400 for England as a whole
- Substantially behind the national average for medium businesses at £8,400 per SME in the region compared to £11,300 nationally.

The picture for overdrafts is similar:

- The West Midlands figure for average overdraft value per SME in the region is £2,600, some £500 per SME above the national average
- For medium businesses, the West Midlands figure (£1,900 per SME in the region) lags a little behind the national figure of £2,200.

This suggests that small businesses in the West Midlands have *slightly* better access to term loans and overdrafts than the England average, whilst medium businesses (turning over more than £2m per year) might experience greater challenges accessing debt finance. However, it is important to note that this data source presents only a partial picture. It is also important to note that, while the picture in the West Midlands might not be substantially worse than elsewhere, national level challenges in the area of debt finance (outlined in the earlier chapters) are likely to affect West Midlands SMEs to the same extent as elsewhere.

Consultations suggest that, as for other regions, SMEs' use of asset-based facilities such as invoice discounting (not captured in the data below or in any regional data) has increased.

This headline data obscures the nuances of SMEs' experiences in the region. Evidence from consultations with banks and the professional advisory community suggest that the smaller end of the SME market, particularly microbusinesses, have been particularly affected by:

- A general tightening up of bank finance around the financial crisis, especially in particular sectors to which banks wished to reduce their exposure; and
- Bank's readjusted risk profiles, which have made it more difficult for SMEs without asset cover or security to access debt finance.

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

- Funding for Lending: As elsewhere the message from consultations appears to have been that Funding for Lending has not had any noticeable impact on the supply of debt to SMEs, and that lending has been focussed on mortgages.8
- Enterprise Finance Guarantee (EfG). Data on the EfG suggests a relatively strong take up of the scheme in the West Midlands to date. The number of loans drawn per 10,000 businesses is ranked third of all regions (behind the North East and North West). The average value of EFG backed loan per SME base in the region is £350, slightly higher than the national figure of £340. The average value of loan backed by the scheme in the region is around £102k (similar to the national figure). This suggests that, like other regions, the scheme has been focussed on smaller amounts of debt, but at somewhat higher levels than what would constitute a microloan.
- The Business Finance Partnership and the British Business Bank Investment Programme provide funding to non-bank channels to invest in small and medium sized businesses.9 Take up of these schemes in the West Midlands is lower than the national average. In 2013 £27m of was invested in SMEs in the West Midlands through this programme. The average value of investment was £113k, much lower than the England average of £200m. This is reflected in a per-SME base average of £270 in the West Midlands, little over half the England average of £500.

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

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

- The Start-up Loans initiative, set up in 2012 to help 18-30 year olds, has had some impact in the West Midlands and consultees see this as an important source of finance for new starts. The latest statistics show that £9.2 million (£3.3million per year on average) in total has been allocated to 1,860 start-ups in the West Midlands. On average, the scheme is providing just under £5,000 per loan, which is much lower than the national average of £9,000 and could explain why the per SME value of start-up loans per SME base in the region is very low (and £33 compared to the national figure of £70)

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Average annual investment with SMEs through the British Business Bank's initiatives (i.e. EFG, SUL, BFP and IP) for England as a whole is £1,250 per £1m GVA. The corresponding figure for the West Midlands exceeds this by some margin (£1,500 per £1m GVA). While this suggests that these schemes could be enjoying very high take up on the region, more detailed analysis suggests that this reflects more upon the region's below average GVA creation than it does take-up amongst SMEs. The average annual drawdown via these schemes per SME in the West Midlands (£180) is substantially below the national average of £230.

It should be noted that alternative sources of debt funding have had a role to play in providing debt to SMEs in the region. The rise of debt-based alternative sources in the UK is well documented and set out in the main report. This may be playing a role in filling gaps at the lower end of the SME debt market, with the average size of loan raised in the UK being £73,000 in 2013 and 33% of borrowers believing they would be unlikely to get funds from elsewhere. There is no regional data on P2P business lending, but it has reportedly had some take up in the West Midlands.

The presence of Peer to Peer lenders in the region (Thincats) and strong growth in this sector reported by consultees suggests that this is an important part of the picture. However, it is important to note that the Peer to Peer sector remains small in the context of overall lending. As set out in the main report, the future role of these sources is unclear.

Finance Birmingham's Mezzanine fund is also notable here. This £56m fund (supported by the Regional Growth Fund) can invest up to £2m in companies located within the GBSLEP area. This fund has been investing for less than a year and has so far invested just under £11m. The fund manager (Finance Birmingham) indicates very strong demand and a conversion rate in the region of 25%. It is too early to assess whether the fund is operating within an area of market failure. Consultees indicate that this fund is particularly well received by manufacturers who require larger amounts of capital but would be reluctant to give up equity.

There are a range of other sources of supply operating in the region and much of this is particularly relevant to the micro end of debt provision. It is outside of the scope of this report to map these out in detail, but many of these are particularly relevant to the micro end of the SME sector. These include:

- CDFIs: Just over 550 loans were made by CDFIs to West Midlands businesses in 2013, with a value of £7 million (an average value of just £13,000 per loan). A proportion of this figure was funded through ERDF but the overall importance of ERDF in the mix of capital that CDFIs are using has lessened over recent years. In 2009 and 2010, ERDF backed CDFI investment into SMEs was in excess of £5m. More recently, the ERDF component has reduced substantially (to less than £1m per year). CDFIs in the West Midlands, like those elsewhere, are drawing more heavily upon RGF funding.
- Local Authority run schemes: For example, the Birmingham City Council Loan Fund (administered by Finance Birmingham) offers loans between £100k and £1m to SMEs that pay business rates in the Birmingham City Council area.
- RGF backed schemes: For example, Green Bridge and BEP are offering a mixture of grants and loans. In addition, Finance Birmingham's RGF funded growth fund has reportedly had very strong take-up.

Most of the RGF backed funds will cease investing by the early or middle part of the ERDF programme period, subject to their arrangements for using legacies.

It is worth noting that ERDF funded schemes operating in the micro-loans area provide mixed evidence of demand. There has been strong demand for the ERDF funded Enterprise 18-30 Small Business Loans Scheme. This relatively small scheme (just under £1m investment pot in total) is focused on a particular segment of the micro finance market. It made 312 investments (totalling £860k) since 2012. The average investment size is £2,800. Defaults to date are reported to be limited (1%). The fund has also met its jobs created target.

Other ERDF backed loan funds providing slightly larger amounts of finance have fared less well. The WS and Stoke and Staffordshire Loan funds (both providing debt finance up to £50k) are both behind their investment and jobs created targets. The distorting influence of RGF has been cited here – grant funds currently available in the region are reportedly stifling demand for these loan funds.

1.5.1.2 Early stage finance

As was noted in the main market assessment, the available data on the supply of early stage finance is limited in so far as much of the investment activity in this area is informal and therefore not wholly captured in published statistics. The available data from the BVCA shows that levels of equity investment in the region are very low compared to national averages at just £83 per SME business in the region, compared to £360 in England. Annual levels of early stage investment in the West Midlands have hovered at between £6-12 million between 2007 and 2010, with around 34 companies per annum receiving investment. This has increased slightly to an annual average over the last three years of £18 million.

As far as Regeneris Consulting is aware, these figures include the investments made by most public and private sector backed equity funds in the region and includes investments made by ERDF backed funds in the region.

There are five major publicly backed early stage equity funds which operate across the full region. These are outlined in the table below. In addition to these, Finance Birmingham's Early Stage Equity fund is active in this space, although this is only available to businesses which pay business rates to Birmingham City Council.

Table 0.7: Summary of Key Public Sector Backed Early Stage Equity Funds in the Region

Fund	Total Fund Value	Investment Period
Midven Early Advantage Co-Investment Fund	£15	2010-2015
Mercia Seed Fund	£3	2012 to 2015
Advantage Media Production Fund 2	£3	2014 to 2015
Advantage Early Growth Fund Augmentation	£5	2013 to 2015
Rainbow Seed Fund	£24m (nationally)	

Note: Total value of funds includes fund management costs

The important thing to note, firstly, is that supply in the region is heavily dependent on ERDF backed venture capital funds. The Mercia Seed Fund, Midven Early Advantage Co-investment Fund and Advantage Media Production Funds are all ERDF funded and are therefore coming to the end of their investment periods.

Recent performance data on these funds highlights some important points in relation to the potential unmet demand in this area:

- The scale of legacy returns projected for these funds indicate that they are, as expected, operating in parts of the market that do not offer fully commercial returns and where much demand would be unmet by private sector funds. However, the positive legacy returns, in conjunction with the wider economic returns (jobs created in investee businesses), indicates that there are viable propositions with good prospects which are not receiving investment due to market failure.
- The average size of investments made reinforces the message from consultations that the gap in this area of the market is below £500k.
- On average, the funds are together making just over 30 investments per year. The average annual value of the investments made (including both public and private sector contributions to the fund, but not coinvestment at the level of the business) is £13 million. **Of this, £5m per year is public sector funds (and £3.5million ERDF).**

In addition to these ERDF backed funds, it is worth noting that there is a reasonably strong base of angel activity in the region. The general consensus amongst consultees is that the ERDF backed funds have provided helpful anchor funds for angels and related network support (now ceased) but that there are still challenges in bringing angels into very early stage ventures. As in other regions, exit speed is an important consideration here and the risk profile of these very early stage activities can be challenging, particularly if they are focused on very high tech businesses.

Consultees also note that there is a need for a greater degree of coordination activity to replace a loss of angel networks in the region.

A number of national initiatives have had some impact on the early stage funding landscape in the West Midlands. These include:

- **The Angel Co-Fund.** This £100m Fund was launched in November 2011 with a grant from the Regional Growth Fund. The aim has been to invest between £100k and £1 million in high potential businesses, and to leverage significant co-investment from business angels. It invests in both early and later stage businesses. The latest monitoring data indicates that a total of £7.5 million (including investment by co-investors to the ACF) has been invested in the region, in three companies. This represents 8% of the value of investment made at a UK level. The value of investment from this fund per SME business in the region (£27) is <u>slightly below</u> the England average of £30. We do not have access to regional data on leverage but at the national level to date £3.80 has been levered in from business angel syndicates for every £1 invested by the ACF itself. At this stage it is clearly too early to judge the level of returns – the data available to Regeneris Consulting is at the national level, which states that one exit has been achieved at a 3 times return.
- **Enterprise Capital Funds** were originally set up in 2005 as a government-backed scheme with the aim of investing up to £2 million in early stage companies. ECFs operate as private companies that back private capital with Government-guaranteed leverage. The limit on the amount that ECFs could invest into any one fund was £25m, which has recently been increased to £50m. The ECFs are typically UK-wide Funds, although regional funds have been supported. There are no West Midlands located ECFs. For various reasons, two thirds of the value of investment made to date has gone to companies based in the southern regions of England (London, South East and East of England). The latest monitoring data shows that 11 investments have been made in the West Midlands to date. These investments total £12.8 million (including co-investment). This represents 6% and 5% respectively of the total value and number of companies in the UK. The level of investment per SME business in the region represents is <u>substantially below</u> the England average (£16 per SME compared to £30).

- **UK Innovation Investment Fund**. This Fund provides capital for existing venture capital funds, with a total capital of £330 million (of which £150m has come from the UK Government and £180 million has come from the private sector). It is targeted at small businesses with growth potential and new ventures in the digital, life sciences, clean technology and advanced manufacturing sectors. Regional data is not available for this fund.
- **Tax incentives.** Collectively tax incentives are the biggest intervention in the UK equity market by value. The Enterprise Investment Scheme (EIS) provides 30% tax relief for investors making an investment of up to £1m in any tax year. SEIS is a derivative of EIS, which aims to encourage seed investment in early stage companies. Investors receive tax relief of 50% on investments up to £100k and Capital Gains Tax exemption on any gains in SEIS shares. ONS data based on HMRC returns shows that a total of £53 million has been invested in 303 companies through the EIS scheme in the West Midlands since 2009. This represents an annual average of £18 million. This is equivalent to just £179 per SME business in the region, which is very low compared to the England average of £650.

Again, alternative funding sources have also played a role in this market, including equity based crowdfunding platforms. These are much smaller in scale than P2P platforms: the latest review of the UK market found that equity based crowdfunding amounted to £28 million nationally, representing very strong growth from the estimated £4m in 2012 (the average amount of money raised was £199,000). The data suggests that these routes have had some penetration in the West Midlands to date. Reward-based crowdfunding (where individuals donate to fund a project with the expectation of a non-financial reward in the event of its success) has also had little penetration in the region, according to the same report, with only 4% of companies using this finance in the UK being based in the region.

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

1.5.1.3 Equity finance for established firms

The BVCA also publishes data on later stage growth deals completed in the region (privately and publicly backed). Since 2007, investment levels have been volatile and annual figures have ranged from £10m to £118m. The overall annual average value of investment between 2007 and 2013 is £53m and the latest data (for 2013) shows that the value of investment in 2013 was £56m. This represents £570 per SME business in the region which is very low compared to the national average of £1150.

Consultees suggest that this reflects limited supply active and available within the region rather than an underlying low level of demand. There is currently only one regional public sector backed expansion equity fund operating in the West Midlands. The sizeable AWM funds which operated in late 2000's have ceased and have not on the whole been replaced. The Exceed Fund is an exception, originally being backed by AWM Single Programme grant and Lloyds Development Capital but latterly received a small amount of ERDF funding. It is a general growth equity fund which can invest up to £500k initially. The fund expected to close for new investment in 2015.

Given the role that business confidence plays in driving demand for this type of investment, growth equity funds face a more challenging climate than the others. Unlike businesses in their early stages of product and business development, established SMEs can easily postpone growth projects whist they wait for conditions to improve. The consultations suggest that this happened in the West Midlands (as it did in other regions).

In spite of this, fund managers do not report any substantial challenges in finding sufficient investable propositions for the Exceed fund. The fund is investing in the region of £3m per year (excluding co-investment), of which around half is public sector funds.

There are several UK level initiatives in this area:

- The Business Growth Fund (BGF) was set up in July 2012 and is backed by a syndicate of banks with £2.5 billion of capital – it focusses on growth equity and mezzanine finance, offering £2m-£10m. It is designed to be an evergreen fund. Published data on the Fund's portfolio indicates that investment totalling £4.1 million has been made in the West Midlands to date. This equates to £60 per SME business in the region and is slightly lower than the national average of £76 per SME.
- Enterprise Capital Funds can also invest in later stage businesses. The latest monitoring data was presented earlier under the early stage section and points to investment levels which are substantially below national rates.

1.5.1.4 Overview of SME finance

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

Table 0.8: Summary of Key Sources of SME Finance Supply in the West Midlands

	Average annual value of Investment, £m	Average value of investment made, £000s (England avg in brackets)	Value per SME Business (England average in brackets)	% change in value 2011-13 (England avg in brackets)
Debt				
New loans to Small Businesses	£793	£86 (£82)	£8,038 (£7,342)	-5% (-12%)
New loans to Medium sized businesses	£828	£291 (£295)	£8,384 (£11,303)	8% (1.5%)
New overdrafts approved for Small Businesses	£255	£16 (£16)	£2,585 (£2,094)	-27% (-25%)
New overdrafts approved for Medium sized businesses	£191	£73 (£81)	£1,937 (£2,229)	-14% (-5%)
Enterprise Finance Guarantee backed lending	£35	£102 (£100)	£349 (340)	NA
Start-up Loans	£3.3	£5 (£9)	£33 (£70)	NA
Business Finance Partnership & Investment Programme	£27	£112 (£207)	£271 (£500)	NA
ERDF backed debt investment	£1.1	£5.6 (£83)	£11 (£40)	63%
Equity				
Early stage equity investment	£24	£765 (£1,081)	£83 (£355)	11% (24%)

Expansion equity investment	£56	£2,060 (£4,830)	£571 (£1150)	-28% (-62%)
Angel Co-Fund	£2.7	£2,513 (£1,832)	£27 (£30)	NA
Enterprise Capital Funds	£1.6	£1,160 (£1,335)	£16 (£27)	NA
Enterprise Investment Scheme (EIS)	£17.8	£176 (£344)	£179 (£650)	58%
Business Growth Fund	£4	£4,130 (£5,617)	£61 (£77)	18%
Equity-based crowdfunding	£1.3	NA	£42 (£26)	NA
Other crowdfunding (reward-based, donation)	£1.7	NA	£17 (£35)	NA
ERDF backed equity investment	£14.2	£159 (£399)	£143 (£59)	33%

1.5.2 Performance of ERDF backed funds

The West Midlands has a lot of experience in the delivery of public sector backed SME finance initiatives. AWM was particularly active in delivering early stage and expansion equity schemes across the region and this has been built upon during the last programme period with a range of ERDF supported early stage funds (an annual and micro and small loan schemes. However, the regional programme was less active in terms of expansion equity orientated schemes. These are set out in the table below – the vast majority of these FIs will cease investment in 2014 or 2015 (although the Advantage Media Production Fund and Early Growth Fund are intended to be evergreen).

Table 0.9: ERDF Backed SME Finance FIs in West Midlands, 2007-13 Programme Period

	Fund	Total Fund Value (£m)	Investment Period
Early Stage Equity	Mercia Seed Fund	£3	2012 to 2015
	Advantage Media Production Funds 2	£3	2014 to 2015
	Advantage Media Production 1	£3	2010-2014
	Midven Early Advantage Co-Investment Fund / Advantage Early Stage Equity Fund	£15	2010-2013
	Advantage Early Growth Fund Augmentation	£5	2013 to 2015
	Advantage Early growth Fund Augmentation 2009	£7	2010 to 2012
Growth Equity	Midven Exceed	£18	2010 to 2015
Small Loan Funds	ART(Aston Reinvestment Trust)	£2.5	2010
	Black Country Reinvestment Society	£6.4	2010
	Coventry & Warwickshire Reinvestment Trust	£1.3	2009 to 2010
	MRRT Ltd	£2.6	2010
	The Princes Trust	£3.1	2011 to 2012
	MRRT Ltd via procurement	£3.1	2013 to 2015
	BCRS via procurement	£2.0	2013 to 2015
	Coventry and Warwickshire Reinvestment Trust (Coventry City Council Accountable	£1.0	2014 to 2015

	Body)		

Note: ART, BCRS and MRRT received ERDF funding to support their activities in 2010 only, but they continue to invest using different sources of public sector backed funding (including RGF).

The evidence in relation to the performance of these funds and the implications / insights that this data offers for the market assessment is set out elsewhere in this section. It is however important to reflect upon partners' experiences of delivering these programmes and the lessons that partners in the region have derived from this recent experience (as well the longer track record of delivery in the region). The main lessons reported by consultees are:

- Flexibility in fund design. Managers of current funds recognise the need for funds to focus on areas of market failure and the businesses that have strategic relevance for the region. However, they also stress the importance of flexibility in fund design and the need to ensure that eligibility criteria (particularly those relating to business sector etc) do not stand in the way of making good investments. This reflects the messages from the evaluation of VC funds in the region in 2009.
- Flexibility to ensure follow on investment is available. Again the experience in the region points to a need for balance between making funds available for follow on investment (particularly important for the earliest stage investments to ensure that public sector investment isn't diluted out) but also ensuring that there are balance in place to make sure that the limited investment available can be spread equitably between viable businesses in the region.

1.6 Implications for Future Public Sector Backed Funds

This section brings together the results of the preceding analysis to draw out the high level implications for future public sector backed SME finance schemes during the 2014-20 programming period in the region. This is done with reference to the area based market assessment framework presented the main report. **The final two steps of the market assessment framework will be completed as part of the block two element of the ex-ante assessment.**

The assessment against the steps in the framework is provided in the summary table overleaf.

	Micro Loans for Small Businesses	Early Stage Risk Finance	Debt for Growing Established SMEs	Expansion Equity for Established SMEs
Step 1 - Demand and Supply Characteristics	• Substantial and growing stock of micro firms (360,000 in 2013) • But relatively poor enterprise performance and start-up activity • Banks investing at levels higher than microloans (average investment in small business is £85k) • Strong CDFI presence and investment from these growing. Patchy coverage of local authority led loan and grant schemes • Relatively poor take up of SUL	• Strong presence of tech companies (medical tech, adv manuf in particular) • Good performance on spin outs, although volumes small • Innovation active businesses at reasonable level and R&D spend improving • Low levels of investment overall in WMs based firms compared to nationally, plus below average take up of BBB provision in this area • Some early stage funds doing limited volumes of investment and reporting demand side constraints, but the picture is mixed. • Reasonable level of Angel activity, but coordination is an issue here. • Crowdfunders contribution is minimal at present.	• Strong demand side indicators (c. 18,000 established SMEs) although pool of demand is smaller than for smaller loans. • Strong presence of high growth firms and firms with high growth potential. • Confidence returning after a period of dampened demand. • Tendency towards increasing loan sizes and tightening criteria • Public sector provision is patchy. • Above average take up of EFG in the region but lower levels of BFP and IP take up • P2P lending has had some penetration but remains relatively small scale	• Substantial number of established SMEs in the region (c18,000) but small proportion (2-8%) likely to be open to / suitable for equity • Strong presence of high growth firms and firms with high growth potential. • Business confidence decline has stifled demand for expansion equity. But some signs of increasing confidence and recovery. • BVCA data suggests low levels of investment compared to nationally • Equity aversion an issue amongst some business owners in region. • Mainstream providers, focussing on larger deals (£2m+) • Public sector provision is reasonable (Mezz and Equity) plus later stage life science fund.
Step 2 – Unmet Demand	• Consultees report growing, difficulties for micros in the face of national trends • Strong demand for micro finance from CDFIs, although (anecdotally) loan size is increasing in this segment also. • Evidence of demand for other micro-loan schemes is mixed (possibly reflects distorting influence of grant schemes on the market) • Theoretical unmet demand of **£40m** pa, although only a proportion of this would constitute market failure.	• Very little mainstream provision of general early stage equity and supply to become constrained as ERDF funds reach completion. • Mixed evidence from consultations but consensus is unmet demand exists for more general early stage VC. This is mirrored in reports of high conversions rates for these funds. • Anecdotally, demand for Angel finance outstrips supply in this area • Potential coordination challenges for angel activity • Survey of intermediaries suggests early stage equity gap is focused at sub £250k level. This reflects views of consultees.	• Survey of intermediaries suggests unmet demand for loans for expansion is a priority. • National evidence base suggests this is focused around (£50 to £300k). Potentially greater amounts for manufacturers. • Theoretical unmet demand for growth focused finance (inc debt and equity) is in the region of £1,600 million per annum, although only a proportion of this would be viable and therefore constitute market failure. • Consultation suggests discouraged businesses a factor here.	• National survey data suggests around 40% of small and 30% of medium sized businesses have problems accessing finance, and this has grown in recent years • Not possible to split theoretical unmet demand calculation for debt vs. equity, but unmet demand for established SMEs as a whole amounts to £210m p.a. even if only 10% of rejected firms had solid business plans. • Consultations suggest that low levels of take-up reflect supply side constraints. • Strong demand for FB mezzanine and Exceed fund echoes this message.

		• Not clear what proportion of these are viable.		
Step 3 – Market Failure	• Smaller firms tend to find it more difficult to access debt, particularly smaller amounts and bank lending above micro level on average. • Low write off rate for ERDF backed micro loans suggest viable businesses in this area (based on single small fund though) • Likewise, CDFIs reporting relatively low default rates and reasonable returns. This suggest5s that there are viable businesses in this segment. • Assuming 10% of unmet demand is viable. Unmet demand constituting market failure is in the region of **£4m per year.** • Consultees point to possible coordination / access issue associated with fragmented supply	• Projected legacy and economic returns of ERDF backed equity suggests that a reasonable proportion of firms being supported are viable • Consultees report existence of viable unmet demand in addition to that supported by these funds • Rapid post-recession increase in demand is not expected. More likely to be steady.	• Smaller firms tend to struggle to access debt, particularly for smaller amounts. • Mixed evidence but general consensus that there are viable proportions that don't get funded • Largely due to lack of asset base and tendency to require smaller amounts. • Manuf / Automotive – strong mkt failure case based on how assets are treated • Assuming 10% of unmet demand is viable, the portion of this which constitutes market failure is in the region of £150 million per year. Note this includes debt and equity. Take-up of FB's mezzanine scheme has been strong. Too early to comment on performance.	• Anecdotal evidence of mkt failure. • Some propositions which don't receive investment are viable. Funds rank and opt for least risky. • Not all operating in areas of market failure •
Step 4 – Persistence of Market Failure	• No indication that trends in lending will change substantially. • Some grant schemes proposed for starts in some LEP areas but no large scale investments expected • Improved economic climate – more start-ups likely and existing micros could move into growth stage.	• Evidence suggests mainstream players will continue to focus on larger, de-risked propositions • No evidence of emerging funds likely to operate in this area	• Consensus view that banks unlikely to return to pre-crisis practices and lending rates • P2P unlikely to fill the gap • No major expansion of supply expected • Economic recovery points to increase in demand for debt and therefore potential increase in unmet demand	• As the economy recovers, demand for expansion equity likely to grow • Plus existing funds nearly fully invested • No sign of mainstream players moving away from fewer, larger deals
Step 5 – Specific Economic Development Priorities	• Focus on enterprise and start-up activity in some LEP areas. • **Analysis to be further tested and reviewed as part of Block two work**	• Substantial focus on innovation and R&D in SEPs • Aspirations (and associated investments) to increase spin out activity • **Analysis to be further tested and reviewed as part of Block two work**	• Business growth is a major consideration across all LEPS • Substantial investment in revenue funded services expected • Manufacturing /advanced engineering likely to lead to increase demand for larger amounts of debt • **Analysis to be further tested and reviewed as part of Block two work**	

Step 6 – Delivery Capacity	• Significant experience in the region of delivering microloan funds, although not as part of a JEREMIE • Capacity to deliver exists amongst CDFIs, plus scope to procure other providers • **Analysis to be further tested and reviewed as part of Block two work, as potential investment strategy and delivery options are developed**	• Track record of delivering publicly funded VC in the region • No JEREMIE experience, but reasonable presence of fund managers in the region • Well-developed financial ecosystem. • Strong linkages developed with intermediaries and professional advisors • Provides a strong base to build on for a future Fund • **Analysis to be further tested and reviewed as part of Block two work, as potential investment strategy and delivery options are developed**	• Experience of delivering large scale loan funds in the region is more limited, although this is not a substantial barrier to delivery (as it might be for equity) • Plus, capacity in the region given presence of Birmingham as a major financial and service centre. • **Analysis to be further tested and reviewed as part of Block two work, as potential investment strategy and delivery options are developed**	• Track record of delivering publicly funded VC in the region • No JEREMIE experience, but reasonable presence of fund managers in the region • Well-developed financial ecosystem. • **Analysis to be further tested and reviewed as part of Block two work, as potential investment strategy and delivery options are developed**