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

North East

January 2015

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

1 Area Overview: North East

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

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

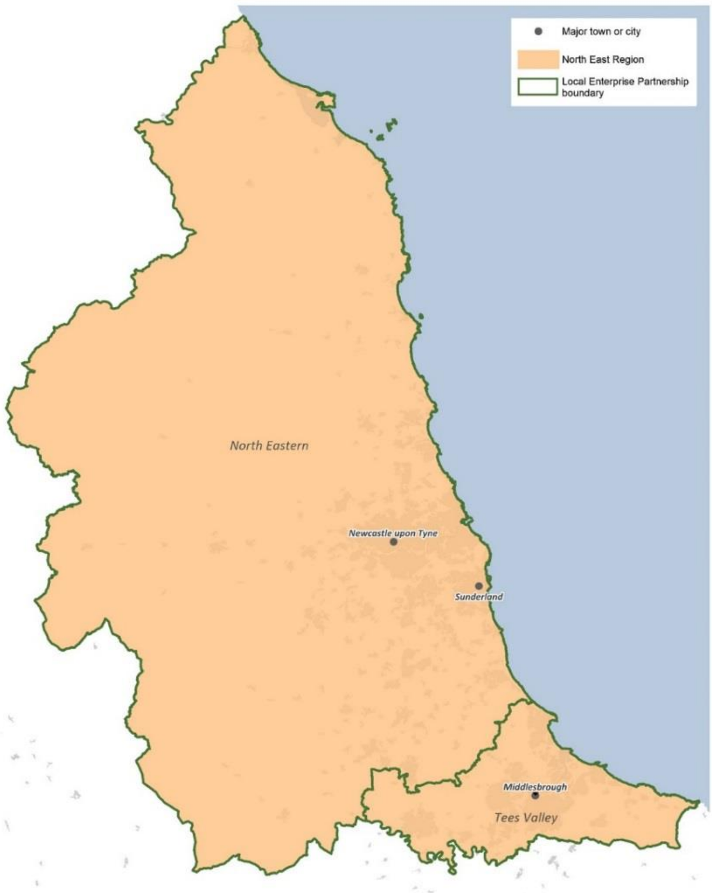
1.1 Economic Geography

The North East is home to 2.6 million residents, 1.04 million jobs, and 135,000 SMEs (35,000 of which have employees).[1] Its total Gross Value Added in 2012 was £41.8 billion, equivalent to £16,100 per head of population, which compares to an England average of £21,900 (or £19,100 if London is removed).

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

- The North East LEP, covering County Durham, Gateshead, Newcastle, North Tyneside, Northumberland, South Tyneside and Sunderland
- Tees Valley LEP, covering Darlington, Hartlepool, Middlesbrough, Redcar and Stockton.

The region and its LEP areas are shown in the map below.



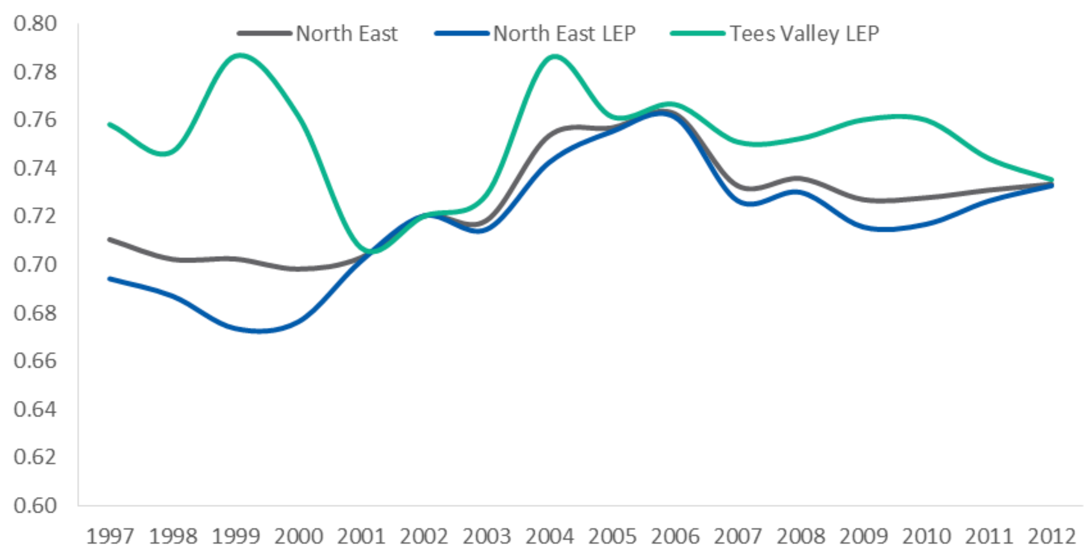
[1] Source: BIS Population Estimates. Note: This includes sole traders and businesses that are not registered for VAT or PAYE. This data is not available at a sub-regional level.

The North East LEP area contains 1.9 million residents (73% of the total population in the North East), and 44,700 enterprises, of which 43,000 are SMEs (including businesses with zero employees).[2] It contributes £30 billion in annual GVA, with the main economic centres being Newcastle, Gateshead, Sunderland and Durham. County Durham and Northumberland account for just under half of the total business base.

There are 665,000 residents in the Tees Valley LEP area, with 13,600 businesses, of which 13,500 are SMEs. Stockton-on-Tees accounts for the greatest proportion of businesses, and is the centre point of the Enterprise Zone for the area. The LEP area is a centre for the process industries and advanced manufacturing, and contributes £10 billion in annual GVA.

Gross value added (GVA) per head of population for both LEP areas has increased steadily in recent years. For the region it has increased from £9,300 in 1997 to £16,100 in 2012. The GVA per head for the Tees Valley LEP area has been consistently higher than the rate for both the region and for the North East LEP area. Post-recession, however, there has been a convergence to a value of approximately £16,100, which is around 26% below the England average, or 16% below the England average less London.

Figure 1.1: GVA per Head (England=100) - 1997-2012



Source: Office for National Statistics

1.2 Policy

The main economic development issues in the area are concerned with employment and innovation gaps and their impact on economic performance in their areas. Although the region has experienced positive job growth since the recession, strategic economic plans for both LEP areas cite not just the overall number of jobs but the quality of jobs in the area as an issue, as well as a shortage of high-level skills. There is also the need to rebalance the economy by increasing the proportion of jobs in the

[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.

private sector. SMEs have a role to play here to increase private sector employment and to contribute to innovation in priority sectors. Both areas highlight the potential for the growth in various low carbon sectors.

As well as these areas of common ground, each of the LEP areas has distinctive challenges and opportunities. For example, the Tees Valley LEP area has historically been dependent on a small number of large employers and is still dealing with the challenges of declining employment stemming from technology and international competition. More than 50% of Tees Valley employees work for a company employing more than 1,000 workers. 70% of the area's large companies are foreign owned subsidiaries. It has a strong base of process industries and advanced manufacturing.

To address these challenges the LEPs have identified the following priorities in the area of SME competitiveness:

- Innovation – both LEPs identify innovation as a key aspect of future economic growth and development. Tees Valley will focus on innovation in advanced manufacturing, low carbon economy and digital/creative sector.

- Business support – both areas include a range of actions in the area of business support. Tees Valley LEP puts a particular stress on increasing start up rates and business density, whilst the North East LEP places more of an emphasis on growing the productivity of existing businesses.

Both LEPs include reference to self-employment as an employment option.

A summary of the key priorities and actions identified by the LEPs, is set out below.

Table 1.1: SME Competitiveness Priorities of North East LEP and Tees Valley LEP

Priority Area	**Actions identified**
North East LEP	
Innovation	• Creation of Innovation Leadership Board • Catalytic innovation competitions • Grand challenge innovation programme • Innovation project support in areas aligned to SEP PhD commercialisation initiative
Business support	• Support for a JEREMIE Fund • Improved access to angel and mentor networks • Development of a Growth Hub • Introduction of an entrepreneurship programme for University leavers • Strengthening support available to social enterprises
Tees Valley LEP	
Innovation and sector development	• Direct support for research and innovation, esp. in process/advanced manufacturing, health and digital • Direct support for businesses to commercialise new products and processes • Supporting collaborative projects • Creating and enhancing open access technology centres • Tailored business support programme • Ensuring a flexible mix of finance is available for SMEs, through support for a successor JEREMIE Fund and a Fund for social enterprises.

Source: Strategic Economic Plans

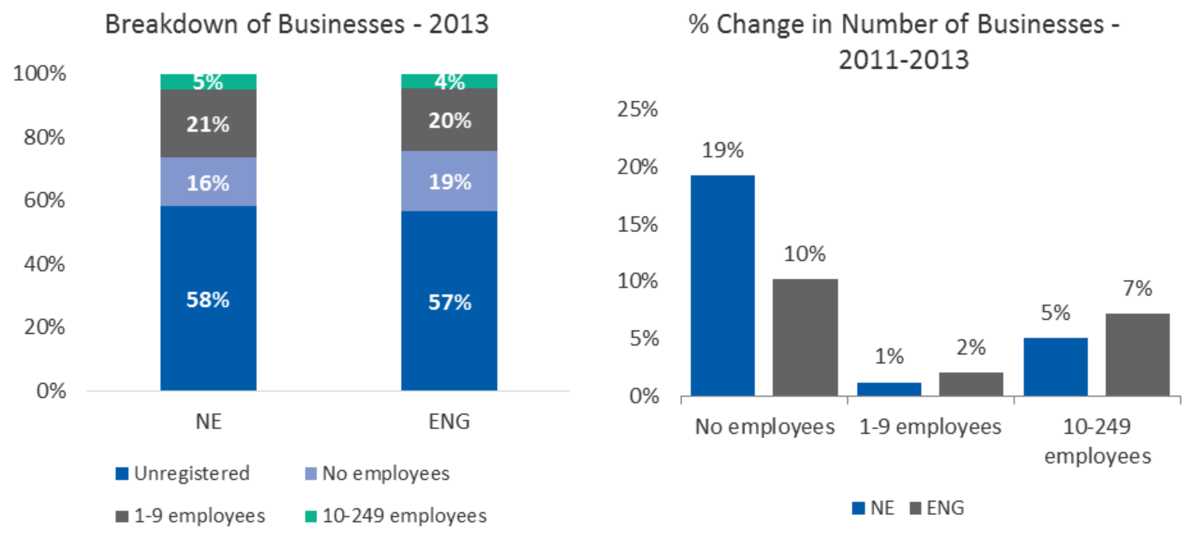
1.3 Business Demography Trends

1.3.1 Business stock

The region is home to 135,200 SMEs, of which 128,500 (95%) are microbusinesses (less than 10 employees), 5,600 are small (10-49 employees) and 1,000 are medium sized firms (50-249 employees). Of the microbusiness stock, 78,500 are unregistered for VAT/PAYE and 6,000 are sole traders.

The region has a slightly greater proportion of unregistered businesses than the UK average, a smaller proportion of sole traders and similar proportion of micro and established SMEs (defined as those with 10-249 employees).[3] In the past three years the North East has seen the number of sole traders (both registered and unregistered) increase by 19%, which is greater than the England average. However, the rate of change for small and medium sized SMEs has been a little below the England average.

Figure 1.2: Composition (%) of SME Stock in 2013 and change 2011-2013



Source: BIS Business Population Estimates 2011-2013

There are around 42,600 SMEs (including sole traders but excluding unregistered businesses) in the North East LEP area, compared to 13,600 in the Tees Valley LEP area.[4] The composition of SMEs by sized band in each area is the same in each area: 86% are microbusinesses, 12% are small firms and 2% are medium sized businesses.

SME business density[5] is significantly below the national average in both LEP areas. SME density in the NE LEP area is 37% below the England average and in the Tees Valley it is 41% below (this falls to 35% and 37% respectively when London is removed from the England average). There is some variation by local authority with the highest SME business density in Northumberland (although this is lower than the

[3] Regeneris Consulting would caveat that this 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.

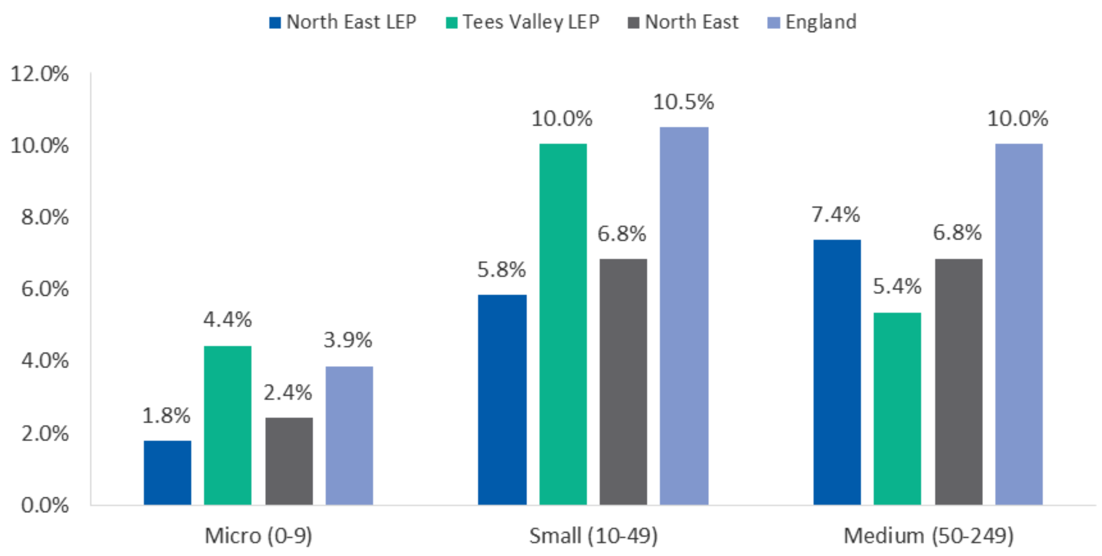
[4] Source: ONS Business counts data

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

England average). SME business density is the lowest in Sunderland, 23% lower than the rate for the North East as a whole.

For micro-businesses and small businesses, growth in the Tees Valley LEP area has been higher than both the North East LEP area and higher than the region. For small businesses, growth in the Tees Valley LEP area is slightly lower than the national rate. For medium sized businesses, growth in the whole area (both LEP areas and the region) is lower than the national growth rate.

Figure 1.3: % Change in Number of Businesses 2011-2013



Source: ONS Business Counts

The majority of microbusinesses in the North East are in the professional, scientifical and technical sector, followed by retail and construction. For the rest of the SME stock in the region, majority of firms in the region operate in the accommodation and food services sector, followed by the health sector and the manufacturing sector.

In terms of the key sectors in the region, both of the LEPs have outlined priority sectors in which they anticipate future growth:

- North East LEP has identified growth to occur in the following sectors: business and professional services, sectors in the new economy such as creative, digital and media and telecommunications, as well as healthcare, tourism and logistics.
- Tees Valley LEP aims to create a more diverse high value economy. As such, growth is anticipated in the following sectors: low carbon, advanced manufacturing, construction, professional and business services, logistics, digital, higher education and health and social care.

1.3.2 Business Starts

In 2012 around 7,300 new businesses formed in the region. At 44 per 10,000 working age adults, this is 38% below the England average, or 29% below the national average once London is removed.

The vast majority of these new businesses were formed in the North East LEP, but when adjusted for population the start-up rate is higher in the Tees Valley LEP. Rates are below the England average in all of the region's constituent local authorities, but there is mixed performance with better performance in Darlington (24% below the England average) and Stockton (22% below the England average), for example. The North East has had a particularly strong rate of business creation from technology start-ups in recent years, with more new technology start-ups in the region than any area of the UK outside London. This has, in part, been driven by the digital games sector.[6]

Notably, the volume of business start-ups was much higher in 2012 than 2009, with a 10% increase in the period. The increase was greater in Tees Valley than the North East LEP.

Table 1.2: Business Starts in North East and its LEP Areas, 2009-12

		Business Starts			Business Starts per 10,000 WAP (2012)	
	2009	2012	Abs Change		Number	England=100
North East LEP	4,895	5,285	390	8%	42.3	60
Tees Valley LEP	1,730	1,980	250	14%	47.1	67
Total North East	6,625	7,265	640	10%	43.5	62

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's business database. It defines high growth firms as those that have revenues of between £2.5m and £100m, and 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. These are the kinds of firm that are likely to have a need for external finance to support this expansion.

The latest report found that 21.2% of businesses with a turnover of between £2.5 million and £100m in the region fall into this high growth category. Although this ranked the North East 8th out of 9 English regions, the proportion has been growing significantly and there has there has been some closing of the gap in recent years: the region is only 0.8 percentage points behind the England average.

Table 1.3: High Growth Firms as a % of Businesses with revenue £2.5m-£100m, 2011-13

	2011 Population of High Growth Firms	Regional Rank (2013)	2011	2012	2013
North East	80	8th	15.8%	18.9%	21.2%
England	4,044		16.9%	20.9%	22.0%

Source: BGF Growth Companies Barometer

[6] North East LEP (2014) *Strategic Economic Plan for the North East*

1.3.4 Innovation activity

The North East overall performs well on a range of indicators of innovation. The region has approximately 3,100 enterprises defined as innovation active, representing 47% of businesses with at least 10 employees in the region. This is higher than the UK average rate of 45%, and is the second highest of all the regions.[7]

There have been 66 university spinouts in the North East since the year 2000, representing 7% of all spinouts in the UK. The North East has the highest number of spinouts of all regions when compared with the size of the working age population. Newcastle and Durham University account for 92% of all spinouts in the region, with more than half coming from Newcastle University.

The region has also had the highest number of tech start-ups in the country in recent years outside London in recent years.[8]

R&D expenditure, in particular that related to the private and university sectors, is one driver of the spinout and creation of companies and the demand for early stage risk finance. Expenditure on research and development has increased significantly from 2001 to 2012, from £275 million to £542 million, an increase of 97% and the highest of all regions in England. However, per head of population R&D spend is the lowest of all regions.

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 (three and a half years). It is a commonly used indicator for assessing the extent of early stage commercial activity in an economy.

Using pooled data for 2008-13 at a regional level[9] suggest that the region had the lowest TEA rate of all the English regions, and was below UK average performance on all indicators. Indeed, the region ranks below other regions on most indicators.

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[7] Source: BIS UK Innovation Survey

[8] Source: North LEP Strategic Economic Plan, 2014.

[9] Pooling was necessary due to low sample sizes at a regional level.

Table 1.4: 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[10]	
			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%
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%
East Midlands	5.2%	3.8%	5.3%	2.5%	2.6%	5.9%	14.7%	2.0%

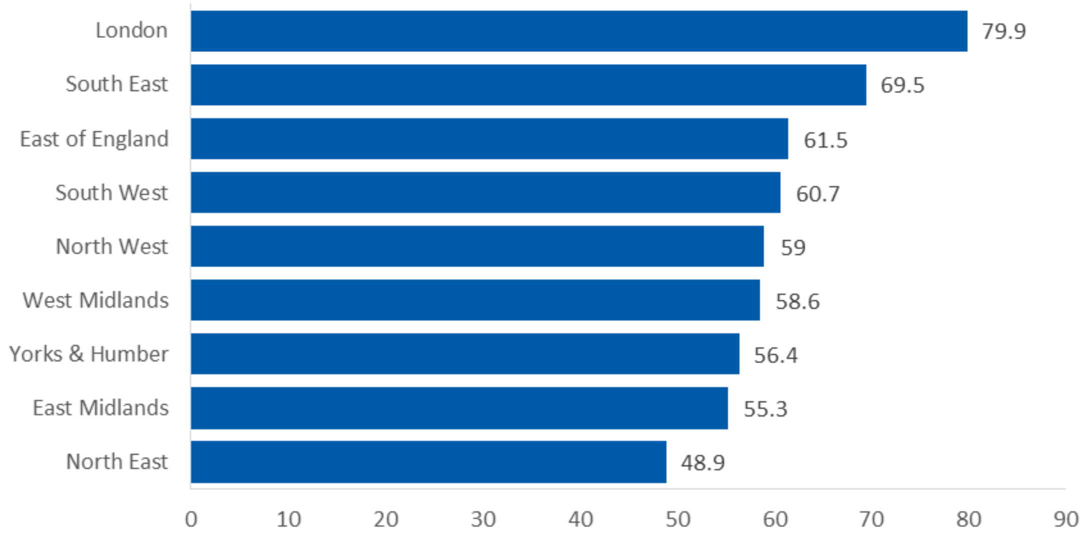
Source: Global Entrepreneurship Monitor 2008-2013, bespoke regional analysis.

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

The latest ranking for 2014 supports the finding of GEM, with the region performing relatively poorly compared to other English regions, although it still ranks within the top 60 of the 125 EU regions considered. The analysis suggests that important factors driving the North East's score on the index revolve around its performance on indices of attitude, abilities and aspiration. In particular, the region scores 35.8 on aspiration, which compares to 77.7 in London (the top performing region) and 49.0 in the North West (ranking 5th out of the English regions). The report emphasises that a lack of entrepreneurial aspiration serves as a "bottleneck factor" preventing UK regions from realising their full economic potential.

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

Figure 1.4: Santander Enterprise Index Score - 2014



Source: Santander Enterprise Index 2014

1.4 Demand for and Take-up of External Finance

1.4.1 Survey evidence

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

43% of SMEs surveyed in the North East in 2013 had used finance of some sort[11] in the past five years. 55% had not used finance at all over this period. 31% had used either an overdraft, loan or credit card. 36% of all SMEs were classed as a "permanent non-borrower" (PNB), meaning that they have not used external finance in the last five years and have not attempted to borrow over the past 12 months, and have no inclination to borrow in the next three months. This PNB proportion has remained constant since 2011, whereas in the UK the proportion has risen. SMEs in the North East are statistically significantly less likely to be a PNB than those in other UK regions.

8% of SMEs applied for a new overdraft or loan facility or sought to renew an existing facility. The proportion of SMEs successful in their application for overdrafts varied over the period 2011-2013, however a greater proportion of SMEs have reported issues[12] in their application before approval. The latest data for loans shows that 53% of those seeking one were unable to obtain one, which is a rise on

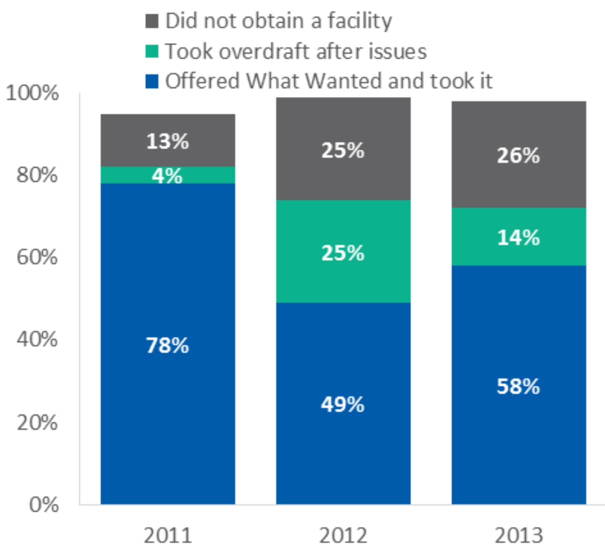
[11] Bank overdraft, Credit cards, Bank loan/Commercial mortgage (these three form the core product category), Leasing or hire purchase, Loans/equity from directors, Loans/equity from family and friends, Invoice finance, Grants, Loans from other 3rd parties, Export/import finance.

[12] 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"

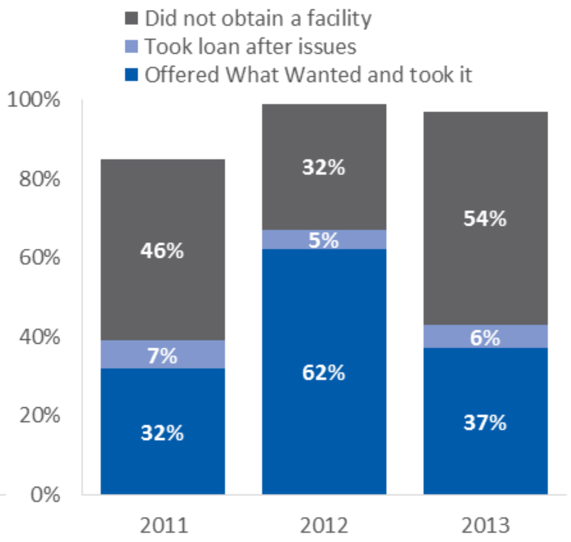
previous years. It should be noted that for both overdrafts and loans the survey report notes that there were no statistically significant differences in success rates between the North East and the UK as a whole.

Figure 1.5: Overdraft and Loan Applications in the North East - 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 regional data only covers debt finance, so in looking at equity finance it is only possible to assess the situation using national level data. The only data provided in the BIS SBS is on the proportion of SMEs that were looking for equity investment. This highlights that only a small proportion actively seek out this type of finance, and that this has remained stable over time (standing at 2% in 2012, 2010 and 2008). Less than 1% were seeking mezzanine finance. This partly reflects the more niche nature of equity and mezzanine finance but also probably illustrates the lack of awareness amongst SMEs of this type of finance. The latest survey also shows an emerging awareness of alternative sources, including 1% who are aware of peer to peer/crowdfunding.

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

It should be noted that partners in the North East have commissioned a bespoke survey of SMEs. However, the results will not be available until 2015, so it has not been possible to draw on this.

1.4.2 Theoretical Unmet demand

Whilst the BIS SBS survey provides data that can be used to assess the extent of unmet demand from SMEs in the UK, this data is not available for the regions due to sample sizes. However, the results of the UK level survey can be applied to the North East's business base to provide indications of the number of SMEs in different size bands 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.

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

- In 2012 there were around 8,500 SMEs in the region looking for external finance, of which 6,300 were microbusinesses
- Of these, around 4,000 had difficulties of some sort in obtaining this finance
- 2,700 SMEs obtained none of the finance they were looking for, and 500 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).
- 1,800 SMEs had a need for finance did not apply, for the reason that they thought they would be rejected (there is no further detail available from the survey on why they thought they would be rejected).

Table 1.5: Illustrative Analysis of SMEs' Experience in Accessing Finance in North East, using Survey Data

Stock of SMEs	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)	28,800	6,300	3,200	2,200	400	1,600
Small (10-49)	5,600	1,800	700	500	100	200
Medium (50-249)	1,000	300	100	50	0	0
All SME employers	**35,400**	**8,500**	**4,000**	**2,700**	**500**	**1,800**

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 then use data on from the survey on the amount of finance being sought by businesses of different sizes to generate **indicative estimates** on the scale of unmet demand. This analysis shows that total unmet demand in the region could be of the order of £560m per annum over and above what the private and public backed providers already provide to SMEs. It is not possible to determine from this type of analysis how much of this is from SMEs that had viable business plans (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 constitutes a market failure).

However, scenarios on the proportion of firms that were viable have been set out below to illustrate the potential scale of market failure. For example, if 10% of these were viable, this would imply a finance gap of £2 million for microfinance and c. £60 million for 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 JEREMIE and other public sector backed initiatives. The survey implies that this unmet demand has grown over time, although this is, of course, based on national rather than regional data.

The survey does not provide data that allows the split the unmet demand for larger amounts of finance between debt and equity finance. The SBS Survey reports that around 2% of SMEs are looking for equity finance. However, this does not necessarily accurately represent the proportion (of SMEs or deal values) that are best suited to equity finance, given the nature of their investment projects. Data presented by the British Business Bank suggests that around 4% of the value of finance to SMEs is in the form of equity. This is also potentially misleading in that it clearly only includes demand that has been met. Using data from SBS and adjusted for the size of debt and equity deals, around 8% of the total unmet demand is equity finance, this would imply a total unmet demand of £45 million per annum for equity (£4.5 million if 10% of propositions were viable), **in addition to that which is already being met by publicly backed initiatives (including the time limited ERDF backed JEREMIE initiative).**

Table 1.6: Illustrative Analysis of Unmet Demand (£millions) for Finance from SMEs in North East, using Survey Data 2012/13

	Micros (1-9)		Small (10-49)	Medium (50-249)	All SME employers
	Seeking microfinance (up to £25k)	Seeking larger amounts			
- those that obtained none of the finance they were looking for	£10	£270	£160	£90	£530
- those that obtained some, but not all, of the finance they were looking for*	£1	£10	£10	£10	£30
Total unmet demand	**£15**	**£280**	**£160**	**£100**	**£560**
Scenarios for % that are viable					
10%	£2	£30	£20	£10	£60
20%	£3	£60	£30	£20	£110
30%	£5	£80	£50	£30	£170
40%	£6	£110	£70	£40	£220

**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 analysis does not cover the latent demand from discouraged SMEs. It is not possible to know how many of those that did not apply due to the expectation of rejection would have had viable business plans. However, for illustration purposes, if 10% of these firms were viable and were seeking similar amounts of money to those who did seek finance, this could add £7 million to the annual gap for microbusinesses and £10 million for other SMEs.

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

- The data is based on a single survey of businesses undertaken in the UK in 2012. Since this is a sample survey the results are subject to sampling error, even at the UK level. Regeneris Consulting have not been able to access any data from the 2014 survey as it will not be published until Spring 2015. Finance market conditions in 2014 will inevitably be different from those in 2012.
- Regeneris Consulting do not know from the survey whether businesses in the North East were more or less likely to be successful in obtaining finance than those in the UK as a whole.
- Although the survey reveals the proportion of SMEs that seek different types of finance, it does not allow the analysis separately unmet demand for these different types of finance.

- The analysis presented above only covers SMEs with at least one employee – it does not include sole traders or businesses unregistered for VAT/PAYE. Regeneris Consulting do not have any data on these businesses' experiences of seeking finance, but they account for 74% of all SMEs in the region. Including this could increase the finance gap, although the vast majority of these will have more modest finance requirements linked to growth plans.
- Similarly, this does not cover the experiences of early stage, pre-revenue businesses.

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

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

1.4.3 Evidence of unmet demand from existing interventions

In addition to the theoretical exercise above, the experience from existing ERDF backed interventions in the SME finance market can provide insight into the level of demand in various segments of the market, including that which is unmet. Regeneris Consulting provide a detailed discussion on the performance of the existing JEREMIE initiative in the region in the analysis of the supply side below. However, here it is worth noting the evidence on demand for the sub-Funds offered:

- Microloans: According to the latest quarterly monitoring information for this £6.5m Fund, the Fund has received a total of 868 applications, of which 316 have been converted into investments, representing a conversion rate of 36%.
- Early stage Funds: The JEREMIE Fund has four sub-funds which invest in early stage ventures (the Proof of Concept Fund, Accelerator Fund, Angel Fund and Technology Fund)[13]. Each of these Funds have had low conversion rates. The latest data shows that, collectively, the Funds have had 2,677 applications, of which 297 had been invested in (an 11% conversion rate).
- Later stage Funds: There are two Funds investing in established SMEs seeking growth: the Growth and Growth Plus Fund, offering predominantly equity or quasi-equity investment[14]. Together these had had 726 applications, and 103 of these had been converted to investments (a 14% investment rate).

The volume of applications in itself provides an indication of unmet demand, with low conversion rates potentially indicating a strong level of unmet demand in the region. The Fund has indicated that with

[13] Proof of Concept Fund has an allocation of £5.5m combining convertible loans and equity finance, the Accelerator Fund has an allocation of £25m combining equity and quasi-equity finance, the Angel Fund has an allocation of £7.5m combining equity and convertible loan finance, and the Technology Fund has an allocation of £25m combining equity and quasi-equity finance.

[14] The Growth and Growth Plus funds have allocations of £23m and £17m respectively, both combining equity and quasi-equity finance.

additional investment readiness support, these conversion rates could potentially be increased. This is discussed further later in the section.

An overall summary of the demand indicators examined above is provided here.

Table 1.7: Summary of Key SME Finance Demand Indicators in the North East

Microbusinesses and start-ups	• 129,000 microbusinesses in NE (including 6,000 sole traders and 78,500 unregistered businesses) • Some growth in micro stock -> necessity entrepreneurs • Start-up rate 38% below UK avg (29% below UK less London), but business starts growing • Region performs relatively poorly on enterprise indices (GEM, Santander Enterprise Index) • Total theoretical unmet demand of £15 million, in addition to that which is served by existing interventions • Strong levels of demand for JEREMIE microloans and 36% conversion rate.
Early stage businesses	Strong demand indicators… • The most tech start-ups outside London in recent years • Highest rate of university spin-outs (compared to working age) of any English Region: University of Newcastle and Durham represent 92% of total • Strong business-HEI collaboration • 47% of enterprises innovation active (UK = 45%) • V. low conversion rates for JEREMIE early stage Funds indicating latent demand.
Established SMEs	• 6,600 "established" SMEs in the region (5,600 small and 1,000 medium sized firms) • Growth in stock (but below Eng avg.) • 21.2% of NE firms w/ t/o £2.5m-100m *high growth* (UK = 22%; NE rank 8th out of 9 regions); but increasing • Total unmet demand of £60m annually (if 10% of these SMEs had viable business plans) over and above the provision of the private sector and public sector backed initiatives • Strong interest and low conversion rates for JEREMIE Growth Funds indicating strong demand not served by the market.

Source: Various

1.5 Supply of External Finance

1.5.1 Trends in supply

The key trends in the supply of finance by market segment, using publicly available data are summarised below. In the discussion of supply reference is made to the performance of the current JEREMIE Fund. Since this Fund has been operating in various segments of the SME finance market in the region for a number of years, and given the limitations to the publicly available data, the experience offers useful insights into the SME finance market and its drivers. The role of publicly backed finance in the region is then reviewed in more detail.

A summary table of the relevant sources of supply is provided at the end of this section.

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 vast reduction in the availability of credit following the financial crisis as banks have been rebuilding balance sheets. Although the precise dynamics vary from one bank to another, and some are more active in lending than others, to a large extent these trends are national (or indeed international) in scope, and hence affect SMEs in all of the English regions.

Nonetheless, it is worth briefly reviewing the available regional data. 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.

The total value of overdrafts held by SMEs in the region fell between Q3 2011 and Q2 2014 from £361m to £339m (-6%), but by a smaller proportion than in the UK as a whole (-20%). This fall was felt by medium sized businesses (small businesses actually saw a small increase according to the data). Consultations suggest that, as for other regions, banks' use of asset-based facilities such as invoice discounting (not captured in the data below or in any regional data) has increased marginally.

In contrast to the UK as a whole the total stock of loans held by SMEs in the region actually increased by 3% to £2.8billion, compared to a 3% fall across the UK. The data suggests that the value of new loans issued by banks increased for small businesses and significantly increased for medium sized businesses.

This headline data obscures the nuances of SMEs' experiences in the region. Evidence from consultations with banks and the professional advisory community confirm that businesses in the region suffered from the general tightening up of bank finance around the financial crisis, especially in particular sectors to which banks wished to reduce their exposure and for those. As a recent research report commissioned by partners in the region put it, "*there have been readjustments in risk profiles, pricing, security requirements and credit terms which make it more onerous to access funding. This applies, in particular, to SMEs which are unable to offer high levels of security or asset cover*."[15] Most of the evidence Regeneris Consulting have heard from the consultations suggests that banks have been focussing on larger, asset-backed propositions within the SME space, which could explain the increase in the total value of new loans for medium sized businesses in the data.

There is some survey evidence to support this from the SME Finance Monitor presented earlier.

The data also obscures the reality that SMEs at the smaller end of the SME market, particularly microbusinesses, have been particularly affected by this readjustment. This would appear to be supported by the data on the performance of the £6.5 million JEREMIE microloan fund operating in the region (offering between £1k and £25k, and up to £50k in exceptional cases). The Fund has seen strong demand, with a flow of good propositions to the Fund. This has been reflected in a steady investment rate of around £1.1m per annum (currently within 7% of the target),[16] strong performance against the original target economic outputs (e.g. 348 jobs have been created to date against the original target of 127) and a relatively high conversion rate of applications to investments (36%). £761k has been levered in from other sources, which is a positive performance given that the Fund did not have any targets for this.

[15] Ekos (2013) *North East Access to Finance Fund Evaluation Research*

[16] It should be noted that the Fund was previously ahead of target but has fallen a little behind due to the recent change in Microloan fund manager linked to the extension of the Fund.

The Fund has the highest level of actual write offs to date of all the JEREMIE sub-Funds (at 20.6%), which is to be expected given the nature of the microbusiness market. Taking into account the net book value of current investments the Fund is on course to make a negative return overall but this is not atypical, given the types of businesses it is supporting. The Fund has been investing in a large number of SMEs, with the consequence that the average investment has been slightly lower than originally modelled, at £13,000.[17]

The Fund was recently extended until Dec 2015 and given an extra £1 million in capital to invest.

Table 1.7: Selected Key Performance Data for JEREMIE Microloan Fund, at September 2014

	Investments made (£000s)	Write offs	Total Value Ratio*	Average Investment	Private Sector Leverage	Jobs Created
Actual to date	3,972	20.6%	70.0%	13	761	348
Target to date	4,254		89.0%	17	-	127
% of target	93%		79%	76%	-	274%

Source: NE Finance Report Quarter ended 30th September 2014

* Total Value Ratio refers to the net book value of investments made plus actual cash returns, divided by the amount invested

The JEREMIE Fund does not operate any sub-fund specifically devoted to the provision of higher levels of debt for more established SMEs. Instead it aims to provide a certain amount of debt within several of its sub-funds, alongside equity and variants of debt based instruments. The reason is to allow Fund Managers to have a degree of flexibility so that they have the discretion to provide different types of finance, depending on the needs of the business and the risk attached to their propositions. It is worth noting that the Growth Fund (aimed at later stage firms) and the Angel Fund (aimed at early stage funds) have provided a lot more finance as debt than as equity.[18] Consultations undertaken by Regeneris Consulting and the North East JEREMIE Project Board suggest that this is partly down to market conditions and partly explained by Fund Managers using debt based instruments in order to help them make capital repayments.

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

[17] Throughout Regeneris Consulting have compared performance to the original forecasts. It should be noted that an updated business plan was submitted to EIB in February 2014, reflecting the fund managers' 2014 business plans.

[18] According to the Quarterly Report for September 2014 the Growth Fund had provided funding 4% as pure equity compared to an anticipated 40%, with the remaining 96% being provided as quasi-equity. The Angel Fund has provided funds 31% as equity compared to the anticipated 100% (the remainder has been provided 52% as loans and 18% as convertible loans.

- 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.[19]
- Enterprise Finance Guarantee (EfG). Data on the EfG suggests a relatively strong take up of the scheme in the North East to date, with the third highest take up compared to the business stock of all English regions (after the North West and East Midlands). The value of EfG-backed loans in the region equates to around £23 million per annum on average over the period (around 2% of total lending in the region, which is of course, the upper end of the target for EfG). The average value of loan backed by the scheme in the region is around £90k, showing that 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.[20] To date, £52m has been invested in the region, which is equivalent to an annual average of £19 million. The average value of investment was 170k, which compares to the England average of £200k. This is equivalent to £540 per SME, which is above the England average of £500.
- The Start-up Loans initiative, set up in 2012 to help 18-30 year olds, has had some impact in the North East. The latest statistics show that £4.8 million (£1.7 million per year on average) in total has been allocated to 1,150 start-ups in the North East.

Alternative sources of debt funding have had a role to play in getting debt out 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 North East. Indeed, in 2014 Newcastle City Council invested £100,000 in Funding Circle to invest in SMEs in the city. However, it remains small in the context of overall lending. As set out in the main report, the future role of these sources is unclear.

There are a range of other sources of supply operating in the region. It is outside of the scope of this report to map these out in detail, but the key sources include:

- CDFIs: Just over 1,000 loans were made by CDFIs to North East businesses in 2013, with a value of £2.6 million (an average value of £2,500 per loan).
- Local authority run schemes: For example, the Falchion Fund in Darlington, which offers £3k to £10k to start-ups and existing businesses operating in sectors identified as significant to the local economy.
- RGF backed schemes: For example, the Five Lamps Loan Fund, offering between £2,500 and £150k to businesses in the North East.

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 early stage investment in the North East hovered at between £6-10 million between 2007 and 2010, with around 20 companies per annum receiving investment. This then increased significantly and the annual average over the last three years has been £19m. This equates to £200 per SME employer in the region, compared to £360 in England.

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[19] 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.

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

These figures include the investment made by the JEREMIE Fund, which has three funds specifically focussed on early stage investments:

- The Proof of Concept (POC) Fund. A £15m Fund providing up to £100k in seed capital to technology sector businesses.
- The North East Angel Fund. A £7.5m Fund offering between £10k and £150k directly to start ups and high growth businesses, and aiming to co-invest with business angels.
- The North East Accelerator Fund. A £20m Fund offering larger amounts (£100k to £750k) to early stage businesses
- A £25m Technology Fund also offers up to £1.25m in seed and development finance, at all stages of development.

These early stage funds have generally performed well:

- The POC and Accelerator Funds have both had a strong investment rate, as has the Angel Fund (after a slow start reflecting the Fund Manager's newness to the region and fewer than expected co-investment opportunities).
- Private sector leverage has been significantly higher than originally expected for the POC and Accelerator Funds, but lower for the Angel Fund, reflecting difficulties in sourcing co-investment from Angels at this stage of business development (with Angels preferring to get involved at a follow-on stage where there is less risk). The Angel Fund has, however, helped to stimulate Angel activity in the region from what was a low base.
- Default rates are generally lower than expected (the POC Fund has a higher default rate than the other Funds, reflecting the higher risk profile of its investments). Consequently the Total Value Ratio (a composite measure of potential investment returns) is healthy across the Funds.
- Each of the Funds has very low conversion rates, particularly the Angel and Accelerator Funds. This partly reflects the latent demand in the market, which is consistent with the data on spin outs, for example, presented earlier. The Holding Fund has commented that they believe that some of those who were unsuccessful in getting finance would have been investable had they had some guidance/mentoring in the area of investment readiness.

Collectively the POC, Angel and Accelerator Funds have invested £45m to the end of September 2014 (c£17.5m in loans or convertible loans and £28.0m in equity or quasi equity), at an annual average investment rate of £10.2m, and created 658 jobs (against an original target of 285 jobs).

The Technology Fund has invested £23m to the end of September 2014 (c£7.7m in debt and £15.3m equity or quasi equity), an annual average of £5.2 million. These investments are performing well in terms of financial returns (as measured by default rates and the total value ratio) and economic returns (measured by job creation). Private sector leverage has been much higher than expected. Moving forward, the Fund is projecting that it will have invested £80 million through these early stage Funds by the end of the investment period. Based on current performance this would be split 36% loans and convertible loans and 64% equity and quasi-equity.

Table 1.8: Selected Key Performance Data for JEREMIE Early Stage Funds, at September 2014

	Investment (£000s)	Conversion rate	Default rate *	Total Value Ratio **	Average investment (£000s)	Private sector leverage (£000s)	Jobs Created
Proof of Concept							
Actual	14,245	21%	44.8%	95.0%	125	12,614	135
Target to date	14,197	-	43.2%	61.0%	103	7,098	76
% of target	100%	-	104%	156%	121%	178%	178%
Angel							
	Investment (£000s)	Conversion rate	Default rate	Total Value Ratio	Average investment (£000s)	Private sector leverage (£000s)	Jobs Created
Actual	7,579	9%	29.0%	76.0%	138	4,842	208
Target to date	7,105	-	29.2%	70.0%	166	7,105	64
% of target	107%	-	99%	109%	83%	68%	325%
Accelerator							
	Investment (£000s)	Conversion rate	Default rate	Total Value Ratio	Average investment (£000s)	Private sector leverage (£000s)	Jobs Created
Actual	23,218	11%	29.5%	83.0%	347	60,987	315
Target to date	18,882	-	35.6%	88.0%	331	22,658	145
% of target	123%	-	83%	94%	105%	269%	217%
Technology							
	Investment (£000s)	Conversion rate	Default rate	Total Value Ratio	Average investment (£000s)	Private sector leverage (£000s)	Jobs Created
Actual	23,003	7%	23.5%	111.0%	377	26,647	225
Target to date	23,679		29.5%	90.0%	415	33,151	236
% of target	97%		80%	123%	91%	80%	95%

Source: NE Finance Report Quarter Ended 30th September 2014

* The default rate presented here is a composite measure taking into account actual write offs, specific provisions and downward revaluations

** Total Value Ratio refers to the net book value of investments made plus actual cash returns, divided by the amount invested

The key role of these Funds in driving investment to early stage SMEs in the region is highlighted by a recent review of deals that took place in 2013.[21] Examining the source of funding for deals identified in the early stage space reveals that the JEREMIE sub-Funds were responsible for almost all deals completed in the year.

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

- **The Angel Co-Fund.** This national £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 £2 million (including investment by co-investors to the ACF) has been invested in the region, in 4 companies. This represents 2% and 8% of the value of investment and number of companies in the UK, respectively, and is £20 per SME employer in the region, compared to £30 for England. Regeneris Consulting do not have access to regional data on leverage but at the national level to date £3.80 has been levered in from business angel syndicates for every £1 invested by the ACF itself. At this stage it is clearly too early to judge the level of returns – the data available to us is at the national level, which states that one exit has been achieved at a 3 times return.
- **Enterprise Capital Funds** were originally set up in 2005 as a government-backed scheme with the aim of investing up to £2 million in early stage companies. ECFs operate as private companies that back private capital with Government-guaranteed leverage. The limit on the amount that ECFs could invest into any one fund was £25m, which has recently been increased to £50m. The ECFs are typically UK-wide Funds, although regional funds have been supported – including the NE JEREMIE Fund. 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 one investment has made in the region to date, with a value of £4.3 million (including co-investment). This represents 2% and 1% respectively of the total value and number of companies in the UK and represents £15 per SME employer in the region, compared to £30 in England.
- **UK Innovation Investment Fund**. This Fund provides capital for existing venture capital funds, with a total capital of £330 million (of which £150m has come from the UK Government and £180 million has come from the private sector). It is targeted at small businesses with growth potential and new ventures in the digital, life sciences, clean technology and advanced manufacturing sectors. Regional data is not available for this fund.
- **Aspire Fund**. This £12.5m British Business Bank Fund provides equity investment of £100k-£1 million for women-led businesses across the UK. £4.7 million has been invested to date in the UK, but no regional data is available.
- **Tax incentives.** Collectively tax incentives are the biggest intervention in the UK equity market by value. The Enterprise Investment Scheme (EIS) provides 30% tax relief for investors making an investment of up to £1m in any tax year. SEIS is a derivative of EIS, which aims to encourage seed investment in early stage companies. Investors receive tax relief of 50% on investments up to £100k and Capital Gains Tax exemption on any gains in SEIS shares. ONS data based on HMRC returns shows that a total of £35 million has been invested through the EIS scheme in the North East, in 136 companies, an annual average of £12 million. This is equivalent to £325 per SME employer in the region, which compares to the England average of £650. There appears to be a general consensus from the consultations that these initiatives have had a strong impact in bringing forward investment from business angels and High Net Worth Individuals in the early stage arena.

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).

[21] The Journal, Annual Deals Survey 2013, in association with PWC.

The data suggests that these routes have had little penetration in the North East 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 1% 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 Expansion Equity

The BVCA also publishes data on later stage growth deals completed in the region (privately and publicly backed, so this is includes JEREMIE investment). According to this data the level of investment hovered at an average of around £80m per annum, and no higher than £95 million in 1999. Since 2006 the data suggests that total investment levels have increased, with £184m of investment in 2006 and £156m in 2007. Whilst there was a drop in 2008, the data shows high levels of investment again in recent years, with an annual average of £140m, although this is extremely skewed by the data showing £352m in deals having been done in 2012 (compared to £58m in 2011 and £7m in 2013).[22] In this most recent period, the region was more active than the UK average when compared to the business stock in terms of the number of companies receiving investment.

Again the JEREMIE Fund has played an important role in this space. Two sub-Funds offer growth finance to established SMEs: the North East Growth Fund (a £20m Fund offering up to £750k) and the North East Growth Plus Fund (a £20m Fund offering up to £1.25m). Each of these offers equity or quasi-equity finance.

Given the role that business confidence plays in driving demand for this type of investment, these Funds faced a more challenging climate than the other Funds. 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 North East (as it did in other regions), particularly around 2010 and 2011. Prevailing economic conditions and attitudes to risk may also explain in part why the Growth Fund has made a much greater proportion of investments as debt rather than equity (at the time of the mid-term evaluation the Fund had made only 4% of investments as pure equity).[23]

The Growth and Growth Plus Funds consequently both experienced a slower investment rate than was originally anticipated. As the Growth Fund was performing much better than Growth Plus, £3m was moved from the Growth Plus Fund to the Growth Fund, which was permitted to use this funding to invest up to £750k. The latest quarterly report for the Fund shows that:

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[22] Regeneris Consulting checked this data with BVCA but were not able to confirm the veracity of this figure.

[23] The consultations indicate that this higher than anticipated debt:equity split may also be partly down to the capital repayment targets set for the sub-Fund managers: provision of debt makes it easier for them to generate a stream of revenues that can be used for repayments.

- The two Funds had invested £34.7m to the end of September 2014, equivalent to an annual average of £7.9m. The performance against target shown in the table below should be considered in light of the reallocation of funds set out above as well as the wider issues around business confidence.
- Private sector leverage has been below target for both Funds, reflecting the difficulties in sourcing co-investment from other sources primarily due to a more risk averse investment climate than anticipated (especially from banks). This is a key reason why the average investment made has been significantly higher than anticipated at the outset of the Fund.
- The default rate for the Growth Fund is below the original expectation and hence the total value ratio looks good. The Growth Plus Fund has had issues with the quality of its portfolio, which the Holding Fund comments is reflective of wider issues with Fund Manager performance.
- Conversion rates are low for the two funds, especially for the Growth Plus fund. This suggests a lot of interest in the funding but issues around investor readiness (which the Holding Fund and other consultees suggest could be addressed through other business support programmes).
- The Growth Fund has exceeded its target to date for jobs created, whilst the Growth Fund is a little behind target, due to the performance issues discussed.

Fund is currently projecting that these Funds will have invested a total of £47 million by the end of the investment period. It is also worth bearing in mind that the Technology Fund also invests in later stage propositions and that this Fund is projected to invest £31 million by the end of the investment period.

Table 1.9: Selected Key Performance Data for JEREMIE Later Stage Funds, at September 2014

Growth							
	Investment (£000s)	Conversion Rate	Default rate*	Total Value Ratio**	Average investment (£000s)	Private sector leverage (£000s)	Jobs Created
Actual	19,723	22%	19.2%	91.0%	253	9,555	491
Target to date	18,924	-	25.8%	89.0%	181	12,490	381
% of target	104%	-	74%	102%	140%	77%	129%
Growth Plus							
	Investment (£000s)	Conversion Rate	Default rate	Total Value Ratio	Average investment (£000s)	Private sector leverage (£000s)	Jobs Created
Actual	14,960	7%	41.1%	74.0%	598	17,885	214
Target to date	18,926	-	25.5%	91.0%	569	25,550	236
% of target	79%	-	161%	81%	105%	70%	91%

Source: NE Finance Report Quarter Ended 30th September 2014

* The default rate presented here is a composite measure taking into account actual write offs, specific provisions and downward revaluations

** Total Value Ratio refers to the net book value of investments made plus actual cash returns, divided by the amount invested

There are several UK level initiatives in this space.

- **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 focuses 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 only one £8 million investment has been made in the North East to date (compared to an average investment of £5.6m in England). This chimes with the comments from stakeholders that the Fund is investing in larger propositions in the £2m-£8m range.
- **Enterprise Capital Funds** can also invest in later stage businesses. The latest monitoring data was presented earlier under the early stage section.

There are other mainstream players in this market with a base in the region, such as NVM Private Equity. The consensus view expressed to Regeneris Consulting is that, like the Business Growth Fund, these mainstream players tend to have been concentrating on supporting fewer, larger deals that are de-risked. Indeed some consultees have suggested that the upper limit of the growth equity gap has therefore increased in recent years to up to at least £5 million. This would appear to be supported by the BVCA data, which shows as an average investment of £7.4 million over the period 2011-13 in the area of expansion equity (including the much smaller investments made by JEREMIE).[24]

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

1.5.2 Performance of ERDF backed funds

The North East has a long track record in the delivery of public sector backed SME finance initiatives, dating back to relatively small scale interventions in the 1990s to larger Funds in later ERDF programmes. Data provided to Regeneris Consulting by DCLG shows that those regional Funds supported under the 2000-06 ERDF Programme are expected to return a legacy of £44 million ERDF by the time the Funds are wound up (given the different wind up dates for individual funds, some of this is available now, and some will be available by the end of 2015 or mid 2016). On current projections there was £10.1 million in ex-RDA Single Programme legacy available and there is a current forecast of £6.5 million due to be realised in the 2014-20 period. It should be noted that some of this legacy may already have been allocated, and that there are no guarantees that these projections will be realised, given the uncertainty attached to them.

[24] It should be noted that this is skewed by some apparently very large deals recorded in 2012.

Table 1.10: Summary of Key Sources of SME Finance Supply in the North East

	Average annual value of Investment, £m	Average value of investment made, £000s (England avg in brackets)	Value per SME, £(England average in brackets)	% change in value 2011-13 (England avg in brackets)
Debt				
New loans to Small Businesses	£496	£58 (£82)	£14,000 (£7,300)	10% (-12%)
New loans to Medium sized businesses	£347	£304 (£326)	£9,800 (£12,500)	35% (2%)
New overdrafts approved for Small Businesses	£167	£15.8 (£15.6)	£4,700 (£2,100)	9% (-25%)
New overdrafts approved for Medium sized businesses	£75	£78 (£81)	£2,100 (£2,200)	-24% (-5%)
Enterprise Finance Guarantee backed lending	£12	£90 (£100)	NA	NA
Start-up Loans	£1.7	£4 (£9)	0	NA
Business Finance Partnership & Investment Programme	£19	£170 (£206)	£500 (£500)	NA
ERDF backed debt	£23	**£255**	£640	NA
P2P Lending to businesses	NA	NA	NA	NA
Equity				
Early stage equity investment	£19	£1,100 (£1,100)	£200 (£360)	-61% (24%)
Expansion equity investment	£141	£7,400 (£4,830)	£4,000 (£1,200)	-88% (-62%)
Angel Co-Fund	£0.71	£502 (£1,830)	£20 (£30)	NA
Enterprise Capital Funds	£0.6	£4,300 (£1,340)	£15 (£30)	NA
UK Innovation Investment Fund	NA	NA	NA	NA
Aspire Fund	NA	NA	NA	NA
ERDF backed equity	£8.6	**£92**	£240	NA
Enterprise Investment Scheme (EIS)	£11.6	£256 (£345)	£326 (£650)	46% (66%)
Business Growth Fund	£8	£8,000 (£5,600)	£82 (£80)	zero in 2011/12
Equity-based crowdfunding	£0	NA	£0 (£26)	NA
Other crowdfunding (reward-based, donation)	£0.43	NA	£12 (£35)	NA

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

This experience has provided very valuable learning for the region over time, and has helped to develop the SME finance ecosystem, bringing new fund managers to the region and developing relationships with the professional advisory community as well as mainstream finance providers. These Funds have also provided legacy funding for future projects. This learning was used to inform the development of the current JEREMIE Fund and is also feeding into the region's plans for a successor fund in the 2014-20 Programme period.

The region commissioned a stock take review of the performance of its legacy funds, which was published in 2013.[25] This found that the funds operating in the period 2003-2010 had:

- Invested over £100m in almost 1,000 businesses, with an investment rate of £10m-15m per annum. By 2006-08 public investment in financial instruments was up to £20m per annum.
- Achieved private sector leverage of more than £150m (i.e. £1.50 for every £1 invested)
- Targeted to return between £58m - £78m for further reinvestment (i.e. a return on public investment of between 70% and 95%)
- Helped to create or safeguard around 10,000 gross jobs in the region. The report concluded that there was a very high level additionality attached to these outputs, stating that, "*in the absence of these funds, it is unlikely that much of this economic activity would have occurred as there is no evidence to suggest the private sector would have stepped in and filled any void*."
- Played "*a key role in driving the North East's economy and are crucial to its 'offer' as a locality*."

There was therefore a very solid base of successful delivery to build on in the region, which was used to develop a JEREMIE Fund.

Regeneris Consulting have reviewed the headline performance of the specific JEREMIE sub-funds in the discussion of the supply side above. The JEREMIE Fund was evaluated at its mid-term in 2013[26] and NE Finance and partners have been engaged in an extensive programme of consultation with stakeholders, intermediaries, advisors and mainstream providers throughout the region, in order to identify lessons for a successor Fund.

This evaluation work, the stock-take review identified above and the most recent consultation with stakeholders has revealed the following messages:

- The JEREMIE Fund is generally well regarded by those operating in the sector in the region. The general consensus is that it is supporting investments that would not otherwise happen (this is supported by the survey evidence presented in the mid-term evaluation, which found that 88% of the beneficiaries could not have gone ahead with the same investment at the same time).
- There are a number of structural market failures affecting the debt and equity markets for SMEs. Those lacking collateral or a track record struggle to obtain debt funding and the research pointed towards an equity gap of up to £3 million.
- Looking ahead, the research found that "there is no reason to expect the overall size of the market to reduce or to change to any significant degree"[27], and that the scale and nature of the funding gap may actually have increased.
- A future fund would benefit from being able to make larger investments due to the economies of scale associated with this (and the nature of the finance gaps observed).
- There is a need for funds to be able to make follow on investments and to work with early stage firms over a long period (this is, of course, subject to the investment period of the fund, which is typically set at 5 years.)

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[25] Ekos (2013) *North East Access to Finance Fund Evaluation Research*

[26] Regeneris Consulting (2013) Mid-term Evaluation of English JEREMIE Funds

[27] Ekos (2013) *North East Access to Finance Fund Evaluation Research*

- There is a concern to ensure that all areas in the region benefit from the funding, and a recognition that a local presence of fund managers can help this. Alongside this, there is a recognition that explicit geographical targeting can restrict the ability of a Fund to make the most productive investments.
- There is a consistent message on the importance of the provision of investor readiness support in order to maximise the number of quality SME investment propositions being generated. This is based on a recognition that some SMEs seeking investment lack financial management skills and systems needed to put together investable business plans, and that some of this investment readiness provision had fallen away in recent years.
- Linked to this, stakeholders expressed the importance of raising awareness amongst SMEs of the funding on offer.
- There is a recognition of the benefits of having multiple fund managers operating the Fund in the region, as a means of ensuring competition and choice for SMEs, and of bringing in expertise and networks to the region. That said, stakeholders expressed the view that four or five individual funds is optimal.
- The majority view is that sectoral targeting is not appropriate as it reduces the ability of the Fund to remain flexible in response to changing market conditions.

1.6 Implications for Future Public Sector Backed Investment

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 with reference to the area based market assessment framework presented in section 12 of the main report. **The final two steps of the market assessment framework will be completed following completion of the block two element of the ex-ante assessment.**

The assessment against the steps in the framework is provided in the table below.

<table>
<tr><th></th><th>Micro Finance</th><th>Early Stage VC</th><th>Debt for Growing, Established SMEs</th><th>Expansion Equity for Established SMEs</th></tr>
<tr><td>Step 1 - Demand and Supply Characteristics</td><td>• 129,000 microbusinesses in NE (including 21,000 with no employees and 78,500 unregistered businesses)
• Region scores poorly on enterprise indices and start-up rates significantly below the national average
• Banks generally investing at levels higher than microloans and focussing on those with assets and track record
• Range of local authority led grant and loan schemes along with start-up loans operating in the region filling some of the gap at lower levels</td><td>• Significant activity. More tech start-ups than in any region outside London
• Highest number of university spin outs in any region on per head basis
• Strong presence of life sciences and tech sectors
• Very little provision of early stage investment outside JEREMIE in region
• EIS has had an impact on supply of co-investment
• Strong leverage effect from presence of JEREMIE Fund managers</td><td>• 6,600 established SMEs in the region (5,600 small and 1,000 medium sized firms)
• National reduction in bank lending has been felt in region
• EfG has had strong take up in the region
• P2P lending has had significant growth – impact on the region unclear and remains low in context of overall lending</td><td>• 6,600 established SMEs in the region (5,600 small and 1,000 medium sized firms)
• 21.2% of businesses in region defined as high growth. NE ranks 8th of all regions but proportion has been growing
• Demand for expansion equity hit by decline in business confidence but some signs of recovery
• Equity aversion an issue amongst some business owners in region
• Few mainstream providers, generally focussing on fewer, larger deals (£5m plus)</td></tr>
<tr><td>Step 2 – Unmet Demand</td><td>• Strong evidence pointing towards particular, and growing, difficulties experienced by micro-businesses in obtaining finance
• Theoretical unmet demand of c.£15m p.a. for microfinance (in addition to the gap being addressed by current JEREMIE)</td><td>• Compelling evidence of demand unmet from mainstream sources
• JEREMIE responsible for funding vast majority of deals in region (and no evidence of crowding out)
• Very low conversion rates of JEREMIE Funds suggests significant levels of unmet demand</td><td colspan="2">• 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 c.£60m p.a. even if only 10% of rejected firms had solid business plans (in addition to the gap being addressed by current JEREMIE)
• Low conversion rates of JEREMIE Growth and Growth Plus Funds suggests significant unmet demand</td></tr>
<tr><td>Step 3 – Market Failure</td><td>• Strong demand for JEREMIE microloan Fund - £900k p.a. invested and 36% conversion rate
• Strong performance against economic outputs and reasonable financial returns given the typically higher default rates in this market segment
Suggests viable firms in this segment</td><td>• Agreement amongst consultees of a structural long term equity gap at the early stage
• Performance of JEREMIE early stage Funds has been strong: investment rate of c.£10m per annum, lower than anticipated default rates and strong economic returns
Suggests that a good proportion of firms being supported are viable</td><td>• Evidence points towards an exacerbation of market failure in the region in recent years.
• Strong demand for debt from JEREMIE Fund</td><td>• Evidence of continuation of long term equity gap for growth capital – if anything the gap has increased, with private sector increasing deal values
• Good performance of Growth Fund in terms of investment rate, projected returns and job creation.
• Growth Plus Fund performed less well, partly due to Fund Manager performance issues</td></tr>
</table>

	Micro Finance	Early Stage VC	Debt for Growing, Established SMEs	Expansion Equity for Established SMEs
Step 4 – Persistence of Market Failure	• Consultations suggest banks likely to continue to focus on asset-backed, larger propositions in coming years • No other major public sector schemes in the pipeline	• Evidence suggests mainstream players will continue to focus on larger, de-risked propositions • No new Fund managers have set up in the region in recent years – no reason to suppose that this might change • JEREMIE has helped to bring in co-investment but these investors unlikely to invest on their own	• Consensus view among consultees that although bank lending to SMEs may be increasing a little, highly unlikely to return to pre-crisis lending rates. • Banks will remain under considerable pressure from regulation and increasing cost of capital. • P2P unlikely to fill the gap and questions about its sustainability • Economic recovery points towards increase in demand for debt and therefore potential increase in unmet demand	• As the economy recovers, demand for expansion equity likely to grow • No sign of mainstream players moving away from fewer, larger deals, leaving a gap at lower levels of equity/mezzanine.
Step 5 – Specific Economic Development Priorities	• Some focus on encouraging self-employment as an option within NE LEP strategy • Focus within TV LEP on start-ups and entrepreneurialism, and increasing business density • Suggests a potential role for microloans in a future fund. • **Analysis to be further tested and reviewed as part of Block two work**	• Strong focus on innovation in both LEP strategies • NELP emphasises burgeoning technology and life sciences sectors and large number of tech start-ups and a range of programmes to bolster this • TV LEP emphasises direct support for R&D, commercialisation, creating open access technology sectors and supporting collaborative projects. • Suggests an important role for early stage finance to support these activities. • **Analysis to be further tested and reviewed as part of Block two work**	• NEP LEP has strong focus on closing the productivity and growth gap amongst existing businesses, with a greater emphasis on this than on start-ups and business density • TV LEP emphasises the need to continue to support the growth and expansion of the area's existing SME base, from engineering/advanced manufacturing to digital/creative and ICT. • Suggests a continuing role for the provision of growth capital to established SMEs in the region (both debt and equity linked). • **Analysis to be further tested and reviewed as part of Block two work**	
Step 6 – Delivery Capacity	• Significant experience in the region of delivering publicly backed funds – dating back to 1990s and developing throughout the 2000s • Presence of several new Fund Managers operating in the region as a result of JEREMIE Fund, with strong linkages developed with intermediaries and professional advisors • Provides a strong base to build on for a future Fund and is a positive factor for the deliverability of a large Fund if desired • **Analysis to be further tested and reviewed as part of Block two work, once further detail on potential investment strategy and delivery options is developed.**			