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 West

January 2015

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

Area Overview: North West

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

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

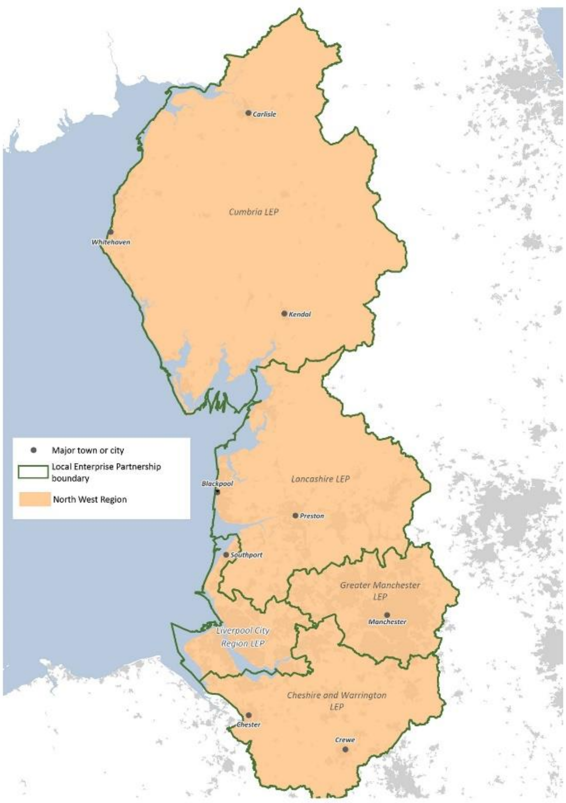
1.1 Economic Geography

The North West is home to 7.1 million people (making it the second most populous region in England), 3.1 million jobs, and 480,000 SMEs (122,000 of which are employers).[1] Its total Gross Value Added (GVA) in 2012 was £130.6 billion, equivalent to £18,400 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 five Local Enterprise Partnerships (LEPs):

- Cheshire and Warrington LEP, covering Cheshire and Cheshire West, Cheshire East, and Warrington
- Cumbria LEP, covering Cumbria
- Greater Manchester LEP, covering Bolton, Bury, Manchester, Oldham, Rochdale, Salford, Stockport, Tameside, Trafford and Wigan
- Lancashire LEP, covering Blackburn with Darwen, Blackpool, Burnley, Chorley, Flyde, Hyndburn, Lancaster, Pendle, Preston, Ribble Valley, Rossendale, South Ribble, West Lancashire and Wyre
- Liverpool City Region, covering Halton, Knowsley, Liverpool, St Helens, Sefton and Wirral.

Figure 2.1 Overview of LEP Geographies in the North West



[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.

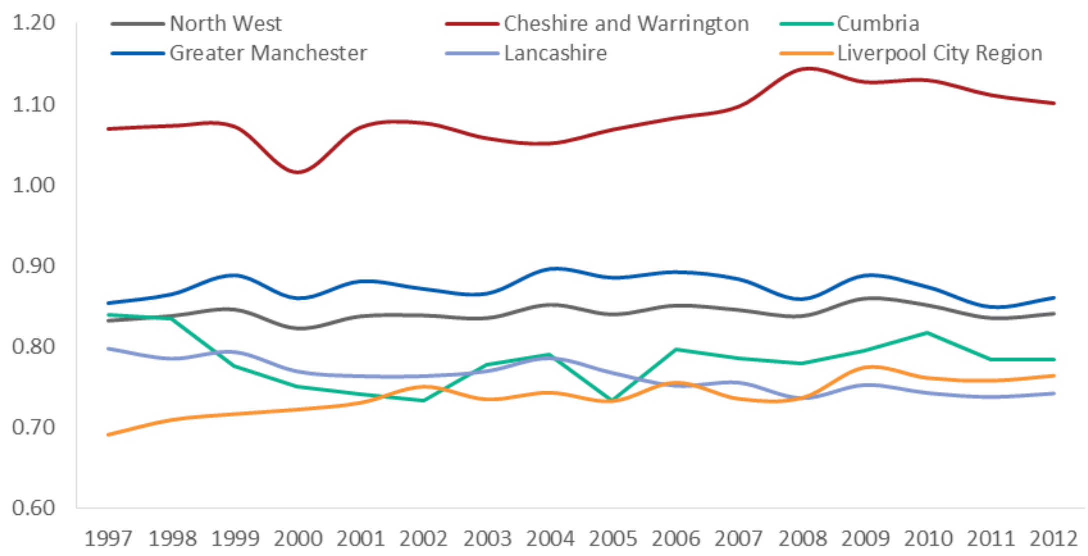
A short overview of each LEP area is provided below:

- Greater Manchester LEP contains 2.7 million residents, the most of any LEP area in the region. There are 75,000 enterprises in the area. It contributes £51 billion in annual GVA (2112), higher than any other LEP area in the region. Manchester, Stockport and Trafford are the main economic centres in the area, accounting for just over half of the total enterprises in the area.

- There are 1.5 million residents in the Liverpool City Region, with 31,600 businesses of which 31,500 are SMEs. The area contributes £25 billion in GVA annually, with Liverpool the main economic centre.
- Lancashire LEP contains 1.5 million residents, 44,200 businesses of which 44,000 are SMEs. Annual GVA is £24 billion.
- Cheshire and Warrington LEP contains 900,000 residents, 35,800 businesses of which 34,600 are SMEs. The area contributes £22 billion in GVA annually.
- There are 500,000 residents in Cumbria LEP, the lowest of all the LEP areas in the region. It is also home to the smallest number of businesses at 21,400, of which 21,300 are SMEs. The area contributes £8.5 billion in GVA annually.

GVA per head of population for the region has increased from £10,900 in 1997 to £18,400 in 2012. GVA per head in Cheshire and Warrington has been substantially higher than for the region as a whole and above the England average throughout this period. As of 2012 GVA per head is 10% higher than the national rate. GVA per head in Greater Manchester follows a similar trend to that of the region, slightly higher than the regional rate. The gap between GVA per head for Lancashire relative to England has increased between 1997 and 2012, and now ranks the lowest of all the LEP areas in the North West, 26% lower than the England average, or 15% lower once London is removed.

Figure 2.2: GVA per Head (England=100) - 1997-2012



Source: Office for National Statistics

1.2 Policy

Table 2.1 below contains a summary of the aims and investment plans contained in the LEP Strategic and Economic Plans relating to two key areas for this study – business growth and research and innovation. There is a strong focus on interventions relating to business growth (in terms of business creation as well as the growth of existing business), which will create demand for financial support more broadly. Each of the LEPs is already delivering or in the process of developing sub-regional Growth Hubs that will place business growth plans at their heart.

It is also clear that the LEPs are prioritising significant investment in improving and expanding the range of research and development facilities across the region and that these will build on existing academic and industry capabilities. This will help place the region in a stronger position when it comes to developing research with commercial application which can bring jobs and economic growth. It will also drive demand for finance to bring this to fruition – most notably early stage and expansion equity investment but also loan finance.

Table 2.1: Overview of the North West LEPs' SME Competitiveness and Innovation *Priorities*

Priority Area	Actions identified
Business Growth	• Expansion of core Growth Hub functions • Better align the National Growth Accelerator programme with the Growth Hub • Implement new services in partnership with UKTI to expand International Trade services and Trade Finance • Delivery of government backed finance schemes through GM Business Finance
Research and Innovation	• A joint Cheshire/GM Skills and Life Sciences Investment Fund to support the transition of Alderley Park into a regional life sciences cluster • Working with the Technology Strategy Board to increase take-up among GM SMEs of product and process innovation provided by TSB • Development of a Graphene Engineering Innovation Centre at the University of Manchester
Business Support	• Specialisation, differentiation and increased productivity in key sectors – with a particular focus on science, technology and manufacturing
Research and Innovation	• Development of sources of R&D, innovation, business expertise, knowledge and specialist labour
Business Support	• Creating an environment for high growth companies • Realising the potential of the area's strengths and capabilities in advanced manufacturing, aerospace, automotive and energy supply chain sectors in particular • Strengthening and refreshing the Growth Hub
Research and Innovation	• Maximising the economic value of Lancashire's centres of research and innovation excellence
Business Support	• To develop a comprehensive Growth Hub offer • To improve business resource and energy efficiency
Research and Innovation	• To build on existing strengths in the nuclear sector through investment in R&D
Business Support	• Establishing a City Region strategy enabling alignment of activity with improved coordination and accountability • Obtaining simplification and commercialisation of business support • Driving business growth in new markets and products • Creating an entrepreneurial environment • Attracting new inward investment

Research and Innovation	• Development of Liverpool's Knowledge Quarter, including proposals for a second phase of development of the Bio-Innovation Hub and for a material innovation facility

Source: LEP Strategic and Economic Plans

Moreover, each LEP has expressed interest in developing SME focussed Financial Instruments in their European Structural and Investment Fund (ESIF) Strategies[2].

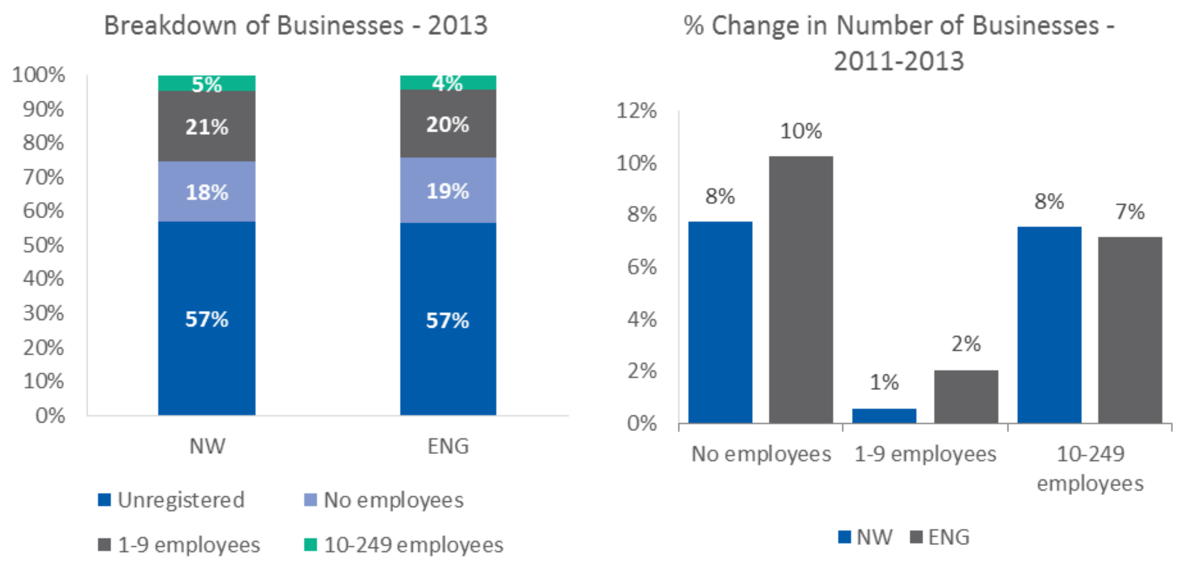
1.3 Business Demography Trends

1.3.1 Business stock

The region is home 479,900 SMEs, of which 456,800 are (95%) are microbusinesses (less than 10 employees), 19,800 are small (10-49 employees) and 3,300 are medium sized firms (50-249 employees). Of the microbusiness stock, 273,400 are unregistered businesses and 84,100 are sole traders.

The composition of SMEs in the region is broadly similar to the national composition. In the past three years the growth amongst micro businesses has lagged behind the national growth rate, whereas the growth rate for small and medium business has been slightly higher than the national rate.

Figure 2.3: Composition (%) of SME Stock in 2013 and change 2011-2013



Source: BIS Business Population Estimates 2011-2013

There is substantial variation in SME business density[3] across the region. Cumbria LEP and Cheshire and Warrington LEP both have a SME density higher than that of the national average (30% and 13% higher respectively). Liverpool City Region has the lowest SME business density in the region, 40% lower than

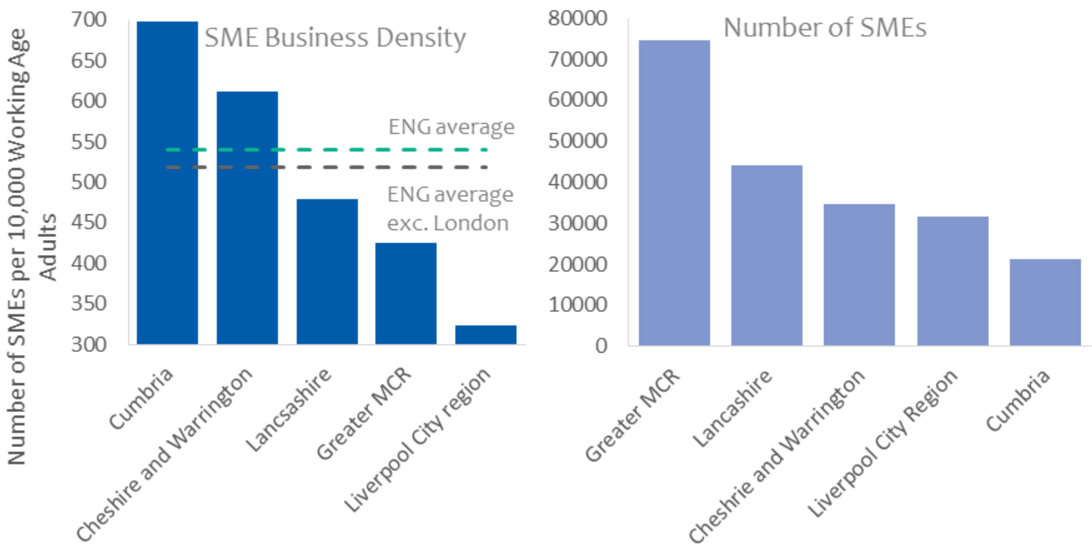
[2] DCLG Summary of FI Proposals, January 2014.

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

the England average (or 38% when London is removed) and 29% lower than the average for the North West.

SME business density is lowest in Knowsley, 47% lower than the rate for the North West as a whole. The four lowest local authorities in the region in terms of SME business density are all located in the Liverpool City Region area.

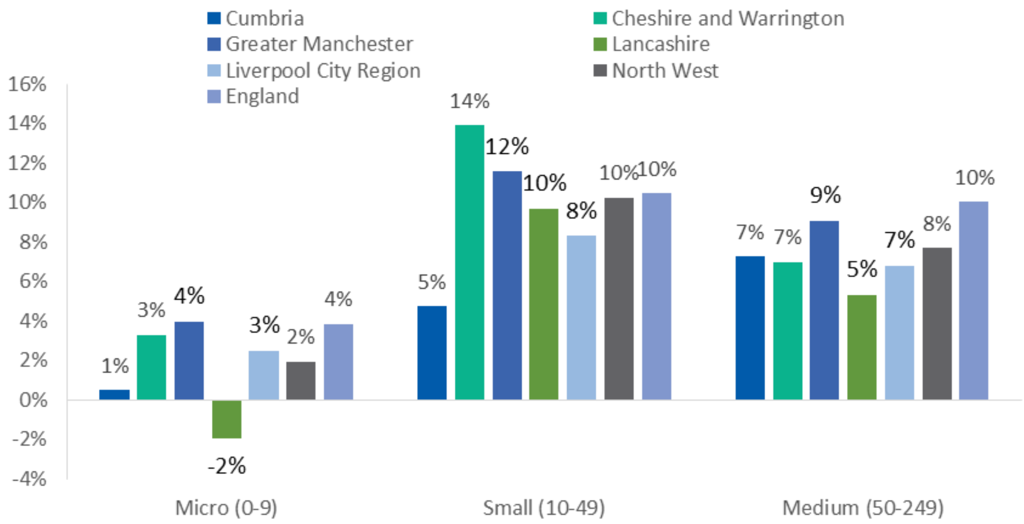
Figure 2.4: SMEs per 10,000 WAP in Region and LEP Areas and Local Authorities



Source: ONS Business Demography

The growth of microbusinesses and medium sized businesses in the region and across the LEP areas has been lower than the national average. For small businesses however, growth in the region is in-line with the national average, and in some LEPs (Cheshire and Warrington and Greater Manchester) growth is higher than the national rate. Notably, there has been a decline in the number of microbusinesses in the Lancashire LEP area. Greater Manchester LEP area stands out as experiencing a rate of growth in the business stock at or above the England average.

Figure 2.5: % Change in Number of Businesses 2011-2013



Source: ONS Business Counts

The majority of microbusinesses in the North West are in the professional, scientific and technical sectors and construction sector. There are notable variations by LEP area. For example there are particularly high concentrations of microbusinesses in Cheshire and Warrington operating in the professional, scientific and technical sector. Liverpool City Region has a greater proportion of microbusinesses in the arts, entertainment, recreation and other services sector compared to other LEP areas. Cheshire and Warrington LEP and Lancashire LEP have a higher proportion of microbusinesses in the agricultural sector. For the rest of the SME stock, there is little variation in sectors, although manufacturing, accommodation and the health sector have a slightly higher concentration of SMEs.

Each of the LEPs have outlined priority sectors in which they anticipate future growth:

- Greater Manchester LEP have identified the health and life sciences, financial and professional services and creative and digital sectors as key. Science, technology and research and development are all anticipated to drive future growth.
- Cheshire and Warrington LEP have identified advanced engineering, life science and chemicals, energy and environment, and the financial and professional services as important sectors for wealth generation, research and development, innovation and to increase exports.
- Lancashire LEP already has a competitive advanced manufacturing sector and expects this to drive future growth, particularly in aerospace, automotive and the energy sectors. However, the health sector, digital, and business process sectors have been identified as able to generating GVA growth.
- Liverpool City region is a broader economy and no single dominant sector has been identified to drive future growth. Rather, a range of sectors have been outlined to deliver economic growth: health and life sciences, financial services, creative and digital, manufacturing, transport and storage, retail, tourism, construction and education.
- Cumbria LEP has identified advanced manufacturing, the nuclear sector, and the rural and visitor economy as key drivers for future growth.

1.3.2 Business Starts and Survival Rates

In 2012 around 26,500 new businesses formed in the region. At 59 per 10,000 working age adults, this is 16% below the national average, or 6% once London is removed.

The vast majority of these businesses were formed in the Greater Manchester LEP area, more than double the amount in any other LEP area in the region. When adjusted for the working age population however the start-up rate is highest in Cheshire and Warrington, 7% higher than the national average. Liverpool City region has the lowest start-up rate, 31% lower than the national average.

Notably, the volume of business start-ups was much higher in 2012 than 2009, with an 11% increase in the period. This increase was more pronounced in Cheshire and Warrington and Greater Manchester. However in Lancashire the number of start-ups was fairly constant over the period with only a 1% increase.

Table 2.2: Business Starts in the North West and its LEP Areas, 2009-12

	Business Starts				Business Starts per 10,000 Working Age Population (2012)	
	2009	2012	Change	% Change	Number	England=100
Cheshire and Warrington	3,650	4,275	625	17%	75.1	107
Cumbria	1,580	1,705	125	8%	55.2	79
Greater Manchester	9,520	10,855	1335	14%	61.8	88
Lancashire	4,955	5,025	70	1%	54.5	78
Liverpool City Region	4,215	4,675	460	11%	48.0	69
Total North West	23,920	26,535	2615	11%	58.6	84

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 company accounts data from Experian UK. It defines high growth firms as of those that have revenues of between £2.5m and £100m, have had 33% increase in turnover over three years, as well as 10% year-on-year growth for a minimum of two of these years.

The latest report found that 21.9% of businesses with a turnover of between £2.5 million and £100 million fall into this high growth category, which ranks the North West fifth out of the nine English regions. This proportion has been growing over the years and is now in-line with the England average.

Table 2.3: High Growth Firms as a % of all Businesses, 2011-13

	2011 Population of High Growth Firms	Regional Rank (2013)	2011	2012	2013
North West	320	5th	16.9%	18.8%	21.9%
England	4,044		16.9%	20.9%	22.0%

Source: BGF Growth Companies Barometer

1.3.4 Innovation Activity

The region has approximately 1,000 enterprises defined as innovation active, representing 42% of businesses with at least 10 employees in the region. This proportion is lower than the national average and is the lowest of all regions.

R&D expenditure, in particular that related to the private and university sectors, is one driver of the spin-out and creation of research and innovation intensive companies and the demand for early stage risk finance. Expenditure on research and development has increased from £2 billion in 2001 to £2.4 billion in 2012, an increase of 23%. This is the lowest level of growth among all regions. However, in absolute terms this expenditure is the fourth highest of the regions in England while per head of the population the North West ranks sixth.

There have been 92 spin outs in the North West since the year 2000, representing 10% of all spinouts in England. When compared with the size of the working population this is the lowest of all regions. The University of Manchester accounts for just over half of the spinouts in the region, followed by the University of Liverpool (20%) and Lancaster University (16%).

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 survey research. 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 suggests that the North West ranked seventh out of the nine English regions on its TEA rate. Its performance against various indicators provided through the GEM is shown below. This shows that the North West stands below the UK average on all but one indicator, the exception being the percentage of established firms with high growth entrepreneurial aspiration.

Table 2.4: Measures of Entrepreneurial Activity, 2008-13

Highlighted cells shows above average results	TEA	% of Opportunity E'preneurs	Stages of E'preneurial Activity				High Growth E'preneurial Aspiration[4]	
			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%

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

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%

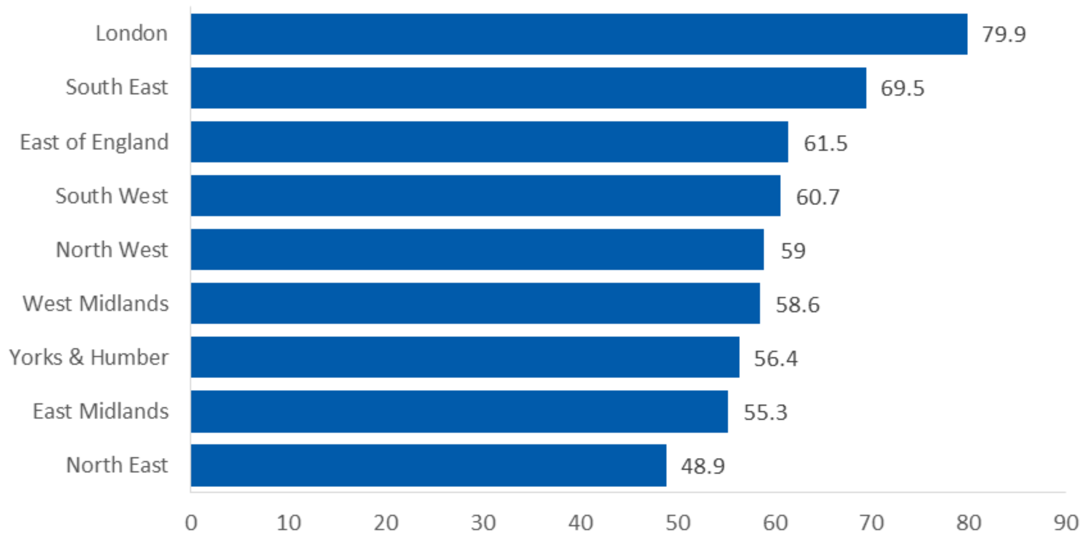
Source: Global Entrepreneurship Monitor 2008-2013, bespoke regional analysis.

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 rankings shows the region ranks fifth out of the nine English regions, although it ranks within the top 30 of the 125 EU regions considered. The analysis suggests that factors driving the North West's score revolve around performance on indices of attitude, abilities and aspiration. In particular, the region scores 49.0 on aspiration, which compares to 77.7 in London (the top performing region). The report emphasises that a lack of entrepreneurial aspiration serves as a "bottleneck factor" preventing the UK regions from realising the full economic potential.

Of course, these regional indices mask the variation within the region and the presence of more dynamic areas such as Manchester and Cheshire.

Figure 2.6: Santander Enterprise Index Score - 2014



Source: Santander Enterprise Index 2014

1.4 Demand for and Take-up of External Finance

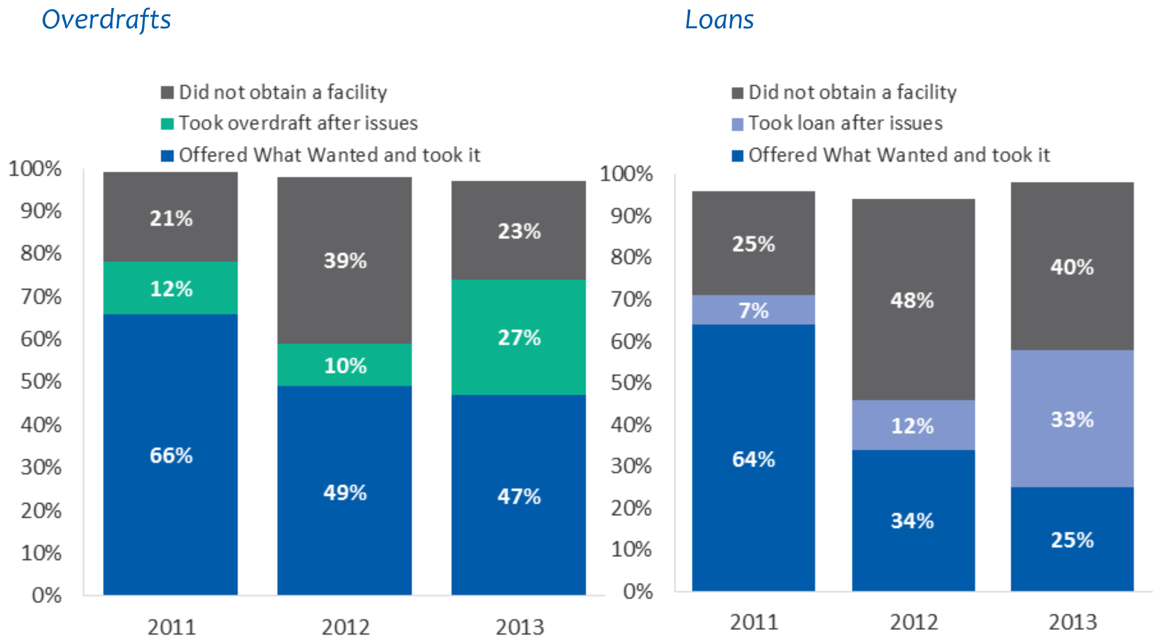
1.4.1 Survey evidence

As was 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 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.

Two fifths (40%) of SMEs surveyed in the North West in 2013 had used finance of some sort[5] in the past five years, whilst 56% had not used finance at all over this period. 28% had used either an overdraft, loan or credit card. 37% 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 increased since 2011, in-line with the overall trend for the UK. SMEs in the North West are statistically significantly less likely to be a PNB than those in other UK regions.

Less than a tenth (7%) of SMEs applied for a new overdraft or loan facility or sought to renew an existing facility. Between 2011 and 2013 success rates for overdrafts have fallen in the North West, with 47% of applicants offered the facility that they wanted and subsequently taking it. The latest data for loans shows that 40% of those seeking one were unable to obtain one, a rise on previous years. It should be noted that for both overdrafts and loans the survey reports that there were no statistically significant differences in success rates between the North West and the UK as a whole.

Figure 2.7: Overdraft and Loan Applications in the North West - 2011-2013



Source: SME Finance Monitor 2011-2013.

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[5] 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.

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 at the national level. The only data provided in the BIS SBS is on the proportion of SMEs that were looking for equity investment. This highlights that only a small proportion actively seek out this type of finance, and that this has remained stable over time (standing at 2% in 2012, 2010 and 2008). Less than 1% were seeking mezzanine finance. This partly reflects the more niche nature of equity and mezzanine finance but is also likely to illustrate 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 or crowdfunding.

Unfortunately the survey evidence does not allow a separate review at the extent to which SMEs seeking this type of finance were successful in obtaining it. Regeneris Consulting are not aware of any regional level surveys of SMEs on this issue (although a survey of Greater Manchester SMEs has been undertaken and some of the evidence from this is noted below).

1.4.2 Theoretical Unmet demand

Unfortunately, whilst the BIS SBS survey provides data that can be used to assess the extent of unmet demand from SMEs, this data is not available for the regions. However, the results of the UK level survey can applied to the North West 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.

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

- In 2012 there were around 29,300 SMEs in the region looking for external finance, of which 21,800 were microbusinesses. Some of these microbusinesses will have been seeking microfinance; others will have been looking for larger amounts.
- Of these, 13,700 experienced difficulties of some sort in obtaining this finance
- 9,400 SMEs obtained none of the finance they were looking for, and 1,700 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)
- 6,300 SMEs had a need for finance did not apply, for the reason that they thought they would be rejected (there is no further detail available from the survey on why they thought they would be rejected).

Table 2.5: Illustrative Analysis of SMEs' Experience in Accessing Finance in the North West, using Survey Data

	Total	Looking for finance	Had difficulties	Unable to obtain any finance	Obtained some, but not all	Discouraged from applying because thought would be rejected
Micros (1-9)	99,300	21,800	10,900	7,600	1,300	5,600
Small (10-49)	19,800	6,300	2,500	1,600	300	700
Medium (50-249)	3,300	1,100	300	150	50	50

All SMEs	122,400	29,300	13,700	9,400	1,700	6,300

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

While no similar survey evidence exists across the North West LEP areas on a consistent basis, the 2013 Greater Manchester Business Survey allows for a comparison of the regional situation against that experienced by businesses across Greater Manchester[6]. In 2013 15% of businesses sought external finance (down from 18% the previous year), versus 24% for the North West.

It is possible to use national survey data on the amount of finance being sought by businesses of different sizes to generate **indicative estimates** of the scale of unmet demand. This analysis shows that total unmet demand in the region could be of the order of £1.9 billion in one year. It is not possible to determine from this type of analysis how much of this comes from SMEs that had viable business plans (i.e. those that 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 a market failure). However, scenarios on the proportion of firms that might have been 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 unmet demand of:

- Around £5 million per year for microfinance and c. £95 million for larger amounts of finance sought by other micro-businesses
- Around £60 million per year of unmet demand amongst small businesses
- Around £30 million of unmet demand amongst medium sized businesses.

It should be noted that this is, in effect, **the gap over and above that what is already being addressed by JEREMIE and other public sector backed initiatives**. The survey implies that this unmet demand has grown over the last three years, although this is of course based on national rather than regional data.

The SBS provides some broad-brush data that allows the split the unmet demand for larger amounts of finance between debt and equity finance. The SBS Survey reports that around 2% of SMEs overall are looking for equity finance. However, this does not necessarily accurately represent the overall value of finance being provided. Data presented by the British Business Bank suggests that around 4% of the value of finance to SMEs is in the form of equity. It should be noted that this is the proportion of equity finance being sought outside of the current provision which includes existing JEREMIE and Business Bank supported equity schemes.

Using this SBS data which allows for the size of the SME and variations in the amount of finance sought by type of finance, around 8% of this overall unmet demand is likely to be accounted by equity finance (and 83% by debt finance and a further 9% by other forms of finance). This would imply a total unmet demand of around £15 million per annum for equity and around £160 million for debt if 10% of propositions are viable. Again, it should be noted that this is in **addition to that which is already being met by publicly backed initiatives.**

Table 2.6: Illustrative Analysis of Unmet Demand (£millions) for Finance from SMEs in the North West, using Survey Data 2012/13

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[6] Results from the Greater Manchester Business Survey have only been obtained for all business as opposed to from SMEs only. These results should therefore be viewed with appropriate caution.

	Microbusinesses (1-9)		Small (10-49)	Medium (50-49)	All SMEs
	Seeking microfinance (up to £25k)	Seeking larger amounts			
- those that obtained none of the finance they were looking for	£50	£920	£550	£310	£1,830
- those that obtained some, but not all, of the finance they were looking for*	£2	£40	£30	£30	£100
Total unmet demand	**£52**	**£960**	**£580**	**£340**	**£1,930**
Scenarios for % that are viable					
10%	£5	£95	£60	£30	£190
20%	£10	£190	£115	£70	£390
30%	£15	£290	£170	£100	£580
40%	£20	£380	£230	£140	£770

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

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.

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 North West were more or less likely to be successful in obtaining finance than those in the UK as a whole – consequently 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 reveal 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 sole traders or businesses unregistered for VAT/PAYE. Regeneris Consulting do not have data on these businesses' experiences of seeking finance, but they account for 75% 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 then the demand for and unmet requirement for seed and start-up funding.

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

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

In addition to the theoretical exercise above, the experience from existing ERDF and other public sector 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. A detailed discussion on the performance of these initiatives in the analysis of the supply side is provided below. However, here it is worth noting the evidence on demand for the sub-funds offered:

Table 2.7: JEREMIE Fund Conversion Ratios, to 2014 Q3

	All Applications	Investments	Conversion Ratio[7]
Digital & Creative	1,030	30	2.9%
Energy and Environment	370	17	4.7%
Biomedical	260	90	36.2%
Mezzanine Loans	360	8	2.3%
Business Loans	1,560	120	8.3%
Mezzanine	80	2	2.6%
Venture Capital	880	55	6.3%
All JEREMIE Funds	**4,550**	**320**	**7.40%**

Source: JEREMIE Quarterly Performance Reports for 2014Q3

Note that Regeneris Consulting do not have any data on conversion rates for the other ERDF backed interventions in the region (for example, the Transitional Loan Funds). However, Regeneris Consulting do have other monitoring data, which is analysed later in this section.

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

Table 2.8: Summary of Key SME Finance Demand Indicators in the North West

Microbusinesses and start-ups	• 457,000 microbusinesses in region (including 84,000 with no employees and 273,000 unregistered businesses) • Some growth in micro stock in last three years • Start-up rate 16% below England average (4% below England less London), but business starts growing • Relatively poor performance in the region on many enterprise indices, although this varies significantly within the region with some significant hotspots of entrepreneurialism in major urban centres • Total theoretical unmet demand of £5 million for microfinance and £95 million for larger amounts of finance sought by micro businesses in addition to that which is served by existing interventions (based on 10% of businesses or investment propositions being viable)
Early stage businesses	• Region has proportionally fewer product and process innovators than UK average • Performs poorly on spin-outs (ranks 5th of English regions, and lowest when compared to working age population) • University of Manchester accounts for majority of spin-outs • However, some significant centres of commercialisation of R&D and innovation, often centred on the region's universities

[7] Excludes those applications that are still being processed.

	and industry-backed research facilities
Established SMEs[8]	• 187,000 established SMES (10-249 employees) • 21.9% of NW firms with turnover of £2.5m-£100m defined as *high growth* (England = 22%) • Theoretical unmet demand of £90 million per year over and above what existing public sector backed FIS delivering, assuming 10% of total unmet demand is viable. This includes small and larger loans and growth equity.

1.5 Supply of External Finance

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 of the other publicly available data on SME finance activity, the experience offers useful insights into the part of the SME finance market in the region which is not met by the private sector. Regeneris Consulting then review the role of publicly backed finance in the region in more detail.

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

1.5.1 Debt

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

Overall the data shows that SMEs in the region have suffered disproportionately from the tightening of bank finance following the financial crisis. The number of loans approved to SMEs in the North West has fallen by 31% between 2011/12 to 2013/14, while the value of lending has also fallen but to a lesser extent – 11% or £266 million pa. Hence the average size of loan approved has grown.

The bulk of the decline in lending has been borne by smaller businesses, where there has been a 42% decline in the number of loans and a 32% decline in total value. Indeed the total value of lending to medium sized business is the same in the latest year of data versus 2011/12, while it actually rose by 1.5% nationally. This trend has been backed-up by consultees, which have typically suggested that banks have been focussing on larger loans to larger more established businesses as part their risk management strategies.

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[8] Defining an established SME as one with 1 0 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.

When compared to the size of the SME base, the value of lending in the region clearly stands below the England average. An average of £7,070 was loaned for every SME business in the North West (bearing in mind that many will not have borrowed at all) which compares £9,440 nationally.

The total stock of term loans held by SMEs in the region has decreased by 5.5% to £2.8 billion between 2011/12 and 2013/14, compared to a 2.0% fall across the UK. This is the second largest fall among the nine regions, behind London. The decline among small businesses was 1.7%.

The experience of the current £10 million Mezzanine Loan and £35 million Business Loan Funds run under the JEREMIE initiative also helps to illuminate the trends in debt markets for SMEs. Both funds are aimed at established and growing SMEs and invests between £50,000 and £750,000 in a single round. The Mezzanine Loan fund has been designed to invest larger amount through subordinated debt to riskier ventures. Neither fund lends to start-up businesses.

Between the two funds, £27.15 million has been invested to date (60% of total fund value) implying an annual average of £7.76 million over the three and a half years of operation to 2014Q2. The investment has been spread across 223 SMEs at an average investment of £120,000. However, this rises to an average of £505,000 spread across eight firms for the Mezzanine Loan Fund.

The largest value of lending from across the two funds – both in absolute terms and when taken per SME - has flowed to Greater Manchester business, at 47% of all lending (£11.87 million or £151 per registered SME Employer)[9]. The second highest value of lending when taken per SME is in Cheshire and Warrington at £138 followed by Merseyside at £133. Only £350,000 has been invested in Cumbria to date – or £16 when spread across all Cumbrian SME Employers.

Demand for loans has been strong – with more than 1,500 applications registered to the Business Loans Fund and 360 to the Mezzanine Loans Fund. 8.3% of applications to the Business Loans Fund have been converted into investments to date – above average when compared to the JEREMIE Fund as a whole. The proportion of applications for larger mezzanine-type finance that have been turned into investment have been lower, suggesting that much of the demand for this type of finance is either not viable or has been for deals that are unrealistically large.

In early 2014, the North West JEREMIE Fund allocated £3 million into the **Microloan Fund** providing loans of between £25,000 and £50,000 (and extending this to up to £150,000 through follow-on investment), a response in part to the perceptions of an unmet finance gap in the North West. The fund, managed by Merseyside Special Investment Fund and Business Finance Solutions, remains in the early stage of delivery with only three investments made to the middle of 2014. The Microloan Fund will operate up to the end of 2015, with the flexibility to allocate up to a further £3 million by the end of 2015 subject to the evidence on demand and market failure.

The £20 million **Greater Manchester Loan Fund** managed by Maven Capital Partners, running from 2013 to 2018, is investing £100,000 to £500,000 (and up to £750,000 including follow-on investment) in SMEs with growth potential and a clear trading history. To date the fund has invested £3.95 million between seven firms, averaging £560,000 per business.

[9] SME Data taken from ONS Enterprise Counts for 2014 and excludes all non PAYE/VAT registered businesses.

The Regional Growth Fund is also channelling additional debt finance to SMEs via CDFIs. These small loans schemes are managed by a number of organisations across the North West and typically provide finance of between £3,000 and £100,000. These funds are delivered in the North West by Business Finance Solutions (Central and South Manchester and Cheshire), Bolton Business Ventures (Lancashire and North Manchester), Enterprise Answers (Cumbria) and the Merseyside Special Investment Fund.

The region has also delivered loan finance between 2009 and 2013 through a series of ERDF (and Single Programme) backed Transitional Loan Funds. Around £6.5 million has been invested through a Small Business Loan Fund, £3.68 million through a wider loan fund and £340 through a transitional fund for social enterprises. These funds are all fully invested, but there are plans to reinvest through legacy returns to the small loan funds which have totalled more than £2 million to 2014Q2.

Overall, despite the arrival of the £3 million JEREMIE Microloan Fund, there has been limited ERDF back finance since the Transitional Loan Fund stopped investing in 2013.

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

- 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 more on mortgages[10]
- Enterprise Finance Guarantee (EfG): The North West has seen the strongest take up of EfG-backed loans per 10,000 businesses of all the English regions. An annual average £53 million has been loaned between 2008 and 2014. The average value of loans backed by the scheme in the region is around £96,000, showing that the scheme has been focussed on smaller amounts of debt, but at somewhat higher levels than what would constitute a microloan.
- The British Business Bank Business Finance Partnership and Investment Programme: provide funding to non-bank channels to invest in small and medium sized businesses[11]. To date, £203 million has been invested in the region off the back of a £59 million contribution from the two schemes. This is equivalent to an annual average of £74 million secured via £21 million of public funding. The average value of investment was £234,000, equivalent to £600 for every SME in the region, which is above the England average of £500.
- The Start-up Loans initiative: funded through the British Business Bank and is delivered sub-regionally by Lancashire Community Finance, MSIF and Business Finance Solutions in the North West. It was set up in 2012 to help 18-30 year olds but has been expanded to cover all age groups, has had has a notable impact in the North West. The latest statistics show that £17.4 million (£6.1 million per year on average) in total has been allocated to 3,245 start-ups in the North West, an average loan of £5,350, or £50 for every SME in the North West compared to £20 per SME delivered nationally.

Alternative sources of debt funding have had a role to play in getting debt to SMEs in the region. The rise of debt-based alternative sources in the UK is well documented, with the latest review of the sector estimating that peer-to-peer lending to businesses in the UK has increased to £193 million in 2013, and is

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

[11] 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

predicted to grow to £750m in 2014[12]. 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 peer-to-peer lending by region, but evidence from the consultations and reports suggest it has played an increasing role in the North West[13].

Whilst there has been significant growth in peer-to-peer lending, it is still relatively small in the context of total debt funding. At the moment, the future role of these sources remains uncertain. Some predict the strong growth to continue, but it is not clear what the impact in the medium-term may be from rising interest rates, which would serve to reduce the attractiveness of these routes for investors. With this form of lending having only existed at scale for a relatively short period of time, the true risks and returns are still unproven.

Finally, it should be noted that while it has been shown that public sector backed SME debt schemes provide significant sums of finance, they represent only a relatively small part of an overall market where bank finance still dominates.

1.5.2 Early stage finance

As was noted in the main market assessment, the available data on the supply of early stage finance is limited in so far as much of the investment activity in this area is informal and therefore not wholly captured in published statistics. Data from the BVCA shows that early stage investment in the North West fluctuated notably year by year. Investment in 2013 alone reached £176 million while from 2010 to 2012 investment averaged £13.7 million. This is notably lower than the pre-crisis annual average of £28.4 million between 2004 and 2008. An average of 36 companies have received early stage investment between 2004 and 2008 at an average deal size of £1.0 million. This average rose to £4.0 million in 2013 and is likely to have been skewed by a relatively small number of large investments.

As far as Regeneris Consulting are aware, these figures include the investment made by the JEREMIE Fund which has three funds focussed on early stage investments[14]:

- The Digital and Create Fund: A £15 million fund managed by AXM Venture Capital providing investments up to £750,000. The fund has mixed smaller scale investments (c. £50,000) in pre-revenue SMEs with larger investments in established businesses. There has been a high volume of demand with more than 1,000 applications made to date (29, or 2.8% of which have been converted into investments). This scale of demand is attributed in part to the larger number of smaller businesses and relatively low start-up costs associated with the sector as well as to the broad sector definition applied to potential investees. A higher failure rate is predicted for the fund compared to the other two sector focussed funds (45% of invested value, compared to 20% for the Biomedical and Energy and Environment funds). This most likely results from the high rate of business start-up and churn in the sector, which is in part a reflection of the fast pace of technological and market change in the digital and creative sector.

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[12] NESTA (2014)

[13] For example http://www.lep.co.uk/news/business/business/peer-to-peer-lending-on-the-rise-in-north-west-1-6167543

[14] It should be noted that while much of the focus of these funds is on earlier stage ventures, they are also providing later stage finance to established businesses

- The Biomedical Fund: A £30 million fund managed by Spark Impact (a subsidiary of Spark Ventures) offering up to £750,000 for bio-medical products and technologies. The fund has performed well from the outset and is ahead of its investment target. The fund managers have established links within the industry and their location at Liverpool Science Park has placed the fund at the centre of research and commercial activity in the sector. The fund has performed well in providing finance to established businesses and early stage ventures but also 'pathfinder' investments to very early stage ventures which has allowed them to move through proof of concept, after which they are able to obtain further finance in order to bring ventures to the market. The fund has also seen eight investments exit.
- The Energy and Environment Fund: A £20 million fund managed by 350 Investment Partners. After a slow start (making only one investment by the end of 2011), the fund is on track to meet its investment target. The fund has operated in a difficult market due to the size and nature of the sector in the region and there are limited opportunities to invest in market-ready R&D. Associated with this, the fund is typically making a relatively small number of larger-scale early stage investments (14 contracted over the lifetime of the fund at an average £1.4 million each). The fund is continuing to target a number of more established businesses, and to implement a pathfinder strategy similar to that employed by the Biomedical Fund and reduce the average size of investment made. The fund has generated one realisation to date.

Table 2.9: Selected Key Performance Data for JEREMIE Sector Funds to 2014 Q3

	Investment to 2014Q2 (p.a. in brackets)	% of Lifetime Funds Invested	Number of Investments	Average Size of Investment	Conversion Ratio[15]	Jobs Created	Private Sector Leverage
Digital and Creative	£9.20m (£2.6m)	61%	29	£317,000	6.8%	212	£5.3m
Biomedical	£21.99m (£6.3m)	73%	92	£239,000	27%	346	£18.9m
Energy and Environment	£13.59m (£3.9m)	68%	17	£800,000	8.6%	253	£18.0m

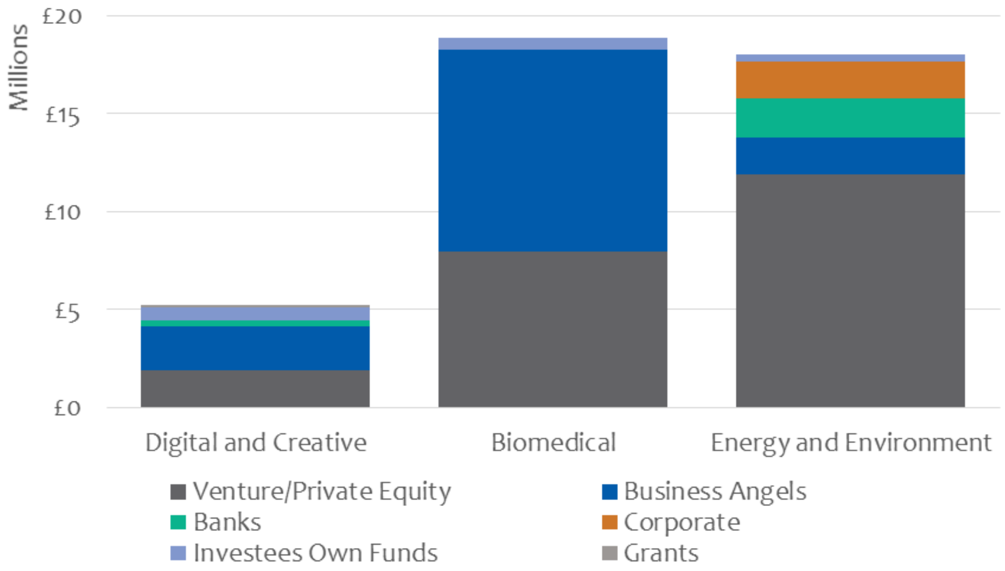
Source: JEREMIE Quarterly Performance Reports for 2014Q3

The presence in the region of the specialist sector expertise brought by these funds has allowed for the business and research base to be tapped into and developed. As a result of the finance provided other investment has been levered. Consultations also suggest that a number of firms have been encouraged as a result of the finance available. The funds have therefore contributed to the development of these sectors in the region and ability of a wide range of businesses to obtain the finance they require to grow.

The sector funds have leveraged a total of £42.1 million of private investment at ratio of £0.94 per £1 invested. The Energy and Environment Fund has been particularly successful in levering other private equity finance. What is also clear is the ability of the funds to lever a significant value of angel finance (£14.4 million across more than 60 angel investments), in a region where – compared to the South East and London – angel investment is quite fragmented. This is especially the case for the Biomedical Fund (£10.3 million across 34 angel investments).

[15] Includes applications still under assessment

Figure 2.8: Source of Private Sector Leverage from the North West JEREMIE Sector Sub-Funds



Source: JEREMIE Quarterly Performance Reports for 2014Q3

A number of national initiatives have been operating in this area of the market. The key statistics on their impact on the region are provided below:

- 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 £1.58 million (including investment by co-investors to the ACF) has been invested in two North West companies. This represents just 1.8% and 4.1% of the value of investment and number of companies in England, respectively. Regeneris Consulting do not have access to regional data on leverage but at the UK 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 too early to judge the level of returns – the data available to us is at the UK level, which states that one exit has been achieved at a three times return.
- Enterprise Capital Funds: 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 NW JEREMIE Fund. For various reasons, two thirds of the value of investment made to date has gone to companies based in London, the South East and the East of England. The latest monitoring data shows that seven investments have been made in the region to date, at a total value of £7.0 million at (including co-investment). This represents just 3.1% and 4.2% respectively of the total value and number of companies in England.
- The UK Innovation Investment Fund: This fund-of-funds 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.

- The Aspire Fund: This £12.5m British Business Bank Fund provides equity investment of £100k-£1 million for women-led businesses across the UK, some of which is early stage. £4.7 million has been invested to date in the UK, but again no regional data is available.
- Tax incentives: Collectively tax incentives provide 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 £86 million has been invested through the EIS scheme in the North West, across 405 companies, at an annual average of £29 million and an average deal size of £211,000. This is equivalent to £232 per SME employer in the region, which compares to an England average of £650. Evidence from the consultations with those engaged in the early stage market suggests that the EIS has had some significant success in stimulating early and later stage investment in the region and in drawing in angel finance in particular.

As has already been stated, the University of Manchester accounted for just over half of the early stage spinout ventures in the North West between 2000 and 2014 – 51 in total – and has attracted more than £150 million in funding for spinouts between 2010 and 2014. This owes much to investments made through the University of Manchester Intellectual Property (UMIP) Premier Fund. With £32 million to invest, this is the largest fund in Europe focussed on one university. The fund was established in 2008 and is managed by MTI Ventures. It is aiming to invest in late-seed cleantech, materials and medical technologies ventures with between £250,000 and £750,000 (but with the capacity go up to £3 million). By the end of 2012, the fund had invested in 12 spinouts and, separate from this, 29 other proof of principle projects. In addition to this, UMIP has established a £5 million proof of principle fund in collaboration with the IP Group. The ventures that emerge from these investments may well create a pipeline of propositions for any future ERDF backed early stage funds to invest in.

Table 2.1 below contains a summary of the aims and investment plans contained in the LEP Strategic and Economic Plans relating to two key areas for this study – business growth and research and innovation. There is a strong focus on interventions relating to business growth (in terms of business creation as well as the growth of existing business), which will create demand for financial support more broadly. Each of the LEPs is already delivering or in the process of developing sub-regional Growth Hubs that will place business growth plans at their heart.

It is also clear that the LEPs are prioritising significant investment in improving and expanding the range of research and development facilities across the region and that these will build on existing academic and industry capabilities. This will help place the region in a stronger position when it comes to developing research with commercial application which can bring jobs and economic growth. It will also drive demand for finance to bring this to fruition – most notably early stage and expansion equity investment but also loan finance.

Table 2.1Further early stage investment will be provided, over the next programme period, through a £40 million Greater Manchester and Cheshire Life Sciences Investment Fund. This will form one part of a strategy to growth the sector and build on existing assets following the departure of AstraZeneca from its Alderley Park site.

Alternative funding sources have also played a role in this market, including equity-based crowdfunding platforms. These are much smaller in scale than peer-to-peer 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 little penetration in the North West 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.

As has been suggested earlier in this section, the North West holds significant potential to generate early stage ventures with strong commercial potential. There is evidence of a latent demand for this type of finance given the capacity and capability of research base which has strong academic and industry backing across a range of institutions and facilities; the regions universities have not (outside of a few universities) produced as many spinouts as might be expected and industry backed R&D investment planned by the LEPs can push the demand early stage finance in this space further still. The early stage JEREMIE funds have played an important role in supplying finance to some of the key sectors producing early stage ventures and have managed to stimulate investment from others while doing so.

1.5.3 Later-Stage Risk Finance

The BVCA also publishes data on later stage growth deals completed in the region (privately and publicly backed). As is the case with early stage data in the North West there are fluctuations across years where the total value of investment is skewed by a few relatively large scale deals. This is the case in 2010 when expansion equity investment peaked at £185 million, 2.25 times higher than the average between 2007 and 2013, while the 31 companies invested in in 2010 was equal to the average. In 2011 the level of investment was high again at £117 (42% higher than the average over the period, while the number of investments in this year was actually 20% below average). Outside of these two years (from 2007 to 2009 and 2012 to 2013) the average scale of investment has been £55 million annually. While this has stayed reasonably constant both before and after the recession, there has been a clear shift in the last two years data towards a smaller number of larger deals (£2.95 million per company in 2012 and 2013 against £1.37 million in 2007 to 2009).

Business confidence and investment was severely hit in the aftermath of the financial crisis. However, as market conditions improve and this confidence returns, an increasing number of businesses can be expected to seek expansion finance. It is not clear from this data whether the supply of such finance would keep in touch with this trend, especially for lower values of expansion capital investments. If supply were not to adjust to demand in this way, the gap in provision for this type of finance may well expand.

Two North West JEREMIE Fund operates two sub-funds providing equity growth finance to established SMEs, both managed by Enterprise Ventures - a Lancashire based equity investment specialist:

- The Venture Capital Fund: A £30.5 million fund investing £50,000 to £2 million. The fund had a slow start, making just two investments by the end of 2011, but had invested 75% of its lifetime investment pot by 2014 Q3 and is ahead of schedule. The fund has balanced its investment between higher risk technology ventures (accounting for around 25% to 30% of the total) with revenue generating investments in other sectors. The fund can invest at relatively small values, which allows it to invest in a wide range of business and ventures including seed and follow-on deals. However, it has tended to concentrate on larger deals (averaging £418,000 versus a £232,000 forecast average) and follow-on investment within its existing portfolio. This may also reflect a relative absence of other publicly-backed provision at this size of deal in the North West.

- The Mezzanine Fund: A £10 million fund formed from the finance reallocated from the previous JEREMIE Development Capital fund. The fund is aiming to provide larger amounts of finance of above £750,000. The two businesses financed to 2014Q2 combined with seven that were being processed as of 2014Q2 represent just 19% of all applications made.

Enterprise Ventures have highlighted in particular the difficulty faced in attracting private sector co-investment, suggesting the gap in finance for these classes of investment appear to be pronounced in the region. This is especially the case for the follow-on investment in earlier stage established businesses and where there are longer-term requirements for on-going business expansion.

Table 2.10: *Selected Key Performance Data for JEREMIE Sector Funds to 2014 Q3*

	Investment to 2014Q2 (p.a. in brackets)	% of Lifetime Funds Invested	Number of Investments	Average Size of Investment	Conversion Ratio[16]	Jobs Created	Private Sector Leverage
Venture Capital	£23.01m (£6.6m)	75%	55	£418,000	83.9%	217	£8.2m
Mezzanine	£1.90m (£0.5m)	19%	2	£950,000	18.6%	8	£2.2m

Source: JEREMIE Quarterly Performance Reports for 2014Q3

Given the role business confidence plays in driving demand for this type of investment, these funds faced a more challenging climate than the other JEREMIE sub-funds. Many established SMEs have postponed growth projects whist they wait for conditions to improve. As stated already, as businesses look to return to growth plans, the finance gap in this part of the market may strengthen if supply does not follow suit. If this were to happen, the requirement for publicly-backed finance would strengthen as a result.

Enterprise Ventures is a well-established equity investor in the North West and has been able to draw on an extensive network of financial and business intermediaries. This said, the Venture Capital Fund has struggled somewhat in securing as much co-investment as it might have liked, suggesting again that potential co-investors may still be being cautious where when it comes to investing in business expansion.

The Merseyside Special Investment Fund's Loans and Equity Fund, established in 2010 to invest legacy funds from an earlier investment period, is also investing in the same £50,000 to £2 million range as the JEREMIE VC Fund. Debt is provided either as traditional loans or through mezzanine finance. ERDF

[16] Includes applications still under assessment

funding ended in 2008 but the fund has continued to invest through legacy funding. Plans to deliver £25 million from 2008 to 2013 were extended recently to £64 million over ten years across all MSIF funds. While the rate of investment provided through the fund dipped post-recession, it has since recovered and the fund is typically delivering around £5 to £7 million annually.

On top of this, 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 focusses on growth equity and mezzanine finance, offering £2 million to £10 million. It is designed to be an evergreen fund. Four investments have been made in the region to date, with an average value of £6.3 million. This supports feedback from consultations suggesting that the fund is investing at higher levels within the £2 million to £10 million range.
- **Enterprise Capital Funds** can also invest in later stage businesses. The latest monitoring data was presented earlier under the early stage section.

Looking ahead, there is little evidence to suggest that the gap for later stage equity will be filled by private sources. It also appears that as private investors have persistently withdrawn from smaller size deals, the demand for later stage finance from existing public-backed funds has expanded to include larger deals. Feedback from consultation has been that this is unlikely to change.

Overall, the JEREMIE and MSIF funds have played an important role in addressing the relative under provision of finance from other publicly backed schemes operating nationally.

1.5.4 Demand and Supply Summary

A summary of the key sources of publicly-backed supply of finance to SMEs is provided below.

With some exceptions (including start-up and small business loans, the Angel Co-Fund and Enterprise Investment Scheme), the table helps to illustrate that when compared to England as whole, the level of finance being delivered in the North West per SME through publicly-backed schemes is strong. ERDF has historically played an important role in the region, especially since the launch of the ERDF backed JEREMIE fund. It is inevitably difficult to estimate what proportion of this provision may have been provided by the private sector in the absence of these publicly-backed schemes. However, the evidence presented here suggests that the public sector is typically operating in markets where there is a clear finance gap, where market failure exists and that it is addressing this failure to at least some degree.

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

Notable exclusions from the table are peer-to-peer lending, the UK Innovation Investment Fund and the Aspire Fund where it has not been possible to obtain up to date information at a regional level.

Table 2.11: Summary of Key Sources of SME Finance Supply in the North West (England averages in brackets)

	Average annual value of Investment, £m	Average value of investment made, £000s	Investment Value for Every SME	% change in value 2011-13
Debt				

New loans to Small Businesses	£660	£73 (£82)	£5,390 (£7,342)	-32% (-12%)
New loans to Medium sized businesses	£1,401	£233 (£295)	£11,452 (£11,303)	0% (1.5%)
New overdrafts approved for Small Businesses	£205	£14 (£16)	£1,679 (£2,094)	-27% (-25%)
New overdrafts approved for Medium sized businesses	£301	£315 (£81)	£2,461 (£2,229)	-6% (-5%)
Enterprise Finance Guarantee backed lending	£53	£97 (£100)	£430 (£340)	NA
Start-up Loans	£6.0	£5 (£9)	£50 (£70)	NA
Business Finance Partnership & Investment Programme	£74	£234 (£207)	£600 (£500)	NA
ERDF backed debt (JEREMIE and Transitional Loan Funds[17])	£9.3	£90 (£83)	£60 (£40)	NA
Equity				
Early stage equity investment	£73	£2,626 (£1,081)	£594 (£355)	1254% (24%)
Expansion equity investment	£76	£3,690 (£4,830)	£624 (£1,150)	-48% (-62%)
Angel Co-Fund	£0.6	£790 (£1,832)	£4.5 (£30)	NA
Enterprise Capital Funds	£0.9	£996 (£1,335)	£7.2 (£27)	NA
Enterprise Investment Scheme	£29	£211 (£344)	£230 (£650)	58% (66%)
Business Growth Fund	£16	£6,325 (£5,617)	£75 (£77)	58% (46%)
Equity-based crowdfunding	£1.2	NA	£14 (£26)	NA
Reward & donation-based crowdfunding	£3.8	NA	£31 (£35)	NA
ERDF backed equity (JEREMIE)	£20	£357 (£399)	£160 (£59)	NA

1.5.5 Performance of ERDF backed funds

Venture capital and loan funds were a well-established part of economic development policy in the North West prior to the development of the JEREMIE project. Several funds operated during the 2000s with public funding support from the NWDA, UK Government and ERDF. Operating between 2002 and 2013, they invested around £160 million in the North West representing an average investment rate of around £25 million per annum.

The individual VCLFs included:

- North West Business Investment Scheme (NWBIS)
- North West Seed Fund (NWSF)

[17] Stopped investing in 2013

- Rising Stars Growth Fund (RSGF)
- North West Equity Fund (NWEF - Regional Venture Capital Fund)
- Merseyside Special Investment Fund (MSIF), comprising four individual funds
- Transitional Loan Funds, comprising separate small business loans fund at a sub-regional level, a wider loan fund and a loan fund for social enterprises.

The largest of these funds was the MSIF which invested around £90m to 2008, and accounted for around 50% of annual VCLF investment in the North West in the early-mid 2000s. The NWEF and NWBIS invested £25 million each. There were earlier predecessors to these funds during the 1990s, which had also drawn on ERDF. Alongside these regional VCLF funds, the UK Government also delivered finance to businesses in the North West focused on a range of investment priorities.

This experience has provided 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. This pre-existing infrastructure and learning was used to inform the development of the current JEREMIE Fund and would feed into any plans for a successor fund in the 2014-20 Programme period.

Evidence from 2013 Mid-Term Evaluation of the North West JEREMIE Fund suggests that after a slow start to it operation, there is now reasonable evidence of emerging impact and value for money coming out of the fund. There is also limited evidence of crowding out of the private sector in current economic circumstances and on balance the fund has most likely played a stronger role in drawing in and stimulating further private investment.

The North West has also benefitted previously from legacy returns from previous ERDF investments in SME finance; around £65 million from investment in 2000-07 with a further c. £105m predicted from investment in 2007-13[18].

Lastly some caution needs to be applied in forecasting the final investment performance of the ERDF backed funds. Overall, performance to date is strong given the inevitable riskiness of the end of the market they are operating in, but this may mask some very good and some other poor performance across and with the funds and sub-funds.

[18] Source: DCLG, January 2015

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 in section 4 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.

	Micro loans	Early Stage VC	Debt for Growing, Established SMEs	Expansion Equity for Established SMEs
Step 1 - Demand and Supply Characteristics	• 457,000 microbusinesses in the North West (including 358,000 with no employees and 273,000 operating below the VAT threshold) • 6% growth in microbusiness (Vs 8% across England) • Growth in sole traders and unregistered businesses potential as a result of increased necessity entrepreneurialism • Start-up rate 16% below the England average, but has grown (11% 2009-2012) • Good performance on enterprise indices • Banks are typically investing at levels above small and micro loans • Microbusinesses are particularly hit by the tightening in bank lending criteria • A strong presence of publicly-backed funds (e.g. JEREMIE Microloan fund, Business Bank start-up loans, Rosebud, CDFI Small Business Loans, Transitional Small Business Loans, credit unions) is helping to fill some of the gap	• Strong R&D base underpinned by universities and industry-backed research and innovation centres • University of Manchester and to a lesser extent Liverpool & Lancaster account for majority of spin-outs • Significant and potentially pent up demand • Evidence of excess demand for JEREMIE and some good propositions not being funded • EIS investment per SME is some way below the England average • Strong leverage effect from presence of JEREMIE Fund managers • Relatively strong supply-side is skewed by larger deals and annual trend is lower than pre-recession • JEREMIE Funds providing a notable scale of finance • Some presence of other players (e.g. MTI Ventures– late seed) • Some crowdfunding penetration, though below UK Av on equity-based • Tax incentives have had an impact: co-investment • Other initiatives (ECF/ACF) have had little penetration in region	• 23,000 established SMEs in the region • Overall there is a fall in bank approvals for small businesses and shift to larger loans. Bank lending to small business has contracted by 32% between 2011 and 2013. • Strong demand for debt from publicly- backed sources • Take-up of JERMIE Business Loan fund around the £80 to £200,000 mark is strong. There has been less demand for the Mezzanine Loan Fund – where investment stands at an average £500,000 • Strong take up of EfG in the region (£430 per SME Vs £340 across England) • Other initiatives (e.g. the GM Loan Fund, BFP and Investment Programme) appear to have had more impact • P2P lending has had significant growth – impact on the region unclear and remains low in context of overall lending	• 23,000 established SMEs in the region • Business confidence and growth plans were hit post-recession but confidence is growing • Long term cultural issues with equity finance remain (equity aversion) to some extent • Annual total investment of £76m in expansion equity across the NW over the past three years (some way below the average per SME across England) • Few publicly backed sources outside of BGF (£6.3m avg. deal size to date), MSIF and JEREMIE • JEREMIE VC fund has invested 75% of its £30.5m value (2014Q2)

Step 2 – Unmet Demand	• Particular, growing, difficulties experienced by micro-businesses in obtaining finance, despite various interventions • Theoretical unmet demand c. **£5m pa for micro finance and £95 pa. for micro and small businesses seeking larger amounts** (with 10% of rejected firms having solid business plans; additional to gap covered by public backed funds)	• Reduced supply post-recession despite a very strong 2013 • Demand for JEREMIE strong in places and scope to achieve a higher investment rate • Much of the publicly-backed provision is focused close to point of commercialisation • Less public-backed finance for very early stage finance (POC/Seed) • **Likely growth in demand, stimulated by public sector led demand side initiatives, but a small part of the market compared to debt**	• Nationally: c.40% of small and 30% of medium sized businesses have problems accessing finance • Difficulties grown in recent years with reduction in bank lending • Strong demand for debt for publicly backed sources indicating demand unmet from private sector • Unmet demand for established SMEs is **£75m p.a**. (based on 10% of propositions being viable) • **Unmet need has grown as banks focus on larger deals – will continue to be the case**	• Demand dampened during recession but evidence points to additional emerging demand • Strong demand for JEREMIE VC Fund finance (and MSIF investment) • Unmet demand for established SMEs is **£7m pa** (based on 10% of propositions being viable) • **Demand to grow, but unlikely to be matched by commercial VC which is focussing on larger deals**
Step 3 – Market Failure	• Continuing area of market failure, nationally and regionally • Public sector backed funding addressing part of this gap, but difficult to assess extent of market failure based on limited information of existing activities • Improved economic climate could lead to an increased start-up rate therefore expanding the scale of any market failure • **Lots of demand but not necessarily market failure**	• Most JEREMIE sector funds performing well on inv. rate, projected returns, economic outputs • Reasonably active private sector funding can be levered with public backing (de-risking) • **But**: caution required – equity aversion remains an issue and there is continued need for awareness raising	• Again major area of market failure, exacerbated by shift in bank activity • Experience of JEREMIE and other funds confirms increased scale and level of finance associated with market failure (up to £200-300k) • Evidence of banks returning to SME market but under continued pressure • Challenger banks: may take market share but impact on overall SME lending unclear • Continued pressure on working capital as come out of recession	• Continued evidence of persistent market failure • JEREMIE experience indicates extent of market failure; increased equity gap • Improved economic conditions likely to strengthen demand, but private VCs likely to continue focus on larger propositions. There is therefore the potential for the finance gap to expand • **But**: caution required – equity aversion remains an issue and there is continued need for awareness raising
Step 4 – Persistence of Market Failure	• Consultations suggest banks likely to continue to focus on asset-backed, larger	• Evidence of structural long-term equity gap at the early stage, but less affected by recession	• Banks under continued pressure from regulation and increasing cost of capital	• No sign of mainstream players moving away from fewer, larger deals, leaving a gap at

	propositions in coming years • Market failure likely to continue for foreseeable future	• Mainstream players are likely to continue to focus on larger, de-risked propositions	• P2P has grown but future path and sustainability is unclear • Economic recovery points towards increase in demand for debt and therefore potential increase in unmet demand – including for larger loan deals.	lower levels of equity/mezzanine. • Economic recovery suggests demand for expansion could pick up and therefore increase unmet demand and market failure
Step 5 – Specific Economic Development Priorities	• Support for development of increased entrepreneurial activity and start-up rates to feature prominently within plans for development of LEP level Growth Hubs • **Analysis to be further tested and reviewed as part of Block two work**	• All LEPs are placing a string emphasis on SME innovation and are planning to invest in the development of a number of industry-led research and development facilities • **Analysis to be further tested and reviewed as part of Block two work**		• Supporting business growth of likely top feature prominently within plans for development of LEP level Growth Hubs • **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 **Analysis to be further tested and reviewed as part of Block two work, once further detail on the potential investment strategy and delivery options is developed.**			