The Provision of Growth Capital to UK Small and Medium Sized Enterprises

23 November 2009

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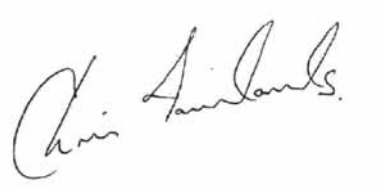
Foreword from Chris Rowlands

I was delighted to be asked to lead this review. With a 36 year career spent lending to, investing in and advising UK SMEs on their capital raising I have a thorough working knowledge of the issues. Nineteen years at 3i instilled a passion for the subject.

The basic question of adequacy of access to capital for SMEs is not a new one and a conclusion of a market gap in provision is unlikely to be controversial. However, the Government was right to ask for an urgent update of the analysis and arguments. Our economy cannot afford the dynamic SME segment to be constrained in its growth and competitiveness, especially with recovery ahead.

The review concludes that this market gap is permanent, not just short term and cyclical, and exacerbated by recession. The easy availability of bank lending in recent years served to obscure an underlying lack of capital provision. So, an intervention from Government is required and I hope one that might have the lasting impact of attracting private sector capital on a large scale and enduring basis. A legacy we could all be proud of.

This review has required an intense effort over a short period to gather and analyse contemporary data, consult widely with interested parties and develop a relevant range of options for consideration. My sincere thanks to the team at the Department for Business, Innovation and Skills, this review's Advisory Panel for their wise councel and Ministers for prioritising their time.



Panel Members

Chris Rowlands (chair)

Chris Rowlands retired in March 2009 when he was a member of 3i's executive team, group investment committee and Chairman of 3i Asia. He worked at Barclays Bank for 11 years, Andersen for 6 years and ICFC/3i for 19 years. During his time at 3i he led their growth capital business and developed 3i in Asia. He is currently non-executive director of The Principality Building Society.

James Caan

James Caan is CEO of private equity firm Hamilton Bradshaw and has been building and selling businesses since 1985, including the Alexander Mann Group and Humana International. In 2001 James was awarded the 'BT Enterprise of the Year' award and was named PricewaterhouseCoopers 'Entrepreneur of the Year' 2003. That same year, having successfully graduated from the Advanced Management Program at Harvard Business School, Caan also won the Entrepreneur of the Year in the Asian Jewel Awards. In 2005 he was voted one of the 100 most influential Asian people in the UK by Asian Power 100. 2007 saw James joining the panel of BBC2's Dragons' Den, investing his own capital in start-ups on national television. In 2008 Caan scooped the prestigious 'Man of the Year' at the GG2 Leadership and Diversity Awards at London's Grosvenor Hotel, coupled with being named 'Asian Business Man of the Year' in quick succession. James most recently was appointed the new co-chair on the Ethnic Minority Business Taskforce, which supports over 280,000 businesses, contributing in excess of £20 billion a year to the UK economy.

Christina McComb

Christina Mccomb is a director of partnerships UK plc, where she is responsible for investment activities, and was previously a director at 3i. She has over 20 years experience investing in venture companies and SMEs. She currently sits on the Boards of several early stage businesses.

Gordon Murray

Gordon Murray holds a Chair of Management (Entrepreneurship) at the University of Exeter Business School. Since 1989, he has researched, lectured and consulted internationally in the two related areas of New Technology-based Firms and the international development of the formal and informal Venture Capital Industry. Dr. Murray is a senior adviser on policy related issues concerning the financing and growth of high potential young firms to the UK government's Enterprise Directorate and is a member of the government's *Expert Group on Access to Finance* (BERR). He has also advised the European Commission on the financing of high growth young firms and was a founder member (2000-2006) of the Professional Chamber of the *Enterprise Policy Group* (DG Enterprise) as well as having served on the *Risk Capital* and *Gazelle Expert Groups* (DGs Enterprise and Research). From 2008, he has been appointed to the newly formed *Research Advisory Board* of the British Venture Capital Association. He is currently involved in the formal evaluation of the Finnish National Innovation Strategy 2008, and providing analysis for a review of 'hybrid' (public and privately joint financed) VC funds for the UK's National Audit Office.

Ray Perman

Ray Perman chairs the Access to Finance Expert Group for the Department of Business Innovation and Skills. He is also a board member at Scottish Enterprise and chair of Social Investment Scotland, which lends money to social economy organisations. Previously a journalist, he founded and built up a magazine publishing business. He is an angel investor and chairs three small companies.

David Quysner CBE

David Quysner began his career at ICFC (latterly 3i). He is currently Chairman of Capital for Enterprise Limited, which manages the government's equity funds and loan guarantee schemes for SMEs. He is also Chairman of Abingworth, a venture capital and growth equity investor in life sciences and a Director of other companies investing in technology.

Danny Truell

Danny Truell is the Chief Investment Officer and a member of the Executive Board of the Wellcome Trust, the largest charitable foundation in Europe with assets exceeding £12 billion invested in a broad range of investments including public equities, private equities, property, venture capital and hedge funds.

Executive Summary

1

1.1 Small and medium sized businesses (SMEs) are vital to the UK for jobs and wealth and a dynamic, growing SME sector is likely to contribute significantly to future growth and productivity. To maximise their contribution, it will be important that the financing needs of viable SMEs which want to grow are fully met.

1.2 This review was asked to consider whether and in what form intervention might help increase the supply of long term growth capital to SMEs. In particular, the review was asked to examine the evidence of market failure and, should there be a case for intervention, to develop proposals for Government to consider on: (i) the focus, size and scale of any new intervention and (ii) the level (if any) of public support.

The nature of growth capital

1.3 Growth capital is a broad term used to describe funding that enables established firms to expand. It is often used by SMEs for a range of expansion activities from investing in new plant or equipment to engaging in marketing or hiring a new team. Growth capital thus forms a vital part of the "funding escalator" that allows companies to meet their financing needs at different stages of their development.

1.4 The nature of growth capital for SMEs varies in its structure or product form. It exists both as term debt, often from traditional sources such as banks and in the form of equity or equity type investments - typically from venture capital or private equity providers. It also exists to a limited degree as mezzanine finance – term lending, with less security than bank debt but at a higher cost, often through a final "kicker" payment or share in the company's equity.

1.5 What differentiates growth capital from other types of investment is the level of risk. It is positioned between the two extremes of high risk -high return pure equity investment and lower risk, usually fully secured, bank lending. Growth capital involves moderate risk with some security and, as a result, providers expect a moderate return. It is for this reason that demand for growth capital may be met through mezzanine finance products.

Demand for and problems in accessing growth capital

1.6 Gaps in current data and analysis make it difficult to draw any firm conclusions on the existence of a permanent gap in the provision of growth capital. However, the underlying market issues, together with anecdotal evidence suggest that a gap currently exits. In addition, we can say with some confidence that unmet demand for growth capital is likely to increase as recessionary effects weaken balance sheets and reduce the capacity to take on debt.

1.7 Drawing on two separate data sources, we estimate that there are 25,000 - 32,000 UK businesses that are growing and/or restructuring and with characteristics that may make them suitable for growth capital. Our analysis suggests that up to 5,000 of these firms per annum will be viable SMEs which are likely to experience significant problems in accessing capital as the economy emerges from recession. It is likely that those SMEs which are seeking to access growth capital in amounts above £2million – the current upper limit of public/private provision – and below £10million – the minimum level at which private equity providers will fund – will face particular difficulties.

Reasons for unmet demand

1.8 There are a number of reasons why the gap in the supply of growth capital to SMEs exists. They fall into a number of categories: structural market failures which are well documented and apply more widely to the supply of capital to SMEs; market issues that apply specifically to the supply of growth capital; and finally, the impact of the recent financial crisis and recession.

Structural market failures

1.9 That a growth capital market does not exist is not a market failure per se. If this is because there is not enough economic value from such transactions when compared against alternative opportunities this is in fact a market working efficiently. However, it is widely recognised that the market for all types of risk capital suffers from failures associated with imperfect information. This is where both SMEs and investors have insufficient information to make optimal investment decisions.

1.10 On the supply side, this leads to a lack of investor appetite for growth capital to SMEs for two reasons:

- The costs of researching information are similar for small and large businesses. Investors therefore tend to prefer larger deals involving larger businesses where the transaction costs are a smaller proportion of the investment made.
- There is little performance measurement data, in other words track record, on investing in SME growth capital. This may make investors more risk averse and can result in higher levels of return being required or lower levels of investment being committed.

1.11 On the demand side, information failures include: lack of 'investment readiness' by entrepreneurs; lack of knowledge amongst SMEs on the nature and availability of equity finance; and a perception by SMEs' owner-managers (and their advisors) that debt finance is the only form of finance suitable for their business. This is a belief that may have been encouraged by the plentiful supply of cheap debt finance in the recent past.

1.12 There is also a significant body of evidence that business owners may not be willing to concede a stake in their business to attract professional investors, preferring to sacrifice potential growth for assured autonomy. This is likely to lead to a relatively lower level of demand for equity finance. It is also likely to constrain the growth of companies not accepting professional resources.

Other market issues

1.13 The review believes that further market issues exist that restrict the supply of growth capital to SMEs:

- A preference in private equity for larger transactions where risk is easier to calibrate and returns have been historically highly attractive;
- Financial incentives for fund managers, which encourage investment in larger transactions; and
- Lack of an established channel for growth capital and the fact that institutions allocate a limited percentage of funds to "alternative assets", a category that includes the whole spectrum of private equity and venture capital investment. Allocations to larger buy-outs and secondary purchases have crowded out other segments of the market.

Impact of recent events

1.14 There are reasons to believe that recent changes in financial markets have intensified the structural market failure in the provision of growth capital as the overall supply of capital has become constrained. Until recently, banks were willing to fill at least some of the demand for growth capital. Competition for market share and low cost of capital led banks to extend traditional short term or working capital debt finance for an increased range of purposes; effectively substituting the growth capital market, with readily available funding that did not necessarily match the return for which it was risked.

1.15 Since the onset of the credit crunch, lending by banks has declined for a number of reasons including retreating into more traditional lending practices possibly reflecting increased risk aversion; these changes are unlikely to be reversed soon. Banks are therefore unlikely to provide sufficient and appropriate capital to fund SME growth plans over the next few years.

1.16 For all of these reasons, and despite lack of absolute certainty on the precise level of unmet demand amongst viable SMEs for growth capital, there is evidence to point to a permanent gap in the provision of growth capital. This situation is potentially exacerbated by the recession. The review believes that this constitutes a strong rationale for Government intervention.

Building an escalator of finance

1.17 Government has recognised the existence of the market failures around the supply of finance to SMEs for many years. It has provided significant investment in recent years into a range of early stage equity funds and programmes as well as through Government guarantee schemes. Many of these schemes have been successful in promoting the productivity and profitability of companies in which they invest and they have also attracted private sector capital and capable management teams into the equity gap at this level. However, they have been primarily focussed on debt finance for start-ups and young businesses and on early stage equity for high growth, innovative businesses, not on the supply of growth capital to established firms with medium to high growth potential.

1.18 Government needs to ensure that interventions are sufficiently flexible to meet the needs of business at many different stages of development. It should consider carefully: the optimal size of

funds; their ability to provide follow-on funding; the size of individual investments; and their sector/geographical focus. Although a small number of the publicly-supported early stage funds have the flexibility to provide mezzanine type funding, they are often restricted in size and scope.

1.19 In order to build an effective escalator of finance within the finance gap, Government needs to intervene to ensure that businesses can access finance to start, expand and grow. It must also ensure sufficient sector/geographical focus and overcome the current restrictions of scale. The size of current equity funds ranges from as little as £2m up to £46m, with the size of investment for many funds limited to a maximum of £2m.

1.20 In mapping current government interventions, the review has concluded that the current landscape would benefit from simplification. Any new intervention to increase the supply of growth capital should be part of an integrated solution to the financing problems of businesses in addition to providing a credible source of follow-on funding for growing SMEs.

Options for intervention

1.21 The review concludes that it is unlikely that the financing gap for growth capital can be resolved without targeted Government intervention. An initial level of government support is likely to be required to initiate activity, in particular to overcome barriers in terms of scale and distribution and to give investors confidence to invest in the area. It concludes that a mezzanine type product is well positioned to address the particular risk/return characteristics of growth capital and can be structured to mitigate the impact of various SME demand-side barriers and support attractive returns for investors.

1.22 A number of broad distribution options exist for the way in which Government can deliver such a mezzanine product to the market:

- a standalone, full scale and commercial institution to raise, manage and directly distribute growth capital
- a "thin" commercial institution to raise and manage capital but with distribution through existing private sector providers
- a "thin" commercial institution to raise capital and deliver investment through a co-investment model with approved private sector partners

1.23 In consulting a wide range of stakeholders and drawing lessons from the experience of previous government interventions in the early stage equity market, the review believes that the design of any intervention should address the following key points:

- **Private funding:** Any intervention should seek to draw in private funding to the maximum extent possible.
- **Scale:** The aspiration should be to have a large total fund size. This would capture economies of scale; allow the intervention to make a significant impact on the gap; provide money for follow on investment; and provide regional coverage.
- **Commerciality:** Private sector capital will be maximised if the intervention operates with entirely commercial objectives and strategies aimed at maximising returns.
- **Long term:** An intervention must be able to avoid the pressure for early exit from investments and provide long term support to SMEs.

1.24 The final chapter of this report considers the merits and drawbacks of the three broad options against these points, but does not offer a final view on which should be pursued. This would be for Government to consider in the broader context of what institutions and delivery bodies already exist.

Conclusion

1.25 In summary, the Review has reached the following seven key conclusions and urges Government to take considered action to address the gap in growth capital facing SMEs.

- A vibrant SME sector displaying strong growth is vital for overall economic growth, leading to increased competition and innovation, and improved productivity. Government should strive to ensure that adequate growth capital is available across the SME growth cycle.
- A gap exists for companies looking for between £2m and £10m in growth capital. Neither bank lending nor equity investors are likely to fill this gap in the foreseeable future.
- A mezzanine product would be best suited to fill this gap. It would help address demand side aversion to pure equity, and provide a return above regular bank lending to reward investors. A well designed intervention could offer a risk/return profile that would attract capital to the sector.

- Any intervention would need scale and a centralised asset allocation and risk management function, perhaps through an institution, which would also set the overall strategic direction of the investment strategy and ensure that there was not "mandate creep."
- Evidence points to a need for the ability to find, assess, and manage investment opportunities in the regions.
- Investments should be made on a commercial basis in order to attract private capital into the asset class, to attract talented investment managers who work on a commercial basis and to avoid distorting the market and crowding out private initiatives.
- The existing landscape of government intervention would benefit from simplification. Any new intervention should not add to, but be part of a solution to resolve these problems, as well as providing a credible source of follow-on funding for growing SMEs.

UK Economy and Growth Capital

2

This chapter defines growth capital and sets out the role and importance of growth capital for SMEs in the UK. SMEs access a variety of forms of external finance and this chapter considers how debt and pure equity finance are unlikely to be suitable products for SMEs needing growth finance. The chapter closes by making an assessment of the level of potential demand for growth capital, and estimates the structural gap in its provision of and how this may change as the economy recovers.

Role of SMEs in UK Economy

2.1 Small and medium sized enterprises play a vital role in the economy. They employ 13.7 million people, about 59% of the total private sector workforce. SMEs also contribute as much as large businesses to UK output. The SME sector has seen strong growth recently with over a million more businesses at the start of 2008 than in 2000 and employment growth of 13% over the same period.

2.2 In addition, a vibrant SME sector is an important driver of economic growth. Through the process of economic churn, new businesses enter the market and displace less efficient established businesses. SMEs also bring forward innovation in products and business processes.

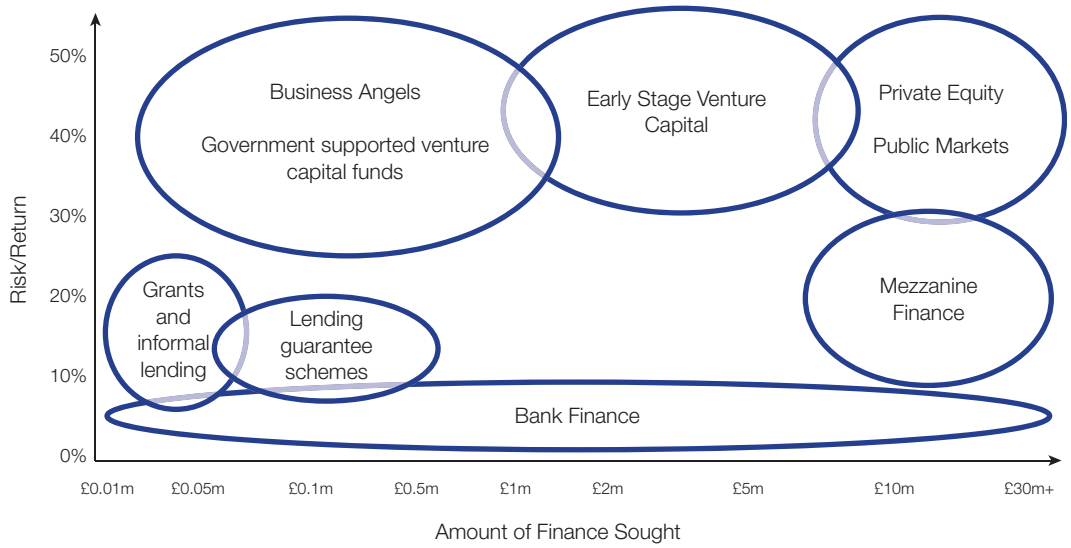
2.3 SMEs are likely to be critical to driving and sustaining the return to economic growth across the economy. As economic conditions stabilise SMEs will have opportunities to expand and grow to meet higher demand, to address new export opportunities and to serve new customers. It is also likely that vibrant SMEs will look to take on business from competitors that did not emerge from the recession as successfully. Whilst this growth will require additional levels of working capital, some of which may be financed through appropriate short term debt, it is likely that finance will be needed to support long term development and structural growth. It is important that the UK's SMEs are supported with the investment to grow and optimise their performance and help drive the economic recovery. Annex B looks in more detail at the links between SMEs and productivity and the impact on business investment and economic recovery through a lack of finance.

The Market for Growth Capital

2.4 The term 'Growth Capital' is usually applied to funding that enables established companies to expand their activities, and is a vital part of the 'funding escalator' that allows companies to move from start-up, expansion, and growth into a larger firm. It can be used for a wide range of activities from investing in new plant or equipment to engaging in marketing or building customer support capability. While the boundaries are blurred, it is usually seen as different from working capital, which is used to fund day to day activities. In terms of investment, it is differentiated from seed or start-up and the very large amounts of capital invested in management buy outs/ buy ins.

2.5 Capital available to SMEs is priced to reflect the risks inherent in the activities that it funds and the downside protection afforded by security. In general terms, the higher the risk of capital loss the greater the return required by the lender or investor. Growth capital requires a level of return below that for Venture Capital/ Private Equity but in excess of what would be appropriate for debt finance on normal terms. Figure 1 maps the different types of finance against their expected return profile.

Figure 1: SME Finance types: Illustrative mapping of expected return profile against amount sought



2.6 Defining the growth capital funding gap in terms of amount sought by SMEs is difficult to do with any precision. However, it is possible to locate a gap at between £2 million and £10 million. Analysis of the growth capital deals within the growth and restructuring population provides a median deal size of £3 to 5million further substantiating that it is within this range that growth capital deals are sought and made. This reflects the £2 million ceiling of existing government interventions (below which start-ups or early stage funds are focused) and the £10 million threshold below which private equity and venture capital rarely invest owing to the structure of their business model.

"Serious consideration should be given to introducing regionally focused development capital funds that fill the current gap of about £2m to £10m." – Partner, Commercial Law Practice

2.7 The next sections set out the suitability of debt and equity finance to meet growth capital needs.

Growth Capital and Bank Debt

2.8 Bank Finance is the primary form of external finance for SMEs, most commonly in the form of overdraft and term loans. However, whilst bank finance is an important source of funding for most businesses, including SMEs, it is not always an appropriate form of growth capital, for a number of reasons:

- The assessment of whether to offer a loan is highly influenced by the security available to support it. The lending is based on a credit decision not an investment decision, which would require looking at the future prospects of the company for growth from which to repay the loan. As such, above a low level, loans are usually secured against assets that can be sold to repay the lender. Therefore the value of an SME's assets against which to secure finance will be essential to their ability to secure finance, rather than the fundamental strength of their business plan.
- Bank finance to SMEs can be relatively short term. Overdrafts are repayable on demand and are therefore not an appropriate form of long-term finance. Term loans are usually less than 10 years and frequently repaid well ahead of maturity.[1] Bank finance may also have restrictive covenants that may impede the performance of the business if market conditions change.
- Bank lending will typically yield a small margin over the Bank of England base rate to the lender and will usually only be advanced where the lender views there to be a very low risk of capital loss. Under normal terms it is uncommon for debt to deliver returns over 10% IRR. Banks are generally unwilling to take the higher risk associated with financing long term growth or, if they are, the price of the debt finance can be prohibitive for the SME.

There is therefore potentially a gap in the provision of finance that is long term, flexible and structured to accurately reflect

1. BIS SME banking data 2009

the risk of capital loss and to capture adequate returns should the firm perform well.

Growth Capital and Private equity/ venture capital

2.9 Equity finance provides an injection of capital into an SME in return for a share of ownership of the business. Equity finance needs to command a high level of return due to its subordinate position to debt holders. In the event of the business performing well, equity holders will get a share of that return. However, in the event of liquidation, ordinary shareholders are the most vulnerable finance providers as they are only entitled to the residual value once creditors and debt holders have been paid.

2.10 This form of capital is not secured against any asset and does not normally receive a guaranteed yield. Typically the potential returns are many multiples of the initial investment and target returns for individual investments may be set at returns in excess of 40% so that successful investments can compensate for losses that will inevitably arise on others.

2.11 Given the requirement for relatively high returns, equity finance may not be suitable as the sole source of growth finance for the majority of SMEs for at least two reasons. Firstly, the anticipated modest growth of many of these firms would not be sufficient to support such high returns. Secondly, as due diligence costs tend to rise only moderately as firm size increases, investment costs for SMEs make a larger negative impact on net returns for these firms than for larger firms.

2.12 The potential to reap higher returns at the larger end of the market has, together with the relatively high costs of making equity investments, driven investors towards larger businesses. Over time this has meant that equity investment has become focussed on the high risk/high return segment of the market. In addition, the aversion that exists within the SME community to equity finance means that this is not always a suitable instrument.

"There are great opportunities to expand… [I looked into] venture capital but they wanted too much. There has got to be something in it for me and if I dilute my share any further I see little point continuing" – Business Owner

2.13 For larger and ambitious firms seeking equity finance to expand, there is also the opportunity to float on the London Stock Exchange Alternative Investment Market (AIM). However, this will not suit the majority of businesses looking to grow. Annex C provides more detailed overview of the market for equity finance for SMEs.

Growth Capital as 'mezzanine'

2.14 This mismatch between the main types of finance instrument – debt and equity – and the finance needs of moderate growth SMEs has led to the development of mezzanine finance services. Mezzanine finance is particularly suited to SME growth because it occupies the middle ground between the lower risk and return of bank debt and the higher risk and return of equity investment. It shares features of debt, but typically provides compensation for greater risk taking on the part of the investor, through a small equity component or redemption premium.

2.15 However, evidence collected when compiling this report indicates that activity in this range is limited, with existing mezzanine providers in the market focusing on investments above £10 million, often as part of large scale private equity deals, and the previous existence of relatively cheap bank debt crowding out provision below £10m.

"From 1997 to 2007 Banks were the key competitors to Mezzanine finance; the cheap debt effectively killed the Mezzanine product [below £10million]" – Partner, Mezzanine provider

Demand for Growth Capital

2.16 During the course of the Review the team have encountered substantial anecdotal evidence of small businesses wanting long term growth capital that they cannot at present access through banks or the venture capital markets. Quantification of this need however comes with a high degree of uncertainty. Much of the data is necessarily based on demand for products similar to but not necessarily identical to those any intervention aimed at the growth capital market would employ. Furthermore, the market issues identified later affect the level and type of demand and not merely the supply of growth capital.

2.17 Rather than making assumptions about the type of firms looking for growth capital, this review has assessed the market for growth capital by identifying what criteria mark out firms that seek and find it. Work carried out for this review by pH Group identified the most common characteristics of those companies that have previously undertaken growth capital deals[2]:

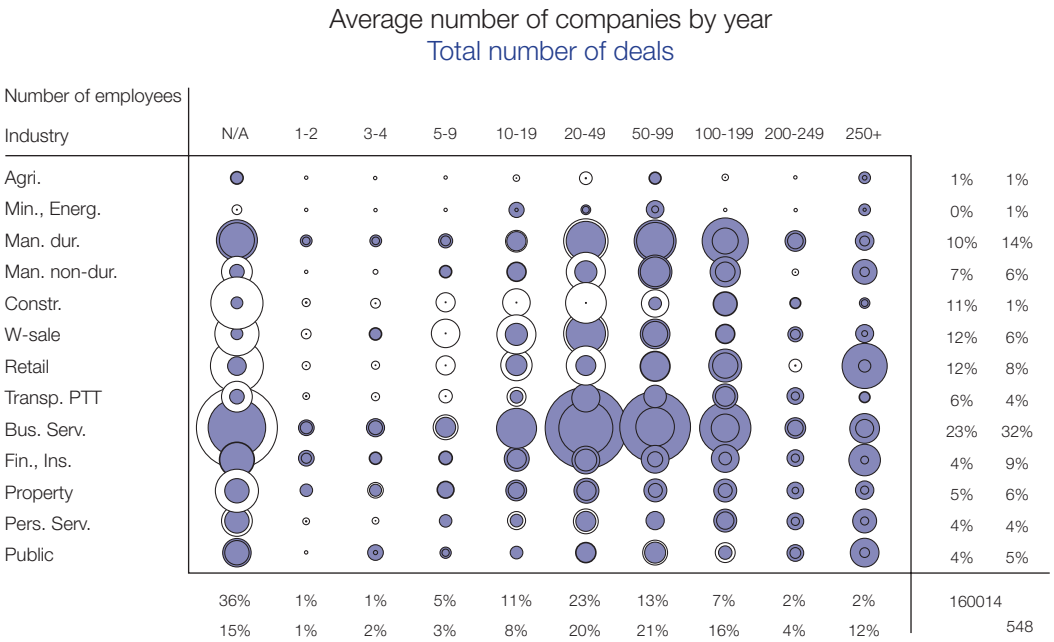
- The analysis (see figure 2) identified around 170,000 SMEs with a turnover between £1-£25m, and which were over 3 years old. This formed the population that was subsequently analysed.
- The more employees a firm had, the more likely it was to do a growth capital deal. The likelihood of doing a deal was highest for those companies with an annual turnover between £5m-£10m, whilst lowest for those companies with a turnover around £1m.
- In terms of sector, there is no significant skew towards one over the other but there is a greater representation of manufacturing and business services.

2.18 Within this defined market it is possible to identify companies undertaking 'growth capital' deals.[3] This allows the identification and analysis of the key characteristics of companies prior to the receipt of development capital. Thus it is possible to quantify the relative importance of certain financial and non-financial drivers to deals, as well as the natural territory of development capital.[4]

2.19 Analysis of the characteristics of firms undertaking growth capital deals (specifically in terms of sales and employment growth over time) highlights three key segments with a differing incidence of deals:

- The highest incidence of growth capital deals occurs amongst firms growing in both employment and turnover with the greatest incidence among those firms with growth of at least 25% per annum in both.
- An above average incidence of growth capital deals appear to be undertaken by firms 'restructuring' – defined as where either employment or turnover increases whilst the other declines, or where both are declining.
- Finally the lowest incidence of deals is found among a cohort of stable companies. This fits with anecdotal evidence that suggests that there are a number of small companies which are moderately successful but whose management have limited ambition to grow further.

Figure 2: Incidence of growth capital deals by industry and size



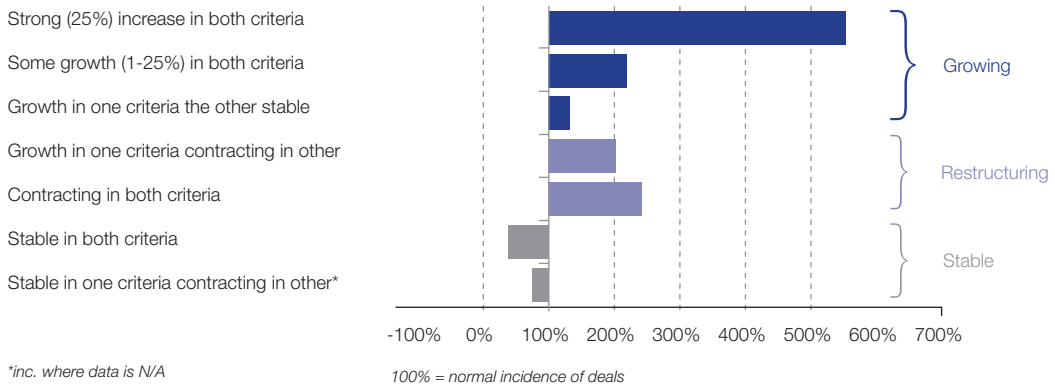
Source: pH Group 2009. Blue filled circles = no. of deals, black rings = no. of firms

2. Data on deals from CorpFin, part of Experian Ltd pH group. Corpfin claims to capture 95% of all deals over £500,000. For the analysis, growth capital deals included: a) Development Capital deals; b) Reconstruction deals; c) Minority stake deals; and d) reverse takeover deals. It does not include e) acquisition; or f) Management buyouts (MBOs) as not considered relevant.

3. Those companies for whom, at any point, growth capital may be appropriate. Deal logged on the Corpfin database that captures all deals over £500,000, claiming 95% coverage.

4. It is important to bear in mind that the overall number of deals is low, and they do not represent demand for growth capital but development capital deals in the existing market. It is possible however to develop some conclusions about what type of firms will by looking for this sort of finance.

Figure 3: Incidence of growth capital deals



Source: pH analysis

2.20 Evidence collected from the consultation interviews confirmed the first two groups as the hotspots for growth capital deals. As well as identifying businesses exhibiting growth, the interviews suggested that those that have hit a plateau through lack of funding or who are unable to secure a second round after initial early stage investment would be suitable targets for growth capital. Further analysis is shown at Annex D.

Estimating the scale of the unmet demand for growth capital

2.21 The previous analysis illustrates that deficiencies in current data make it difficult to estimate with any degree of precision the number of SMEs that might benefit from a growth capital injection. However, the analysis of two data sources – pH data and the Business Structures Database, provides an indication of the broad orders of magnitude using the pH analysis. It estimated that of the circa 170,000 companies there are approximately 25,000 to 32,000 SMEs in the growing and restructuring bracket with characteristics that may make them suitable for growth capital finance. This is supported by analysis of the Business Structures database (based on VAT returns and employee numbers) which gives a figure of circa 25,000 for growth firms within the same parameters.[5] Only a smaller proportion of these SMEs will be seeking finance at any one time.

Unmet demand prior to the recession

2.22 Although data does not exist directly on the scale of unmet demand, surveys of small businesses before the recession provide figures both for the number of businesses seeking finance, and the proportions experiencing problems in obtaining any finance.

2.23 To estimate the structural gap in the provision of growth capital it is necessary to draw on survey data from prior to the beginning of the credit crunch. The BIS Annual Small Business Survey 2007/08 found that of the 35 percent of growth businesses seeking finance, only 21 per cent had problems raising finance from the first source approached and 4 per cent were unable to access any finance from any source.

2.24 Applying these percentages to the mid point (28,500) of the estimated range (25,000-32,000), produces a figure of between a few hundred (400) and a few thousand (2,100) businesses experiencing problems raising finance. Given both the problems with survey data and precisely estimating the number of firms which might benefit from an injection of growth capital, these figures should only be viewed as indicative of the scale of the problem.

2.25 Table 1 illustrates the impact of two plausible scenarios on the scale of unmet demand for growth capital over the next few years.

- Both supply and demand continue to be subdued relative to pre-recession conditions. Under this scenario the scale of unmet demand could rise to between 1,300 and 2,100 businesses per year.
- Demand for finance amongst SMEs returns to its pre-recession level as recovery accelerates but the supply of finance remains constrained at current levels. This scenario of supply remaining constrained is entirely plausible, as for

5. pH analysis showed circa 20,000 “growing” firms and circa 12,000 “restructuring”.

instance banks react to the anticipation of regulatory changes to both capital & liquidity requirements, and the trend of reduced foreign lending looks set to continue. Under this scenario, the scale of unmet demand could rise to between 2,700 and 4,400 businesses.

2.26 Depending on the medium term trends in both demand and supply of finance, we estimate that up to 5,000 SMEs per annum seeking growth capital could experience problems raising this capital. Again, given the number of other factors that might influence the demand for growth capital, inadequacies in data and the uncertainty about how the financial markets will adjust as the recovery accelerates, these estimates should only be taken as indicative of the possible scale of unmet demand.

Impact of recession on number of SMEs financially constrained

2.27 There are strong reasons to believe that problems faced by some SMEs in raising growth capital will have been accentuated by the recent events in financial markets. Business surveys since the recession have found that whilst there has been a fall in demand for finance by SMEs, there has also been an increase in the proportion of SMEs facing difficulties accessing it. For example, the June 2009 BIS Barometer found that of the 17 per cent of all SMEs seeking finance, 44 per cent had problems raising finance from the first source approached and 27 per cent of all SMEs seeking finance were unable to access any finance from any source.

2.28 Experience of previous recessions indicates that it could take several years before the supply, and possibly the demand for finance, returns to pre-recession levels. This is important, as research has shown that the ability to fund growth internally is directly linked to the extent to which a firm is financially constrained.[6] Capital structure, specifically levels of debt and interest cover are good indicators of how financially constrained SMEs are.

2.29 The data depicted in Figure 4 suggests that in aggregate UK businesses entered this recession with both considerably more debt and cash than they did historically. This is reflected at the very small end of the market in companies with turnover less than £1m and to a lesser extent in our target SMEs with turnover above this. However, growth companies have traditionally borrowed more and more often and are now overleveraged.

"We are already seeing businesses which need to invest to meet forecast increases in demand but which find themselves unable to raise bank finance to assist" – Fund Manager, Private Equity Firm

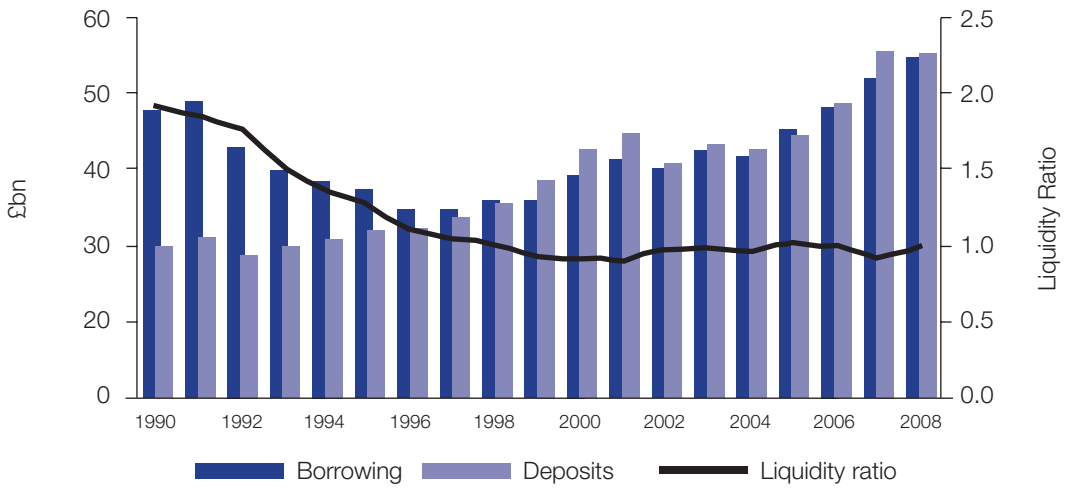
2.30 Analysis of historic data across the SME population also shows that although since 1999 there are a declining number of businesses borrowing, those that are doing so borrow more and are likely to have low levels of interest coverage: 44% of businesses that borrowed in 2008 had less than 2 times interest cover.[7] Historical precedent suggests that profitability could deteriorate before it gets better, and may also struggle to recover even when GDP growth does.

Table 1: Estimation of potential unmet demand for finance

	Population of businesses suitable for growth capital	Businesses Seeking external finance	Number of businesses unable to raise finance from any source	Number of businesses having problems raising finance from first source approached
Pre-recession demand and supply	**28,500**	**10,000**	**400**	**2,100**
Recession demand and supply	**28,500**	**4,800**	**1,300**	**2,100**
Demand at pre-recession levels, supply at current levels	**28,500**	**10,000**	**2,700**	**4,400**

6. D. Harhoff, "Are There Financing Constraints for R&D and Investment in German Manufacturing Firms?", Annales d'Economie et de Statistique, 1998
7. pH Group 2009. Analysis completed on behalf of the Rowlands Review.

Figure 4: Trends in borrowing and deposits of SMEs



2.31 In addition, analysis of the two types of business identified in paragraph 2.19 as being more likely to require growth capital – growing and restructuring firms – show signs of their being more financially stretched than the wider SME population.

2.32 Growing SMEs are more likely to borrow; on average over the past three years 42% of growing SMEs borrowed compared to 36% of the wider SME population. In addition, both growing and restructuring SMEs are less likely to have substantial interest coverage on existing debt than the wider population; 48% of growing SMEs have interest cover of less than two times. Amongst restructuring SMEs the situation is even more pronounced with 78% in this position. This could be particularly problematic as in 2008 17% of SMEs across both groups were geared over 200%.[8]

2.33 Despite the estimation difficulties, for the reasons explored in this chapter, the possibility that several thousand SMEs with growth potential face difficulties in raising appropriate finance to fund their growth plans constitutes a strong rationale for intervention. The next stage in the analysis, assessing whether there are market failures leading to this under allocation and whether they can be effectively addressed, are considered in the next chapters.

8. pH Group 2009. Analysis completed on behalf of the Rowlands Review.

3 Causes of the Gap in SME Growth Capital

This chapter explores the reasons for the apparent under provision of growth capital to SMEs. The review has found that a number of issues have led to the gap in SME growth capital, namely:

- **Permanent market failures affecting both supply and demand sides;**
- **A number of other market issues that have an adverse impact on the supply of growth capital including methods of risk reduction in private equity, remuneration of fund managers and the lack of an established channel for growth capital;**
- **The impact of the recent financial crisis and the economic downturn on bank financing of growth**

Market failures

3.1 The reasons why some viable SMEs with growth potential can experience problems in raising capital is well documented, and is, at least in part, the result of a number of market failures. These market failures relate to imperfect information and other structural issues on the demand and supply side that have resulted in fund managers making fewer, larger and later stage equity investments. The supply side market failures identified by the review are:

Cost structure of growth capital deals

3.2 The prohibitive cost of identifying, transacting with and exiting from smaller growth capital deals has been commonly cited by fund managers and investment firms.[9] Consensus suggests that deal structuring and due diligence on a 'typical' deal can take about 3 months. For a technically complex company, the costs can easily account for 10% or more of the investment. Thus for smaller deals the due diligence can represent a larger proportion of the deal. This issue particularly affects SMEs as relatively more information is obtainable with regard to larger businesses.

Track record

3.3 Data on returns from growth capital investment is limited, as only a limited number of growth funds exist. Lack of track record is likely to make investors more risk averse when investing in this sector, and as a result demand a higher level of return as compensation. Anecdotally this is supported by evidence from the British Venture Capital Association (BVCA), which shows that those institutional investors not investing in venture capital significantly underestimated the returns achieved by this asset class, whilst those that did invest generally had more accurate perceptions.[10] If investors have incorrect expectations, this will result in a sub-optimal allocation of capital.

Potential market failures affecting the demand side are:

Lack of investment readiness

3.4 This leads to SMEs lacking the ability to present themselves as investable opportunities, for instance due to poor business plans or inadequate management skills, constraining the ability of the business to obtain investment.

SME aversion to equity

3.5 Research estimates that up to 20% of incorporated SMEs consider equity finance to fund growth although the numbers that actually use this form of finance is much lower at 1%.[11] There are a number of reasons why equity is not well favoured; lack of understanding and reluctance to cede ownership are most commonly cited with 35% of SMEs stating they do not want to cede control of their business as a reason for not taking equity finance.[12] However, research also suggests that SME owners and managers can lack the skills or knowledge to understand and secure the most appropriate type of investment. In addition, lack of information about the supply of finance, differences in valuation of businesses, and a tendency on the part of SMEs to put off growth plans if they do not secure a favoured form of finance are also common.

9. Respondents to the Review's 'Call for Evidence' and 80 + stakeholder interviews

10. British Venture Capital Association, Institutional Investor Attitudes to Venture Capital in the UK, 1999.

11. CBR SME Financing Survey, 2008

12. Annual Small Business Survey, 2008

"I would rather retire than give up control or ownership of my businesses" – SME Business Owner

Preference for debt finance

3.6 SMEs have become accustomed to the availability of relatively cheap debt finance and this may have contributed to the culture of equity aversion, despite debt not being the most appropriate form of finance, particularly for long-term growth. Selecting the wrong type of finance may constrain future growth, for instance, covenants in loan agreements could be too restrictive if business circumstances change.

"Too many SMEs "max out" on the cheapest, most available and easiest sources of finance. Short term finance is often used to fund long term assets" – Fund Manager, Private Equity

Other Market Issues

3.7 The review believes that there are further permanent market issues are constraining the supply of growth capital to SMEs:

Methods of risk reduction in private equity

3.8 The private equity/venture capital industry has, over the years, sought to limit its exposure to risk in a number of ways. Firstly, through a greater focus on buyout and secondary purchase investments, which tend to be larger and are perceived to hold less uncertainty and risk. Secondly, through a focus on a smaller number of investments with majority control, giving the fund manager direct influence over business operations and strategic decisions.

3.9 In the past five to ten years large buy out investments have delivered significantly higher returns than growth capital for investors.[13] Available and cheap debt combined with large deals has helped contribute to these extraordinary returns to be made with very high leverage.

Remuneration of fund managers

3.10 Later stage and buyout deals have also provided better returns to fund managers themselves. Personal remuneration can be maximised through successfully managing a larger fund. Fund managers have historically received a management fee each year of c.2% plus a profit share referred to as "carried interest". This is typically 20% of the capital gain after investors have had their capital returned and a minimum rate of return, or "hurdle". The carried interest represents a significant financial incentive and can be maximised through closing larger leveraged deals.

"There is not a lot of commercial logic investing in growth capital at this level when viewed against high end Private Equity and their returns". –Fund Manager, Private Equity Firm

Lack of channel to growth capital

3.11 Over the past decade institutional investors have increasingly allocated capital to the alternative investment asset class where growth capital resides. However within this asset class funds have not been directed to growth capital investments. Instead capital has been invested by fund managers in higher risk and return investments such as large scale private equity.

"Many institutions place their money with fund of funds which tend to look at larger international funds as offering the best return and greater diversity of risk" – Fund Manager, Private Equity Firm

3.12 When allocating capital institutional investors make a series of trade offs. Among others, they balance the illiquidity of their investments with the prospect of either a high capital gain return or if available, an acceptable level of annual yield. Private equity and venture capital equity investments are generally illiquid, do not provide annual yield and rely on an exit event to release large capital gains. Historically fund managers have been able to generate significant returns of above 25% per annum[14] for these investments which have proved high enough to attract institutional capital into this area.

3.13 Partly driven by the lack of performance data, institutional investors currently perceive the levels of risk and illiquidity that growth capital offers not to be compensated by the returns available.

3.14 In addition to returns, scale of fund is critical to establishing an effective investment channel. A fund needs to be of a size to allow institutional investors to make their minimum investment commitment without going over 10% allocation of the total fund size. Currently there are no funds of this size established, and therefore a credible channel, to attract significant amounts of private sector capital into UK growth capital.

13. G. Murray and J. Lott, "Have UK Venture Capitalists a Bias Against Investment in New Technology Based Firms", Research and Policy 24, 1995

14. British Venture Capital Association Performance Management Survey 2008

3.15 These structural issues have contributed to fund managers migrating away from investing in growth capital towards making fewer, larger and later stage investments. Fund managers increasingly specialise in specific investment types and do not typically invest in SMEs 'from cradle to grave'. This results in an exclusive focus on a single funding round creating barriers between successive rounds of funding. This is problematic for UK SMEs seeking multiple rounds of investment to fund ongoing growth. Provision of adequate follow-on funding requires ability to make large individual investments from a fund with the capacity not to be restricted by over exposure to a single firm in the portfolio.

3.16 This suggests that UK SMEs suffer from a 'drip feed' of capital, which is most acute in the 'growth phase'. Research has explicitly pointed out the importance of follow-on finance for the commercial expansion of an SME once the available resources from its early stage investor are exhausted.[15]

Impact of recent events

3.17 In the decade to 2007, banks increasingly operated outside their traditional risk profiles, lending money to finance growth at low cost and through short term and working capital instruments, such as overdrafts. For loans between £1m-£20m demand significantly increased from late 2005 and through 2006, with a smaller increase being reflected in marketing loans of less than £1m albeit to a lesser extent.[16] This was a function of both price and availability of loans and the fact that the UK lending marketplace was very competitive. Evidence suggests that bank lending substituted a proportion of growth capital investment, in areas they would not traditionally lend.[17] Fund managers offering equity or mezzanine investments in SMEs found their terms undercut by banks seeking to gain market share.

"Banks have exacerbated the troubles we now face; they have provided equity priced as debt; relaxed lending criteria, increasing leverage and loan multiples whilst keeping rates low" – Head of UK Corporate and Business Bank

"The crucial issue is that currently and arguably for some time, there has been no long-term capital for steady growth available except where there is assured security" – Fund Manager, Private Equity Firm

"'Normal' banking activity will return to those £25m+ turnover firms sooner than those below £25m turnover…this is due to high costs of distribution and realisation that you can not make these lending decisions via 'scorecards'" – Head of UK Corporate and Commercial Bank

3.18 In the past 24 months there have been notable changes in both the capacity of the lending market and attitudes of banks to lending. UK banks lending criteria were relaxed as competition for borrowers increased and significant growth in lending occurred. As the economy entered recession a significant reduction in the capacity of UK bank lending has taken place. This has reduced any 'substitute' effect where debt finance has been used, perhaps inappropriately, as a source of capital for growth. By the end of 2008 foreign lenders dwindled to only 10% of growth as the overall rate of growth declined.[18]

3.19 The current reduction in credit mirrors trends seen in past recessions (see figure 5). Historically, lending to businesses falls during periods of recession and takes some time to recover. Following the 1990s recession, net lending to public non-financial companies (PNFCs) did not recover until 1995, by which time the economy had been growing for some time.

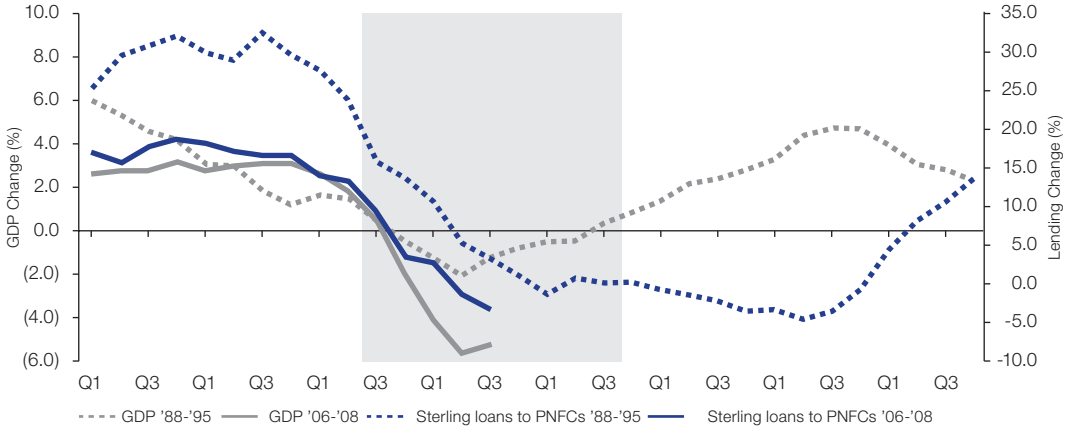
15. G. Murray, "The Second Equity Gap: Exit Problems for Seed and Early Stage Venture Capitalists and Their Investee Companies", International Small Business Journal 12, 1994

16. Bank of England Lending Reports 2009

17. Rowlands Review Call for Evidence responses, 2009

18. Bank of England Lending Report

Figure 5: Sterling lending to PNFCs against GDP growth



Source: Bank of England

3.20 There are two reinforcing trends. Firstly on the supply side we can expect capacity in UK lending to be constrained and that banks will be more risk averse for some time. This will mean that they are unlikely to return for some time to lending growth capital to SMEs outside traditional risk profiles and through non-traditional instruments. Secondly on the demand side SMEs are likely to have a greater appetite for external finance to fund growth, driven in part by reduced ability to fund plans internally.

3.21 Thus the banks display two significant behaviours: they have become extremely risk averse in assessing individual applications and they have retreated into more traditional business lines. In itself this does not represent a market failure, but exposes the existing market failures and makes them more acute. Together, these market failures and other issues have resulted in inconsistent financing of SMEs, most acutely in the growth phase.

Current Interventions

3.22 Current government interventions in finance markets for SMEs are summarised at Annex E. Recent assessment of these interventions has found that they have had a positive effect on the companies in which they invest, and have stimulated growth where it might not otherwise exist.

3.23 Current Government interventions have focussed primarily on the equity gap, with the majority of funds being limited to investment of up to £2m. Government has not, to date, focussed explicitly on the provision of growth capital to 'non-stellar' established SMEs looking to expand their businesses. In addition, the effects of small scale of funds, over specialisation and geography may have made them less efficient than they might otherwise have been. Any new intervention to address a gap in growth capital should fit with existing programmes.

3.24 The following chapters highlight the factors that should be considered in designing any intervention and broad options for delivery.

4 Design Factors

The review has shown that there is compelling evidence to suggest a gap in the provision of growth capital to viable and established SMEs, that this gap is caused by factors that are unlikely to be bridged without some form of Government intervention, and that, as past interventions have been broadly successful, Government intervention can address these factors. A number of options exist for intervention, which are considered in the next chapter, but the consultations for this review have highlighted key factors that can affect the positioning and commercial success of any intervention. These factors should be considered carefully in the design of any intervention.

Private Sector Funding

4.1 Any government intervention envisaged to address the UK SME growth capital gap should seek to draw in private funding to the maximum extent possible.

4.2 The principal role for government must be to focus on the market failures identified in this report, which will lead to greater private sector activity in the area of SME growth capital. An initial level of government support is likely to be required to initiate activity, in particular to overcome barriers in terms of scale and distribution and to give investors confidence to invest in the area. Any intervention should be designed with the medium term objective of commercial viability in mind.

4.3 Building a solution that draws principally on private funding is also an important consideration in terms of attractiveness to SMEs themselves. A purely publicly funded scheme may be regarded with greater scepticism among target SMEs, particularly with respect to equity ownership and their ability to attract follow-on funding and therefore may become an obstacle to investment take-up.

Achieving Scale

4.4 There are a number of reasons why achieving sufficient scale for an intervention is important:

- **Impact:** an intervention of scale helps to overcome information asymmetries that contribute to the market failure
- **Reduce fragmentation and provide follow-investment:** a larger scale intervention reduces the risk of fragmentation in the market and provides a more effective escalator of finance for SMEs to secure follow-on funding through multiple funding rounds
- **Create economies of scale:** by spreading the fixed costs of a fund across a larger number of investments, including reducing the average cost per investment.
- **Risk and attracting private investors:** ability to diversify risk across a large fund will be key to attracting private investment
- **Provide effective regional coverage:** Linking into regional networks is critical to establishing a strong pipeline and effectively identifying opportunities in every region.
- **Impact on the problem:** Our evidence suggests that there is the potential for up to several thousand businesses seeking between £2 – £10m of investment. To make any impact on this gap would require a fund of scale.

Impact

4.5 There is clearly a strong relationship between the scale of any intervention, and the market impact. An intervention that is national in scope, with considerable resources for marketing, promotion and communication will have the potential to reach most stakeholders in SME growth capital. Although this is unlikely to overcome all the information asymmetries, such a 'high impact' set of initiatives has much greater likelihood of overcoming managerial inertia and having impact with owners, accountants and other advisors whose networks will be important for finding opportunities.

Reducing fragmentation and providing capacity for follow-on funding

4.6 Reinforcing this, a number of academics and commentators have recently observed that existing publicly-funded venture

capital interventions are fragmented in terms of scale, geographical location and sector focus. The development of this network of arrangements, with varying qualifying criteria and differing objectives can result in barriers to the effectiveness from both supply and demand-side perspectives.

"[the Government should] create a more connected environment in the market place to enable businesses to access the relevant sources of finance according to growth stage [and] overcome the current fragmented approach to these funds" – Fund Manager, Private Equity firm

4.7 An important constraint that has been seen to limit the effectiveness of existing schemes has been the lack of ability to provide 'follow-on' funding through a lack of overall fund scale. It is vital that any intervention is not only able to complement other interventions in terms of development stage and investment size, but also in being able to provide follow-on funding for SMEs that smaller funds cannot accommodate.

"the 'shallow pockets' of HMG interventions is of concern as SMEs lack credibility when going on to seek additional new investors. It is therefore important to bring in private sector funds early to help facilitate follow-on investment across multiple rounds" - Fund Manager, Private Equity Firm

Creating economies of scale

4.8 One of the key barriers to existing investors participating in SME growth capital is the due diligence and deal costs. To create economies of scale in professional fees and due diligence, and to achieve material savings through standardisation in processes and documentation requires an intervention of suitable scale. Smaller funds are comparatively more expensive to operate on a per investment basis. This includes the cost of establishing and running skilled investment teams.

Risk diversification

4.9 Scale is critical to achieving effective diversification across the total portfolio of SME investments for the underlying fund investors. Effective risk diversification across geography, sector, and company size (among other factors) will be an important consideration for the achievement of long term objectives and a condition for attracting private sector investors.

4.10 Additionally, the scale of any intervention is important to the success of securing institutional and corporate investment into any SME growth capital vehicle. Pension fund and insurance company investors often seek minimum individual investments of above £20m whilst at the same time being constrained to a maximum participation in any fundraising of 5-10%.

'scale is vital to provide the diversity the funds need in their own investments. Funds need to be sufficiently large to attract the large pots of capital and provide diversification' - Major UK pension fund

Effective regional coverage

4.11 Linking into regional networks will be critical to establishing a strong pipeline and effectively identifying opportunities. This should not lead to segmentation into regional funds. However, a delivery channel which has close integration with the local business community has two advantages:

- It helps to increase the volume of applications from SMEs and quality referrals from local accountants and advisory firms. Research suggests that between 74% and 94% of SMEs rely on accountants to provide business advisory services and particularly amongst businesses with 10-49 employees.[19] Data obtained from a Private Equity Fund which provided equity, loans and mezzanine finance to SMEs showed that from a sample of 1100 deals 40% came from accountant referrals, 27% from boutique corporate finance adviser referrals and just 13% direct.[20]
- They reduce the cost of screening investments as the fund manager will have expert knowledge of local businesspeople and markets.

"One cannot underestimate the importance of accessing local networks of investors and commercial partners" – Partner Commercial Law Practice

4.12 A fund of significant scale is likely to be better able to plug into these networks than a smaller intervention.

19. R. J. Bennett and C. Smith, „The influence of location and distance on the supply of business advice", Entrepreneurship and regional development 11, 2002; L. Jay and M. Schaper, "Which advisers do micro-firms use? Some Australian evidence", Journal of Small Business and Enterprise Development 10, 2003 and A. Cosh et al, "Financing UK Small and Medium-Sized Enterprises", Centre for Enterprise and Business Research, 2008

20. Large Private Equity firm, 2001

Impact on the problem

4.13 Our evidence suggests that there may be several thousand businesses potentially requiring up to £10m of investment. To have any impact on this gap would require a fund of significant scale.

4.14 This will require institutional and corporate investment into any SME growth capital vehicle. Pension fund and insurance company investors often seek minimum individual investments of above £20m whilst at the same time being constrained to a maximum participation in any fundraising of 10%. This leads to a self-reinforcing need for the fund to be at scale: the fund must be large to address the gap; the gap can only be addressed by attracting institutional investment, which in turn requires the fund to be of scale.

'scale is an important factor when structuring any intervention; it is important as it will enable a greater number of investments that will diversify the risk. This will enhance the ability of the fund to generate returns and, in addition, reduce the level of appropriate due diligence for each investment, a principle driver of cost' – Partner, Private Equity Firm

Commercial Operation

4.15 The review believes there is a commercial opportunity in providing growth capital to SMEs at a rate of return above bank lending and below that of high risk venture capital. To demonstrate this to institutional investors any intervention needs to be delivered commercially – in structure, management and objectives.

4.16 Demonstrating a clear commercial management framework, independent of government involvement in strategic and operational decision making, will be critical to attracting and retaining suitably experienced investment managers. This is likely to be most apparent in terms of structure and level of remuneration where successful recruitment of high quality managers will require commercially competitive terms.

'Any intervention has to be on a commercial basis in terms of remuneration…otherwise the calibre of people will not be attracted and investment quality will suffer' - Fund Manager, Regional Private Equity Firm

Long Term Solution

4.17 The market failures in provision of SME growth capital have been driven in part from short-term investment horizons and intermittent investment appetite among private sector investors.

4.18 It has been seen that within the venture capital/private equity industry in general, and in the case of ICFC/3i in particular, there has been a trend over time from smaller to larger deals and therefore for investment into larger companies. Measures will need to be designed within any intervention to deter such a drift. It is particularly important to ensure that any intervention supports SMEs through recovery from recession, when demand for growth capital increases while supply is still relatively constricted and thereby providing a more enduring, dependable source of growth finance for the future.

High Level Options for Intervention

5

In addition to investigating whether there is a gap in the provision of growth capital, the review was also asked to present options setting out what a government intervention might look like and how it might be delivered. Three broad delivery options have been identified and are considered in more detail in this chapter. The benefits and drawbacks of each broad option are considered against the factors identified in chapter 4. However, this chapter first considers what the product for investing growth capital might look like based on discussions and views provided to this review by industry experts.

An independent institution

5.1 Any intervention in the market for growth capital should be free to make investment decisions independently of government influence, and to set out how investments should be made so as to best fit the market within the investment mandate. The institution would raise funds and have a portfolio governance and monitoring function.

5.2 Careful consideration would need to be given to the design, legal basis and classification of any new institution so that it balanced the need for commerciality with the control required to avoid mandate creep. The experience of ICFC/3i provides an important lesson for government in designing an institution. In implementing a growth capital fund two factors deserve close consideration: the design of an appropriate set of financial instruments and the appropriate distribution mechanism for funds.

Product offering: 'mezzanine'

5.3 In order to address the market for growth capital successfully, the range of financial products offered will need to balance risk and return. It should address the needs and capabilities of SMEs, as well as having credibility for investors and enable any fund raised to be financially attractive.

5.4 Investment in SME growth capital sits between bank lending (usually asset-backed) and much higher risk venture capital investment. In the market the risk/return position broadly equates to that of mezzanine instruments; a term used to identify lending that is subordinate to senior (bank) debt, usually on an unsecured basis and with a clear repayment schedule, but which ranks ahead of equity. Mezzanine lending is often accompanied by an equity warrant that may crystallise at final repayment or upon particular events (such as a sale). The precise structure of a mezzanine product can vary making it flexible to the financing needs of business and the return required by investors.

'many of our debt based deals are with companies that can service the loan on a cashflow basis but do not have the security to satisfy the Bank's lending requirements' - Mezzanine debt provider

5.5 A set of mezzanine products as part of the government's wider suite of instruments could enable effective SME growth capital investment. The review considers that an indicative range of expected returns from such mezzanine loans might be considerably above senior debt. Within this broad structure, it would be possible to offer a range of flexible instruments that match appropriate returns with the level of risk taken.

CASE STUDY

Mezzanine finance proved suitable instrument to fund growth

A business producing baby food was established in 2001. Original funding came from remortgaging the owner's home, overdraft and loans from family. Whilst these sources were initially sufficient to enable the business to become established, a greater amount of finance was needed to expand the business in order to meet the owner's high growth objectives and fund marketing activities to establish a brand name.

Initial equity investment of around £2m was raised from Business Angel investors over a number of years. The owner was not averse to equity but was limited in obtaining bank finance due to a lack of collateral to secure additional debt.

Although sales experienced steady double digit growth, the firm was not meeting its full potential due to delays in signing a nationwide distribution deal that would transform the business. Additional finance was required to cover working capital and fund an increase in capacity.

Appropriate finance was hard to come by; there was little collateral to secure debt and additional equity would dilute the owners share too much. The owner believed there was a 'post code lottery' of securing Government funding and the bureaucracy involved in accessing this funding were too onerous.

A mezzanine loan with small equity warrant proved an ideal form or funding. There was flexibility in the design of the loan around the needs of the business and there was not significant dilution of ownership.

5.6 Using a 'mezzanine' instrument has a number of advantages as a product:

- It can help address the problem of SME aversion to parting with equity.
- It provides an alternative source of capital for businesses who would not attract equity investment or be inappropriate for debt finance due to a lack of available collateral.
- May attract a different class of investors seeking a cash yield.

Aversion to equity

5.7 SME attitudes to different types and sources of finance show a strong and enduring aversion to equity investment. Survey data suggests that although 20% of firms would consider equity investment, only 2% of those seeking finance have sought equity finance in the previous three years. This in part may reflect a strong cultural preference for 100% ownership among owner-managed firms.[21] Survey evidence confirms that many owners fear a loss of control with equity investment and the cost is often perceived as too high compared with the money raised. Although attitudes among SME owners may change as scarcity of debt finance increases, it is anticipated that the reluctance to cede any ownership stake will mean that mezzanine-type debt instruments will more often match the preference of SMEs when securing growth capital.

Provide an alternative source of capital

5.8 Only a very small proportion of UK SMEs finance their business through equity investment, which is not appropriate to all businesses. By contrast, debt finance may not be suitable for growth firms as its tight convenants may be too restrictive if expansion plans fail or the firm has too small a level of working capital to be able to meet regular debt repayments. Mezzanine provides greater flexibility.

'high growth SMEs can usually attract the interest of equity, but those with more pedestrian growth will have problems, but the availability of mezzanine debt can in part address this' - UK fund manager

Encouraging investors

5.9 The product mix is an important consideration when raising private sector funds for any new investment vehicle. In this regard it will be important to match the cash flow profile of the underlying SME investment products with the requirements of any instrument being issued to institutional investors. Some investors will not be attracted by the high return on equity investments because of the comparatively high level of risk. These investors may prefer a lower yielding instrument, with lower level of risk. A mezzanine instrument for SMEs could meet these preferences as risk is reduced through regular payments (yield) and the fact that in the event of the company folding, mezzanine debt holders will be entitled to repayment before ordinary shareholders.

5.10 The business model to support an entity undertaking principally mezzanine lending, at a scale that delivers scale economies and achieves the market impact identified above, will differ significantly from existing venture capital operations. In the current market there are few, if any, firms operating at scale in the SME growth capital market or with a business model designed toward this end.

5.11 It is anticipated that a successful intervention will need to combine relatively high volume deal flow, managed to tight constraints on due diligence and deal costs. As such the requirement in terms

21. CBR SME Financing Survey 2008

of investment manager skills is likely to be for those able to adapt to an environment that resembles a mix between that of a commercial bank credit analysis team and a venture capital player.

'the majority of our people bring a credit analysis background gained in commercial banking rather than pure private equity, but approaching investments from a cashflow rather than asset perspective'- UK mezzanine loan provider

Distribution Options

5.12 There are a wide range of delivery options that a growth capital fund might employ.

- Fund management to be done in-house, with people employed to find and assess deals and manage the portfolio of investments.
- Capital raised and managed in-house, but using existing providers as a distribution network.
- Investments made on a co-investment model with private sector partners, piggybacking on existing deals.

Option 1: Fund management to be done in-house, with staff employed to find, assess, and follow up deals

5.13 Under this option, the investment function would operate through a geographic network of offices with experienced investment executives supported by analysts. Talent would be attracted by the scale of funds under management and appropriately incentivised. The portfolio governance and operations team would provide logistical support across all investments, leveraging scale economies from professional services providers for example, and have primary responsibility for meeting the institutional mandate at a portfolio level. This would include ongoing monitoring of performance and managing risk diversification.

'The regional office and focus structure [of 3i] would be of huge benefit. The local relationships and connections built up by such a structure are invaluable in helping companies see the benefits [of growth capital]' –Partner, Commercial Law Practice

5.14 One significant challenge under this option is likely to be the ability to attract private sector capital at the outset. Critically, without a track record a new institution may find it difficult to convince private sources of finance to invest. This could in part be mitigated by recruiting credible investment executives, although directing them to operate in this section of the market, where they may not have operated before, may not fully mitigate the lack of a track record. Furthermore, it could also distort activity away from other priority sectors like early stage. As a result the appetite of investors to back the fund is likely to remain highly uncertain during the early phase of the launch and may take time to build momentum thereafter.

Option 2: Establish a 'thin' institution that uses private sector distribution channels

5.15 Establishing only a 'thin' management function would leave investments to be made through a network of existing providers who have the appropriate profile in terms of track record, skills, investment range and geographic presence. A 'thin institution' would maintain oversight of distribution and the overall portfolio management and maintain alignment to the mandate.

5.16 The advantage of using existing fund managers with established reputations and proven track records, would be to give confidence to investors. Investors tend to be more confident backing existing firms with which they have experience than brand new firms, even if the individual managers are known to them. This might make raising funds marginally less challenging than option 1.

5.17 Delegation of investment sourcing and assessment to private sector fund managers could pose a greater risk of mandate creep would be a greater risk than under Option 1, although the centralised governance and portfolio management function would mitigate this risk.

5.19 One of the key risks with this option is that a sufficient number of suitable providers operating directly in this market cannot be found. However considerable scale might be achieved by engaging the broader venture capital and mezzanine finance market as these players might be persuaded to deliver SME growth capital. This might require some adjustment to their current operating model and would be dependent on the design and incentive structures of any intervention.

Option 3: Establish an institution to co-invest with approved private sector partners

5.20 The final option considered is a co-investment model, where existing private sector fund managers are able to call down funds raised by a new government intervention, to supplement their own individual investments. The release of funds would be subject to approval by the new entity. This structure reflects programmes undertaken in other governments around the world and within the UK by Scottish Enterprise, Capital for Enterprise Ltd and the Regional Development Agencies.

5.21 The pre-qualified private sector investors would be selected to make up a wide geographic distribution network. Deal flow would be market led, incentivised to operate in this area through the possibility of matched funding. The co-investment approach is likely to be the fastest to market as it is likely that pre-qualification of fund managers and initial organisational set-up could be completed ahead of more complex requirements of the other options.

5.22 Of all the options this approach relies most heavily upon existing market players – to both deliver growth capital to the SME market and invest their own funds. The obvious challenge, as has been observed throughout this review, is that a number of significant obstacles exist to private funds investing in SME growth capital market, only some of which are related to the availability of capital. There is a risk that a co-investment approach alone would be insufficient to stimulate new private sector investment in an area where it is not already taking place at any scale.

5.23 Table 2 below provides a summary of the considerations given to the three options. It highlights the relative strengths and weaknesses of the models against the factors identified in chapter 4, as well as considering how well they are positioned to address the structural market failures, the set up costs to government, speed of delivery and whether they help to achieve a real 'escalator of finance' for SMEs in the UK.

Table 2: Summary consideration of options

	A standalone commercial institution to raise, manage and directly distribute growth capital "in-house"	A commercial institution to raise and manage capital but with distribution through existing providers	A commercial institution to raise capital and deliver investment through a co-investment model with private sector partners
Attracting private sector funding	Could initially prove the most difficult, as institution comes without a track record, though can be mitigated by recruitment of quality investment team. In the long-term, likely to have most impact	Accesses existing track record, skills and expertise of existing distribution networks helping to attract private capital	Accesses existing track record, skills and expertise of fund managers, but less likely to attract funding of any scale
Achieving scale	More certainty in achieving scale. Potential to reduce cost of capital through scale economies	Also has the potential to achieve scale, depending on the number of distribution channels	Less likely to achieve scale and large numbers of co-investors make significant economies of scale less deliverable
Enduring solution	Provides an enduring mechanism for channelling investment to SMEs. If unmet viable demand exists, this should lead to additional growth capital funding	Could be issues and fund managers indirectly employed focus on other opportunities	Potentially could provide enduring solution, if more private sector capital is attracted into SME growth finance
Distribution	Provides the opportunity to establish regional distribution network	Relies on existing channels of distribution which may be insufficient	Relies on existing investors and is unlikely to provide any shift in the current distribution of capital
Cost of establishment	Likely to carry the greatest cost due to establishment of institution and delivery channel	Lower upfront costs with majority of these costs being to establish relationship with existing providers	Lowest upfront cost option with little institutional/ set-up but would have to pay a share of the due diligence and search costs for deals
Speed of setup	Most complex to establish, at least 6-8 months before fist investments	Potential to be slightly faster to market if distribution partners can be identified	A co-investment approach is likely to be the fastest to market
Simplification & follow on funding	An institution provides an opportunity to simplify the existing landscape and provide follow on funding through a number of managed interventions	An institution provides an opportunity to simplify the existing landscape and provide follow on funding through a number of managed interventions	Less likely to help government simplify the landscape as would be another separate, free standing intervention. Co-investors may not be interested in undertaking follow-on investments

6 Conclusion

This review has considered carefully the available evidence and data on the supply and demand for growth capital amongst UK SMEs. It has also considered the views of a wide range of industry and market experts and has drawn the following high level conclusions:

- A vibrant SME sector displaying strong growth is vital for overall economic growth, leading to increased competition and innovation, and improved productivity. Government should strive to ensure that adequate growth capital is available across the SME growth cycle and should consider carefully its model of intervention.
- A gap continues to exist for companies looking for between £2m and £10m in growth capital. Neither bank lending nor equity investors are likely to fill this gap in the foreseeable future.
- A mezzanine product would be best suited to fill this gap. It would help address demand side aversion to pure equity, and provide a return above regular bank lending at a level of risk lower than for venture capital or private equity. A well structured intervention could attract capital to this risk/return profile.
- Any intervention would need a centralised asset allocation and risk management function, possibly an institution, which would also set the overall strategic direction of the investment strategy thus ensuring that there was not "mandate creep."
- To ensure that SMEs and capital can be matched, evidence points to the need to be able to find, assess, and manage investment opportunities at a local or regional level.
- Investments should be made on a commercial basis in order to attract private capital into the asset class, to attract talented investment managers who work on a commercial basis and to avoid distorting the market and crowding out private initiatives.
- The existing landscape of government intervention would benefit from simplification. Any new intervention should not add to, but help resolve those problems and provide a credible source of follow-on funding for growing SMEs

Annexes

7

Annex A: Review Terms of Reference and Methodology

The Growth Capital Review was announced in 'New Industry, New Jobs' in April 2009. Venture capital expert Chris Rowlands and an independent advisory panel of industry specialists were tasked to consider whether there was a gap in the provision of growth capital in the market and whether, and in what form, further Government intervention could help increase the supply of long term growth capital to SMEs.

The Review was supported by both the Department for Business, Innovation and Skills and HM Treasury, with research and analysis conducted by both departments.

In the process of gathering evidence to input into the review a number of different approaches were taken including:

- Consultation with industry and SME experts
- An open "call for evidence"
- Analysis of finance and SME datasets
- Assessment of SME surveys
- Literature review of wider evidence

Methodology

Over the course of the project the review team met with and gathered the views of over 80 stakeholders, including banks, private equity and venture capitalists; private and institutional investors; industry representatives; the academic and research community; government agencies; regional bodies; and small and medium sized businesses and their representative organisations.

In addition, an open 'call for evidence' for the Review was launched in June 2009 to help gain a full and representative understanding of the environment for raising finance and likely issues. Evidence from 47 respondents helped shape the direction of the Review, highlighting key issues and providing evidence the Review team used to help develop its analysis. In the 'call for evidence' stakeholders were asked eight key questions:

Q1: Is there is a failure in the supply of long term finance to support the growth of SMEs? Does the suitability of different types of finance vary for different categories of business growth? Please outline your definition of 'SME' in this context.

Q2: If there is a failure, what is its scale and nature and which type of SMEs does it affect?

Q3: What is the level of demand amongst SMEs for additional long term capital for growth, as opposed to shorter term, flexible and available capital? If there is demand, what are acceptable costs of raising such capital and the appropriate return i.e. is dilution of equity acceptable? What evidence would you cite in support of this view?

Q4: If a financing gap exists, is there a range in the size of investments or risk:return profile of investment that is particularly difficult to obtain; at what level is this and why?

Q5: Is there a difference across regions in the ease with which SMEs can access the appropriate type of long term growth capital, and if so why?

Q6: Is private capital available and willing to be invested in SME Growth Capital asset class? What would the minimum return expectations be?

Q7: Should Government seek to intervene in this market, and if so, what are the policy options and measures for doing so?

Q8: What would be the appropriate approach to the delivery of any Government interventions for meeting this objective?

Analysis of datasets

pH Group was commissioned to undertake a more detailed study into the size and scale of the growth capital market and the types of firms that currently benefit from it. Using pH Group own data, which is based on Companies House data and finance database (Corpfin), pH developed an overall insight into the UK market for growth capital transactions based on existing growth capital deals. More specifically, this analysis helped to identify key factors affecting the prevalence of growth capital deals and also attempted to ascertain whether there currently is a significant gap in the supply of this type of capital to SMEs, made more acute by the recent liquidity crisis.

Assessment of SME surveys

Although no new survey evidence was commissioned, this review has widely used evidence from existing BIS surveys like the Annual Small Business Survey and SME Business Barometer surveys, as well as other survey evidence such as the Financing UK SMEs survey undertaken by CBR. Evidence was also used from business representative bodies such as the CBI.

Literature review of wider evidence

Further work was undertaken to assess the landscape of existing literature and previous studies on the existence of and solutions to finance gaps for UK SMEs. This literature review (Annex F) surveyed existing academic research papers and government or independent evaluations on the following key issues:

- the supply-side research on financing gaps for UK SMEs
- the demand-side research on financing gap for UK SMEs
- the effectiveness of public interventions in the UK
- international comparisons on the research on financing gap and government interventions
- a review of ICFC/3i on the delivery of long-term investment capital to UK SMEs

Summary of Terms of Reference

The review will consider whether and in what form further intervention could help increase the supply of long term risk capital to small and medium sized businesses. There is currently insufficient evidence to conclude the target, level or scale of investment required. The review is asked to examine the evidence of market failure, the case for intervention, as well as develop proposals for HMG to consider on the focus, size and scale of any new intervention and the level, if any, of public support required.

Market provision of growth finance has, over the last 10 years, been through easily available bank debt on the one hand and highly leveraged equity on the other. However, experience of fundraising immediately after previous recessions shows us that access to longer term risk capital is most difficult as the economy begins to pick up. This is also the time that demand for growth finance will increase significantly. Long term risk finance is often at a level beyond a business's capacity to borrow on normal commercial terms and is therefore more suitable to equity or debt/equity funding. Historically, there has been some evidence to suggest that businesses seeking between £250k and £2m may have particular problems attracting equity finance, but further consideration needs to be given to the availability of these levels of debt/equity funding.

The review will focus on the following key issues:

- **Examine the market for investments with a return profile below that of Venture Capital/Private Equity investors and consider the availability of, and access to, capital of this nature.**
- **Consider the appropriate form of any intervention in terms of scale, number of companies, asset class and size of those companies, sectors and size of investment.**
- **Consider what infrastructure is required to deliver an effective supply of growth capital including institutional structures/partnerships with the private sector, skill sets, business models and cost bases in a cost effective manner for both public and private investors.**

Annex B: SMEs and Economic Growth

A dynamic SME sector drives higher levels of productivity

A successful modern economy is characterised by small businesses expanding to become national and global champions: by way of comparison, 40 per cent more US businesses achieve high growth than in the UK.[22] The UK has made substantial progress in closing its productivity gap with France and Germany (measured in terms of GDP per worker). Fig. 6 shows that over the past decade, the UK has narrowed its productivity gap with France and Germany and kept pace with the performance of the US.

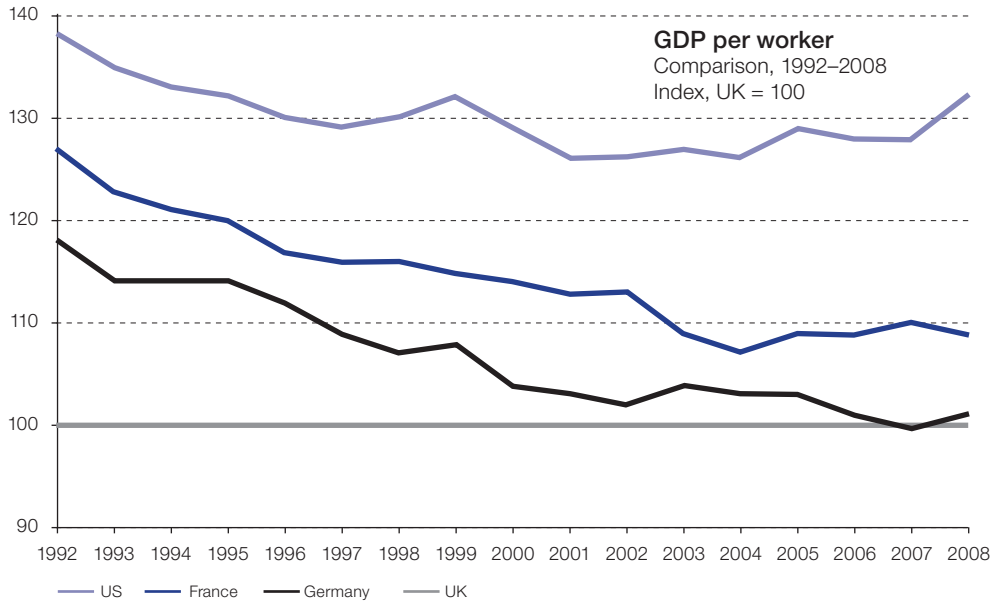
Evidence suggests that the UK underperforms Europe in terms of its productivity performance due to the comparatively low level of capital intensity. Improving the supply of growth capital will make more funds available for investment in both physical capital, such as machinery, equipment and buildings, and intangible capital, such as intellectual property, software, branding and process improvements. Such investment will increase the amount of capital available to each worker, which in turn will facilitate greater productivity and lead to higher growth.[23]

By contrast, evidence suggests that the productivity gap with the US is largely down to differences in the efficiency with which each economy uses its labour and capital resources to produce output.[24] Improving the supply of growth capital can also be expected to contribute to closing this gap, as increasing capital can lead to an increase in efficiency due to the presence of spillover benefits that may accompany capital investment.[25]

In addition, there is evidence that there are additional spillover benefits associated with accessing external finance, and in particular venture capital, which are benefits also likely to accrue to growth capital.

- There is evidence that venture capital backing leads to higher rates of innovation, leading to newer and more productive techniques being introduced to the production process.[26]
- Those accessing venture capital also gain through receiving management advice and mentoring from the venture capitalist. This will benefit firms by providing greater levels of information and advice as to how they can operate more efficiently and effectively.

Figure 6: UK Productivity Performance 1992-2007



Source: ONS

22. A. Hoffman and M. Junge, Documenting Data on High-growth Firms and Entrepreneurs across 17 countries, 2006

23. By contrast, evidence suggests that the productivity gap with the USA is largely down to differences in the efficiency with which each economy uses its labour and capital resources to produce output, (known in the economic literature as Total Factor Productivity (TFP), which aims to measure the efficiency with which the UK uses both labour and capital inputs).

24. Known in economic literature as Total Factor Productivity (TFP)

25. A good example of this is investment in computers. Here you may get an immediate benefit to productivity, as the computer may now allow a business to carry out activities faster. However, adoption of computer technology may also lead to a business changing the way that it operates and its underlying processes, leading to additional efficiency benefits which would be recorded as TFP benefits.

26. S. Kortum and J. Lerner, "Does Venture Capital Spur Innovation?", Harvard Business School Working Paper 99078 1998.

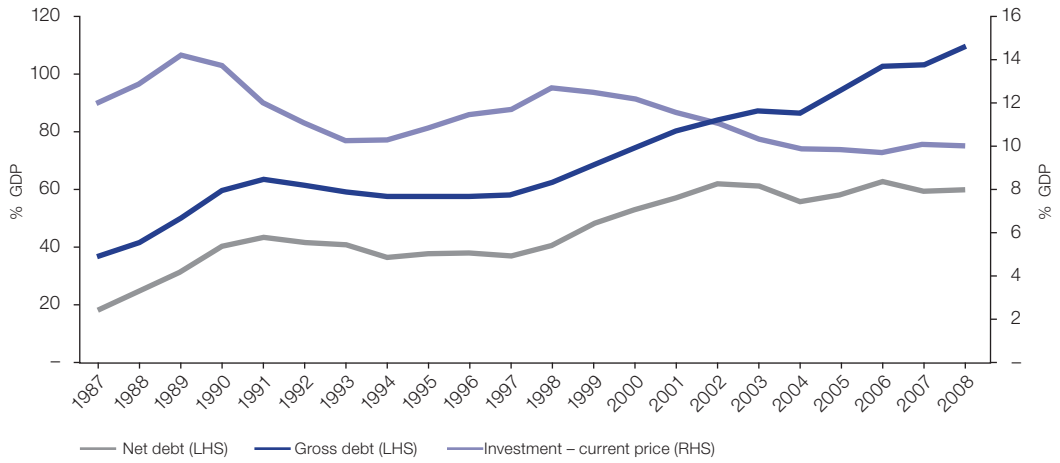
Weakness in business investment caused by lack of availability of growth capital may stifle economic recovery

Since 1997, firms have taken on ever increasing levels of debt to the point where at the end of 2008 gross and net debt levels are at historical highs. From Fig. 7, though, it is clear that this additional capital has not been used to significantly increase investment, even at a time (since 2003) when record levels of cash have been maintained on balance sheet, as business investment in nominal terms accounts for a falling share of GDP.

The 20% drop in investment experienced to date is consistent with previous recessions. However, as with other indicators, the rate of change in the current recession has been much more rapidly felt. Recovery in investment could be considerable given trough to peak growth in the 1990s of over 35% (at constant prices), although the change in sector weighting over the years away from capital-intensive sectors is likely to have an effect on both the decline and recovery. It is important to ensure that there are as few obstacles as possible to the recovery in investment in business as the economy begins its recovery.

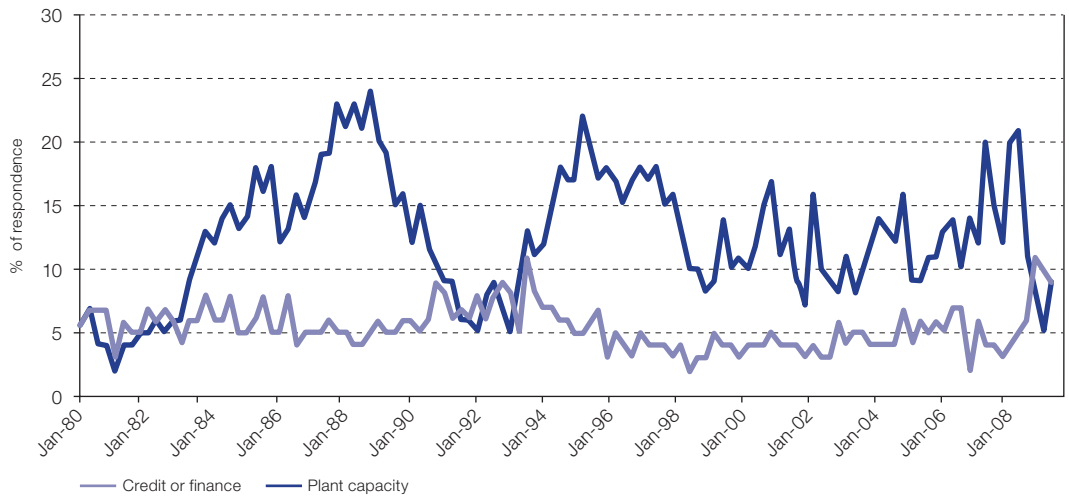
Data in Fig. 8 shows that plant capacity becomes a significant limiting factor to growth in output as the economy recovers. The issue is that having reduced capacity during the recession, businesses then find ramping up again during recovery is a significant obstacle to raising output. At the same time, businesses experience an increase need for credit or finance limiting their output.

Figure 7: Ratio of business investment to GDP



Source: ONS, Budget 2009

Figure 8: Factors limiting output over the next 3 months for small businesses (0-199 employees)



Source: CBI survey data

Annex C: SME Venture Capital Market

Sources of equity finance

Venture capital describes the making of equity investments in young companies with strong potential for growth. Initial funding is often provided pre-revenue and usually pre-profit. Private equity is the term used to describe larger levels of investment, typically over £10m that are targeted at established firms, most often those with a proven track record.

Equity finance represents a level of risk and return significantly higher than the majority of bank funding. Investment for high risk activities is structured in a way to give higher prospective returns to compensate the investor for the higher probability of capital loss. Returns are achieved by taking a stake in the business whose value can be realised at a liquidity event, such as sale to another investor or flotation. The investing cycle for the majority of early stage venture investors and funds is three to five years, with the focus on follow-on investment thereafter. Providers of this type of finance often focus on a particular sector, geography or other category of firms they invest in.

Business Angel investment or Informal Venture capital are the terms given to High Net Worth Individuals that actively invest on their own, or as part of a syndicate, in high growth businesses. In addition to capital, they provide skills and experience to the company and take an active role in helping the company achieve their growth ambitions. In recent years Business Angels have been significant investors of capital in amounts £10,000 to £750,000 predominately in early-stage, pre-revenue ventures.[27] Tax incentives appear to have a material effect on encouraging business angel investing, specifically the Enterprise Investment Scheme (EIS) and the Venture Capital Trusts (VCTs.)[28]

Since their inception in 1995 VCTs have raised £3.5 billion. They encourage private investors to subscribe for Funds that invest in UK SMEs, by offering them tax relief on their investment. VCTs have always been restricted as to the size of companies and the amounts in which they can invest but VCT managers have been adept at finding ways to circumvent these restrictions, for instance by syndication with other VCTs. However, changes introduced in 2007 have again focused VCT investment on smaller, early stage firms. Newly raised VCT capital can only be invested in companies with less than 50 employees and with a limit of £7m of gross assets.

As with venture capital, private equity investors will often look to realise profits on an exit but within reasonably short order, perhaps within three years. Private equity deals are often highly leveraged, where borrowing covers part of the investment, increasing the possible return on equity. As a consequence, many of the deals done are large in scale and focus on management buy outs (MBOs) or management buy-ins (MBIs).

Both Venture Capital and Private Equity make investments where the returns are sufficiently high to compensate for the level of risk. Typically, only a small proportion of the businesses within a portfolio are successful, but those generate such returns that they cover the costs of investing in the whole portfolio and generate a return. In terms of cost the higher risk of the investment is reflected in the overall higher costs to the company of transferring some ownership to the investor. While venture capital can be suitable for funding some types of growth, especially in very young companies, its characteristics mean that it is not always suitable for growth capital where the risk is lower but returns are anticipated as more modest.

For larger and ambitious firms seeking a greater amount of equity finance to expand, there is the opportunity to go public and float on the London Stock Exchanges Alternative Investment Market (AIM). AIM has played an important part in the SME funding ecosystem. It does this in two ways; through the provision of initial and follow-on funding and as an exit route for earlier stage investors, enabling private investors to recycle their capital.

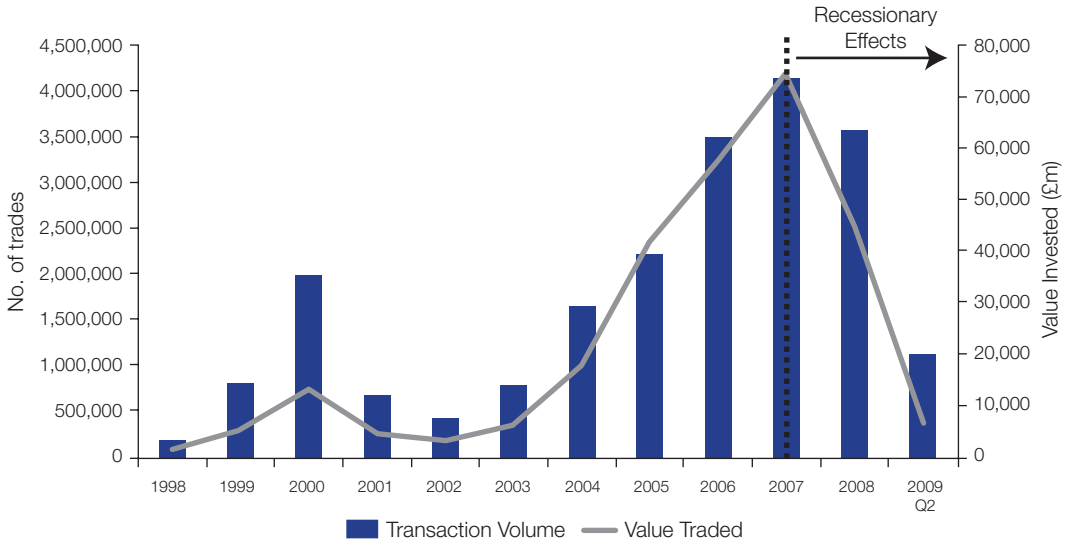
Following the boom and bust of 2000 the role of AIM in SME funding grew rapidly, particularly the use of the exchange as a source of follow-on funding. After 2000 the total value of capital raised fell 68% but in the following 5 years has increased dramatically. In 2007 total funds raised were £16.1bn, 59% of which was follow-on capital.

However, since 2008 the amount of money raised and liquidity have fallen sharply. Current market conditions have led to increased uncertainty, significantly lower trading volumes and downward pressure on share valuations. With an intrinsic link between liquidity and the cost of capital for companies, AIM reflects at a broad level the trends of the SME funding market over the past 10 years.

27. HM Treasury and Small Business Service, Bridging the finance gap: next steps in improving access to growth capital for small businesses, 2003

28. R. E. Wiltbank, "Siding with the Angels: Business angel investing – promising outcomes and effective strategies", BBAA and NESTA Research Report, 2009

Figure 9: AIM trading volumes and values 1998 - 2009 Q2



Source: London Stock Exchange 2009 – Excludes shell companies

Recent growth in unquoted equity funding has not led to an increase in the availability of finance for small firms, and this trend will be exacerbated by recessionary effects

The aggregate level of UK unquoted equity investment has seen significant growth, but this growth has not led to the wider availability of finance to small firms in the past decade. Data shows that fund raising has been unproblematic during benign economic conditions but is particularly challenging during and immediately after recession.

Between 2001 and 2007 the total value of equity investments increased 168% to £11.9bn. In this period the industry raised 30% more money than it invested.[29] In part this reflects the ease of availability of leverage, buoyant economic conditions across many sectors and the greater appetite of institutional investors to allocate capital to the alternative investments asset class within which private equity, venture capital and growth capital reside.

The overall asset mix of UK domiciled retail and institutional funds has changed in the past 10 years. There is a broad shift of UK institutional money both overseas and away from UK public equities.[30] Over this period the alternative asset class (within which venture capital and other SME equity investment would fall) has also increased; now accounting for approximately 3% of assets under management in 2007.

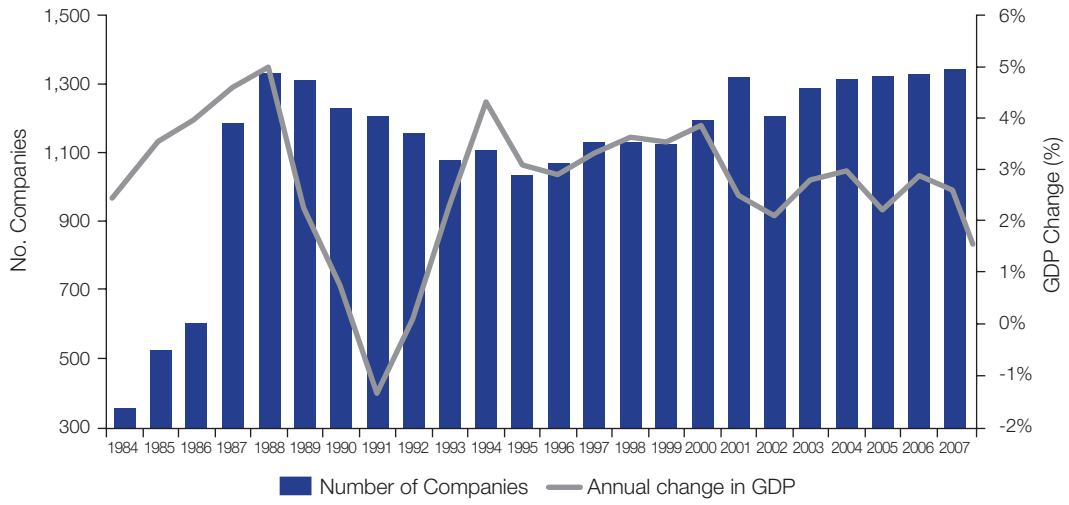
Growth in UK private equity and venture capital investment has, in part, been driven by overseas investors coming into the UK, increasing from 23% of funds in 1987 to 75% in 2007.

Data supports the observation that SME equity fund raising is especially challenging in the period coming out of recession. The number of firms receiving finance fell after the 1990s recession by 18% and took 10 years to return to pre-recessionary levels. A 1990s scenario would forecast 2011 deal volumes to fall by 350 to around 1,000 firms per annum.

29. HM Treasury and Small Business Service, Bridging the finance gap: next steps in improving access to growth capital for small businesses, 2003

30. R. E. Wiltbank, "Siding with the Angels: Business angel investing – promising outcomes and effective strategies", BBAA and NESTA Research Report, 2009

Figure 10: Companies receiving equity investment against annual GDP change 1984 - 2007



Source: BVCA Investment Activity Reports, ONS

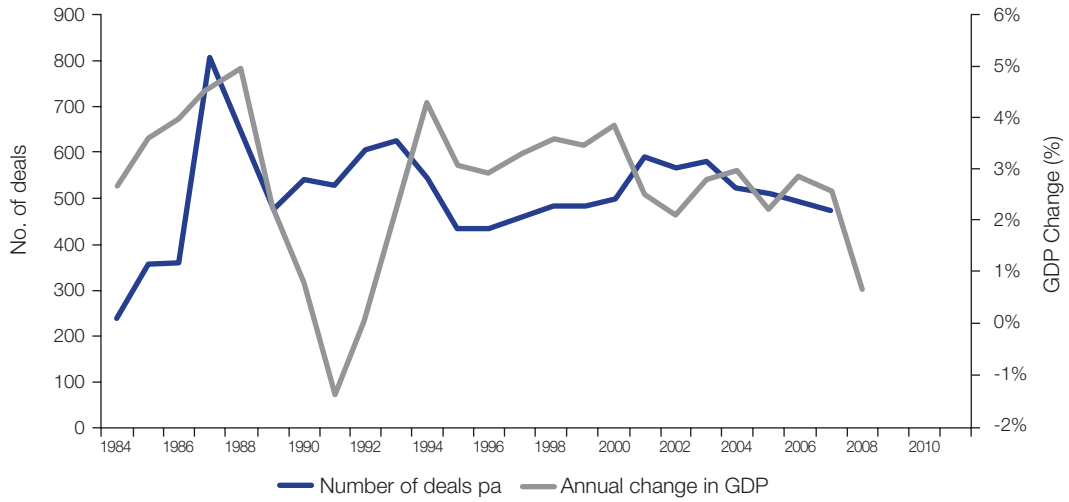
Over time, the total value of equity deals has increased, but absolute numbers of UK firms receiving equity finance has plateaued. In 2007 the number of firms stood at 1,330 compared to 1,326 19 years previously. Over the same period there has been a trend away from growth capital investments towards later stage deal types such as management buyouts and secondary purchase deals between private equity firms.[31]

There has been a steady increase in the number of private equity and venture capital investors since 1984 but the average number of deals made by each equity investor has fallen by half, to 6 deals per annum. Smaller and less diversified portfolios have increased the need for comprehensive due diligence as fund managers seek to manage risk exposure through detailed analysis rather than spread across a broader portfolio.

Pressure to invest ever larger funds quickly has contributed towards larger investments. Estimates are that half of fund managers' time is devoted to tracking down suitable investment opportunities and selecting the most attractive. With successful fund managers investing larger funds there are pressures to invest funds quickly. The result is that the same amount of time is dedicated to identifying a similar number of deals but with more capital invested into each. At the larger end, the drift to larger deals has been accentuated and sometimes driven by the potential to increase profit by leveraging.

Over the long term, growth capital deal volume and value have been in slow decline, a trend particularly pronounced since 2003. It is worth noting that, even over the economic cycle, the number of deals per annum has exceeded 400 since the late 1980s and the median exceeds 500 per annum. Indeed data suggests that growth capital deals have not followed the economic cycle as closely as later stage investments such as buyouts.

Figure 11: Growth capital deal volume against GDP change 1984 - 2007



Source: BVCA Investment Activity Reports, ONS

31. BVCA Investment Activity Report 2007

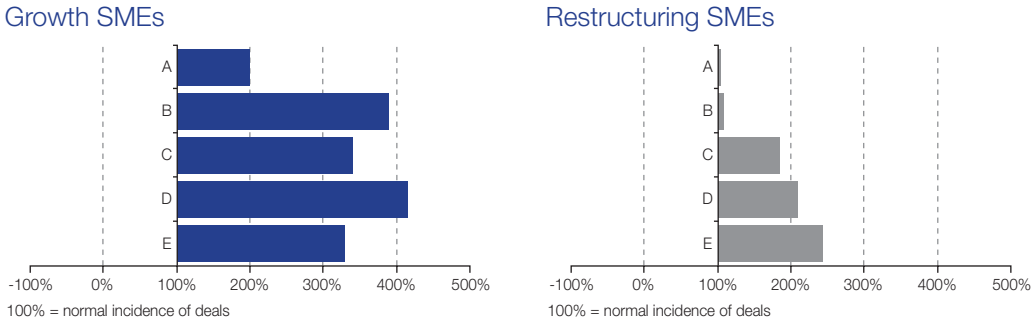
Annex D: Balance Sheet Characteristics

Balance Sheet characteristics

Further analysis of these companies' balance sheet characteristics is possible, using a measure of SME financial strength that is based upon a range of publically held data. However, the data shows that demand for growth capital, reflected in the observed deals, is not limited to those of weaker financial strength but is relatively high across companies in all different financial positions. Somewhat fewer deals are entered into by those with very strong balance sheets, but the value of deals tends to be much larger.

When looking at those SMEs seeking growth capital for restructuring purposes (i.e. those with declining employee or turnover trends) a very different pattern is evident. The highest incidence of growth capital deals occurs amongst firms with weaker balance sheets and decreases as the level of financial strength improves. It is within this group that the relationship between financial strength and demand for capital is most evident. This reflects the fact that where a clear track record of growth is absent an SME is unlikely to be able to secure more traditional types of bank finance.

Figure 12: Growth Capital deal incidence relative to balance sheet strength, Growth and Restructuring SMEs (2005-2007) with A strong and E weak



Source: PH Group 2009

Although data is incomplete for 2008, the trends follow the same pattern. This suggests that there will be continuing demand for growth capital among firms who have demonstrated growth and have good prospects for the future, and those whose balance sheets will mean it is highly unlikely that they can secure bank funding and therefore seek additional sources of capital. There is a need for growth capital amongst fundamentally good SMEs who are looking to restructure their balance sheets post recession.

Annex E: Existing Government Interventions

There is a well established 'equity gap' for small firms seeking equity to start up and finance early growth in the £250k-£2m range. As for growth capital, this gap is attributable to structural market failures and the lack of an established channel to market. Search, due diligence, monitoring and transaction costs do not vary proportionally with the size of investment, meaning that larger investments (above £2m) are more commercially attractive to investors.[32]

Since 1999 the Department for Business Innovation and Skills (and its predecessors BERR and DTI) has provided some £400m into supporting the provision of early stage equity to SMEs. This has leveraged around £535m of private capital and is being invested into businesses in every sector.[33] In addition, the Regional Development agencies have channelled significant European funding into similar funds. The main programmes are:

Enterprise Capital Fund programme was launched in 2005. This is a rolling programme of investments into early stage technology-oriented venture capital funds, many managed by new and emerging fund management teams, typically investing between £1m - £2m into SMEs. There are currently 11 ECFs with ranges from £10m to £30m and with an average fund size of just over £26m. As of November 2009, these funds total £297.5m with a £196.2m government commitment supported by private investor commitment of £101.3m. £46m has so far been invested in 50 companies.

The UK Innovation Investment Fund, announced in June 2009, will provide an additional boost for high growth, high tech businesses struggling to raise equity finance. The Government has committed £150m with the aim of attracting significant private sector investment into a fund of funds, to invest into underlying specialist technology venture capital funds. The UK Innovation Investment Fund has the flexibility to make larger investments than Enterprise Capital Funds, which are restricted to a maximum of £2m. The fund expects to start making investments in 2010.

Regional Development Agency venture capital funds

In addition to national led funds RDAs operate their own venture capital programmes which aim to provide investment for SMEs drawing on European structural funds and tied to wider economic and regeneration objectives. RDAs draw down European Regional Development Funds to fund these - which can be used in regional venture capital and loan funds targeted at that region. These typically invest smaller amounts than national schemes (between £250k-£1m) in a wide range of local business sectors, not just technology.

The Capital for Enterprise Fund (CfEF) supports viable business with equity or mezzanine investment aimed at releasing and sustaining growth and can invest between £200,000 and £2 million where the business has exhausted its borrowing capacity with lenders. It is a £75m fund (£50m in Government funds and £25m from the main banks), announced as part of the Real Help Now programme in January 2009 and is distributed through two fund managers and a small element (£15m) of co-investment. The fund will invest up to March 2010 with £20m held back for follow on investment.

The **Aspire Fund** was launched in November 2008 and acts as a beacon for women's access to finance. This £25m fund (£12.5m of government funds to be matched by the private sector) has a particular focus on women-led businesses with high-growth potential seeking equity investment of between £100,000 and £2m.

Research on recipients of BIS equity schemes shows that almost 80% of firms receiving funding said that this had helped them to access additional finance or would make them more confident to do so from additional funding sources, such as banks. In the absence of support from Government backed funds, 23% said they would not have gone ahead with their growth plans; of those that would have persisted, 71% would have delayed plans and 66% reduced their scale.

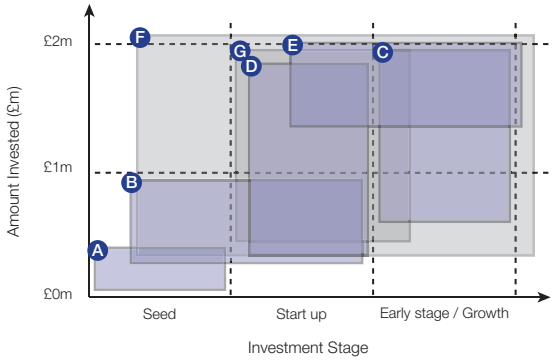
Recent econometric analysis comparing firms that received investment with a matched sample found a positive effect on firm performance. Productivity tended to increase rapidly upon investment compared with other firms, in a 'typical' firm equating to £57,000 (sales per worker) in increased labour productivity. In terms of profitability, firms typically went through a 'j-curve' pattern of falling profits during restructuring followed by strong growth by the sixth year following investment.[34]

32. Bridging the Finance Gap, HMT 2003

33. Capital for Enterprise Ltd., November 2009.

34. P. Nightingdale, G. Murray et. al, "From Funding Gaps to Thin Markets: UK Government Support for Early Stage Venture Capital", BVCA and NESTA Research Report, 2009

Figure 13: Current HMG Risk Capital Interventions



	National Schemes	Products
A	9 Early Growth Funds	- Equity
	1 Imperial Low Carbon Seed Fund	- Equity
	9 University Challenge Seed Funds	- Equity
B	Enterprise Investment Scheme (tax)	- Equity
C	1 Capital for Enterprise Fund	- Equity and Mezzanine
	Aspire	- Equity
D	8 Enterprise Capital Funds	- Equity
	1 Community Development Fund	- Equity
	UK IIF	- Equity
E	Venture Capital Trusts (tax)	- Equity and Mezzanine
	Regional Schemes	**Products**
F	17 Regional Venture Capital and Loan Funds	- Equity and Mezzanine
G	9 Regional Venture Capital Funds	- Equity
	3 JEREMIE	- Equity and Mezzanine

Current Government interventions have focussed primarily on the equity gap, with the majority of funds being limited to investment of up to £2m although more recent evidence suggests the equity gap may now be higher for some businesses. Government has not, to date, focussed explicitly on the provision of growth capital to 'non-stellar' established SMEs looking to expand their business.

Recent assessments of the Government's risk capital interventions have highlighted a number of areas for further improvement which should be reflected in the design of a new growth capital intervention.[35] In the first place, existing interventions very often lack scale, with some funds as small as £2.5m in size and most funds £30m or less. Secondly, there are restrictions in the amount that can be invested in any one enterprise, driven either by State Aid rules or prudence – ensuring that the fund is not overly exposed to any one firm. Thirdly, the landscape of publicly supported risk-capital is fragmented, with varying objectives for different central-Government and RDA led funds.

For SMEs, the impact of these factors combined is that they perceive artificial barriers between successive rounds of funding which are costly and disruptive to overcome. Successful SMEs may be restricted in their ability to access the capital they need to build further on the progress they have made thanks to the initial Government backed investment, meaning that they are unable to exploit their full potential. Even if they are able to access further funding elsewhere, management time and effort which could have been spent on growing the business may be diverted towards looking for new investors.

For Government, the impact of these factors combined can mean below average returns on investments. This is because commentators now agree that to be able to diversify risk adequately by holding a sufficiently large portfolio of investments, funds should of a sufficient size. Research by NESTA suggests "small early-stage funds (circa £20m) are vulnerable to commercial failure. It is suggested that VC fund sizes should be at least £50m in order to realise minimum scale effects".[36] Meanwhile, limits on the level of investment in any one company can mean that Government finds its stake in that company diluted if and when the firm goes elsewhere for follow on funding, diluting the return that Government can expect to make from the investment. While the overall level of all Government interventions to provide risk capital in the equity gap is sufficient to address these issues, this support is fragmented into many different funds led both centrally and regionally, often with slightly differing objectives and criteria, which individually may not deliver optimum support to SMEs or maximise the prospects of a return on investments made.

"[Government should] Create a more connected environment in the market place to enable businesses to access the relevant sources of finance according to growth stage [and] overcome the current fragmented approach to these funds." – Fund Manager, Regional Private Equity Firm

35. NESTA (2009) "From Funding Gaps to Thin Markets: UK Government Support for Early Stage Venture Capital".

36. NESTA (2009) "From Funding Gaps to Thin Markets: UK Government Support for Early Stage Venture Capital".

Annex F: Executive Summary of the Literature Review and History of 3i

Key Findings

- Whilst many studies have focused on the provision of capital to SMEs at innovation or early stages, studies on the provision of long-term growth or development capital to SMEs are scarce.
- There are sufficient empirical supports for the existence of the Macmillan gap, or the equity gap in the provision of equity type investment capital for SMEs in the UK.
- The UK private equity industry is increasingly biased towards larger, later-stage deals with absolute investments in early and growth stage firms remained constantly low.
- The current economic recession suggests that the problem of insufficient equity at the lower end of the capital market could be prolonged until VCs can raise funds themselves. Moreover, institutional fund raising, new early stage deals and exits are all adversely affected by current uncertainties over company valuation.
- There are mainly two methodologies in assessing the existence and the size of the financing gap. Survey methods are more commonly used but may not be statistically robust and may be subjective to survivorship bias. Regression analysis may be more robust but has higher data requirements and the method is more computationally complex.
- Information gap is the main reason that causes the financing gap as it results in credit rationing by investors in SMEs.
- The provision of investment capital to SMEs also tends to bias towards certain regions in the UK and some specific sectors.
- Demand-side research on equity gap raises questions on whether the characteristics of the firm are investment-ready enough. Regardless of the empirical results found, it is now widely realised that investment readiness is a key area of improvement in closing the equity gap in SME financing.
- Government interventions have important roles in facilitating SMEs' access to private financing. However they usually take with them political objectives other than commercial objectives.
- For most of the UK public initiatives, it is too early to draw any conclusions regarding their effectiveness in closing the equity gap.
- Most early-stage or ex-ante evaluations are positive. However there are large scopes for improvement.
- Similar to UK studies, difficulties in access to finance in other countries also pose a major problem for SME development and have significant (and possibly negative) impact on firm performance.
- The review investigates the evaluations on government interventions in the US, European Union, Germany, Finland, Australia and Scotland. Similar to UK interventions, they contribute to the improvement in access to credit for SMEs. However further enhancement is called for and the successful story of one country may not apply to other countries.
- If there is a Macmillan gap, ICFC/3i had at least played an important role in attempting to fill it. 3i has gradually shifted away from its initial focus on small businesses to the larger and more commercially viable MBOs/MBIs.

Introduction

This literature review provides a systematic survey of the literature and previous studies regarding the existence of and solutions to finance gaps for UK SMEs. A finance gap is defined as 'where the funding requirements of a company are greater than those that can be met by the small scale providers of finance, but not substantially enough to be considered by the large (…) providers'. It can refer to the provision of equity, debt or mezzanine debt (quasi-equity). The aim of this review is to ensure a broad understanding of the sources of information, the data analysis that has been done in the past and the various conclusions drawn and the implications for further studies or data collection.

The Focus

This literature review surveys existing academic research papers and government or independent evaluations on the following key issues:

- the supply-side research on financing gaps for UK SMEs
- the demand-side research on financing gap for UK SMEs
- the effectiveness of public interventions in the UK
- international comparisons on the research on financing gap and government interventions
- a review of ICFC/3i on the delivery of long-term investment capital to UK SMEs

The Findings

1. SUPPLY-SIDE RESEARCH ON FINANCING GAPS FOR UK SMES

Using both survey and regression analyses, there appears to be an underprovision of equity capital to UK SMEs between the amount of £250,000 and £2 million, between the investments provided by the more informal, packaged finance structures and the formal venture capital market which is dominated by MBOs and MBIs. For some businesses the upper bound of the gap may extend to up to £15 million. However an evaluation of the difficulty of SMEs in access to general finance, especially debt and mezzanine debt, suggests that access to finance is not a barrier for most SMEs.

Whilst the majority of research is focused on start-up and early-stage SMEs, studies on the provision of growth capital have found access to long-term and sustainable finance does propose a major obstacle for firm development. DTI first introduced the concept of 'non-stellar' gap which means the underprovision of 'additional' or follow-on financing to support future growth. Limited evidence suggests that 5% of all SMEs, mainly high-tech firms, are in need of such equity funding and a further 30% of all SMEs with no need for external finance may be targets for other forms of growth capital.

The agent theory suggests that the information asymmetries between investors and entrepreneurs are the major reason for equity gap and subsequently the market failure in the lower end of the market. Government interventions should aim at removing such information gap by the dissemination of information on both supply- and demand-side. The existence of funding gap may affect the performance of firms especially in time of financial crisis. The current economic recession reduced the availability of external finance in general. The market for early-stage financing won't pick up until VCs can raise funds themselves. Moreover, institutional fund raising, new early stage deals and exits are all adversely affected by current uncertainties over company valuation.

It is found that the provision of investment capital to SMEs tends to bias towards certain regions such as London and south east and sectors requiring high capital inputs or complex R&D such as high-technology firms.

2. DEMAND-SIDE RESEARCH ON FINANCING GAP FOR UK SMES

The demand-side equity gap is mainly represented by limited understanding of equity instruments, poor quality and presentation of business plans and reluctance to cede control reduce the attractiveness of SMEs to formal equity financing, all of which make SME entrepreneurs not investment ready. Literature suggests an effective intervention designed to improve investment readiness should consist of:

- information seminar
- investment readiness review
- investment readiness development programme
- investment readiness presentational review
- investment networking

Besides investment readiness, it is found that SMEs can have better access to finance if the firm:

- can provide high-quality collateral
- has good business plan
- has good track record
- is managed by experienced and high-quality entrepreneurs
- has good product and market perspective

Other than the above factors, entrepreneurs' perception of ownership and non-commercial objectives also prevents them from seeking equity finance. In many cases, entrepreneurs will willingly sacrifice potential growth for assured autonomy or in favour of other important non-financial gains even if the decision is sub-optimal.

3. EFFECTIVENESS OF PUBLIC INTERVENTIONS IN THE UK

Government intervenes in the capital market to provide fundings for SMEs mainly because of their importance to the national economy such as job creation and also to bridge the gap between investors and entrepreneurs which causes market failure.

Current public initiatives can be divided into the following categories:

- debt finance (SFLG)
- tax incentives (EIS and VCT)
- public-private hybrid funds (RVCFs)
- technology funds (High-tech Fund of Funds, University Challenge Fund)
- access to finance in disadvantaged areas (Bridges Community Development Venture Fund, community investment tax relief)

For most of the UK public initiatives, it is too early to draw any conclusions regarding their effectiveness in closing the equity gap. However it is clear from most early-stage or ex-ante evaluations that the existing interventions have gone some way towards satisfying their long-term objectives, in providing SMEs with finance otherwise would not have been invested by those same investors in the absence of the schemes. However there are large scopes for improvement such as a better targeted investment, less distortion to the private market and a more efficient information flow between investors and entrepreneurs.

Recommendations or experiences drawn from previous evaluations include:

- more focus on long-term commitment and follow-on financing
- addressing the problem of capital under-provision from both supply- and demand-side perspectives
- larger-sized funds to provide follow-on finance, to exploit economy of scale and diversification, and to lower the costs of funding
- exploring alternative investment vehicles such as mezzanine-typed instruments

4. INTERNATIONAL COMPARISONS

It has been internationally recognised that SMEs have become an increasingly important component of economic development. Both academic and government studies show that in both US and Europe, SMEs are vital for future job creation. However this positive externality cannot be achieved if SMEs are unable to get access to the financing for innovation and growing. Although possibly different in magnitude, difficulties for SMEs in getting access to risk capital, or equity gaps, have been identified in the rest of the world as the case in the United Kingdom. Access to general finance such as debt is unlikely a major barrier for SME financing in most countries. However it has been reported that financing gaps (in general) are more pervasive in emerging markets than in developed countries.

A survey on the evaluations of existing government interventions for the US and major developed countries is undertaken and the results are broadly similar to the UK. Most schemes seem to be successful in meeting their policy objectives to improve access to credit for SMEs however this is usually achieved by sacrificing the economic objectives on performance. Sometimes the profitability goal set for the schemes has become a major barrier to them fulfilling their policy goals. An international comparison has significant implications for the design of future interventions in the UK. First, schemes using debt finance (e.g. SBIC Debenture Programme) yield better performance than equity schemes in general. Second, long-term of continuous commitment of public initiatives is strongly recommended. Third, possible distorting effect to the market by government-backed schemes means there is a large scope for further improvement. Last but not least, the successful story of one country may not apply to other countries.

5. LESSONS FROM ICFC/3i

ICFC and later 3i were designed to fill the equity gap. Its unique business model which has contrived to satisfy the general demand of SMEs for permanent and long-term capital without sacrificing the investee firms' ownership as well as the need to reward its own shareholder's capital, still has far-reaching implications today in the design of future public initiatives.

Besides the mezzanine-typed instrument ICFC/3i adopted in investing in SMEs, ICFC/3i's fundamental differences from the traditional venture capitalists may also shed some lights on the design of future interventions. The returns on 3i's investment capital, although modest, proved to be commercially acceptable over a much longer period than venture capital. Moreover, it enabled 3i to maintain its commitment to the provision of long-term and permanent capital to SMEs and add significant value to the economy as a whole.

This review, led by venture capitalist Chris Rowlands, aims to examine the market for growth capital available to UK small and medium sized enterprises. Combining evidence from interviews and quantitative analysis, it examines how effectively the markets for bank and venture capital finance supply the need for growth capital, and how government might intervene to ensure that UK companies with the potential to grow have the finance they need.

Chris Rowlands has said:

"The basic question of adequacy of access to capital for SMEs is not a new one and a conclusion of a market gap in provision is unlikely to be controversial. However, the Government was right to ask for an urgent update of the analysis and arguments. Our economy cannot afford the dynamic SME segment to be constrained in its growth and competitiveness, especially with recovery ahead."

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