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THE ROLE OF POLICY IN SME FINANCE: DEMAND SIDE PERSPECTIVES

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FOREWORD

The supply and demand for external finance (both debt and equity) at early and growth stages of SME development have changed somewhat in recent years. Challenging conditions were triggered by the Global Financial Crisis, which exacerbated the barriers faced by SMEs in securing external finance. There has been a rapid rise in alternative finance sources such as crowdfunding and peer-to-peer lending, partly enabled by technology. Other changes have continued to follow past trends, such as the shift of venture capital (VC) towards later stage investments, and the increasing scale of business angel investments as they become more networked and organised.

The focus of UK government policy has been to intervene on the supply side, including through tax incentives and as a direct investor, e.g. in VC funds. Despite these interventions, the knowledge and take-up of equity investment by SMEs has not changed in recent years, and the UK still performs relatively less well on scaling up its micro businesses, which is the ultimate objective of these investments.

This Viewpoint, which focuses on equity finance, emphasises that government policy ought to complement its efforts on the supply side by also stimulating the demand side for finance to ensure that quality propositions are put in front of investors. This will require capacity development amongst business advisors, a better join-up in the business support landscape, and enhanced provision and take-up of investor readiness support. In addition, government and its partners have a role in creating an enabling environment that supports investment in new ideas and experimentation by entrepreneurs. Our research has identified a number of lessons from international practice that ought to have particular resonance for sub-national initiatives such as the Northern Powerhouse and Midlands Engine.

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The Viewpoint series is a series of 'thought piece' publications produced by SQW and Oxford Innovation, the operating divisions of SQW Group.

The aim of the Viewpoint series is to share our thoughts on key topical issues in the arena of sustainable economic and social development, public policy, innovation and enterprise with our clients, partners and others with an interest in the particular subject area of each paper. In each Viewpoint, we will draw on our policy research and implementation experience to consider key topical issues, and provide suggestions for strategic and practical solutions.

INTRODUCTION

Following the Global Financial Crisis (GFC) it became more difficult to access seed, early stage and growth finance. There was a reduction in the supply of bank lending and of venture capital (VC) for businesses in start-up and scale-up phases. Research for the British Business Bank (BBB)[1] suggests that there has been some level of recovery, although European Venture Capital Association (EVCA) data indicate that VC investment, in terms of deals done, has not recovered to pre-GFC levels[2].

Challenges in accessing capital for SMEs continue and governments have sought to respond by increasing the supply through publicly-backed schemes that aim to fill gaps at different stages of the 'funding escalator'. This is perhaps because such interventions are measurable and direct.

This paper draws on SQW's own research and wider literature on SME finance, as well as our experience in the broader business growth support arena. We use this to outline some of the main developments in VC, with a particular focus on the UK.

We then argue that more attention needs to be given to understanding and improving the demand for finance, in order to complement the government's focus on the supply side. In doing this, we identify lessons from research we have undertaken on international comparators. This research has highlighted a series of ways in which the ecosystem can be developed to support early and growth-stage businesses.

[1] Beauhurst and British Business Bank (2015) Small Business Investment: Equity Tracker
[2] EVCA Yearbook 2015.

KEY DEVELOPMENTS IN EQUITY FINANCE

Drawing on our own and other research we identify some of the main recent developments in the landscape for equity finance. This highlights that there remain issues in equity finance, in particular in relation to long-term investments and the regional imbalances in the UK. There is also emerging evidence on incompatibilities between angel finance and crowdfunding.

AN INCREASING EQUITY GAP IN VC

For a long time, VC firms have been moving to later stage investments, exacerbating the gap, particularly in the early stage market. This gap is especially acute for certain sectors/technologies.

The traditional "2 and 20" model prevalent in the VC industry - typically where a VC fund requires a management fee of 2% per year, plus 20% of the profits - incentivises funds to do fewer and larger deals. Added to this, the costs of due diligence and transacting are disproportionately high for smaller investments, which results in larger deal sizes and larger/less risky firms. The transaction costs are not helped by *'thin markets'* with small numbers of investors and firms having difficulty in finding each other and contracting at reasonable cost[3].

As a result of these factors, VC firms have tended to move to later stage investments, creating a gap in the seed and early stage market. The "equity gap" particularly exists in the £2m-5m bracket, and for amounts below £2m[4].

[3] Nightingale et al (2009) From funding gaps to thin markets: UK Government support for early-stage venture capital. NESTA & BVCA Research Report
[4] SQW (2015) The Future of Early Stage and Growth Finance in Northern Ireland, Synthesis Report to the Department for Enterprise, Trade and

Our VC research for BIS (2010)[5], and our more recent experience, has found that technologies and projects in life sciences, physics and cleantech, where it can take over 10 years to bring products to market, experience particularly acute and larger equity gaps of up to £10m or more.

RISE OF BUSINESS ANGELS

In the past, angel investment, an important source of equity finance for early stage enterprises, has been principally associated with investments below £1m. In recent years, amounts invested have increased to up to £2m, thereby helping to address some of the gap left by venture capitalists. These larger investments have partly resulted from the development of increasingly organised angel groups and formal syndicate structures. In addition, they have been assisted by the ability to co-invest alongside public sector schemes, which helps to share risk.

Business angels may play a further role beyond finance, by actively supporting company development, in particular where they have strong interest in the business's concept/technology. However, this is not always the case. Our own work has found that the added value of angels through mentoring and advice can be lower in some geographical areas where the angel market is still developing[6]. We have also found that other investors, e.g. publicly-backed VC funds, may be more active than angels in honing investment plans and refining propositions for subsequent rounds[7], partly to pursue economic development objectives.

Where local angel capacities are developing, they can be enhanced by establishing links to experienced investors elsewhere, whose expertise can be leveraged. Supporting cross-referral protocols between funds and fund managers across the UK may help in this regard. Over time, as we have found in our research in other countries such as Canada and Estonia, the less-developed markets may mature as exits result in the recycling of wealth into new investments and the passing on of valuable experience, as also found by Mason and Botelho (2014)[8].

PLAYING TO THE CROWD

Facilitated by technology that has enabled the development of online platforms, crowdfunding has grown significantly in recent years. Indeed, using Beauhurst data, BBB (2016) highlighted that crowdfunding was the largest funder at seed stage than any other source in 2014 in terms of number of businesses funded, with over 140 deals (increasing from under 10 in 2011)[9]. The amounts invested for each deal are smaller, however, and private equity still makes up more than twice the value of seed stage investments than crowdfunding.

Investment. See *https://www.detini.gov.uk/publications/future-early-stage-and-growth-finance-northern-ireland*

[5] *SQW Report for BIS (2010) Improving the coherence, co-ordination and consistency of publicly-backed venture capital provision. See* *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32240/10-1300-improving-venture-capital-provision.pdf*

[6] *SQW (2015) The Future of Early Stage and Growth Finance in Northern Ireland, Synthesis Report to the Department for Enterprise, Trade and Investment. See* *https://www.detini.gov.uk/publications/future-early-stage-and-growth-finance-northern-ireland*

[7] *See example of the Rainbow Seed Fund. SQW (2013) Assessing the economic and wider benefits of the Rainbow Seed Fund, Final Report to Midven Ltd on behalf of the Rainbow Seed Fund partners. See* *http://www.sqw.co.uk/files/1413/9828/7771/Rainbow_Seed_Fund_Report.pdf*

[8] *Mason and Botelho (2014) The Role of the Exit in the Initial Screening of Investment Opportunities: The Case of Business Angel Syndicate Gatekeepers*

[9] *British Business Bank (2016) Small Business Finance Markets 2015/16, British Business Bank: Sheffield.*

Despite this growth, crowdfunding is still developing as a source of funding, with question marks against investor returns and regulation. There have been few exits so far in the UK. As an example, E-Car Club provided a respectable 3-4x return for its investors[10], but only time will tell how average returns perform against benchmarks.

There is currently limited evidence on the relationship between crowdfunding and business angel investment. Beauhurst (2015) highlighted that crowdfunding may pose a challenge to angel networks, with both built on the premise that risks are mitigated and scale economies gained by investing alongside others. The research indicated that there may be competition between crowdfunding and angel networks in attracting angels[11].

The picture is complicated, however, and there is variation in the attitudes and preferences amongst angel investors. Some crowdfunding platforms recognise this. One platform, SyndicateRoom, is aimed at the sophisticated and active angel investor. Here, an experienced business angel negotiates the valuation and invests first, before the opportunity is presented to other investors. This also helps to overcome issues related to entrepreneurs setting valuations.

Research that we have been involved in in Ireland suggests that some angels avoid investing through crowdfunding, for various reasons, including because they want the personal contact with the businesses[12]. Moreover, some angels are reluctant to invest in firms that have secured earlier finance through crowdfunding. This may imply that sourcing early stage finance through crowdfunding may damage prospects of securing subsequent investment from certain angels, which may include those with the most appetite to mentor and support company development.

REGIONAL IMBALANCES CONTINUE

There continues to be a regional imbalance in equity investment, with investment concentrated in London and the South East[13]. However, BBB's recent report on small business finance markets shows a more nuanced picture[14]. Using data from Beauhurst, and presenting the proportion of deals alongside proportions of businesses and new starts, it is clearly evident that there is concentration in London and the South East. Though it is notable that the South East is over-represented on investment volumes, but under-represented on the number of deals relative to the size of its business base. Interestingly, the North East and Scotland punch above their weight on the number of deals, though we know that much activity here is dependent on public money. Clearly there is more to do to redress the balance and develop the equity markets outside the Greater South East, and we return to this later.

THE ROLE OF THE STATE

The UK government, in common with governments elsewhere, has focussed its intervention on the supply side. This has included the provision of incentives to investors, such as the introduction in 2012 of the tax incentive, the Seed Enterprise Investment Scheme (SEIS), which supplemented the existing Enterprise Investment Scheme (EIS) that was also enhanced. These incentives

[10] Green, H. (2015) "What should investors make of the first equity crowdfunding exit", in City A.M.
[11] Beauhurst (2015) Equity crowdfunding in the UK: Evidence from the Equity Tracker, British Business Bank: Sheffield.
[12] InterTradeIreland (2016) Funding for Growth: the Business Angels Market on the Island of Ireland

[13] SQW (2013) SME Finance in London. Report for Greater London Authority.
[14] British Business Bank (2016) Small Business Finance Markets 2015/16, British Business Bank: Sheffield

may have contributed to aforementioned larger investments by business angels.

In addition to such incentives, a key response from UK and other European governments has been to intervene directly as a VC, e.g. through sole publicly-backed funds, co-investment with the private sector (e.g. Angel CoFund), and fund of funds models (government invests in a portfolio of VC funds). EVCA data (2015)[15] indicate that around 30% of all funding for European VC in 2014 came from government agencies (see Figure 1). According to The Economist (2014)[16] the European Investment Fund (EIF) alone supplied €600m in 2013 out of a Europe-wide total of €4bn of venture funds.

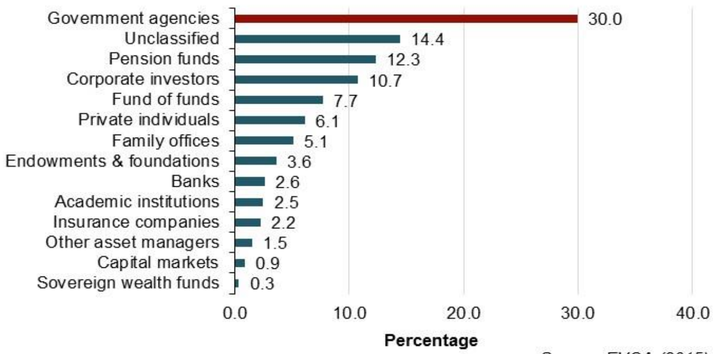
With so much attention on the supply-side, we believe that demand side issues have not been sufficiently considered, and this is an area that requires more action, as we discuss below.

DEMAND SIDE STIMULATION

Awareness of different sources of finance, such as venture capital and crowdfunding, has increased in recent years, but there is evidence to suggest that more needs to be done to improve the number and quality of propositions seeking funding. This is needed to ensure that the market functions effectively and the impact of government supply-side policies can be maximised.

Notably, knowledge of specific providers, the propensity to take expert advice and actual take-up of equity finance is limited (only 1% of SMEs have sought equity finance in the last three years, and this has remained fairly static since 2012)[17]. Our own research in Northern Ireland found there to be insufficient skills and knowledge among those seeking finance

Figure 1: European Venture Funds by Investor Type, 2014



Source: EVCA (2015)

on the role of equity, and a need to develop the quality of investment propositions to attract more investors[18].

These points suggest a key role for investment readiness programmes (IRP). Mason and Kwok (2010) identified three aspects in relation to equity finance[19]:

- "Equity aversion" - IRPs can provide information about equity and discuss with businesses issues around control/ownership so that firms can realise their full growth potential.
- "Investability" - a high proportion of applications to VCs and angels are rejected because the business is not a good "fit" for the investor, or because of question marks over returns. IRPs can help businesses to understand better the expectations of investors.
- "Presentational failings" - many small businesses lack the expertise in making investment propositions, and therefore do not effectively promote themselves. Expert advice can assist

[15] EVCA Yearbook 2015. VC data is for 2014.
[16] The Economist (2014), European venture capital, Innovation by fiat – Well-meaning government are killing the continents' start-ups with kindness.
[17] British Business Bank (2016) Small Business Finance Markets 2015/16, British Business Bank: Sheffield.
[18] SQW (2015) The Future of Early Stage and Growth Finance in Northern Ireland, Synthesis Report to the Department for Enterprise, Trade and Investment. See https://www.detini.gov.uk/publications/future-early-stage-and-growth-finance-northern-ireland
[19] Mason and Kwok (2010) Investment Readiness Programmes and Access to Finance: A Critical Review of Design Issues. Working Paper 10-03, University of Strathclyde

through developing business plans, propositions and pitches.

To facilitate the demand side, our work has highlighted that entrepreneurs want clearer information on where they can access equity. The BBB's Business Finance Guide, which explains the different types of finance available, should help here. This needs to be supported by cross-referrals between advisors and intermediaries (e.g. coaches, accountants, financial advisors etc.) to stimulate greater take-up of specialist advice. Policy-makers may consider providing capacity development for business advisors to raise levels of understanding of the role of equity finance, and support to develop links to specialist finance advisors and investors.

Specialist advice on accessing finance can help[20]. Those receiving finance advice of the now-closed GrowthAccelerator/ Business Growth Service had attracted over £100m of investment, of which over one-third was from venture capital, business angels, government-backed funds and crowdfunding[21]. However, the service is now closed, and whilst specialist advice is available from alternative sources, including private sector providers, the reduced availability of subsidised support means lower take-up, especially amongst SMEs with limited ability to pay.

The relative underperformance in the UK in the number of 'scale-ups' is also relevant here. Whilst the UK performs well on start rates compared to international comparators, it performs relatively poorly on the proportion of starts reaching 10 employees after three years. There are a range of business development issues here, as found in our work in Northern Ireland, and accessing finance is one of these, but there are also important links to 'growth ambition' and 'mindset'.

A JOINED-UP LANDSCAPE

The current landscape encourages innovation in the UK, including through Innovate UK support, Catapults and University Enterprise Zones. There has also been growth in the numbers and variety of accelerators in the UK (both public and private), as part of a European-wide trend that has learnt from the USA. All of these encourage experimentation by start-ups and small firms, which may then need advice on finance options and other types of assistance. If the demand side is to operate more effectively, with more and higher quality propositions to investors, then joining-up the landscape, including to private sector sources of advice, is a key area for improvement. This was noted, for instance, in our evaluation of Smart, which is a scheme that supports R&D projects amongst SMEs. Our evaluation found that improvements could be made in the aftercare stage of the scheme, when firms required signposting or advice on how to progress with the results of their R&D[22].

CREATING THE RIGHT ECOSYSTEM

Direct interventions on the supply side can also be complemented by actions and policies that help to create a supportive ecosystem. This is particularly important for those parts of the UK where the market is under-developed, i.e. outside of the Greater South East. Our research for the Department for Enterprise, Trade and Investment in Northern Ireland reviewed international

[20] *Access to finance is improved through high quality external assistance. See e.g. Baldock R., et al. (2015) Finance Pathways for Innovative SMEs: The New UK Finance Escalator.*

[21] *Source: http://www.ga.businessgrowthservice.greatbusiness.gov.uk/what-we-offer/access-to-finance/ [accessed 7th January 2016].*

[22] *SQW (2015) Evaluation of Smart, Report to Innovate UK. See http://www.sqw.co.uk/files/7914/4615/4871/Smart_Evaluation_-_Final_Final_Report_7_October.pdf*

practice in four outlying countries (Estonia, Finland, Republic of Ireland, New Zealand) and two outlying regions (North East England, Nova Scotia in Canada).

From our review seven key themes emerged, and these are presented below. They provide lessons for creating an enabling environment, and all are particularly relevant for regional economies in the UK (especially those regions outside the Greater South East). Points 2 and 5 have relevance for UK policy as a whole, given our view of the need to establish a stronger demand side.

Box 1: Seven key themes to inform ecosystem development[23]

1. An international mind- and action-set: Early stage investments favour geographical proximity. Some countries/regions have developed pipelines to investors elsewhere, e.g. New Zealand has adopted an 'external facing' approach in developing its early stage and growth finance market, including establishing a joint fund with Taiwan, and importing expertise and knowledge from Israel and the USA to help develop the market in venture capital and angel investment.

2. Focused demand side stimulation: New initiatives to increase the supply of venture capital must be accompanied by interventions to increase the demand for risk capital. Interventions in Finland have been adopted to improve entrepreneurial capabilities including competence building of start-ups through an investment readiness programme and the merger of three universities into Aalto University, as an explicitly innovation-focused institution and a catalyst centre for an entrepreneurial culture.

3. Funding models at an appropriate spatial level: Smaller economies have sought to address this with funds that operate at a scale wider than their own country or region. For example, the Baltic Innovation Fund is a fund of funds initiative across Estonia, Latvia and Lithuania, and Nova Scotia has collaborated with three other provinces in the Atlantic region.

4. Exit-centric approaches to market development: Estonia, Nova Scotia and New Zealand emphasise the impact that 'blockbuster' exits can have on the local market through raising interest and awareness. Exits create new investment through re-cycling of funds, and indirectly provide a signalling effect to others both internally and externally (e.g. entrepreneurs and non-local investors).

5. A functioning finance escalator: Gaps earlier in the escalator can have knock-on effects. Flexibility is often required to ensure sufficient funding at the earliest stages, in addition to where authorities seek to address the principal "equity gap", in order to generate sufficient flow through. This may include other types of funding such as loans and grants.

6. Effective business angel networks: A strong angel community is important as it can facilitate information flows between entrepreneurs and investors, and groups of angels can also make larger investments. Strong networks were identified in New Zealand and Nova Scotia, and weaker ones in the North East of England and Ireland. The value of angels can also be in the mentoring and advice they provide to entrepreneurs, though there is a good deal of variability in how well they do this.

7. Dedicated institutions and agencies playing policy and advocacy roles: Where the market was identified as being less mature, e.g. in New Zealand, North East England and Nova Scotia, dedicated venture capital and access to finance agencies have been important, playing policy and advocacy roles in addition to the management and distribution of finance. In the North East of England, for example, North East Access to Finance has been the 'policy' lead and North East Finance the 'delivery' lead.

[23] *SQW (2015) The Future of Early Stage and Growth Finance in Northern Ireland, Synthesis Report to the Department for Enterprise, Trade and Investment. See* https://www.detini.gov.uk/publications/future-early-stage-and-growth-finance-northern-ireland

CONCLUDING REMARKS

SQW has had recent involvement in research on early stage and growth finance, as well as on practical programmes to improve firm growth. We have observed that there is a focus for government policy in the UK on the supply-side, including through inducements such as favourable tax incentives and as a direct investor in VC. Even with these interventions, there remain key challenges, in particular in relation to long-term investments and in regional imbalances. There are also weaknesses in understanding on some issues, for example the relationship between business angel finance and crowdfunding.

In order to complement the supply-side response, we believe that there should be greater emphasis in the UK on stimulating the demand for finance, ensuring more high quality propositions are put in front of investors. There is a need to:

- invest in the capacity development of business advisors and others to understand the role of equity finance in company growth
- ensure greater signposting and take-up of specialist advice on finance
- enhance provision and take-up of investment readiness programmes
- improve join-up in the landscape of innovation support, business support and access to finance.

In implementing these points there are clearly important roles for the Department for Business, Energy and Industrial Strategy and the devolved administrations, BBB, with its national reach and scale, and Innovate UK, including as part of its intent to evolve innovation funding models. The points are also pertinent at spatial scales below the national level, and cooperation between national and local organisations is important, for example as the BBB and partners in the north of England are doing on the supply side.

In addition, there should be increased focus on developing an environment and culture that encourages experimentation, and enables small business creation and growth. We have provided a number of lessons, drawing on practice elsewhere, and these should be used to complement potential supply-side interventions within initiatives such as the Northern Powerhouse and the Midlands Engine.

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