

SME HOLDING FUND

PERFORMANCE REPORT 2018



EUROPE & SCOTLAND
European Regional Development Fund
Investing in a Smart, Sustainable and Inclusive Future

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1. Introduction

The SME Holding Fund is part financed by the European Regional Development Fund (ERDF) from the 2014-2020 European Structural and Investment Fund Programme in Scotland. The Fund was created to address key market failures in the provision of access to finance for SMEs. These failures were identified in the 'ex-ante assessment of financial instruments' carried out by Scottish Government and published in 2015.

The SME Holding Fund is managed by Scottish Government and provided funding that allows businesses in Scotland to grow and export, in doing so generating business innovation, investment and productivity, all vital to Scotland's economic growth. Scotland's economic success lies in the strength of its SMEs. However, since the financial crisis there has been a decline in the extent to which SMEs are using external finance. Current uncertainty is adding to this and putting investment at risk, especially the encouragement of ambitious investment needed to deliver jobs, growth and exports.

The SME Holding Fund contributed to the delivery of the priorities set out in *Scotland's Economic Strategy*¹ by supporting more SMEs to grow, increase their levels of investment, and boost their exporting ambitions. It operated by appointing a range of public and private sector delivery agents through a public procurement process as required under the European Commission rules and regulations. The delivery agents invest in, or lend directly to, SMEs on a fully commercial basis. The Fund provided microfinance up to £25,000, loans up to £100,000, and equity investment up to £2 million. It also provided support to a Trade Body which increases the capacity and capability of Scotland's informal investment market so that SMEs can access additional funding from new and existing business angels and business angel syndicates. Three Fund Managers and a Trade Body received offers of grant and were appointed as delivery agents in November 2016.

The Fund's allocated £40 million ERDF was matched by an additional £60 million from public and private sector delivery partners, with anticipated leverage of at least £150 million from other private sector investors so that at least £250 million would be available to Scotland's SMEs to fund their growth and exporting ambitions to December 2018. This joint approach enhanced the scale of resources available, and provided greater choice of funding options to SMEs.

This report sets out the reported performance of the delivery agents up to December 2018 in meeting their target outputs for the SME Holding Fund. When the SME Holding Fund was introduced it was expected to assist 360 companies in accessing £250 million by December 2018². To December 2018, the appointed delivery agents reported performance of 513 companies assisted accessing £268 million and creating 1301 jobs under the Fund - these figures will be verified by the Holding Fund team as part of their audit check of Final Claims during the 1st half of 2019.

¹ <https://beta.gov.scot/publications/scotlands-economic-strategy>

² SME Holding Fund outputs were enhanced as a consequence of the competitive bidding process, and delivery agents accumulative outputs resulting in an increased target of 2,600 new jobs.

2. SME Holding Fund Performance: 1st July 2015 – 31st December 2018

Whilst the performance of individual Delivery Agents vary, their collective reported contribution to the Holding Fund's targets mean that the Fund has exceeded almost all of its targets as evidenced in the table below. In a period during which the Scottish economy showed signs of a more steady recovery, the SME Holding Fund has scaled up its activities.

Targets	Total Holding Fund (target)	Total Delivery Agents (actual)	Result (%)
SMEs receiving lending or investment support	360	513	exceeded
SMEs receiving advisory support	30	680	exceeded
SMEs exporting	120	99	83*
SMEs supported to introduce 'new to the market' products	100	118	exceeded
Private sector leverage (£m)	32.25	199.5	exceeded
Jobs created	1950	1301	33*
No of innovative active SMEs	100	118	exceeded
Business Expenditure on Research and Development (£m)	30	135	exceeded
No of new angel groups	5	5	achieved

* jobs and exports are created well downstream of investment in companies, especially young innovative businesses who may be pre-revenue, so these targets are likely to be achieved in coming years.

3. Delivery Agent Activity to December 2018

3.1 Microfinance

Microfinance is generally recognised as an effective financing channel for job creation and social inclusion, whilst contributing to entrepreneurship and economic growth in Scotland. Microenterprises are important contributors to employment, acting as a driving force for job creation. In light of this, it is particularly problematic that their overall

business environment remains unfavourable compared to their larger peers.

Consequently, the need to address market failure in the provision of microfinance was identified in the ex-ante assessment as a key activity for the SME Holding Fund to support, and DSL Business Finance appointed as a Delivery agent to address that gap.

Case Study

Angel Share Glass Ltd has been trading since 2013 and manufacture “hand blown” glass products primarily for the whisky industry in Scotland. With a total funding package of £25,000 the company completed a refit of a new production area to enable the business to expand. As a result, 2 new jobs were created and 4 safeguarded.

DSL Business Finance Ltd (DSL) is a Community Development Finance Institution, (CDFI), a member of the Community Development Finance Association and the European Microfinance Network. As a not-for-profit lender, any profit made is re-invested to achieve DSL’s objectives of jobs and enterprise creation in Scotland with the long term goal of contributing to a more inclusive economy. Since 1993 DSL has provided business start-up and growth loans to small businesses and social enterprises that cannot access funding from banks and other traditional sources.

DSL Business Finance Ltd was awarded an ERDF grant of £2.8 million to create a £6m microfinance fund providing loan finance of up to £25,000 to small, new and growing SMEs. The Fund opened in November 2016 and **at 31 December 2018, had reported providing loan finance of £4.7 million (£0.51 million in Highlands & Islands), leveraging in a total of £3.45 million of private sector investment, therefore investing £8.15m in 220 companies and creating 375 jobs.**

DSL Business Finance Ltd has reported the following results:

Target/Indicator	Target	Achieved
No. of SMEs receiving financial support	300	220
Value of loans	£6m	£4.7m
Private sector leverage	£4.08m	£3.45m
Number of jobs created	540	375

3.2 Lending

Detailed recent analysis³ by the British Business Bank on the provision of debt finance to SMEs indicates that weaknesses and structural supply problems persist in the smaller business bank lending market due to information asymmetry. Analysis of rejected loan applications continues to show higher rejection rates for younger small businesses and for those looking to scale-up – the latter being important because these businesses are shown to have a high positive impact on job creation. Evidence suggests that a material portion of smaller businesses who apply for finance are still rejected because of a lack of proven track record or lack of collateral. This issue of constrained lending due to information asymmetries applies to small businesses at all stages of development, whether they are starting-up, scaling-up or seeking finance to stay-ahead in their particular area of the market. Consequently, the need to address market failure in the provision of lending was identified in the ex-ante assessment as a key activity for the SME Holding Fund to support, and Business Loans Scotland was appointed as a Delivery agent to address that gap.

Business Loans Scotland was formed in 2016 to build on the experience of the West of Scotland Loan Fund, the East of Scotland Investment Fund, and the South of Scotland Loan Scheme, thereby forming a single, Scotland-wide Loan Fund. It is a consortium of Scotland's local authorities, providing loan finance of £25,000 to £100,000 for new and growing small and medium sized enterprises across Scotland.

This was an innovative public-private partnership which aimed to help accelerate the growth of businesses in Scotland, complementing other private and public sector forms of funding, and creating a valuable increase in the supply of loan finance for SMEs.

Business Loans Scotland was awarded an ERDF grant of £3.25 million to create a fund of £7.16m providing loan finance of between £25,000 and £100,000 to new and growing SMEs. The Fund was operational from November 2016.

Unfortunately, Business Loans Scotland did not reach sufficient lending levels to accrue ERDF grant, and the match funding already provided by BLS from the individual Local Authorities was more than sufficient to meet its achieved lending commitments to SMEs. Whilst overall lending performance was well short of targets, performance at individual local authority area varied, with some local authority areas lending well above target. However the majority did not lend as forecast. Poor performance was highlighted by the Advisory Group on a number of occasions including discussions on corrective action with the Fund Manager. Unfortunately performance levels remained poor throughout the delivery period (November 2016 to December 2018).

Business Loan Scotland failed to achieve minimum baseline activity to fulfil ERDF requirements, therefore all investments were fully financed directly by match funding provided by Local Authorities and the performance activity has been removed from this report.

³ 'Small Business Finance Markets', British Business Bank, 2016/17

3.3 Equity

“There is academic unanimity concerning the fact that the equity market does not function at the lower end”⁴. Access to equity for SMEs remains difficult, with private equity volumes still well below pre-crisis levels and the venture capital segment still very dependent on government support⁵. There are underlying structural weaknesses and there is systemic failure in the early stage risk capital markets across the EU and in Scotland which continues to support a compelling case for long term government intervention. Consequently, the need to address market failure in the provision of early stage equity was identified in the ex-ante assessment as a key activity for the SME Holding Fund to support, and Scottish Enterprise was appointed as a Delivery agent to address that gap.

Case Study

Vert Rotors based in Edinburgh produces the world’s smallest, most powerful compact air compressors. With a total investment from the Scottish Investment Bank of just under £1.5m to help make the transition from research and development to major commercial contracts. The company is forecasting sales growth over the next 2 years with 5 new jobs being created.

Scottish Enterprise is the Scottish Government’s main economic development agency. The Scottish Investment Bank (SIB) is the investment arm of Scottish Enterprise (SE), with the objective of increasing the supply of finance for Scottish SMEs with high growth potential. The SME Holding Fund awarded SE ERDF grants totalling £28.5m which, together with match funding from SE capitalised the Scottish Co-Investment Fund (SCF) at £20.16m and the Scottish Venture Fund (SVF) at £47.05m respectively. Through both funds, SIB co-invests and syndicates with private sector investors to provide equity finance for SMEs of up to £2 million within a maximum deal ceiling of £10 million - both funds have been investing under the SME Holding Fund since July 2015. **As at 31 December 2018, Scottish Enterprise had reported investing £63.75 million through both funds, leveraging in a total of £179 million of private sector investment with 156 companies receiving total investment of £242.75 million.**

Scottish Enterprise has reported the following results:

Target/Indicator	Target	Achieved
No. of SMEs receiving financial support	180	156
Value of equity investment	£71.25m	£63.75m
Private sector leverage	£213m	£179m
Number of innovative active SMEs	143	110
Number of jobs created	1400	607

⁴ ‘Executive Forum, the scale-up gap and how to address it’ Rudy Aernoudt, Ghent Univ, June 2017

⁵ ‘Investment and Investment Finance in Europe – financing productivity growth’, EIB, 2016

3.4 Business Angel Market

Business Angels and Business Angel syndicates invest primarily in the form of equity into young, innovative companies, and therefore any initiative aimed at increasing the number and quality of angels/syndicates will make a material contribution to addressing the early stage equity gap, one of the key objectives of the SME Holding Fund. Consequently, LINC Scotland was appointed as Delivery Agent to provide Trade Body services to Scotland’s informal investment market.

LINC Scotland is the national association for business angels in Scotland, with a membership which includes many active individual investors and most of the main angel groups or syndicates. Since 1993, LINC has played a significant and active part in changing the business culture in

Scotland and has helped promote the Scottish business angel marketplace which is now recognised as amongst the most developed in Europe.

LINC was awarded an ERDF grant of £1.9 million to further improve the capacity and capability of the business angel marketplace in Scotland, increasing the number of active business angels and new business angel syndicates as well as improving their professionalism. This means that over time, substantial additional capital and greater choice is available to young, innovative companies seeking to access equity finance. LINC has been delivering this service on behalf of the SME Holding Fund since July 2015. **As at 31st December 2018, LINC Scotland’s members had reported investing a total of £17.1 million in 137 companies across Scotland.**

Case study

Scottish Bioenergy has developed a natural blue extract from algae (phycocyanin) that is used as an internationally approved blue food colourant, powerful anti-oxidant, and anti-inflammatory. An investment of over £500k to allow the company to scale up and expand was led by LINC members Kelvin Capital and Investing Women. The market for phycocyanin is growing rapidly with limited worldwide supply. With its IP established, Scottish Bioenergy is now in a position to scale up and expand its operations in a global marketplace.

LINC Scotland and its members has reported the following results:

Target/Indicator	Target	Achieved
Number of SMEs receiving financial support	215	137
Private investment matching public support (£m)	75	17.1
New Angel Groups formed	5	5
Business Expenditure on R&D (£m)	30	135
Number of jobs created	0	319

(LINC’s private sector leverage figure has been adjusted downwards to exclude any double counting with investment activity undertaken by Scottish Enterprise who already claim all private sector leverage when co-investing with LINC members)

4. Governance

4.1 SME Holding Fund Advisory Group

The SME Holding Fund Advisory Group is a key component in the governance of the SME Holding Fund. The Advisory Group's role was to provide overall strategic and operational support to the SME Holding Fund team: strategic in the form of guidance on the direction of the Fund's investment activities; operational in the form of appraising bids from prospective delivery agents, and regular scrutiny of their performance.

The Advisory Group consisted of a panel of nine members drawn from the public and private sectors, each with expertise in different aspects of the access to finance market for SMEs ranging from the management of microfinance, debt and equity funds to the provision of financial readiness advice to ambitious SMEs.

The Group's structure and terms of reference was designed to prevent any perceived or actual conflict of interest, with individual members chosen for their specific expertise. Whilst some of the members are representatives of Delivery Agents, procedures were in place to prevent conflicts of interest arising, ensuring that those members could not participate in decisions relating to their organisations. All meetings were minuted by the secretariat and approved by the Group.

During 2016, the Group played a key role in the procurement process which led to the selection and appointment of the current delivery agents. Following the appointment of the delivery agents, the Group met on a number of occasions throughout 2016 to 2018 to scrutinise and review performance and the contribution towards the Fund's targets, allowing oversight of the delivery and development, and reviewing the impact of, the SME Holding Fund.

SME HOLDING FUND ADVISORY GROUP MEMBERSHIP

Ronnie Smith (Chair)	Lanarkshire Enterprise Services
David Grahame	LINC (Scotland)
Andrew Dickson	Business Loans Scotland
Jan Robertson	Scottish Enterprise
Jeff Foot	Highlands & Islands Enterprise
Martin Hughes	University of Strathclyde
Eric Munro	Royal Bank of Scotland
Gillian Henderson	HBOS
Anne Clyde	UK Steel Enterprise

4.2 Verification

The SME Holding Fund works closely with the Managing Authority for European Structural Funds to ensure that the Fund is delivered in a manner which is compliant with all of the applicable European Commission Regulations.

The SME Holding Fund operates within a multi-layered control system. Segregation of duties is maintained between the verification and payments function with the latter being subject to a payment process which is out with the control of the verification team.

Once the verification process has been completed, a further independent review is carried out by the Managing Authority which sits within the European Structural Funds Division in the Scottish Government.

Further verification work may also be carried out by the European Commission and the European Court of Auditors although their work is restricted to the information held by the Managing Authority.

The outputs from the Fund have been enhanced as a consequence of a competitive bidding process to appoint delivery agents, such that delivery agents' reported performance has exceeded the Holding Fund's targets. Outputs to 31st December 2018 reported by the delivery agents will be confirmed by verification checks on Final Claims carried out by the SME Holding Fund team during the first half of 2019.

5. Legacy

5.1 Economic

The economic effects of the activity of the SME Holding Fund are described at Section 3 which details the Fund's Output targets and the delivery agents reported performance against each. Section 3 demonstrates that the SME Holding Fund exceeded almost all of its targets. It should be noted that Section 3 underestimates the full economic effect of the SME Holding Fund since it does not account for the multiplier effect of investments (increased spending, etc) nor the downstream benefits (as realisations are re-invested, these in turn will yield a series of returns and benefits, eg, further realisations, job creation, increased spending, etc).

5.2 Financial

The EU Regulations which govern the use of European Structural and Investment Funds (ESIF) as they apply to Financial Instruments ensure a significant economic and financial legacy in that, inter alia, they stipulate that the ESIF element of realisations from investments must continue to be invested for the same purpose and for at least 8 years after the Programme end. In other words, the ESIF element of realisations from investments made under the Scottish Microfinance Fund, the Scottish Co-investment Fund and the Scottish Venture Fund must continue to be reinvested in SMEs via those same (or if wound up) similar funds and for similar purposes until at least 31st December 2031. This requirement is reflected in the contracts (Funding Agreements) between Scottish Government and the Delivery Agents who manage loan/investment funds, including a reporting requirement for the same legacy period. Scottish Government will carry out verification checks during the legacy period to quantify the ESIF element of realisations and ensure that they are re-invested for eligible purposes.

In this way, investment funds which have received ESIF support from the SME Holding Fund will provide a substantial and lasting legacy not least because those funds have been invested on a fully commercial basis and should appreciate, rather than diminish, over time.

5.3 New Delivery Model

The SME Holding Fund team has considered the lessons learned over the 2015-2018 period in applying them to a potential future delivery model. These include, inter alia: how to attract private sector professional fund managers; how to attract private sector monies to Scotland; how to achieve financial and economic sustainability at the level of the Holding Fund; lessons learned from other countries. This led to the fund-of-funds model adopted under the Scottish Growth Scheme, a series of Scottish Limited Partnerships managed on a fully commercial basis by private and public sector fund managers appointed following a full procurement process. This fund-of-funds has been fully operational since January 2019, with 5 fund managers providing microfinance, debt and equity investment to Scottish SMEs with growth and/or export potential.