

# SME HOLDING FUND PERFORMANCE REPORT 2017



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

## Foreword - Ronnie Smith, Chair of SME Holding Fund Advisory Group

Scotland has been the beneficiary of substantial EU monies over several decades as we have worked to improve our economy. From an early focus on physical infrastructure projects in the '80s and '90s, Scotland became increasingly sophisticated in using EU funds to support SME business development programmes. This led to the development of a number of innovative financial instruments from the late '90's onwards.

Addressing the problems of access to finance for Small and Medium-sized companies (SMEs) with growth and export potential is a key priority for the Scottish Government. This was reflected in the introduction of the ERDF-supported SME Holding Fund in 2015. The Holding Fund provides grant support to part capitalise funds for microfinance, debt and equity, as well as helping to increase the capacity and capability of Scotland's informal investment market.

The SME Holding Fund Advisory Group is made up of experts drawn from the public and private sectors providing both strategic and operational advice to the SME Holding Fund Manager and playing a key role in selecting the delivery agents. Three fund managers and a trade body were selected during 2016: DSL Business Finance Ltd for microfinance, Business Loans Scotland for lending, and Scottish Enterprise for equity, with LINC Scotland being appointed as the trade body.

In the 2016 Programme for Government, *A Plan for Scotland*<sup>1</sup>, the Scottish Government announced its intention to "invest in ambition" by creating the Scottish Growth Scheme (SGS). Over three years (June 2017 – June 2020) the Scheme will deliver £500 million of investments. As part of this, an additional £25 million has been provided under SGS to use the structure of the SME Holding Fund to undertake new and additional investment to assist companies seeking early stage equity investment up to £2 million from 1 October 2017 to December 2018<sup>2</sup>.

The SME Holding Fund has played an important role in stimulating smart, sustainable and inclusive growth throughout Scotland. **To December 2017, the four appointed delivery agents' reported performance indicates that 330 companies had accessed £223 million under the Fund, creating 1005 jobs.**

I would like to take this opportunity to thank the members of the Advisory Group for their involvement over the past two years. Their hard work and diligence in helping to shape and direct the SME Holding Fund has made a significant contribution to addressing some of the important business support issues within the Scottish economy.

**Ronnie Smith**

---

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

<sup>2</sup> This "additional" activity will be monitored separately.

## 1. Introduction

The SME Holding Fund is part financed by European Regional Development Fund (ERDF) monies from Scotland's 2014-2020 European Structural and Investment Fund Programme. It is managed by the Scottish Government and provides funding that allows businesses in Scotland to grow and thrive. Having access to a range of financial products fuels business innovation and increases 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 type of innovative and ambitious investment needed to deliver jobs, growth and revenue.

The Fund's initial £40 million ERDF is matched by an additional £60 million from public and private sector delivery partners, alongside anticipated leverage of at least £150 million from other private sector investors so that at least £250 million is available to Scotland's SMEs to fund their growth and exporting ambitions to December 2018. This joint approach with the public and private sector provides the opportunity to enhance the scale of resources available, and gives SMEs greater choice of funding sources.

The SME Holding Fund contributes to the delivery of the priorities set out in *Scotland's Economic Strategy*<sup>3</sup> by supporting more SMEs to grow, increase their levels of investment, and boost their exporting ambitions. It operates 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 appointed delivery agents will invest in, or lend directly to, Scottish SMEs on a fully commercial basis.

The Fund provides microfinance up to £25,000, loans up to £100,000, and equity investment up to £2 million. It also provides support to a Trade Body which will increase the capacity and capability of Scotland's informal investment market so that SMEs can access additional funding from 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.

This report sets out the performance of the delivery agents up until December 2017 in meeting their target outputs for the SME Holding Fund. When the SME Holding Fund was introduced it was expected to assist 500 companies in accessing £250 million by December 2018<sup>4</sup>. To December 2017, the four appointed delivery agents' reported performance indicates that 330 companies had accessed £223 million under the Fund, creating 1005 jobs - these figures have been adjusted downward to account for potential duplication of reporting in instances where two or more delivery agents are investing in the same company.

---

<sup>3</sup> <https://beta.gov.scot/publications/scotlands-economic-strategy>

<sup>4</sup> 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. Recent Trends in the SME Finance Market

This section provides a brief summary of the available evidence on recent trends in the supply of finance to and demand for finance from SMEs in Scotland and the UK, and the resulting gaps which appear to exist in the market.

### Demand for finance

- Evidence from the Small Business Survey and the SME Finance Monitor suggests that SME demand for external finance has fallen in recent years and remains muted.<sup>5</sup>
- Demand for certain types of finance remains low, with the great majority of SMEs in Scotland continuing to prefer debt (particularly overdrafts and loans) over equity<sup>6</sup>.
- The most common reason SMEs in Scotland seek finance is for working capital/cash flow<sup>7</sup>.
- Evidence from the BDRG Group suggests that the proportion of ‘non borrowers’ in Scotland has risen in recent years<sup>8</sup>. The evidence suggests that reasons for not borrowing include risk aversion, control, anticipated rejection and perceived time/effort required<sup>9</sup>.

### Supply

- Although the growth rate in lending to UK SMEs has been broadly positive since mid-2015, the latest Bank of England data indicates a decline in lending since December 2017<sup>10</sup>.
- Evidence from the Small Business Survey Scotland suggests success rates in securing finance increase with business size<sup>11</sup>.
- UK Finance data suggests that in Scotland, overall net lending to SMEs has been positive since mid-2015, although net lending has generally been negative for smaller firms<sup>12</sup>.

---

<sup>5</sup> Scottish Government, Small Business Survey Scotland 2016; and BDRG Group, SME Finance Monitor 2016 Annual Report.

<sup>6</sup> Evidence from the Small Business Survey Scotland indicates that in 2016, the most common forms of external finance sought by SMEs were overdrafts (34 per cent of SMEs that applied for finance in the last 12 months) and loans (32 per cent). Just 1 per cent applied for equity finance. Scottish Government, Small Business Survey Scotland 2016.

<sup>7</sup> Scottish Government, Small Business Survey Scotland 2016.

<sup>8</sup> BDRG, SME Finance Monitor 2016 Annual Report.

<sup>9</sup> Please see: Scottish Government, Small Business Survey 2016; British Business Bank, Small Business Finance Markets 2016/17; BDRG, SME Finance Monitor 2016 Annual Report; Freel, Carter, Tagg and Mason, The Latent Demand for Bank Debt: Characterising “Discouraged Borrowers”.

<sup>10</sup> The Bank of England’s Monthly Lending to Businesses statistics indicate that the 3 month growth rate in lending to UK SMEs was negative at -2.7 per cent in January 2018. Bank of England, BankStats database, Monetary financial institutions’ loans to UK non-financial businesses, by size of business.

<sup>11</sup> Scottish Government, Small Business Survey Scotland 2016.

<sup>12</sup> UK Finance, Banking Support for SMEs in Great Britain statistics. Please note that this data covers lending by six major lenders (Barclays, HSBC, Lloyds Banking Group, Clydesdale Bank, RBS, Santander and the Co-operative Bank) which collectively account for around 60 per cent of SME lending across the UK as a whole.

- Evidence from the British Business Bank (BBB)<sup>13</sup> indicates there has been a significant increase in the flows of equity finance to smaller businesses in the UK over the last five years.
- Evidence from Scottish Enterprise suggests Scotland's risk capital market has grown considerably since 2005<sup>14</sup>.
- Evidence from the BBB indicates there has been continued growth in the use of alternative sources of funding including asset financing, crowd funding and peer-to-peer lending. However, these remain a small proportion of lending to SMEs<sup>15</sup>.

### Gaps in the market

- The available evidence suggests that many SMEs are able to access the finance they require.<sup>16</sup> However, funding gaps for some SMEs exist in both debt and equity markets which result in some SMEs being unable to secure the finance they need<sup>17</sup>.
- Whilst the scale and nature of gaps change over time, they reflect cyclical factors<sup>18</sup> and long-term structural gaps.
- The evidence<sup>19</sup> suggests that structural gaps tend to affect certain types of firms, including micro firms, start-ups, growth firms and innovative firms, and primarily arise due to the existence of information asymmetries<sup>20</sup> between lender and borrower.
- The evidence<sup>21</sup> suggests that demand side market failures also appear to exist which lead to a sub-optimal number of viable SMEs demanding external finance.
- Evidence from the BBB suggests that whilst there is a fairly even distribution of core bank lending products across the UK, a clear regional imbalance is evident for equity finance, where investment is concentrated in London and the South East<sup>22</sup>.

<sup>13</sup> British Business Bank, Small Business Finance Markets 2016/17.

<sup>14</sup> Scottish Enterprise, Risk Capital Market in Scotland 2016 Annual Report.

<sup>15</sup> British Business Bank, Small Business Finance Markets 2016/17.

<sup>16</sup> The Small Business Survey Scotland 2016 estimated that 68 per cent of SMEs that applied for external finance in the previous 12 months were successful in obtaining at least some of the external finance sought. This figure may however be artificially low as the outcome of 21 per cent of applications was still pending at the time of the survey. In 2015, when a lower proportion of applications were pending (12 per cent), the success rate was higher, at 83 per cent.

<sup>17</sup> Evidence from the Small Business Survey Scotland suggests that in 2016, 12 per cent of SMEs in Scotland that applied for external finance in the previous 12 months did not obtain any finance sought. In 2015, where a smaller proportion of applications were still pending at the time of the survey, the proportion that did not obtain any finance was lower, at 6 per cent.

<sup>18</sup> Cyclical factors affect a range of SMEs and reflect changes in economic conditions and regulatory requirements.

<sup>19</sup> Please see the following publications: Scottish Government, Small Business Survey Scotland 2016; BDRC, SME Finance Monitor; British Business Bank, Small Business Finance Markets 2016/17; Scottish Government, SME Access to Finance Survey 2014.

<sup>20</sup> Information asymmetries exist where the prospective borrower has more information about their financial viability than the lender, making it difficult for the lender to distinguish between high and low risk firms. Viable borrowers who are unable to provide lenders with assurance of their viability through providing evidence of financial track record and/or tangible collateral as security may therefore be unsuccessful in their applications for finance, resulting in 'market failure'.

<sup>21</sup> Please see: Scottish Government, Small Business Survey 2016; British Business Bank, Small Business Finance Markets 2016/17; BDRC, SME Finance Monitor 2016 Annual Report; Freel, Carter, Tagg and Mason, The Latent Demand for Bank Debt: Characterising "Discouraged Borrowers".

<sup>22</sup> British Business Bank, Small Business Finance Markets 2016/17.

### 3. Business Activity to December 2017

#### 3.1 Microfinance

**DSL Business Finance Ltd** 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 ploughed back to achieve the company's objectives of jobs, and enterprise creation in Scotland with their long term goal of creating 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 provide loan finance of up to £25,000 to small, new and growing SMEs. The Fund was operational from November 2016. **As at 31 December 2017, DSL Business Finance Ltd had invested £1.9 million (£0.24 million in Highlands & Islands), leveraging in a total of £2.3 million of private sector investment in 124 companies, creating 223 jobs.**

DSL Business Finance Ltd has made progress towards its required targets and has achieved the following results:

Target/Indicator	Target to 31 Dec 2018	Achieved to 31 Dec 2017
Number of SMEs receiving financial support	300	124
Value of loans	£6m	£1.9m
Private investment matching public support	£7.3m	£2.3m
Employment increase in supported SMEs	540	223

#### 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.

## 3.2 Lending activity

**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.

Business Loans Scotland 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 is an innovative public-private partnership which aims to help accelerate the growth of businesses in Scotland, complementing other private and public sector forms of funding 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 provide loan finance of up to £100,000 to new and growing SMEs. The Fund was operational from November 2016. **As at 31 December 2017, Business Loans Scotland had invested £0.84 million (£0.24 million in Highlands & Islands), leveraging in a total of £2.7 million of private sector investment in 14 companies.**

Business Loans Scotland has made progress towards its required targets, and has achieved the following results:

**Case Study**  
**Water and Pipeline Services Ltd (WPSL)** began trading in 2012 and provides specialist construction and pipeline services to the UK's utility companies and their main contractors. Customers are blue chip companies that are mainly in the gas, water, electric and civil engineering sectors. The company received a loan of £100,000 to invest in a suction excavator to improve productivity, safety and competitiveness. WPSL will be the only company in Scotland to have this piece of equipment. The company currently has 35 staff and is forecast to double its employment as a result of this expansion.

Target/Indicator	Target to 31 Dec 2018	Achieved to 31 Dec 2017
Number of SMEs receiving financial support	179	14
Value of loans	£7.1m	£0.84m
Private investment matching public support	£21.5m	£2.7m
Number of SMEs exporting	54	14

### 3.3 Equity activity

**Scottish Enterprise** is Scotland's main economic development agency and is a non-departmental public body of the Scottish Government.

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 and export potential.

The SME Holding Fund has awarded an ERDF grant of £19.9 million to the Scottish Co-Investment Fund and £8.6 million to the Scottish Venture Fund (two equity investment schemes delivered by SIB). Through the Scottish Co-Investment Fund, SIB works with their approved co-investment partners to provide equity finance for SMEs in the range of £10,000 to £1.5 million. Through the Scottish Venture Fund, SIB works with private sector investors to provide equity and venture debt finance deals in the range of £10,000 to £2 million. Both funds invest within a maximum deal ceiling of £10 million.

Investment commenced under both these funds from July 2015.<sup>23</sup> **As at 31 December 2017, SIB had invested £63.6 million (£3.6 million in Highlands & Islands), leveraging in a total of £137 million of private sector investment in 163 companies.**

SIB has made progress towards its required targets, and has achieved the following results:

Target/Indicator <sup>24</sup>	Target to 31 Dec 2018	Achieved to 31 Dec 2017
Number of SMEs receiving financial support	180	163
Value of equity investment	£71.2m	£63.6m
Private investment matching public support	£213m	£137m
Number of innovation active SMEs businesses	143	65

#### 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.

<sup>23</sup> SE and one other delivery agent were able to take advantage of retrospection offered to all four delivery agents, so that their activity started from July 2015.

<sup>24</sup> The target/indicator excludes deals, investments and jobs funded since 1 October 2017 through new and additional ERDF investment under the Scottish Growth Scheme.



### 3.4 Business Angel market activity

**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 Scotland was awarded an ERDF grant of £1.9 million to further improve the capacity and capability of the business angel marketplace in 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.

This activity commenced operation in July 2015. **As at 31<sup>st</sup> December 2017, LINC Scotland business angel members had invested a total of £74 million in 113 companies across Scotland.**

LINC does not undertake direct investment, instead this is delivered by its business angel members. LINC has made progress towards achieving its required targets, and has achieved the following results:

Target/Indicator	Target to 31 Dec 2018	Achieved to 31 Dec 2017
Number of SMEs receiving financial support	215	113
Private investment matching public support	£75m	£74m
New Angel Groups formed	5	4

## 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 is 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; and operational in the form of appraising bids from prospective delivery agents, then regular scrutiny of their performance.

The Advisory Group is 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 are 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 are in place to ensure that those members cannot participate in decisions relating to their organisations.

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 and 2017 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 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 payment process which is out with the control of the verification team.

The outputs from the Fund have been enhanced as a consequence of its competitive bidding process to appoint delivery agents, so that partners' performance is likely to exceed the Holding Fund's initial targets. Targets in this publication are those reported to date by the delivery agents and are subject to on-going verification checks (for example, to minimise duplication of reported outputs) by the SME Holding Fund 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.