1 EXECUTIVE SUMMARY

1.1 Northern Ireland Operational Programme and the Need for Financial Instruments to increase the supply of finance to Growth SMES.

The Northern Ireland economy is dominated by SMEs (98.2% of companies) and of that 89% are micro enterprises. Access to finance is a major constraint to their growth, both from a perception issue and in reality. Ninety-one percent of Northern Ireland SMEs expect it to be difficult to access finance, the highest of any UK region[1].

Northern Ireland has significant market failures with regard to both the supply and demand for finance. The banking sector has been significantly impacted by the recession and banks have deployed restricted lending practices. The equity market is still very underdeveloped in comparison to other parts of the UK and Ireland. The amount of UK BCVA VC investment in Northern Ireland in 2012 was £2m, lower than Wales (£9m) and Scotland (£23m).[2] In addition, the level of angel investment remains lower than other parts of the UK and angel syndicates are less advanced.

There is a demand for finance from Northern Ireland growth companies; however there is a reluctance to move away from traditional bank finance partly due to a lack of knowledge and understanding of the alternatives. When Northern Ireland is compared to more mature finance ecosystems, it exhibits:

- A lack of local based institutional investors;
- A lack of a 'churn' of attractive high potential portfolio companies (i.e. only 1% of SMEs seek to use equity or loan support);
- The presence of only a small number of venture capital firms, all of whom are State backed;
- A lack of investment readiness by many companies needing financial support and a need for hand-holding to get them to that stage;
- A comparatively small network of high quality VC advisers. The principal issue being that they are based locally and do not have the necessary national and international connections essential for knowledge exchange and the further spreading of risk through syndication; and
- A lack of access to equity markets such as the Alternative Investments Market.

This means that not only is the local market not working effectively, but that the market is not able to access either the European or UK level initiatives as there is either a lack of quantum (in terms of number and size of transactions) in the local market or

[1] Department for Business, Innovation and Skills: SME Journey Towards Raising External Finance October 2013.
[2] BCVA, *Private Equity and Venture Capital Report on Investment Activity 2012* (2013). Note: The BVCA data does not present a comprehensive picture of investment activity in Northern Ireland as not all local providers are BVCA members and investment activity from non-UK funds is also excluded.

financial sophistication amongst financial intermediaries and/or borrowers to deliver these schemes in Northern Ireland.

1.2 Access to Finance Vision and Target Results

In drafting the ERDF Programme for Northern Ireland, DETI has identified, as one of its investment priorities, the need to 'support the capacity of SMEs to engage in growth in regional, national and international markets, and in innovation processes' and to deliver this requires that the market failures with regard to the availability of finance are addressed.

The vision therefore is to **'ensure SMEs in Northern Ireland can access finance to support growth'.**

In achieving the vision and addressing the market failures with regard to the availability of finance for SMEs, it will be necessary to positively alter both the perception and experience of SMEs in accessing finance to support growth. To demonstrate that the market failures have been addressed both perception and experience should be measured:

- perception of SMEs on their ability to access finance to fund growth (to be measured through survey); and
- experience of SMEs in accessing finance to fund growth (to be measured through survey).

Currently there is a widespread perception amongst businesses in Northern Ireland that the market is failing in the supply of debt finance to SMEs[3]. At present only 9% of Northern Ireland based SMEs perceive it to be easy to access finance compared to 37% in the West Midlands.[4] Given that the West Midlands is the next region above Northern Ireland in terms of this perception, it is felt that this should be the minimum level of improvement.

The target therefore should be: A 28%[5] increase (in perceived ease in accessing finance) to bring NI up to the West Midlands level.

In Scotland the change in perceptions of access to finance brought about a move up the value added continuum (from grants to loans, and loans to equity and with a greater private sector role). With 91% of NI SMEs sceptical as regards access to finance, there is a continuing need to demonstrate locally the benefits of using loans and equity instead of grants and bank loans.

[3] Economic Advisory Group: Review of access to finance for NI businesses, March 2013
[4] Department for Business Innovation and Skills, *Small and Medium Sized Enterprise (SME) Journey Towards Raising External Finance* (2013)
[5] The 28% reflects the difference in perceived ease of access to finance between Northern Ireland (the region with the lowest perception of ease of access to finance), compared to the West Midlands (which is the second lowest perception of ease of access to finance).

It is recommended that the experience of SMEs in accessing finance to fund growth is benchmarked and then continually measured to assess performance. A target result should be set based on the benchmark analysis to demonstrate that market failure has been addressed.

1.3 Market Failures and Interventions Needed to deliver on Vision

Table 1.1 sets out the market failures, the intervention needed and the public sector funding needed.

Table 1.1 Debt and Equity Gaps in Northern Ireland

Form of Financial Instrument	Market Failures	Intervention needed	Size of Gap for 2014-2020	Size of Gap for 2014-2023
Debt	Banks have changed their policies for providing finance to SMES since 2008. They have tightened their lending requirements and with a stronger focus on needing security for all deals make it difficult for SMEs to access finance. This is particularly the case for those with a property overhang.	Growth businesses, which do not have the security needed for bank finance, need support. Support is needed to allow these businesses to get the finance they need to grow. Growth businesses with a property overhang need to be able to set this aside and get access for the funding needed to grow their core non-property related business.	Expect 40 – 50 deals per annum. **Growth Loan Fund (GLF) I:** Public (ERDF): £19m & Private: £19m **GLF II**[6]: Public (ERDF): £21.5m & Private: £21.5m There is also demand from companies that have property overhang – which needs to be dealt with, but they have not been included	Expect 40 – 50 deals per annum. **GLF I:** Public (ERDF): £19m & Private: £19m **GLF II**[7]: Public (ERDF): £30m & Private: £30m There is also demand from companies that have property overhang – which needs to be dealt with, but they have not been included
	Supply of Capital: Lack of sufficient finance available for companies (at seed or early stage of development). VCs will generally not invest in the sub £2m space (due to the high transaction costs) and therefore the FIs are needed below this level. Business Angels are the main	Needs to be Equity Support given that the companies at this stage will have no or limited track record; little or no assets to act as security and they will also need access to management expertise through the investors. Intervention needs to	Equity needed 2014 - 2020: **<u>University Funds:</u>** **University Innovation Fund (UIF) Northern Ireland Spin Out Funds (NISPO II):** Public (ERDF &	Equity needed 2014 - 2023: **<u>University Funds:</u>** **UIF (NISPO II):** Public (ERDF & other) £3.6m **UIF (NISPO III)**[:12]**:** Public (ERDF & other) £2.4m

[6] GLF II subject to proportionate Business Case/ EA – assume commences June 2019; overall fund size £60m
[7] GLF II subject to proportionate Business Case/ EA – assume commences June 2019; overall fund size £60m

Form of Financial Instrument	Market Failures	Intervention needed	Size of Gap for 2014-2020	Size of Gap for 2014-2023
	source of finance in the sub £2m space as they do not have the same costs. **Information**: promoters at this stage are often unaware of the full range of financial instruments available or how they can benefit their business. They will also tend to be wary of selling part of their business for equity, and part of the support must involve selling equity investment to them. **Investor Readiness**: promoters at this stage are often not investor ready and they need significant help developing their business plans and understanding the commercial issues involved in their project. **Coordination**: there need to be FIs that can support the project from start up through to the stage where they can present their company to private investors and get the finance they need.	support both university early stage and non university early stage companies move from start up through to companies that can present to VCs/ Banks and get the finance they need. The FIs at seed/ early stage need to be strongly promoted to the target market. The FIs for this stage must include investor readiness support. The FIs available at the seed/ early stage need to work to be sufficient to get the businesses to an investor ready level.	other) £3.2m **UIF (NISPO III)**:[8]**:** Public (ERDF & other) £0.4m **<u>Early stage/ seed deals:</u>** **Invest Growth Fund (IGF) (NISPO II):** Public (ERDF & other) £15.3m & Private £4.9m **IGF (NISPO III)**:[9]**:** Public (ERDF & other) £4.3m & Private £1.4m **<u>Co-Investment deals:</u>** **Co-Fund I:** Public (ERDF) £8m & Private £9m **Co-Fund II**[10]**:** Public (ERDF) £9.5m & Private £11m **<u>Development stage deals:</u>** **Development Fund I:** Public (ERDF) £25m &	**<u>Early stage/ seed deals:</u>** **IGF (NISPO II):** Public (ERDF & other) £17.5m & Private £5.6m **IGF (NISPO III)**:[13]**:** Public (ERDF & other) £11.6m & Private £3.7m **<u>Co-Investment deals:</u>** **COIF I:** Public (ERDF) £8m & Private £9m **COIF II**[14]**:** Public (ERDF) £15.9m & Private £18.3m **<u>Development stage deals:</u>** **Dev Fund I:** Public (ERDF) £26m & Private £26m **Dev Fund II**[15]**:** Public (ERDF) £20m & Private £20m

[12] UIF (NISPO III) subject to proportionate Business Case/ EA – assume commences April 2019; same as UIF (NISPO II)
[8] UIF (NISPO III) subject to proportionate Business Case/ EA – assume commences April 2019; same as UIF (NISPO II)
[9] IGF (NISPO III) subject to proportionate Business Case/ EA – assume commences April 2019; same as IGF (NISPO II)
[10] COIF II subject to proportionate Business Case/ EA – assume commences June 2017; similar to COIF I but £2.5m pa

Form of Financial Instrument	Market Failures	Intervention needed	Size of Gap for 2014-2020	Size of Gap for 2014-2023
			Private £25m **Development Fund II[11]:** Public (ERDF) £7.9m & Private £7.9m	

1.4 Financial Instruments needed to Meet these Market Failures

The following Funds are recommended in order to fill the finance gaps and deal with the market failures for growth SMES in Northern Ireland.

- **University Fund** – two equity funds (£1.5m each) providing equity finance to potential universities' spin outs. Their main purpose will be to encourage and fund spin outs from the universities and it is anticipated that a pipeline will emanate from the university Proof of Concept (POC) grants. These sit alongside the Seed Fund which is targeted at SMEs;
- **A Seed Fund** – an equity fund of £13m (requiring at least 30% private sector match funding on each investment) providing equity finance to seed/early stage SME in NI which have high growth potential. This is the "entry level" source of equity finance in the funding continuum;
- **A Co-Investment Fund (Co-Fund)** – an equity fund of £7.2m providing equity finance to support seed and some expansion companies in NI. The Co-Fund is aimed at stimulating more private investment in NI companies who demonstrate high growth potential and have innovative and export focused products. It is aimed an identified equity gap of £250k - £450k and involves investing alongside private investors on a pari passu basis up to 50% of the total deal. A requirement for each deal is the need to have private funding to match the co-investment funding (business angels have a key role to play);
- **A Development fund** – an equity fund of £60m (2 funds managed by 2 fund managers) which provides equity finance to expansion companies;
- **A Loan Fund –** a £50m fund which provides mezzanine finance ("quasi equity" – a hybrid of debt and equity financing – debt financing that gives the lender the rights to convert to ownership or equity interest if the loan is not paid back in time or in full) to (profitable) SMEs who have tried unsuccessfully to secure

[13] IGF (NISPO III) subject to proportionate Business Case/ EA – assume commences April 2019; same as IGF (NISPO II)
[14] COIF II subject to proportionate Business Case/ EA – assume commences June 2017; similar to COIF I but £2.5m pa
[15] Dev Fund II subject to proportionate Business Case/ EA – assume commences June 2018; similar to Dev. Fund I
[11] Dev Fund II subject to proportionate Business Case/ EA – assume commences June 2018; similar to Dev Fund I

bank finance. The Loan Fund does not seek security but interest rates are higher than bank rates.

1.5 Conclusions and Recommendations

- We recommend that ERDF funding is used to support the five funds set out in section 8 and to the value of £110m.The funds provide value add as they will be additional to the baseline supports and they have been tailored to the market failures which exist for companies at each stage in their development. They also provide the mechanism for leveraging, accessing private sector investment and sharing risks with the private sector. They also provide the opportunity to build awareness and capacity of local companies to access alternative forms of finance to bank finance and also to access experienced fund managers hence building the capacity of the local VC market. The proposed funds could also complement the grants for research and development which are proposed for inclusion in the draft ERDF Programme, particularly at a seed/ early stage and enable pull through of companies to support the NI economic objectives and targets.

- We recommend that the lessons are learnt from the funds implemented to date and specifically that:
  - Subordination of Venture Capital Loan Funds (VCLFs) for SMEs is essential
  - Providing funds based on specific stages of company development is effective, rather than taking a sector based approach
  - Locally based fund managers are key to ensuring they have access to local business/ university networks to capture deal flow, but that the fund managers need to also have links to wider VCs in order to help access further funding down the line
  - Incentivising Fund Managers to get quality as well as quantity targets, is important to long term success
- We recommend that a Fund of funds is used to deliver the 5 funds as it provides the delivery option that is least cost for the greatest impact.
- We recommend that the funds' performance is measured quarterly with regard to the output indicators as set out in section 10.2.1.
- We recommend that interim evaluations at a Fund level are completed independently to ensure that the Funds are delivering as planned and/ or any action taken to ensure the targets are delivered.
- We recommend that the performance at a results level is measured as set out in section 10.2.2.
- We recommend that the Ex Ante Assessment should be updated if the market changes and the output and result targets are not being delivered.