DP 65/99-03

FINANCE FOR SMEs IN WALES

Current Supply, Demand and Potential New Schemes

INDEX

1. EXECUTIVE SUMMARY

1.1 Economic Context

1.1.1 The economy of Wales has undergone a major transformation particularly in the last 20 years moving away from dependence on coal and steel to a more diversified industrial base. Much of this diversification has been achieved, with the aid of public sector support, through inward investment.

1.1.2 Despite its many successes the Welsh economy has a number of structural problems one of the most important of which is an underdeveloped indigenous SME sector. Government policy is to encourage the expansion and growth of a vibrant SME sector a pre-requisite for which is appropriate and comprehensive supplies of finance.

1.2 Background

1.2.1 This report has been compiled at the request of the European Commission to assist in the assessment of applications for ERDF support under Priority 3 Measure 3 (Direct Investment in SMEs) of the Single Programming Document (SPD) for Industrial South Wales (ISW).

1.2.2 The aim of the report is to set out the current position with regard to the supply of and demand for finance, highlight areas where funding gaps exist and to set a framework within which potential solutions may be implemented. It is not the function of this report to provide a critique of individual schemes which are currently seeking ERDF support. However, the report will provide criteria against which potential schemes can be assessed.

1.2.3 The report is written in the context of the private sector addressing the vast majority of business finance needs. The aim of the report is to identify viable funding gaps as opposed to those that exist because they can not be viably addressed.

1.2.4 The decision has been taken to focus on finance that is, or could be, provided on broadly commercial terms and not subsidised or grant finance mechanisms.

1.3 Current Supply of Finance

1.3.1 The private sector provides the vast majority of business finance in Wales. This ranges from low risk/low return secured lending to high risk/high return venture capital. Appendix 2 sets out the current suppliers of finance by type.

1.3.2 There appears to be no meaningful gap in the provision of secured lending.

1.3.3 The supply of finance is skewed towards low risk/low return products with fewer suppliers, and possible funding gaps, as the spectrum shifts towards high risk/high return. This is exacerbated at lower levels of investment.

1.3.4 The Government's Small Firms Loan Guarantee Scheme (SFLG) is a valuable source of funding for SMEs with a lack of security for debt mechanisms. However, its coverage appears to be incomplete and the take up in Wales is lower than other areas.

1.3.5 The most significant areas of potential funding gaps appear to be in the provision of small scale risk capital, risk capital for technology based businesses and partly secured/secondary debt.

1.4 Demand for Finance

1.4.1 Much of the unsatisfied demand for capital, as expressed in funding gaps, exists because its satisfaction is not commercially viable.

1.4.2 There are two types of funding gap; perceived and real. The real funding gap is represented by proposals which are commercially viable but, nevertheless, unable to attract funding. This is likely to be a small proportion of the perceived funding gap.

1.4.3 The conclusions of the reports contained in Appendix 3 and the majority view of the Mapping Study Group is that viable funding gaps do exist. However, it is important that any measures to increase the supply of finance are complemented by measures to increase the supply and quality of potential investment proposals.

1.5 Conclusions and Recommendations

1.5.1 The analysis of existing supply and demand and the evidence provided by the research referred to in Appendix 3 leads to the conclusion that finance for SMEs would be significantly enhanced if schemes were implemented the following areas:

Direct Investment Mechanisms

1. Small scale risk capital including unsecured loans and equity, particularly for early stage SMEs.

2. Risk capital for technology based businesses.

3. Subordinated risk finance - mezzanine loans.

Support Mechanisms

1. Measures to address the quality and quantity of investment opportunities.

1.5.2 Any proposed direct investment or support initiatives must be able to demonstrate certain minimum criteria based on thorough research and sound practice.

1.5.3 The broader issue of improving general management is important in contributing to the overall success of SMEs and therefore their ability to attract finance.

1.5.4 There is a case for establishing an advisory panel drawn from public and private sector organisations to oversee the development of new finance initiatives.

2. ECONOMIC CONTEXT

2.1 Wales is a small country (population < 3 million: GDP around ECU 35 billion) at the western periphery of Europe. Its history has been closely intertwined with that of its neighbours within the British Isles. Economically it has throughout modern times been full integrated within the UK economy.

2.2 In early history is topography and remoteness from the European mainland made it a haven for those evading successive invasions: in more recent times those same features have impeded its ability to share fully in the growing prosperity of the southern England/northern Europe belt. To this day it remains very unevenly populated and industrialised. The majority of the population is to be found along the southern and northern coast-lines with a preponderance towards the eastern border in each case. Much of the centre of the country, and to a degree the south-west and north-west, is sparsely populated and heavily dependent on agriculture (predominantly of a precarious, upland type) and tourism. 80% of Wales is rural.

2.3 Despite these natural disadvantages Wales has enjoyed a period of very significant economic prosperity from the industrial revolution until the second world war based on the exploitation of its natural mineral resources; iron and coal. The post war period has been marked by the declining importance of those industries and, particularly since the 1970's by increasing public sector efforts to arrest this decline and restructure the economy through such organisations as the Welsh Development Agency.

2.4 Recent public sector policy can be divided conveniently into two main themes:

- The first theme was at its peak in the 1970s and was aimed at the immediate problem of finding new employment. In the 60s and 70s Wales was taking very severe blows to its traditional industries. This led to traumatic job losses and the priority was to replace those jobs (many of which were well paid, "male", jobs in industries which called for considerable skill and discipline) as comprehensively as possible. That could only be done by attracting "ready made" solutions in the form of large inward investment projects usually of a manufacturing kind. Public sector effort therefore focused on land clearance and reclamation; the provision of grants related to job creation/safeguarding; the provision, often speculatively, of factory space; and the improvement of road and rail links to the industrial heartlands in the north and south.

- The second theme, which continues to grow in importance, addresses the longer term issues of developing prosperity and employment into the next century. It focuses on embedding the inward investors into the economy; at expanding indigenous firms; at spreading prosperity throughout Wales; at exploring new electronic working methods which will obviate the disadvantages of peripherality; and of developing skills (and thus moving employment up the skills/pay spectrum).

2.5 On assuming office in May 1997 the current Government conducted an audit of the Welsh economy. This confirmed the views it had formed when in Opposition. Its views were published in a consultation document "An Economic Strategy for Wales" (Appendix 4) published in October 1997 with comments sought by 20 December 1997. An action plan will be produced early in 1998.

2.6 The Government's view is that Wales' economy has some strong points (eg the world-beating steel plants) and whilst it is to be congratulated on surviving the collapse of its traditional industries, its singular economic history and its natural disadvantages leave it with a string of significant problems which must now be addressed. These include:

a) the branch plant syndrome

as a producer of raw materials under nationalised industries, and more recently as the manufacturing base for international companies, Wales has grown used to producing goods/materials on time and to specified standard. But is has little experience in the "headquarters" functions - design, marketing, strategic planning, research. This shows itself in the structure of the economy which is strong on manufacturing but weak on the high skill services (eg the financial sector). Arguably it also shows itself in a weak tradition of entrepreneurialism.

b) high economic inactivity rates

although unemployment is falling and is in touch with the GB average (5.9% seasonally adjusted cf 5.2% at October 1997) Wales has far fewer of its working age population in the workforce. This appears to be due to a high level of limiting long term sickness - a phenomenon spread throughout the age groups and so not simply a legacy of the heavy industries of the past. Thus although productivity per worker in Wales is unremarkable, total

GDP (because there are fewer workers to generate it) has remained stubbornly at around 4/5ths of the UK average for the last two decades.

c) low education/training levels

d) uneven economic development

the reliance on inward investment has meant that the eastern parts of the country (which inward investors prefer) have benefited from the bulk of new activity. The potential of west and central Wales has not been fully realised.

2.7 Against this background The Economic Strategy for Wales (Appendix 4) underlines the fundamental importance of SMEs to the development of the economy in Wales. Greater emphasis will be given to the development of indigenous SMEs particularly those with high growth potential.

2.8 The Economic Strategy for Wales makes specific reference to the importance of finance to the development of SMEs. It states that despite a wide variety of funding sources there remains concern that some elements of the market are not well served. In particular it suggests that it may be difficult for smaller businesses to obtain finance if:

- It is newly established.
- Its product or service is experimental, unproven or involves new technology.
- It is seeking equity finance of less than £250,000.

2.9 The Economic Strategy Paper states that the Welsh Office and WDA will consider whether funding for business start ups can be refocused and to work to improve access to equity finance for high calibre SMEs, particularly those exploiting new technology.

3. BACKGROUND

3.1 This report has been produced at the request of the European Commission to establish the current status of finance for SMEs in Wales.

3.2 The aim of the report is to set out the current position with regard to the supply of and demand for finance, highlight areas where funding gaps exist and to set a framework within which potential solutions may be implemented. It is not the function of this report to provide a critique of individual schemes which are currently seeking ERDF support. However, the report will provide the context and a set of criteria against which potential schemes can be assessed.

3.3 The Commission will be able to draw on the information provided in this report in its assessment of applications for European Regional Development Fund (ERDF) support under Priority 3 Measure 3 (Direct Investment in SMEs) under the Single Programming Document (SPD).

3.4 This report has been compiled by the Welsh Office following a series of discussions with a wide range of organisations both public and private (The Mapping Study Group). In addition, the subject matter has been extensively researched and published in reports both at a UK national level and within Wales. A list of these reports and summaries from each are contained in Appendix 3 and provide further detailed information. This report represents the majority view of the participating organisations but is not a policy statement by all or each of them.

3.5 The context in which this report is produced is that the private sector provides the vast majority of business finance. The existence of gaps in the provision of finance will therefore most likely be because of one of the following:

- Market failure or inefficiency.
- Lack of commercial viability.

3.6 The biggest challenge in analysing the possible existence of funding gaps is in identifying whether that gap exists because of market failure or lack of commercial viability in investment proposals. Where a funding gap is concluded to exist because of lack of commercial viability the assumption is that no action will be recommended.

3.7 This report on the provision of finance on broadly commercial terms as opposed to subsidised or grant investment mechanisms. Whilst proposed schemes may require ERDF to support their overall activities this does not mean that investments in individual SMEs must be on subsidised terms or in the form of a grant. The basis for this approach is that:

- The fundamental issue addressed by this Mapping Study is the identification of viable funding gaps. Where these exist, it is assumed they should be filled by broadly commercial investment mechanisms. If it is subsequently decided that subsidised or grant finance is desirable then these could be devised for the identified gaps.
- It is likely to be easier to attract private sector funds, upon which any proposals will rely, to schemes which provide finance on broadly commercial terms.
- The analysis of market failure or inefficiency is complicated by measures which distort that market through subsidy.

- Providing finance on a subsidised or grant basis is a policy issue outside the scope of this report.

4. CURRENT SUPPLY OF FINANCE

4.1 In the majority of circumstances the private sector adequately supplies finance to meet the investment requirements of SMEs. The provision of finance and the existence of funding gaps may also vary with economic cycles. However, given the complexity in adding economic cycles to the variables considered, it has been decided not to address this issue and restrict the analysis to the present position.

4.2 Commercial finance is provided on the fundamental economic premise that potential returns must be commensurate with inherent risks. That is, the lower the risk associated with a proposal, the lower the cost and vice versa. Appendix 2 provides an analysis of current supply by provider, across a spectrum ranging from low risk/low return to high risk/high return.

4.3 The Mapping Study Group concluded that there is very little, if any, market failure or inefficiency in the provision of secured (low risk/low return) lending. This sector of the market is highly competitive and yields relatively low margins for suppliers.

4.4 However, it is equally clear, as presented in Appendix 2, that there is a general correlation between a rise in risk and a fall in the number of suppliers of such finance. In addition, in the case of risk finance, there also appears to be fewer suppliers the smaller the amount of investment. This could be because of sound commercial reasons; a point which is explored further in Section 5.

4.5 The discussions of the Mapping Study Group and the analysis of the published material on the subject led to the conclusion that the focus of this report should be upon risk finance. Furthermore, the most fertile ground for investigation, appears to be small scale risk finance which is of most relevance to SMEs.

4.6 The Small Firms Loan Guarantee Scheme (SFLG) exists to support SMEs who are unable to attract secured lending because of a lack of security. To overcome this problem, the Government provides a guarantee to lenders of between 70%-80% of a loan. The scheme is administered through the main Banks and the investment decision is based on their normal lending criteria. Therefore, from the Bank's perspective the loan is much the same as any other secured loan with corresponding low margins. However, the loan nevertheless involves risk (to the Government).

4.7 The SFLG should supply a very high proportion of small scale risk lending (that is where conventional security is not available). However, supply may not be as complete as required and the take up in Wales in proportionately lower than in other parts of the UK. In recent reports by The Bank of England and the report by Ernst and Young on Small Loans Funds (Appendix 3) some of the reasons for this were highlighted:

- Provision of a loan is dependent on the knowledge and co-operation of individual branch managers. It seems clear that some managers are more disposed to the scheme than others, resulting in inconsistent supply.
- The SFLG gained a poor reputation amongst Banks during its early years when it was used for unsuitable propositions.

- There are circumstances where a loan is not suitable for small scale risk propositions. For example, technology based companies may need investment mechanisms which reflect their performance and revenue streams. A scheduled loan requires a predictable cash flow which is not always possible in new product development.

4.8 The SFLG is currently undergoing a review of its scope and focus and it may be that greater emphasis will be given to technology based businesses if the scheme is revised.

4.9 Secured lending is the core business of the main Banks which, with the exception of associate companies, do not provide risk finance. Moreover, if a lack of security is the only reason why a proposal can not be progresses then the SFLG should provide a solution. Institutional risk finance is almost exclusively provided by specialist organisations.

4.10 The UK has the most mature venture capital market in Europe and there are many suppliers of such finance. However, of the major organisations only one, 3i Plc, has an office in Wales. Other smaller providers based in Wales include British Steel (Industry), The Midland Enterprise Fund and the WDA.

4.11 Risk finance can take many forms and be provided at many levels. However, according to statistics provided by the British Venture Capital Association (BVCA) the majority (over 80%) is aimed at large management buy out deals. A minority is aimed at smaller deals, start up companies and high technology businesses.

4.12 It is apparent that there are fewer suppliers of small scale risk finance, partly secured loans and risk finance for technology based businesses. Even where there may be one or two suppliers operating on an occasional basis this does not reflect the true level of viable demand. In addition, it is not satisfactory to have such low levels of supply in a given sector.

4.13 The evidence provided by the published reports in Appendix 3 and the majority view of the Mapping Study Group is that there is inadequate supply of certain types of finance. This is predominantly in the areas of small scale risk finance, particularly for early stage SMEs and finance for technology based businesses.

5. DEMAND FOR FINANCE

5.1 It is difficult to draw meaningful conclusions regarding possible funding gaps from an analysis of demand. By its very nature, demand for finance is virtually unlimited and, in addition, that demand will be for finance on as favourable terms as possible. Businesses will demand the lowest cost finance unencumbered by security considerations.

5.2 However, it is equally true that demand alone is no indication that finance can be supplied on a viable basis. Funding gaps will always exist where viability is questionable. In practice, many funding gaps exist because of fundamental commercial factors. Unfulfilled demand, therefore, can not be assumed to indicate market failure.

5.3 There are two distinct types of funding gaps:

- **The Perceived Funding Gap** - This occurs where a business is unable to raise a particular form of finance because its viability is questionable. Even in the absence of any market failure, this gap will remain and will be a constant source of frustration for those who find themselves in it.
- **The Real Funding Gap** - It is likely that the real gap in the provision of finance is small in comparison to the perceived gap.

5.4 It seems reasonable to assume that the real gap in the provision of secured finance is very small indeed given the number of suppliers in this sector, the high level of competition and the relatively small margins earned by providers.

5.5 The most commonly expressed source of unfulfilled demand is in the area of risk finance; the so called "equity gap". Once again the same principles of perceived and real equity gaps exist. However, the provision of risk finance is further complicated by the commercial reality that risk finance can be provided only if potential returns are commensurate with risk. The perceived equity gap will be more acute in this sector because much of the demand will be unable to offer the prospect of appropriate returns to finance providers. This is usually because of a combination of the following:

- **High Failure rates** - Potential returns must be commensurate with risk. Failure rates are highest among smaller and early stage SMEs and those who have products or services which are unproven in the market place.
- **Low growth potential and ambition** - To achieve the returns necessary to justify a risk investment, most companies will need to be able to demonstrate the ability to achieve significant and sustained growth. Many SMEs are limited by low growth markets, localised sales, exposure to economic cycles and lack of ambition.
- **High investment costs** - The assessment of risk propositions is expensive because it necessitates a sophisticated analysis of the potential of a proposition. In addition, these investments will require close monitoring which again tends to rise disproportionately where management teams are small or inexperienced. These are effectively a cost of capital to the finance provider which must be recouped.
- **Lack of management expertise or track record**- The exploitation of a business idea depends on management qualities which many companies lack. Having a good idea or novel technology is very rarely enough in itself. In some circumstances a Company may have a capable management team but not a track record to prove it.

- **Lack of appropriate exit routes** - The nature of risk investments is that their repayment is dependent, in a large measure, on the relative success of the business. Equity investments are one method of achieving this. However, taking a share in a business will only yield a return where that share can be sold at a significant capital gain. Achieving such a sale within the foreseeable future may be difficult, particularly for SMEs. Other mechanisms can be used which generate above average returns. These can include unsecured lending at high interest rates, sales royalties and preference share structures. However, these presuppose that a business is capable of generating substantial excess profits which can be extracted from the business on a regular basis. Few businesses can sustain these payments at a high level and many require their cash resources to achieve growth.

5.6 It is clear, both from the discussions of the Mapping Study Group and the conclusions of the reports referred to in Appendix 3, that viable gaps do exist in the current provision of risk capital.

5.7 This topic has been extensively researched both at a UK national level and in Wales. The Bank of England reports highlighted the problems of raising small scale risk capital, especially for technology based businesses. The Innovation Partnership report concluded that "there is a gap in the market for a fund which will look at the £150k- £750k range and which will seriously consider technology". The Ernst and Young report on a small loans fund concluded that "On the basis of independent research and discussions with banks and financial intermediaries there is a need for a loan scheme, showing equity characteristics, to support smaller companies."

5.8 Defining the precise size of the of the real equity gap is difficult. The reports on the market in Wales have given estimates for the potential in individual sectors for example the Ernst and Young report estimates that the viable funding gap in ISW for small loans may be 80 - 100 cases a year and the Innovation Partnership report estimates the number of viable new venture capital deals to be 4-5 per annum. However, it must also be recognised that the implementing new funds and support initiatives is likely to stimulate the market, improving the quality and numbers of viable deals. This is for the following reasons:

- New Funds and support initiatives will highlight activity in this sector.
- By raising the profile of risk finance as a potential funding opportunity for SMEs.
- Any increase in competition will force funds to promote themselves more aggressively and seek out potential opportunities. In addition, they may be more likely to support underdeveloped proposals rather than only considering fully developed and packaged opportunities.

5.9 The majority view of the Mapping Study Group and the conclusions of the research indicate that funding gaps exist in the following forms of finance. In many of these sectors, the gaps may be relatively modest but, nevertheless, economically significant:

1. Small scale risk capital including unsecured loans and equity, particularly for early stage SMEs.
2. Risk capital for technology based businesses.
3. Subordinated risk finance - mezzanine loans. The Mapping Study Group believes that further research in this area would contribute to a detailed understanding of the potential requirements.

5.10 It was also concluded that the successful provision of risk finance in the above sectors is dependent on adequate support initiatives. These should not only encourage businesses to consider risk finance as a funding option but also improve the quality and supply of investment proposals. The latter is not an issue of presentation, it is one of ensuring that the fundamental weaknesses in many proposals, that either prevent them from raising risk capital or contribute to their failure, are addressed. It is important that the rate of quality deal flow is improved and failure rates decreased.

6. CONCLUSIONS AND RECOMMENDATIONS

6.1 The growth of the indigenous SME base in Wales is fundamental to the development of the economy of Wales. This is accepted by Government and is a priority for economic development organisations. Appropriate and comprehensive sources of finance are a pre-requisite for the successful expansion of this SME base and it is, therefore, imperative that where viable funding gaps in the provision of finance are identified they should be filled.

6.2 The analysis of existing supply and demand and the evidence provided by the research referred to in Appendix 3 leads to the conclusion that the supply of finance to SMEs would be significantly enhanced if schemes were implemented the following areas:

Direct Investment Mechanisms

1. Small scale risk capital including unsecured loans and equity particularly to early stage SMEs.

2. Risk capital for technology based businesses.

3. Subordinated risk finance - mezzanine loans.

Support Mechanisms

Measures to address the quality and quantity of investment opportunities, including:

1. Mentoring and non executive director schemes.

2. Schemes which support previous "near miss" applicants for venture capital.

3. Incubator Units.

4. Subsidised due diligence and post investment monitoring schemes.

5. Education initiatives to encourage companies to consider equity capital.

These are analysed in further detail as follows:

Direct Investment Mechanisms

6.3 There currently exists market failure in specific areas of direct investment provision. Notwithstanding this, it is apparent that those gaps exist where (and probably because) the provision of such finance faces considerable challenges. The reality is that operating in these sectors involves risk and that, unless proposed schemes are effectively organised and clearly targeted, there is the potential for significant losses. It is proposed, therefore, that all prospective schemes must be able to demonstrate the following characteristics:

- Quality fund management with relevant experience.
- Private sector involvement.
- Clear objectives based on research of the target market.
- Operated with a commercial focus. It is important that investment schemes are operated under broadly commercial criteria. Any investment scheme which accepts overall losses on its portfolio as inevitable, is likely to achieve precisely that.
- Support of the economic development infrastructure. Schemes must demonstrate a capability to maximise the assistance available from the support infrastructure.
- Commitment to aftercare. Schemes must provide quality post investment advice and support, either directly or through other support infrastructure.
- Commitment to and awareness of the necessity to impose rigorous selection criteria in identifying quality proposals.
- Realistic assessment of and targets for likely deal flow. Any proposed scheme which is over optimistic in its assessment of likely deal flow will face pressure to invest in unsuitable proposals.

- Critical mass. Small sub regional funds are likely to face considerable challenges in meeting many of the above criteria.
- Complements other schemes.

6.4 Small scale risk capital

The conclusion of the Mapping Study Group, supported by the reports referred to in Appendix 3, is that an equity gap exists in the provision of small scale risk finance up to approximately £250,000, particularly for early stage SMEs. However, there are a number of important qualifying factors in this conclusion:

- The majority of the equity gap, as expressed in demand for such finance, is represented by a perceived equity gap.
- The real equity gap does exist but the number of proposals is likely to be modest in comparison to the business finance market as a whole. Nevertheless, substantial benefit to the economy will be gained from funding viable proposals which otherwise would be unable to proceed. Moreover, many proposals in the real equity gap will be capable of rapid growth and becoming significant companies. This may be especially true of technology based businesses.
- There are already providers in this sector such as British Steel Industry, The Midland Enterprise Fund, WDA and Business Angels. However, this coverage is not complete and does not represent the totality of viable proposals.

There is therefore the potential to establish a scheme in this sector. The emphasis should be upon flexible funding packages which may include equity and debt targeted primarily at early stage SMEs.

6.5 Risk capital for technology based businesses

There is compelling evidence as concluded in the Innovation Partnership, Bank of England and Regional Technology Plan Reports (Appendix 3) that technology based businesses face additional challenges in sourcing appropriate finance. These companies are often high risk start ups but with the added uncertainties of unproven technology and emerging markets.

Many venture capital organisations avoid technology based businesses and, therefore, in this sector the equity gap may extend as far as sums up to £1 million.

A scheme is required which provides risk capital for such companies which is capable of providing start up and development capital to at least £750,000 for successful cases.

6.6 Subordinated risk finance - mezzanine loans

The Mapping Study Group believe that many larger, successful SMEs would benefit from the provision of a subordinated debt fund. However, there is a need to undertake further detailed research in this area to validate this view.

Mezzanine finance is occasionally and informally provided to such companies by the main Banks. That is, Banks will provide debt to larger SMEs where they are not fully secured based on an assessment of the overall strength of the business and its cash flow. However, this provision is incomplete.

A mezzanine loan fund specifically aimed at larger established SMEs would assist them in undertaking particular projects. For example such project finance in the form of secondary debt could finance major new orders, possibly from inward investors.

Support Mechanisms

6.7 A general consensus has emerged that appropriate support mechanisms are vital in improving the quality and quantity of viable proposals and in contributing to their subsequent success. It is imperative that support mechanisms exist which address the reasons why companies are unable to raise finance and which support their subsequent growth.

6.8 The quality of such support services would be greatly enhanced if the involvement of the private sector is maximised. The experience of, for example, Xenos, the Wales Business Angle Network, has demonstrated the substantial value of involving senior personnel from private sector business service providers and companies in the inception and implementation of such initiatives.

6.9 Such support mechanisms must be focused on the classic limitations of many SMEs as identified in section 4:

- High Failure rates
- Low growth potential
- High investment costs
- Lack of management expertise
- Lack of appropriate exit routes

6.10 Clearly, it is not possible to eradicate the above and the aim of any direct investment schemes must be to avoid proposals which are irreversibly limited by the above. However, there are cases, particularly for companies in the equity gap, where effective support mechanisms could rectify some of these problems, providing they are not too entrenched. The focus of any such support mechanisms should be on targeting those cases which are potentially fundable but which are hampered by specific weaknesses. Many companies, particularly those that are growing quickly, experience periods in their development during which they need specific and intensive support.

6.11 The existing economic development infrastructure must be fully utilised. However, there are examples of possible support mechanisms which are either not currently provided or which could be provided on a wider basis:

- Mentoring and non executive director schemes.
- Schemes which support previous "near miss" applicants for venture capital.
- Incubator Units.
- Subsidised due diligence and post investment monitoring schemes.
- Awareness initiatives to encourage companies to consider equity capital.

6.12 As with the direct investment schemes, any proposed support mechanisms must be of the highest quality and demonstrate the following:

- Quality management with relevant experience.
- Private sector involvement both from business service organisations and companies.
- The support of the economic development infrastructure.
- Clear objectives based on research of the target market.

- Strong links with finance organisations.

6.13 It is clear that some of the limitations displayed by SMEs do not solely impact on their ability to raise finance. Many are relevant to the fundamental growth potential of SMEs and, therefore, initiatives in the general area of management development will also influence, indirectly, their ability to raise finance. Such management development initiatives are outside the scope of this report. However, suffice to say that general management development programmes, such as, for example, the Gwent TEC Elite and North Wales TEC Enterprise Cells programmes, will have a positive benefit on the ability of Companies to raise finance. Such schemes could be expanded and finance organisations should be encouraged to refer the management teams of potential investment cases to such programmes.

6.14 Any proposed new schemes may be able to take advantage of support offered by UK national and EU sources; for example programmes organised by the UK Department of Training and Industry (DTI) such as Biotechnology Means Business, the ITEC initiative of the European Commission and guarantees offered by the European Investment Fund. In addition, new programmes are being developed by these bodies which may be relevant in the future.

6.15 The provision of finance to SMEs is a complicated, diverse and controversial issue. Appropriate sources of finance are fundamental to the survival and growth of SMEs and in turn the economic balance and well being of the Welsh economy. However, ensuring the provision of such finance, and supporting this with public funds, is full of pitfalls. Unless schemes are well managed, based on thorough research and closely targeted there is the

potential that truly additional economic benefits may not ensue and that losses could be incurred.

6.16 The Mapping Study has drawn on the collective view of a broad range of organisations in Wales, in addition to the considerable published research. There may be an argument for establishing a structure that will assess and co-ordinate future finance scheme proposals, monitor progress and avoid duplication in provision. An advisory panel could be drawn from existing organisations, both public and private sector, with a remit to oversee activity in this area.

APPENDIX 1.

Mapping Study Participants

The following individuals represented their organisations at one or more of the mapping study meetings.

Individual	Organisation
Russel Arroyo	West Wales TEC
Jean Blamire	European Affairs Dept. Welsh Office
Sue Camper	Bank of England
Richard Coppock	Ernst & Young
Alasdair Denton	WDA
David Notley	WDA
Jonanthan Fogg	British Steel (Industry)
Bernard Humphreys	Lloyds Bank
Ray Hurcombe	Xenos Business Angel Network
Philip Kerkin	Midland Bank
John Kilner	Welsh Office
Ron Loveland	Welsh Office
Bob Jones	Welsh Office
Greg Kaminaris	Neath Port Talbot Business Connect
Mike Phelps	Economics Division Welsh Office
James Bowler	Economics Division Welsh Office
Charles Sammons	North Wales Business Connect
Richard Weston	NatWest Bank
Victoria Winkler	Welsh Local Government Association
Paul Roberts	Welsh Local Government Association
Richard Harbottle	Wales Fund Managers

The following received papers:

Elizabeth Haywood	CBI
Rudi Plaut	CBI

The following were invited to comment on the draft report:

Tim Beddoe	Wales Tourist Board
J. Fraser	Bank of Wales
Martin Gush	Barclays Bank
Gwynant Roberts	WDA North Wales
Gareth Jones	WDA West Wales
Sian Lloyd Jones	Development Board for Rural Wales

APPENDIX 2.

Current Supply of Finance by Type

Profiles have been drawn up of the current supply of finance by major type. These are not intended to be exhaustive, particularly in the most competitive sectors.

1. Secured Lending

Notes: This is by far the largest sector in the market. Secured lending may take the form of term debt or Bank overdraft and is used for a wide variety of purposes. Overdraft has, in recent years, been declining as a funding tool as the Banks now predominantly restrict its use to working capital requirements.

Asset finance in the form of hire purchase or lease finance is also included in this section.

It has been concluded that there is currently very few, if any, measurable, gaps in the provision of secured lending. However, it is recognised that this may be influenced by the stage of the economic cycle and could be subject to change.

The list of providers is dominated by the main clearing Banks for term debt as well as specialist asset finance companies, both subsidiaries of the main Banks and independent organisations. There are many other sources of secured lending based outside Wales.

Investment ranges: £1k - £unlimited for practical purposes

Suppliers:

National Westminster Bank
Barclays Bank
Midland Bank
Lloyds Bank
Co-Operative Bank
Bank of Wales
Royal Bank of Scotland
Chemical Bank
Bank of Ireland
Allied Irish Bank
Coutts Bank
N.M. Rothschild
Julian Hodge Bank
Unity Trust Bank
Lombard North Central
NWS Bank
Standard Chartered Bank

2. Working Capital Finance

Notes: Financial products such as factoring and invoice discounting are becoming increasingly important as a means of financing working capital requirements. All of the main clearing banks have subsidiaries operating in this sector as well as a number of independent specialist suppliers. This finance is effectively fully secured against book debts.

Investment Ranges: £1k - £unlimited for practical purposes.

Suppliers:

The main clearing Banks
Kellock
Arbuthnott Commercial Finance
TransAmercia
Alex Lawrie
Venture Factors
Trade Indemnity Heller
UCB invoice discounting
International Factors

3. The Loan Guarantee Scheme

Notes: The LGS is effectively an extension of the Bank's normal secured lending but with a guarantee from the government where security is not available. The decision to invest is based on the Bank's normal lending criteria.

Investment Ranges: £1k - £200k

Suppliers:

The main clearing Banks
Bank of Scotland
3i.

4. Mezzanine Finance

Notes: Mezzanine finance is debt which ranks behind other secured lenders and may not be fully secured, therefore involving risk. A premium rate of interest is charged to compensate for this added risk. This type of finance is usually restricted to large sums and large companies. The main clearing Banks are providers as well as specialist merchant banks. With the exception of N.M. Rothschild, the merchant Banks do not have offices in Wales, although some do have clients in the Principality.

The main clearing Banks may also provide smaller partly secured finance where they have a client of an appropriate size, track record and cash flow. However, it is not widely promoted or a specific product in their portfolios.

Investment Ranges: £500k +

Suppliers:

The main clearing Banks
N. M. Rothschild
Singer and Friedlander
Arbuthnott
Guinness Mahon
ING Baring
Morgan Grenfell

5. Equity/Risk Finance

Notes: Equity and risk finance can take many forms and is used for a broad spectrum of activities. The table below summarises existing provision. In the case of large scale equity, the UK is one of the most developed markets in Europe. Because of the specialist nature of such finance, providers do not always have a base in Wales.

The range of products for each provider has been restricted to their most common activities. Some providers have a capability to undertake certain types of investments but may rarely utilise this in Wales. Funds which have very restricted geographic coverage, such as the BP Llandarcy Fund, have not been included.

Business Angel investment is an emerging sector in business finance. The Xenos Business Angel Network in Wales has recently been established with ERDF support. However, because this funding relies on the numbers and preferences of individuals, it is difficult to predict, or indeed control, where its focus will be.

The role of grant aid is important in this sector because its specific aim is to address funding gaps.

Relative levels of activity in Wales are indicated as follows:

√ √ - strong presence
√ - occasional activity

Provider	Investment Ranges	Financial Product	Deal Type				
			Start ups	Early stage	Development	MBO/ acquisition	Technology
3i Plc	£250k+	equity and debt	√	√	√√	√√	
WDA	£50k - £150k	equity and debt	√	√	√		√
BS(I)	£10k -£100k	equity and debt	√	√	√√	√	
Wales Fund Managers	£75k -£150k	equity			√√	√	
City based venture funds	£500k +	equity and debt			√√	√√	
Celtic House	£250k +	equity					√
Business Angels	£10k +	equity and debt		√	√√	√	√
Smart/Spur grants	£10k -150k		√√	√√			√√

APPENDIX 3.

Bibliography

The following reports were used as background research to the Mapping study. They have been referred to in the body of the text where their conclusions or observations were felt to be pertinent. A summary has been included for each and copies of the full reports are available on request.

Source	Report
Bank of England	The Financing of Technology Based Small Firms
Bank of England	Finance for Small Firms
Innovation Partnership	The Establishment of a New Venture Fund in Wales
Ernst and Young	Access to Capital Initiative
Ernst and Young	Small Loans Fund
Regional Technology Plan Consortium	Regional Technology Plan

APPENDIX 4.

An Economic Strategy For Wales.
A Welsh Office Consultation Document.