Economy, Energy and Fair Work Committee

Scottish Enterprise: Scottish Investment Bank Information Paper

Introduction

Views on a proposed national long-term investment bank are being sought by the Economy, Energy and Fair Work Committee as part of their scrutiny of the Scottish National Investment Bank (SNIB) Bill. The Bill was introduced to Holyrood on 27th February and will grant the powers required to establish the bank. SNIB will build on the success of operations and initiatives currently underway including consolidating the investment arm of Scottish Enterprise (SE), the Scottish Investment Bank (SIB) into the Bank. This information paper provides background on the current focus and operational activity of SIB.

1. Background

Since 2003, the SE investment function, with the introduction of the Scottish Co-Investment Fund has evolved in response to evidence of market failure and gaps in the market that limit the amount and types of growth finance available to Scottish SMEs. SIB, created in 2010, is the investment arm of SE, and operates Scotland-wide in partnership with Highlands and Islands Enterprise (HIE).

The availability of appropriate capital is critical to a successful entrepreneurial ecosystem to support the creation and development of internationally focused firms with the potential to scale. The ambition is to support the creation of a growing pipeline of ambitious companies, helping more to scale, raise the finance they need and to increase the capacity of the market to provide appropriate growth finance. Equity and debt finance is important for Scotland’s SMEs who make up 99% of the business population, accounting for 60% of private sector employment and contributing 50% of annual turnover in the private sector (49% of GDP).

SIB directly manages funds, participates, alongside other investors, in private sector managed funds and delivers innovation investment models. SIB manages a portfolio of investments (circa 280 companies) and has a team of financial readiness specialists that guide and support companies to raise appropriate finance.

All funds are operated on a fully commercial basis, under the Market Economy Operator Principle (MEOP), to ensure compliance with state aid. This means that investments are made in a way that would be acceptable to a private investor, with SIB sharing the same upside and downside risks and rewards.

SIB only invests where there is a funding gap, meaning investment is within the highest subset of a risk market. The outcomes and impacts of SIB investment activity (including financial and economic performance) reflect this investment remit and approach.

Once invested, SIB plays an active role in follow on investment activity, whilst balancing provision of gap funding with MEOP considerations. Whilst there will be
Scottish Enterprise: Scottish Investment Bank Information Paper

successful exits which generate strong returns, the counter is exposure to a higher failure rate which determines overall financial performance.

SIB, as part of SE, is subject to SE governance, accountability and performance arrangements. SIB activities and contribution to SE Business Plan performance measures are reflected in the latest SE Annual Report and Accounts (for the year ended 31st March 2018).

Funds that SIB directly manages and participates in are subject to review and independent evaluation, supported by monitoring and evaluation frameworks that track performance and are in place from the outset. SE Evaluations are published and can be accessed via evaluations online.

2. Interventions – Summary

Equity Finance

Equity finance is appropriate for a relatively small cohort of companies; those who are ambitious for growth and who present a higher risk proposition to funders and are therefore unable to access the amounts of growth finance they need from other types of funding providers. These companies are often those with potential to scale and with the capability to exploit international growth opportunities, resulting in a disproportionate contribution to economic growth. SIB interventions in the equity market are based on evidence of gaps and market failures that directly impact on this type of company.

Debt Finance

SIB intervenes in the debt finance market are also based on where there is evidence of gaps that are constraining the growth prospects of Scottish SMEs. All interventions are supported by market evidence of a gap and are positioned not to overlap or compete with existing public and private sector funding provision.

SIB ACTIVITIES OVERVIEW

Scottish Co-Investment Fund (SCF) and Scottish Venture Fund (SVF) - the focus of the equity co-investment funds is to stimulate early stage risk capital investment into high growth potential Scottish companies across a range of sectors, given the strong evidence of a long term, systemic market gap constraining company and economic growth. These funds are private sector investor led, bringing investment to high risk opportunities by sharing the risks and rewards with investors, where there is an investment gap in a deal. SIB can invest up to £1.5m through the SCF alongside accredited investment partners, allowing the investment decision making to be delegated to experienced, known investors. This allows for the streamlining of processes and timelines to encourage the delivery of a high volume of investments while maximising company support. The SVF enables SIB to invest up to £2m per annum alongside a wider range of investors, increasing diversity and reach. The
Scottish Enterprise: Scottish Investment Bank Information Paper

SVF has allowed SIB to engage with international investors with global connections and support other priority areas such as foreign direct investment.

**Energy Investment Fund (EIF)** - previously the Renewable Energy Investment Fund – is a Scottish Government Fund delivered by SIB. EIF is designed to provide flexible investments for energy projects in Scotland that will support Scotland’s transition to a low carbon economy. EIF focuses on accelerating the development of commercial low carbon energy projects and increasing community ownership of energy projects in Scotland (including a focus on community stakes in commercial schemes). A specialist team is in place delivering deal origination, financial readiness services, deal structuring, investment and portfolio management.

**The Scottish-European Growth Co-investment Programme (SECGP)** - supports companies to access scale up finance addressing the lack of available growth capital primarily in the £2m plus area of the market. It is a £200m mechanism to access funding, where £50m of capital commitment from SE (provided by Scottish Government under the Scottish Growth Scheme) is matched by £50m from the European Investment Fund and £100m+ of private sector capital from a range of UK and European Fund Managers supported by the European Investment Fund.

**Scottish Loan Scheme (SLS)** – recently introduced and provides loan funding of £250,000 to £2 million (and up to £5 million in exceptional circumstances) to established and viable companies that have a minimum turnover of £250,000 and an ability to repay the debt. A loan is available for working capital or to invest in facilities or equipment. The terms of the loans are flexible and can be tailored to the specific needs of the company.

**Market Analysis and Stakeholder Engagement** – a dedicated team within SIB is responsible for intelligence gathering, research and analysis of data and reports, including publication of the annual Risk Capital Market Report which monitors and assesses trends within Scotland’s risk capital investment market. This activity supports our understanding of market gaps, information deficiencies or actions needed in the market to support SMEs with funding.

SIB maintains close links with both internal and external stakeholders and plays a policy influencing role such as responding to consultations such as the recent UK Government Patient Capital Review. SIB maintains regular engagement with the British Business Bank (BBB) to understand policy focus, share research and where alignment and partnership working can be improved. Ongoing learning, best practice and benchmarking work is undertaken, with strong mutual relationships developed with other UK and European public-sector investment bodies.

**Investor Relations** – SIB is well connected with investors, locally, nationally and internationally at all stages of development. Targeted activity (such as regular company showcases and investor roadshows) is undertaken to profile Scotland and Scottish investment opportunities, attracting new investors into the Scottish market. SIB works closely with other key players such as SDI and the London Stock Exchange to provide companies with knowledge and access to a variety of growth funding opportunities, utilising Scotland House on a regular basis. The introduction to
a wider range of European fund managers through SEGCP and EIF will create legacy relationships for future years.

**Fund Investment (Third Party Managed)** – SIB has developed new policy responses where market gaps are identified which cannot be supported through existing interventions alone. These have included: setting up and fund raising for the £113m Scottish Loan Fund, providing mezzanine finance for established businesses (now closed to new investments); committing to a £50m life sciences fund securing its base in Scotland (Epidarex Capital II) to stimulate higher levels of early stage funding to one of Scotland’s key sectors; providing financing of £2.75m through a funding model to stimulate growth in a Scottish based Peer 2 Peer lender (LendingCrowd); and, a £20m commitment into Maven Capital Partner’s Regional MBO Fund. This all adds to diversity and choice for companies looking to raise additional finance for growth. All these initiatives have leveraged significant sums of private capital at the respective fund level, maximising the reach of public sector funds.

**Financial Readiness**

SIB has a team of financial readiness specialists that help SMEs to identify their growth funding requirements, and source growth funding from an appropriate funder. In an increasingly complex funding market, the financial readiness service (FR) helps SMEs to prepare to raise finance and works intensively with over 400 companies a year. Businesses that are prepared to take advice are more likely to be successful in raising finance as it increases the chance of them being matched with the most appropriate source of funds. The FR service supports companies to: navigate the complexities of the funding environment, identifying the most appropriate sources of funding; preparing to raise funding; appraising funding options; considering support networks; and, providing introductions to funders. The FR specialists work on varied access to finance issues including cash flow management, restructuring and supporting companies in distress. They play a crucial role identifying appropriate finance options for companies, providing tailored advice and support based on their extensive networks and knowledge of finance providers.

3. **Performance**

**SIB Performance** –. Overview of performance is provided up to end 2017-18 financial year. 2018-19 figures are subject to Audit and will be included in SE Annual Report and Accounts that will be published later in the year.

As the scope of SE Investment activity broadens, the cumulative private sector leverage and financial returns are increasing.

- From 2003 to 2018 total SIB investment has reached £467m.

---

1 Access to Finance Report, BEIS, 2016-17
Scottish Enterprise: Scottish Investment Bank Information Paper

- The private sector leverage attained on the back of this investment has reached £1.4bn or some 3 times SIB investment.
- Over 500 companies have received SIB investment.
- In 2017-2018 SIB:
  - Invested £43.5 million in 147 Scottish companies
  - Leveraged over £206 million of investment (includes REIF)
  - Supported over 500 companies through SIB’s Financial Readiness Service
  - Generated £17.6 million of income from SIB investments
- In 2017-18 SIB had an investment portfolio of 288 companies that supported 3,400 jobs in the Scottish economy and collectively generated annual turnover of over £400m
- SIB portfolio companies also reported £275m of international sales.
- Over the year, SIB worked with 35 investors from beyond Scotland and helped companies secure £105m of international investment.

**Equity Evaluation Evidence**

Evaluation evidence highlights that the Scottish model of co-investing with experienced private sector investors is effective in addressing the equity gap up to £2m.

Without continued co-investment and risk sharing it is unlikely that private sector investors would sustain the current levels of activity, which evidence shows is increasing over the medium term.

For companies seeking larger amounts, typically above £2m, the evidence points to securing this funding (usually from investors based outside Scotland) as also being challenging, with Scottish companies competing with other global opportunities.

Market analysis and evaluation evidence\(^2\) points to SIB activity having had a catalytic, positive influence on increasing both the supply of scarce capital to innovative growth companies and delivering sustainable economic impact.

The evaluations have identified strong benefits to companies from SIB’s support, including increased R&D activity, successful commercialisation, registering of new intellectual property and the development of new products and services. This in turn has delivered turnover growth and entry into new domestic and export markets and increased penetration in existing markets. This has often been associated with employment growth and increased labour productivity.

The evaluations identified high levels of investment additionality, both absolute and scale. There is agreement amongst co-investors that the funds have resulted in more and bigger deals being made in Scotland than would otherwise have been the case.

and that the SIB funds attracted many new and international private sector investors to the Scottish market.

The recent evaluations have been used to estimate the net GVA impact for the companies supported. While impact ratios vary across the funds (based upon the investment stage and the extent of additional investment required from SE), an average impact across the funds has been calculated as 1:6 over a ten-year period, which results in a GVA impact range of £739m up to £1.2Bn.

Many of the companies supported by the funds are pre-revenue, reducing the cumulative GVA impacts, but these companies are adding value to the economy in terms of high value jobs and investment in R&D. The funds also have the added benefit of delivering a financial return to the public purse.

4. Market Context
SIB examines risk capital market trends, with comparisons made to the countries and regions of the UK, as well as to the Republic of Ireland. These trends, together with SE Fund evaluations, are used as evidence to consider the merits of current support, and the potential for new interventions.

Equity
Scotland has a vibrant risk capital market. Over the last 3 years Scottish risk capital investment has exceeded £1bn across almost 1000 deals.

The overall size of the market can be highly variable year-to-year due to the impact of large deals (above £10m) influencing the overall total, but the underlying market is stable and in growth mode. In 2017 the overall market exceeded £500m and was over £300m in 2018. The market has exceeded the £300m annual threshold every year since 2015.

The underlying market (deals below £10m), where 98% of deals are transacted (338 deals from a total of 342 deals for 2018), has grown by over 60% since 2012. (see Figure 1 below).

A strength of the market is the diverse range of investors active in Scotland and over the past 10 years the market has grown three-fold.

Despite a lower level of total equity investment going into companies in 2018, compared to a record breaking 2017, the underlying market (below £10m) remains strong. This is encouraging to see and shows that many companies are successfully securing the funding they need to grow. This reached £243m in 2018, compared to a previous record high of £225m in 2017, which was up from £189m in 2016.

There is a spread of companies securing investment – strengths in Life Science (NuCana and Lamellar), digital (Exerity), food and drink (Loch Duart), and continued development of other key sectors including Renewable Energy (Orbital Marine Power formerly Scotrenewables).

Using the Global Entrepreneurship and Development Index (GEDI) methodology, Scotland’s ecosystem is ranked as the 5th most supportive globally, ahead of all
Scottish Enterprise: Scottish Investment Bank Information Paper

other UK nations (England is 7th) and up from 12h in 2013. (Top 4: US, Australia, Denmark, Sweden)

Compared to the rest of the UK, Scotland has a diversity of active investors and companies seeking investment that contribute to, and is testament to, the strength of the overall business growth ecosystem.

Scotland also benefits from an established business angel market, with over 20 active investor groups. Again, outside London, Scotland has the most active business angel investment market.

Figure 1. Investment (£m) and Number of deals for Scotland’s Risk Capital Market


Debt Finance
Lending is distributed across the UK in line with the overall business population. Around 80% of all debt funding is provided by the main high street banks. In Scotland, this is even more concentrated amongst fewer banks.

The latest Bank of England data\(^3\) indicates that UK Net lending flows are flat amid weak demand and there are some signs of tighter supply.

Take up of alternative finance such as challenger banks and P2P (Peer to Peer) lending is increasing but remains lower in Scotland. The latest SME Finance Monitor 2018\(^4\) reported that application rates fell again in 2018, with 4% of SMEs applying for a new or renewed loan or overdraft facility (down from 5% in 2017 and 11% in 2012).

In 2018, 36% of UK SMEs were using external finance, almost unchanged from 2017 (38%).

80% of SMEs reported that their plans were based on what they could afford themselves and 73% would accept slower growth rather than borrowing to grow faster. Smaller SMEs were more likely to agree with these statements, but there was little variation by other demographics such as age or sector and there has been little change in sentiment over time.

In 2018, 10% of SMEs planned to apply for finance in the next 3 months, continuing a slow decrease from 2012 when 14% planned to apply. The key reasons for planning to apply for finance were to fund UK expansion and/or for working capital to help cash flow and/or for plant and machinery (all mentioned by 26% of those planning to apply).

The share of SMEs holding large credit balances remains high. In 2018, 23% of SMEs held more than £10,000 in credit balances, compared with 16% in 2012. Most SMEs with large credit balances reported less of a need for external finance, and this may be contributing to weak demand.

SME Lending in Scotland has declined from 2014 with a partial recovery during early 2018, that now appears to be running out of steam (see Figure 2 below).

SME Lending for Scotland £Bn (April 2019 release)

\(^3\) [https://www.bankofengland.co.uk/credit-conditions-survey/2019/2019-q1](https://www.bankofengland.co.uk/credit-conditions-survey/2019/2019-q1)

The companies that did not want to apply for external finance gave reasons including too expensive, too much hassle, a fear of losing control of the business, a preference to seek non-bank sources of funding or the current economic climate (reported by significantly more companies than seen before).

**Summary**

Significant impact has been achieved to date in addressing the demand and supply challenges of the Scottish market for risk capital and more recently debt finance. SE activities have helped to develop the market by increasing the available finance options, investor numbers, investment levels, levels of international investment, increasing the profile of SMEs on the international stage and supporting more SMEs to access finance and implement growth. Collaboration and partnership working is at the forefront of the approach taken. The innovative co-investment model is based on sharing risk and reward with the private sector and aligning objectives to improve the growth prospects of Scottish SMEs.

However, it is recognised that even more needs to be done in an increasingly uncertain economic environment. The integration of SIB into SNIB and alignment between SE and SNIB is essential to make a step change in the market. Substantial demand stimulation activities are required, with an increase in the support activities alongside the new SNIB investment capability.