



Graham Review into the effectiveness of the Small Firms Loan Guarantee
(SFLG)

Response to call for evidence: April 2004

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Background

NESTA – the National Endowment for Science, Technology and the Arts – was established by the 1998 Lottery Act to pioneer ways of supporting and promoting talent, innovation and creativity in science, technology and the arts. We do this primarily through our three core programmes – Learning, Fellowship, and Invention and Innovation. To date we have made 424 awards through these programmes and invested over £26million in supporting creativity and talent across the UK.

Through the Invention and Innovation programme we help turn ground-breaking ideas into innovative products, services or techniques. We have invested almost £9million in start-up businesses, which has led to NESTA becoming one of the UK's biggest single sources of early-stage seed funding.

Further to these we have also sponsored a number of other projects, such as:

- Ignite, a programme of support for creative and innovative young people aged 10-21;
- The Graduate Pioneer Programme – support for new graduates to set up their own innovative business; and
- NESTA Futurelab, working to use new technology to improve teaching and learning.

In the future, we will be building on the knowledge gained from these activities and making sure that the lessons learnt impact on a wider UK audience.

We feel that we can contribute to this call for evidence through our role as a supporter of industries that are traditionally neglected by equity finance. In responding to this consultation NESTA will not attempt to discuss all of the questions being raised. Rather, we will restrict our responses to those areas into which our experience provides an insight.

As an organisation that deals with innovative business models in science, technology and the arts, we are well placed to recognise where current SME finance does not meet the needs of these sectors.

Overview

As a supporter for innovative small businesses and start-ups we fully support the aims of the Graham Review into the effectiveness of the Small Firms Loan Guarantee (SFLG) scheme and the government's desire to address the questions of:

- Whether the structure and rules of the SFLG are appropriate to the scheme's effective operation; and
- Whether the SFLG is sufficient to tackle the barriers faced by start-ups and small businesses.

High Technology and Creative Industries are large and fast-growing sectors of the UK economy. The Creative Industries represent almost 8% of GDP, with a disproportionate number of micro-businesses and SMEs represented in the sector.

The rationale for providing support for high-tech and innovative businesses is laid out in the DTI *Innovation Report*. In a global market place the UK is increasingly competing against cheaper labour markets and thus must rely on the exploitation of knowledge, skills and ideas. It is evident that the development of science, technology and creativity are essential for providing growth opportunities. They allow us to maintain a competitive advantage over low wage developing economies. The report also recognised that our exploitation of these ideas, as measured by patents issued, is lagging behind many of the other OECD economies. We believe that the best means of reversing this is to provide support for innovative entrepreneurial businesses, which is consistent with the aims of the SFLG scheme.

For reasons set out below, these sectors find it more difficult than other sectors to attract finance at all stages of their development. In order to be able fully to realise their potential, we feel that any reform of the SFLG should include measures to improve the access to finance for these high-performing sectors.

Barriers

Our experience shows that the High Technology and Creative Industries sectors suffer from a number of barriers to accessing equity finance. Chief amongst these is the investment criteria used by retail banks in assessing business opportunities. Our research suggests that most banks assess whether to offer debt finance to those seeking to start a business on the basis of the investment readiness of the business, and in particular look for:

- robust business plans,
- an acute awareness of markets,
- solid management structures,
- existing equity and
- clear growth potential.

Innovative science and technology businesses potentially fail to meet a number of these criteria, even though the business proposition itself may be solid:

- The nature of the business proposition they are offering does not always lend itself to description using traditional business planning models, although the potential of the proposition itself is sound;
- Their businesses often have longer lag times between the idea and its realisation as a commercial asset than more traditional business ventures – this can be problematic for a lender seeking a return within a narrow time frame;
- The major asset of these businesses is intellectual property, which often makes the relationship between the market and product difficult to gauge. For

the most innovative propositions, the market may need to be built, rather than being already in existence; and

- They tend to be perceived as higher risk ventures, though they potentially have higher returns.

This is further compounded for the Creative Industries:

- They are often perceived (often without foundation) as being lifestyle orientated, without serious commercial intent or potential; and
- They have few tangible assets such as property and many are often located within deprived areas and little existing capital.

Given that the SFLG is an initiative designed to provide debt finance opportunities to businesses that lack security one might expect it to remove barriers to debt finance for these sectors. However, there is a perception that the banks apply their criteria equally strictly when considering a SFLG loan as they do when providing finance secured against a business's assets. We believe that this represents a failure in the market. It appears that the banks feel unable to undertake an appropriate risk assessment with the High-Tech and Creative Industries due to the unusual characteristics of the sectors. As a result, whilst the SFLG will guarantee 75% of all loans, the banks cannot afford 25% of the loan book to go bad, and they are therefore unwilling to support these sectors. It is important that reform of the SFLG addresses this issues. Put simply, the retail banking system adheres to exactly the same investment criteria for any small business. Unfortunately our experience, backed up by research¹, shows that the traditional investment criteria they use are often unmeetable by creative or high-tech businesses, even if they have strong business propositions.

Some improvement could be achieved simply through better intelligence. There is perceived to be a misconception of the innovative high-tech and creative industries amongst the investment community. Our research has found that while many investors recognised that these sectors are an area of growth they significantly underestimate their importance to the UK, not merely economically but also socially, as seen in the regeneration of Hoxton in London and the Northern Quarter in Manchester. While these sectors are providing innovative new services and products of immense value in the modern global market place, the investor community has little knowledge of them and is resultantly reluctant to invest, despite a huge proportion recognising the sectors' recent growth and potential for growth in the future.²

This in part explains the difficulty they face in accessing finance. However, while there undoubtedly exist some market barriers to those seeking access to the SFLG scheme there are also many more subtle barriers.

Under the current scheme a bank's Branch Manager will perform the certification of the SFLG. Some experts in the investment community believe that these managers are unwilling to take the time to offer this service and consider the process unnecessary, as they are more interested in traditional companies, which have solid assets that can already act as security.

¹ *New Solutions to Old Problems – Investing in the Creative Industries* NESTA, 2004.
<http://www.nesta.org.uk/assets/pdf/Investing%20in%20creative%20doc.pdf>

² The Creative Industries, for example, account for 7.9% of UK GDP – a figure significantly higher than the construction industry, the insurance and pensions sector and the pharmaceuticals sector. Furthermore this figure is growing; as a sector it increased by an average of 8% between 1997 and 2001, which compares to an average of 2.6% for the whole economy during this time.
[www.nesta.org.uk/assets/pdf/ICM Creative Industries Poll.pdf](http://www.nesta.org.uk/assets/pdf/ICM%20Creative%20Industries%20Poll.pdf)

This may be further compounded by the infrequency that Banks offer the application service and their failure adequately to market the SFLG. However, further research is needed to assess if this perception really does meet the reality of the situation.

Recommendations

In order to redress this market failure, we would like to propose a number of changes to the existing SFLG scheme in order to improve its support:

- The SFLG should be made more available to some of the sectors that currently find it most difficult to access support;
- There should be an increased flexibility in the repayment length of the SFLG; and
- Ways of targeting and accessing the SFLG should be improved.

There are currently exclusions to the scheme that we would like to see removed. Many of the people that we were set up to support are currently not eligible for support through the SFLG. These include almost all self-employed artists - authors, composers, playwrights, musicians, actors, and theatrical companies.

Second, the guarantee length is not sufficiently flexible for some creative products. The current SFLG is available for terms between two and ten years, including any capital repayment holiday. However, many of the finance needs of the Creative Industries do not require such long repayment schedules. We feel that the scheme could offer guarantees on the basis of shorter loan periods. NESTA has some experience of administering this sort of arrangement – making a number of investment over durations of less than one year.

Finally, the government might also wish to address means by which the SFLG could be better targeted to certain industries that are poorly served by the current debt finance opportunities. We have a number of recommendations to address this, addressing many of the barriers that we identified earlier.

We recommend that the SFLG could be targeted to certain poorly served sectors through a higher guarantee rate being offered for loans to these businesses. A number of the respondents to the SBS/Treasury *Bridging the Finance Gap* consultation argued that the government should adopt a tiered approach to government leverage for the Enterprise Capital Funds. A similar approach could be offered for the SFLG, with a tiered government guarantee being offered. The principle of leverage within the SFLG has previously been accepted: prior to 1 April 2003 the SBS guaranteed 70% of the loan but this rose to 85% if the business has been trading for more than 2 years. Instead of offering leverage to companies that would have found it easier to access debt finance we believe this mechanism could be used to target investment to companies that have traditionally found it harder to access finance – such as the Creative Industries and high-tech businesses. Further discussions would need to be held with lenders in order to assess the impact of this.

The SBS should also consider introducing a different application process. Instead of the Bank filling out the paperwork, which we have pointed out is a time-consuming and unattractive process, we believe it should become the responsibility of the business seeking the loan to make the application directly to the SBS or a relevant body (such as a business link) that could make the approval. This certification of support through the SFLG could then be taken to the Banks, thus addressing the skills shortage we feel exist in their current role in certifying the SFLG. A guarantee of support for the loan through the SFLG would

also act as an incentive for banks to support applications, increasing the take-up of the scheme.

Another viable option for targeting the SFLG to deprived sectors might be to simply widen the lender base for this scheme. As stated earlier Banks currently administering the SFLG only consider the loan if the application passes every commercial consideration. Increasing the number of SFLG schemes could mitigate this by encouraging more specialized lenders. This would have the twin benefit of speeding up the process, as the industrial experts who would judge the application are better placed than Banks to assess the viability of businesses in specialised sectors, and it would also be likely to increase the awareness of the scheme as it would be in the hands of the sectors that would most benefit from it.

Conclusion

In addition to the recommendations above, NESTA would welcome the opportunity to talk in more detail about the issues surrounding the SFLG and how it fits with NESTA's role in helping the government to create a more enterprising and innovative economy. We would welcome the opportunity to talk in more detail about what we do and how we can play an active role in reforming the SFLG.