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Scottish Enterprise



10 March 2016

Mr John Swinney
Deputy First Minister and Cabinet Secretary for Finance and Economy
St Andrew's House
Regent Road
Edinburgh
EH1 3DG

Dear Deputy First Minister

SCOTTISH BUSINESS DEVELOPMENT BANK: THE FUTURE

Thank you for your letter of 24 February confirming your plans to enhance the remit of the Scottish Investment Bank (SIB), within Scottish Enterprise (SE) in order to deliver on the ambition to help more companies access growth funding in Scotland.

I welcome your decision, as recognition of the real impact that has been made by SIB's activities over a number of years, and also as a reflection of the integrated role access to finance plays in the wider work SE, HIE and our partners undertake with SME's in Scotland. Through our on-going work to help more companies innovate, to trade overseas and to develop their leadership and workforce, we can help stimulate greater demand for growth finance that can be enabled through the activities of the Scottish Business Development Bank (SBDB), as an integrated element of the support SE provides to business.

As requested, I have set out SE's initial plans for developing the SBDB, describing the core operating principles, the main themes and the early actions proposed for our work in 16/17. These cover actions to:

- Simulate more viable demand for finance from SMEs.
- Improve the provision of capital by others into the Scottish market.
- Respond to evidenced gaps in the supply of capital to growth SME's.

These actions will draw on the funding provided to SE as part of the recent Scottish Government Budget settlement, including the provision of £21.5M of funding under Financial Transactions. This allows for the continuation of current successful activities and the introduction of some new actions outlined in the initial plan. The proposals also describe the approach to governance of the Bank's activities as part of SE, which have been shared with colleagues in HIE.

Dr Lena C Wilson CBE
Chief Executive

Atrium Court
50 Waterloo Street
Glasgow G2 6HQ

Telephone 0141 228 2904
Fax 0141 228 2040
Email lena.wilson@scotent.co.uk
www.scottish-enterprise.com
www.sdi.co.uk



As your letter identifies, planning for the full implementation of the SBDB agenda will require a phased approach and we will continue to engage with the market and with partners to develop our plans over the medium term. This will also allow confirmation of some remaining areas, in particular the appropriate branding we will use to build on the work of SIB, and extend this under the SBDB approach, and also the funding arrangements required to accommodate additional supply side interventions beyond those covered via the early actions described.

I believe these initial plans provide an opportunity to make meaningful early progress on the SBDB agenda and I look forward to continued engagement with you on this key matter for economic growth.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Lena Wilson', written in a cursive style.

Dr Lena Wilson CBE

Enc:

THE SCOTTISH BUSINESS DEVELOPMENT BANK PHASE 1 IMPLEMENTATION PLAN

This plan sets out proposed early actions to expand the Scottish Investment Bank's remit to evolve it into the Scottish Business Development Bank (SBDB) as part of Scottish Enterprise's (SE) operations. It aims to support Ministers' ambitions to assist company growth (in particular to build more medium-sized enterprises) and to support the business finance market to work more effectively in Scotland, helping more companies access the appropriate finance to realise their growth ambitions.

Context

Small and Medium Enterprises (SMEs) are essential to the Scottish economy and in delivering Scotland's Economic Strategy. For SMEs to grow, innovate, create jobs and seek opportunities in new markets, they require appropriate finance. Availability and accessibility of finance therefore underpins, and is an integral part of, an integrated approach to sustained company growth. With economic conditions significantly more challenging, SE recognises that it is more important than ever before to build an internationally competitive, resilient economy. In part, this requires a diverse funding environment across a range of markets for our companies and sectors.

The amount and availability of finance required by companies is increasingly determined by a range of factors such as risk, sector and company ambition as well as development stage. The expanded SIB remit will provide for a wider range of funding approaches and support to address market failures and gaps, recognising that the funding landscape is now markedly more dynamic, diversified and complex.

Operating Approach for the Scottish Business Development Bank

SE will progress actions under three main themes:-

1. Increasing advice and support to companies to stimulate more viable demand for finance from SMEs in Scotland.
2. Improving capital provision by other funders into the Scottish Market.
3. Responding to evidenced gaps in the supply of capital to support growth companies in Scotland.

The operating principles for the SBDB will be:-

- Evidenced based - using existing evidence and commissioning new research to be clear on the scale and nature of gaps in the supply of finance for growth companies.
- Targeted - on areas of clear market failure and seeking to secure adjustment in private sector/market provision (over the medium term).
- Collaborative - investing in a commercial manner alongside private sector partners and engaging with public sector partners.

To achieve this, our work under the SBDB will aim to:-

- Provide support to a broader number and range of growth SMEs in Scotland.
- Create a recognised centre of expertise and market information in SME finance.
- Provide funding advice, guidance and services to help SMEs in Scotland navigate the funding landscape and stimulate increased viable demand for finance.
- Support increased co-ordination of the provision of financial support and advice with Government agencies to provide effective sign-posting to partner organisations.
- Operate in partnership with UK and European provision, maximising availability and access of funding from other sources to Scottish SMEs.
- Create new targeted mechanisms to support evidenced market gaps, encouraging increased diversity in funding within Scotland to provide more options to SMEs.

Proposed Early Actions towards establishing the Scottish Business Development Bank

1. Stimulating Viable Demand for Finance by the provision of Expert Advice & Support

Scotland needs ambitious companies with the capability to successfully access and exploit funding opportunities to grow, supporting sustained economic growth. To maximise the impact of any financial interventions, it is essential that they are coupled with advisory-led support and linked to other business support for SMEs provided by SE, HIE and others to ensure effective stimulation of viable demand.

SIB's Financial Readiness Service provides hands-on support for companies seeking to raise finance, helping companies to ensure they are financially prepared, have a strategic funding plan in place, and the necessary knowledge and support to secure the funding most appropriate to their individual circumstances. This includes increasing awareness and understanding of the role that different types and sources of finance can play at distinct stages in a company's development. Success will mean more SMEs in Scotland seeking and securing growth finance.

To both widen and deepen the support available to SMEs, SE will:-

- 1.1 Deliver new simplified **digital content** on the MyGov site through:-
 - Developing a **diagnostic tool** to produce a tailored report for SME's signposting companies to appropriate funders, advisors or events. The tool will allow a significantly larger number of companies to be supported to become ready to raise finance.
 - Trialling a funding **insight tool** to supplement the Finance Finder tool already available, to help companies quickly identify the category of funding appropriate for them.
 - Creating a depository of **self-help finance guides** (such as the importance of corporate governance and an outline of alternative finance) and **downloadable tools** (such as a business plan template and a financial model tool) which will help companies as they prepare to approach funders and ensure that this process is more efficient and effective for them.
 - Producing and disseminating **videos, blogs and forum discussions** to increase funding and financial readiness knowledge amongst businesses, improve the quality of funding propositions and help stimulate demand for funding.
- 1.2 Expand the team of **financial readiness specialists** to provide increased 1:1 specialist support in areas where particular funding challenges are evidenced such as raising investment of scale, securing international investment and support for manufacturing, oil and gas and exporting businesses.
- 1.3 Deliver **targeted** events supporting companies in their fund raising efforts, specifically focused on equity and debt raising and pitch training for SMEs.
- 1.4 With partners expand the market **intelligence** capability to focus increased efforts on understanding the changing funding environment and dynamics to ensure companies and partners are provided with relevant and up-to-date intelligence and data. This will ensure the development of initiatives and interventions are evidence based and effectively designed.
- 1.5 Deliver a pilot **Non-Executive Director Programme** to oversee, manage and grow a database of quality non-executive directors in order to increase the pool of available talent to support companies.

- 1.6 Establish SME Financial Readiness '**drop-in**' hubs in key locations in Scotland. This will allow companies to easily access FR support on an informal and "as needs" basis.

This expanded approach will be delivered in partnership with public and private sector providers to avoid duplication of efforts, allow parties to play to their strengths and ensure a cohesive and coordinated approach to SME financing across Scotland.

These additional services and support functions will be put in place during 2016/17. It is anticipated that around 5,000 companies could be supported via this new approach over the next 2 years.

2. Improving Capital Provision in the Scottish Market

To encourage company growth, we need more Scottish companies accessing initial funding of the appropriate scale from supportive sources and to help these companies access further growth funding as their development accelerates. Success will mean increased diversity of funding available and improvements to the scale of funding made into SMEs in Scotland.

Early actions proposed are:-

- 2.1 Increase the profile of Scottish investment opportunities in key markets, starting with **London** and building stronger links with funders in these markets. London engagement will be a stepping stone to meeting the long-term goal of continuing to showcase Scotland as a rich source of investment opportunities for international investors and funders in particular in North America and China. This will be delivered as part of the Innovation and Investment Hub model. Recruitment will commence in Quarter 1 2016/17 for a specialist investment resource based in the new London Innovation & Investment hub with the aim of targeting and attracting investment of scale to Scotland's most ambitious companies.
- 2.2 Assess the need for a **digital investment marketplace** bringing together investors and investee companies aimed at improving and increasing deal flow and fundraising activities (including syndication of deals). This would seek to improve investor relations and communications as well potentially providing a mechanism to allow investors to sell their shares through a secondary market to increase liquidity. Work will commence in Quarter 4 2016/17.
- 2.3 Facilitate increased access to **UK and European funding** sources to increase the scale and diversity of accessible funding options for Scottish SMEs. We will identify opportunities and encourage and promote these to Scottish-based funders as well as directly to SMEs. Initial focus will be on the British Business Bank and European Investment Bank. The first outcomes of this focused effort will be expected during Quarter 4 2016/17.

3. Responding to Evidenced Funding Gaps

Action will focus on responses to support areas where clearly identified market gaps exist. Responses can only be effective if the demand side challenges are addressed in parallel, by having ambitious and innovative companies with the capabilities to secure finance in an increasingly competitive funding environment.

3.1 Gaps in the Supply of Risk Capital

The lack of adequate and appropriate finance for many innovative growth companies is a significant obstacle to their development and ability to achieve their global ambitions and consequently impacts significantly on the growth of the economy. Via SIB, SE has been at the forefront in developing and delivering an innovative model where SIB co-invests with private sector investors, underpinning the delivery of risk capital funding to address structural gaps in Scotland's early stage risk capital market. Market evidence demonstrates that these interventions have a positive impact by increasing the supply of scarce risk capital to innovative growth companies, enhancing the number of investors active in Scotland and delivering significant economic impact.

As a result, the Scottish early stage risk capital market has grown significantly over the past 10+ years and these signs of market adjustment are encouraging. However, there is continued evidence of increasing demand and an on-going lack of early stage funding for innovative high growth companies. Evaluations of the SE co-investment funds have consistently highlighted the systemic and long-term market challenges that have combined to cause funding gaps for SME businesses and the need for an integrated support package of more than just the funding to support their growth.

We will continue to support this market gap in **early stage equity funding** with activity focused on supporting increased liquidity in the market, entry of new investors into this area and increased sustainability of operations through a focus on successful exits and recycling returns. Early action will be to:-

- 3.1.1 **Continue investment via the Scottish Co-Investment and Scottish Venture Funds.** Public investment of up to £25m pa over the next two years (inclusive of European Funding) is expected to leverage private sector funding of over £160m.
- 3.1.2 Respond to the challenge to increase the availability and diversity of later stage (£2m plus) risk capital funding by **attracting an increasing number of mobile international investors** who can invest at the scale needed and provide additional value to growing companies and by investigating other options to **leverage later stage risk capital of scale.**

3.2 Gaps in the supply of Debt Finance

Companies with insufficient track record or tangible assets find raising appropriate finance difficult, with evidence suggesting raising less than £1m is the most challenging. Under SIB's expanded remit, early actions will:-

- 3.2.1 Seek out opportunities to support increased funding from **challenger or alternative funders** to provide a greater diversity of funding options which have different risk appetite and conditions for support. An early intervention in this area is anticipated during Quarter 2 2016/17.
- 3.2.2 Building on SIB's innovative intervention establishing the £113m Scottish Loan Fund to provide **mezzanine finance** to growth companies, investigate the case for ongoing intervention for this type of alternative funding and for the provision of this higher risk class of debt for companies seeking to raise less than £1m for growth. Work will commence during Quarter 1 2016/17

- 3.2.3 Undertake research to determine the particular challenges faced by **exporting companies** and potential support mechanism to improve their ability to access the finance they require. One of the greatest challenges for many SMEs in moving to an international operation is overcoming exchange rate fluctuations, coping with extended payment terms and maintaining a healthy cash flow. Evidence suggests that SMEs seeking to export find access to finance particularly challenging. Take-up of funding support such as the UK Export Finance guarantee scheme is dominated by larger SMEs. Given the importance of improving Scotland's export performance, and in particular encouragement to help more companies become first time exporters, the availability of finance has a key role to play. This work will commence during Quarter 3 2016/17.
- 3.2.4 Review the current UK **guarantee schemes** operated by the British Business Bank and availability of European guarantee schemes designed to stimulate increased bank lending to SMEs. We will consider, alongside the High Street Banks, the case for supplementing current provision to ensure Scottish SMEs benefit from increased availability of funding options. The case for a **co-lending product** alongside debt providers to share risks and allow increased lending to Scottish SMEs will also be investigated. Consultations will commence during Quarter 1 2016/17 with requests for proposals anticipated during Quarter 4 2016/17.
- 3.2.5 Investigate how Scottish **intellectual property (IP) rich** companies can utilise their assets to raise finance. The work will be undertaken in partnership with other working groups and will pull on research undertaken to date across the UK and other initiatives focused on this area. It will investigate the barriers to finance and examine innovative approaches in other parts of the world. Initial consultations with funders and stakeholders have commenced. This investigative work will establish what viable opportunities there are for SE to play a role to increase lending to Scottish SMEs. The initial report will be available during Quarter 2 2016/17.

3.3 Specialist Sector Support

Work will continue to assess any specific growth funding gaps that constrain ambitious companies in Scotland's key sectors. Whilst many sector funding needs can be met through general provision, there are occasions when specific funding gaps are evidenced in certain sectors, requiring a tailored response such as SIB's strategic investment into the £47m Epidarex Life Sciences Fund, attracting significant external finance.

Support for funding for SMEs during the downturn in the **oil & gas sector** has already commenced. Research is underway to understand the specific access to finance challenges facing oil & gas supply chain companies and an appropriate response to the identified market gaps. Additional expert advice and support is likely to be put in place alongside any new product development response. The research will be available Quarter 1 2016/17 and will support consideration of options and appropriate responses that complement existing provision and works alongside private sector finance.

In 2014, SIB opened the **Renewable Energy Investment Fund (REIF)** to address the emerging renewable energy market. This fund has attracted considerable interest at both UK and EU level. Under the expanded remit, we will continue to support funding into the renewables market using the ring fenced resources provided by Scottish Government. A review of this fund and options to expand activity in this area has commenced with recommendations expected in Quarter 2 2016/17.

Governance of the Business Bank

As the Scottish Investment Bank evolves into the SBDB, it will remain an integrated operating division within SE and therefore accountability will be to the SE Chief Executive and Board who will provide overall strategic direction and regular review of progress and performance.

As with the Scottish Investment Bank, the operations of the Business Bank will be Scotland-wide and therefore Annual Operating Plans will be agreed in consultation with HIE. Quarterly performance reports will be shared with HIE and an annual discussion on progress and priorities held with the HIE Board.

Strong operational links will be developed with other public sector funders, in particular Local Authority Loan Funds and the Business Gateway, to ensure a coordinated, collaborative and inclusive approach to supporting SMEs' access to finance.

SE proposes to establish an Advisory Group from across the public and private sectors, for the next year as the work of the SBDB becomes established. This will ensure that the approach works in partnership with appropriate public sector partners and private sector providers. This advisory input will support on implementing the best mix of products and services.

In establishing the expanded operations within SE, consideration will be given to the branding of the various advisory and investment functions. It is proposed that the operation of SE's access to finance functions will be branded the Scottish Business Development Bank reflecting the wider range of companies supported and products and services provided. Stakeholder engagement will help determine the continued role for the Scottish Investment Bank brand. Discussions with the Financial Conduct Authority, given the regulatory status that SE enjoys which applies to the Scottish Investment Bank's current activities, will also be important.

Measuring Progress

Progress of the Business Development Bank approach will result in more companies seeking and securing the growth finance they need in order to achieve more innovation and internationalisation from Scotland's SMEs. Current progress measures around leveraging private sector investment and companies supported to seek and secure finance will be reviewed and built on as part of the next phase of work.