ACCESS TO FINANCE FOR GROWTH FOR SMEs ON THE ISLAND OF IRELAND

December 2013

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Acknowledgements

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Foreword

There are approximately 300,000 small and medium sized enterprises (SMEs) on the island of Ireland. These enterprises have a disproportionate reliance on the banking sector for their external financing needs. The well-documented distress experienced by that sector has had a powerfully disruptive influence on the wider economy. This has had a particularly negative impact on the market for finance, the proper functioning of which is a prerequisite of a growing economy.

The primary aim of this report is to provide, for the first time, a reliable indication of the supply of finance for businesses across the island. More specifically, the report fills the gap that has been caused by the unavailability of supply-side data for the Northern Ireland market. Using, as far as possible, the same methodology as is used in Ireland, we estimate that, in total, bank funding to SMEs in Northern Ireland in 2012 amounted to £4.7bn. It is important for policy makers that this figure is available on an annual basis as this informational deficit seriously curtails their ability to respond to the needs of Northern Ireland's SME community.

The fracture in the relationship between banks and our SME community, while leaving a considerable problem in terms of property debt and bank recapitalisation, has also revealed a serious number of defects in the wider financial ecosystem that supports the needs of growth-focused SMEs. This report seeks to widen the debate from an important but narrow focus on the supply of and demand for bank finance to a broader, more comprehensive discussion on the availability and use of appropriate financial instruments to support and drive growing SMEs. The need to broaden the diversity of lending options accessible to SMEs has become even more urgent, particularly in Ireland where the banking sector has become extremely concentrated with the withdrawal of several foreign-owned banks.

In both Ireland and Northern Ireland there is a disproportionate reliance on short term financing options, particularly overdrafts, which in many instances are not the best vehicle to finance growth strategies. It is important not just to widen the availability of more suitable funding options, creating a more sophisticated and diverse financial ecosystem across the island but, just as crucially, to ensure that businesses are aware of their options and informed about their choices.

The recommendations therefore address two key areas: information and financial capability. They are consistent with and designed to support and perhaps accelerate work already ongoing in both jurisdictions by improving the likelihood that the financing product sought is the most appropriate match to the SMEs needs.

1. Executive Summary

This report presents the results of a study into access to finance for growth amongst SMEs in Ireland and Northern Ireland. The study aims, for the first time, to examine not only bank finance but finance available to SMEs from other sources such as government funding, venture capital and angel finance.

The study uniquely presents a complete picture of the supply of finance to SMEs across the island of Ireland, in particular the supply of bank finance in Northern Ireland. In Ireland, banks provide supply-side data to the Central Bank of Ireland. However, at present, no such process exists within Northern Ireland. This study provides the first analysis of the total value of the credit extended by banks in 2012 to SMEs in Northern Ireland. This study is an important component in the complete and rigorous assessment of the current supply and demand side issues related to bank and non-bank finance for SMEs trading in Ireland and in Northern Ireland.

The key findings and recommendations are summarised below.

1. KEY FINDINGS

IMPORTANCE OF UNDERSTANDING THE LENDING CONTEXT FOR SMES

- **Demand is at least as important, if not more important than supply, as the key SME finance issue.** The data gathered for this report shows that demand for credit is currently at its lowest level since 2010, as measured by applications for credit by SMEs. In addition, businesses say that the supply of finance is no longer the most significant issue facing them, with finding new customers and/or addressing cost pressures now cited as their most significant challenge. However, a concern remains that, when an economic recovery begins to gain momentum, it could be inhibited or even derailed by a supply-side deficit.

- **There is a dearth of diversity in the financing landscape for SMEs across the island.** The capital structures, market and economic position of SMEs on the island have a disproportionate reliance on banks for their funding needs. Bank funding, largely in the form of overdrafts and loans, accounts for 94% of total SME finance which is comfortably greater than other European counterparts.

- **A general lack of financial literacy exists across the broad financing landscape.** A lack of knowledge on alternative funding options is inhibiting the development of a more diverse funding panorama for SMEs and the subsequent use of more appropriate and less costly funding alternatives. Not only is there an over-reliance on bank funding but local SMEs are also more reliant on short term finance, in particular overdrafts and trade credit, in comparison to the EU average. They also still have a significant dependency on cheques rather than funds transfer or other payment methods.

- **There is a lack of balance sheet "right sizing".** In general, Irish and Northern Irish banks need to be more engaged in the debt restructuring or write off of debt for SMEs who demonstrate sustainable trading positions but are over-leveraged due to property or other legacy debt issues. Banks are only very slowly disengaging from short term forbearance measures, a temporary and short term solution which, in the absence of strong economic growth, may not address the need for long term restructuring of the balance sheets of many SMEs. A sustainable SME whose debt has been "right sized" to a level which they can service is a better asset to both the bank and wider economy.

- **A lack of investment is potentially damaging SMEs businesses.** The economies of Ireland and Northern Ireland are both heavily dominated by SMEs, particularly micro companies with low levels of turnover, employees and a domestic economy focus. While there are encouraging signs that more firms are moving to a growth mode, a still significant proportion of SMEs are focussed on survival or stabilisation not on growth or expansion and, as such, are not looking for growth or development capital from any finance source. A lack of investment in a business ultimately damages that business and therefore represents a systemic and long term risk to the economies of Northern Ireland and Ireland.

- **There is a continued need to leverage EU-wide and UK initiatives.** Both Ireland and Northern Ireland have been successful in drawing down support under EU measures. Ongoing engagement with the EU will remain an important aspect of SME policy to ensure maximum potential is derived from the range of available EU funding initiatives, such as the Competitiveness and Innovation Programme, JEREMIE and the European Investment Bank. With regard to UK initiatives the authorities in Northern Ireland remain concerned to ensure that regional needs are addressed and responses can be tailored, in order to ensure maximum benefit from the Enterprise Finance Guarantee Scheme and the Funding for Lending Scheme.

SUPPLY OF AND DEMAND FOR FINANCE FOR GROWTH

Bank Finance

- **The report provides, for the first time, a picture of total supply of bank finance for both Ireland and Northern Ireland.** As at 31st December 2012 total bank finance of €31.5 / £25.7 billion had been extended to Irish and Northern Irish SMEs. Of this total €25.7 / £20.9 billion is to Irish SMEs and €5.8 / £4.7 billion to Northern Irish SMEs.

- **Businesses are over-reliant on bank funding.** As at 31st December 2012 94% of total SME finance for both Irish and Northern Irish SMEs came from bank funding. In comparison to European SMEs, Irish and Northern Irish SMEs demonstrate an overreliance on short term bank finance with a disproportionately high use of overdrafts.

- **A lack of bank supply data exists for Northern Ireland.** The absence of regularly reported figures for Northern Ireland presents a significant gap in the analysis of total funding available to SMEs in Northern Ireland and thus hampers the development of policy responses to funding gaps that might exist in that market.

- **There has been a fall in both the supply of and demand for bank finance.** Both the supply of and the demand for bank finance has fallen significantly in the period since 2008. In Ireland, the fall in supply has also been impacted by the withdrawal of a number of providers from the Irish market, in 2010 and 2013. Total outstanding credit to Irish SMEs had decreased from €34 billion at the end of Q1 2010 to €26 billion at the end of Q4 2012. No trend figures are available for Northern Ireland.

- **High levels of bank debt exist for the largest sectoral employers.** Of the four main sectoral employers in each jurisdiction, three (retail, construction and hospitality) are in distress, are very dependent on the domestic economy, and have high levels of bank debt.

- **Demand for bank finance is focused on short term working capital needs.** Demand for credit amongst SMEs in Ireland and Northern Ireland has fallen significantly since its measurement began on a systematic basis in 2009 and, where demand currently exists, it is primarily to fund short term working capital and to support cash flow.

- **SMEs with property debts are more likely to need working capital.** SMEs with legacy property debt are three times more likely to request working capital finance than their counterparts, pointing to the difficulty many SMEs are facing in servicing this debt and the delayed beginning of restructuring programmes for such debt in many banks.

- **Most SMEs are approved for bank finance when they apply formally.** While 7% of SMEs who require finance are afraid to approach their bank, all surveys have consistently shown that the majority of SMEs who apply for credit receive a favourable response. This figure is relatively consistent with patterns shown in similar studies carried out in other European countries.

- **SME views on bank lending are often not based on personal experience.** SMEs are primarily forming the view that banks are not lending from the information they receive from the media, business groups or the experience related by peers rather than from direct experience. Banks should encourage SMEs to formally apply for credit or, at a minimum, direct them to mediation support services within the bank to support them with their application. This is a model that has been adopted very successfully in France where local mediators provide support to SMEs in the completion of their credit applications.

- **There is a misconception about SME credit ratings.** Many SMEs are concerned that a declined credit application may impact their credit rating. This is an incorrect assumption and SMEs should be encouraged by policy makers, advisors and business representative groups alike to make applications for credit formally (i.e. by completing a formal written application form). This is then subject to internal bank assessment and the decision may also be appealed internally within the bank or, in Ireland, to the Credit Review Office.

- **The average bank decision time is a concern for SMEs.** Survey results suggest that the average time from application to reaching a decision on the loan request is 21 working days. In many cases, decision time is much longer and this is a source of concern and, in some cases, distress for SMEs.

Public Finance

- **Direct government funding represents less than 1% of total SME finance.** Direct government funding, not included in equity finance, represents less than 1% of all finance extended to SMEs as at 31st December 2012.

- **Poor knowledge of finance schemes exists amongst SMEs and their advisors.** The research has found that SMEs and their advisors, business representative groups, accountants and other professional advisors are typically unaware of the public schemes and funds that are available. The complex nature of non-bank funding sources and the varied application routes makes the use of non-bank funding difficult and often expensive for SMEs.

- **In practice, funding schemes are focused on exporting SMEs or companies trading in specific sectors.** Whilst in theory the majority of schemes or funds are open to all business sectors, in practice the main beneficiaries are those SMEs who export and those operating in the manufacturing, information and communication technology and tradeable professional and scientific and administrative/ support service sectors. There is limited support for SMEs operating in most distressed sectors outside of traditional bank finance, the Credit Guarantee Schemes (in Ireland and UK) and the MicroFinance scheme in Ireland, some of which, in their early stages, show low levels of take up.

- **The SME support infrastructure is more developed in Ireland.** The SME support infrastructure, in the area of bank finance, has developed significantly in Ireland in recent years. Given the similarity in access to finance issues apparent amongst SMEs in Ireland and Northern Ireland, there are a number of measures implemented in Ireland in the period since 2009, that should be considered in Northern Ireland either on a cross-border or a specifically Northern Irish basis.

- **The supports required by SMEs have changed since the economic crisis began in Ireland and Northern Ireland.** SMEs now require tailored support in the restructuring of balance sheets, in engaging with banks on negotiating sustainable debt restructuring initiatives, in developing funding strategies for the current economic environment and in developing overall solutions to their finance needs.

Equity Finance

- **Equity finance is now a significant source for SMEs.** The second most significant source of funding for SMEs is external equity finance as represented by seed capital, venture capital and business angel finance. External equity finance, including government-backed equity finance, accounted for approximately 5.6% of total SME funding at 31st December 2012, with the proportion significantly higher in Ireland than in Northern Ireland. Total equity finance of €1.9 / £1.5 billion had been invested in Irish and Northern Irish SMEs in the five year period to 31st December 2012, the majority invested in Irish companies.

- **Equity finance is focused on a small number of business sectors.** In general equity finance is targeted very specifically at a small number of business sectors, mainly Information and Communications Technology, Professional, Scientific and Technical Services, and Manufacturing, particularly Medical Devices.

- **Demand for equity finance is low.** Existing survey data would suggest that the demand for any form of non-bank finance is low in the general SME community. It is generally accepted that equity finance will only ever be suitable for a small minority of SMEs, often start-ups and/or high potential growth businesses and more mature companies with short to medium term growth or expansion plans. Thus demand for equity is restricted by the fact that government, angel and venture capital investors typically only provide finance to a small number of specific businesses in targeted industry sectors which match the investor's portfolio, risk and return on investment goals. Among the factors which explain low levels of demand for and take up of equity finance in Ireland and Northern Ireland are the profile of SMEs, supply side issues impacting demand and confidence in equity, and a lack of awareness and understanding of equity finance amongst SMEs.

- **A significant SME finance capability gap exists.** Despite some improvement due to access to investment readiness support, early stage companies still require support to improve commercial and management skills of investee teams and support in preparing and presenting for follow-on funding.

- **There is a vibrant Irish venture capital landscape.** The Irish venture capital industry has received significant and sustained support from the Irish Government over the last few decades. In this time, the Irish Government, through Enterprise Ireland (EI), has committed approximately €348mn to 41 local Seed and VC funds resulting in capital of approximately €1.2 billion for investment in innovative high growth companies. The challenge is for potentially strong start-ups to secure follow-on funding, pointing to a continued need for government support of seed and early stage finance in Ireland.

- **Supply gaps exist in the Northern Ireland equity market.** Significant additional investment in seed and early stage capital is required in Northern Ireland as a demand stimulant. A strong consensus exists that there has been insufficient availability of risk finance at pre-seed, seed and early stage in Northern Ireland. In early 2013, the Invest Growth Proof of Concept Fund (pre-commercial grant), which was fully committed at the end of 2012, and the Invest Growth Fund were extended by £2m each to March 2014, with a view to putting in place increased seed and early stage funding from April 2014.

- **The level of angel investing is increasing.** The importance of business angel investing at seed and early stage has received increasing attention due to its growth internationally relative to venture capital investing. The formal angel networks have and are continuing to develop in line with international best practice and the development of formal angel investing has been significant over the last number of years, including the increased development of angel groups/syndicates. Supply statistics on formal angel investing indicate that angel investment has increased year-on-year since 2008. In Northern Ireland, while levels of investment are small but developing, angel investment is in relative terms more important, due to the low level of venture capital activity in Northern Ireland. It was suggested in the course of the study, that a co-investment fund (one is already in place in Northern Ireland) would be an important feature in continuing to develop business angel investment in Ireland as a complement to the range of other funds in place including the Enterprise Ireland (EI) Seed and Venture Capital Programmes.

- **Northern Ireland Growth Loan fund serves a specific demand.** The Growth Loan Fund in Northern Ireland is a mezzanine debt product, which primarily allows growth companies to draw down unsecured loans at higher interest rates based on growth projections. Although primarily a debt product, this alternative financing product may have the potential to overcome the reluctance on the part of some growth businesses, as outlined in Section 4.3.2, to go down the route of equity. This would appear to have tapped in to some latent demand in Northern Ireland and may be an important consideration in Ireland in terms of extension of financing options.

- **The Irish National Pension Reserve Fund (NPRF) Turnaround Fund should provide a useful policy tool.** The new NPRF SME Turnaround Fund, introduced in Ireland in January 2013, will invest in underperforming businesses which are at, or close to, the point of insolvency but have the potential for financial and operational restructuring. Demand statistics on this fund including profile of applicants, even where unsuccessful on the fund, may provide important information for evidence-based policy making for such SMEs (potential but hamstrung) and may be a useful source of information in both jurisdictions to address this important cohort of SMEs.

1.2 RECOMMENDATIONS

Both the supply of and demand for finance are now at necessarily lower levels than the artificially inflated and unsustainable peaks of a few years ago. However the readjustment process has exposed a very narrow SME financing landscape and provided a window of opportunity to develop a broader and more informed financing ecosystem that will support and not inhibit economic recovery. Much has already been undertaken in this regard in both Northern Ireland and Ireland to ensure a financial ecosystem that can support the needs of customers, support recovery and growth and avoid the mistakes of the past. The recommendations that follow are consistent with and intended to support the work already completed or ongoing. They focus on two areas that are critical for the development of a more diverse funding landscape across both jurisdictions. These are:

- Information; and
- Financial capability

The report then concludes with a number of recommendations aimed at encouraging the further development of the venture capital and angel investor markets on the island.

INFORMATION

The availability and flow of high quality and relevant information is fundamental to the smooth operation of any marketplace. The following recommendations are designed to address informational deficiencies in the market for finance in Ireland and Northern Ireland.

Recommendation R1 – Capture bank lending figures in Ireland and Northern Ireland

The recent Economic Advisory Group for Northern Ireland report (EAG, 2013) highlighted that the absence of bank lending data was a significant issue for Northern Ireland. It stated that *"there was a general sense that banks would sign up to the provision of regional lending data for Northern Ireland on the proviso that they all sign up to it and they are confident in the organisation holding the information".* On the basis of the framework developed in Ireland since 2009, and the fact that supply data had been made available by the main banks operating in Northern Ireland under that process, these banks provided Northern Ireland data to the researchers in the course of this study. This is an important milestone in understanding the SME finance environment in Northern Ireland, but the process needs to be maintained and improved in order that patterns and trends may be monitored and analysed over time and appropriate policy responses developed.

Therefore, a clear and comprehensive framework for the supply side capture of SME lending, application, approval and rejection rates should be introduced in

Northern Ireland with quarterly returns of data to the Department of Finance and Personnel. The model which was introduced in Ireland in 2009 and handed over to the Central Bank in 2011 could be used in this regard. An initial process of bank data cleansing and review would be required to support the ongoing reporting of SME supply side data in order to ensure the accuracy and consistency of the data provided.

Recommendation R2 – Capture demand for finance among SMEs in Northern Ireland

A lack of regular and consistent demand-side or lending surveys of Northern Ireland SMEs makes it difficult to analyse the extent of any demand gap. Regular and detailed surveys, along the lines of the Irish Department of Finance's bi-annual demand surveys should be introduced in Northern Ireland. The InterTradeIreland Business Monitor could be used for this purpose with the questionnaire and sample designed in consultation with the new Access to Finance Implementation Panel.

Policy makers also need a clearer profile and better information on the attributes of the SME population to inform policy development (in addition to data on lending which receives the most attention). The Australian model referred to in Section 6 should be considered in this regard. This data should be maintained on an ongoing basis, developed and held centrally in both Ireland and Northern Ireland and access provided to government agencies and policymakers. This data should include:

- Sectoral profiles;
- SME employment profiles;
- Levels of reliance on domestic economy;
- Levels of distress in specific sectors;
- Extent of impact of property debt overhang; and
- Characteristics of export base and identification of potential exporters.

Recommendation R3 – Provision of Better Information to SMEs by Funding Providers

All banks and public funding agencies should endeavour to provide their SME customers with a written and clear reason as to why their formal application for credit has not been accepted in both Ireland and Northern Ireland. We acknowledge this is required at present under the Code of Conduct for Lending to SMEs in Ireland and the need to take into account the difficulties of communicating a negative outcome. The explanation that is currently provided is generally derived from a master system list of reasons and does not provide adequate information in many cases to the SMEs. Banks in both Ireland and Northern Ireland should also introduce internal programmes to ensure quicker turnaround on decisions especially at the smaller end of SME lending (e.g. €25k to €75k).

In the case of public funding agencies this written explanation should include some element of future signposting – i.e. directing the SME to other more possible alternative finance sources. This follows a model which has been successful in France where OSEO publishes a guide to its schemes specifically for banks so that lenders can direct SMEs whose application for credit has been declined to other funding agencies.

Recommendation R4 – Encourage Formal Credit Applications

Continued work is required to encourage SMEs to pro-actively and formally apply for credit. Recent initiatives such as the standardisation of the application process in Ireland and other awareness campaigns should assist this conversion and should be examined for roll-out in Northern Ireland. Above all, it is important that SMEs are made aware by banks that a rejected application does not result in a negative credit rating.

Recommendation R5 – Promoting Alternative Sources of Finance

Consideration should be given in Ireland to promoting alternative financing options such as quasi-equity/mezzanine products to provide alternatives to those SMEs who do not want to cede control via a full equity play. While relatively new (late 2012), the Growth Loan Fund in Northern Ireland would suggest that there is demand for a middle ground option such as mezzanine finance, albeit that some commentators have suggested that some of this demand may be due to the absence of alternative equity options in Northern Ireland. In Northern Ireland, as this is a relatively new fund, there may be potential to increase awareness and education of this fund and source of finance at both the demand (SME) and supply sides (front line bank staff, other advisors and intermediaries).

A range of alternative forms of finance have also been relatively widely used in other countries as outlined in Section 6 (Canada, France, Germany, US, UK), as a post-crisis government response to reduced availability of bank debt. Further consideration needs to be given in both jurisdictions to extending the range of alternative financing options available to SMEs.

A single public body in both Ireland and Northern Ireland should be charged with the development and maintenance of a single repository of all schemes / supports / funds / credit facilities available to SMEs. This database should include bank, public and equity funding and should be both accessible and searchable by sub-region and sector. It should be made available publicly to SMEs, public bodies who advise SMEs, business groups and accountants so that the complex SME funding landscape that currently exists with over 50 funders and upwards of 170 schemes is easier to navigate for SMEs and their advisors.

CAPABILITIES

The following recommendations are aimed at improving financial literacy within the broader financing ecosystem which is necessary to develop a broader based market with a wider portfolio of financing products and solutions. Improving the strategic preparation of SMEs for dealing with funding providers will be key to the exploitation of the opportunities offered by such a wide portfolio.

Recommendation R6 – Non-Financial Support Measures for SMEs

SMEs require support in assisting them to become more competitive, acquiring the skills to enter new markets, securing new customers and exporting. However, SMEs also need to acquire the financial and development skills pertinent to the current economic environment.

A series of publicly funded, practical educational programmes should be made available in Ireland and Northern Ireland to support SMEs, especially at the micro / smaller end. These programmes should focus on:

- Navigating the funding landscape;
- Preparing cash flows for sustainable trading businesses;
- Preparation of business plans in the current environment including stabilization planning;
- Restructuring of balance sheets / finance positions appropriately (balance sheet “right sizing”);
- Negotiation with banks on restructuring of debt;
- Matching finance needs with finance products or sources;
- Management of working capital;
- Developing export capabilities;
- Analysis of finance needs (funding mix, appropriate use of long and short term finance etc.); and
- Investment readiness preparation for companies applying for equity or similar forms of finance.

InterTradeIreland has developed expertise in the area of improving investor readiness for equity finance, through EquityNetwork, and ought to explore the potential for expanding these services and solutions for a broader range of financing options including applications to banks.

In particular the support provided should focus on assisting SMEs in the capital restructuring[1] of their balance sheets so that sustainable trading businesses[2] can be prepared and supported in approaching their bank or funding institution with a view to securing a fundamental balance sheet restructure. This type of support has to be developed and delivered by those currently advising SMEs. The advisors need to be fully

[1] Restructuring refers to a fundamental change in the capital structure of a borrower either by mutual agreement and/or a legal process. A restructuring can be deemed as sustainable if the borrower is in a position to ultimately repay the restructured debt amount either through amortisation payments or asset sales.

[2] A business can be deemed sustainable if it can generate a positive free cashflow before debt service, through the business cycle.

conversant with balance sheet restructuring models and best practice SME sustainability metrics which is the case for a limited number of professional advisory firms.

In Ireland, the establishment of the Local Enterprise Office (LEO) framework (from the conversion of County and City Enterprise Boards) represents an ideal opportunity to implement this recommendation and fundamentally change the skills profile of front line publicly funded support staff advising SMEs. There will also be the opportunity to promote awareness and use of the voucher schemes, soon to be operating in both Northern Ireland and Ireland, which are there to support SMEs improve their financial capabilities.

Consistent with the initiatives in Australia, New Zealand and the UK outlined in Section 6 of this document, we suggest that a national helpline be considered to operate on an all-island basis, possibly co-ordinated by a cross-border body such as InterTradeIreland. This helpline could follow a model similar to the well-established Australian model and could also take account of the new UK Business Link helpline. Whilst we acknowledge that a helpline was considered in Ireland in 2011 and discounted for cost reasons, we suggest it should be re-examined and developed in accordance with the models put in place in Australia, New Zealand and the UK, that it is integrated into an existing support agency and leverages the benefits of additional measures such as a comprehensive database of the products, schemes and solutions across the funding landscape in both jurisdictions. The helpline could operate both before and after normal business hours, and provide information on finance options, cash flow management, balance sheet restructuring, government supports, business planning, accounting, taxation and diagnostic services. An all-island helpline could deliver economies of scale but would also ensure that cross border initiatives as well as new learnings from both jurisdictions are leveraged.

Recommendation R7 – SME Voucher Schemes

Governments in Ireland and Northern Ireland currently have SME Voucher schemes in place. This report identified a need to enhance the capability of a significant number of SMEs in the areas of financial and commercial management capability, areas in which there would appear to be a high requirement and preference for tailored and one-to-one support. Vouchers represent an important support for SMEs who are currently unable to afford professional advice in engaging with their banks or in applying for credit or restructuring their debt levels. International research has also suggested that cost is a significant impediment to SMEs drawing down business support services even where there is clear need for support. These voucher schemes would allow SMEs to procure and pay for professional support in particular to:

- Analyse existing balance sheet or funding positions;
- Develop funding proposals to banks, public funding agency, venture capital or other third party funders; and
- Support the SME in engaging with their bank in restructuring existing debt positions for sustainable SME trading businesses.

Demand for such voucher schemes is always high, and they provide an effective way of both addressing the varied needs of the heterogeneous population that SMEs represent (micro, small, traditional, high tech, high growth etc.), and allowing individual SMEs to cost effectively draw down bespoke support. The governments should monitor the uptake of these and then consider their extension, possibly on a joint North/South basis, like the Innovation Vouchers.

Recommendation R8 – Further Development of the SME Capabilities of Banks

Consideration should be given to putting in place a small dedicated team within each pillar bank in Ireland. This team would:

- Review rejected SME credit applications for appropriateness and consistency of decline decisions, thereby negating the need for an SME to separately apply to the Credit Review Office.
- Explore the options which exist through the full or partial use of other government backed schemes (e.g. Credit Guarantee Scheme / Microfinance scheme) thereby negating the need for the SME to reapply to each scheme or fund individually, completing different forms and providing different information in each case.
- Reviewing informal applications or enquiries (which the main banks are now starting to log) which are not put forward to credit commities by the bank relationship manager to whom the enquiry was made and performing follow up satisfaction calls to SMEs making such enquiries.

Some of the banking initiatives recently introduced by banks in Ireland, partly at the request of the Central Bank of Ireland and Department of Finance, should be introduced in Northern Ireland, for example:

- Front line staff training on cash flow lending, SME funding available, debt restructuring, sustainability assessment;
- Dedicated distressed credit / challenged units;
- SME coaching initiatives;
- Single application form, standard business plan, cash flow model;
- Auto grading of micro loans;
- SME feedback initiatives; and
- Dedicated SME officers in 2013.

Whilst not all the banks operating in Northern Ireland who lend to SMEs are regulated in Ireland, for a number of them their primary regulator is Irish and they are supervised under passporting rules in the UK. As such, some of these schemes could be supported or encouraged by the Irish Central Bank. However they represent best practice in dealing with SMEs and distressed credit and are being rolled out in many banks internationally and in the UK. This issue has also been raised in the *Review of Access to Finance for SMEs in Northern Ireland* (EAG, 2013).

Consideration should also be given to the development of international trade finance products for SMEs, i.e. export-focused guarantee scheme to support lending under guarantee. We acknowledge that at the date of publication of this report, this recommendation is being considered in Ireland by the Department of Jobs, Enterprise and Innovation.

Recommendation R9 – Further Development of Credit Review and Mediation Services

A number of recommendations have been made in a recent Department of Finance report following an assessment of the operation of the Credit Review Office (CRO) (Grant Thornton, 2012). We welcome those recommendations and suggest that consideration should also be given to expanding the remit of the CRO to include:

- Further encouragement of non-pillar banks operating in Ireland to engage with the CRO.
- Consider the extension of the remit of the CRO beyond its current brief to include a credit mediation service following the example of the French credit mediation office. The French model as (set out in detail in Section 6) should be reviewed to assess the benefits of a wider and distributed mediation role for SMEs.
- Quicker turnaround times as, when an SME has a credit problem, time is of the essence (the above mentioned report includes recommendations on expediting the application process).
- Sample testing of credit applications which have been rejected by the banks but which have not been referred by the SME to the CRO. This will over time improve the quality of credit assessments, encourage banks to focus more on solutions rather than just credit decisions and ultimately will provide increased assurance to SMEs on the robustness of the bank credit application process. Alternatively banks should refer a sample of all rejected credit applications across each sector to the CRO by the participating banks.
- Consideration should be given to adopting a version of a model similar to that developed and rolled out in the last 3 years in France. Location of a CRO officer in each pillar bank on an ongoing basis, so that whilst the officer is operating independently of the bank, he/she is none the less working in closer proximity and thus able to discuss possible solutions with the bank and to provide sign posting for under funding options.

We recommend that the Department of Finance and Personnel and the Northern Ireland banks, in conjunction with the British Banking Association and the Independent External Reviewer agree an approach to systematically promote the uptake of the UK Banking Taskforce Appeals Process by Northern Irish SMEs to ensure that existing processes are leveraged to the greatest extent possible. In addition, consideration should be given to an extended independent mediation support for SMEs in Northern Ireland which incorporates some of the benefits of other models, including elements of the French model set out in Section 6. This could entail a separate unit which coordinates access to finance issues for SMEs who have been refused bank finance but who may also require specialist advice on their application quality and improving the standard thereof, advice on capital structure and financing options and signposting to more appropriate financing solutions.

DEVELOPMENT OF THE VENTURE CAPITAL AND ANGEL INVESTOR MARKETS

Recommendation R10 – Continuation of Government Support for Seed and Early Stage Finance in Ireland

Consideration should be given to the following in relation to seed and early stage finance:

- Introducing an investment follow-on fund specifically targeted at participants of seed programmes.
- Ensuring that an appropriate range of alternative finance options (as per recommendation R5 above and based on examples in section 6) is available to such businesses including entrepreneur loans or hybrid instruments incorporating debt and subordinated tranches.
- Targeted venture capital funding, including consideration of Ireland-only or all-island non-seed funds, to allow for a lower bar for some emerging viable seed companies who may not compete at the international level in terms of follow-on funding. The five new Enterprise Ireland non-seed funds (Ireland-only), currently at expression of interest stage, may address some of these issues, albeit that they are focused on the broad technology and life sciences sectors.
- Continued support and assistance to emerging Irish seed companies in competing for commercial funding from international venture capital funds to raise the standard in terms of financial, commercial, management and presentational skills amongst this group.
- Consideration may need to be given to addressing the lack of diversification in seed and early stage funds (focused primarily on high-tech) to ensure that potential high-growth companies which are not necessarily high tech are not dissuaded from the equity route (self-selecting themselves due to a perception that the funds are not relevant to their sector or company type), or otherwise restricted due to fund restrictions or the specialist focus and preferences of the VC fund managers. We understand that Enterprise Ireland is in discussions with the European Investment Fund in this regard.

Recommendation R11 – Support of Angel Investment across the island of Ireland

The establishment of an Irish dedicated co-investment fund or angel fund should be considered where investment selection is initially led by the private investors, who set the terms, but with the remaining funding provided by the co-investment fund.

We recognise the existence of the Co-Fund NI which supplied £1.7m in funding to seed and early stage businesses. Co-Fund NI leveraged additional private sector investment of £3m in addition to the Invest NI (INI) portion of £1.7m (2012).

The establishment of a co-investment fund or angel fund, which has merit in its own right to further promote business angel investing, may also promote further diversification where initially led by the private investors.

The recent establishment of a new all-island food business angel syndicate may demonstrate potential for funding of 'non-tech' sectors by equity investment although it is too early to make any detailed assessment of the syndicate.

As the visible business angel market in Ireland is small relative to other countries and due to the fact that investments through structured vehicles such as the Seed Capital Scheme (SCS) and the Employment and Investment Incentive (EII) scheme show a downward trend in overall investing, consideration should be given to the following:

- Further promotion and awareness raising of the benefits of the existing SCS and the EII scheme are required; and
- Extension of the terms of the EII relief in line with the more extensive and attractive UK-based Enterprise Investment Scheme and the Seed Enterprise Investment Scheme.

Due to the increasing relative importance of business angels as a source of finance for SMEs and, the as yet relatively small size of the total business angel market in Ireland and Northern Ireland, we recommend continued public funding of both the jurisdictional and cross-border Business Angel network infrastructure.

Recommendation R12 – A Venture Capital Strategy for Northern Ireland

Echoing the recent *Review of Access to Finance for SMEs in Northern Ireland* (EAG, 2013), we recommend that a comprehensive Venture Capital Strategy is developed for Northern Ireland which informs and develops the equity funds under the Access to Finance Strategy, dovetails with the new Innovation Strategy (to be published in early 2014) and supports wider policy objectives to further promote entrepreneurial activity in Northern Ireland. This strategy should address medium to long-term considerations including the avoidance of future gaps in the continuum of funding, an issue which is likely to have impacted demand and confidence in equity funding in Northern Ireland. And, in the shorter term, it should frontload early risk capital initiatives and associated support services to take into account the importance role of proof of concept, seed and early stage capital availability as a demand stimulant.

Two new development capital funds of £30m each were awarded in 2013 and are understood to be subject to contract at the date of writing. In early 2013, the Invest Growth Proof of Concept Fund (pre-commercial grant), which was fully committed at the end of 2012, and the Invest Growth Fund were extended by £2m each to March 2014, with a view to putting in place increased seed and early stage funding from April 2014.

Recommendation R13 – Investment in Seed and Early Stage Capital in Northern Ireland

The extension of risk capital needs to be supplemented by a range of wider support initiatives to promote innovation and the entrepreneurial environment and provide wrap around services to start ups. Despite acknowledged success of some investment readiness support programmes, it was considered that further work was required to simplify and streamline the full range of supports, promote them in a more user-friendly and understandable manner, improve the commercial and management skills of early stage company teams, and extend the level of support available recognising that a significant degree of handholding was required for early stage companies. Consideration needs to be given to the appropriate nature and level of wrap-around services appropriate to an extension of risk capital for seed and early stage companies to address potential demand side weaknesses and leverage the benefits of the investment.

2. Introduction

This report presents the results of a study into access to finance for growth amongst SMEs in Ireland and Northern Ireland. The study, for the first time, examines not only bank finance but finance available to SMEs from other sources such as government funding, venture capital and angel finance.

The study also, for the first time, presents a complete picture of the supply of finance to SMEs across the island of Ireland, in particular the supply of bank finance in Northern Ireland. In Ireland, banks provide supply side data to the Central Bank of Ireland. However, at present, no such process exists within Northern Ireland. This study provides a unique analysis of the total value of the credit extended by banks in 2012 to SMEs in Northern Ireland.

This study is an important component in the complete and rigorous assessment of the current supply and demand side issues related to bank and non-bank finance for SMEs trading in Ireland and in Northern Ireland.

2.1 OBJECTIVES OF THE STUDY

The three main objectives of the study are to provide:

- A review of the current information covering access to finance for SMEs and, in particular, clarify the balance between the supply-side and demand-side issues;
- A review of the current supply of various types of finance for growth (including bank lending, business angel finance and Venture Capital (VC)) and assessing the potential for new and alternative ways of financing enterprise growth; and
- A series of recommendations for the financial providers, businesses and policy makers with a particular emphasis on where cross-border cooperation can deliver mutual gains to Northern Ireland and Ireland.

2.2 DEFINITIONS USED IN THE STUDY

The following definitions and explanations should be considered in the context of the study:

- The study concentrated on direct sources of finance which include the physical transfer of funds from a lender or other finance provider to an SME.
- The study excluded detailed commentary on indirect sources of finance which support SMEs by means of trade credit, access to staff resources and/or tax incentives.
- At an overall level, an SME is defined (using the standard EU definition) as any entity engaged in an economic activity, irrespective of legal form (i.e. corporation, partnership, sole-trader, etc.), which employs fewer than 250 persons and whose annual turnover does not exceed €50m or whose annual balance sheet does not exceed €43m.
- The study included companies falling into one of three categories of SME, as determined by the EU definition of each category, which can be broadly summarised as follows:

	EMPLOYEES	TURNOVER	BALANCE SHEET VALUE
MICRO	<=10	<=€2M	<=€2M
SMALL	<=50	<=€10M	<=€10M
MEDIUM	<=250	<=€50M	<=€43M

- In instances where data which would allow categorising SMEs accurately was not available, or was deemed unreliable, the number of employees employed in the enterprise was used as a proxy.
- Business sectors were mapped to the NACE Rev. 2 statistical classification of economic activities in the EU.[3] As such, the study included companies from sectors A to Q.
- The study draws on relevant reports largely published before January 2013 and the results of surveys, including those of the Q3 and Q4 2012 InterTradeIreland Business Monitor [4].
- Data was collected from seven banks and ten other finance providers in the course of the study and this covered the period 1st January 2012 to 31st December 2012.

Bank Data Analysis

For the analysis of data provided for the study by banks in Ireland and Northern Ireland, two methods have been employed:

- Full reporting method (all sectors); and
- Real economy data method – i.e. certain sectors are excluded, following the same approach as that employed by the Central Bank of Ireland in the Trends in Business Credit and Deposits publication. The following sectors have been excluded:
  - F. Construction – to remove speculative property related lending;
  - K: Financial Intermediation; and
  - L: Real Estate, Land and Development Activities – to remove speculative property related lending.

The reporting method used in this study is similar to that employed by the Central Bank of Ireland for reporting on SME lending, with one exception. The Central Bank reporting method is more comprehensive than this report as it includes SMEs involved in financial intermediation (i.e. lending to certain financial vehicle corporations (FVCs), mostly mortgage backed securitisation vehicles), whose balance sheet size brings them into the SME definition. Lending to these SMEs is not included in the data presented in the report.

In the case of the data reported under the real economy data method – which is the most accurate and more widely used method of presenting SME lending data - the Central Bank of Ireland numbers are fully reconciled with the data presented in this report and the reporting methodologies are fully aligned.

The original exercise to collect data from the banks in Ireland to facilitate reporting of this data, now undertaken by the Central Bank of Ireland, was a comprehensive exercise. It involved the lengthy on-site collection and audit of the data by Mazars at the beginning of the process to ensure its completeness, accuracy and definition. This form of data audit did not take place as part of this study due to time and resource limitations. This initial step is an important component in the reporting of accurate bank supply data, as it ensures that the different operational methods of the various banks, the different definitions used and the data collection systems are fully understood and accommodated. For this study a number of assumptions have been made in the compilation of the Northern Ireland bank data figures (see Appendix 3). In the event that ongoing reporting of bank data is envisaged, further work would be required to improve the robustness and consistency of the data.

2.3 REPORT STRUCTURE

This report has been structured as follows, in order to respond to the objectives outlined in Section 2.1:

- **Section 3** provides a contextual picture of the environment in which SMEs are operating, the economic environment in which they are trading, their importance to the Irish and Northern Irish economies, trends in SME business performance and the manner in which SMEs in both jurisdictions are currently financing their businesses.

[3] The NACE Code system is a pan-European classification system which groups organisations according to their business activities. It assigns a unique 5 or 6 digit code to each industry sector e.g. B - Mining and quarrying - B5 - Mining of coal and lignite. These sectoral definitions are used in Eurostat and Central Bank of Ireland reports on SME data.

[4] The InterTradeIreland Business Monitor interviews 1,000 business owner/managers across the island of Ireland each quarter. Results can be accessed at http://www.intertradeireland.com/researchandpublications/

- **Section 4** is structured around an analysis of the demand for finance amongst Irish and Northern Irish SMEs. It examines the absolute levels of demand for bank, equity and other forms of finance, the nature of this demand and the purpose for which finance is being sought. It also examines the sectors and types of SME with the highest demand for finance and the extent to which demand varies by business growth stage. Finally this section examines the extent to which demand is impacted by other factors.

- **Section 5** examines the supply of finance to Irish and Northern Irish SMEs from all the major funding sources – banks, equity providers, public funds and other sources. For the first time it quantifies the absolute level of total and real economy credit being supplied by banks operating in Northern Ireland and the nature of this supply.

- **Section 6** provides an overview of the SME finance products, schemes and initiatives being undertaken in other countries that may be of interest in Ireland and Northern Ireland.

- **Section 7** sets out a series of recommendations to address the issues noted in this study and to improve access to finance for SMEs in Ireland and Northern Ireland.

3. Lending Context

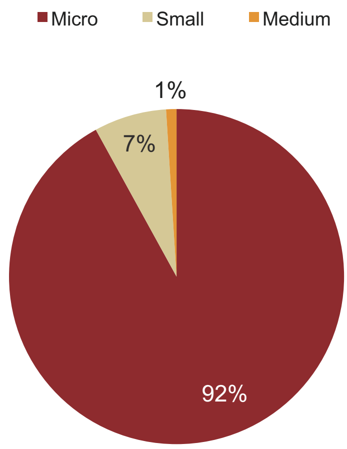
3.1 THE IMPORTANCE OF SMES TO THE ECONOMY[5]

Approximately 300,000 Small and Medium Enterprises (SMEs) are active in Ireland and Northern Ireland employing 1.4 million people. This represents almost 70% of the total work force on the island of Ireland. SMEs represent 99.8% of all enterprises in Ireland and 99.9% in Northern Ireland.

SMEs can be categorised as micro, small or medium enterprises and Figure 1 shows that the vast majority of SMEs are classed as micro enterprises (i.e. companies which employ less than 10 people with turnover or balance sheet values of less than €2m).

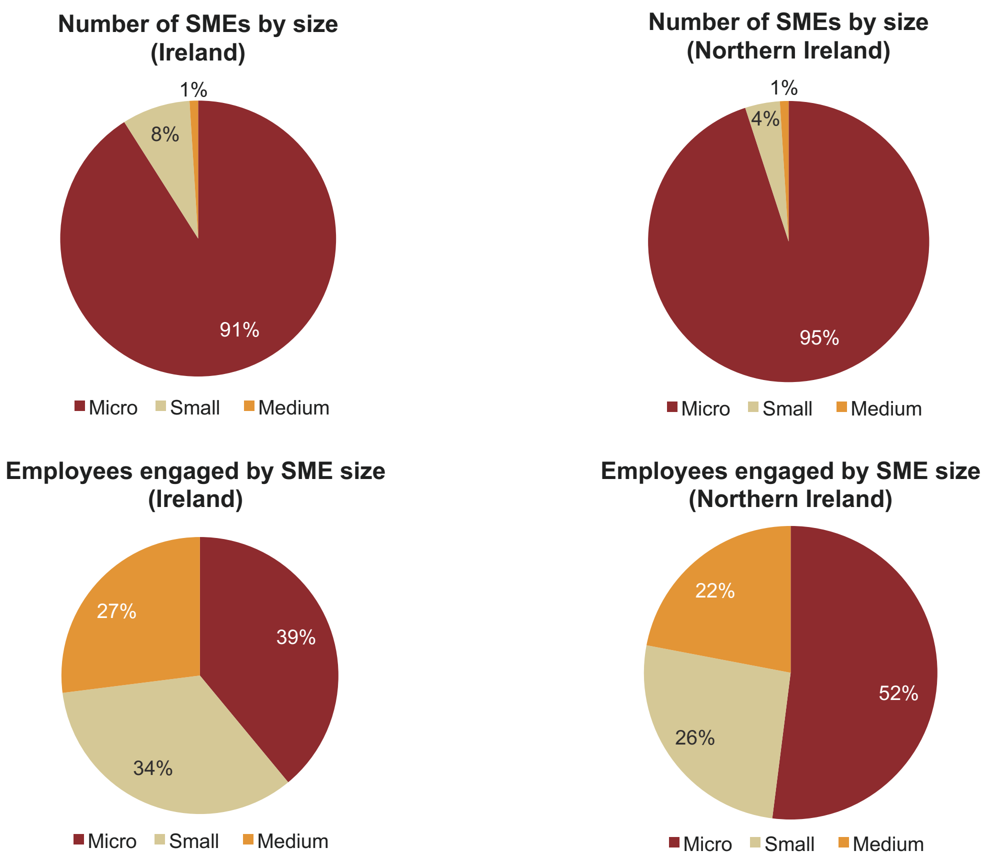
When analysed by the number of persons engaged (often used as a proxy for economic weight), micro SMEs employ over half of all those working in SMEs in Northern Ireland and just under 40% in Ireland.

Figure 1: SME Size Split



Source: Ireland: CSO, Northern Ireland: BIS UK

Figure 2: SME Profile – Number and People Employed

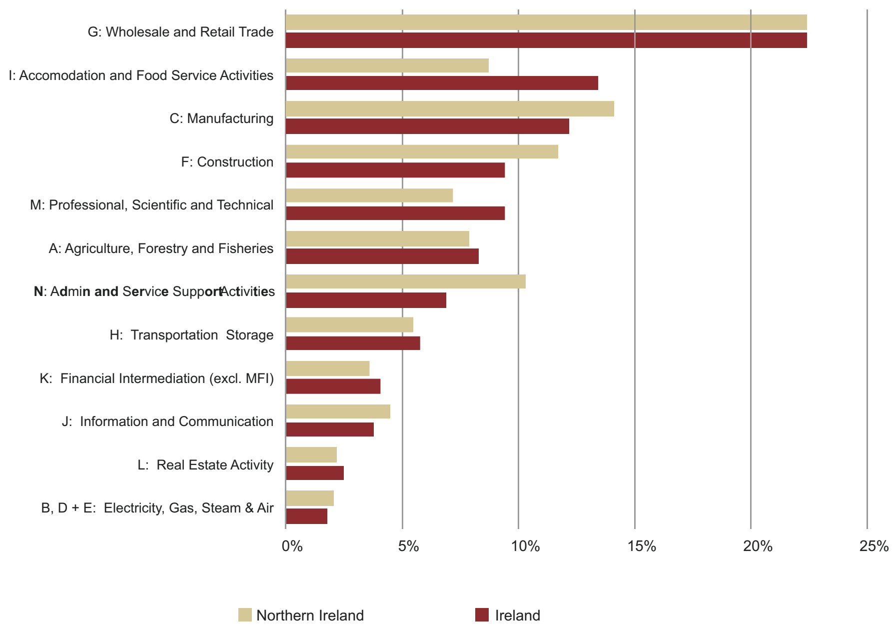


Source: Ireland - CSO, Northern Ireland - BIS UK

[5] Figures in this section are taken from: Ireland - Central Statistics Office (CSO), *Business Demography 2010,* (includes Sectors B-P) and *Quarterly National Household Survey* (QNHS) for Q2 2012 (includes Sector A: Agriculture, Forestry and Fisheries); Northern Ireland - Department of Business Innovation, *Business Population Estimates for the UK and Regions 2012* (for Sectors A – S).

In Ireland the Wholesale & Retail, Accommodation & Food Services, Manufacturing and Construction sectors dominate the SME employment landscape, whereas in Northern Ireland, Wholesale & Retail, Manufacturing, Construction and Administration & Service Support Activities are the dominant four sectors.

Figure 3: Employee Share of Total SME Employment by Business Sector



Source: CSO, Department of Agriculture, Fisheries and Food, BIS UK

Of the four main sectoral employers in each jurisdiction, three have been in distress and are very dependent on the domestic economy, with high levels of debt. Conversely sectors with the potential for most growth on the basis of their export-oriented nature (e.g. Information and Communication) employ significantly fewer people. Agriculture, which is traditionally not included in SME statistics, is also a significant employer in both Ireland and Northern Ireland.

In Gross Value Added (GVA) terms, SMEs account for about 82% of GVA in Northern Ireland and 52% in Ireland.

3.2 ECONOMIC CONTEXT

At the time of the research in 2012, the trading environment for SMEs operating in Ireland and Northern Ireland was difficult, something which has begun to ease in 2013.

In 2012 this environment was characterised by:

- Unemployment rates of 7.8% in Northern Ireland and 14.7% in Ireland[6] against an EU average of 10.9% and an increase of 3.5% in Northern Ireland and 10% in Ireland in the previous four years. Within the OECD, only Spain and Greece had experienced a more significant change than Ireland.
- A retail sales index in Ireland which was almost 22% lower than it had been in 2007.[7]

[6] Figures from the Department of Enterprise, Trade and Investment (DETI) and CSO.
[7] Figures from CSO.

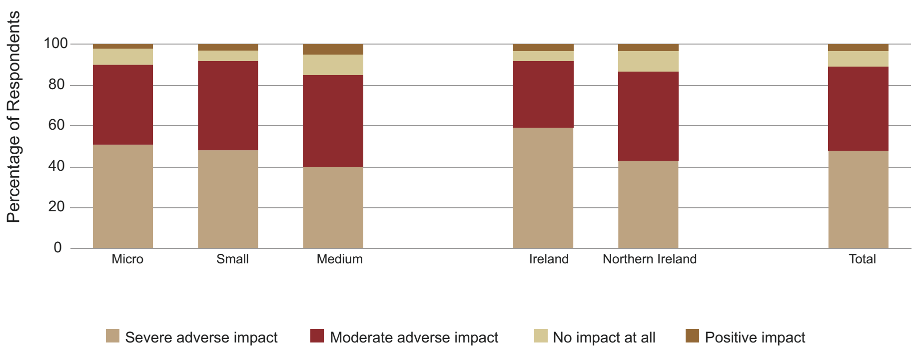
- Personal consumption at its lowest level since 2004 in Ireland and Northern Ireland.
- Falls in consumer sentiment of almost 63% in Ireland.
- Significant reductions in residential property prices (approximately 50% in Ireland and 56% in Northern Ireland[8]) in the previous five years.
- Levels of insolvency that peaked in Ireland at 450 companies in Q3 2012 and at 118 in Northern Ireland in Q2 2012.[9]

The Irish economy was technically in recession between 2008 and 2011 (ESRI, 2013a). Whilst the UK technically entered recession in 2008 and exited it in Q4 of 2009, the recession in Northern Ireland has been deeper and longer than in the rest of the UK. The private sector has contracted by approximately 15% from its peak in 2007 and Northern Ireland was one of only two UK regions which reported a fall in output during the last quarter of 2012. It also recorded the fastest quarterly fall in employment across the UK regions (EAG, 2013).

3.2.1 IMPACT OF ECONOMIC PERFORMANCE ON SMES

The impact of the trends in 2012 on companies provides a snapshot of the overall health of SMEs. The results of the InterTradeIreland Q4 2012 Business Monitor demonstrated that approximately 90% (Ireland 92%; Northern Ireland 88%) of respondents had experienced either a severe or moderately adverse impact on their business since the onset of the economic downturn in 2008.

Figure 4: Impact of Economic Downturn



Source: InterTradeIreland Q4 2012 Business Monitor Survey

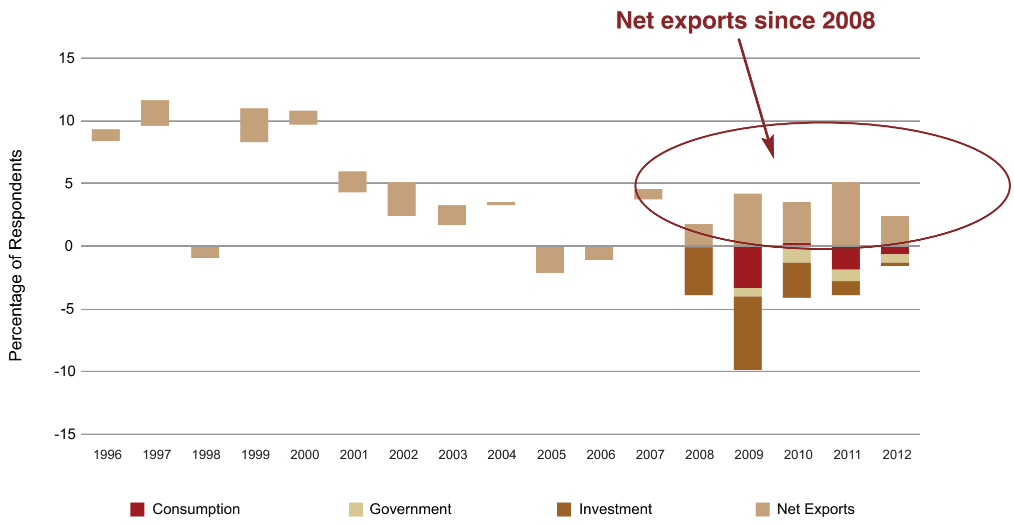
This impact can also be seen in the churn of enterprises. The data[10] suggests that in Ireland the rate of companies being created is just over half of those being closed, while in Northern Ireland the rate of SME company creation is about 20% below the rate of closure. Therefore, in both jurisdictions, the net number of companies in operation has decreased since 2008.

[8] Figures from the Department of Finance and Personnel (DFPNI) and CSO.
[9] Figures from www.insolvencyjournal.ie and DETI.
[10] For this data see Office of National Statistics (ONS), *Business Demography 2011* and CSO, *Business Demography 2011*.

3.2.2 DRIVERS OF ECONOMIC GROWTH

Whilst comparable figures for Northern Ireland are currently not available[11], it is possible to examine the source of economic growth in Ireland in the period 2008-2012. The majority of growth in the economy in this period has been based on exports as is shown in Figure 5.

Figure 5: Components of Irish Economic Growth (GDP) 1996-2012



Source: DKM, 2013

However, the National Competitiveness Council (NCC, 2012) cautioned that, while exports are forecast to increase in 2013 and 2014 they will do so at a slower pace than in recent years, pointing to a difficult international trading environment.[12]

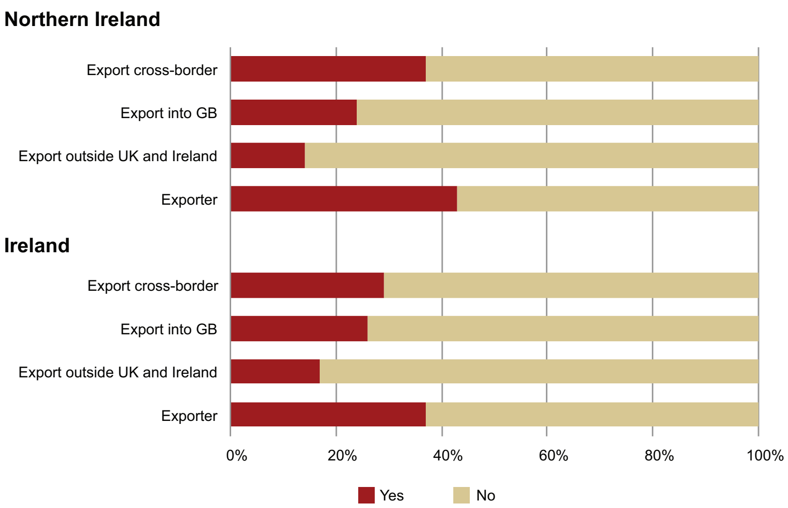
Data from the Department of Enterprise, Trade and Investment (DETI, 2013) supports this, showing that Northern Ireland's goods exports decreased by 5.5% in 2012/2013, driven by decreases to key export markets such as Ireland and the Euro zone. Accordingly, the new NI Composite Economic Index has shown a 1.2% decrease in NI output compared to a 0.2% increase in UK GDP over the same period (Q1 2012 to Q1 2013).

3.2.3 SME RELIANCE ON THE DOMESTIC ECONOMY

Across the island of Ireland, as shown in Figure 6, the InterTradeIreland Business Monitor for Q3 2012 reported that approximately 65% of micro enterprises, 50% of small enterprises and 40% of medium enterprises do not export goods or services and, as such, are heavily reliant on the domestic economy.

[11] There are main two measures of exports from Northern Ireland, the Regional Trade Statistics produced for UK regions by HMRC and the NI Manufacturing Sales and Exports Survey produced by DETI.
[12] National Competitiveness Council, *Irelands Competitive Scorecard 2012.*

Figure 6: Exporting Profile



Source: InterTradeIreland Business Monitor survey, Q3 2012

This makes these businesses more dependent on domestic personal consumption levels, consumer sentiment and retail sales figures, all useful indicators of the level of confidence in the domestic economy. A recent report (DKM, 2013) compared consumer sentiment indices in Ireland with those of Eurostat. The results indicated that Ireland demonstrated the strongest peak decline in consumer sentiment to February 2013 of any European country measured, including Greece. Comparable Eurostat figures are not available for Northern Ireland.

A number of factors have an impact on personal consumption and domestic demand including:

- The contracting market value of residential property and any increase in mortgage defaults;
- High levels of unemployment and increased net emigration;
- Degradations in consumer spending as recorded by consumer-led indexes such as the retail sales index or consumer sentiment indices; and
- Increases in gross household savings.

The Central Bank of Ireland (CBI, 2013) reports that domestic indicators in Ireland suggest that households and SMEs are continuing to reduce their debt levels, and that public spending is cautious. Households and governments are spending less and saving more or paying down existing debt levels. The National Competitiveness Council (NCC, 2012) reports that weak consumption represents a major drag on economic growth *"whereas excessive domestic consumption in the second half of the last decade – most evident in the mania for property – was a significant contributory factor in undermining Irish competitiveness and was unsustainable, the pendulum has now swung in the opposite direction".*

Whilst this rebalancing is necessary, it constrains domestic demand. The Economic Advisory Group (EAG, 2013) suggests that a similar trend is apparent across the UK. Bank of England data clearly shows that new lending has been falling while repayments of existing debt have risen. British Banking Association (BBA) data also suggests that businesses are still largely focused on repayment of debt.

Additionally, public spending programmes and demand by state and semi-state bodies for publicly procured capital works, goods and services has reduced by approximately 16% in recent years across Ireland and Northern Ireland due to fiscal adjustment. There is little prospect of a significant increase in spend in the all-island public procurement market in the next few years.

3.2.4 CHALLENGES FACING THE IRISH BANKING SECTOR

The Irish banking system faces a number of challenges including addressing levels of distressed credit, managing capital positions, funding and increasing regulatory requirements.[13]

Legacy lending decisions mean that large volumes of existing assets (mortgages, commercial loans, and SME loans) are underperforming. It has been reported that *"increases in credit allocated to a sector that outstrips the amount predicted by a long-run linear trend are likely to be highly correlated with decreases in credit standards in lending to that sector"* (Lawless & McCann, 2012). These findings suggest that decreasing credit standards during a boom cycle lead to increased loan delinquency during a crisis.

Unsustainable lending products created during the boom, such as tracker mortgages and certain Commercial Real Estate (CRE) loans, now require significant balance sheet management, potential borrower resolution or restructuring. In 2012, the pillar banks in Ireland made tentative returns to the funding markets, but a weakened international reputation means that credit risk and the cost of doing business remains high.

For the major Irish-owned banks operating in Ireland and Northern Ireland[14], costs are currently greater than income and are likely to remain so for some time. These organisations have been focusing in the short term on streamlining operations, splitting their portfolios into core and non-core assets and changing their local banking networks and staffing levels.

Increased regulation is also evident in the change of approach and tone taken by regulators and Government. While various programmes are driving deleveraging in the banks, Basel III requirements are also placing a further emphasis on level of capital required. A move towards banking union in the EU is also likely to increase regulation.

Other major challenges for the banks in 2012 included the following:

- The interconnectedness of borrowers across commercial and residential loan books;
- Financial instability within the Eurozone, impacting on access to funding and liquidity;
- The view of the markets on the sovereign debt crisis in the EU and elsewhere;
- The potential impact of new personal insolvency legislation in Ireland;
- The outlook of economic recovery with the consequent pressure on asset quality and increased provisioning; and
- Restrictions on the wholesale funding market.

3.2.5 CHANGES IN BANK CAPITAL REQUIREMENTS

The current banking environment in which SMEs are seeking to secure credit is fundamentally different to that which was in operation in the period prior to 2009.

Under the bank recapitalisation programmes in both Ireland and the UK, banks and, in particular those banks who are the primary lenders to SMEs in Ireland and Northern Ireland, have been obliged to significantly change their bank funding and capital practices. Therefore, *"Irish banks are engaging in a process of de everaging whereby they are disposing of non-core assets over time, in order to bring down their loan-to-deposit ratios and reduce their dependence on Central Bank funding. In the aggregate, domestic banks' deleveraging has exceeded the programme's targets for 2011 as a whole"* (Forfás, 2012).

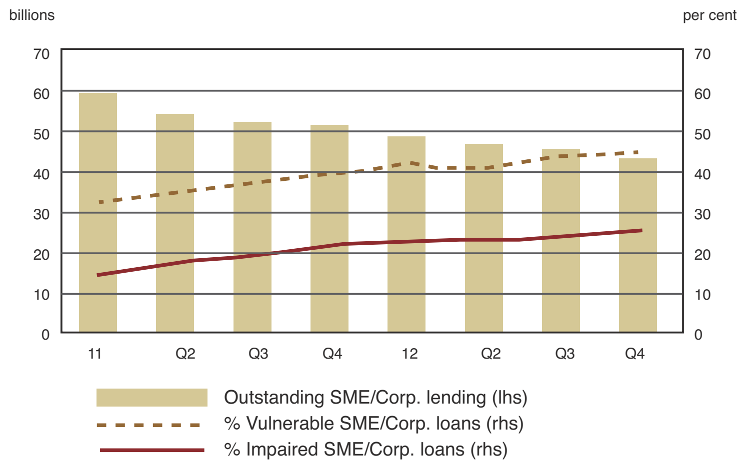
[13] This was before the announcements in October 2013 that Danske Bank and ACC Bank were to close their retail banking services in Ireland from 2014.

[14] According to the results of the Q3 2012 Business Monitor Bank of Ireland and AIB/First Trust Bank account for approximately 80% and 30% of business banking accounts in Ireland and Northern Ireland respectively.

Additionally, under the Prudential Liquidity Assessment Requirement (PLAR) process in 2011, Irish pillar banks were required to change the capital composition of their balance sheets, in particular the loan to deposit ratios: *"under the PLAR requirement established at the end of 2010, the main Irish controlled banks were required to shrink their balance sheets so that by the end of 2013, credit advanced would be no more than 121% of the banks' deposits, compared with a ratio of over 180% at the end of 2010. The PLAR targets have been since modified towards a specific target for reduction in non-core lending and that this deleveraging is leading to a… contraction in the domestic loan book"* (DKM, 2013).

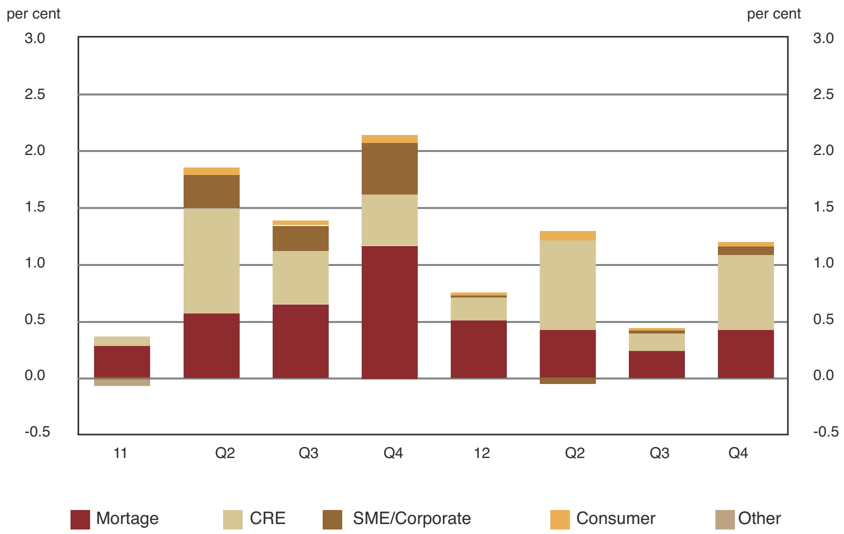
At the same time, as Figures 7 and 8 demonstrate, the stock of impaired loans has continued to rise across the main banks which are lending to SMEs in Ireland. Whilst statistics are not separately collected for Northern Ireland, in Ireland the value of impaired loans to Irish SMEs and non-financial firms stood at €10.8 billion at December 2012. This represented 25% of the SME/corporate loan book, an increase from 21% of the book at December 2011 (CBI, 2013).

Figure 7: Irish Domestic Banks' SME/Corporate Lending, Impaired and Vulnerable Loans 2012



Source: Central Bank of Ireland

Figure 8: Irish Domestics Banks' Flow of Impaired Loans as a Percentage of Outstanding Lending 2012



Source: Central Bank of Ireland

It is important to note that bank lending tends to be cyclical. Capital requirements increase when credit conditions deteriorate. As the probability of default increases in weakening credit conditions, the quantum of risk-weighted-assets also increases and the Tier 1 and Tier 2 capital ratios fall. As banks are required by their supervisors to maintain certain capital ratios, they can only continue to achieve this in a weakening credit environment by reducing the volume of lending or increasing the quantum of capital available to them. This leads to restrictions in credit. This can have knock on consequences for borrowers that do not appear to be vulnerable but are reliant on refinancing to repay debt. The likelihood of securing refinancing decreases as credit conditions weaken, thereby increasing the probability that the customer will default.[15]

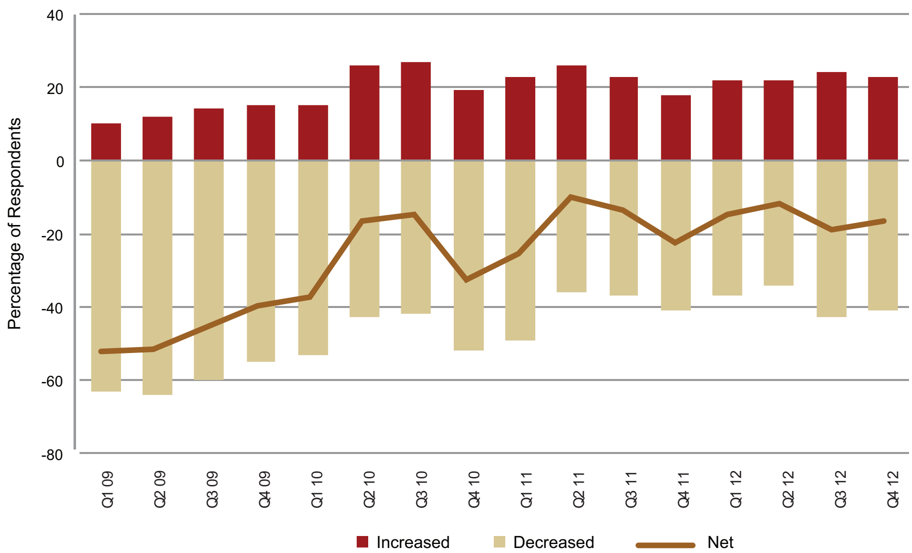
In the case of Northern Ireland, the absence of bank headquarters has several implications. It would appear to have restricted more timely access to initiatives such as the Funding for Lending Scheme as well as impacting on the effectiveness of other national initiatives implemented by the UK government. In addition, the non-devolution of regulation means that the Northern Ireland Executive is limited in its power to address and influence banking and finance matters.

3.3 SME BUSINESS PERFORMANCE

Numerous surveys, including the quarterly InterTradeIreland Business Monitor and twice-yearly Irish Department of Finance SME demand survey, have indicated that micro-enterprises, domestically focused businesses and businesses in sectors such as Wholesale & Retail, Accommodation & Food Services and Construction have experienced the most severe degradation in trading conditions. In general, SMEs in Northern Ireland have fared better than those in Ireland.

Economic indicators in 2012, such as GNP and unemployment rates, began to point to a stabilisation in the economies in Ireland and Northern Ireland. Consecutive InterTradeIreland Business Monitor surveys in 2012 also suggested that, while more SMEs were continuing to report decreased sales rather than increased sales, an incremental recovery was apparent, as can be seen in Figure 9. These positive movements have continued into 2013.

Figure 9: Sales Performance in Ireland and Northern Ireland

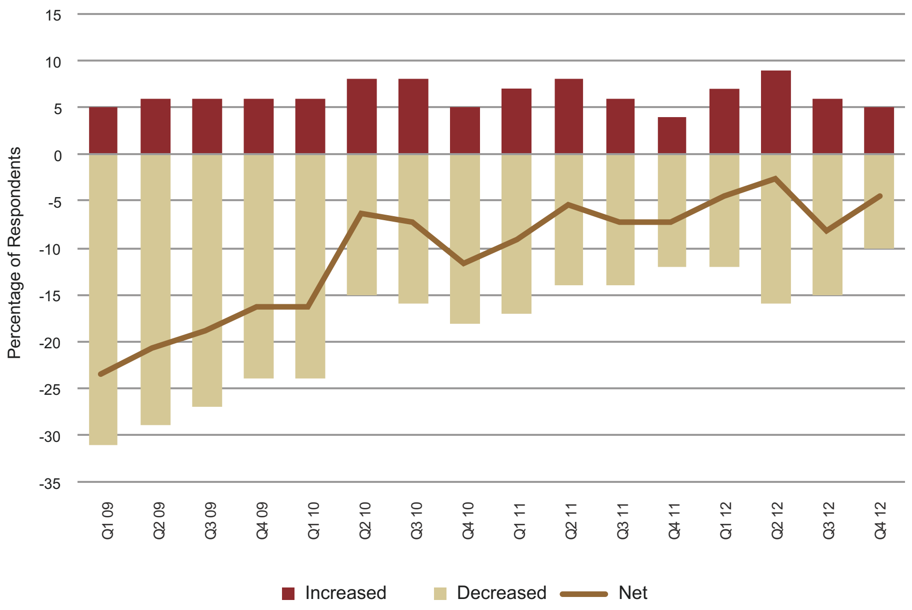


Source: InterTradeIreland Business Monitor surveys, Q1 2009 to Q4 2012

[15] The importance of lending to SMEs is recognised in the supporting or special discount factor for SME lending that has been included in the European Commission's Capital Requirements Directive (CRD) IV introduced in 2011.

It would appear from Figure 10 that, in net terms, while more SMEs continued to reduce employee numbers rather than increase employee numbers, this trend had begun to level off in 2012 and 30% of medium companies were hiring staff. In addition, staff reductions amongst micro SMEs stabilised.

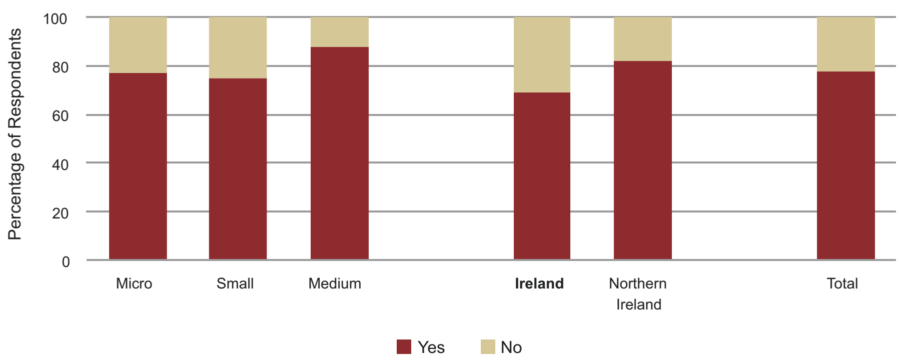
Figure 10: Employment Performance in Ireland and Northern Ireland



Source: InterTradeIreland Business Monitor surveys, Q1 2009 to Q4 2012

Figure 11 shows that the majority of respondents (80% - Ireland 72%; Northern Ireland 85%), despite the tough trading conditions, indicated that they had made a profit in the previous 12 months. Medium businesses appeared to perform the best.

Figure 11: Profit in the Business in the Last 12 Months



Source: InterTradeIreland Business Monitor survey, Q3 2012

This is supported by research in the UK (BDRC Continental, 2012). SMEs in Northern Ireland are as likely to be as profitable as their UK counterparts but where they made a profit, the median profit was likely to be lower than the UK average. Also the EAG reported that, *"while the Northern Ireland Annual Business Inquiry shows that SME turnover had remained largely stable between 2008 and 2010, investment in terms of capital has decreased by 48%"* (EAG, 2013).

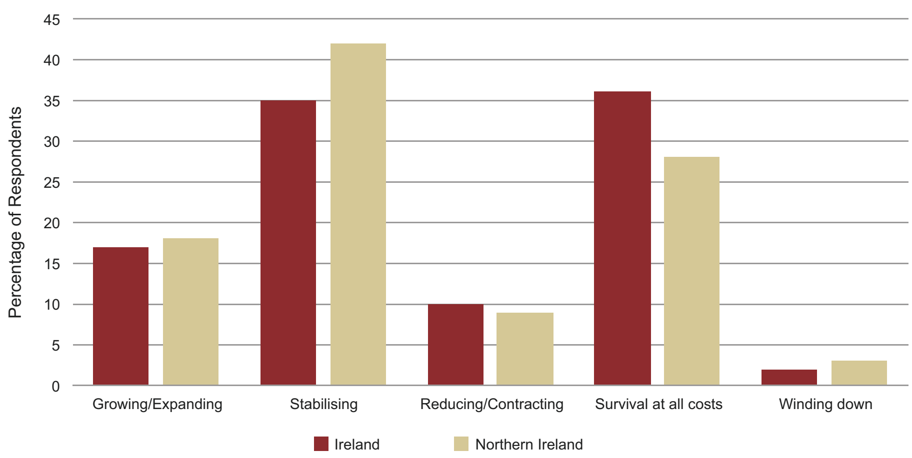
This suggests that, in general, businesses have been cutting costs and restructuring the business in order to ensure continued profitability.

3.3.1 SME GROWTH PLANS

The performance and growth outlook of an SME is an important factor in its ability to secure finance. In 2011 and 2012 the InterTradeIreland Business Monitor consistently found that the majority of SMEs described themselves as stable. However, more SMEs were describing themselves as 'surviving at all costs', rather than 'growing or expanding', indicating a net reduction in the quality of the SME population.

As Figure 12 shows, only 13% (12% Ireland; 13% Northern Ireland) of survey respondents indicated that they were 'growing' and 48% reported that they were 'stabilising' (43% Ireland; 52% Northern Ireland) in Q4 2012. More SMEs in Northern Ireland were focused on growing or stabilising their businesses than in Ireland; a higher percentage of SMEs in Ireland was focused on 'survival at all costs'. Latest figures would suggest however, that a business-led recovery is beginning to take root with a significant increase in companies reporting growth in Q3 2013.

Figure 12: Current Status of the Business.

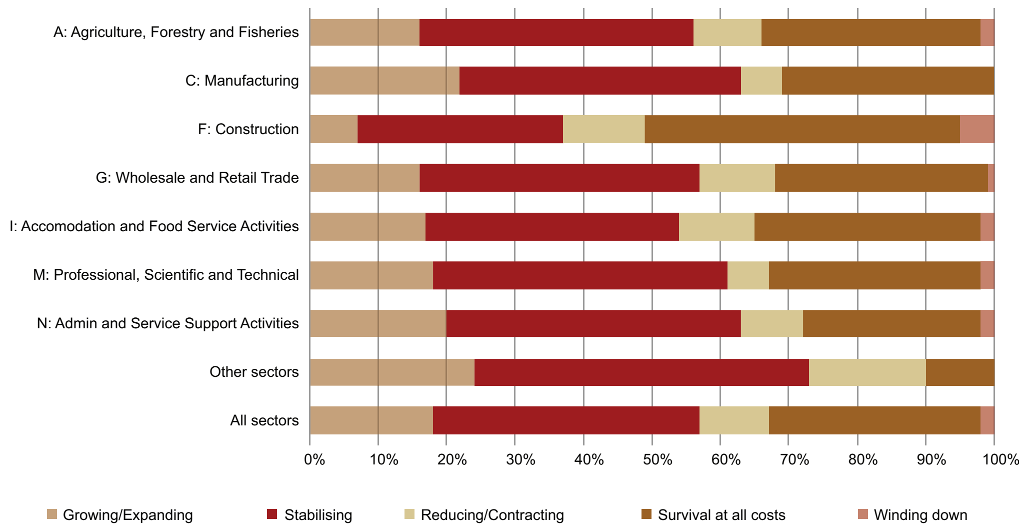


Source: InterTradeIreland Business Monitor survey, Q4 2012

If growth is examined on a sectoral basis, as in Figure 13, the following patterns are apparent:

- Manufacturing and ICT are the sectors showing the most growth/expansionary intention;
- In spite of the large numbers of staff employed the Wholesale & Retail, Accommodation & Food Services and Construction sectors are least likely to be expanding; and
- The Construction and Agriculture sectors are most likely to include SMEs who are surviving at all costs.

Figure 13: Current Status of the Business by Sector



Source: InterTradeIreland Business Monitor survey, Q4 2012

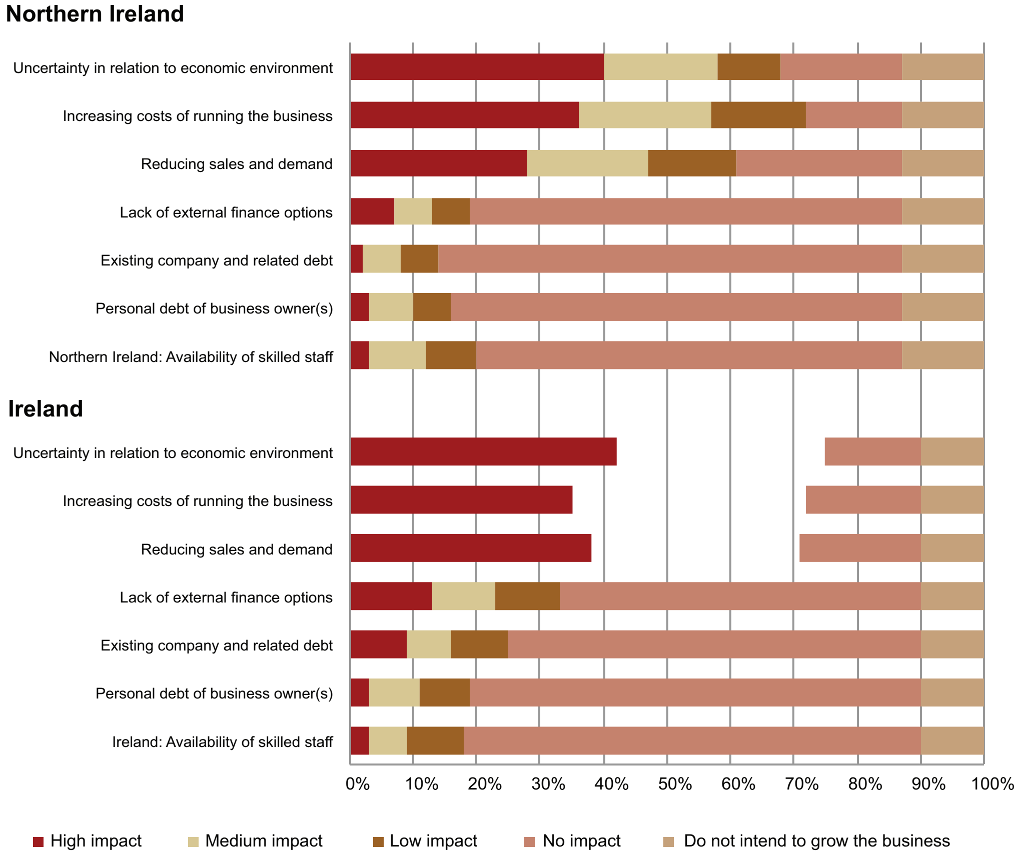
3.3.2 CONSTRAINTS ON GROWTH

When respondents were asked about preconditions needed for growth in the InterTradeIreland Business Monitor in Q4 2012, it was found that macro-economic factors ranked higher than other business issues. This has remained largely unchanged since 2011, with SMEs indicating that external economic factors still represent the greatest constraint to growth.

Most SMEs consider uncertainty in the economic climate, the resultant increase in the cost of running their business and reductions in trading activity due to decreases in consumer demand to be more important (75-80% of SMEs) than access to finance (20-30% of SMEs). This point is further substantiated by the 2011 UK Finance Monitor (BDRC Continental, 2012) which reported that 34% of SMEs in Northern Ireland considered the economic climate their major obstacle. The Northern Ireland Access to Finance survey (Department of Finance and Personnel, 2011) also reported that nine out of every ten businesses operating in Northern Ireland cited the general economic outlook at the time as being the main constraint for their business, with 59% citing the limited demand in the domestic market as the most significant limitation on the growth of their business. This is over 10 percentage points higher than the average UK figure.

Even with those figures Northern Irish SMEs appear to be less concerned about reductions in sales and the impact of the economy than Irish SMEs as is demonstrated in Figure 14.

Figure 14: SME Constraints on Business Growth Plans



Source: InterTradeIreland Business Monitor survey, Q4 2012

Figure 14 also highlights the proportion of SMEs who 'did not intend to grow the business' at all (a larger prevalence amongst small and stable SMEs). The provision of additional finance sources may be irrelevant to these SMEs. Policy may need to focus on how and to what extent additional SMEs can be encouraged to grow and indeed export into new markets thereby reducing their reliance on the challenged domestic market.

Existing levels of personal and company debt would appear to be more of an issue in Ireland than in Northern Ireland. More Irish SMEs indicated that the lack of external finance options was a growth constraint than SMEs in Northern Ireland. This may be due in some part to the existence of additional debt levels, in particular property debt, in Irish companies (see Section 4.1.14).

3.4 SME BUSINESS CONCERNS

3.4.1 MOST PRESSING BUSINESS CONCERNS FOR SMES IN IRELAND AND NORTHERN IRELAND

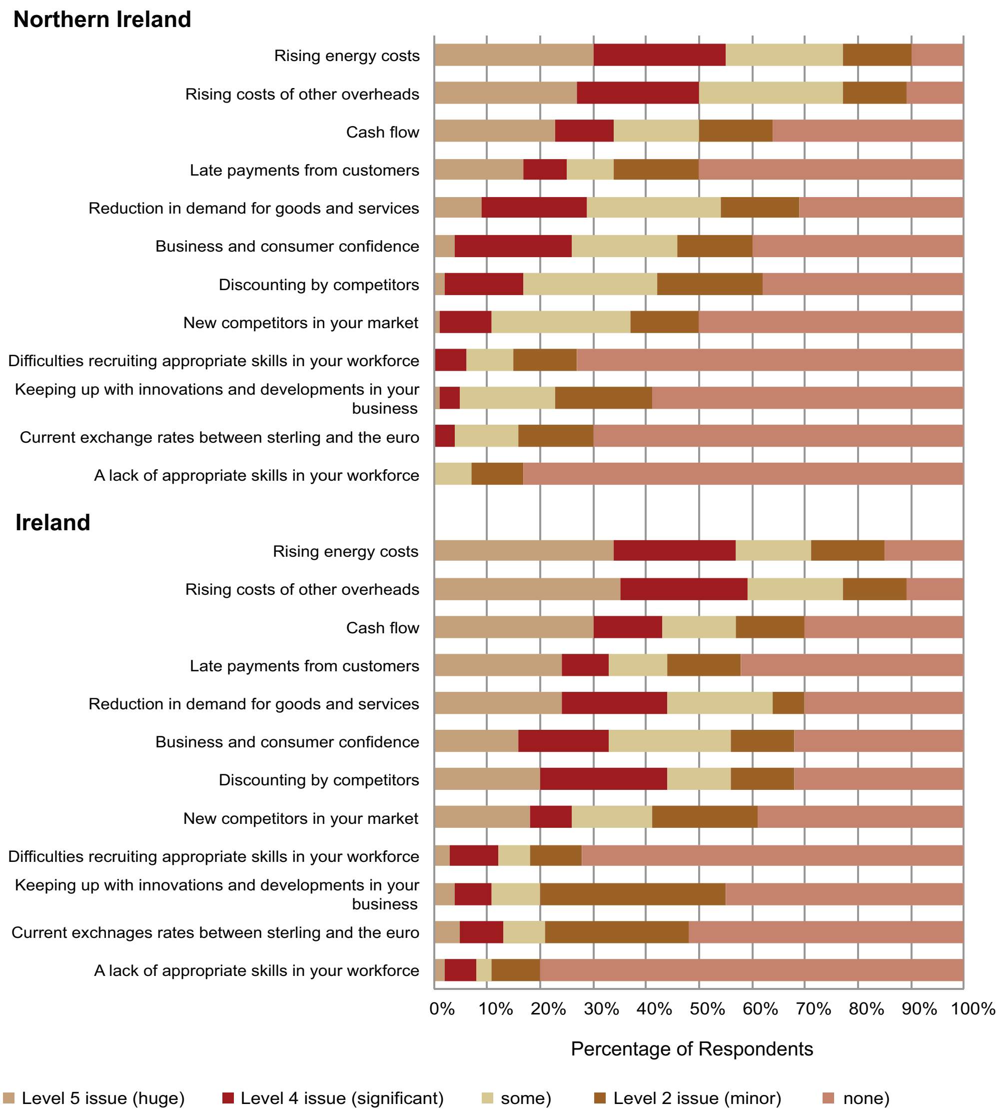
InterTradeIreland has been monitoring the primary business issues facing SMEs in its Business Monitor survey since 2009. This survey has consistently indicated that external cost pressures, in particular energy costs, are the main concern facing most SMEs regardless of their size.

As shown in Figure 15 cash flow pressure is also a significant issue[16] for approximately 41% of SMEs surveyed followed by a reduction in demand for their goods or services (33%). Access to finance is one of many issues noted by Irish and Northern Irish SMEs but the Business Monitor would suggest it is not the most important issue.

[16] Respondents who scored the issue four or five on a scale of one to five

With the exception of the issue of energy costs, the two jurisdictions are generally consistent in their overall ranking of business issues. Northern Irish SMEs are concerned, but not as concerned, about the impact of the external economic environment as their Irish counterparts. This clearly reflects the harsher economic climate in which Irish SMEs are trading and the lower levels of consumer confidence and levels of domestic demand in Ireland when compared to Northern Ireland.

Figure 15: Current Issues for SMEs in Business.

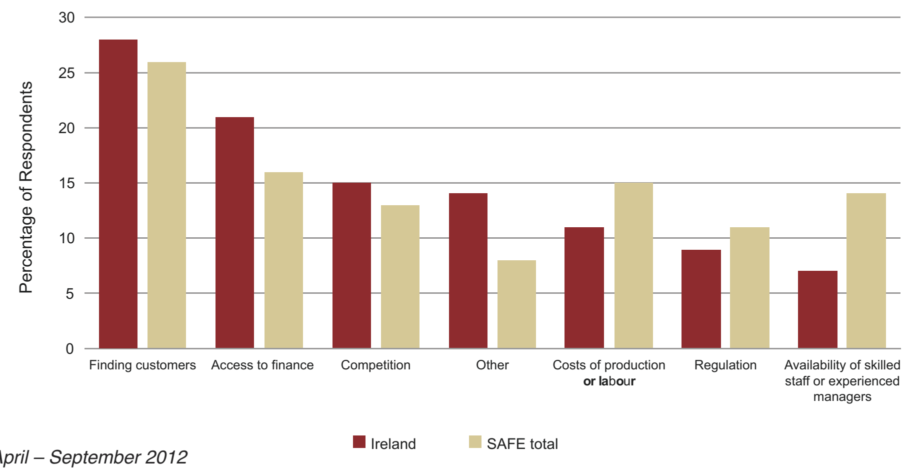


Source: InterTradeIreland Business Monitor survey, Q4 2012

3.4.2 MOST PRESSING BUSINESS CONCERNS FOR SMEs ACROSS EUROPE

The survey on access to finance of SMEs in the Euro area (SAFE)[17] has been monitoring the most pressing concerns of SMEs within the EU since 2009.

Figure 16: SAFE Survey Euro Area SME Business Issues

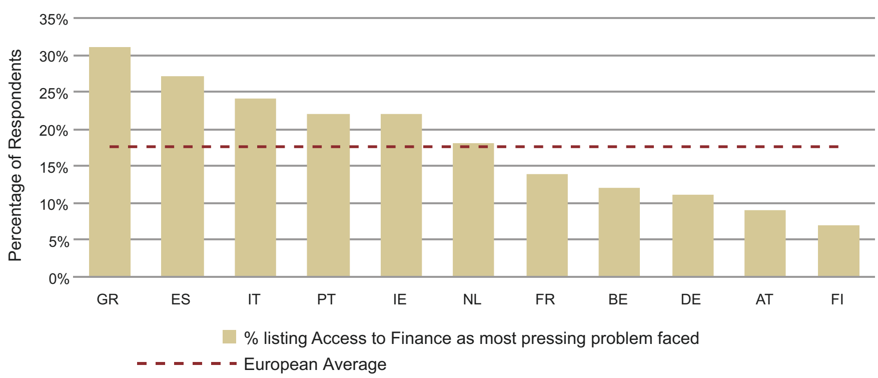


Source: SAFE, April – September 2012

The results of these surveys have consistently shown that although "access to finance" was cited as the most pressing problem for between 15%-20% of respondents, the dominant concern for SMEs was "finding customers" (25-30%).

When the issue of "access to finance" is reviewed in isolation it can be noted that, at 21%, Irish respondents indicate a slightly higher than average (18%) requirement for finance. Ireland is in a similar but slightly better position than Greece, Spain, Italy and Portugal –countries which are experiencing similar macro-economic difficulties – but is not a significant outlier in a European context. The SAFE survey does not examine business issues in the UK or in Northern Ireland.

Figure 17: SAFE Survey Euro Area SME Business Issues – Country Comparison



Source: SAFE, April – September 2012

[17] The survey is commissioned jointly by the European Commission's Directorate General Enterprise and Industry and the European Central Bank (ECB).

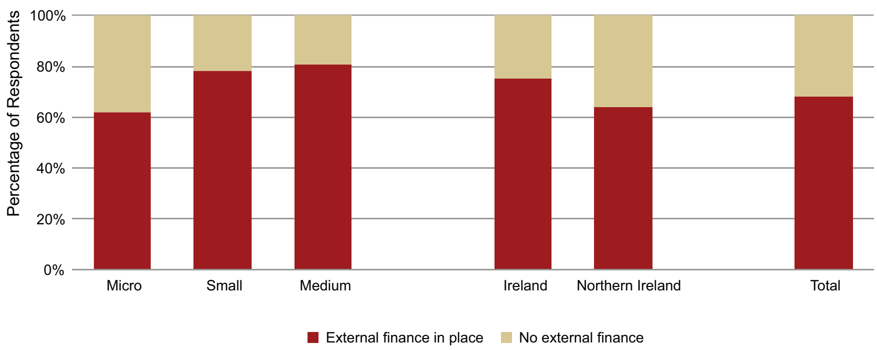
3.5 HOW SMEs ARE FINANCING THEIR BUSINESSES

3.5.1 OVERALL SME FUNDING POSITION

SMEs are generally financed through a combination of internal and external means. Internally, an SME is able to draw on its existing capital and reserves or to use working capital for short term finance. Externally, an SME can seek funding from a number of third party sources: family and friends, banks, venture capital, business angels, grants and other public funding sources (Mac An Bhaird, 2010).

As Figure 18 shows, 25% of SMEs in Ireland and 36% of SMEs in Northern Ireland reported no external finance requirements in the Q3 2012 InterTradeIreland Business Monitor. This suggests that these businesses were able to fund their businesses needs through internal resources. The results are similar to those in the 2011 UK SME Finance Monitor (BDRC Continental, 2012), which found that SMEs in Northern Ireland (42%) are more likely to have no external finance requirement than their UK peers (60%).

Figure 18: SMEs with Some Form of External Finance in Place



Source: InterTradeIreland Business Monitor survey, Q3 2012

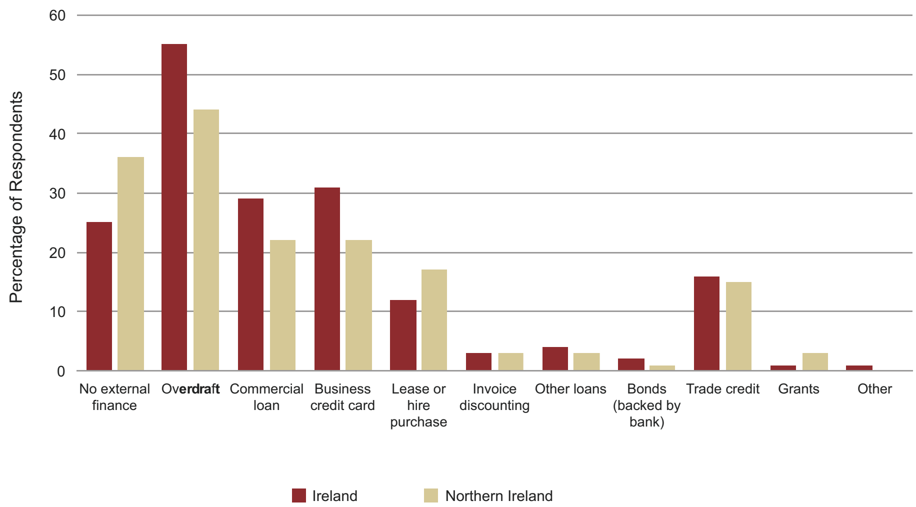
It should be noted that many SMEs in Ireland and Northern Ireland do not require and may never require external finance to grow their businesses. The use of external finance is not necessarily in all cases a prerequisite to or determinant of business success or growth. However, the level of SMEs who are looking for external finance may also reflect the fact that many SMEs are focusing their efforts on stabilising their businesses, breaking even, turning a small profit or survival. These goals are in marked contrast to growth or expansion into new markets which are typically activities that consume higher levels of capital.

Where SMEs are not investing in or improving their businesses over a protracted period, they will over time damage them. Where stabilisation or survival rather than development or growth remains the focus for a long period of time, this represents a risk to the economies of Ireland and Northern Ireland as the quality and stock of SMEs will degrade.

The overall funding position of Irish and Northern Irish SMEs is shown in Figure 19 with a clear preference for bank finance apparent amongst Irish and Northern Irish SMEs and a specific focus on short term facilities such as overdrafts. That this trend is more pronounced in Ireland supports recent research from the Central Bank of Ireland (Lawless, McCann and O'Toole, 2013).

According to Figure 19, SMEs in Ireland have a higher proportion of external finance in place than their Northern Ireland counterparts (especially overdrafts, loans and credit cards), while there is a higher use of lease and hire purchase in Northern Ireland.

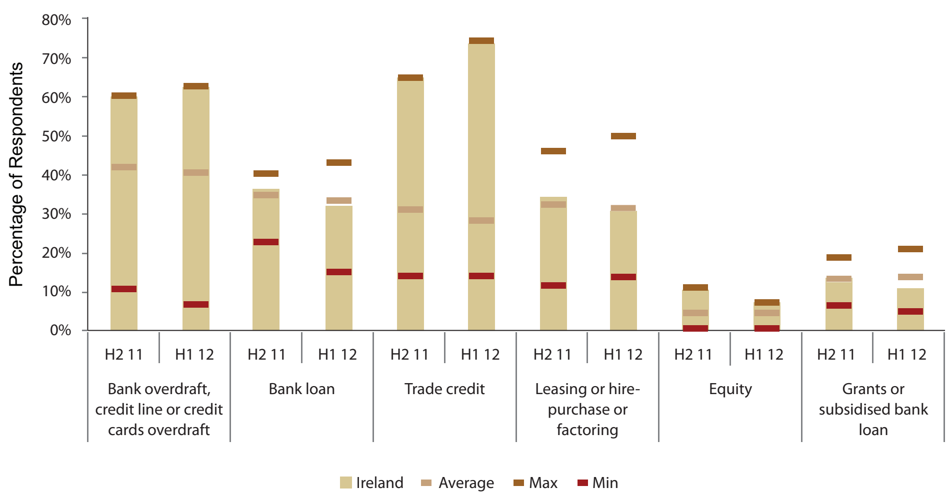
Figure 19: Types of Finance in Place



Source: InterTradeIreland Q3 2012 Business Monitor Survey

Figure 20 shows that Irish SMEs are more reliant on short term finance, in particular overdrafts and trade credit, in comparison to the EU average, with the gold indicator demonstrating average levels of finance used for each bank product over time and the brown the highest level of demand. In the case of all short term measures of credit (overdrafts, trade credit), Ireland demonstrates the highest usage. Neither Northern Ireland nor the UK is included in the SAFE surveys.

Figure 20: Sources of Finance – Ireland v EU Average



Source: SAFE surveys, H1 2011- H2 2012

This suggests that SMEs in Ireland and Northern Ireland may be over-reliant on short term credit which is expensive for both SMEs and banks alike. Whilst many SMEs regard overdrafts as a convenient form of ongoing finance, overdrafts are in fact designed for short term and temporary purposes only and should not be used constantly. The pricing of an overdraft reflects this with overdrafts commonly priced as the most expensive form of finance available to an SME.

Best practice in the funding of a business would suggest that the type of funding used should be consistent with the purpose to which the funding will be put (i.e. short term finance such as overdrafts should be used for short term finance purposes such as a seasonal drop in turnover and long term finance such as term loans should be used for longer term purposes such as expansion into new markets). A long term and permanent drop in turnover and thus cash flow should not however be financed by means of an ongoing expensive overdraft. Rather a restructuring of the overall funding position of the business is required.

3.5.2 DIVERSITY OF EXTERNAL FUNDING

Of those SMEs surveyed who had external finance in place it is apparent that bank finance is the primary source of external finance by a significant margin. Only 2-3% of respondents had other forms of finance in place.

In addition to banks, specialist finance houses also provide working capital credit products such as debt factoring, leasing and invoice discounting. Consultations as part of this study have indicated that the take up of such alternative products is low in both jurisdictions.

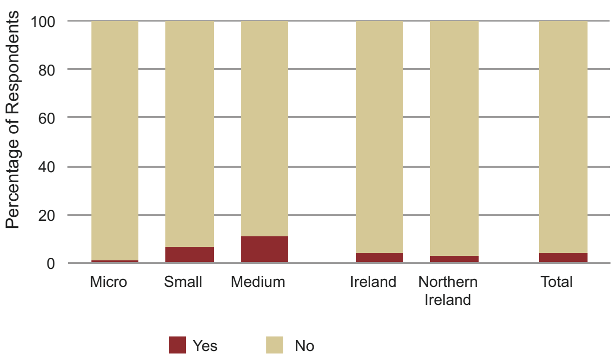
Invoice discounting and similar products are often inappropriate for those SMEs whose turnover and thus debtors are falling and the receipts cycle is becoming longer. In those instances, invoice discounting becomes an expensive and more risky form of finance for an SME.

Business finance can also be provided by other non-bank external means. Investment which is made directly from owners, friends and family is notoriously difficult to measure because there are no systems or formal requirements to collect or report such information. Nonetheless, a report published by DCU's Ryan Academy in 2013 found that about 28,000 family, friends, and colleagues provided money to new businesses in Ireland in 2011.

Results from the October 2011 – March 2012 ECB SAFE survey indicated the significant majority of SMEs believe that equity is not relevant to their business. This is further validated by the results of recent InterTradeIreland and Irish Department of Finance surveys which show that typically, less than 1% of respondents are financed through external equity or have applied for venture capital finance.

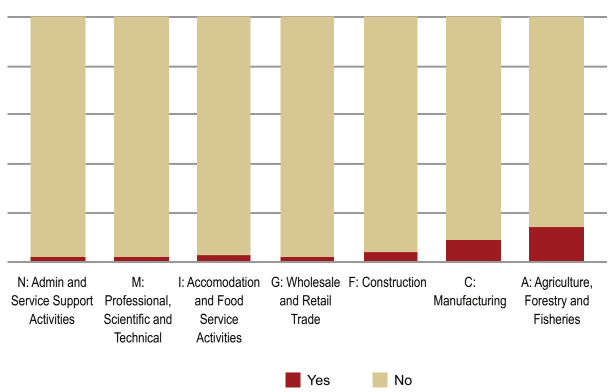
Aside from equity capital, SMEs can also seek finance from government via a number of funding channels. Public finance plays a minor part in external finance for the majority of SMEs. Only 3% of SMEs surveyed in the InterTradeIreland Business Monitor in Q3 2012 had publicly-funded grants in place. Larger SMEs and those operating in the Agriculture and Manufacturing sectors are the most likely to have grants in place as can be demonstrated by Figures 21 and 22.

Figure 21: SMEs with Grants in Place



Source: InterTradeIreland Business Monitor survey, Q3 2012

Figure 22: Sectoral Profile of SMEs with Grants in Place



Source: InterTradeIreland Business Monitor survey, Q3 2012

The European Commission found that *"there is a correlation between the supply (and demand) of (external) finance for SMEs and the expansion and contraction phases of the business cycle"*. The authors noted that this cyclicality was also found to be evident in venture capital and business angel finance. They highlighted the worsening finance gap facing SMEs in accessing external finance and noted that the public sector had an important role to play in overcoming cyclicality in the supply of external sources of finance during periods of economic difficulty. The report concluded that a firm-specific outlook is of greater importance during recessions and recommended that *"policy makers should make SMEs aware that they should focus more on transparency of information. On the other hand the conditions of banks for approving a loan should be more transparent and stable"* (European Commission, 2009).

3.5.3 INTERNAL FUNDING

Many businesses will seek to grow through organic means using their historic reserves or the free cash flow generated by the business. It should be noted that optimal balance sheet structure for SMEs as a whole or for an individual SME depends on a range of factors including growth ambitions, retirement or succession plans, risk appetite, working capital cycle.

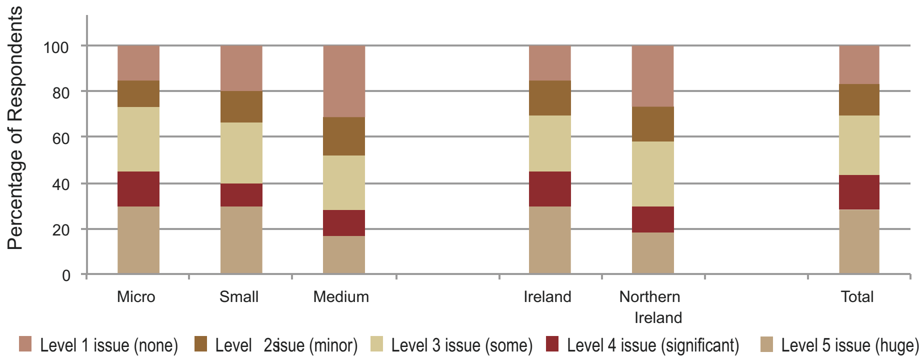
Approximately 25% of SMEs in Ireland and 36% of SMEs surveyed in Northern Ireland are managing to finance their business solely from internal resources. The importance of internal sources of finance was also highlighted by the 2012 Department of Finance demand survey (Mazars, 2012) which found that 62% of respondents financed working capital by internal funds/retained earnings.

However, internal sources of finance are not available to all SMEs equally. Struggling SMEs or SMEs who have been in business for a short period of time are less likely to have accumulated significant cash reserves. The longer the difficult economic environment continues, the more internal resources are depleted. The depletion of existing reserves also reduces internal headroom and impacts balance sheet ratios which lenders review as part of new credit application assessments.

Positive cash flow will generate the funds required for the business to pay its creditors. Managed correctly and in a controlled manner, it is possible for some business to grow organically using positive cash flow generated from business operations. This cashflow is also the source for the repayment of longer term external debt.

Despite this, results from recent Department of Finance and InterTradeIreland Business Monitor surveys indicate that cash flow is one of the main problems facing SMEs in Ireland and Northern Ireland. 41% of SMEs surveyed in Northern Ireland and 43% of SMEs surveyed in Ireland in Q4 2012 indicate that the issue was a significant one, impacting on their ability to run their business (see Figure 23). Whilst cashflow appears to be a significant issue for all SMEs, it is more pronounced for micro SMEs, those operating in the Construction sector and for SMEs who are either "surviving at all costs" or contracting in size.

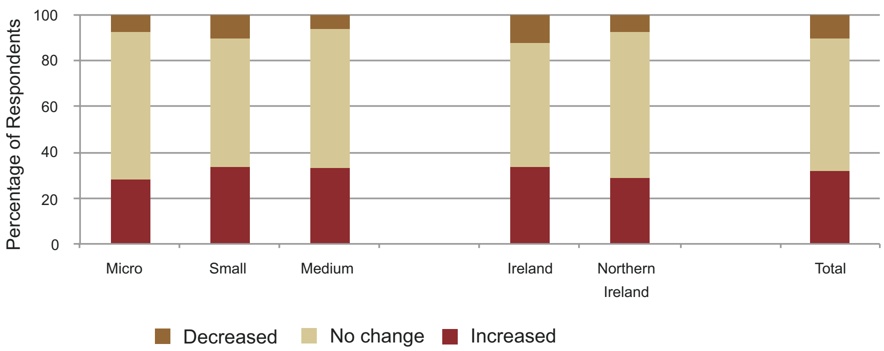
Figure 23: Cashflow as an Issue for the Business



Source: InterTradeIreland Business Monitor survey, Q3 2012

Coupled with the issue of cash flow are other working capital management issues such as trade credit management. A number of surveys report that the funding of this working capital or trade credit cycle continues to be an issue for SMEs. The Q3 2012 InterTradeIreland Business Monitor survey reported that late payments from customers were considered an issue for 61% of SMEs across Ireland and Northern Ireland. In addition, 32% of respondents (34% in Ireland; 29% in Northern Ireland) reported that the average number of days within which their customers pay them had increased, putting further pressure on the financing of working capital.

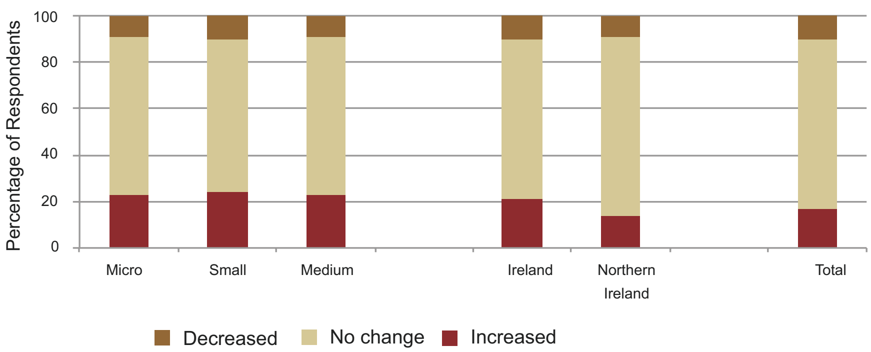
Figure 24: Working Capital Management – Changes in Receipts from Customers



Source: InterTradeIreland Business Monitor survey, Q3 2012

In turn, as can be demonstrated by Figure 25, 17% of respondents (21% in Ireland; 14% in Northern Ireland) reported that they had increased the time in which they paid their suppliers, suggesting a vicious circle of ever increasing cash flow pressure amongst SMEs with a late payment from one SME becoming a late receipt to another.

Figure 25: Working Capital Management – Changed in Payments to Suppliers

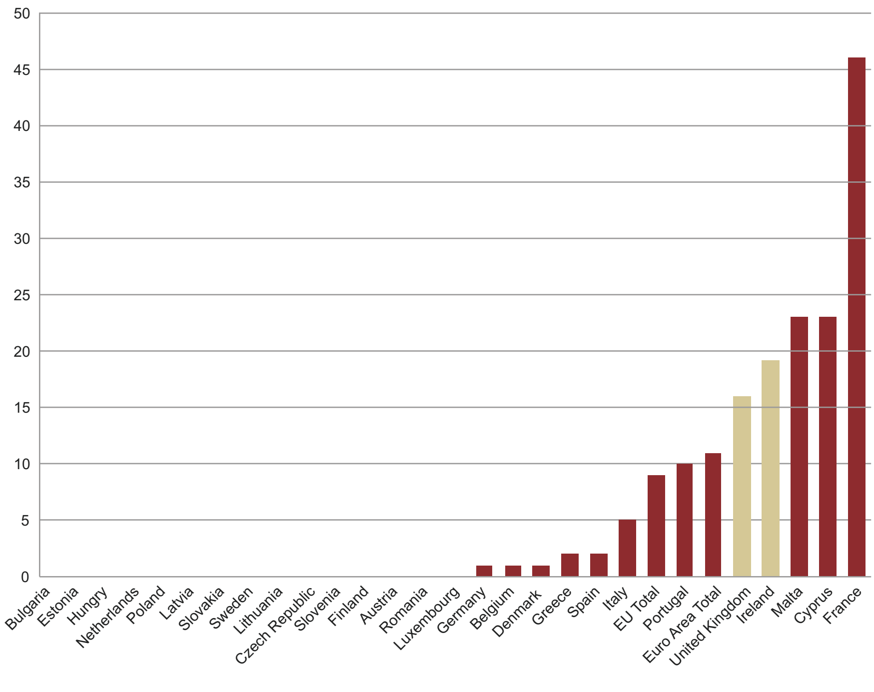


Source: InterTradeIreland Business Monitor survey, Q3 2012

Consultations held as part of this study have highlighted trade credit and the impact that late payments have on working capital as one of the major issues affecting SMEs. It is worth noting the difference between Ireland and Northern Ireland in this regard. Late payment from customers was considered an issue by 70% of SMEs in Ireland, but slightly less at 56% of SMEs in Northern Ireland. That fewer of those surveyed reported pressure on their working capital/cashflow cycles suggests that SMEs in Northern Ireland are better able to fund their working capital which may, in turn, have an impact on their requirement for bank credit to fund this cycle. Cashflow and working capital issues can drive demand for short term finance from external providers and may in part explain the higher than EU average use of overdraft facilities in Ireland.

The Central Bank of Ireland's Cheque Survey 2012 (CBI, 2012) reported that Ireland is one of only a few EU countries that still have a significant dependency on cheques and that the cheque usage in Ireland is dominated by smaller businesses. The results also indicated that the UK (including Northern Ireland), one of the main Irish trading partners, is also a heavy user of cheques. The use of cheques rather than funds transfer or other payment methods is often associated with a longer trade credit cycle.

Figure 26: Cheque Usage in Europe



Source: Central Bank of Ireland Cheque Survey 2012

The lower use of alternative finance options such as asset finance may also explain the heightened working capital issues and overuse of short term purchases where available reserves and cashflow are absorbed in financing longer term assets.

4. Demand for Finance

4.1 DEMAND FOR FINANCE

One of the key objectives of this study was the examination of the demand for different forms of finance amongst SMEs in Ireland and Northern Ireland by business sector and growth stage. The study also attempts to quantify the total demand for finance amongst SMEs by category of finance:

- Bank finance;
- Equity finance; and
- Public finance.

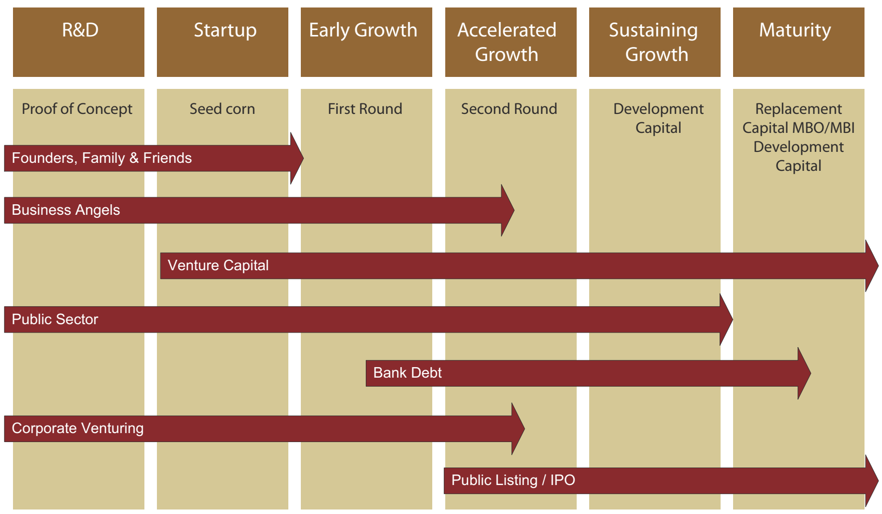
A number of approaches have been developed by organisations in Ireland, Northern Ireland, the UK and in Europe to measure the demand for finance amongst SMEs. These have primarily focused on the demand for bank finance as banks are the most significant source of finance for SMEs across Europe. This study has extended that analysis beyond bank finance and examined all sources of finance for SMEs operating in Ireland and Northern Ireland. To do this, the research primarily analysed the information from the 2011 and 2012 InterTradeIreland Business Monitor surveys in this section of the report.[18]

In September 2012 the IMF Country Report 12/265 for Ireland (International Monetary Fund, 2012), reported that *"lending standards are stable but credit demand conditions remain weak, suggesting that the reduced activity is primarily demand driven."*

Other research (Mac an Bhaird, 2010) suggests that the funding profile of a business will change based on the characteristics of the firm (i.e. its age, size, ownership structure, expenditure on R&D and the availability of collateral). This research suggested that firm specific risk factors are a more important determinant of funding than sectoral factors and that, although firms generally gain access to increased amounts of financing from a greater diversity of sources as they develop and mature, start-up firms source finance from a greater variety of sources than older firms.

In a similar vein, the lack of collateral or business track record for start-up enterprises increases the risk for external lenders and consequently impacts on the level of access to finance that is available to an SME at the early stage of its business life. The funding journey of many SMEs is represented in Figure 27.

Figure 27: The Funding Journey



Source: Adaptation of Enterprise Ireland chart

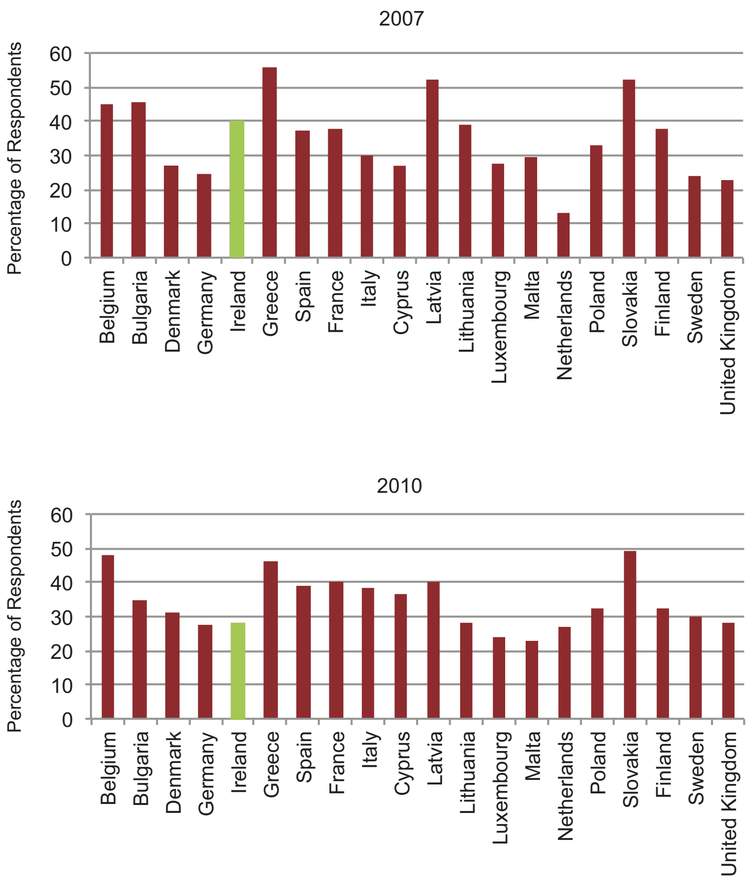
[18] Other sources of information used in this section include: the Irish Department of Finance SME Lending studies; the SAFE surveys; the UK SME Finance Monitor surveys; the Northern Ireland Access to Finance survey (2011); and the Euro Area Bank Lending Survey (BLS). There are several approaches to measuring the demand for bank credit amongst SMEs which are currently being used in Ireland, Northern Ireland and internationally making comparison between them difficult.

4.1.1 DEMAND FOR BANK FINANCE MEASURED BY EXISTING SURVEYS

Prior to the credit crisis little or no data was collected on the demand for credit from SMEs and hence it is difficult to estimate the "normal" level of demand for credit amongst SMEs in either Ireland or Northern Ireland. At present there is a significant gap, created by the lack of regular surveys, in the level of information available on the demand for finance amongst SMEs in Northern Ireland. This makes any trend analysis of the extent to which a demand gap exists difficult and lacking in concrete evidence.

An EU-wide survey on access for finance was undertaken in 2011 by Eurostat across 20 countries. Figure 28 shows the patterns reported in applications for finance, by country, in 2007 and in 2010.

Figure 28: Credit Demand Rates, 2007 v 2010



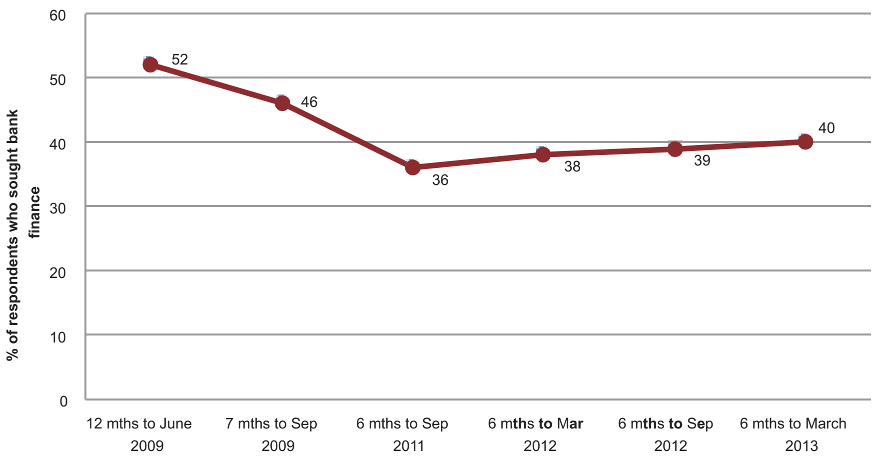
Source Eurostat Access to Finance survey, 2011

A Northern Ireland component of this study was completed by the Department of Finance and Personnel, which focused on SMEs with between 10 and 249 employees (i.e micro SMEs were excluded). The survey reported that demand in Ireland had dropped from 46% in 2007 to 41% in 2010, but that demand in Northern Ireland had remained relatively constant between 2007 and 2010 at 38% and 39% respectively. The primary demand measure for this survey was whether the respondent had requested any form of finance.

The results of the InterTradeIreland Business Monitor survey for Q4 2012 indicate that 22% of respondents (24% Ireland, 21% Northern Ireland) demanded external finance in the 12 month period to December 2012. The InterTradeIreland Business Monitor has consistently shown levels of demand that are half the levels of demand found in Irish Department of Finance survey. This can probably be explained by differences in the survey methodologies and, in particular, the large number of micro SMEs included in the Business Monitor surveys. However, time series trends on demand in both surveys appear to be consistent in directional terms.

The Irish Department of Finance survey shows a significant decrease in the demand for bank finance amongst SMEs since 2009 and a recent more gradual increase to 40% at present, as shown in Figure 29.

Figure 29: SME Demand for Finance per Department of Finance SME Lending Studies

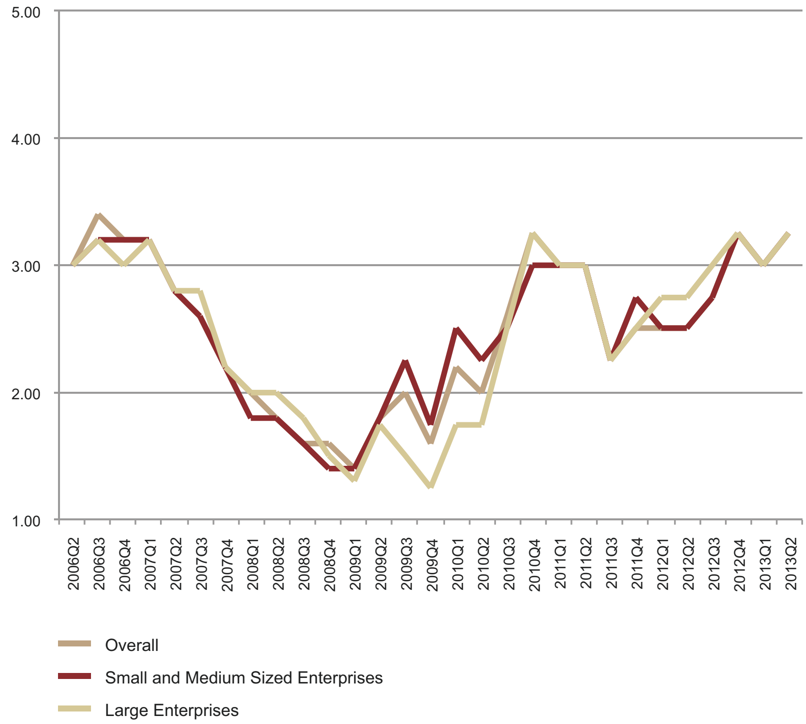


Source: Department of Finance SME demand surveys, 2009 – 2013

The Euro Area Bank Lending Survey (BLS) collects qualitative data on the Euro area bank loan market including demand and supply conditions. The BLS asks 17 regular questions focusing on demand and supply conditions in credit markets. This quarterly survey is completed by senior lending officers in each participating bank rather than by SMEs themselves and, as such, cannot be considered to represent a complete picture of the demand for finance amongst SMEs.

Results from the BLS (shown in Figure 30) indicate that demand from SMEs in Ireland has stabilised after a period of decline. The pattern for SMEs and for large enterprises is very similar and is following the pattern of domestic demand very closely. This further highlights the link between the performance of Irish businesses and domestic demand.

Figure 30: Changes in Credit Demand [19]



Source: Central Bank of Ireland figures from BLS

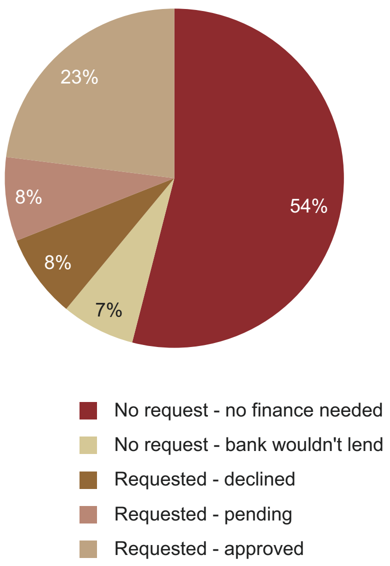
A number of organisations at both local and international level have studied the underlying causes of the reduction in the demand for finance apparent in both Ireland and Northern Ireland and they suggest that it is primarily driven by the economic conditions in which SMEs are trading. For example, the Central Bank of Ireland's Q4 2012 bulletin (CBI, 2012) reported that *"weakness of domestic demand, particularly the collapse in investment during the crisis, has led to more suppressed need for longer-term funding across many sectors as opportunities for expansion were constrained. Requirements for financing working capital would also have fallen somewhat, but are reported by all surveys of SME demand for finance to remain significant."*

In the same year an IMF report (International Monetary Fund, 2012) into access to credit and debt overhang in Ireland investigated lending to corporates and reported that *"lending standards are stable but credit demand conditions remain weak, suggesting that the reduced lending activity is primarily demand driven"* and *"the economic effect of demand-side factors for lending to corporates is substantial".* It should be noted that the authors added a caveat that the findings were applicable to businesses as a whole and not specifically to SMEs.

[19] The key to Figure 30 is as follows: 1=decreased considerably, 2=decreased somewhat, 3=remained basically unchanged, 4=increased somewhat, 5=increased considerably.

As Figure 31 shows the Irish Department of Finance demand surveys indicate that the vast majority of SMEs do not apply for bank credit because they do not need it. This may be because they are focussing on short term survival or stabilisation, because they can finance their growth plans from internal sources or because they have other external forms of finance in place. A small proportion (7%) of SMEs in Ireland indicate that they did not apply for credit because they perceived banks not to be lending or because they feared rejection by the bank.

Figure 31: SME Demand Profile



Source: Department of Finance survey, April-September 2012

On the issue of discouraged borrowers, the EU SAFE survey 2012 reports that *"the perception of firms not applying for a loan for fear of rejection stayed broadly stable at 6%, compared with 7% in previous survey round."* And the 2011 UK SME Finance Monitor (BDRC Continental, 2013) reports that *"7% of SMEs had wanted to apply for a loan or overdraft facility but something had stopped them, with discouragement and issues around the process of borrowing most likely to be mentioned."*

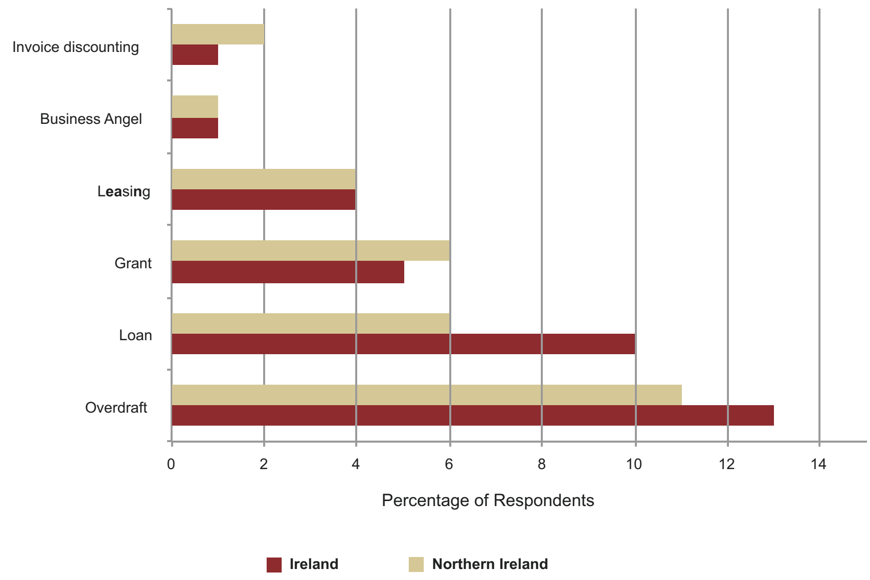
As such it would appear that Ireland is in line with the European average in terms of SMEs who fear rejection by their bank. However, this data has been only collected since 2011 and so a baseline level is only beginning to be established.

4.1.2 DEMAND FOR BANK FINANCE BY PRODUCT TYPE

As noted in section 3.5.1 above, Irish SMEs rely heavily on short term forms of bank finance such as overdrafts and other working capital products. The results from the InterTradeIreland Business Monitor surveys (see Figure 32) provide a general pattern in the demand for bank products, which is consistent with that shown in each of the last three Irish Department of Finance surveys shown in Figure 33. These surveys both show that SMEs in Ireland and Northern Ireland are very reliant on short term credit with demand highest for overdrafts, a fact that is also consistent with the pattern emerging from the European SAFE survey. Ireland has a higher level of demand than Northern Ireland for overdrafts and the Irish Department of Finance surveys show that, where overdraft demand is analysed by demand for renewed / restructured overdrafts versus new overdrafts, the demand for renewed / restructured overdrafts is almost three times as large.

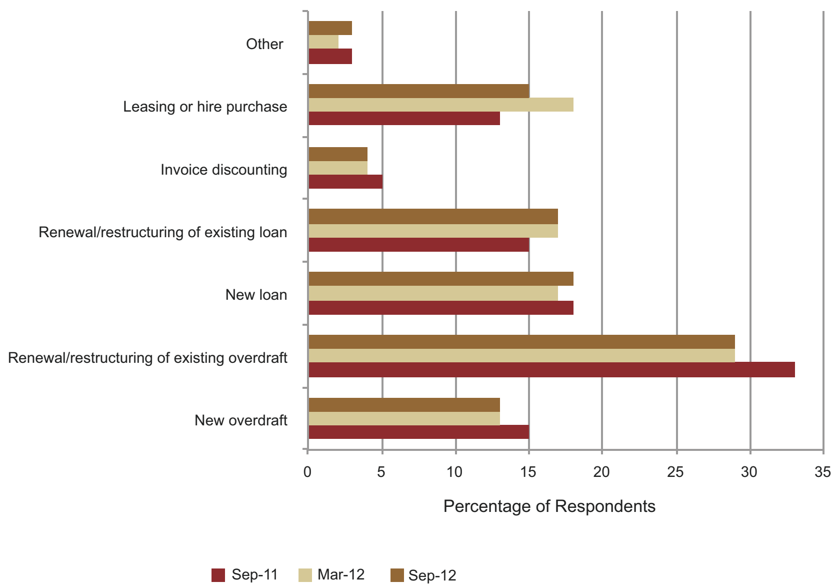
Given that overdrafts are generally the most expensive forms of finance for SMEs and bank alike, this focus on short term financing measures further underlines the need for SMEs working in conjunction with banks to ensure their capital positions are appropriate. This could involve resizing their balance sheets to reflect the trading conditions and economic environment with which they are now faced, rather than try to finance the downturn in the cycle through short term financing means.

Figure 32: Lending Products Requested by SMEs - InterTradeIreland



Source: InterTradeIreland Business Monitor survey, Q4 2012

Figure 33: Lending Products Requested by SMEs – Department of Finance



Source: Department of Finance SME demand surveys, 2011-2012

Some types of credit can be directly linked to other economic indicators, for example, the demand for leases, which are taken out by SMEs to finance the acquisition of vehicles or equipment. The demand for leasing or hire purchase finance can be linked to the demand for licensing goods / commercial vehicles. As demonstrated in Figure 34, the demand for commercial vehicles, although increasing slightly in the last three years, has dropped significantly in comparison to the previous ten year period in Ireland.

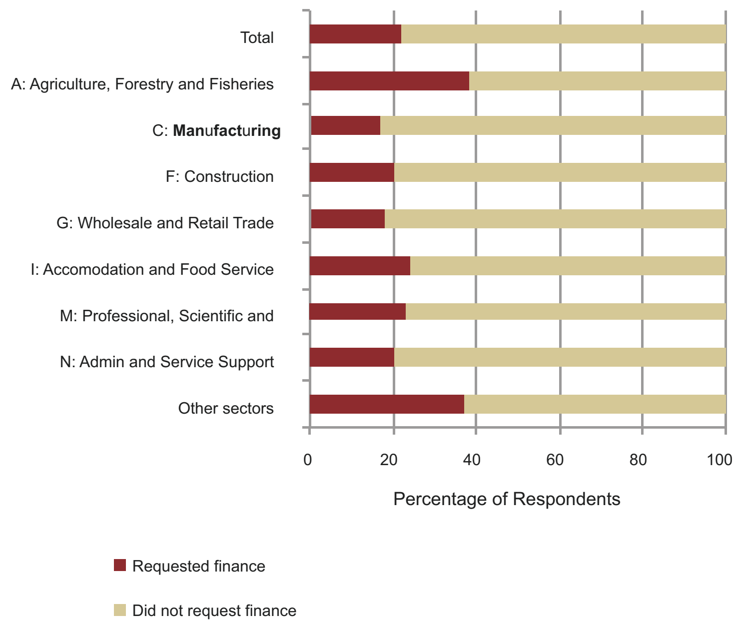
Figure 34: Goods/Commercial Vehicles Licensed for the First Time

Source: CSO, New Goods Vehicles Licensed for the First Time

4.1.3 DEMAND FOR BANK FINANCE BY SECTOR

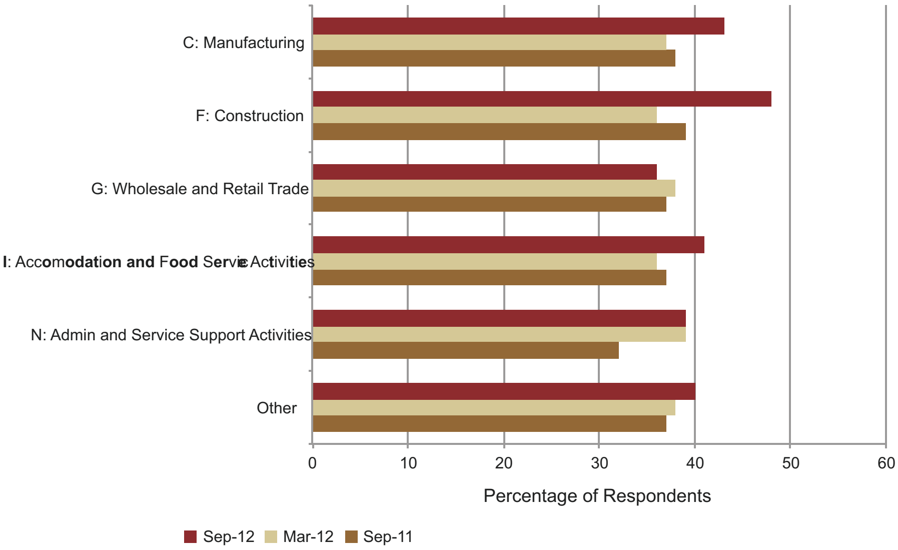
The sectoral results from the InterTradeIreland Business Monitor surveys (see Figure 35) are again consistent with the three most recent Irish Department of Finance studies shown in Figure 36 with the exception of a higher demand for credit amongst those SMEs operating in the Agriculture sector.

Figure 35: Demand by Business Sector – InterTradeIreland



Source: InterTradeIreland Business Monitor survey, Q4 2012

Figure 36: Demand by Business Sector (Ireland) – Department of Finance



Source: Department of Finance SME demand surveys, 2011-2012

These figures do not distinguish between the demand for renewals of existing debt and the demand for new credit and therefore do not show the potential for growth that is being stifled by the lack of availability for credit within a specific sector.

4.1.4 SEASONALITY OF DEMAND FOR BANK FINANCE

While no information is available on the seasonality of demand for bank credit amongst Northern Irish SMEs, the results of the Irish Department of Finance surveys suggest that, whilst approximately 45% of SMEs surveyed have a seasonal nature to their business, only a quarter of respondents demonstrate a corresponding seasonality in their demand for credit.

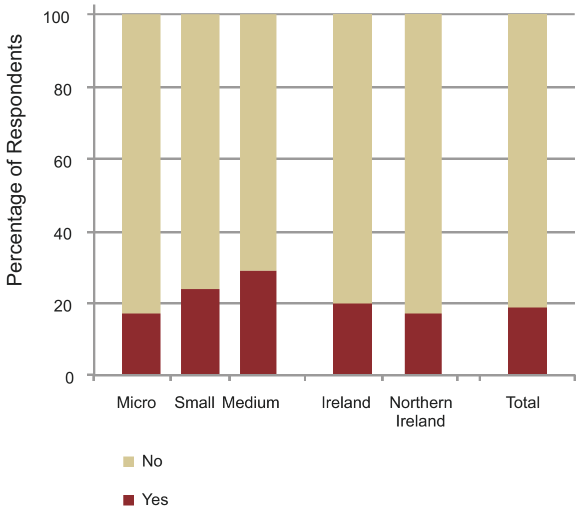
Where a seasonal demand for credit does arise, it is generally up to 20% higher than the normal level and typically for increased overdraft facilities. As such, while a seasonal demand for credit is clearly an issue for some SMEs (e.g. those operating in the Accommodation & Food sector, such as hotels, pubs and restaurants), it is not a material issue for the SME population overall.

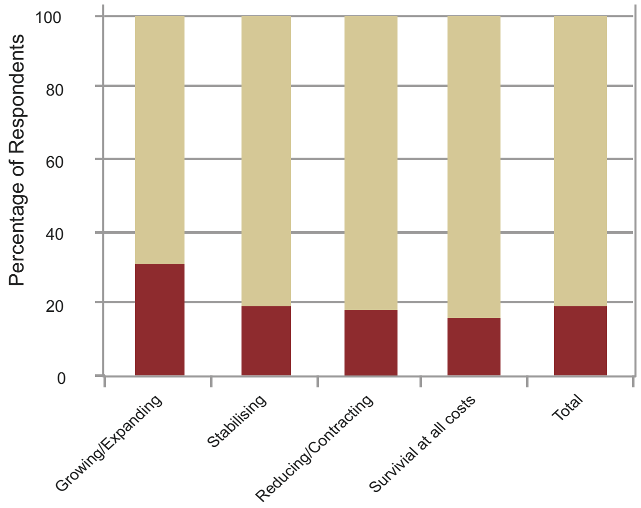
4.1.5 PROJECTED FUTURE DEMAND FOR BANK FINANCE

Demand for finance from an SME is based on a number of SME characteristics including the growth plans of the business. The results from the Q3 2012 InterTradeIreland Business Monitor indicate that smaller SMEs are less likely to need finance in the future: only 16% of micro SMEs predicted a future finance requirement, compared to 33% of medium SMEs.

The results also indicated that respondents who reported they were growing / expanding predicted a higher likelihood that they would require finance in the next 12 months. This suggests that, as the economies of Ireland and Northern Ireland improve and more SMEs begin to migrate from focusing on stability and survival to growth, a corresponding increase in demand for finance may result.

Figure 37: Likelihood of Requiring Finance in the Next 12 Months



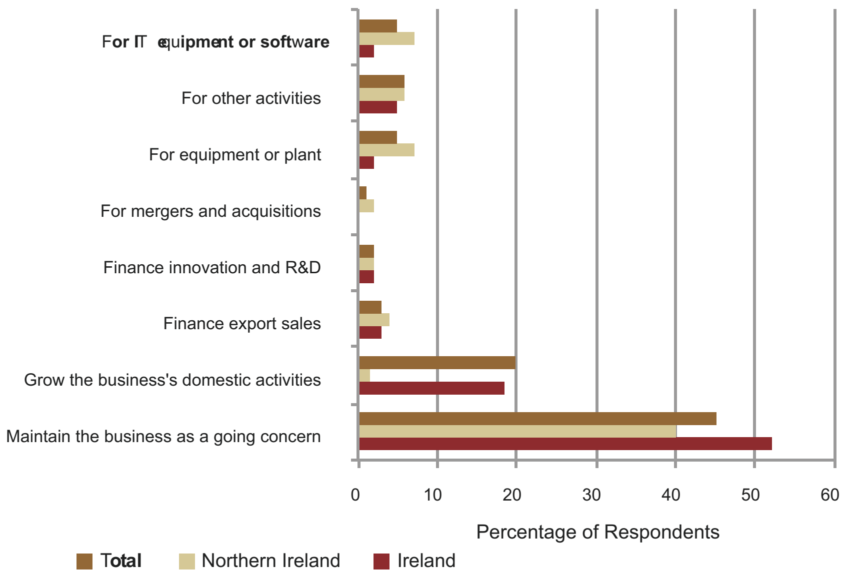


Source: InterTradeIreland Business Monitor survey, Q3 2012

4.1.6 BUSINESS PURPOSE OF BANK FINANCE

Consecutive Irish Department of Finance lending surveys have shown that working capital and cash flow needs are the primary drivers of demand for bank credit amongst SMEs as opposed to growth or expansionary finance needs. The Q4 2012 InterTradeIreland Business Monitor also indicates that SMEs are primarily looking for credit to maintain the business as a going concern, rather than credit for growth or for expansion or new business activities.

Figure 38: Purpose of Finance Applied For



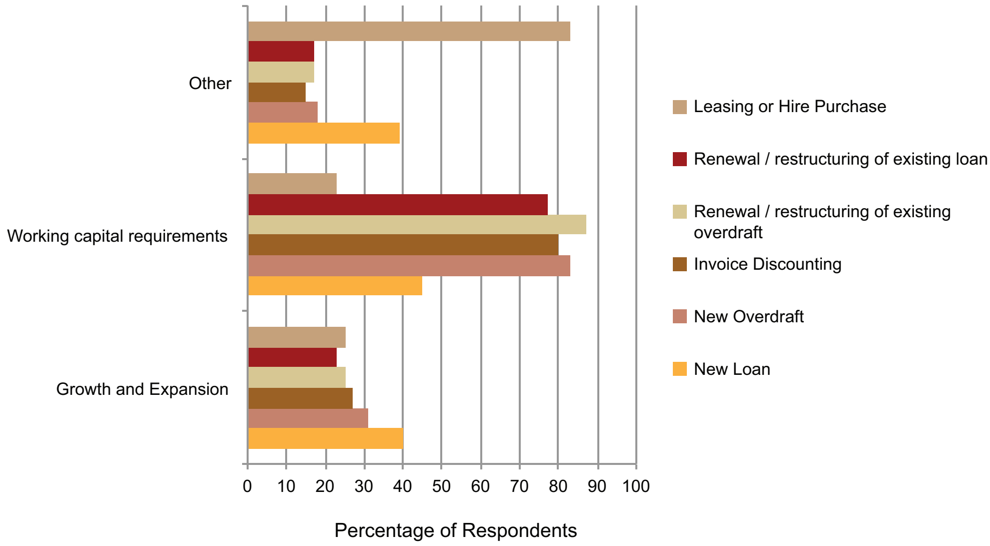
Source: InterTradeIreland Business Monitor survey, Q4 2012

These results are supported for Northern Ireland by both the 2011 Access to Finance survey 2011 (Department of Finance and Personnel, 2011) and the 2011 UK Finance Monitor (BDRC Continental, 2012) which reported that twice as many Northern Ireland applicants for new / renewed overdrafts were more likely to be seeking an increase in their facility than their UK peers (35% v 18%).

The type of bank product sought can provide an insight into the purpose for the facility. Every finance product is designed to address a particular business need. For example, invoice discounting will typically be to smooth out cash flow cycles, whilst term loans of 10-15 years will be used to fund longer term capital development, the purchase of commercial property or the funding of a business acquisition. However, international research suggests that such analysis needs to be approached carefully as there is a level of inappropriate financing amongst SMEs, with shorter term products used to finance longer term assets. The high usage of overdraft facilities would also suggest that this may be an issue for firms in Ireland and Northern Ireland. The low use of specialist finance such as asset finance may also be a signal that longer term assets are being financed from short term cashflow.

As shown in Figure 39 applications for new loans and new overdrafts are more likely to be used for growth and expansion reasons rather than for working capital purposes. Given this, it is therefore possible to assume that a change in the mix of applications towards new lending rather than the renewal of existing lending facilities, will demonstrate a greater demand for finance for growth amongst SMEs.

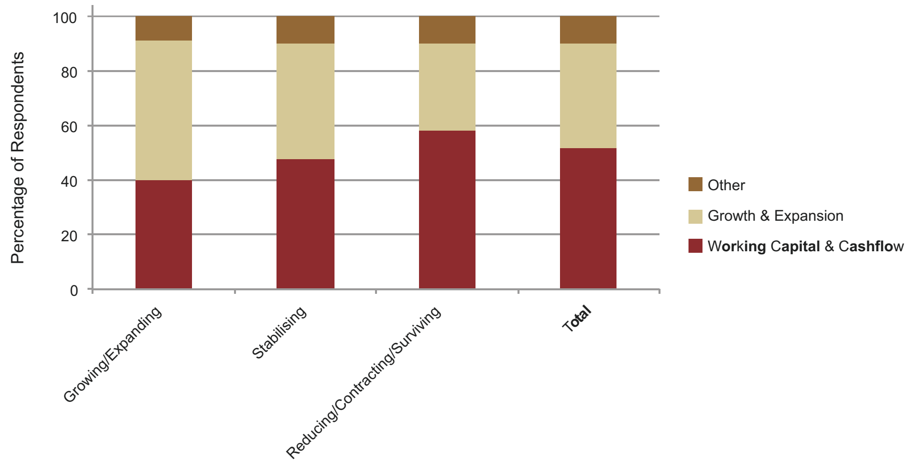
Figure 39: Purpose of Application by Product



Source: Department of Finance demand survey, April – September 2012

When applications from respondents are categorised between those SMEs who considered themselves to be in a stage of growth, compared to respondents who considered themselves to be “reducing” or “surviving at all costs”, results suggest that the purpose of finance is closely related to the performance and growth aspirations of the SME. As Figure 40 shows SMEs who are “growing” their businesses rather than stabilising or contracting are more likely to need finance for development and investment purposes. These applications for finance tend to be for higher amounts and for longer periods. “Stable” SMEs request a relatively consistent mix of working capital and growth finance, but “struggling” SMEs are more likely to request short term working capital and cash flow type finance. These applications tend to be for lower value amounts and for shorter durations.

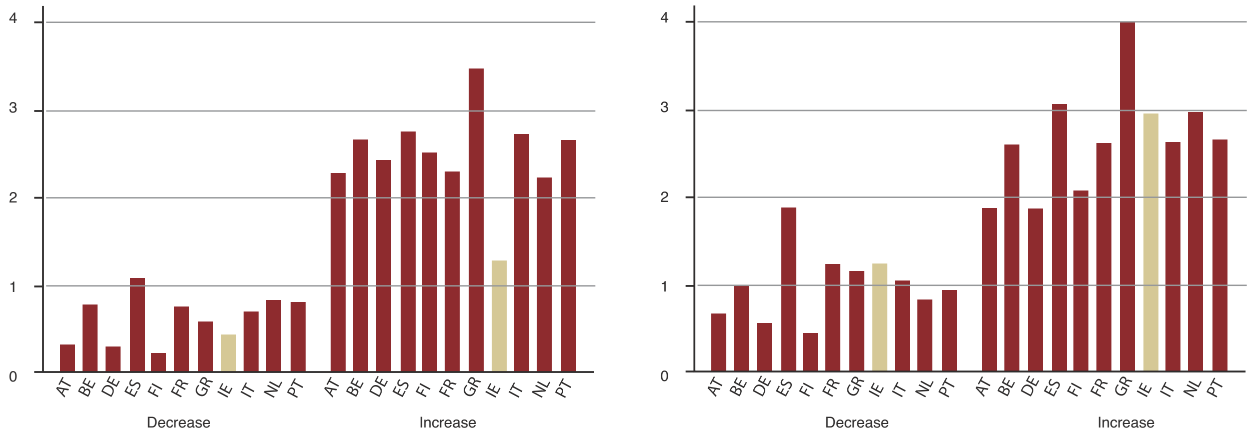
Figure 40: Purpose of Finance Applied by Business Status



Source: InterTradeIreland Business Monitor survey, Q4 2012

Recent research (McCann, 2013b) has shown that cash/working capital-based applications for credit are more likely to involve a restructuring of an existing facility and little or no additional lending in comparison to applications for investment purposes which tend to be for higher values and do not involve significant restructuring. This feature of applications is also likely to impact on the supply of bank finance (if supply is measured by volumes) and, if approved, the measurement of increased lending. As depicted in Figure 41, it appears that Irish SMEs are demanding lower levels of finance for investment and growth in comparison to other EU countries but above average levels for working capital type finance (i.e. shorter term debt). No comparable figures are captured for the UK or Northern Ireland.

Figure 41: Demand by Business Purpose (Investment – v- Working Capital)



Source: McCann, 2013b

4.1.7 AVERAGE SIZE OF BANK FINANCE PRODUCT REQUESTED

The Q3 2012 InterTradeIreland Business Monitor indicated that 76% of loan applications from micro SMEs were for less than €50,000, in comparison to 31% for small applicants and 14% for medium applicants. The Department of Finance survey for April – September 2012 reported that the respective average application values for new credit were €69,000, €712,000 and €4.5m. Consultations indicated that average application figures may be distorted due to a small number of high value applications and that the majority of applications are actually under €50,000.

A detailed analysis of the average size of credit facilities, as reported by the Irish and Northern Irish banks for this study, is set out in Section 5 of this report. This demonstrates:

- The average value of credit facilities in Northern Ireland was £85,000/€102,000 (total lending) and £60,000/€72,000 (core business lending).
- The average value of credit facilities in Ireland was £82,500/€99,000 (total lending) and £66,666/€80,000 (core business lending).

4.1.8 RESTRUCTURING OF BANK OVERDRAFTS

An overdraft is repayable on demand and, as it is typically unsecured, there is a risk that a non-viable business will be unable to repay the amount borrowed. The nature of overdrafts also allows for a bank to call in or reduce the loan with very short notice which can be a factor of distress for an SME if it is also struggling with trade credit problems. The debate over reducing an overdraft facility or converting the overdraft into a loan is often an area of contention between banks and their SME customers. Banks may observe that an element of the overdraft is 'hardcore' (i.e. always in overdraft) or that the overdraft is no longer matching the finance needs of the organisation and that such a facility should be reduced or restructured as a loan.

Of those respondents who indicated that their overdraft requirements had changed in the Q3 2012 Business Monitor survey, 46% had their overdraft increased or renewed, 42% had their overdrafts reduced and 12% had their overdrafts converted to a term loan. This indicates that there is a constant mix of SMEs who are either increasing or decreasing overdrafts. Although the numbers of applicants make it difficult to conclude definitively, it appeared that increases and renewals were more likely for those respondents who were 'growing / expanding' and reductions more frequent for those who were not.

Results from the Business Monitor also indicated that, in the past, the practice of reducing overdrafts was poorly communicated by banks and found to be irrational by and a cause of concern to SMEs. It should be noted that, of those respondents who had their overdrafts reduced, the vast majority gave very negative feedback on their banking experience indicating that they had very little input into the matter and that 'the banks just reduced it'. Of those businesses who had their overdraft limits reduced, the majority described their relationship with the bank as 'quite dissatisfied' or 'very dissatisfied'.

It is possible that the practice of reducing overdrafts has contributed to a perception that banks are not open for business, which likely could have compounded difficulties and certainly would have damaged relations between SMEs and their lenders.

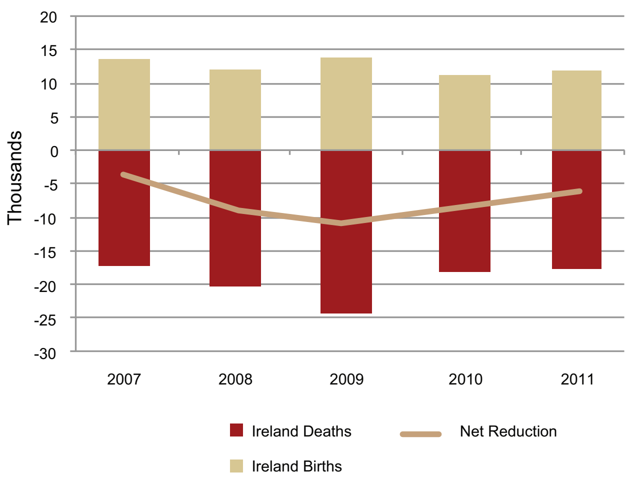
At present there is no external appeals process to review changes to overdrafts. The Credit Review Office (CRO), which operates in Ireland only, deals only with commercial loans, while the Independent Appeals Process in Northern Ireland has had limited uptake to date.

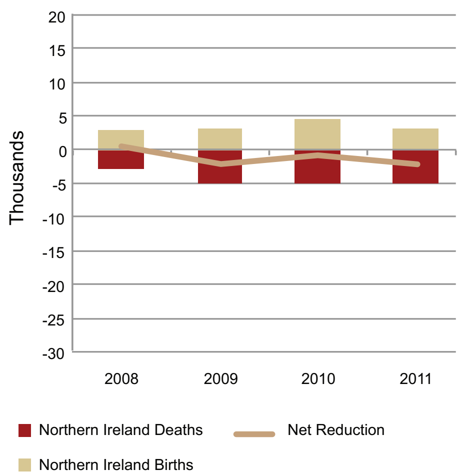
4.1.9 DEMAND FOR BANK FINANCE FROM NEW BUSINESSES

There is a gap in knowledge about the levels of demand by age of businesses. This is something which surveys and the bank lending data need to begin to establish in future as it will provide a clearer picture of the finance demands of start-ups.

In terms of new businesses, the CSO reports that, in Ireland, 64% of new enterprises established in 2006 survived in business for four years. Figure 42 shows business 'births' and 'deaths' and reveals that the number of businesses operating in Ireland and Northern Ireland has reduced in the last five years. The most recent available data, from 2011, shows that, in Ireland, approximately 10,000 more businesses were closed than were created, while, in Northern Ireland, there were 2,000 more business deaths than births.

Figure 42: Enterprise Births and Deaths on the Island of Ireland





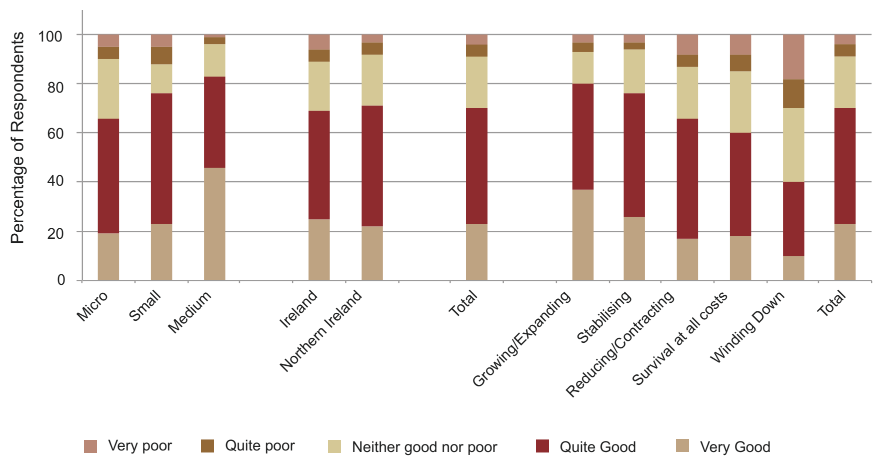
Source: CSO and ONS

The National Competiveness Council (NCC, 2012) commented on the business demography figures to say that "given the importance of new firms to job creation and innovation, it is a concern that the business churn rate in Ireland (the total number of firm births and deaths as a proportion of the enterprise population) was one of the lowest in the euro area in 2008".

4.1.10 SME / BANK RELATIONSHIPS

The larger the SME the higher the satisfaction level with their banks. Satisfaction also tended to follow the performance of the business: profitable businesses or businesses which were growing or stable were more likely to indicate that they were satisfied with their bank in comparison to those businesses which were not profitable, as seen in Figure 43.

Figure 43: SME Bank Relationship



Source: InterTradeIreland Business Monitor survey, Q3 2012

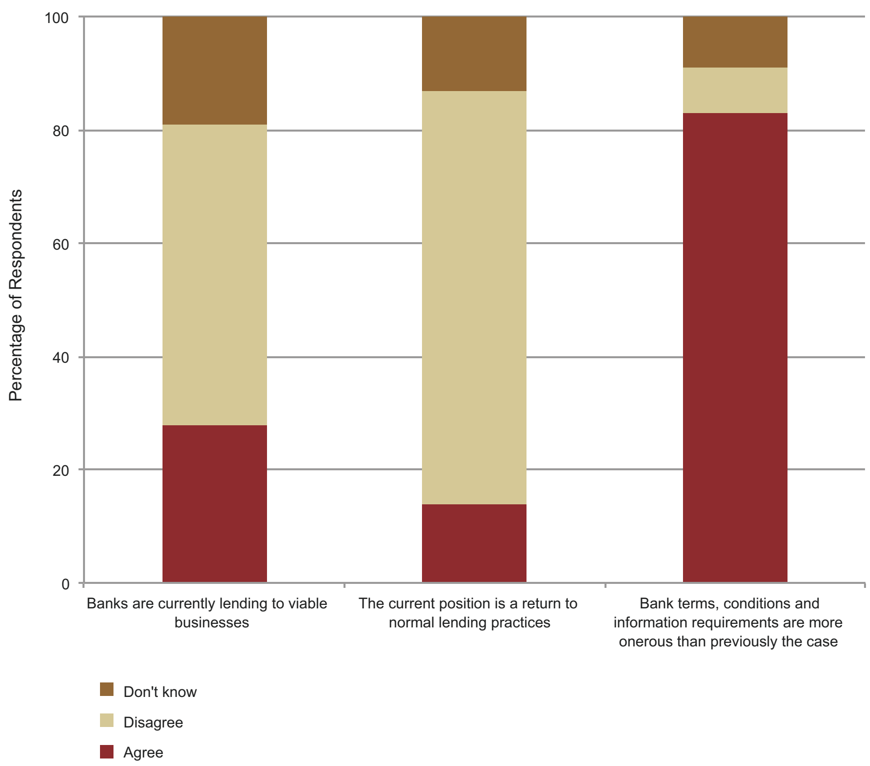
4.1.11 SME PERCEPTIONS OF LENDING TERMS AND CONDITIONS

The high proportion of 'very' or 'quite good' SME/bank business relationships does not translate into a positive perception of lending by firms. The majority of Irish and Northern Irish SMEs have a negative perception of bank lending practices, believing that banks are not lending to viable businesses. This compares to only 7% of respondents who indicated that they had an actual finance requirement but felt that the bank would not lend to them.

The Q3 2012 InterTradeIreland Business Monitor reports that only 28% of SMEs (Ireland 27%; Northern Ireland 29%) believe that banks were lending to viable businesses, whereas 38% of respondents in the April-September 2012 Irish Department of Finance SME demand survey were of the view that the banks were lending. According to the data from SAFE, SMEs across the Eurozone reported a further deterioration in their view as to the availability (i.e. supply) of bank loans in 2012. Interestingly, Ireland fared better than the EU average. The Northern Ireland Access to Finance survey (Department of Finance and Personnel, 2011) reported that, in 2010, 42% of Northern Irish SMES perceived that the willingness of banks to lend had worsened that year as compared to 33% in the UK.

Figure 44 shows that 83% of SMEs believe that the cost of borrowing has increased together with a tightening of terms and conditions and a more onerous requirement to produce information to allow the bank review a credit application. Interestingly, when the relative change in demand for finance (see Figure 30) is compared to the change in terms and conditions of lending to SMEs in Ireland and Northern Ireland, it is apparent that the reduction in demand for finance is greater than the tightening in terms and conditions.

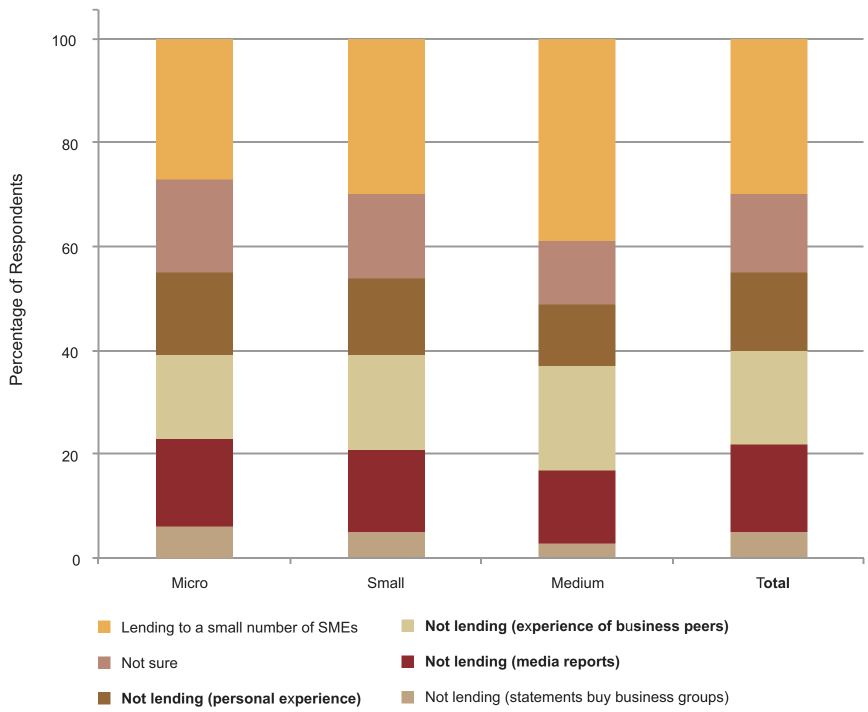
Figure 44: SME Perception of Bank Lending Practices



Source: InterTradeIreland Business Monitor survey, Q3 2012

The Q3 2012 InterTradeIreland Business Monitor survey also investigated this issue and again the majority of SMEs were of the view that banks were not lending because of the information they got from the media (43%), the experience of business peers in the last year (42%), and their informal contact with their bank (25%) rather than their own experience of applying to the bank. This is supported by the Irish Department of Finance SME demand surveys conducted in the period since 2009 which indicate that SMEs are not forming their opinion based on personal experience. Rather their views are based more on media reporting, on what business groups and what their business peers are saying than on their own personal experience. Only 20% of those surveyed who indicated that their banks were not lending had formed their view from personal experience. Larger businesses were more likely to believe that banks are lending to SMEs than smaller businesses (see Figure 45).

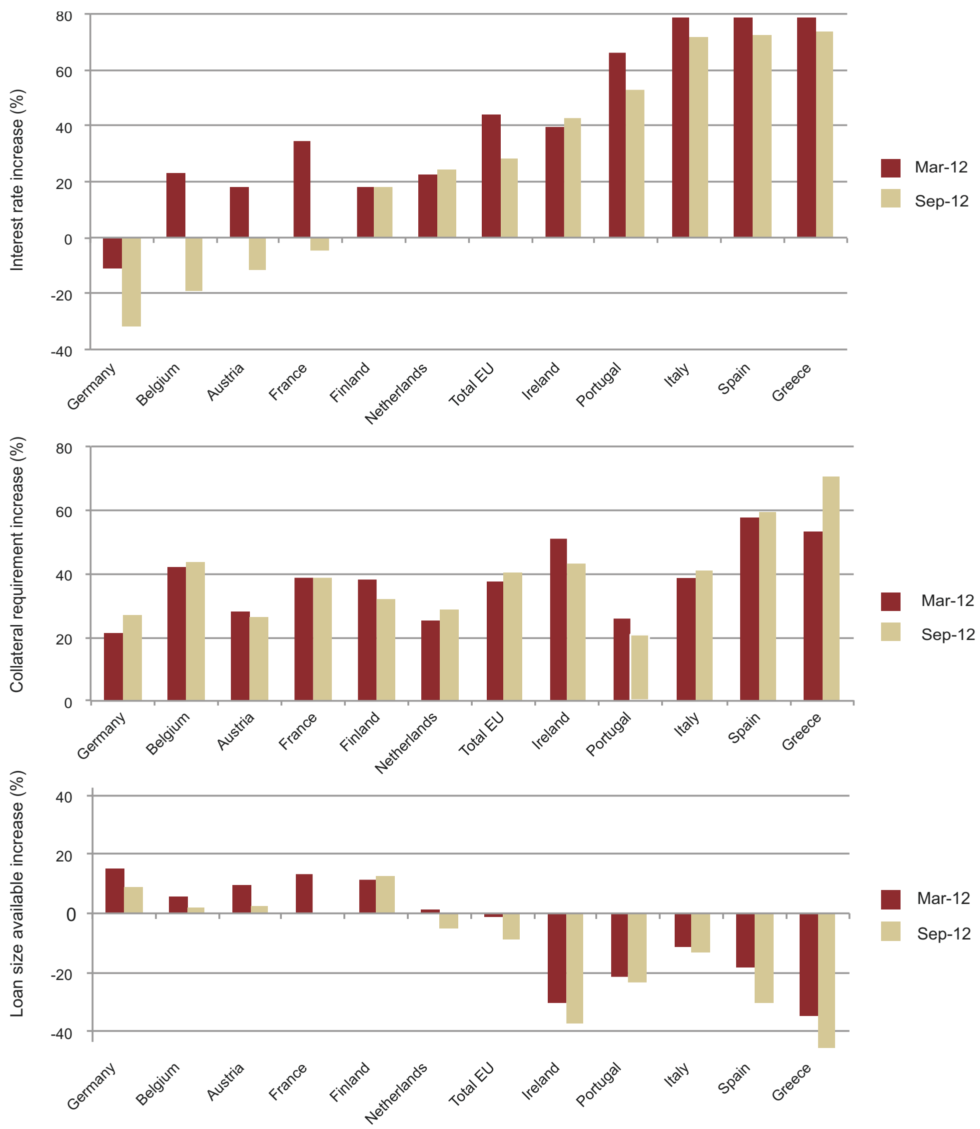
Figure 45: Business View Lending to Irish SMEs in the Last Six Months



Source: Department of Finance SME demand survey, April – September 2012

When compared to international practices, and whilst no equivalent data is available for Northern Ireland, it is apparent that changes in Irish business bank terms and conditions broadly follow those countries which have experienced economic difficulty. Figure 46 demonstrates changes in three types of credit condition; interest rates, collateral or security and loan size. In all cases terms and conditions have changed more in Ireland than in the countries with less banking instability and/or stronger performance, but reflect similar or lesser changes than other countries experiencing banking instability and/or poorer economic outlooks - Portugal, Italy, Greece and Spain.

Figure 46: Changes in credit conditions in Europe



Source: EU / Central Bank of Ireland research

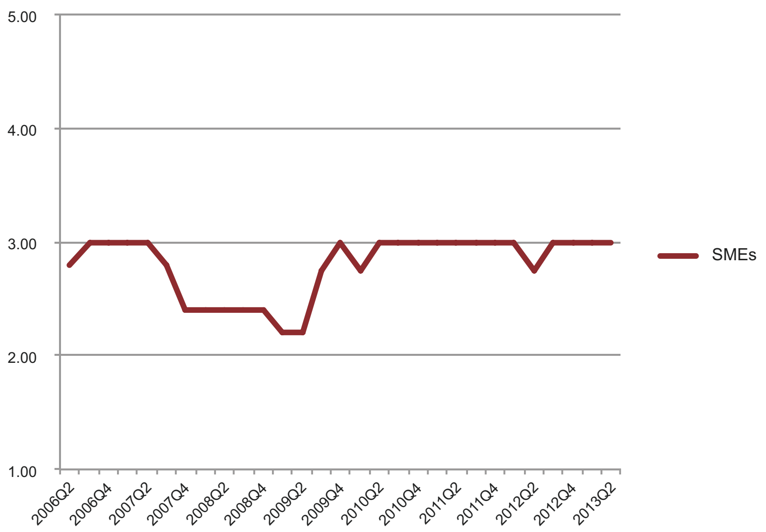
It is important to note as the business performance of an SME worsens and where the value of their collateral (e.g. property) decreases, the risks associated with a bank lending to that SME increase. As such for SMEs with poor performance, low collateral, and who are hamstrung by debt or otherwise have poor capital structures, the terms and conditions associated with any new lending will tighten and lending will become more expensive reflecting the cost of risk.

The existence of a correlation between the perception of the SME on the extent to which banks are lending and the business performance of the SME is supported by research (Holton, Lawless, & McCann, 2012). This found that two important variables in explaining perceptions of a reduction in credit availability amongst SMEs are a reported decrease in profits and SME's negative perceptions of the economic environment.

4.1.12 BANK PERCEPTION OF LENDING TERMS AND CONDITIONS

On the basis of results reported in the BLS for the Eurozone the lending terms and conditions that banks are using have tightened significantly since 2006 but have largely stabilised since 2009. The data is compiled based on the views of banks operating in the Irish market and no comparative data is available for Northern Ireland.

Figure 47: Changes in Credit Standards on Loans to Enterprises[20]



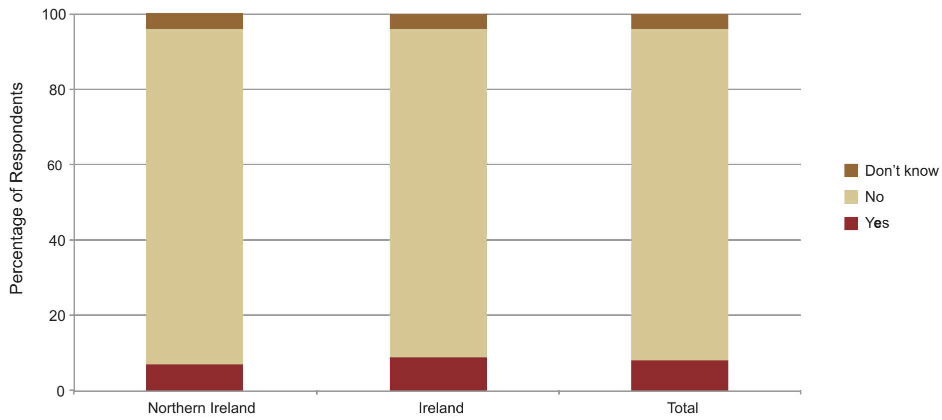
Source: Central Bank of Ireland BLS results

4.1.13 SMEs WHO DON'T APPLY FOR BANK FINANCE

Various surveys investigate the reasons as to why SMEs do not apply for bank finance. The Irish Department of Finance SME demand surveys consistently show that over 75% of businesses indicate that they did not apply for credit due to factors relating to their own business.

The Q3 2012 InterTradeIreland Business Monitor found that 8% (Ireland 9%; Northern Ireland 7%) of respondents considered applying for bank finance (i.e.) they determined that they had a finance need) but decided not to proceed. Micro and small SMEs (both 9%) were less likely to proceed compared to medium SMEs.

Figure 48: Businesses Considering Applying for Finance but Deciding Not to Proceed



Source: InterTradeIreland Business Monitor survey, Q3 2012

[20] The key to Figure 47 is as follows: 1=Decreased considerably, 2=Decreased somewhat, 3=remained basically unchanged, 4=increased somewhat, 5=increased considerably.

When these SMEs were asked why they did not proceed with their application for bank credit when they had a finance need, they indicated that they were concerned that the bank would reject their application or that they considered that the cost of funding would be too high, as shown in Figure 49.

Figure 49: Reason for Not Proceeding with Application for Finance

Source: InterTradeIreland Business Monitor survey, Q3 2012

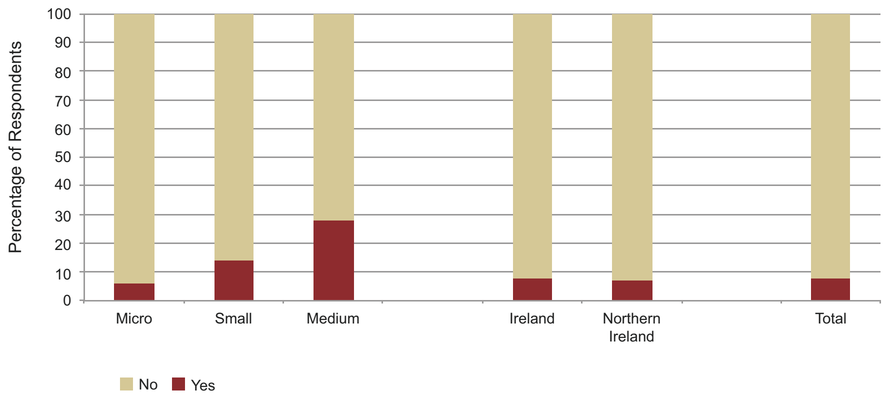
This builds on the results of previous Irish Department of Finance surveys which indicated that a small proportion of SME businesses, in particular micro-enterprises, do not feel that they can apply to the banks for fear of rejection. It also highlights that this is a small proportion of the overall SME population and that there may be an element of self-assessment in the decision of an SME to progress (i.e.) not all businesses who choose to proceed with an application do so because of external factors).

The 2011 UK Finance Monitor (BDRC Continental, 2012) also reported that SMEs seeking bank finance in Northern Ireland were more likely to cite issues with the process of borrowing than their UK counterparts. Additionally this report suggested that 52% of would-be borrowers in Northern Ireland cited the economic climate as the main barrier to seeking bank finance (as compared to a UK average of 47%).

4.1.14 PROPERTY DEBT OVERHANG AND IMPACT ON BANK FINANCE

It is clear that when a bank is considering a new application for credit, existing debt levels are taken into consideration. Results from the InterTradeIreland Business Monitor reveal that a significant porportion of firms invested in property in the past five years using bank debt. Figure 50 demonstrates that four times as many medium firms (28%) did this compared to micros (6%), while there is little difference between businesses in Ireland and Northern Ireland.

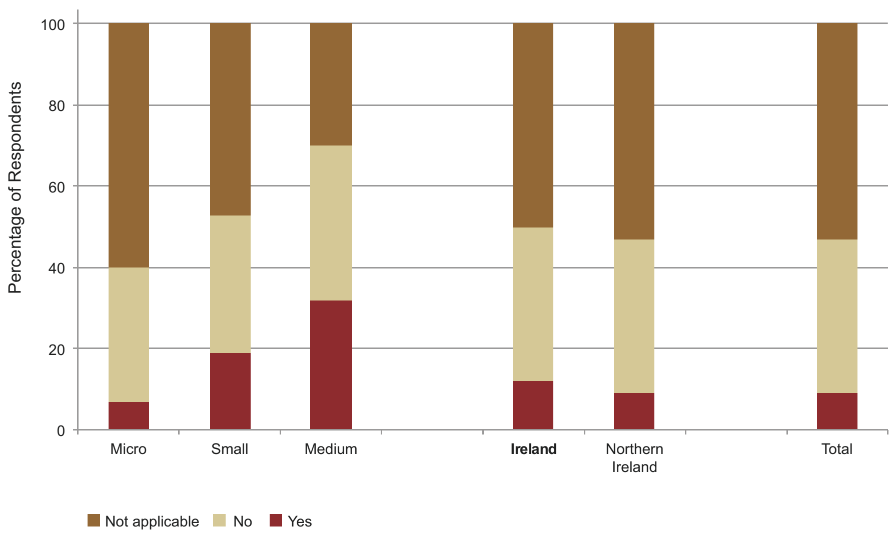
Figure 50: Property Purchased by Company Since 2005 using Bank Debt



Source: InterTradeIreland Business Monitor survey, Q3 2012

As shown in Figure 51, 7% of micro businesses indicate that property debt was a consideration when raising new finance, while 19% of small and 23% of medium enterprises consider it to be an issue. However, those companies with existing debt are constrained in their ability to take on new debt. Of SMEs with existing debt, 25% in Ireland and 15% in Northern Ireland indicated that personal or existing business debt was a constraint in securing new bank finance.

Figure 51: Relevance of Property Debt in Consideration in Raising New Finance for Business



Source: InterTradeIreland Business Monitor survey, Q3 2012

The Q3 2012 Business Monitor also found that SMEs with legacy property debt are almost three times more likely to request bank credit than those without. This suggests that many SMEs may be attempting to take on additional short term borrowings in order to make property debt repayments rather than to finance the trading debt associated with their business.

One consequence of these investments is that, while banks are required to hold capital against all facilities that are provided, they are required to provide additional capital against impaired loans (of which property or CRE loans make up a large proportion) thus impacting on their ability to lend.

Findings from a recent IMF study (Abiad et al., 2011) indicate that 'creditless recoveries,' while not the norm (they occur in one in five recessions), tend to result in slower recoveries. The research finds that general growth can be impeded in instances where there has been a banking crisis, a credit boom, a real-estate boom-bust cycle. A lack of credit growth can also result from an over-indebted private non-financial sector (Forfás, 2012) and, even in the presence of relatively healthy banks, the existence of previous debt may inhibit the private sector from accessing credit for potentially profitable investments.

This has also been noted by the Credit Review Office (CRO) in one of their regular reports (Trethowan, 2012) as follows: *"...the bank solvency crisis was largely caused by Commercial and Residential property lending; and only to a lesser degree in lending to SMEs – and this mainly through financing the 'non core' property investments made by business owners. The overhang of legacy debt in banks' lending books is requiring a certain level of forbearance. This legacy debt, together with the weakened condition of many businesses which may also require further remedial lending action, is a challenging backdrop to the banks' lending performance. This forbearance requires high level of capability and experience by lending officers. Given that the large banks have all announced restructuring plans it is essential that their Boards ensure that adequate capabilities will remain in place to deal with current and future forbearance requirements, as their lending books continue to be scrutinised by the Regulator and Troika."*

Central Bank of Ireland research (Lawless & McCann, 2012) has also pointed to *"the dangers of post-boom debt overhang"* and has provided evidence *"on the effect of relaxed credit standards during a boom on crisis-era loan delinquency."* The research indicated that, for Ireland:

- Excess credit accumulation is positively associated with credit risk during the downturn, thus exposing the dangers of credit expansions such as that experienced in Ireland up to 2008; and
- A decrease in employment of 10,000 leads to a 1% decrease in the share of performing loans.

The authors conclude that *"this legacy debt issue or 'bubble lending' has consequences for the banks' ability to extend new credit to the SME sector, as well as the borrowers' ability to invest and grow. The economic crisis has resulted in a broad-based decline in the quality of outstanding SME loans, but a considerable degree of heterogeneity is found to exist across sectors. The presence of excess or bubble credit accumulated during the pre-2008 boom is also an important factor associated with higher levels of current impairment. This highlights the extent to which debt overhang can be a drag on the banking system even if economic conditions more generally improve. This also has consequences for the banks' ability to extend new credit to the SME sector, as well as the borrowers' ability to invest and grow."*

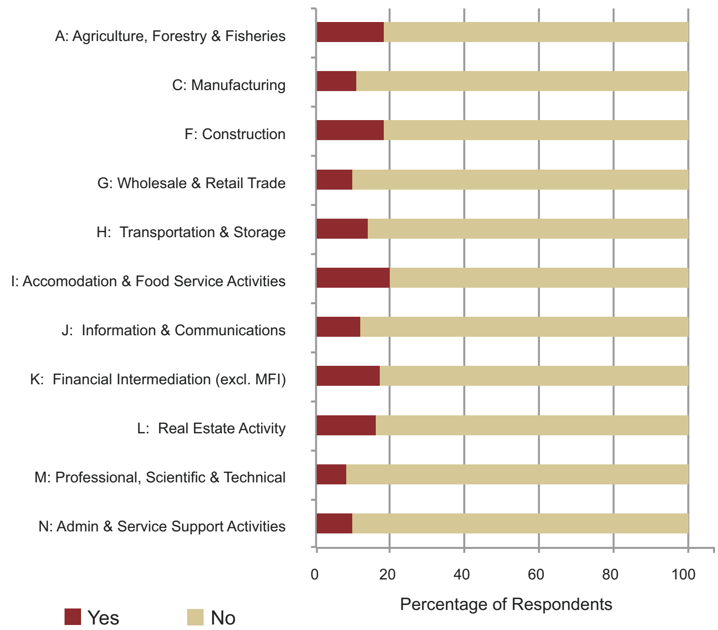
The recent Northern Ireland Economic Advisory Group report (EAG, 2013) concurs *"that there is also no doubt that the property debt overhang is causing problems in the market in that viable trading businesses with property exposure are experiencing more constrained access to finance. Without the unlikely event of some form of forgiveness of this debt, it will take some time for banks to work through their books and for this overhang to work its way through the system. In the meantime this will restrict bank lending to a significant proportion of firms, highlighting the need for business to develop alternative means of financing their business growth."*

Finally, the National Competitiveness Council (NCC, 2012) suggests that the debt overhang continues to undermine Ireland's competitiveness capacity. It suggests that *"the debt crisis has had a major impact on firms also. Many firms are over indebted and need to restructure. For growing firms, the cost and availability of credit continues to be a significant constraint. Investment in productivity enhancing capital is essential if Irish firms are to compete internationally."*

4.1.15 MISSED BANK REPAYMENTS

The ability of an SME to service existing debt levels has an impact on their ability to secure new credit. The Irish Department of Finance survey for April-September 2012 explored this issue and Figure 52 shows the business sectors most likely to miss a monthly repayment on an existing loan. SMEs operating in the Hotels & Restaurants sector (20%) are mostly likely to miss a repayment, followed by Agriculture (18%), Construction (18%) and Financial Intermediation (17%). This issue is not measured in other SME demand surveys covering Ireland or Northern Ireland.

Figure 52: Missed Repayments on Existing Bank Credit Facilities by Sector



Source: Department of Finance SME demand survey, April – September 2012

4.1.16 INFORMAL CONTACT WITH BANK LENDERS

The Q3 2012 InterTradeIreland Business Monitor suggests that up to 27% of SMEs base their impression of lending conditions on their informal contact with their bank. This is a natural process for most loan applicants who prefer to determine the probability of success before commencing on a lengthy and time-consuming application process. However in his ninth quarterly report the head of the CRO, John Trethowan, noted that *"from time to time I receive reports of some businesses being dissuaded from applying for loans, by banks frontline staff. Businesses which require credit, (particularly those with employees depending on its survival), have a duty to ensure they make a formal application in writing for lending"* (Trethowan, 2012).

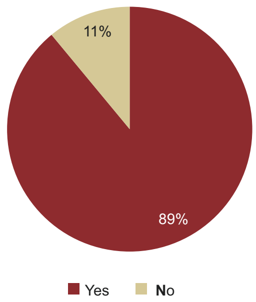
The approval rate for formal applications is higher than that for informal applications, while informal applications cannot be appealed to the CRO in Ireland.

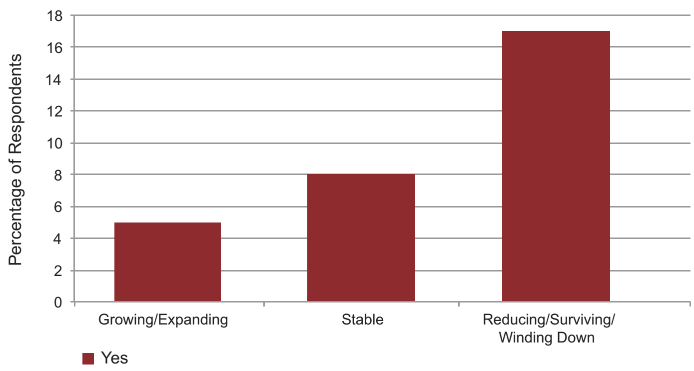
4.1.17 AVOIDING AN APPLICATION FOR BANK FINANCE

The Q3 2012 InterTradeIreland Business Monitor indicated that 11% (Ireland 12%; Northern Ireland 10%) of SMEs with existing bank credit in place avoided approaching their bank in case they tried to restructure their existing arrangements.

Micro and small businesses were more likely to avoid their banks than medium businesses, as were unprofitable or struggling businesses. Businesses not making a profit (19%) were over twice as likely as profitable businesses (9%) to avoid their bank. Likewise, reducing / surviving and winding down businesses were three times as likely as growing businesses to avoid their bank, and twice as likely as stable businesses.

Figure 53: SMEs Avoiding Approaching their Bank in Case They Try to Restructure Existing Credit Arrangements



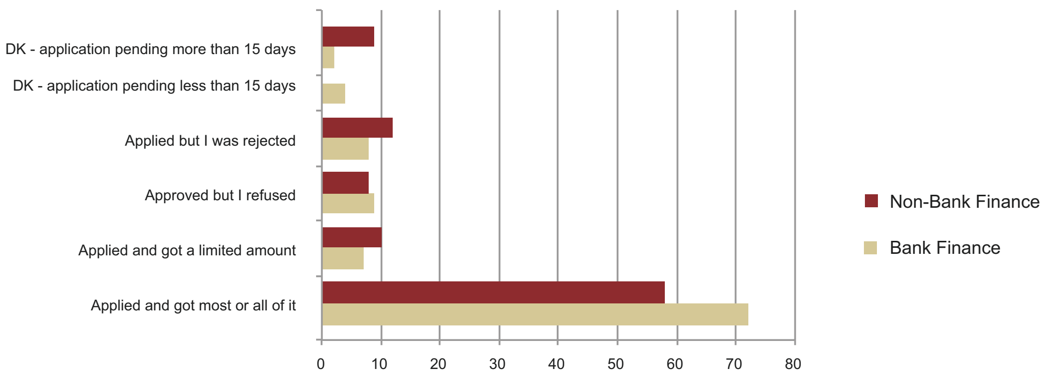


Source: InterTradeIreland Business Monitor, Q3 2012

4.1.18 DECLINE RATES

Although different surveys employ different calculation methodologies in their reporting on the application decline rate by banks, all of them report that the majority of SME applicants who apply receive funding, either in whole or in part. This can be demonstrated by Figure 54, arising from the Q4 2012 InterTradeIreland Business Monitor.

Figure 54: The Outcome of Applications for Finance



Source: InterTradeIreland Business Monitor, Q4 2012

The survey shows a decline rate of 9% overall for Ireland and Northern Ireland and a decline rate of 16% for loans only. Other surveys show a slightly higher rate of declines but they still happen in a minority of cases. The Irish Department of Finance SME demand survey for April-September 2012 shows a decline rate of 19% overall and 22% for loans only, while the EU SAFE survey, which excludes the UK, shows a decline rate for loans only of 23% for Ireland and 15% for the EU average. In Northern Ireland the 2011 Northern Ireland Access to Finance survey (Department of Finance and Personnel, 2011) was conducted on a similar basis to the EU SAFE survey and reported that the decline rate for bank loans had increased from 3% in 2007 to 18% in 2011, while the increase in the UK was from 6% to 21%.

The Business Monitor figures are actually closer to the decline rates being reported by the banks in the data they provided as part of this study. These represent formal applications for credit which were assessed in accordance with a formal decision for credit (credit committee or similar) and are set out in Section 5 of this report. They show that decline rates vary significantly across products and by bank, but that an overall decline rate of approximately 12% is apparent across the banking sector in Ireland and Northern Ireland.

The key message arising from an analysis of all of the evidence on decline rates is that the majority of applicants who apply receive funding, either in whole or in part. This rate is increased when applicants who make formal applications for bank credit are analysed. Many SMEs are concerned that a declined credit application may impact their credit rating. This is an inaccurate assumption and SMEs should be encouraged by policy makers, advisors and business representative groups alike to make applications for credit formally, i.e. by completing a formal written application form. This is then subject to internal bank assessment and the decision may also be appealed.

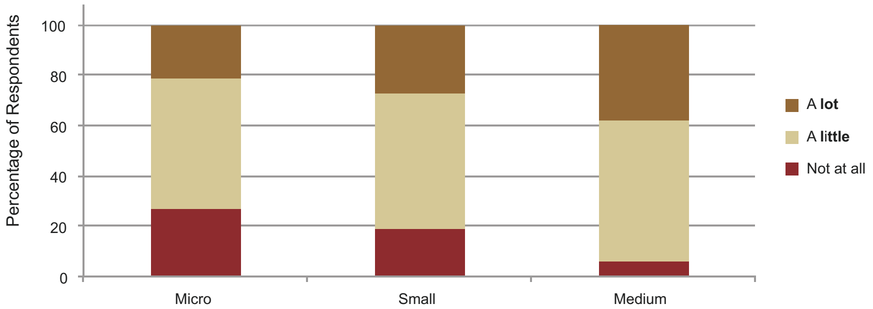
4.1.19 SME OPINION ON A DECLINED BANK APPLICATION FOR FINANCE

All Department of Finance and InterTradeIreland surveys have found that in the majority of cases where a formal application for credit is declined by a bank, the SME applicant did not agree with the reason provided by the bank.

This is significant because it may indicate that the applicant did not consider the bank to have made a fair assessment of the application and in turn this view may be contributing to the perception of some SMEs that the "banks are not lending".

Supporting this, the Q3 2012 Business Monitor found that a significant minority of firms reported that banks don't support their business: 35% of micros and 20% of medium-sized firms. Allied to this 27% of micro-enterprises considered that their bank did not understand the financial needs of their business although this decreased depending on size (19% for small and 6% for medium-sized).

Figure 55: SMEs Perception of Banks Understanding their Business



Source: InterTradeIreland Business Monitor, Q3 2012

Businesses from Ireland were more likely to indicate that banks had a lack of understanding in comparison to Northern Ireland and businesses from more heterogeneous sectors such as manufacturing and professional services were more likely to have an issue than those from homogeneous sectors (e.g. agriculture, construction, hotels).

The 2011 Northern Ireland Access to Finance Survey (Department of Finance and Personnel, 2011) reported that in 2010, the most common reasons given by banks to SMEs for refusing or partially refusing an application for credit was that the project had insufficient potential or was too risky. These reasons were followed closely by the lack of business capital and also that the business already had too much debt. Although numbers are too small to be conclusive, applicants who were refused credit were more likely to indicate that the bank did not understand their business and suggests that the SMEs believed they were unfairly assessed.

Coupled with Irish Department of Finance data, it is clear that declined applicants strongly disagree with the decision of a lender and that, where the lender makes a commercially valid decision to reject an application, this is not being clearly explained to the SME. This communication gap is contributing to the perception amongst SMEs of an unfair application process. However it should be noted that, in Ireland, the small number of applicants to the CRO might suggest that a majority of declined SMEs do not consider the process to be sufficiently unfair to submit an appeal.

4.1.20 NON-DRAWDOWN OF BANK FINANCE

A significant proportion of SMEs, for whom a credit application was approved are not drawing down or using that credit. Irish Department of Finance surveys indicate that approximately 20% of respondents whose requests for credit were approved did not (either wholly or in part) avail of the facilities. A higher proportion of newly-requested credit facilities are not drawn down in comparison to renewed facilities. This has not been measured to date for Northern Ireland.

The most frequent reason cited for not availing of approved credit continued to be ‘not needed at present time’. There also appears to be an increase in the number of respondents who reported that the criteria / conditions attaching to the credit approval prevented them from availing of the sanctioned facility (this proportion was up from 3% in March 2012 to 8% in September 2012).

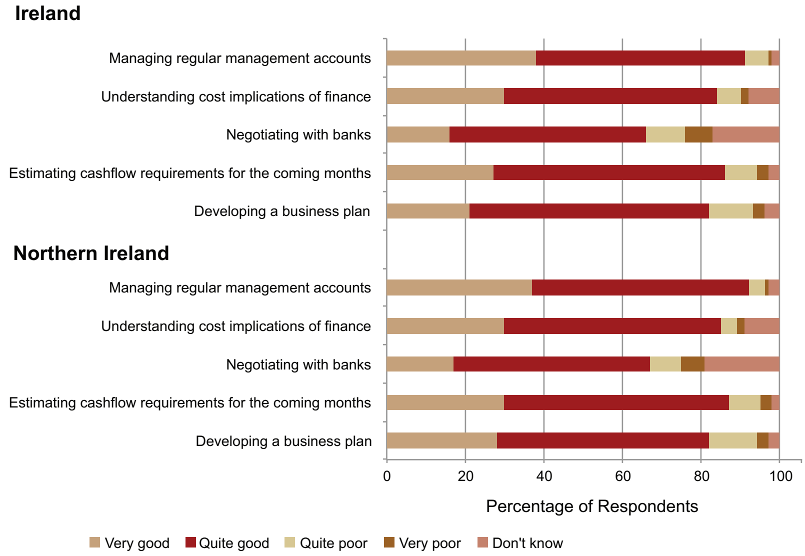
4.2 THE BANK APPLICATION PROCESS, PROCEDURES AND CRITERIA

4.2.1 HOW BUSINESSES RATE THEIR ABILITIES

The Q3 2012 InterTradeIreland Business Monitor found that the majority of SMEs believed that they have good capabilities in relation to maintaining regular management accounts, estimating cash flow requirements, and in understanding the cost of finance. As Figure 56 shows, one area where SMEs identified a weakness was in negotiation with banks. Capabilities tended to increase with size which is not unexpected given job specialisation in larger businesses, while SME perceptions of their abilities across both jurisdictions were similar.

The findings are in line with the 2011 UK Finance Monitor, which reported that 33% of Northern Irish SMEs are likely to have a business plan and 39% produced regular management accounts which was in line with the UK average.

Figure 56: How Businesses Rate Their Abilities



Source: InterTradeIreland Business Monitor, Q3 2012

The results above indicate that the vast majority of SMEs surveyed perceived that their abilities are very/quite good. However, the views of funding providers (banks, equity investors and government finance providers) and benchmarking reports offer a less favourable assessment. Consultations conducted in the course of this study indicated that standards varied greatly across the SME population and there was strong consensus among various lenders that the quality of application / business plan received was, in general, poor. This may be because of the increase in applications from applicants in distress with little or no experience in financial restructuring or access to training programmes. The CRO has recently commentated that for marginal businesses in Ireland which can show a route to recovery the *"onus here is on SME owners to ensure they have robust business plans and competent management – not on banks to support the status quo in marginal businesses"* (Trethowan, 2012).

Those consulted in the course of this study highlighted:

- A lack of financial skills within many SMEs and of financial restructuring skills courses available to SMEs;
- That the majority of intermediaries involved in advising SMEs are not adequately familiar with the bank application processes, conditions and structures;
- That many SMEs are unable to afford the accountancy fees needed to support making applications for new credit to their bank or an equity source or to restructure existing credit facilities; and
- Existing state-funded training or development programmes are focused on particular types of business or high growth business.

The importance of management capability has been highlighted in a number of reports (e.g, InterTradeIreland et al, 2009). Improving management capability within SMEs can lead to significant returns in terms of increased productivity, increased employment, better business survival rates and a more skilled workforce. Management practice in the high value manufacturing sectors in Ireland was considered to be above average but there was considerable variation in performance by sector and firm size and firm category. SME businesses in Northern Ireland and Ireland ranked 9th and 10th out of 14 countries measuring average management practices, and well behind leading performers such as Hong Kong, Austria, US and the Scandinavian countries.

Governments in Ireland and Northern Ireland have either rolled out "SME Finance Vouchers" or had begun to do so, at time of publication.[21] These are intended to meet the need to enhance the capability of a significant

[21] This measure was introduced in Budget 2014 for Ireland to be available to 1,000 businesses and has been available in Northern Ireland since 2012 (see www.investni.com/jobs/access-to-finance).

number of SMEs through direct support in the areas of financial management and building commercial management capability. Given that many SMEs say they are unable to afford professional advice in engaging with their banks or in applying for credit or restructuring their debt levels these voucher schemes will provide an important support.

There remains a question whether improving capability is the responsibility of the SME, accountant / business adviser, the bank, or of government. However, some banks are also starting to introduce customer mentoring programmes due to their belief that SMEs, especially micros and small firms, need assistance in navigating the funding landscape. And best practice initiatives internationally (see Chapter 6) suggests that an increased focus on one-to-one support for SMEs such as helplines, mentoring and voucher schemes (noted above) can help reduce the cost of drawing down financial services.

4.2.2 HOW PROVIDERS RATE THEIR ABILITIES

Whilst there is little published or survey evidence which examines how providers rate their abilities to evaluate a credit application, consultations conducted in the course of this study demonstrate that, in particular, banks are very well aware of the need to address certain gaps.

These can be summarised as capability gaps in the following areas:

- The preparation or review of cash flows or cash flow rather than asset-backed lending;
- Analysis of business plans;
- The sustainability or viability assessment of SME trading businesses;
- The restructuring of SME balance sheets / finance positions; and
- The development of multi-type finance solutions.

Supporting the consultation findings a recent report (Forfás, 2012) has called on lenders to improve their abilities in assessing high tech and innovative businesses in particular: *"even before the current financial crisis emerged, a number of structural issues were evident. Innovative exporting small and medium enterprises (SMEs) traditionally experience difficulty in accessing external credit finance. The reasons may be that newer technology and business models might not neatly fit into existing lending criteria of financial institutions; a lack of collateral or a lack of track record. In this regard, a move towards a banking system with an in-depth understanding of innovative sectors (e.g. software, telecoms, digital content, medtech and life-sciences) and a pro-active overseas banking network are required in the medium term. More immediately, there needs to be a focus on supporting internationally trading businesses in terms of both the provision of credit and the bank facilities/products. In particular, concerns have been raised about the availability of products such as international invoice discounting, performance bonds and specialised leasing, amongst others. For example, banks can be reluctant to provide leases for specialist equipment where there is no obvious resale market in Ireland or to provide international invoice discounting to exporters in markets the banks are not familiar with."*

Survey respondents often complain that banks do not provide adequate feedback to SMEs as to the reason their application for credit was declined and a number of banks have started to implement schemes to address this. However, the quality of front line staff in many banks and their knowledge of cash flow lending, robust financial analysis, funding restructuring and the Irish funding landscape is poor, as many have spent the last number of years in "sales" roles. To deal with this issue banks in Ireland have begun, in 2012 and 2013, to introduce programmes in the areas of front line staff training, cash flow lending, debt restructuring, dedicated distressed credit units, SME coaching initiatives, single application form, standard business plan, auto grading of micro loans, SME feedback initiatives, and dedicated SME officers in 2012. In general, banks in Northern Ireland would appear to lag behind on these initiatives.

Concluding on this issue, John Trethowan, head of the CRO, noted in his 8th report (Trethowan, 2012): *"I am however disappointed that there is not more evidence of support for 'enterprise risk taking' on new and increased lending in the banks' current lending policies. This would suggest that their current risk appetite needs to be reassessed in order to support economic and employment recovery…My reviewers get particularly disheartened when customer focus is not evident and it is clear that the bank has a declined an* *application which has devastated the owners of a hard working SME or farm, but which is potentially viable with some creativity and banking skill. They are also, by default, providing forbearance options to those businesses which have 'legacy debt overhangs' on their lending books from the boom years….the challenge for banks is to develop approaches which can provide credit for those businesses within the SME sector, whereby they can be seen to lead rather than follow economic recovery; this relates particularly to still viable SMEs within trade sectors which have been worst affected by the downturn; Property, Construction and Hospitality. This is evidenced by our opinions' upholding 60% of borrowers' appeals, with up to 600+ jobs protected."*

4.3 DEMAND FOR NON-BANK FINANCE

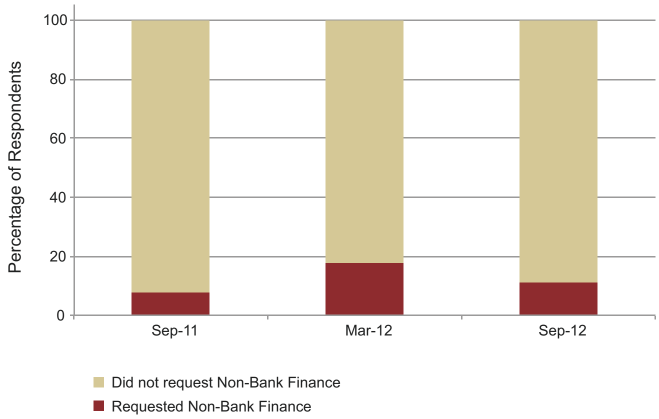
Existing survey data would suggest that the demand for non-bank finance is low. While it is generally accepted that this is the case, the demand has to be understood within the following context:

- Existing surveys often underrepresent particular cohorts of clients such as new start up businesses and, as such, may understate the demand for equity; and
- The absence of a wide range of alternative non-bank products historically is also a supply factor which influences demand.

It is worth noting that some research (Mac an Bhaird, 2010) found that the demand for non-bank finance is also restricted by the fact that government, angel and venture capital investors typically only provide finance to a small number of specific businesses in targeted industry sectors which match the investor's portfolio, risk and return on investment goals. However, an ESRI working paper (Casey & O'Toole, 2013) concludes that *"bank lending constrained SMEs are significantly more likely to avail of alternative forms of external finance"*, suggesting that the importance of non-bank finance to SMEs should have increased in the period since 2009.

The evidence to support this is still slight, given the small numbers and higher margins of error. However, the Q3 2012 InterTradeIreland Business Monitor demonstrated that only 5% of SMEs (Ireland 6%; Northern Ireland 4%) had applied for non-bank finance. The Irish Department of Finance surveys since September 2011 have found that demand for all types of non-bank finance is typically between 10%-15% with demand increasing with business size.

Figure 57: Demand for Non-Bank Finance



Source: Irish Department of Finance SME demand surveys, 2011-2012

Government support and loans / equity from family or friends are the most popular types of non-bank finance although this demand is affected by a number of factors including business age, sector and size.

4.3.1 DEMAND FOR EQUITY FINANCE

The results of the Q4 2012 InterTradeIreland Business Monitor reported that around 1% of respondents indicated that they sought financial support from equity sources (i.e. business angels or venture capitalists) in 2012. These figures are in line with the Department of Finance SME demand survey for April–September 2012 which indicated that, in the previous six month period approximately:

- 5% of respondents demanded loans or equity from family and friends;
- 4% of respondents requested loans or equity from business partners;
- 2% of respondents requested venture capital finance; and
- 2% of respondents requested business angel finance.

However, a report prepared by the European Parliament (Tykvová, Borell, & Kroencke, 2012) suggests that *"the results from such surveys may deliver important insights, but they must be interpreted with caution when trying to assess how much venture capital is lacking. First, the samples include all SMEs, the vast majority of which will be credit-financed and not targets or potential targets of VCs...[and]...only existing companies are under survey, which may bias the results."*

As noted above, it is generally accepted that equity finance will only ever be suitable for a small minority of SMEs, often start-ups and / or high potential growth businesses (Nesta, 2009) and more mature companies with short to medium term growth or expansion plans. However, it will remain a key source of finance for this cohort of businesses. In many cases these companies will not be able to meet the lending criteria of banks due to one or more of the following: lack of a track record, inadequate cashflow, lack of collateral, high existing debt levels or low equity ratios. These companies, can, by definition, be considered to be higher risk in nature.

Recent research internationally (DG Enterprise & Industry and DG Research & Innovation, 2011) and in Ireland (Forfás, 2012) has suggested that there has been some increase in interest by SMEs in the use of equity finance and that there may be potential for promoting and increasing the use of equity and quasi-equity finance options across a slightly wider range of SMEs than has heretofore been the case, albeit that this will always remain a relatively small cohort as a percentage of overall SMEs. Demand for seed and start up finance is also impacted by the dynamics of the local entrepreneurial ecosystems, such as policies, support and finance to stimulate entrepreneurialism or create the right environment (Duruflé, 2010)

The majority of consultees with whom discussions were held in the course of this study in both jurisdictions suggested that the demand for equity finance, the pipeline or deal flow is significantly lower in Northern Ireland than in Ireland. However, it was generally considered that the increased supply and availability of seed and early stage funding over a number of years in Ireland had been a significant demand stimulant.

The increased supply of seed and early stage funding is not, however, the only factor which should be considered in comparing the two jurisdictions and it would be overly simplistic to compare Ireland and Northern Ireland along these lines. A range of other factors present distinguishing advantages in Ireland, including the competitive tax regime, the significant presence of large multi-nationals in Ireland, the strong knowledge economy focus and presence, and the examples of high-profile entrepreneurs who have used and exited venture capital schemes. Additionally in Ireland, the business community is larger, the venture capital environment is more mature, and both the government and the National Pension Reserve Fund have played important roles in the Irish equity landscape in recent years.

4.3.2 WHY SMEs DO NOT APPLY FOR EQUITY FINANCE

Demand for equity finance from venture capital funds and business angels as distinct from personal finance or other informal forms of finance from friends and family is inherently difficult to measure. This is because in general demand cannot be measured in formal applications, such as with bank finance. Also, with the exception of the data collected by the Irish Venture Capital Association (IVCA) and the British Venture Capital Association (BVCA) there is no central data collection or reporting entity which captures data from all individual equity sources.

There is limited data available on enquiries and applications to the various equity sources. While some data was collected on enquiries and applications for some of the government-backed funds, this was neither comprehensive nor consistent across all schemes and did not allow for analysis by sector, size of company or lifecycle stage.

Consultation and desk based research conducted in the course of this study, would suggest that the following are the three main, but not only, factors which explain the low levels of demand for and take up of equity finance across the island:

- The profile of SMEs;
- The supply side issues impacting demand and confidence in equity; and
- A lack of awareness and understanding of equity finance amongst SMEs.

SME profile in Ireland and Northern Ireland
Section 3 of this report demonstrates the extent to which SMEs across the island of Ireland are concentrated (by number of enterprises) in a small number of sectors and the extent to which they heavily rely on the domestic economy. This reliance and the resultant low growth potential, in particular at present, may not be attractive to equity investors seeking a short to medium term return on their investment.

In addition, there are a large number of SMEs operating in traditional sectors in Ireland and Northern Ireland who do not have a culture or history of using equity capital. Large numbers of these SMEs are lifecycle or family businesses and, in general, their owner/managers are reluctant to cede control of their business, which they perceive equity finance would require them to do.

That said, opportunities for investment still exist in certain sectors, businesses and types of SME.

Supply issues impacting demand and confidence in equity as a viable option
A number of supply side issues impact on demand and confidence in equity as a viable option in Ireland and Northern Ireland.

These include:

- The absence of a continuum of funding in Northern Ireland where a young firm which secures funding at an initial stage of their development, can in turn progress to middle and later stage equity investment.
- The specific or niche focus of Irish government-backed seed and early stages funds, with high levels of investment in high tech companies, may not be fully suitable or be perceived as suitable for some SME sectors (e.g. companies with high growth potential who are not necessarily high tech). High technology companies account for over 90% of venture capital investment in Ireland compared to a weighting of 31% in Europe (Irish Venture Capital Association, 2012). This suggests that equity investing in other countries is more diverse, and as such that there may be supply gaps for the equivalent cohorts in Ireland. This may not necessarily need to be addressed by VC funds but could also be addressed by a range of other non-bank financing options.
- Low levels of seed and equity finance in Northern Ireland over the last number of years may have impacted confidence in the availability of equity finance amongst Northern Irish SMEs and, in turn, this can impact on the demand for such finance.
- The objectives of venture capital firms / private investors and SME owner/managers are often not aligned – quick sale/return versus control, longevity and succession planning. Many private investors also fear becoming entangled in SME familial disputes and succession planning.

Low levels of awareness and understanding of equity options amongst SMEs
Much work has and continues to be done to promote equity as an option. While it is considered to be well known and understood within the start-up and high tech community, the consultations for this study indicate that there is a lack of awareness and understanding of equity, and quasi-equity options, across some sectors and more mature businesses for whom equity may be an option. This may contribute to lower levels of demand across this cohort of SMEs.

It would appear that there is also a low level of awareness amongst SMEs of the benefits of complementary funding and use of alternatives such as mezzanine finance. From a demand perspective, there is a strong belief that the quality of investment proposals and business plans at seed and early stage have benefited from the range of investment readiness support platforms and initiatives, in particular in Ireland. Consultees in Ireland however suggested that there was a skills and capability issue in terms of moving to the next stage for many SMEs; in particular, preparing for follow on funding and reaching the bar expected by private equity funds at that stage of the funding cycle.

Consultees in Northern Ireland suggested that some work was still required to coordinate, streamline, and extend the range of investment readiness and business supports available to early stage and growth companies and to make it easier for SMEs to understand the relevance of particular programmes to their specific stage of development and their needs. Despite jurisdictional differences, consultees in both Ireland and Northern Ireland believe that the commercial and management skills of investee management teams remain a weakness and require improvement.

Some research (Industry Taskforce, 2012, and FGS Mc Clure Watters, 2010) has suggested that the role of equity finance may become increasingly important to a wider cohort of SMEs due to changes in the bank lending environment as summarised elsewhere in this report (Section 4.1).

More mature companies looking to finance growth and expansion plans may increasingly look to quasi-equity options, along the lines of the evidence from international analysis. In Northern Ireland the Growth Loan Fund, a mezzanine debt product which allows companies to draw down unsecured loans at higher interest rates based on growth projections, would appear to have tapped in to some latent demand in this area. Due to the global financial crisis there may also be SMEs who are highly leveraged (including those with significant property debt), who may have limited other finance alternatives, and who will increasingly look to equity and quasi-equity options to restructure and / or finance the growth plans of their trading businesses, albeit that it must be expected that restructuring cases will always be reviewed selectively and critically. In this regard, the new National Pension Reserve Fund (NPRF) SME Turnaround Fund should begin to provide useful statistics on demand.

It is not possible to ascertain the level of unmet demand for equity finance from survey data or for the numbers of SMEs for whom equity finance might be a viable funding option. These could include SMEs with strong growth potential in sectors or with profiles (e.g. low-tech, generalist) that are not currently supplied or targeted by venture capital funds. Thus policy and practice may also need to focus on those SMEs who may be suitable for equity finance but who either do not consider themselves to be suitable (e.g. high growth but not high tech) or those SMEs who are not aware of, do not understand, have no track record in using equity or quasi-equity finance and who may also not be on the radar of investors.

Policy may also need to focus on the needs of SMEs carrying high levels of debt and in need of refinancing who may increasingly look to equity and quasi-equity options to refinance and support the growth of their core trading businesses. Improved demand side statistics would be required to facilitate evidence-based decisions in this area. In this regard it will be interesting to monitor demand statistics on the new funds (NPRF SME Turnaround Fund in Ireland and the Growth Loan Fund in Northern Ireland) discussed further in Section 5.4.1. The collection and analysis of enquiries and applications to government backed schemes (equity and other) may provide an avenue to assess the level of demand and the profile of those companies seeking alternative means of finance to further improve policy development in this area, albeit that the emerging solutions may not necessarily be equity financing in all cases.

The importance of ready availability of seed and early stage finance as a demand stimulant must also be addressed in Northern Ireland. We note that the Northern Ireland Executive’s Access to Finance

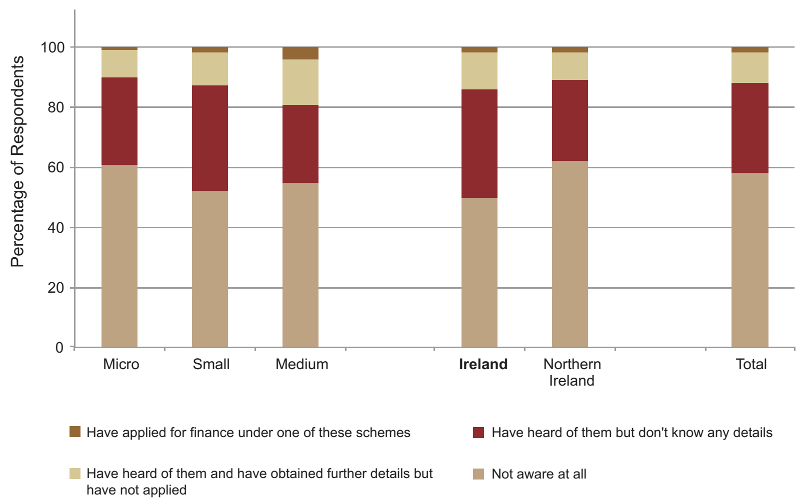
Strategy has taken cognisance of this with the extension of seed and early stage funding in 2013 and there are plans to put in place increased seed and early stage funding from April 2014. Policy and practice in both jurisdictions must also continue to assess how to address any demand side weaknesses around the area of business supports including the suite of investment readiness programmes, supporting businesses to secure follow on funding and enhancing commercial and management skills of investee teams.

4.3.3 DEMAND FOR PUBLIC FINANCE

A large number of public finance schemes for SMEs exist in Ireland and Northern Ireland, which are outlined in greater detail in Section 5.4. SMEs and their advisors, business groups and accountants typically are not aware of the public schemes and funds that are available to their clients. The complex and distributed nature of non-bank funding sources, as outlined in the funding landscape maps (Appendices 1 and 2 to this report), and the varied application routes makes the use of non-bank funding difficult and often expensive for SMEs. A lack of awareness of non-bank and Government schemes could act as a barrier to demand.

Results from the Q3 2012 InterTradeIreland Business Monitor indicate that there is a low level of awareness amongst respondents for publicly funded finance or support schemes. 58% (50% Ireland; Northern Ireland 62%) of respondents were unaware of publicly-funded schemes set up to assist businesses that required finance. As shown in Figure 58, a general lack of awareness was higher amongst smaller SMEs and respondents from Northern Ireland were less aware than those in Ireland. The lowest level of awareness was found among SMEs in sectors such as construction (70%), accommodation and food (68%), and the services sectors (67%), which may reflect the fact that most government schemes do not target these sectors.

Figure 58: Awareness of Public Finance Schemes



Source: InterTradeIreland Business Monitor, Q3 2012

There are significantly lower levels of awareness for newly-launched schemes. Of those businesses based in Northern Ireland who were asked about the Enterprise Finance Guarantee (EFG) scheme and the Northern Ireland Spin Out (NISPO) initiative only two businesses had applied for both schemes. By the end of 2012, a total of 215 EFG loans had been approved in Northern Ireland.

Whilst the responsibility to research and identify potential financial assistance should rest on the actual SME, funding providers should make every effort to simplify this process via awareness campaigns. In addition, more accurate data on the demand for public finance schemes is needed (by sector, size, etc.) on the number or value of enquiries received or applications for schemes made.

5. Supply of Finance

5.1 OVERALL SUPPLY OF FINANCE

This study presents the first comprehensive analysis of the supply of finance from bank, public and equity funding sources to Irish and Northern Irish SMEs. The information is based on data supplied by the various funding suppliers (banks, VCs, public sector bodies, angel groups) to the research team and on further analysis of available public information. The inclusion of funding suppliers has been carried out on a "best efforts" basis and attempts have been made to include all available material from suppliers of funding to Irish and Northern Irish SMEs.

This data is particularly pertinent to Northern Ireland where the Economic Advisory Group (EAG, 2013) has highlighted that the absence of bank lending data is a significant issue for policy makers. In particular, since bank finance makes up 95% of all finance provided to Northern Irish SMEs, the lack of a formal process for the collection and analysis of bank supply side data is impacting on the ability of policy makers and funders to adequately respond to the needs of SMEs. The fact that detailed supply data has been provided by the main banks operating in Northern Ireland is an important milestone in understanding the SME finance environment in the jurisdiction. However, the process needs to be maintained and improved in order that patterns and trends may be monitored and analysed over time and appropriate policy responses developed.

The total supply of finance to SMEs across all sources at 31st December 2012 was €33.7 / £27.5 billion[22]. The total current supply of finance to SME is measured as follows:

- In the case of bank lending as exposure or stock of "real economy" lending[23];
- In the case of external equity (including government backed equity participation) as the total value of investments made over the last 5 years; and
- In the case of public finance schemes as the gross balance sheet value of investments/ funding as at 31st December 2012.

Total bank SME funding in Northern Ireland was approximately €5.8 / £4.7 billion. As this data has never before been captured, it is impossible to tell if this has fallen or risen in recent years. In Ireland, total bank SME funding was approximately €25.7 / £21.0 billion, down from €34 billion in Q4 2010 (when bank supply data began to be captured by the Central Bank of Ireland). Bank funding is by far the most significant source of funding amongst both Irish and Northern Irish SMEs at 93.4% of total SME finance at 31st December 2012.

The second, most significant source of funding is external equity finance as represented by seed capital, venture capital and business angel finance. External equity finance, including government backed equity finance, accounted for approximately 5.5% of total SME funding at 31st December 2012. The smallest element, direct government funding not included in equity finance, represented 1% of all finance extended to SMEs as at 31st December 2012.

The total supply of finance from all sources to Irish and Northern Irish SMEs is summarised in Table 1.

Table 1: Total Supply of Funding to SMEs

	Ireland	Northern Ireland	Total	% of total
Bank Finance €/£m	25,697/ 20,971	5,815/ 4,744	31,512/ 25,715	93.4
Seed & VC €/£m	1385/ 1,130	249/ 203	1,634/ 1,333	4.8
Angel & Private (visible and invisible) €/£m	184/ 150	62/ 50	246/ 200	0.7
Public Finance €/£m	312/ 254	27/ 22	339/ 276	1.0
Total €/£m	**27,578/ 22,504**	**6,153/ 5,021**	**33,731/ 27,524**	**100**
Total %	81.8	18.2	**100**	-

[22] Using an exchange rate of €1 = £0.816 (as at 31st December 2012 taken from the Central Bank of Ireland).
[23] Bank finance data has been compiled using the real economy method i.e. a similar approach to that employed by the Central Bank of Ireland in the *Trends in Business Credit and Deposits* series and, as such, includes only real economy activity and excludes financial intermediation, real estate and construction lending.

5.2 SUPPLY OF BANK FINANCE

Total bank finance of €31.5 / £25.7 billion had been extended to Irish and Northern Irish SMEs as at 31st December 2012.

This figure for total bank funding in the Irish and Northern Irish markets for SMEs has been collated on the basis of detailed data returns completed by each of the main SME banks operating in each jurisdiction. This study did not incorporate an audit of data provided by individual banks. Rather each bank was asked to complete a detailed data return by extracting data from their core systems covering the period up to 31st December 2012 and to provide those completed returns to the researchers.[24] These returns were based on the model established by Mazars for the supply of data to the Department of Finance in Ireland in 2009, a model that has since been used by the Central Bank of Ireland. Completed data returns were received for seven banks and were analysed in detail by the research team. The results of that analysis, where they are deemed to be reliable, are included in this study.

In the event that ongoing reporting of bank data is envisaged, further work would be required to ensure a more in-depth understanding of the data and to identify any changes required to the model to improve the robustness and consistency of the data. The detail of the original exercise performed by Mazars in 2009 in order to facilitate ongoing collection and reporting of bank data is detailed in Section 2.2. Such an exercise was not possible within the time and resource limitations of this study and, as such, a number of assumptions have been made in the compilation of the Northern Ireland bank data figures presented in this report.

For this study the data returns included requests in relation to:

- Enquiries;
- Applications for new credit received (formal applications);
- Applications approved; and
- Exposure or stock of credit.

Data returns included the following bank products:

- Loans;
- Overdrafts;
- Finance and leasing; and
- Invoice discounting.

Data was split across the NACE sectoral codes A-Q (see Section 2.2 for detail). Total lending to SMEs (line 1 in Tables 2 and 3) has been prepared on a full reporting basis (i.e. including all business sectors). Total business lending to SMES (line 3 in Tables 2 and 3) has been prepared on the basis of the exclusion of the Construction, Financial Intermediation, and Real Estate, Land & Development sectors, using an approach similar to that followed by the Central Bank of Ireland.

The analysis of bank data was limited by the following:

- Many banks operate a number of disparate systems covering the lending process from enquiry through application to approval and ultimately to drawdown, which makes it impossible to create links between all stages of the lending process.
- The systems in place within the individual banks are very different and operate on a bank-specific basis, making the information contained within them difficult to compare.
- It is not always possible to analyse lending on a product-by-product basis in all banks as applications for certain products are not separately coded in back office systems.
- In the case of some banks, different systems are used in the same bank, depending on the type or size of the credit facility in question and these systems are not consistently structured even within that bank.
- It is not always possible to separately distinguish bank customers by size of SME (i.e. micro, small and medium) due to the lack of information held in bank systems, so, by necessity, assumptions have been made.
- Differences in the models and nature of data collected (e.g. some banks in Ireland record data for loans and overdrafts together (due to system limitations), whereas banks in Northern Ireland all report them separately).

[24] The bank funding figures for Ireland are taken from Central Bank of Ireland, Trends in Business Credit and Deposits, December 2012.

These differences in systems, lending processes and data models have impacted on the ability to prepare a detailed consolidated and comparative picture of lending to SMEs across the banking sector in Ireland and Northern Ireland, as represented by the banks included in this study. However, the final overall picture and the information presented in this report are materially correct and present a clear and, insofar as it is possible, accurate picture of SME lending in Ireland and Northern Ireland.

The following sections summarise the current volumes of lending activity to SMEs as represented by the seven banks participating in the research. These volumes are expressed by an analysis of:

- Total bank lending to SMEs (including by sector);
- Value of credit requested (new and restructured credit);
- Approval rates; and
- Average values of credit applications by lending products.

The report cannot provide additional analysis on the total value of new lending or enquiries due to inconsistencies or limitations in the data provided. The assumptions made in the compilation of this data are set out in Appendix 3.

5.2.1 TOTAL BANK LENDING TO SMEs

Table 2 provides a summary of total bank lending to SMEs in Ireland and Northern Ireland as at 31st December 2012.

Table 2: Total Bank Lending to SMEs (Exposure)

	Ireland	Northern Ireland	Total	% of total
Real economy lending to SMEs €/£m	25,697/ 20,972	5,815/ 4,745	31,512/ 25,717	43
Financial intermediation, real estate and construction (i.e. non real economy) €/£m	32,479/ 26,506	8,984/ 7,332	41,463/ 33,838	57
Total bank lending to SMEs €/£m	**58,176[25]/ 47,478**	**14,799/ 12,077**	**72,975/ 59,555**	**100**
Total %	82	18	**100**	-

In Ireland, the four sectors with the highest levels of SME lending (i.e. bank exposure) are:

- Real estate, land and development activities (by far the most significant at 55.8% of total lending);
- Wholesale and retail trade, repair of motor vehicles and motorcycles;
- Accommodation and food service activities; and
- Agriculture.

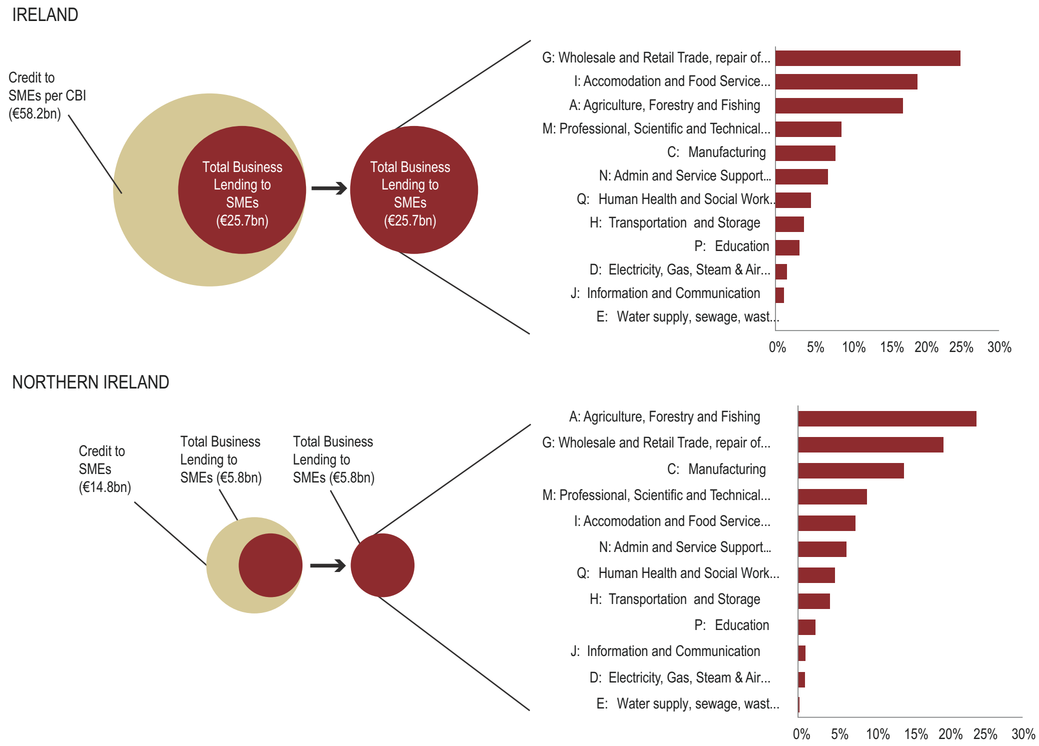
In Northern Ireland, the four sectors with the highest levels of SME lending (i.e. bank exposure) are

- Real estate, land and development activities (by far the most significant at 60.7% of total lending);
- Primary Industries (i.e. Agriculture);
- Wholesale and retail trade, repair of motor vehicles and motorcycles; and
- Manufacturing.

Figure 59 shows the sectoral profile of bank exposure by real economy business sectors in Ireland and Northern Ireland.

[25] It should be noted that the total lending figure included in the Central Bank of Ireland Table A 14.1 – Credit Advanced to Irish Resident Small and Medium Enterprise as at 31 December 2012 is €71billion as this includes lending to certain financial vehicle corporations (FVCs) in the financial intermediation sector, mostly mortgage backed securitisation vehicles reported to the Central Bank, whose balance sheet size brings them into the SME definition. This data is removed by the Central Bank for reporting purposes as it does not reflect "real economy" SME lending. The data provided by the participating banks specifically excluded this data from the outset and as such it did not have to be excluded separately.

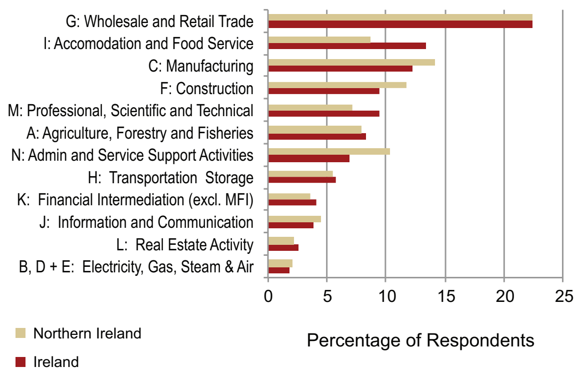
Figure 59: Total Bank Lending to SMES (Exposure) in Euro



Source: Irish figures are based on Central Bank of Ireland. Northern Ireland figures are based on bank returns provided for this research

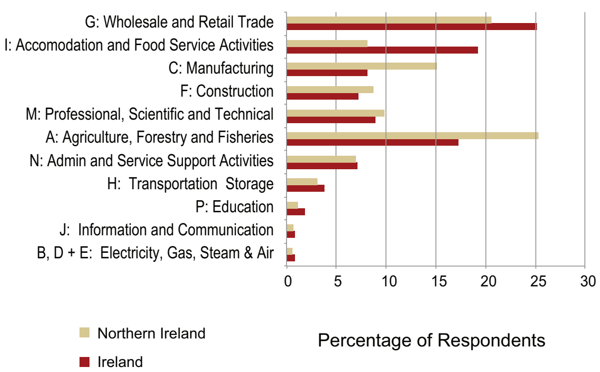
Figures 60 and 61 show the sectoral employee shares among SMEs and the levels of credit outstanding, as represented by bank exposure, by sector. A clear picture emerges of high levels of debt apparent in a number of the sectors employing the largest numbers of people.

Figure 60: Employee Share of Total SME Employment by Business Sector



Source: CSO; Department of Agriculture, Fisheries and Food, BIS UK

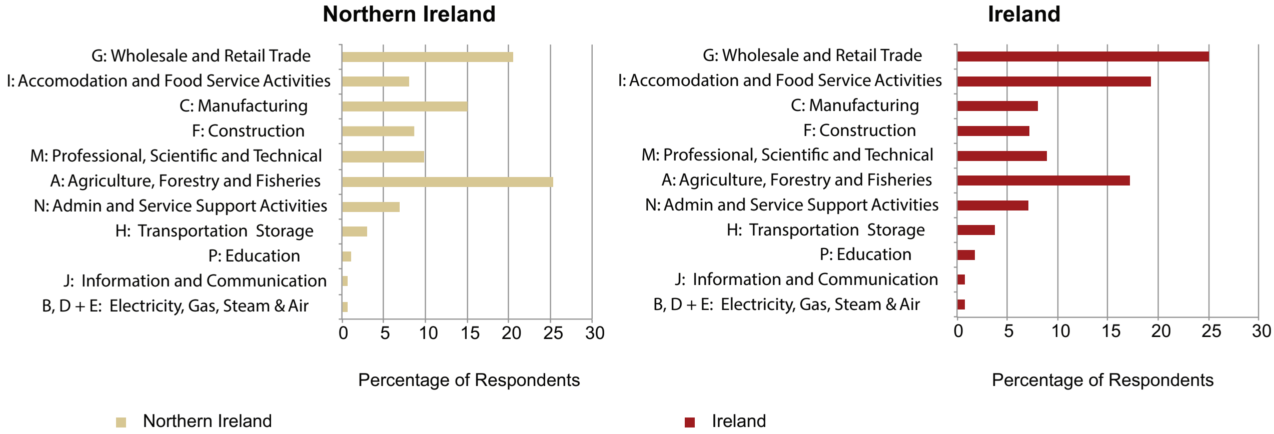
Figure 61: Outstanding Credit (Exposure) Share of Total SME Credit by Business Sector



Source: Irish figures are based on Central Bank of Ireland; Northern Ireland figures are based on bank returns provided for this study

Of the four main sectoral employers in each jurisdiction, three are in distress, very dependent on the domestic economy and have high levels of debt. Figure 62 shows the sectoral profiles of bank credit as at 31st December 2012 by jurisdiction and shows that the Accommodation & Food Services sector has a higher share of exposure in Ireland, while Manufacturing has a higher share in Northern Ireland.

Figure 62: Outstanding Credit (Exposure) Share of Total SME Credit by Business Sector – Ireland and Northern Ireland Separated



Source: Irish figures are based on Central Bank of Ireland. Northern Ireland figures are based on bank returns provided for this study.

5.2.2 VALUE OF CREDIT REQUESTED

A formal application for credit can be defined as one for which a customer is required to complete an application form which is assessed internally by the bank. Formal applications for credit can broadly be split into the following two categories:

- New applications from both new and existing customers;[26] and
- Applications for renewals and rescheduling existing credit facilities (e.g. interest only, extension of term, etc).

In most cases, initial enquiries for credit from SMEs are assessed informally by the relationship, lending or branch manager who form an initial assessment as to the merits or otherwise of the credit proposal. Using their experience of the lending process and the customer's background, the manager decides whether the enquiry is suitable to proceed to the formal application stage.

Records of enquiries for credit are generally not maintained by the participating banks. For the period under review, it has not been possible to secure any meaningful analysis of credit enquiries, as only a small number of banks have recently started to record them. Credit enquiries are typically not reported on by any Central Bank or public entity in any EU country.

Although for these reasons formal credit applications cannot be considered as a reliable gauge of full demand for credit, the review of credit requested is based on these formal applications received by the banks. The total value of new credit requested in the year to 31st December 2012 was €13.6 billion as set out in Table 3.

[26] This application category includes the top-up portion where an existing customer applies for an increase in an existing facility.

Table 3: Value of Credit Requested

	Ireland	Northern Ireland	Total	% of total
Total credit requested €/£m	11,713/ 9,558	7,813/ 6,375	19,526/ 15,993	100
Financial intermediation, real estate and construction (i.e. non real economy) €/£m	3,017/ 2,462	2,918/ 2,381	5,935/ 4,843	30
Total business lending to SMEs €/£m	**8,696/ 7,096**	**4,895/ 3,994**	**13,591/ 11,090**	**70**
Total %	64	36	**100**	-

It should be noted that this includes requests for restructuring of existing credit facilities in addition to requests for new credit and, as such, a proportion of the credit requested reflects credit facilities already included in the total exposure figures in Table 2 above.

The average value of a request across the two jurisdictions was broadly similar:

- Northern Ireland - £85,000/€102,000 (total lending) and £60,000/€72,000 (core business lending); and
- Ireland - £82,500/€99,000 (total lending) and £66,666/ €80,000 (core business lending).

In Ireland, the main real economy sectors requesting the highest level of credit are, in descending order:

- Primary Industries (i.e. Agriculture);
- Wholesale and retail trade, repair of motor vehicles and motorcycles;
- Human health and social work activities;
- Accommodation and food service activities; and
- Manufacturing.

In Northern Ireland, the main sectors requesting the highest level of credit in descending order:

- Primary Industries (i.e. Agriculture);
- Wholesale and retail trade, repair of motor vehicles and motorcycles; and
- Administration and service support activities.

5.2.3 APPROVAL RATES

Approval rates vary significantly on an individual bank basis. However, a summary of the average approval rates for formal applications for credit across the seven banks who participated in this study is shown in Table 4

Table 4: Approval Rates by Product

	Ireland	Northern Ireland
Loans	-	85%
Overdrafts	-	89%
Loans and overdrafts (combined)	88%	
Finance and leasing	88%	97%
Invoice discounting	88%	91%
Average approval rate	**88%**	**89%**

The overall rate of approval, as determined by the demand surveys summarised in Section 4, presents a slightly different picture to that presented by the data from the banks. The Q4 2012 InterTradeIreland Business Monitor showed approval rates of 91.2% overall for Ireland and Northern Ireland and 84% for loans only. The Irish Department of Finance SME demand survey for April-September 2012 showed respective approval rates of 81% and 78%.

This difference can probably be explained by the fact that most SMEs consider both informal requests for credit (e.g., a conversation with their bank manager) and formal requests for credit (where a credit application is completed) as representing a demand for finance. However, banks only measure the responses which they provide on formal credit applications. In addition, a certain number of SMEs remove themselves from the credit application process at an early stage having completed a "self assessment" of their potential to secure bank credit. SMEs should be encouraged to submit a formal request for credit on all occasions and not to be discouraged by any initial discussions held with bank staff.

Many SMEs are afraid that a decline in a request for credit will impact their credit rating. This is not the case. Moreover, in the case of Ireland's CRO, only declines of formal application for credit may be appealed by the SME. Business groups representing SMEs should encourage them to always submit a formal request for credit when seeking bank finance.

5.2.4 AVERAGE APPLICATION VALUES BY TYPE

The average value of a formal application for credit made by an SME is summarised in Tables 5 and 6. It is not possible to analyse loans and overdrafts separately in Ireland due to system limitations in a number of the reporting banks and, as such, a combined figure is presented.

In conclusion, while no trend data is available for Northern Ireland, credit supply information reported to the Central Bank of Ireland shows that lending to non-financial, non-property related SMEs has shown a declining trend since the series started in Q1 2010. Total outstanding credit to SMEs, shown in Figure 63, has decreased from €34 billion at the end of Q1 2010 to €26 billion at the end of Q4 2012.[27]

Table 5: Average Formal Credit Application Value – Total

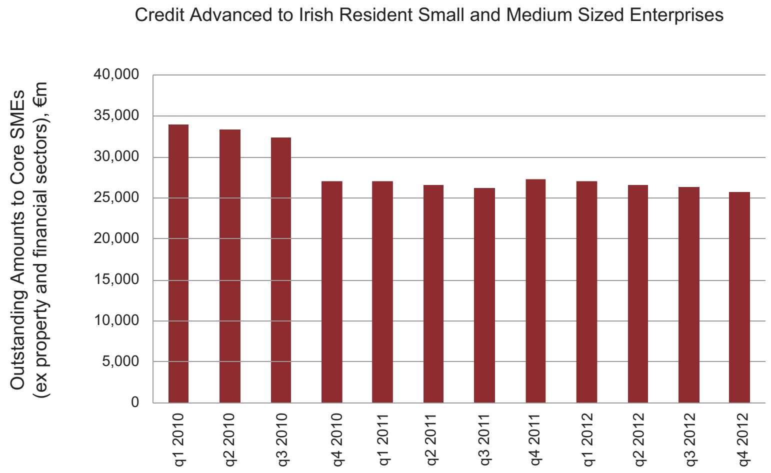
	Ireland €	Northern Ireland £
Loans	-	197,000
Overdrafts	-	46,000
Loans and Overdrafts (combined)	105,000	85,000

Table 6: Average Formal Credit Application Value – Core Business Lending

	Ireland €	Northern Ireland £
Loans	-	109,000
Overdrafts	-	41,000
Loans and Overdrafts (combined)	81,000	60,000

[27] Some of this decline can be attributed to Bank of Scotland no longer reporting figures to the CBI after Q3 2010.

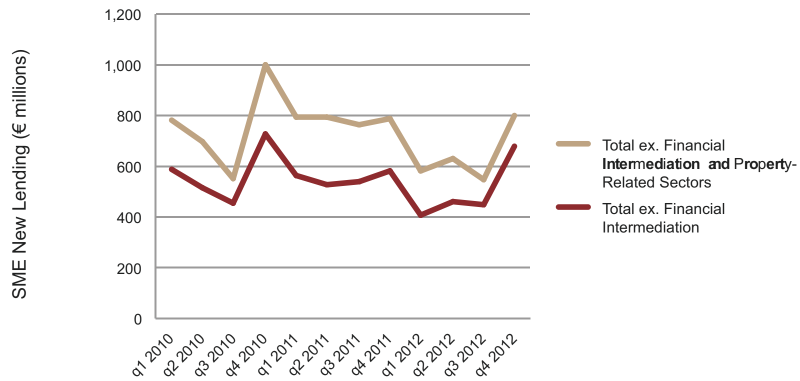
Figure 63: Credit Advanced to Irish Resident Small and Medium Sized Enterprises (Ireland only)



Source: Central Bank of Ireland

In the same period in Ireland, Figure 64 demonstrates that new lending, as recorded by the Central Bank, has not grown significantly.

Figure 64: New Lending Advanced to Irish Resident Small and Medium Sized Enterprises (Ireland only)



Source: Central Bank of Ireland

Finally, an analysis of the data returns provided by individual banks suggests that limited cross-border lending is taking place at present, with each bank servicing its local market only.

5.3 SUPPLY OF EQUITY FINANCE

Some commentators have stated that for there to be a long term industry ultimately Venture Capital (VC) needs to perform commercially and to provide decent financial returns – this would attract investors on its own merits and limit the need for government intervention (Kauffman, 2012). Some consultees for this study agreed that, in an ideal world, the VC industry shouldn't have to rely on the government for support. However, VC and other equity finance funds internationally have become and are likely to remain dependent on government and public sources of funding at least in the medium term. In fact, the general trend has shown an increase in the percentage of non-private funding required in VC funds.

Examples of potential issues cited as a result of government intervention included the convergence of objectives or lack of diversification, and the risk that geographic limitations imposed by government, will limit the financial returns from a private investor viewpoint. Subordination in government-backed equity funds (i.e. where the government effectively receives the return last) can act as an incentive but also risks providing a signal to the market that the fund needs a 'sweetener' to get private investment, and, as factors other than commercial return drive state objectives, this can impact the nature and structure of the fund. Nonetheless, due to the particular importance of this source of funding to a certain cohort of SMEs, it was generally accepted that government intervention will remain important and that certain restrictions and incentives were necessary and justified. Consultees also made the point that there was also a continued requirement for government to continue to financially support formal business angel networks.

This study specifically examined the supply of formal, external equity finance by private equity funds (including government-supported VC schemes) and business angels. The informal equity financing by promoters, friends and families, or sophisticated private investors not registered with any of the formal networks cannot be calculated but is extremely important to firms.

In addition, due to limitations in existing data (e.g. while investments are captured and reported exits are not), an assumption has been applied to the supply of equity investments to provide a comparable baseline over time. This equates total supply/lending to the level of annual investments made over a period of five years based on data reported by the IVCA for Ireland and the BVCA for Northern Ireland.[28] This does not take account of either exits or investments made in previous years and as such is a "best efforts" approximation of the equivalent bank exposure figure. With the exception of seed funds (which are capped at low levels) many of the funds invest across the business lifecycle and as such it is not possible to specifically locate them within discrete lifecycle stages.

Within these limitations the study estimates that a total of €1.9/£1.5 billion in equity finance had been invested in Irish and Northern Irish SMEs in the five year period to 31st December 2012. This is represented in Table 7.

Table 7: Total Estimated SME Equity Finance

	Ireland	Northern Ireland	Total	% of total
Seed & VC[29] €/£m	1,385/ 1,130	249/ 203	1,634/ 1,333	86.9
Angel & Private (visible and invisible)[30] €/£m	184/ 150	62/ 50	246/ 200	13.1
Total Equity Finance Available €/£m	**1,569/ 1,280**	**311/ 253**	**1,880/ 1,533**	**100.0**
Total %	83.4	16.6	**100.0**	

[28] There are complications in the data in respect of venture capital investment in Northern Ireland. This is reported by some organisations to the IVCA, the BVCA or both. The Northern Ireland data demonstrates that there is a higher level of reporting to the BVCA than to the IVCA, albeit that there may be some level of duplication in reporting. As the BVCA does not publish data on individual investments, it is not possible to identify the existence or extent of such overlap. Investments in Northern Ireland reported within the IVCA data could not be identified for the full five year period and as such have not been excluded from the Irish data. However, this is not considered material as the level of investments in Northern Irish SMEs in 2012 was only €3.5m.

[29] Based on cumulative 5 year investment figures

[30] Based on cumulative 5 year investment figures and an estimate of invisible Angel funding

The significant differences between the equity finance landscape in Ireland and Northern Ireland and some of the key components and characteristics are described in Sections 5.3.1 and 5.3.2. Figure 65 provides a map of the equity landscape on the island of Ireland, with the exception of UK initiatives which are not considered to have effectively translated to Northern Ireland (e.g. the Business Growth Fund). The landscape map represents the major funds where information relating to the total size of the fund is publicly available and as such is not a complete representation of the level of equity investment.

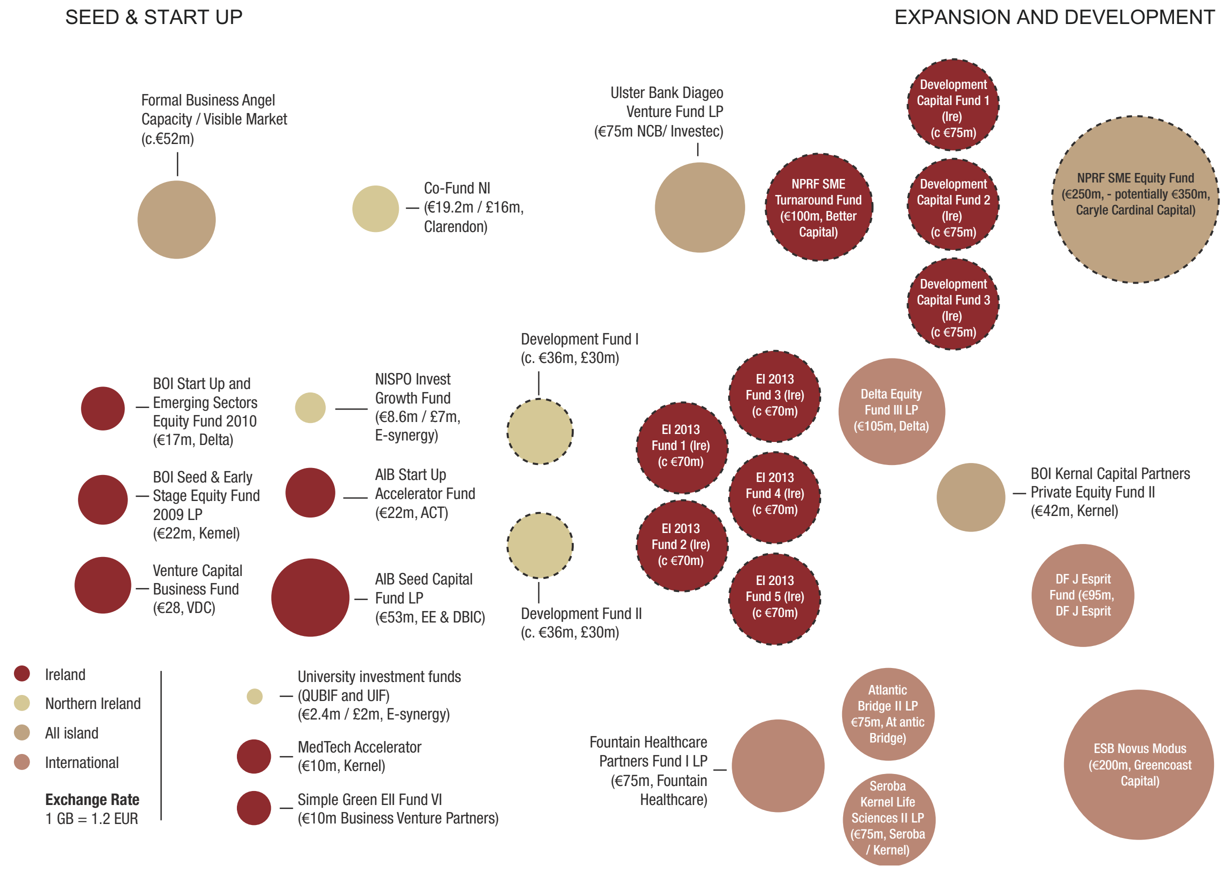
The IVCA data provided for this study and their quarterly VenturePulse report (which sets out venture capital investments made in Ireland and Northern Ireland) comprises 34 different investors/funds, which, if co-related to the landscape map outlined below, means that the funds represented in Figure 65 were involved in whole or in part in 73% of the companies invested in. The remaining balance of non-represented investing is largely due to the fact that Enterprise Ireland (EI), as a direct investor, is not represented on the landscape map, nor are private investors, due to the lack of available fund size information for both these investor types. Figure 65 also includes a number of additional funds not active in 2012, but which were planned or became active in 2013 (with black dotted lines).

In sum, 89% of the companies included in the IVCA data raised funds, in whole or in part, from one of the following sources:

- Funds represented on the landscape map (73% of companies);
- Enterprise Ireland (EI) as a director investor (41% of companies); and
- Private investors (46% of companies).

The remaining 11% were ad hoc investments by investors including international VC funds and/or funds for which no information is available publicly. The map includes an estimate of formal business angel investments based on data collected from Halo Business Angel Networks across the island.

Figure 65: Island of Ireland Equity Landscape



Source: IVCA

As noted above, Figure 65 is not the complete picture as there are a number of other funds with an Irish presence which receive some level of government backing through Enterprise Ireland and the NPRF. One is the Innovation Fund, for which full fund size is not available, and thus has not been included. A second is the number of accelerator schemes from Enterprise Ireland which also invest directly in companies. Finally, other VC funds which have been reported as investing in Ireland or Northern Ireland have also not been included, because there is no publicly available fund size information.

5.3.1 SUPPLY OF EQUITY FINANCE IN IRELAND

The majority of the €1.6 / £1.3 billion invested in Irish and Northern Irish SMEs in the five year period to 31st December 2012, has been invested in Irish companies. The VC market in Ireland is well developed with a high number of fund managers and active funds. The IVCA reported that 189 companies raised €269m in 2012, an increase on the number of companies raising finance in 2011 but a 2% reduction in the overall amounts raised. This is a pattern which is reflected in both the BVCA and European Venture Capital Association (EVCA) data.

The Irish VC industry has received significant and sustained support from the Irish government since 1994. In this time, the Irish government, through Enterprise Ireland, has committed approximately €348m to 41 local Seed and VC funds resulting in capital of approximately €1.2 billion for investment in innovative high growth companies (Enterprise Ireland, 2013).

Under the 2007-2012 Seed and VC Scheme, Enterprise Ireland committed €175m to improve access to finance for SMEs and continue to develop the seed and VC Industry in Ireland. Under this programme, Enterprise Ireland committed investment to four seed funds and six VC funds. Many of these funds leveraged significant investment from local banks, with all four seed funds also part financed by the pillar banks. (As noted in Figure 65 these seed funds can only invest in Ireland.) In addition to the government-backed schemes, the attraction of external/international venture capital investing in Ireland is also a key focus.

Enterprise Ireland reports that in 2011 international VC Funds invested more than €75m in their clients (Enterprise Ireland, 2011). Innovation Fund Ireland is also an important initiative of the Irish government aimed at attracting leading international venture capitalists to the Irish market. It comprises three elements – exchequer funding managed by Enterprise Ireland, investment by the NPRF in line with the commercial investment criteria of its private equity programme, and the balance raised by private venture capital managers participating in the fund. VC funds receiving investment from Enterprise Ireland will have to invest a meaningful proportion of their fund in Irish companies or companies with significant Irish operations. Funding from the NPRF is under its commercial mandate and may invest internationally but may be required to fulfil conditions favourable to the Irish innovation infrastructure.

From 2013, as part of a series of initiatives by the Irish Government aimed to make €2 billion in additional non-bank lending available to Irish businesses, Enterprise Ireland will commit a further €175m to the 2013-2017 Seed and VC Scheme, with an initial investment of up to €100m to establish five non-Seed funds (development funds) in the Technology and Life Sciences sectors. Other initiatives under this €2 billion programme include the establishment of three new development capital funds of €75m with EI investment, and two funds, an SME Equity Fund and SME Turnaround Fund, with cornerstone investment by the NPRF.

The SME Equity Fund will focus on investing in healthy businesses seeking to grow, including those with over-leveraged balance sheets, while the SME Turnaround Fund will aim to invest in under-performing businesses which are at, or close to, the point of insolvency but have the potential for financial and operational restructuring (Department of Finance, 2013). It should be noted that the SME Equity Fund has the potential to invest in both Ireland and Northern Ireland.

The new €2 billion programme also includes a new €10m International Start-Up Fund, managed by Enterprise Ireland to attract entrepreneurs to relocate and establish their start-ups in Ireland.

5.3.2 SUPPLY OF EQUITY FINANCE IN NORTHERN IRELAND

The level of VC activity in Northern Ireland has traditionally been low. The IVCA data shows that €3.5m was invested in four Northern Irish companies in 2012. While BVCA figures do not include all investment activity in Northern Ireland, figures for 2012 show a 57% drop from £21m in 2011 to £9m in 2012. The BVCA reported a drop in investment levels overall and individually across the vast majority of UK regions, with the exception of the North East of England, East of England and Wales. While investment levels were down in Northern Ireland, the number of companies raising finance increased from 13 to 26, with 24 of the 26 companies receiving VC finance (seed, start up, early stage and later stage). Three companies in Northern Ireland (one of which also received VC funding) also raised expansion finance.

The VC market in Northern Ireland is now supported by the recent Invest NI Access to Finance Strategy, comprising a £143m fund of funds of debt (£5m), mezzanine-debt (£50m), grant (£5m), and equity (£83m) funding options.

Table 8 demonstrates the equity fund position as at end of 2012, with equity funds of £84m, of which £21m was active at the end of 2012. Based on supply data under the Invest NI access to finance strategy, the two active funds – the NISPO Invest Growth Fund (seed fund) and Co-Fund NI supplied £1.1m and £1.7m respectively in funding to seed and early stage businesses. However, Co-Fund NI leveraged additional private sector investment of £3m in addition to the £1.7m.

Table 8: Northern Ireland Equity Funds - 2012

FUND	NATURE OF FUND	DEAL SIZE	£ FUND SIZE	£ COMMITTED
NISPO Invest Growth Fund	**Seed Fund**	**50k - 250k**	**£5m**	**£2.5m**
Co-Fund NI	**Seed / early stage Fund**	**250k - 450k**	**£16m**	**<£2m**
Development Fund I	VC (Development/ Expansion Capital)	450k - 2m	£30m	Not yet active
Development Fund II	VC (Development/	450k - 2m	£30m	Not yet active

Two new Development Capital Funds of £30m each were awarded in 2013, while the Invest Growth Proof of Concept Fund (pre-commercial grant), which was fully committed at the end of 2012, and the Invest Growth Fund, were extended by £2m each to March 2014, with a view to putting in place increased seed and early stage funding from April 2014.

The fund of funds also includes a mezzanine debt product, the Growth Loan Fund (£50m) which appears to have attracted a relatively high level of demand since it became operational in September 2012. Although primarily a debt product, this alternative financing product may have the potential to overcome the reluctance on the part of some growth businesses, as outlined in Section 4.3.2, to go down the route of equity. The structure of the product is similar to a bank loan but is unsecured, based on growth projections, and carries a higher interest rate, with some element of profit share during the period of the loan in addition to standard interest payments. Default conditions also include taking a share in the business.

5.3.3 BUSINESS ANGELS

As per Table 7 above, it is estimated that total business angel capital of €246/£200m had been invested in Irish and Northern Irish SMEs in the period to 31st December 2012 including both visible and invisible angel finance.

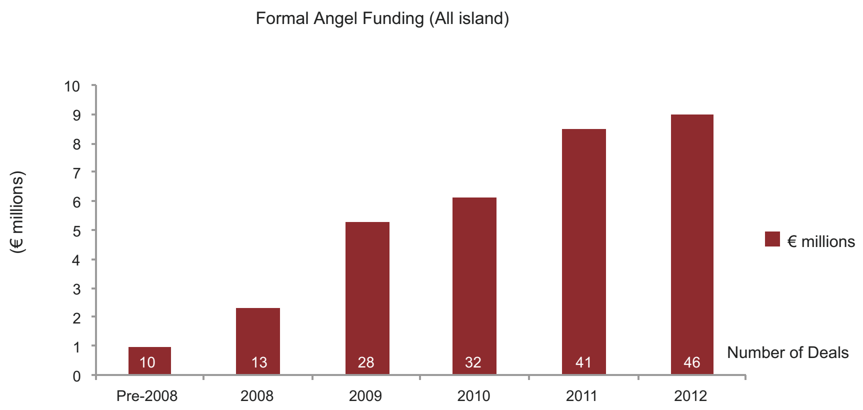
Business angels are an important source of investment for SMEs particularly at the seed and early stage of financing. Internationally, business angels have become an increasingly important source of financing relative to the venture capital market. The size of the business angel market is extremely difficult to quantify and most reports rely on a number of assumptions applied to the visible business angel market. For the purposes of this study the visible business angel market is equated to the data captured through formal investment channels and reported by the Halo Business Angel Networks (HBAN) to which a multiplier of 6.5 has been applied to capture the "invisible" market.

Formal investment channels are in place across the island of Ireland via HBAN. The formal angel investment structure in Ireland and Northern Ireland comprises two streams:

- To connect individual angels on a standalone basis to potential investment opportunities (HBAP); and
- To promote angel investment and facilitate the creation of business syndicates in Ireland and, via Halo NI, in Northern Ireland or fixed groups of investors (HBAN).

Supply statistics on formal angel investing indicate that angel investment has increased year on year rising from 13 deals worth €2.3m in 2008 to 46 deals worth €9m in 2012. Several additional all-island business angel syndicates specialising in food and med tech were expected to be active in 2013.

Figure 66: Angel Funding in Ireland and Northern Ireland (Combined)



Source: HBAN, HBAP, Halo NI

This rise in the visible angel market is likely to be due to the continued formalisation of investment figures, the continued support by government to fund formal business angel networks[31] and the inflow of investment from investors who may have previously invested in an informal capacity.

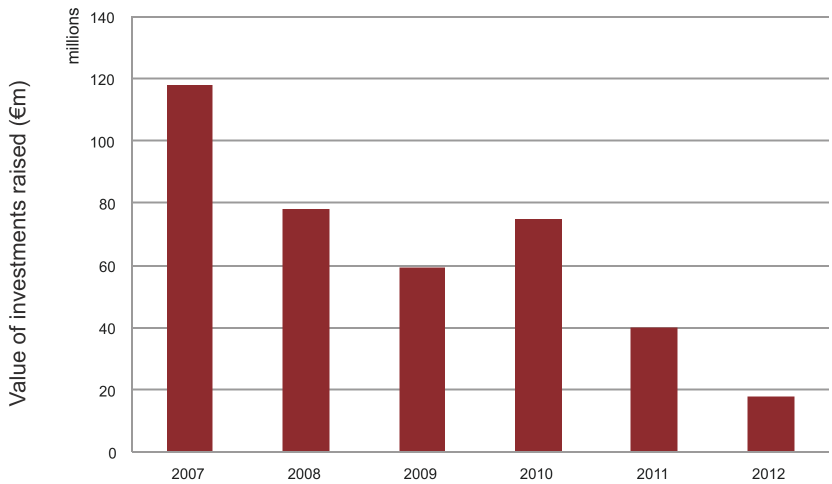
However, a recent review of the equity landscape in Ireland (Forfás, 2012) reported that, despite some growth in the visible business angel market in Ireland, the market appears underdeveloped relative to the sector size in other countries and relative to the size of the Irish VC market. In Northern Ireland, while levels of investment are also small but developing, angel investment is in relative terms more important, due to the low level of VC activity in Northern Ireland. As part of the Access to Finance Strategy in Northern Ireland a co-investment fund, Co-fund NI has been created. This fund is based on the Scottish Enterprise model which has been recognised as a significant catalyst in

[31] InterTradeIreland, Enterprise Ireland and Invest Northern Ireland all fund the Halo Networks.

developing business angel investing in Scotland. Angels or other private investors lead the deal and set the terms, and may avail of matched funding from the Co-fund of no more than 50% (although in practice the level of matched funding is significantly less).

On the basis of revenue data in Ireland on structured investment or investment vehicles including the Seed Capital Scheme (SCS) and Enterprise Investment Incentive Scheme (EII) and its predecessor the Business Expansion Scheme (BES), it appears that the level of investment raised through these schemes has faced a downward trend post-boom with the exception of some heightened activity in 2010. There is no equivalent regional data for Northern Ireland and the overall UK data is subject to a range of caveats.

Figure 67: Equity Raised through BES/EII/SCS in Ireland



Source: Irish Revenue Commissioners [32]

Figures 66 and 67 demonstrate trends across overall investing. Figure 67 shows that private investment would appear to be down while visible investing, as depicted in Figure 66, is increasing. This appears to be primarily driven by the fact that more investors are joining formal business angel groups.

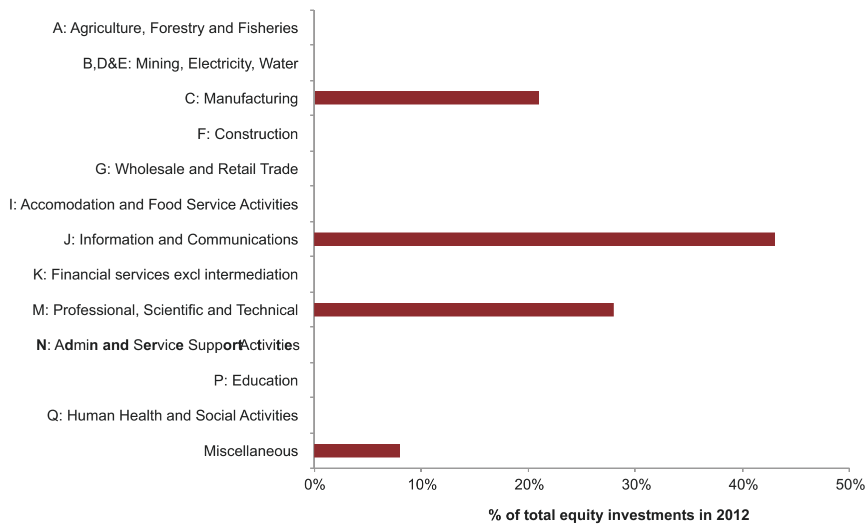
5.3.4 BUSINESS SECTOR FOCUS OF EQUITY FINANCE

In general equity finance is targeted very specifically at a small number of business sectors. When the IVCA figures[33] for 2012 are examined, it is apparent that equity funding was provided primarily to SMEs operating in the following three sectors:

- J: Information and Communication;
- M: Professional, Scientific and Technical; and
- C: Manufacturing.

[32] Figures from BES/EII/SCS shares issued on or after 1st January 2007.
[33] No equivalent sectoral data is reported by the BVCA for Northern Ireland alone.

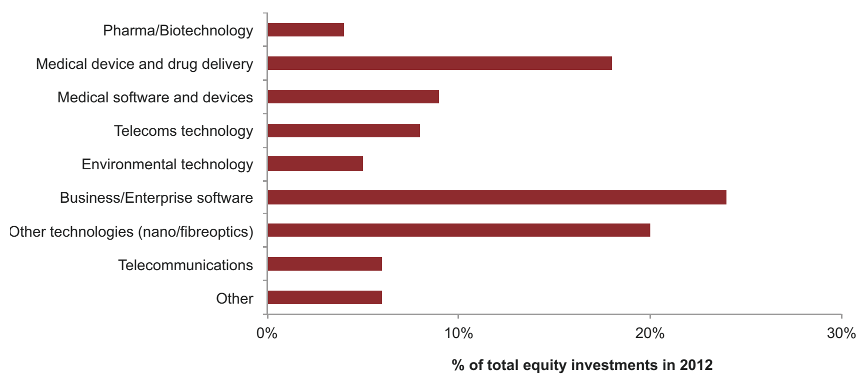
Figure 68: Business Sector Analysis of Equity Funding - 2012



Source: IVCA

This can be further analysed, using IVCA sector definitions, as follows:

Figure 69: Detailed Business Sector Analysis of Equity Funding - 2012



Source: IVCA

5.3.5 EQUITY GAPS IN THE CURRENT MARKET

Ireland

The Irish VC landscape is considered vibrant. The Irish government has invested significantly in seed funding and internationally is considered a strong player in the area of early risk finance for knowledge based and high tech start-ups.

The following points were noted in consultations relating to the supply of equity funding in Ireland and the associated gaps in that market:

- While it was difficult and too early to measure the overall success of the seed and venture capital programmes, it can be considered successful in promoting an entrepreneurial culture that should serve Ireland well in the future. This funding approach was considered to have changed the culture and mentality of Irish business owners in terms of risk capital including venture capital funds now looking to earlier stage businesses for potential investments. There was also a strong consensus, in line with international research (European Union, 2012), that demand, entrepreneurialism and deal flow had improved in Ireland due to the availability of seed funding, albeit that there were some concerns about the quality and capability of these companies to obtain follow-on funding.

- Due to the significant investment in seed funding the possibility of a supply gap or bottle neck may now arise where SMEs, who have received seed and early stage funding, will seek follow-on funding. While all consultees were of the opinion that a really strong candidate will always find investment from somewhere, many considered that some reasonable but not very strong propositions may struggle to attract investment. While this could be accepted as part of the natural selection process, government policy objectives are wider and as such consideration may need to be given to how best to support sustainable or potential growth businesses who do not reach the bar in attracting VC funding.

- Potentially strong start-ups might not be able to secure follow-on funding for some or more of the following reasons:
  - Investment caps at seed fund level can restrict the ability of fund managers to continue to support potential winners;
  - A capability gap amongst management teams of investee companies in terms of presenting and competing for follow-on funding; and
  - Some VC firms active later in the funding lifecycle and capable of investing outside of Ireland are not investing in Irish companies because they perceive the outside investments had a better chance of success, albeit that some of these Irish firms still have potential which would satisfy local government objectives.

- Concern was raised in the consultations as to the uniformity of the current seed funds with little differentiation between funds, primarily driven by common Government objectives. This can result in a risk that the supply offering to SMEs is not adequately diverse. While there has been significant investment in seed finance in Ireland, the majority of funds are concentrated in a small number of sectors focussing on high tech companies. An SME who does not meet the criteria of one seed fund is not likely to be attractive to other seed funds. An option which might support further diversification is the use of a dedicated co-investment fund or angel fund where investment selection is initially led by the private investors, who set the terms, but with the remaining funding provided by the co-investment fund (like the one already in place in Northern Ireland [34]).

Despite some improvement due to access to investment readiness support, early stage companies still require support to improve the commercial and management skills of investee teams and support in preparing and presenting for follow on funding. Fund, managers do not, in general, perceive the majority of those who apply directly as being as investor ready as those who use intermediaries. In general the business plans of those who apply directly have not been adequately challenged. As such increased focus should be placed on encouraging the use of professional support services, particularly as companies prepare to seek follow-on funding.

Options to address these gaps include extending the investment cap on seed funds to allow continued support for selected companies and/or introducing an investment follow-on fund specifically targeted at companies emerging from seed programmes or ensuring that alternatives are available to such businesses including entrepreneur loans or hybrid instruments incorporating debt and subordinated tranches. The new Enterprise Ireland non-seed funds, while only at expression of interest stage, may address some of this potential equity gap or bottle neck, albeit that these focus on the broad technology and life sciences sectors.

Northern Ireland

In Northern Ireland there has been much debate on the question of whether there are equity supply gaps with some arguing that it is a problem of demand as opposed to supply and others arguing that there are supply gaps across the continuum. A number of reports (EAG, 2013; Varney, 2008; Independent Review of Economic Policy, 2009) reveal the lack of consensus on this question.

Invest NI acknowledge both demand and supply side issues but argue that market failure does exist (EAG, 2013) and have responded with the Access to Finance Strategy, described above. The vast majority of

[34] The European Investment Fund (EIF) also initiated a pilot co-investment fund for angels in Germany with further pilot programmes proposed for Austria and Spain in 2013.

consultees participating in this study considered that there were supply gaps in the current market, albeit that there were different views as to the nature and extent of these gaps. Many however acknowledged that demand was impacted by other factors including the economic profile of Northern Ireland and wider entrepreneurial ecosystem.

The following points were noted in relation to the supply of equity funding in Northern Ireland and the associated gaps in that market:

- There is strong consensus that there was insufficient availability of risk finance at pre-seed, seed and early stage in Northern Ireland with many arguing that whether supply meets current demand is a redundant question as enhanced risk capital is necessary as one of the key precursors to kick-start demand. Aligned to this the consultees expressed concern that there was only one fund manager with government-backed investment active at seed stage thus impacting on choice and competition for investees. There was a divergence of opinion as to whether equity gaps exist for larger quantums of finance further along the lifecycle. Some consultees argue that demand was low but that a viable business would be able to source funding from the Dublin or London markets and that some more mature companies also had alternative funding options.

- Many consultees consider that the historically low levels of risk capital availability and ongoing gaps in the continuum of funding over the last number of years, including the lack of funding in the £500k+ bracket as at 2012, are issues which impact on the demand for and confidence in equity funding. IVCA data for 2012, where detail on investments was disclosed,[35] shows that no investments were made by VC funds with a presence in Ireland in Northern Irish companies (although consultations indicated that there was at least one investment in Northern Ireland which would have been included in private/undisclosed transactions). All four investments in Northern Ireland were made by one Northern Ireland-based fund.

- Early statistics on the new Growth Loan Fund in Northern Ireland (a mezzanine debt product, which is essentially an unsecured loan with higher interest rate incorporating an element of profit share and default conditions including an equity stake in the participating company) suggest relatively high levels of demand for this alternative finance product. This somewhat counters the opinion that there is low demand for alternative sources of finance at least from a cohort of SMEs. Due to the reluctance, noted above, of some SMEs in both Ireland and Northern Ireland to go down the equity route, quasi-equity options such as mezzanine finance (even where primarily debt based) may be an important middle ground alternative financing option for some SMEs. This includes those who have growth potential or plans but may have insufficient collateral or are reluctant to adopt a full equity play. As the Growth Loan Fund is a relatively new fund (operational since late 2012), it was considered necessary to increase awareness and education at both the demand (SMEs) and supply sides (e.g. front line bank staff, government agencies and other advisors and intermediaries).

- Despite acknowledged success of some investment readiness support programmes, consultees believed that further work was required to address potential demand side weaknesses and leverage the benefits of the investment: simplify and streamline the full range of supports, promote them in a more user-friendly and understandable manner, improve the commercial and management skills of early stage company teams, and extend the level of support available recognising that a significant degree of handholding was required for early stage companies.

Geographical Investment Boundaries

Most of the currently active seed and early stage funds are mandated to invest either wholly or to a significant extend within the local jurisdiction – Ireland or Northern Ireland. Most of the consultees suggested that while there may be some scope for an island of Ireland seed and/or early stage fund, in many cases start-ups require a lot of handholding at initial stages and as such the structure and delivery would have to address the

[35] Detail on investments is disclosed for 106 of the 189 companies invested in and in respect of €216m of the total €269m of investment raised. Information on private investments is excluded as these have not been disclosed.

importance of local knowledge, relationships and contacts and may be complicated in practice. At later stages of the investment lifecycle, most consultees suggested that location was not an issue, pointing to the existence of the numerous island of Ireland and internationally-focused funds currently operating in Ireland. Notwithstanding this, there were only limited examples recounted in recent years of investments by island of Ireland or international funds in Northern Ireland.

Table 9 summarises the geographical restrictions/emphasis of the funds included on the landscape map above. It also includes the additional funds which were planned or became active in 2013.

Table 9: Geographical Focus of Equity Funds

FUND TYPE	NORTHERN IRELAND ONLY	IRELAND ONLY	ISLAND OF IRELAND	INTERNATIONAL
Seed Funds	1[36]	7		
Non seed VC and later stages	3	8	2	7
Other / targeted - overleveraged balance sheets, restructuring, recovery		1	1	
Total	**4**	**16**	**3**	**7**

The following table summarises the actual investment trend by jurisdiction of the investee company [37] based on the IVCA data where detail on investment is disclosed. [38]

Table 10: Investment Trend by Jurisdiction of Investee Company

JURISDICTION OF INVESTEE COMPANY	NUMBER OF COMPANIES
Ireland (Total)	**100**
Dublin	64
Cork	15
Galway	11
All other counties	10
Northern Ireland (Total)[39]	**4**
International (Total)	1
United Kingdom (other excluding NI)	1
Undetermined (Total)	1
Total	**106**

[36] There are also 2 university seed funds in NI of £1m each which are not included in this figure.

[37] Jurisdiction was determined firstly by their company registration details and secondly based on the geographic location of their headquarters as determined by the company's website.

[38] Detail on investments is disclosed for 106 of the 189 companies invested in and in respect of €216m of the total €269m of investment raised.

[39] The total for Northern Ireland is underrepresented in this data. BVCA data suggests 26 companies raised £9m in 2012. There may however be some overlap in reporting to the IVCA and BVCA.

Consultees in both jurisdictions suggested that market failure is probably greater in Northern Ireland than in Ireland and thus greater fund incentives (subordination/junior investor to leverage private capital) or fund restrictions (geographic limits) are thus required to ensure investment in Northern Ireland. In 2012 the IVCA reported four investments in Northern Ireland companies, all of which were by one Northern Ireland based VC fund. While there was some scepticism about the level of demand emerging from Northern Ireland for non-seed or later stage VC, some consultees suggested that greater engagement with, and promotion of, all-island and international funds operating within the Irish market, may be beneficial.

There was some concern expressed by Irish consultees that non-seed funds looking internationally may not pick up potentially emerging Irish deals as they may not compare as favourably to international deals, thus potentially resulting in an equity gap for Irish seed-financed companies now looking for follow-on funding. As mentioned above, in Section 5.3.5, recent initiatives by Enterprise Ireland to establish five non-seed funds, albeit focussed on the technology and life sciences sectors, will partly address this issue but consideration may need to be given to the range and appropriateness of the funding options and supports available to these emerging seed companies.

5.4 SUPPLY OF PUBLIC FINANCE

Total finance from public sources (excluding public-backed equity finance) of €339/£276m had been invested in Irish and Northern Irish SMEs as at 31st December 2012. Of this €312/£254m related to Ireland and €27/£22m to Northern Ireland.[40]

These figures are not based on the total size of the schemes available (which in 2012 amounted to €1.36 billion across the island), but rather on the gross value of funds extended to and drawn down by SMEs over a five-year period. These funds are in the form of direct financial supports through the main public funding schemes operating in Ireland and Northern Ireland where such schemes are specific to the region/ country. For example, the Northern Ireland element of the UK-wide Credit Guarantee Scheme has not been included.

5.4.1 PUBLIC FUNDING IN IRELAND

In Ireland, the primary source of public funding support to SMEs is the support provided by Enterprise Ireland, whose priority is the achievement of export sales growth from Irish-owned companies. The Enterprise Ireland strategy has been developed on the basis that export sales growth leads to an increase in demand for Irish goods and services, and thus increases the overall flow of income into the Irish economy. The agency focuses primarily on supporting the following categories of business:

- High potential start-up (HPSU) companies with the capability to sell in export markets;
- Established manufacturing and internationally traded services businesses that are SMEs;
- Large companies (employing more than 250); and
- Irish-based food and natural resource companies that are overseas-owned or controlled.

In general, Enterprise Ireland does not work with locally traded service companies or with micro-enterprises such as sole traders. Support for these companies or individuals is provided in Ireland by the local County Enterprise Board network throughout Ireland, which is migrating into the new Local Enterprise Office (LEO) network overseen by Enterprise Ireland. At the end of 2012, the latter organisation operated 23 discrete funds or support schemes primarily targeting manufacturing and internationally traded companies.

A network of 35 County & City Enterprise Boards (CEBs) currently operate in Ireland which will become the LEO network. These organisations are funded by the Irish Government and EU Structural Funds and have a focus on providing support for micro-enterprises at local level. CEBs provide direct grant-support to new and existing enterprises and promote entrepreneurship, capacity building and women-in-business. At the end of 2012, the CEBs provided three main forms of finance support to micro SMEs – feasibility grants, business expansion grants and priming grants.

[40] Invest NI figures include an allocation to SME funding of “unknown” categories. Detailed assumptions are provided in Appendix 3.

In recent years a number of new funding options have been introduced by the Irish government to address potential lack of supply from traditional sources. These include:

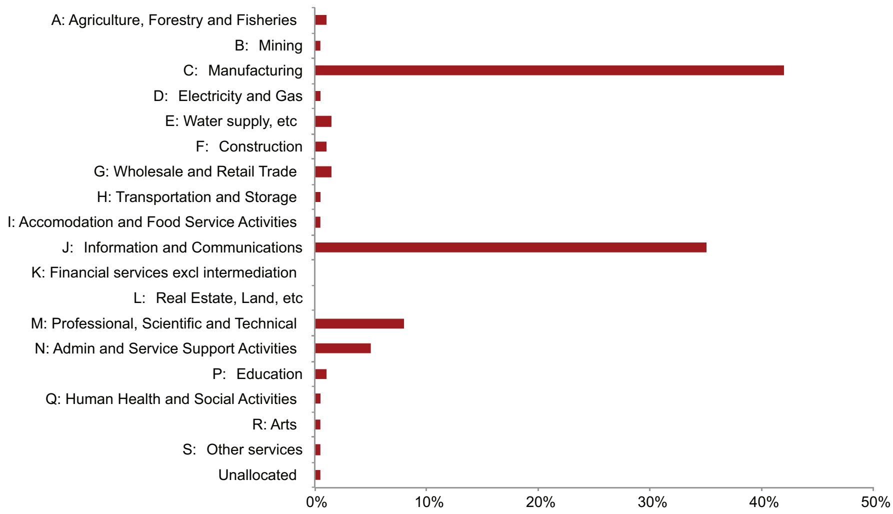
- The Credit Guarantee Scheme - launched by the Department of Jobs, Enterprise and Innovation towards the end of 2012 with the purpose of encouraging additional lending to SMEs, not to substitute for conventional lending that will otherwise have taken place. The scheme is run through the main SME banks trading in Ireland and operates under the *de minimis* State Aid rules.
- The Microfinance scheme - operated by Microfinance Ireland and funded by the Department of Jobs, Enterprise and Innovation to provide loans to newly established and growing micro-enterprises that do not meet the conventional risk criteria applied by banks. Microfinance Ireland operates in partnership with the CEBs and its loans benefit from a guarantee issued under the 'European Progress Microfinance Facility' established by the European Union.

Given their recent launches, by the end of 2012 the take up on both these schemes had been very low.

The state has also invested via the bank recapitalisation programme, through the seed and venture capital scheme, in private venture funds and through the National Pension Reserve Fund (NPRF).

Figure 70 provides a summary of the business sector focus of publicly funded schemes in Ireland. On the basis of the analysis of the data returns completed by public funding organisations in Ireland, it is clear that whilst in theory the majority of schemes or funds are open to all business sectors, in practice the main beneficiaries are those SMEs operating in the manufacturing and information and communication technology sectors, with those companies operating in the professional and scientific and administrative / support services also in receipt of funding.

Figure 70: Sector Focus of Publicly Funded Schemes (Ireland)



Source: Data Returns Provided by Publicly Funded Bodies

Additionally in Ireland, the Government established the Credit Review Office (CRO) in 2010 as a support to help SMEs in securing credit from pillar banks in respect of applications up to €500,000. Whilst the CRO is a very positive appeals tool in Ireland, it suffers from the fact that all banks servicing SMEs are not required to engage with it. Additionally, its application process is onerous, requiring an SME to complete a detailed CRO specific application process in addition to the application for credit and subsequent appeal already completed in the bank. Consultations conducted in the course of this study would suggest that this is a significant deterrent to SMEs. Demand for support from the CRO is low with 205 appeals made in the period since establishment to January 2013.

5.4.2 PUBLIC FUNDING IN NORTHERN IRELAND

In Northern Ireland, Invest NI is the regional business development agency, supporting SMEs to grow the local economy. Invest NI is part of the Department of Enterprise, Trade and Investment. It targets its support to those businesses that can make the greatest contribution to growing the local economy; businesses that have the ability to grow and drive productivity and are keen to export outside Northern Ireland.

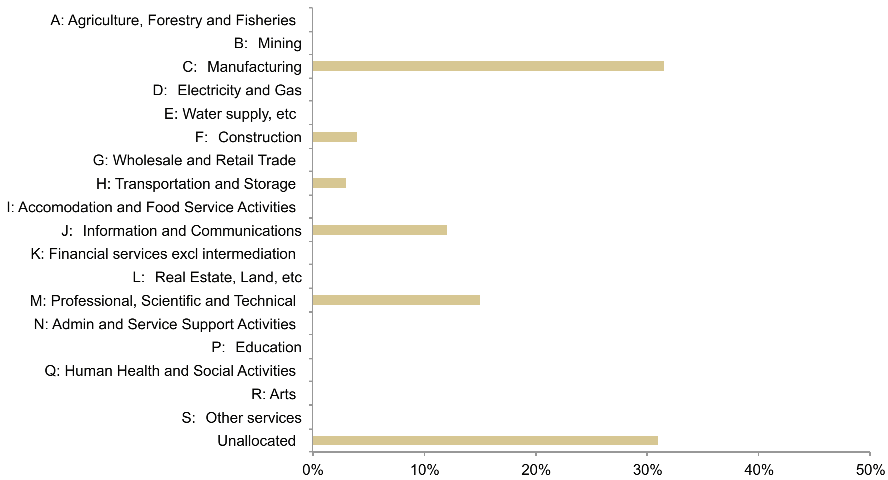
Invest NI provides financial support to SMEs through its Solutions Framework/Boosting Business under 5 key themes: Starting a business; Growing your business; Maximising efficiencies; Product development; and International trade and investment. Under each of the five themes there are a number of solutions made up of either advisory or financial support, or both.

Companies are encouraged to contact Invest NI to discuss their needs and determine the most suitable form of financial support under this overall programme. In addition the organisation also provides the five funds included in the Access to Finance Strategy and operates two voucher schemes: the Innovation Voucher Scheme and the Finance Voucher Scheme (operational from 2013 and noted in Section 3.2.1).

Enterprise Northern Ireland, which represents the network of Local Enterprise Agencies in Northern Ireland, also administers the Loan Fund which provides loans to those starting or operating a small business. The Local Enterprise Agencies (LEAs) also provide accommodation and related services as well as business support services to SMEs in Northern Ireland.

Figure 71 provides a summary of the business sector focus of publicly funded schemes in Northern Ireland. On the basis of the analysis[41], it is clear that, just as in Ireland, the main beneficiaries are those SMEs operating in the manufacturing, and information and communication technology and professional and scientific sectors.

Figure 71: Sector Focus of Publicly Funded Schemes (Northern Ireland)



Source: Data Returns Provided by Publicly Funded Bodies

[41] Reliable business sector profiles are unavailable for approximately 30% of finance reported by public funding organisations for this study.

There has been a significant UK national policy response and a number of new measures have been introduced to improve the supply of credit to SMEs, including a series of government initiatives managed through HM Treasury, the Department of Business, Innovation and Skills and the Bank of England. In general they have not translated effectively to Northern Ireland, with the Enterprise Finance Guarantee scheme and the Funding for Lending scheme not being appropriately adapted to the needs of the region. In addition, the absence of bank headquarters in Northern Ireland has an implication and would appear to have restricted more timely access to initiatives, such as the Funding for Lending scheme, as well as impacting on other national initiatives implemented by the UK government.

The UK Independent Appeals Process operates within Northern Ireland. This is, however, based on a different model to that of the CRO in Ireland. While all of the major banks in Northern Ireland are signed up to this process, there would appear to be very little take up and awareness of the scheme in Northern Ireland among SMEs and unsuccessful bank applicants have made very limited use of the appeals process. It has been described as effectively invisible in Northern Ireland by most of those consulted throughout the course of this study.

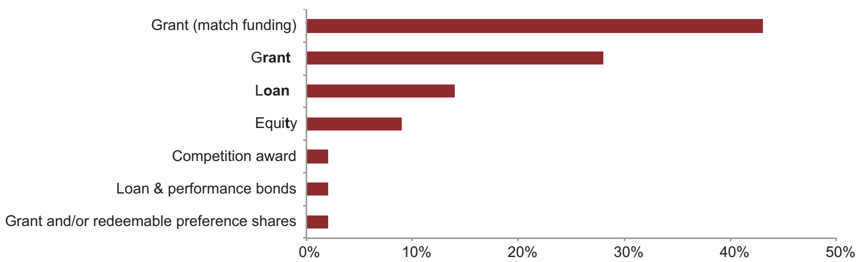
5.4.3 CROSS-BORDER PUBLIC FUNDING

The main organisation focusing on cross-border trade and financial support in Ireland is InterTradeIreland. The organisation focuses on enhancing the cross-border export and innovation potential of SMEs in Ireland and Northern Ireland. InterTradeIreland provides support in two areas: trade (with programmes such as Acumen and Elevate) and innovation (with programmes such as Fusion and Innova). InterTradeIreland's innovative suite of programmes also includes supports for early stage companies in raising venture capital through the Equity Network initiative.

5.4.4 PROFILE OF THE TYPE OF PUBLIC FUNDING

Figure 72 is based on an analysis of a funding database, which pulls together all of the main funding schemes and products aimed at SMEs in Ireland and Northern Ireland by funding source. It provides a profile of publicly-financed schemes or funds which shows that the majority of public funding is provided to SMEs by means of direct matching funding, followed by direct grants and then public sector loans. It should be noted that Figure 72 shows the number of individual schemes or funds, rather than their size.

Figure 72: Profile of Government Funding



Source: Funding database

5.5 THE FUNDING LANDSCAPE

Detailed funding landscape maps for Ireland and Northern Ireland (see Appendices 1 and 2) present a visual representation and clearly illustrate the complexity facing SMEs in their search for funding support, given the number of funding sources, their fragmentation and the multiplicity of organisations providing funding both directly and indirectly to SMEs. No single organisation involved in or consulted for this study was fully aware of or had a comprehensive list of the funding schemes or funding organisations operating on the island of Ireland. This results in some level of silo-based financial advice to SMEs whereby individual supply organisations predominantly inform and promote based on their own supply capacity, which alone may not meet all of the needs of the SME.

SMEs, in particular smaller owner-managed businesses, lack available time and resources to navigate such landscapes and to filter out the relevant alternative funding options for their businesses. Many SMEs seek support on funding matters from their business representative groups, from their main bank or from their accountant. They can be considered to be intermediaries in the funding landscape, positioned at a critical juncture. However the majority of these organisations are also unaware of the full suite of funding options available to Irish or Northern Irish SMEs.

Both the Irish and the Northern Irish SME funding landscapes are characterised by:

- **Information overload and duplication -** There has been a significant increase in the number of websites providing information on access to finance in the last number of years. These websites have been developed by businesses, private individuals, business lobby groups, banking institutions, universities and Government departments. Whilst these innovations are welcome and a rich source of information, the volume of information now available is overwhelming. Additionally, no single source is complete or provides a full and accurate database of funding sources and eligibility criteria. It is also apparent that once established, many funding lists are not maintained and updated by the organisations who created them and as such lose their value very quickly. A model is available in the newly created EU portal (www.euraxess.ie) for Ireland, creating a single and up-to-date database of information, which can be maintained on an ongoing basis and is available to SMEs, their advisors and all funding organisations.

- **Non-standard applications -** each bank, venture capital firm, public sector organisation or other funders operates their own application process and application form. Each funder, even those targeting similar sectors or sizes of SME request different types of information (financial statements, cash flows, business plans, principal details, etc.) This means that an SME who wishes to apply to multiple funders has to prepare multiple application packs providing substantially the same information but in a variety of different formats. This is both inefficient and costly for the SME. The Irish banks have started to come together and have agreed to use a standard application form and business plan template, developed by the Institute of Chartered Accountants and the Irish Banking Federation. No such initiative has taken place in Northern Ireland as yet.

- **Eligibility information -** the assessment of applications is governed by significantly different criteria depending on the funding supplier. The type and level of information which is required to be submitted to support an application for finance varies significantly from funding organisation to organisation even within the same category of funding (i.e. within bank funding). This complicates the application processes for SMEs and results in a lack of understanding amongst SMEs as to the schemes or funds for which they might be eligible.

- **Absence of tailored one-to-one support -** the international research, as outlined in Section 6.2, demonstrates that SMEs prefer one-to-one or specific support tailored to the SME rather than self-service web-based supports or websites. The take up of the recently introduced Business Link helpline in the UK has been much more significant than any previous web-based services with SMEs clearly preferring one-to-one, telephone or other tailored support in supporting their search for finance or the restructuring of existing finance.

5.6 SOURCES OF FINANCE

Outside of traditional bank finance, the Credit Guarantee Schemes (in Ireland and UK) and the MicroFinance scheme in Ireland, there are very few SME specific schemes which can be accessed by companies operating in the sectors (retail, hotels, construction etc.) employing the highest number of people and with the highest levels of distress.

As part of this study, the researchers compiled a database of all funding schemes operating in Ireland and Northern Ireland and on a cross-border basis. We identified 173 direct funding products / schemes / funds available to SME from approximately 50 different funding providers. This excludes indirect sources of funding, such as training and education programmes, or tax incentive schemes and was completed on a best efforts basis with the input of funding providers.

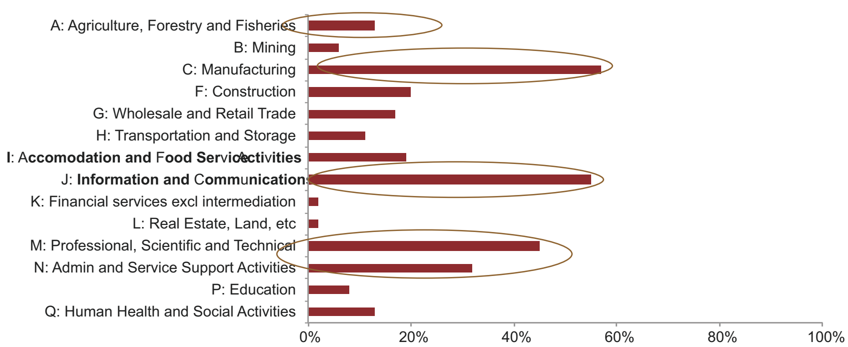
Table 11 lists the current funding providers and the funding products / schemes / funds which they offer to SMEs.

Table 11: SME Funding Providers and Schemes

SOURCE	IRELAND	NORTHERN IRELAND	ISLAND OF IRELAND	TOTAL
Bank	36	28		64
Public Funding	68	6	5	79
Visible Angel	7	1	1	9
Seed and VC	7	4	8	19
Crowd Funding	1	1		2
Total	**119**	**40**	**14**	**173**

As Table 11 demonstrates a large number of funding options are available to SMEs. However many SMEs will find that they are not eligible for certain products / schemes / funds because of the business sector in which they are operating or the type of business activity in which they are engaged. When the declared sectoral focus of each scheme / product or fund is analysed, the following business sector pattern emerges, as shown in Figure 73. Whilst approximately 30% of lending products provided by banks are focused on specific business sectors, 78% of public schemes, 100% of business angel and 100% of venture capital schemes include some form of business sector focus as eligibility criteria.

Figure 73: Sectoral Profile of all SME Products/ Schemes



Source: Database of all SME Finance Products/Schemes / Funds in Ireland and Northern Ireland

It is apparent that while most bank funding and some public funding is open to all business sectors, the majority of non-bank funding is targeting the same business sectors. These sectors include those most likely to have exporting companies, high growth companies, ICT, medical devices, high-tech manufacturing and life science companies.

Government, VC, angel and some new emerging bank funds are also very focused on a small number of high growth, high potential sectors with very few schemes or funds in place to support SMEs operating in the sectors which are most depressed and employing the largest number of people. There is a debate whether more concentrated funding can encourage innovation and incentivise high calibre teams to start new projects because of the perceived availability of funds or that the majority of government funding and venture capital funding is pursuing the same high potential / early stage / specific sector type initiatives and that the quality of projects will decrease as a result.

Whilst no banking schemes have a specific requirement for exporting, all business angel and venture capital schemes seek some level / potential to export. 63% of public schemes required the SME to be an exporter. It should also be noted that the majority of the other public schemes listed the potential to export as a qualifying criteria.

Of non-bank schemes that did not have a specific export potential requirement, all required compliance with some specific criteria (such as location within the Gaeltacht, led by a female entrepreneur, be a micro SME, or be involved in a specific business such as crafts or fishing). The success of specific schemes launched during 2012, such as schemes targeted at female entrepreneurs, have also demonstrated how demand can be created through the supply of funding to certain specific target groupings.

Almost three quarters (73%) of banking schemes identified did not require a borrower to be incorporated, compared to 16% of government backed schemes and all business angel or venture capital schemes require incorporating. Government-backed schemes which do not require incorporation are typically for proof of concept funding which subsequently require incorporation.

In terms of cross-border coverage most schemes operate in one jurisdiction only. Six of the nine active formal business angel schemes invest primarily in their local region and one is cross-border. Several additional all-island business angel syndicates specialising in food and med tech were planned to be active in 2013. The four specific Northern Ireland seed and start-up capital schemes invest solely in one jurisdiction as do the Irish seed and start-up capital schemes. Most venture capital schemes will review prospects across the island (and further abroad).

To conclude, it is clear that in a number of business sectors, bank funding or more recently government bank guarantee schemes are the only external finance option for SMEs, in particular for SMEs operating in domestically focused, non-exporting sectors.

6. International Best Practice

6.1 INTRODUCTION

In the period following the global financial crisis there was a strong convergence internationally and particularly within the EU in the responses of governments aimed at alleviating pressures on SME finance. A range of traditional measures were introduced but also some new supplementary initiatives and instruments were introduced, comprising loans, guarantees, microfinance, venture capital (VC) and other equity financing measures.

In parallel to this the European Commission also focused on the development of a framework for supporting access to finance amongst SMEs including, for example, the integration of the VC market to allow venture capitalists to operate more efficiently across borders within the EU and the launch in 2013 of a new single online portal for all financial instruments available to SMEs.[42] While both Ireland and Northern Ireland, similar to most other member states, have drawn down supports under these measures, continued engagement with the Commission is ongoing to ensure maximum potential is derived from the range of funding initiatives available.

This section focuses on country-specific responses to access to finance challenges, in order to identify areas of good practice including responses, from both within and outside the EU, which may be of interest to policy makers in Northern Ireland and Ireland. Many are not necessarily new ideas in themselves or have been around in some shape or form for a number of years and across many countries. The review of international experience suggests that there are no standalone silver bullet solutions in terms of new credit products or initiatives that could be directly transferred from one country to another. And because the environment in which SMEs are operating in each country is unique, each initiative must be assessed on a case by case basis. However, there are a number of examples of good practice which merit consideration within the Ireland and Northern Ireland contexts.

The responses described below are organised in the three areas of particular concern for policy makers in Ireland and Northern Ireland:

- Diversifying finances used by SMEs and promotion of these options;
- Improving financial capability of SMEs and others in the finance for growth area; and
- Improving information sources and the accessibility of these.

6.2 DIVERSIFYING FINANCING AND THE PROMOTION OF ALTERNATIVE FINANCING OPTIONS / NON-BANK LENDING

In this section the research provides an overview of some measures which have been introduced in selected European counties: Germany, France and the UK.[43] The countries were selected as they all have a wide range of measures across the broad SME spectrum (by age, stage, size, growth characteristics). The section finishes with an example of a country-specific approach to promoting the supply and diversification of funding alternatives for SMEs – the UK Business Finance Partnership.

The measures which have been introduced in Germany, France and the UK include selected debt, hybrid and equity options. At an overall level their key characteristics include:

- A range of classical debt instruments - including guaranteed loans, low cost loans, etc - aimed at addressing/reducing cost of credit, addressing lack of collateral, facilitating payment flexibility (e.g. allowing deferral of capital repayments).
- Subordinated loans or hybrid packages aimed at supporting SMEs to improve capital structure – aimed at extending the choice of financing options and ultimately supporting SMEs in improving their capital structures.

[42] See for example (1) at an overall level - http://ec.europa.eu/enterprise/policies/finance/financing-environment/index_en.htm and (2) for individual countries - http://www.access2finance.eu/

[43] Examples derived from country reports for Germany and France accessed at: http://ec.europa.eu/enterprise/policies/finance/guide-to-funding/indirect-funding/files/fact-sheets/germany_en.pdf and …….france en.pdf respectively. UK examples derived from Department for Business, Innovation & Skills, *SME Access to Finance Schemes: Measures to support growth* (2013).

- Equity products - including seed funds, co-investment funds to support leveraged private investment and later stage funds - which can target particular SME cohorts (e.g. mature organisations in difficulty).

The above finance types (debt, equity and hybrid packages) are made available to either a wide cross section of SMEs (e.g. Enterprise Finance Guarantee scheme in the UK available to all SMEs with limited exceptions) or to a specific and targeted population (e.g. start-up businesses – ERP Start-up loans in Germany for young people, Start-Up Loan Programme in the UK for entrepreneurs – various KfW loans in Germany for high growth, high tech or companies of specific sizes). All have various restrictions or conditions including the amount of funding which can be drawn down.

A report on best practice amongst member states (Centre for Strategy and Evaluation Services, 2012a) highlighted the importance of building in flexibility across initiatives so that terms and conditions and restrictions can be tailored to changing circumstances, including increasing investment limits or changing the profile of qualifying companies. Some of the best products from the UK, France and Germany recognise that the characteristics, capital structures and financing needs of SMEs can vary significantly across that category and at different lifecycle stages. This moves the discussion beyond certain over-simplistic and sometimes mistaken assumptions in relation to demand and supply, including the idea that early stage high growth firms can only be supported by or only seek risk capital. Products like the *Prêt Participatif d'Amorçage* in France take into account that as companies move from seed to early stage and further along the cycle it is possible that they can, and should be, supported by debt including loans and subordinated loans. The initiatives found in these countries also highlight the important role of subordinated debt and mezzanine debt instruments for improving or restructuring the balance sheet positions of certain firms (growth, restructuring firms etc), and thus improving their credit ratings and their ability to draw down future debt. In light of the fact that a significant portion of applications for credit are rejected because of balance sheet reasons (over-leverage, inappropriate capital structure), ensuring more appropriate capital structures for SMEs becomes more important.

In addition, and similar to the new NPRF Turnaround Fund in Ireland, the French *Fonds de consolidation et de développement des enterprises* is aimed at SMEs with growth potential who have been hard hit by the financial crisis and represents an example of a response specifically tailored to a current problem.

The use of co-investment funds to stimulate business angel activity across many EU countries is also important to note when referring to diversifying funding sources. The use of co-investment funds have also been widely used internationally and a recent evaluation, while cautious due to limited data and evaluations, concludes that they appear to be effective in stimulating the business angel market (Centre for Strategy and Evaluation Services, 2012b).

Some countries are utilising or developing the concept of a business or development bank to comprehensively and more effectively deliver government support (Canada, Germany, France, UK). Many of the major government programmes in Germany are delivered by the KfW development bank. Equally in France many of the programmes are delivered by OSEO, soon to be transferred under the umbrella of a new French Public Investment Bank. The UK government schemes will also transfer to and be delivered by the new UK business bank.[44]

Alongside the supply of appropriate non-bank financing there is the need, identified in the research, to promote these sources of funding. The UK Business Finance Partnership (BFP), soon to be encompassed within the new business bank, provides a useful example of a country-specific approach to promote and better facilitate alternative non-bank lending opportunities to SMEs. A key aim of the BFP is to increase the supply of capital through non-bank channels and help to diversify

[44] Due to past experiences with national initiatives, some regions within the UK (notably North East of England and Wales) have expressed concern that the new business bank needs to respond to different regional economic contexts. In light of the poor success of previous national UK initiatives within the region, Northern Ireland will similarly have to engage strongly with this new business bank to ensure that regional needs are addressed and responses can be tailored to ensure maximum benefit.

the sources of finance available to businesses (Department for Business, Innovation & Skills, 2013). The BFP is responsible for investing up to £100m through non-traditional private sector lending channels that lend directly to small businesses. These channels include mezzanine finance funds, supply chain finance schemes, specialist financing schemes such asset finance, and peer-to-peer lenders as represented in Table 12 below.

Table 12: UK Channel/ Source of Finance

LENDER NAME	DESCRIPTION OF CHANNEL/SOURCE OF FINANCE
Market Invoice	Innovative online platform through which SMEs can raise funds by selling individual invoices to a pool of investors.
URICA	New supply chain finance platform to provide a consistent channel of cash from institutional investors to SME suppliers by enabling early payment of their bills to mid-sized growth companies.
Beechbrook Capital	Mezzanine fund to lend to SMEs focused on growth capital.
Funding Circle	Peer-to-peer lender enabling people in the UK to lend money directly to small businesses, offering a more efficient way of helping firms to access loans.
Zopa	Online peer-to-peer lender. Through the website investors can lend directly to small business, offering a more efficient way of helping firms to access loans.
Boost & Co	Fund focussed on providing loans to growing and innovative small business.
Credit Asset Management Limited	Provides specialist financing to SME sector – asset finance and professional loans.

6.3 IMPROVING FINANCIAL CAPABILITY THROUGH AWARENESS OF FINANCING SCHEMES AND TARGETED SUPPORT TO SMEs SEEKING FINANCE

Policy makers need to consider how best to provide advice on access to finance to SMEs, including not only the range of alternative financing options, but also improving awareness of the appropriate funding solution for the specific firm taking into account its capital structures and medium to longer term financing needs. Aligned to this there is also a need to ensure that multiple applications to multiple lenders, an appropriate feature of a competitive lending landscape, is not overly burdensome on SMEs requiring multiple different application forms and different supporting information. Table 13 provides some relevant examples from Australia, New Zealand, the UK and France dealing with awareness of access to finance initiatives.

Table 13: Awareness of access to finance initiatives

INTERACTIVE TYPE	COUNTRY EXAMPLE	KEY CHARACTERISTICS/ BENEFITS
SME Helplines/Hotlines	• **Australia -** Small Business Support Line and Live Chat was established in response to the global recession and is open 8am - 8pm Monday to Friday. It provides information on finance and cash flow management (including loan and banking products), marketing and promotion, business planning and diagnostic services, legal, accounting and taxation services. The top call enquiries include Government initiatives, grants and assistance, business planning and diagnostic services. • **New Zealand -** hotline similar to Australian example above. • **United Kingdom -** Business Link Helpline offers advice and information on financing your business and is open Monday to Friday, normal office hours.	Central support point. Facilitates bespoke support. Interactive service / human contact. Supplements information web portals which can be difficult to navigate or result in information overload.
Provision of targeted support to SMEs seeking finance	• **Australia -** The SME Association of Australia (SMEAA) negotiated an arrangement with a private sector grants consultancy, who will evaluate the entitlement of an interested SME to the various government schemes available and then provide them with a written report of eligibility. If the SME appoints the company to complete applications on its behalf they will only charge a success fee (i.e. no funding, no fee). SMEAA members receive a 10% discount off these fees.	SMES can avail of the services of experts of the financing landscape to identify grants. SMEs can avail of services of experts to complete applications. Cost effective – no funding, no fee.
Improved information for lenders	• **France -** Recognising that front line private sector lenders are an important point of contact to SMEs and play a pivotal role in advising and arranging suitable finance for SMEs, OSEO for example publishes a "Guide to the banks" in which it sets out all its products. This type of information dissemination is important as it ensures that front line lenders are aware of, and can advise on government schemes.	Improves advice to SMEs through intermediaries including front line advisers such as banks. Builds awareness on government schemes through existing support channels.

Allied to this issue of awareness a significant number of international reports (Audet & St-Jean, 2007) and a recent UK report on business supports (Department for Business, Innovation & Skills, 2011) refer to the widespread and substantial underuse of supports by SMEs, even where there is a demonstrable need for support. The UK report concludes that only 40% of SMEs made use of formal business support assistance in the three year period of the study and it estimated a latent demand across over a further quarter of the SME population. This latent demand included non-users of assistance who did not recognise their need for assistance despite experiencing problems, those that did recognise their problems but did not avail and those that availed to an extent but required further and more extensive assistance. Due to the importance of improving the capability and performance of SMEs, as outlined elsewhere in this report, the key findings on barriers to using business supports from the recent UK study are summarised in Table 14.

Table14: Barriers to Take Up and use of Business Support

RESEARCH TO UNDERSTAND THE BARRIERS TO TAKE UP AND USE OF BUSINESS SUPPORT: KEY FINDINGS

Demand side patterns

- Growth plans - SMEs with growth plans were more likely to draw down assistance than those in survival mode.
- Age - New businesses were more likely to avail than those aged 6 years and over.
- Size - Medium-sized businesses were more likely to seek formal assistance; a high proportion of micro businesses used solely public sources compared to their small and medium counterparts.
- Sector - SMEs in the hotel and catering sector used support services least.
- Management team characteristics - SMEs with larger management teams and more highly qualified managers used services most.
- Actual performance - Those who had drawn down support were more likely to have improved (employment and turnover).

Supply side patterns

- Importance of one-on-one contact methods - Business Link, the new UK helpline service was the main public sector provider of advice with e-mail, telephone and face-to-face services being used more frequently than web-based methods.
- Higher use of private sector support - Almost 30% of SMEs used private sector support and 20% used public sector support. A significantly greater proportion of users of private sector advice considered that the business was performing significantly better than users of only public sources. In addition there was a greater tendency to provide advice / services by telephone or face-to-face by private sector providers and a greater tendency to provide via website amongst public service providers.

Barriers to accessing support services

- Doubts about the benefits and value of assistance in relation to the expense and time involved.
- Cost - Non-users of business support services were willing to pay for the services but are only willing to pay relatively low rates in comparison to what is being paid by actual users of such services. Cost was a particular issue for those in the hotel, restaurant and catering and financial and business services sectors.
- Difficulties in finding the time for survival orientated businesses.
- Not being able to trust external advisors.
- Concerns about external advisors not understanding the business.
- Lack of confidence to approach business advisors (particularly among young business and less experienced owner/managers).

Consultations carried out as part of this exercise would suggest that the level of awareness and uptake of business support services remains an area which could be improved, especially with the concerns expressed about capability. Although the evidence remains to be collected, it is also likely that the UK trends, in relation to latent demand and in particular underuse of business support services by certain types of SMEs and certain sectors, would be repeated in Ireland and Northern Ireland.

The high use of one-to-one methods, as opposed to websites, is an important consideration in service design as it suggests that bespoke and individualised support is more appropriate and favoured by SMEs to a generalised response. The importance of cost as an impediment to drawing down services is also an important consideration and an area where government-backed vouchers can play an important role.

Another area of concern is that those businesses who may be in most need of services (in survival, in struggling sectors, small management teams with no formal qualifications) are those who are least availing of business support services either because they are not aware that they require them or for other reasons, including financial and time resources.

Some international financing schemes have integrated business development support or wrap-around services with the finance product to leverage the benefits of the funding. Depending on the nature of individual schemes, consideration should be given to the integration of both generic and bespoke support services and whether, and to what extent, some services should either be mandated or more proactively encouraged for SMEs. At a more general and non-scheme specific level, and taking into account the results of the UK study above, consideration should be given to cost-effective measures which facilitate the draw-down of bespoke and appropriate support to the widest possible cohort of SMEs (vouchers, business mentors). Table 15 provides details on some international examples.

Table15: International Business Development Services

INTERACTIVE TYPE	COUNTRY EXAMPLE	KEY CHARACTERISTICS / BENEFITS
Business Mentors Programme	**New Zealand -** Business Mentors New Zealand delivers a business mentoring programme that is partly funded by New Zealand Trade and Enterprise (NZTE) and partly by the private sector. More than 1,400 volunteer mentors offer an extensive range of business knowledge, skills and experience. Registration for SMEs costs $150, but there are no other costs (i.e. there is no cost for the subsequent consultations and drawdown of support from business mentors). **United Kingdom -** Mentorsme.co.uk is a mentoring gateway that links businesses to mentoring organisations across the UK to find a mentor that suits the business, including specialist financial support. The British Bankers' Association hosts the portal and has provided 1,000 volunteer bank mentors recruited from the business community.	• Extensive low cost support option. • Significant private sector support. • (Supplements competitive or grant-based mentor programmes as more widely accessible).
Vouchers	While vouchers have been used across a lot of countries, including Ireland and Northern Ireland, some countries have either not restricted the range of services which can be drawn down or have expanded the range previously available. The NZTE Capability Development Voucher (New Zealand) vouchers may be used to help pay up to 50% of the cost of services (max. value of $5,000) from registered providers that improve management capabilities in the following areas (business planning, marketing strategies, finance, business systems, managing resources, governance, sustainability, lean manufacturing/ business, operations, exporting, capital raising).	• Facilitates drawdown of bespoke support within an extensive range of business development services (less restrictions). • Help address widespread reluctance of SMEs to drawdown professional services (reduced cost).

While a number of countries have implemented some form of credit mediation (Germany, Belgium, France, Spain, Ireland, United Kingdom), France's Credit Mediation Office is probably the most extensive. It is based on a significantly different model to that in place elsewhere and is much more heavily resourced than the Irish CRO and other international models. It acts as a catalyst to the provision of high quality financial advice to SMEs (via public or private sector advisors and intermediaries) on capital structure, restructuring of balance sheets and financing issues (Liebert, 2009).

The key features of the French model include a network which operates at both the local level (with 105 local mediators usually the first point of contact and who are often departmental directors of the Banque de France) and nationally (with an executive committee supported by analysts and administrative staff). The local mediators analyse the financial and strategic situation of the firm, in order to assess the nature of the difficulties to be resolved with the financial partners (banks, credit insurers, investors, factoring companies, etc). If it is not possible to engineer a financing solution, other options such as legal proceedings or industrial restructuring measures are examined.

The mediation application process in France is as follows:

- Company (or a third party mediator) provides information on their financial position and their funding requirement in a mediation application on the website.
- In the 48 hours after validation of the on-line mediation application, the local mediator contacts the company, informs it as to its decision on whether or not the application is eligible, and develops an action plan with the firm.
- The credit institution is notified that mediation proceedings have been initiated and have five working days to review their position, after which time the local mediator contacts the business to see how the situation is developing.
- If the difficulties persist, the mediator personally gets in touch with the firm's financing partners to identify the sticking points.

The credit mediation framework is largely built on existing structures and some of its key strengths are:

- The cooperation at a local level between the range of financing partners and other interested parties (arising from MoUs with banks, credit insurers, investment funds, government/OSEO, SME representative organisations, etc).
- The gradual extension of the role of mediation from the first iteration dealing with increased refusals by banks of small loan applications to the withdrawal of credit insurance cover and the treatment of firms' equity financing needs.
- The close cooperation of mediators with OSEO, through its loan guarantee programmes, to find financing solutions for companies is also considered crucial.
- It is supported by a complementary network of "third-party mediators" which coordinate on the ground actions aimed at advising companies / CEOs about mediation strategies and assisting them with implementation of the solutions identified during mediation.
- The access for mediators and companies to a wide range of solutions and information/processes in the most complex cases. This can point businesses to the most suitable bodies dealing with, for example, requests to reschedule a company's tax and social security liabilities, financing a strategic audit or full restructuring.

While it is acknowledged that the model and the level of resources deployed vary significantly as between the French Credit Mediation system and the Irish CRO, consideration can be given as to how and to what extent the more extensive support provided to French SMEs (in terms of identifying, designing and implementing appropriate finance solutions) could be provided to SMEs on the island.

6.4 IMPROVING INFORMATION ON SMEs AND FINANCE

The strides made by the Central Bank of Ireland and the Department of Finance in terms of regular data collection and detailed research on both supply of and demand for finance by Irish SMEs provides an example of good practice which has continued to develop since 2010.

With regard to further improvements in the area of SME data collection and analysis, the examples of Canada and Australia are useful in that they profile a large proportion of the SME population at a granular level, something which stand-alone surveys do not easily facilitate, and provide analysis at the country-specific level to inform national/regional policy and allow for on-going time series analysis.

- **Canada:** The Business Development Bank of Canada (which also publishes detailed supply side data) conducts ongoing research on the SME demand side including access to finance, SME profiles which can inform demand and the exploration of specific sectoral and size problems. Recent research in 2013 has included reports on mid-tier firms (including growth plans and access to finance challenges), on the specific access to financing needs of manufacturers and the regular "SMEs at a glance" profile.[45]
- **Australia:** The Australian Department of Industry, Innovation, Science Research and Tertiary Education[46] publishes an annual report on Australian small business which follows the same structure each year to facilitate trend analysis. This also includes additional specific research, for example, in 2012, on early stage start-ups. The annual report uses a range of external sources from the Australian Bureau of Statistics and includes comprehensive detail on the SME population, including number of SMEs by sector and region; business performance including profit, growth, exports, employment, business conditions and confidence; entries, exits and survival rates; business lending; innovation performance, collaboration, R&D and e-commerce.

[45] See http://www.bdc.ca/EN/about/sme_research/
[46] See http://www.innovation.gov.au

7. Conclusions and Recommendations

The conclusions and recommendations have been prepared on the basis of the preceding analysis of the demand and supply factors impacting on the SME funding landscape in both jurisdictions and on examples of best practice arising from international research.

The implementation of the recommendations will depend on the engagement of individual stakeholder groups involved in supporting SMEs in securing finance or in the provision of that finance to SMEs, including:

- Banks;
- Public policy stakeholders;
- Equity stakeholders;
- Business representative groups; and
- Financial intermediaries and advisors.

7.1 CONCLUSIONS

KEY OVERALL CONCLUSIONS

Demand is at least, if not more important than supply as the key SME finance issue. The work carried out as part of this study clearly shows that in Ireland and Northern Ireland, the supply of finance is no longer the most significant issue facing SMEs and instead most pressing problems for most Irish and Northern Irish SMEs is finding new customers and/or addressing cost pressures.

It is difficult to say what a normal level of demand for finance is in Ireland or in Northern Ireland, as it was never measured prior to 2009. However, on the basis of Irish total private sector credit figures, demand for credit increased to a peak in 2009 when it was 120 percentage points higher than in 2003. Demand for finance amongst SMEs in Ireland and Northern Ireland has fallen significantly since 2009 when its measurement began on a systematic basis. Where demand currently exists it is primarily to fund short term working capital and to support cash flow. Where SMEs are looking for growth finance, they are more likely to be rejected than those companies looking for working capital finance. A higher level of demand is apparent amongst those SMEs who are involved in exporting.

The demand for credit amongst the SME community in Ireland and Northern Ireland has been depressed due to a range of factors including a fall off in domestic demand, lack of consumer confidence and legacy debt levels. Indeed, the low level of demand for credit now threatens to become a much greater problem for SMEs in both jurisdictions than the supply of credit, as the nature and volume of SME-specific schemes and funds has increased significantly in the period since 2011.

Nevertheless, while the demand for credit is at its lowest level since 2010, as measured by credit advanced to Irish resident SMEs, there remains a concern that if an economic recovery were to gain momentum, it could be inhibited or even derailed by a supply side deficit.

There is a dearth of diversity in the financing landscape for SMEs across the island. The capital structures, market and economic position of SMEs on the island have a disproportionate reliance on banks for their funding needs. Bank funding, largely in the form of overdrafts and loans, accounts for 94% of total SME finance which is comfortably greater than other European counterparts.

A general lack of financial literacy exists across the broad financing landscape. A lack of knowledge on alternative funding options is inhibiting the development of a more diverse funding landscape and the subsequent use of more appropriate and less costly funding alternatives. Not only is there an over reliance on bank funding but local SMEs are also more reliant on short-term finance, in particular overdrafts and trade credit, in comparison to the EU average. They also still have a significant dependency on cheques rather than funds transfer or other payment methods.

There is a lack of balance sheet "right sizing". In general, Irish and Northern Irish banks need to be more engaged in the debt restructuring or write off of debt for SMEs who demonstrate sustainable trading positions but are over-leveraged due to property or other legacy debt issues. Banks are only very slowly disengaging from short term forbearance measures, a temporary and short term solution which, in the absence of strong economic growth, may not address the need for long term restructuring of the balance sheets of many SMEs.

The Central Bank of Ireland began to engage with Irish pillar banks in 2012 in relation to the restructuring of SME bank debt, but action in this area remains too limited. The work which has begun in this area needs to be accelerated and a clear policy is required in both Northern Ireland and Ireland to address current levels of debt overhang amongst viable SMEs and to "right size" SME balance sheets. This will require fundamental bank debt restructuring, debt write-off, parking and debt/ equity swap models and, in some cases, placing non-viable SMEs into receivership or liquidation.

In many cases, current debt levels cannot be serviced through existing cash flows. In those cases, the SME will never be able to repay debt levels in full, will continue to struggle and will not be in a position to grow or develop as a business. For those SMEs long term debt restructuring (including write-off in some instances) is the only option. Debt write-off or partial debt write-off should only be offered to those businesses who can demonstrate the generation of sustainable trading cash flows from normal business operations following restructure. Until such time as the balance sheets of SMEs are "right sized" (i.e. until such time as debt levels are sustainable), SMEs will be unable to secure additional finance, fully grow or develop.

A sustainable SME whose debt has been "right sized" to a level which they can service is a better asset to both the bank and wider economy.

A lack of investment is potentially damaging SMEs businesses. The economies of Ireland and Northern Ireland are both heavily dominated by SMEs. The majority of these SMEs are the smallest of companies – micro companies with low levels of turnover, employees and a domestic economy focus. While there are encouraging signs that more are moving to a growth mode, a still significant proportion of these SMEs are focussed on survival or stabilisation not on growth or expansion and, as such, are not looking for growth or development capital from any finance source. A lack of investment in a business ultimately damages that business and therefore represents a systemic and long term risk to the economies of Northern Ireland and Ireland.

There is a continued need to leverage EU-wide and UK initiatives. Both Ireland and Northern Ireland have drawn down support under these EU measures. Ongoing engagement with the EU will remain an important aspect of SME policy to ensure maximum potential is derived from the range of EU funding initiatives available to member states, such as the Competitiveness and Innovation programme, JEREMIE and the European Investment Bank. The list of EU support measures[47] has been widely documented elsewhere and is not reiterated here.

Additionally, in light of the poor success of previous national UK initiatives within the region, the relevant government departments in Northern Ireland (DFP and DETI) will have to engage strongly with the new business bank to ensure that regional needs are addressed and responses can be tailored to ensure maximum benefit. Other regions within the UK (North East of England and Wales) have similarly expressed concern that, due to past experiences with national initiatives, the business bank needs to respond to their different regional economic contexts. In Northern Ireland DFP and DETI need to also explore how best to progress existing national initiatives such as the Enterprise Finance Guarantee Scheme and the Funding for Lending Scheme, and determine if, how and to what extent, they can be tailored to or made more effective with the Northern Ireland context.

CONCLUSIONS IN RELATION TO THE SUPPLY OF AND DEMAND FOR BANK FINANCE

The report provides, for the first time, a picture of the total supply of bank finance for both Ireland and Northern Ireland. As at 31st December 2012, total bank finance of €31.5 / £25.7 billion had been extended to Irish and Northern Irish SMEs. Of this total €25.7 / £20.9 billion is to Irish SMEs and €5.8 / £4.7 billion to Northern Irish SMEs.

[47] See for example (1) at an overall level - http://ec.europa.eu/enterprise/policies/finance/financing-environment/index_en.htm and (2) for individual countries - http://www.access2finance.eu/

Businesses are over-reliant on bank funding. As at 31st December 2012 94% of total SME finance came from bank funding. Commercial banking cannot and should not be expected to take on all the risk associated with financing SMEs in either jurisdiction. In comparison to European SMEs, Irish and Northern Irish SMEs demonstrate an over-reliance on short term bank finance with a disproportionately high use of overdrafts.

A lack of bank supply data exists for Northern Ireland. The absence of regularly reported figures for Northern Ireland presents a significant gap in the analysis of total funding available to SMEs in Northern Ireland and thus hampers the development of policy responses to funding gaps that might exist in that market.

There has been a fall in both the supply of and demand for bank finance. Both the supply of and the demand for bank finance has fallen significantly in the period since 2008. In Ireland, the fall in supply has also been impacted by the withdrawal of a number of providers from the Irish market, in both 2010 and 2013. Total outstanding credit to Irish SMEs has decreased from €34 billion at the end of Q1 2010 to €26 billion at the end of Q4 2012. No trend figures are available for Northern Ireland.

High levels of bank debt exist for the largest sectoral employers. Of the four main sectoral employers in each jurisdiction, three (retail, construction and hospitality) are in distress and are very dependent on the domestic economy, and have high levels of bank debt.

Demand for bank finance is focused on short term working capital needs. Demand for credit amongst SMEs in Ireland and Northern Ireland has fallen significantly since its measurement began on a systematic basis in 2009 and this is now becoming a more significant issue than the supply of finance. Where demand currently exists it is primarily to fund short term working capital and to support cash flow.

SMEs with property debt are more likely to need working capital. SMEs with property debt are three times more likely to request working capital finance than their counterparts pointing to the difficulty many SMEs are facing in servicing legacy property debt and the slow pace of restructuring programmes for such debt in most banks.

Most SMEs are approved for bank finance when they apply formally. While 7% of SMEs who require finance are afraid to approach their bank, all surveys have consistently shown that the majority of SMEs who apply for credit receive a favourable response (Section 4.1.18). This figure is relatively consistent with patterns shown in similar studies carried out in other European countries.

SME views on bank lending are often not based on personal experience. SMEs are primarily forming their view that banks are not lending from the information they receive from the media, business groups or the experience related by peers rather than from direct experience. Banks should encourage SMEs to formally apply for credit or, at a minimum, direct them to mediation support services within the bank to support them with their application. This is a model that has been adopted very successfully in France where local mediators provide support to SMEs in the completion of their credit applications.

There is a misconception about SME credit ratings. Many SMEs are concerned that a declined credit application may impact their credit rating. This is an incorrect assumption and SMEs should be encouraged by policy makers, advisors and business representative groups alike to make applications for credit formally (i.e. by completing a formal written application form). This is then subject to internal bank assessment and the decision may also be appealed internally within the bank or, in Ireland, to the Credit Review Office.

The average bank decision time is a concern for SMEs. Survey results suggest that the average time from application to reaching a decision on the loan request is 21 working days. In many cases the decision time is much longer and this is a source of concern and, in some cases, distress for SMEs.

CONCLUSIONS IN RELATION TO THE SUPPLY OF AND DEMAND FOR PUBLIC FINANCE

Direct government funding represents less than 1% of total SME finance. As at 31st December 2012, direct government funding, not included in equity finance, represents less than 1% of all finance extended to SMEs.

Poor knowledge of finance schemes exists amongst SMEs and their advisors. SMEs and their advisors, business representative groups, accountants and other professional advisors are typically unaware of the public schemes and funds that are available to their clients. The complex and distributed nature of non-bank funding sources and the varied application routes makes the use of non-bank funding difficult and often expensive for SMEs.

In practice, funding schemes are focused on exporting SMEs or companies trading in specific sectors. On the basis of the analysis of the data returns completed by public funding organisations in Ireland and Northern Ireland, it is clear that while the majority of schemes or funds are open to all business sectors, the main beneficiaries are those SMEs who export and, those operating in the manufacturing, and information and communication technology sectors and tradeable professional and scientific and administrative/ support services. There is limited support for SMEs operating in most distressed sectors outside of traditional bank finance, the Credit Guarantee schemes (in Ireland and UK) and the MicroFinance scheme in Ireland. So far, the Credit Guarantee and MicroFinance schemes are seeing slow rates of take-up despite significant fund values. Ongoing monitoring of these schemes must ensure that the terms, cost, exclusions, application processes, nature of the funding (loans rather than overdrafts) and lack of knowledge amongst SME advisors (banks, business groups and accountancy firms) do not have a negative impact on levels of take-up.

The SME support infrastructure is more developed in Ireland. The SME support infrastructure, in the area of bank finance, has developed significantly in Ireland in recent years. Given the similarity in access to finance issues apparent amongst SMEs in Ireland and Northern Ireland, there are a number of measures implemented in Ireland in the period since 2009 that should be considered in Northern Ireland either on a cross-border or specific Northern Irish basis. The measures in question can be considered to be primarily emergency measures (as defined by the OECD) in both jurisdictions.

The supports required by SMEs have changed since the economic crisis began in Ireland and Northern Ireland. SMEs now require tailored support in the restructuring of balance sheets, in engaging with banks on negotiating sustainable debt restructuring initiatives, in developing funding strategies for the current economic environment and in developing overall solutions to their finance needs.

CONCLUSIONS IN RELATION TO THE SUPPLY OF AND DEMAND FOR EQUITY FINANCE

Equity finance is now a significant source for SMEs. The second most significant source of funding is external equity finance as represented by seed capital, venture capital and business angel finance. External equity finance, including government backed equity finance, accounted for approximately 5.6% of total SME funding at 31st December 2012; the proportion is significantly higher in Ireland than in Northern Ireland. The report estimates that a total equity finance of €1.9 / £1.5 billion had been invested in Irish and Northern Irish SMEs in the five year period to 31st December 2012. The majority of this has been invested in Irish companies.

Equity finance is only appropriate for some SMEs. It is generally accepted that equity finance will only ever be suitable for a small minority of SMEs, often start-ups and/or high potential growth businesses and more mature companies with short to medium term growth or expansion plans. However, it will remain a key source of finance for this cohort of businesses.

Equity finance is focused on a small number of business sectors. In general equity finance is targeted very specifically at a small number of business sectors, mainly:

- J: Information and Communication;
- M: Professional, Scientific and Technical; and
- C: Manufacturing (including Medical Devices).

Demand for equity finance is low. Given the above conclusions it is not surprising that existing survey data would suggest that the demand for any form of non-bank finance is low in the general SME community in both Ireland and Northern Ireland. Demand for equity is restricted by the fact that government, angel and venture capital investors typically only provide finance to a small number of specific businesses in targeted industry sectors which match the investor's portfolio, risk and return on investment goals. The following are the three main, but not the only factors which explain low levels of demand for and take up of equity finance in Ireland and Northern Ireland:

- The profile of SMEs;
- Supply side issues impacting demand and confidence in equity; and
- Lack of awareness and understanding of equity finance amongst SMEs.

A significant SME finance capability gap exists. Despite some improvement due to access to investment readiness support, early stage companies still require support to improve commercial and management skills of investee teams and support in preparing and presenting for follow-on funding. Fund managers cited that people who apply directly are not as investor ready as those applying through intermediaries as both they and their business plans have not been sufficiently challenged and, therefore, increased focus should be placed on encouraging the use and benefits of professional support services, particularly as companies prepare to seek follow-on funding.

There is a vibrant Irish venture capital landscape. The Irish venture capital (VC) industry has received significant and sustained support from the Irish Government over the last few decades. In this time, the Irish Government, through Enterprise Ireland, has committed approximately €348m to 41 local Seed and VC funds resulting in capital of approximately €1.2 billion for investment in innovative high growth companies (Enterprise Ireland, 2013). However, this study suggests a number of potentially strong start-ups might not be able to secure follow-on funding. Due to the significant investment in seed funding to date, there is a concern among many consultees about a supply gap or bottle neck possibly arising where SMEs who have received seed and early stage funding now seek follow-on funding. The new Enterprise Ireland non-seed funds, while only at expression of interest stage, may address some of this potential equity gap or bottle neck. There remains, however, a continued need for government support of seed and early stage finance in Ireland.

Supply gaps exist in the Northern Ireland equity market. Significant additional investment in seed and early stage capital is required in Northern Ireland as a demand stimulant. The vast majority of consultees participating in this study considered that there were supply gaps in the current Northern Ireland equity market, albeit that there were different views as to the nature and extent of these gaps. Many acknowledged that demand was impacted by other factors, including the economic profile of Northern Ireland and the wider entrepreneurial ecosystem. There is strong consensus that there was insufficient availability of risk finance at pre-seed, seed and early stage in Northern Ireland. In early 2013, the Invest Growth Proof of Concept Fund (pre-commercial grant), which was fully committed at the end of 2012, and the Invest Growth Fund were extended by £2m each to March 2014, with a view to putting in place increased seed and early stage funding from April 2014.

The level of angel investing is increasing. The importance of business angel investing at seed and early stage has received increasing attention due to its growth internationally relative to venture capital investing. The formal angel networks have and are continuing to develop in line with international best practice and the development of formal angel investing has been significant over the last number of years, including the increased development of angel groups/syndicates. Supply statistics on formal angel investing indicate that angel investment has increased year-on-year since 2008. In Northern Ireland, while levels of investment are also small but developing, angel investment is in relative terms more important, due to the low level of venture capital activity in Northern Ireland. It was suggested in the course of the study, that a co-investment fund (one is already in place in Northern Ireland) would be an important feature in continuing to develop business angel investment in Ireland as a complement to the range of other funds in place, including the Enterprise Ireland Seed and Venture Capital Programmes.

The Northern Ireland Growth Loan Fund serves a specific demand. The Growth Loan Fund in Northern Ireland is a mezzanine debt product, which primarily allows growth companies to draw down unsecured loans at higher interest rates based on growth projections. Although primarily a debt product, this alternative financing product may have the potential to overcome the reluctance on the part of some growth businesses, as outlined in Section 4.3.2, to go down the route of equity. This would appear to have tapped in to some latent demand in Northern Ireland and may be an important consideration in Ireland in terms of extension of financing options.

The Irish National Pension Reserve Fund (NPRF) SME Turnaround Fund should provide a useful policy tool. This new fund, introduced in Ireland in January 2013, will invest in underperforming businesses which are at, or close to, the point of insolvency but have the potential for financial and operational restructuring. Demand statistics on this fund including profile of applicants, even where unsuccessful, may provide important information for evidence-based policy making for such SMEs (potential but hamstrung) and may be a useful source of information in both jurisdictions to address this important cohort of SMEs.

7.2 RECOMMENDATIONS

Both the supply of and demand for finance are now at necessarily lower levels than the artificially inflated and unsustainable peaks of a few years ago. However the readjustment process has exposed a very narrow SME financing landscape and provided a window of opportunity to develop a broader and more informed financing ecosystem that will support and not inhibit economic recovery. Much has already been undertaken in this regard in both Northern Ireland and Ireland to ensure a financial ecosystem that can support the needs of customers, support recovery and growth and avoid the mistakes of the past. The recommendations that follow are consistent with and intended to support the work already completed or ongoing. They focus on two areas that are critical for the development of a more diverse funding landscape across both jurisdictions. These are:

- Information; and
- Financial capability

The report then concludes with a number of recommendations aimed at encouraging the further development of the venture capital and angel investor markets on the island.

INFORMATION

The availability and flow of high quality and relevant information is fundamental to the smooth operation of any marketplace. The following recommendations are designed to address informational deficiencies in the market for finance in Ireland and Northern Ireland.

Recommendation R1 – Capture bank lending figures in Ireland and Northern Ireland

The recent Economic Advisory Group for Northern Ireland report (EAG, 2013) highlighted that the absence of bank lending data was a significant issue for Northern Ireland. It stated that *"there was a general sense that banks would sign up to the provision of regional lending data for Northern Ireland on the proviso that they all sign up to it and they are confident in the organisation holding the information".* On the basis of the framework developed in Ireland since 2009, and the fact that supply data had been available by the main banks operating in Northern Ireland under that process, these banks provided Northern Ireland data to the researchers in the course of this study. This is an important milestone in understanding the SME finance environment in Northern Ireland, but the process needs to be maintained and improved in order that patterns and trends may be monitored and analysed over time and appropriate policy responses developed.
Therefore, a clear and comprehensive framework for

the supply side capture of SME lending, application, approval and rejection rates should be introduced in Northern Ireland with quarterly returns of data to the Department of Finance and Personnel. The model which was introduced in Ireland in 2009 and handed over to the Central Bank in 2011 could be used in this regard. An initial process of bank data cleansing and review would be required to support the ongoing reporting of SME supply side data in order to ensure the accuracy and consistency of the data provided.

Recommendation R2 – Capture demand for finance among SMEs in Northern Ireland

A lack of regular and consistent demand-side or lending surveys of Northern Ireland SMEs makes it difficult to analyse the extent of any demand / supply gap. Regular and detailed surveys, along the lines of the Irish Department of Finance's bi-annual demand surveys should be introduced in Northern Ireland. The InterTradeIreland Business Monitor could be used for this purpose with the questionnaire and sample designed in consultation with the new Access to Finance Implementation Panel.

Policy makers also need a clearer profile and better information on the attributes of the SME population to inform policy development (in addition to data on lending which receives the most attention). The Australian model referred to in Section 6 should be considered in this regard. This data should be maintained on an ongoing basis, developed and held centrally in both Ireland and Northern Ireland and access provided to government agencies and policymakers. This data should include:

- Sectoral profiles;
- SME employment profiles;
- Levels of reliance on domestic economy;
- Levels of distress in specific sectors;
- Extent of impact of property debt overhang; and
- Characteristics of export base and identification of potential exporters.

Recommendation R3 – Provision of Better Information to SMEs by Funding Providers

All banks and public funding agencies should endeavour to provide their SME customers with a written and clear reason as to why their formal application for credit has not been accepted in both Ireland and Northern Ireland. We acknowledge this is required at present under the Code of Conduct for Lending to SMEs in Ireland and the need to take into account the difficulties of communicating a negative outcome. The explanation that is currently provided is generally derived from a master system list of reasons and does not provide adequate information in many cases to the SMEs. Banks in both Ireland and Northern Ireland should also introduce internal programmes to ensure quicker turnaround on decisions especially at the smaller end of SME lending (e.g. €25k to €75k).

In the case of public funding agencies this written explanation should include some element of future signposting – i.e. directing the SME to other more possible alternative finance sources. This follows a model which has been successful in France where OSEO publishes a guide to its schemes specifically for banks so that lenders can direct SMEs whose application for credit has been declined to other funding agencies.

Recommendation R4 – Encourage Formal Credit Applications

Continued work is required to encourage SMEs to pro-actively and formally apply for credit. Recent initiatives such as the standardisation of the application process in Ireland and other awareness campaigns should assist this conversion and should be examined for roll-out in Northern Ireland. Above all, it is important that SMEs are made aware by banks that a rejected application does not result in a negative credit rating.

Recommendation R5 – Promoting Alternative Sources of Finance

Consideration should be given in Ireland to promoting alternative financing options such as quasi-equity/mezzanine products to provide alternatives to those SMEs who do not want to cede control via a full equity play. While relatively new (late 2012), the Growth Loan Fund in Northern Ireland would suggest that there is demand for a middle ground option such as mezzanine finance, albeit that some commentators have suggested that some of this demand may be due to the absence of alternative equity options in Northern Ireland. In Northern Ireland, as this is a relatively new fund, there may be potential to increase awareness and education of this fund and source of finance at both the demand (SME) and supply sides (front line bank staff, other advisors and intermediaries).

A range of alternative forms of finance have also been relatively widely used in other countries as outlined in Section 6 (Canada, France, Germany, US, UK), as a post-crisis government response to reduced availability of bank debt. Further consideration needs to be given in both jurisdictions to extending the range of alternative financing options available to SMEs.

A single public body in both Ireland and Northern Ireland should be charged with the development and maintenance of a single repository of all schemes / supports / funds / credit facilities available to SMEs. This database should include bank, public and equity funding and should be both accessible and searchable by sub-region and sector. It should be made available publicly to SMEs, public bodies who advise SMEs, business groups and accountants so that the complex SME funding landscape that currently exists with over 50 funders and upwards of 170 schemes is easier to navigate for SMEs and their advisors.

CAPABILITIES

The following recommendations are aimed at improving financial literacy within the broader financing ecosystem which is necessary to develop a broader based market with a wider portfolio of financing products and solutions. Improving the strategic preparation of SMEs for dealing with funding providers will be key to the exploitation of the opportunities offered by such a wide portfolio.

Recommendation R6 – Non-Financial Support Measures for SMEs

SMEs require support in assisting them to become more competitive, acquiring the skills to enter new markets, securing new customers and exporting. However, SMEs also need to acquire the financial and development skills pertinent to the current economic environment.

A series of publicly funded, practical educational programmes should be made available in Ireland and Northern Ireland to support SMEs, especially at the micro / smaller end. These programmes should focus on:

- Navigating the funding landscape;
- Preparing cash flows for sustainable trading businesses;
- Preparation of business plans in the current environment including stabilization planning;
- Restructuring of balance sheets / finance positions appropriately (balance sheet “right sizing”);
- Negotiation with banks on restructuring of debt;
- Matching finance needs with finance products or sources;
- Management of working capital;
- Developing export capabilities;
- Analysis of finance needs (funding mix, appropriate use of long and short term finance etc.); and
- Investment readiness preparation for companies applying for equity or similar forms of finance.

InterTradeIreland has developed expertise in the area of improving investor readiness for equity finance, through EquityNetwork, and ought to explore the potential for expanding these services and solutions for a broader range of financing options including applications to banks.

In particular the support provided should focus on assisting SMEs in the capital restructuring[47] of their balance sheets so that sustainable trading businesses[48] can be prepared and supported in approaching their bank or funding institution with a view to securing a fundamental balance sheet restructure. This type of support has to be developed and delivered by those currently advising SMEs. The advisors need to be fully conversant with balance sheet restructuring models and best practice SME sustainability metrics which is the case for a limited number of professional advisory firms.

[47] Restructuring refers to a fundamental change in the capital structure of a borrower either by mutual agreement and/or a legal process. A restructuring can be deemed as sustainable if the borrower is in a position to ultimately repay the restructured debt amount either through amortisation payments or asset sales

[48] A business can be deemed sustainable if it can generate a positive free cashflow before debt service, through the business cycle

In Ireland, the establishment of the LEO framework (from the conversion of County and City Enterprise Boards) represents an ideal opportunity to implement this recommendation and fundamentally change the skills profile of front line publicly funded support staff advising SMEs. There will also be the opportunity to promote awareness and use of the voucher schemes, soon to be operating in both Northern Ireland and Ireland, which are there to support SMEs improve their financial capabilities.

Consistent with the initiatives in Australia, New Zealand and the UK outlined in Section 6 of this document, we suggest that a national helpline be considered to operate on an all-island basis, possibly co-ordinated by a cross-border body such as InterTradeIreland. This helpline could follow a model similar to the well-established Australian model and could also take account of the new UK Business Link helpline. Whilst we acknowledge that a helpline was considered in Ireland in 2011 and discounted for cost reasons, we suggest it should be re-examined and developed in accordance with the models put in place in Australia, New Zealand and the UK, that it is integrated into an existing support agency and leverages the benefits of additional measures such as a comprehensive database of the products, schemes and solutions across the funding landscape in both jurisdictions. The helpline could operate both before and after normal business hours, and provide information on finance options, cash flow management, balance sheet restructuring, government supports, business planning, accounting, taxation and diagnostic services. An all-island helpline could deliver economies of scale but would also ensure that cross border initiatives as well as new learnings from both jurisdictions are leveraged.

Recommendation R7 – SME Voucher Schemes

Governments in Ireland and Northern Ireland currently have SME Voucher schemes in place. This report identified a need to enhance the capability of a significant number of SMEs in the areas of financial and commercial management capability, areas in which there would appear to be a high requirement and preference for tailored and one-to-one support. Vouchers represent an important support for SMEs who are currently unable to afford professional advice in engaging with their banks or in applying for credit or restructuring their debt levels. International research has also suggested that cost is a significant impediment to SMEs drawing down business support services even where there is clear need for support. These voucher schemes would allow SMEs to procure and pay for professional support in particular to:

- Analyse existing balance sheet or funding positions;
- Develop funding proposals to banks, public funding agency, venture capital or other third party funders; and
- Support the SME in engaging with their bank in restructuring existing debt positions for sustainable SME trading businesses.

Demand for such voucher schemes is always high, and they provide an effective way of both addressing the varied needs of the heterogeneous population that SMEs represent (micro, small, traditional, high tech, high growth etc.), and allowing individual SMEs to cost effectively draw down bespoke support. The governments should monitor the uptake of these and then consider their extension, possibly on a joint North/South basis, like the Innovation Vouchers.

Recommendation R8 – Further Development of the SME Capabilities of Banks

Consideration should be given to putting in place a small dedicated team on site within each pillar bank in Ireland. This team would:

- Review rejected SME credit applications for appropriateness and consistency of decline decisions, thereby negating the need for an SME to separately apply to the Credit Review Office.
- Explore the options which exist through the full or partial use of other government backed schemes (e.g. Credit Guarantee Scheme / Microfinance scheme) thereby negating the need for the SME to reapply to each scheme or fund individually, completing different forms and providing different information in each case.
- Reviewing informal applications or enquiries (which the main banks are now starting to log) which are not put forward to credit commities by the bank relationship manager to whom the enquiry was made and performing follow up satisfaction calls to SMEs making such enquiries.

Some of the banking initiatives recently introduced by banks in Ireland, partly at the request of the Central Bank of Ireland and Department of Finance, should be introduced in Northern Ireland, for example:

- Front line staff training on cash flow lending, SME funding available, debt restructuring, sustainability assessment;
- Dedicated distressed credit / challenged units;
- SME coaching initiatives;
- Single application form, standard business plan, cash flow model;
- Auto grading of micro loans;
- SME feedback initiatives; and
- Dedicated SME officers in 2013.

Whilst not all the banks operating in Northern Ireland who lend to SMEs are regulated in Ireland, for a number of them their primary regulator is Irish and they are supervised under passporting rules in the UK. As such, some of these schemes could be supported or encouraged by the Irish Central Bank. However they represent best practice in dealing with SMEs and distressed credit and are being rolled out in many banks internationally and in the UK. This issue has also been raised in the *Review of Access to Finance for SMEs in Northern Ireland* (EAG, 2013).

Consideration should also be given to the development of international trade finance products for SMEs, i.e. export-focused guarantee scheme to support lending under guarantee. We acknowledge that at the date of publication of this report, this recommendation is being considered in Ireland by the Department of Jobs, Enterprise and Innovation.

Recommendation R9 – Further Development of Credit Review and Mediation Services

A number of recommendations have been made in a recent Department of Finance report following an assessment of the operation of the Credit Review Office (CRO) (Grant Thornton, 2012). We welcome those recommendations and suggest that consideration should also be given to expanding the remit of the CRO to include:

- Further encouragement of non-pillar banks operating in Ireland to engage with the CRO.
- Consider the extension of the remit of the CRO beyond its current brief to include a credit mediation service following the example of the French credit mediation office. The French model as (set out in detail in Section 6) should be reviewed to assess the benefits of a wider and distributed mediation role for SMEs.
- Quicker turnaround times as when an SME has a credit problem, time is of the essence (the above mentioned report includes recommendations on expediting the application process).
- Sample testing of credit applications which have been rejected by the banks but which have not been referred by the SME to the CRO. This will over time improve the quality of credit assessments, encourage banks to focus more on solutions than just credit decisions and ultimately will provide increased assurance to SMEs on the robustness of the bank credit application process. Alternatively banks should refer a sample of all rejected credit applications across each sector to the CRO by the participating banks.
- Consideration should be given to adopting a version of a model similar to that developed and rolled out in the last 3 years in France. Location of a CRO officer in each pillar bank on an ongoing basis, so that whilst the officer is operating independently of the bank, he/she is none the less working in closer proximity and thus able to discuss possible solutions with the bank and to provide sign posting for under funding options.

We recommend that the Department of Finance and Personnel and the Northern Ireland banks, in conjunction with the British Banking Association and the Independent External Reviewer agree an approach to systematically promote the uptake of the UK Banking Taskforce Appeals Process by Northern Irish SMEs to ensure that existing processes are leveraged to the greatest extent possible. In addition, consideration should be given to an extended independent mediation support for SMEs in Northern Ireland which incorporates some of the benefits of other models, including elements of the French model set out in Section 6. This could entail a separate unit which coordinates access to finance issues for SMEs who have been refused bank finance but who may also require specialist advice on their application quality and improving the standard thereof, advice on capital structure and financing options and signposting to more appropriate financing solutions.

DEVELOPMENT OF THE VENTURE CAPITAL AND ANGEL INVESTOR MARKETS

Recommendation R10 – Continuation of Government Support for Seed and Early Stage Finance in Ireland

Consideration should be given to the following in relation to seed and early stage finance:

- Introducing an investment follow-on fund specifically targeted at participants of seed programmes.
- Ensuring that an appropriate range of alternative finance options (as per recommendation R5 above and based on examples in section 6) is available to such businesses including entrepreneur loans or hybrid instruments incorporating debt and subordinated tranches.
- Targeted venture capital funding, including consideration of Ireland-only or all-island non-seed funds, to allow for a lower bar for some emerging viable seed companies who may not compete at the international level in terms of follow on-funding. The five new Enterprise Ireland non-seed funds (Ireland-only), currently at expression of interest stage, may address some of these issues, albeit that they are focussed on the broad technology and life sciences sectors.
- Continued support and assistance to emerging Irish seed companies in competing for commercial funding from international venture capital funds to raise the standard in terms of financial, commercial, management and presentational skills amongst this group.

- Consideration may need to be given to addressing the lack of diversification in seed and early stage funds (focused primarily on high-tech) to ensure that potential high-growth companies which are not necessarily high tech are not dissuaded from the equity route (self-selecting themselves due to a perception that the funds are not relevant to their sector or company type), or otherwise restricted due to fund restrictions or the specialist focus and preferences of the VC fund managers. We understand that Enterprise Ireland is in discussions with the European Investment Fund in this regard.

Recommendation R11 – Support of Angel Investment across the island of Ireland

The establishment of an Irish dedicated co-investment fund or angel fund should be considered where investment selection is initially led by the private investors, who set the terms, but with the remaining funding provided by the co-investment fund.

We recognise the existence of the Co-Fund NI which supplied £1.7m in funding to seed and early stage businesses. Co-Fund NI leveraged additional private sector investment of £3m in addition to the Invest NI (INI) portion of £1.7m (2012).

The establishment of a co-investment fund or angel fund, which has merit in its own right to further promote business angel investing, may also promote further diversification where initially led by the private investors.

The recent establishment of a new all-island food business angel syndicate may demonstrate potential for funding of 'non-tech' sectors by equity investment although it is too early to make any detailed assessment of the syndicate.

As the visible business angel market in Ireland is small relative to other countries and due to the fact that investments through structured vehicles such as the Seed Capital Scheme (SCS) and the Employment and Investment Incentive (EII) scheme show a downward trend in overall investing, consideration should be given to the following:

- Further promotion and awareness raising of the benefits of the existing SCS and the EII scheme are required; and
- Extension of the terms of the EII relief in line with the more extensive and attractive UK-based Enterprise Investment Scheme and the Seed Enterprise Investment Scheme.

Due to the increasing relative importance of business angels as a source of finance for SMEs and, the as yet relatively small size of the total business angel market in Ireland and Northern Ireland, we recommend continued public funding of both the jurisdictional and cross-border Business Angel network infrastructure.

Recommendation R12 – A Venture Capital Strategy for Northern Ireland

Echoing the recent *Review of Access to Finance for SMEs in Northern Ireland* (EAG, 2013), we recommend that a comprehensive Venture Capital Strategy is developed for Northern Ireland which informs and develops the equity funds under the Access to Finance Strategy, dovetails with the new Innovation Strategy (to be published in early 2014) and supports wider policy objectives to further promote entrepreneurial activity in Northern Ireland. This strategy should address medium to long-term considerations including the avoidance of future gaps in the continuum of funding, an issue which is likely to have impacted demand and confidence in equity funding in Northern Ireland. And, in the shorter term, it should frontload early risk capital initiatives and associated support services to take into account the importance role of proof of concept, seed and early stage capital availability as a demand stimulant.

Two new development capital funds of £30m each were awarded in 2013 and are understood to be subject to contract at the date of writing. In early 2013, the Invest Growth Proof of Concept Fund (pre-commercial grant), which was fully committed at the end of 2012, and the Invest Growth Fund were extended by £2m each to March 2014, with a view to putting in place increased seed and early stage funding from April 2014.

Recommendation R13 – Investment in Seed and Early Stage Capital in Northern Ireland

The extension of risk capital needs to be supplemented by a range of wider support initiatives to promote innovation and the entrepreneurial environment and provide wrap around services to start ups. Despite acknowledged success of some investment readiness support programmes, it was considered that further work was required to simplify and streamline the full range of supports, promote them in a more user-friendly and understandable manner, improve the commercial and management skills of early stage company teams, and extend the level of support available recognising that a significant degree of handholding was required for early stage companies. Consideration needs to be given to the appropriate nature and level of wrap-around services appropriate to an extension of risk capital for seed and early stage companies to address potential demand side weaknesses and leverage the benefits of the investment.

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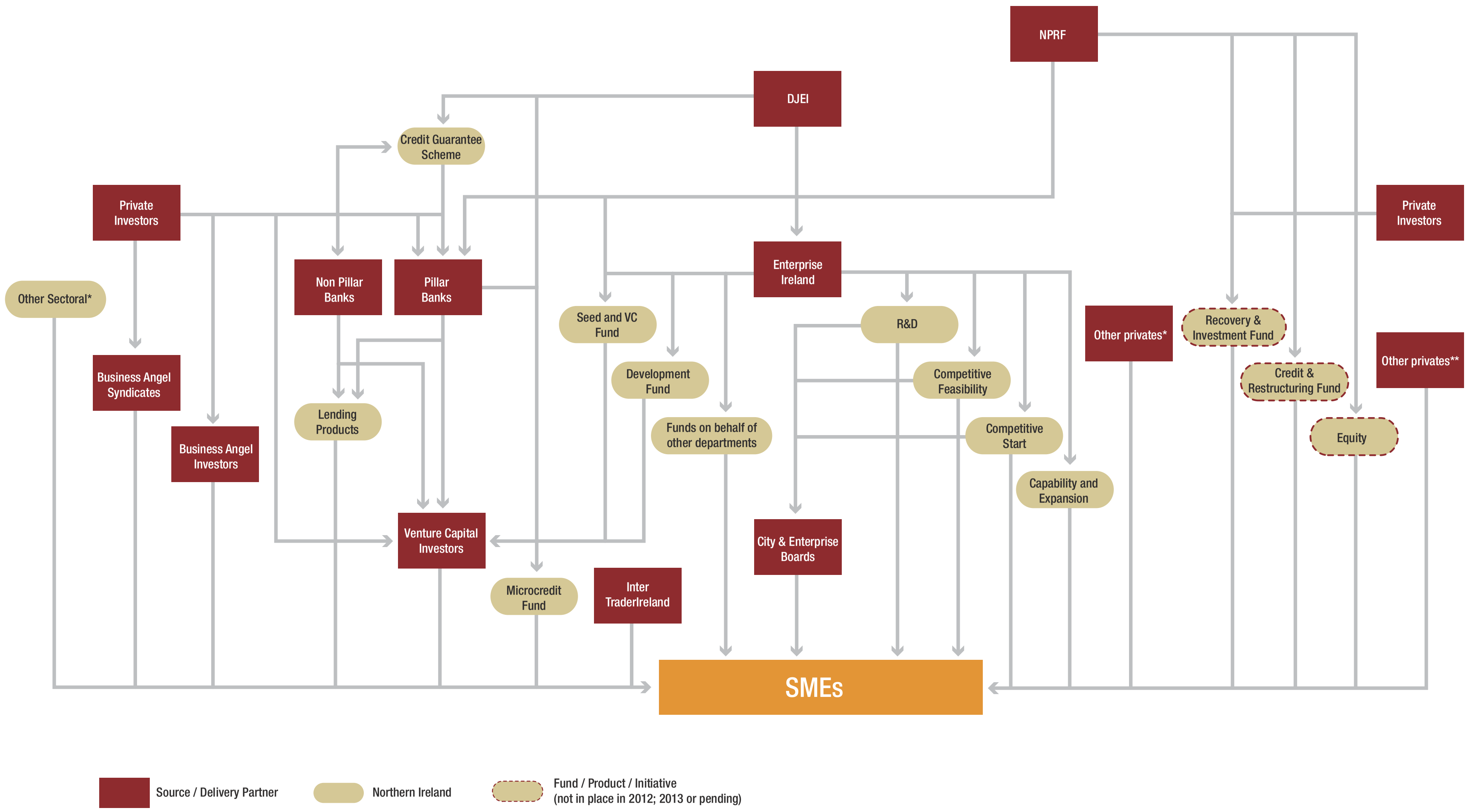
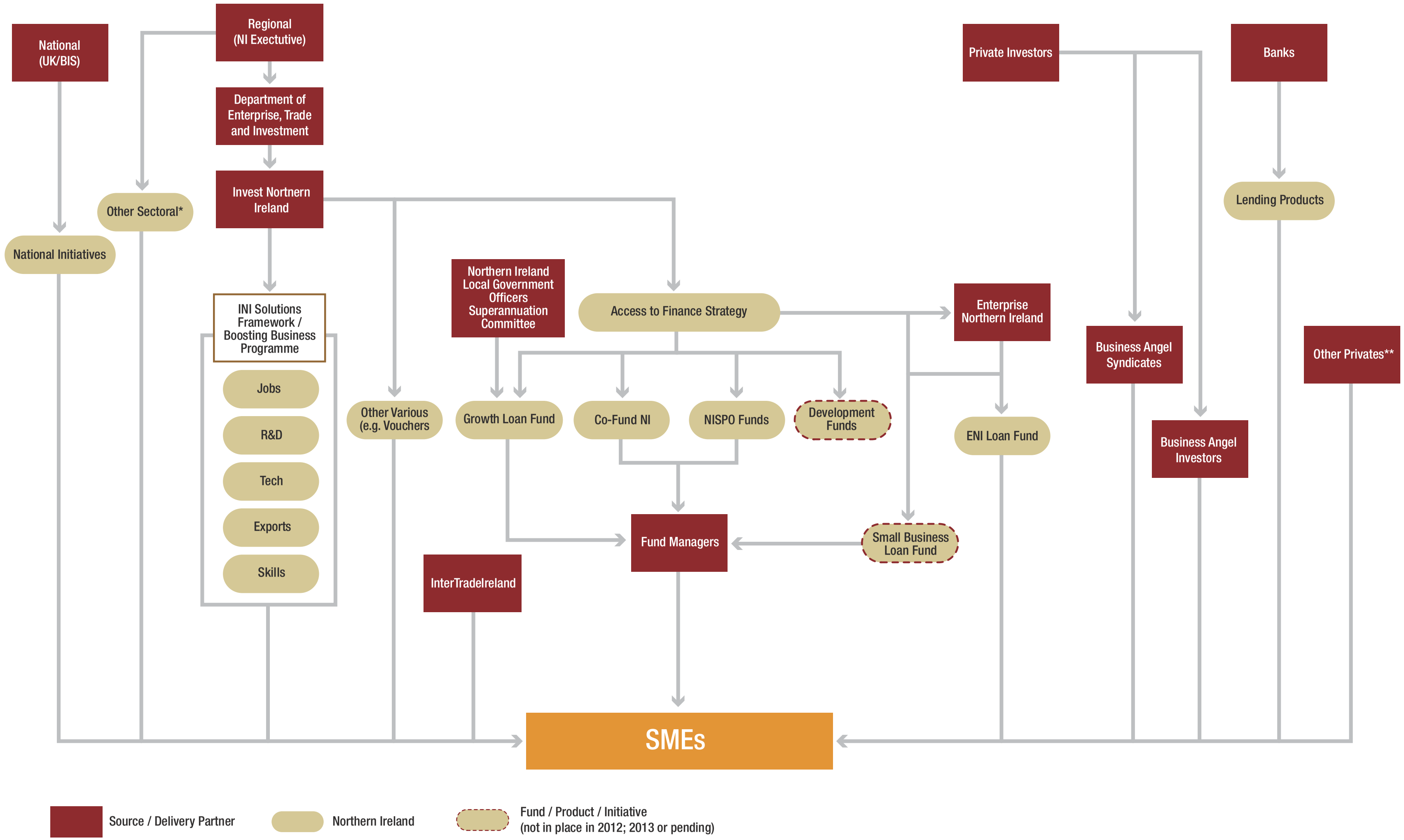
Appendices

APPENDIX 1: FUNDING LANDSCAPE MAP – IRELAND



APPENDIX 2: FUNDING LANDSCAPE MAP – NORTHERN IRELAND



APPENDIX 3: ASSUMPTIONS USED IN COMPILING SUPPLY SIDE DATA

The figures used in the compilation of finance supply figures were provided subject to strict confidentiality agreements and were not audited by Mazars as part of this research.

The bank stock of lending or credit exposure figures should be read in conjunction with the following assumptions:

1. Ireland Bank exposure -
- Data returns made to the researchers were validated against the Central Bank of Ireland Table A14.1 – Credit Advanced to Irish Resident Small and Medium Enterprise – as at 31 December 2012.
- Applications received, approval rates and the average size of facilities were based on the data returns.

2. Northern Ireland Bank exposure -
- Data returns made to the researchers for the main banks were then grossed up. This was based on estimations of market share from responses to the Q3 2012 InterTradeIreland Business Monitor surveys and consultations with the small number of banks who lend to the SME market in Northern Ireland and who were not requested to submit data.
- Banks in Northern Ireland use SIC sectoral coding. To complete the returns sectoral codes were mapped to the NACE Rev 2codes based on a best estimate basis.

3. Exposure for venture capital firms -
- Represents the total funds raised by SMEs in the period 2008 to 2012, based on Irish Venture Capital Association (IVCA) and British Venture Capital Association (BVCA) figures provided to the researchers.
- The IVCA figure includes venture capital funds in which Enterprise Ireland has a vested interest.
- Whilst the term exposure is not normally used for venture capital funding, in this instance it can be considered comparable to total bank exposure as an estimate of all monies invested in Irish SMEs where the original venture capital investor has not yet exited.
- There is a possibility of some double counting between IVCA and BVCA data but this is not considered to be material.

4. Angel and private investment exposure -
- Represents the total funds raised by SMEs in the period 2008 to 2012 as provided by Halo Business Angel Network, Halo Business Angel Partnership and Halo NI.
- A factor of 6.5 is used to represent invisible private investment which is not captured in any formal method at present.

5. Exposure under Government backed funding -
- Based on the main public funds targeted at SMEs which are either repayable to the funding agency by the SME in question or for which a return is anticipated.
- Government funding in Ireland is based on data provided to the researchers.

6. In instances where exposure figures were not available the balances, as reported on the latest available set of financial accounts, was used. Figures were based on gross valuations (i.e. did not exclude provisions).

7. Due to data limitations arising from legacy systems and data, it was not possible to report for SMEs alone in some instances. In such cases non-SME balances were allocated to SME lending categories on a proportionate basis.

8. An exchange rate of 0.8161 as at 31st December 2012 was used unless data was supplied with € / £ rates already included.

APPENDIX 4: LIST OF CONSULTEES

ALL-ISLAND AND OTHER

1. InterTradeIreland
2. Halo Business Angels Network
3. European Investment Fund

IRELAND

1. ACT Venture Capital
2. Allied Irish Bank
3. Bank of Ireland
4. Bibby Financial Services
5. Central Bank of Ireland
6. Chambers Ireland
7. Credit Guarantee Scheme (Capita)
8. Credit Review Office
9. Delta Partners
10. Department of Jobs, Enterprise and Innovation
11. Department of Finance
12. DFJ Esprit
13. Enterprise Equity
14. Enterprise Ireland
15. Forfás
16. Institute of Bankers
17. Irish Banking Federation
18. Irish Venture Capital Association
19. Kernel Capital
20. Micro Credit Ireland
21. NCB Ventures
22. Small Firms Association
23. Ulster Bank

NORTHERN IRELAND

1. Bank of England
2. Bank of Ireland
3. British Venture Capital Association
4. CBI Northern Ireland
5. Clarendon Fund Managers
6. Crescent Capital
7. Danske Bank
8. Department of Enterprise, Trade and Investment
9. Department of Finance and Personnel
10. Enterprise Northern Ireland
11. E-synergy
12. First Trust Bank
13. Federation of Small Business
14. Halo Northern Ireland
15. Institute of Directors
16. Invest Northern Ireland
17. Northern Ireland Chamber of Commerce
18. Northern Ireland Science Park
19. Strategic Investment Board
20. Ulster Bank
21. Whiterock

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