

# WALES' MISSING MIDDLE



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## INTRODUCTION

Since devolution began in 1999, Wales' economic development landscape has changed significantly. There have been a number of strategies and targets, organisations such as the WDA, IBW and FS4B have disappeared and key issues such as sectors have emerged. More recently, the decision by voters to begin the UK's process of leaving the European Union marks the start of a process of redefinition in economic terms. This process should prompt all of those involved in economic development to critically analyse what's worked (or not) in the past and whether we need to act differently in the future.

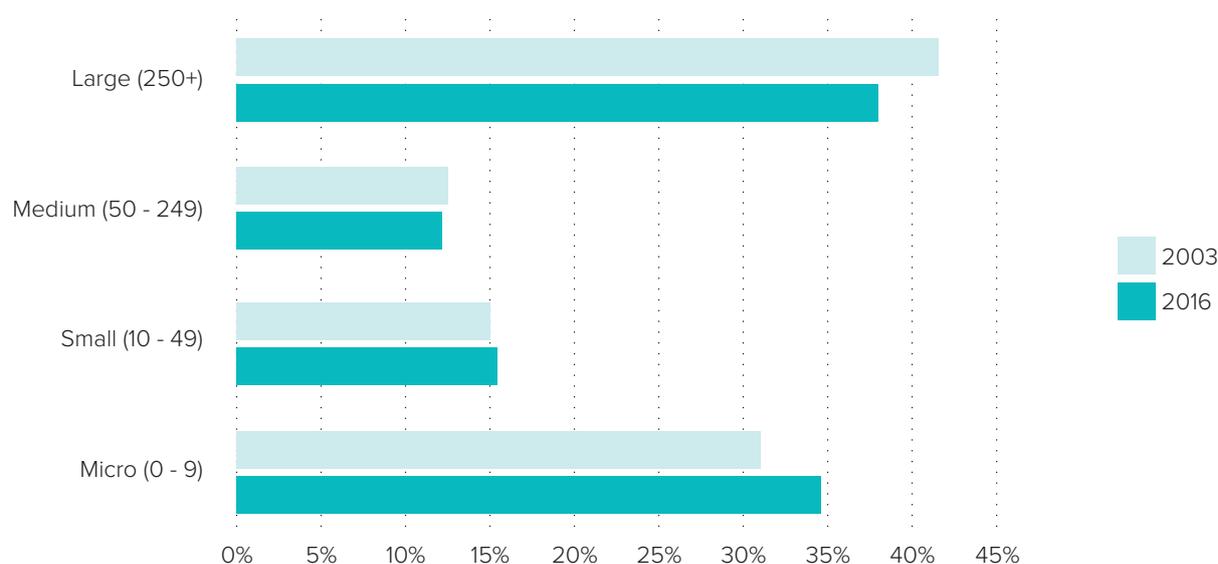
It is in this context that the Cabinet Secretary for Economy, Infrastructure and Skills is developing a much anticipated new approach to economic development in Wales. For our part, FSB Wales has produced a number of reports on key issues such as self-employment, rural economies and what small firms need from Brexit, which we hope will help to create a broad evidence-base for discussion.

This paper is a further contribution to this evidence-base, focusing on medium-sized firms in Wales and how we can help foster their number. In presenting this paper we hope to add value to the debate around economic development in Wales and to provide focus to the choices Welsh Government has before it.

## BACKGROUND

Wales has a “missing middle”. In terms of employment, it is a country dominated by micro-business and multi-national business (see graph one). On the one hand Wales has a thriving and entrepreneurial micro-business scene with firms employing fewer than 10 people making up around 35 per cent of private sector employment. At the other end of the scale large firms with their headquarters elsewhere in the world account for 38 per cent of private sector employment. In the missing middle medium-sized firms, those employing between 50-250 people make up a slim 12 per cent of employment.

Graph 1: Employment and business size<sup>1</sup>



There are strong historical reasons for this. As a country, Wales was quick to industrialise in the 18th and 19th centuries with large companies employing significant numbers of people to extract our rich endowment of natural resources. Thus, the development of Copperopolis at the Hafod in Swansea, the Cambrian Combine in the South Wales Coalfield and the Penrhyn slate quarry in Bethesda led to an employment boom emerging over a largely rural and traditional business environment.

<sup>1</sup> Statistics for Wales. 2016. *Size Analysis of Welsh Business 2016* [Online]. Available at: <http://gov.wales/docs/statistics/2016/161129-size-analysis-welsh-business-2016-en.pdf> (accessed 23rd August 2017)

Fast-forward to the 21st century and the disappearance of these mammoth industries was replaced by the pursuit of foreign direct investment and an emphasis on creating new businesses in Wales. Both of these are noble aims, but a consequence of this approach has been the poor development of a Welsh *Mittelstand*, or medium-sized firms that are locally-grounded but with a global reach.

But why are medium-sized firms important? An *Economist* article on Japanese medium sized firms highlighted their importance saying:

*“The Japanese even have a term for them: chuken kigyo (strong, medium-sized firms). It doesn't matter if the brand on the casing says Apple, Nokia or Samsung: the innards are stuffed with Japanese wares... Germany's Mittelstand, the closest Western equivalent of the chuken kigyo, also boasts many smallish world-beaters. In much the same way as the Mittelstand, Japan's chuken kigyo is not simply a part of the national economy, but the core of its industrial structure.”<sup>2</sup>*

This paper argues that in the current economic environment our conventional approach to economic development needs to change and the Welsh Government's current re-appraisal of economic development strategy offers the opportunity to do so. In an era of uncertainty for future foreign direct investment, we must look to develop our own Welsh brands that can compete globally whilst being rooted in their communities. We must find the missing middle.

**Wales has an economy with a missing middle, dominated by micro-firms and multi-national firms.**

<sup>2</sup> Economist. 2009. *Invisible but Indispensable* [Online]. Available at: <http://www.economist.com/node/14793432> (accessed 23rd August 2017).

## DIAGNOSING THE PROBLEM

### The Inward Investment Zeitgeist

Following the decline of Wales' heavy industry, the policy zeitgeist shifted towards replacement of the lost economic activity by attracting inward investment. This has been largely consistent and is still a key focus of current economic policy. For instance, in 1997 the Welsh Development Agency pronounced:

*“Attracting over £7 billion of investment through Investors in Wales, the WDA’s inward investment success comprises many of the world’s leading companies including the recently secured, largest inward investment project ever undertaken – the LG investment of £1.7 billion.”*

WDA Website – April 1997<sup>3</sup>

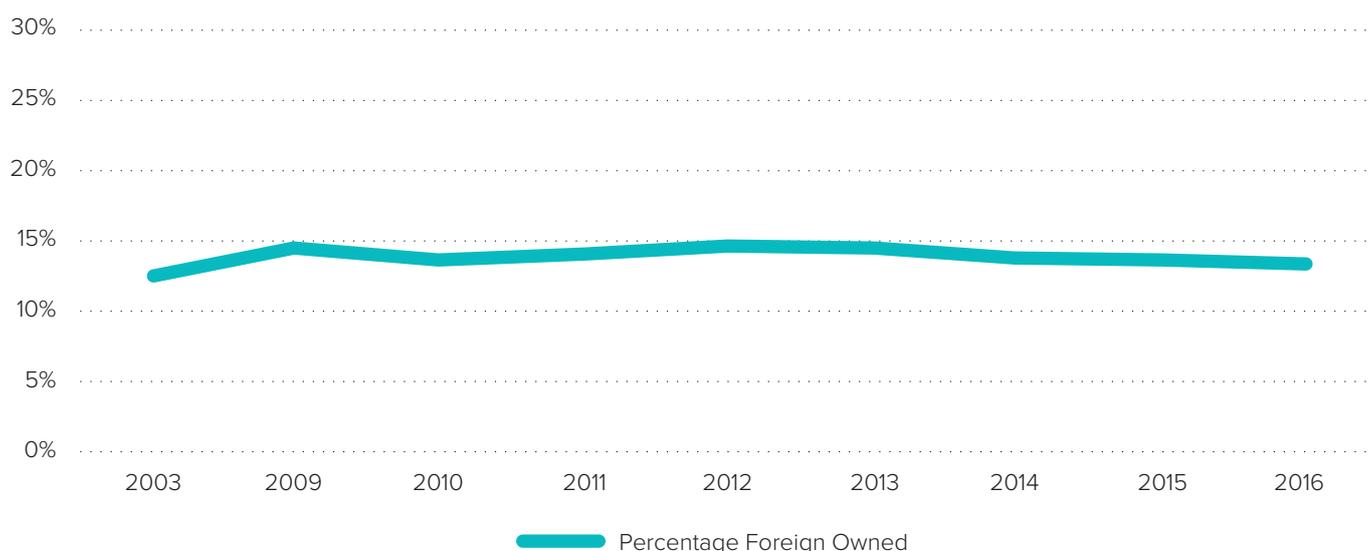
By 2016, very similar policy priorities and the perceived benefits were being espoused as Cabinet Secretary for the Economy Ken Skates notes:

*“Project numbers are the second best on record, beaten only by the previous year’s exceptional results. We are attracting new investment from high quality companies like Aston Martin and re-investment from global businesses like General Dynamics and Raytheon that are creating a substantial number of new, highly skilled, well paid jobs and career opportunities.”*

Ken Skates, Cabinet Secretary for Economy and Infrastructure – June 2016<sup>4</sup>

However, the value of this policy in terms of leveraging additional economic activity is questionable. For instance, if we take employment by foreign-owned companies in Wales (those that are the target of foreign direct investment schemes) they have accounted for a largely flat or even slightly decreasing proportion of Welsh employment (see graph 2).

Graph 2: Employment<sup>5</sup>



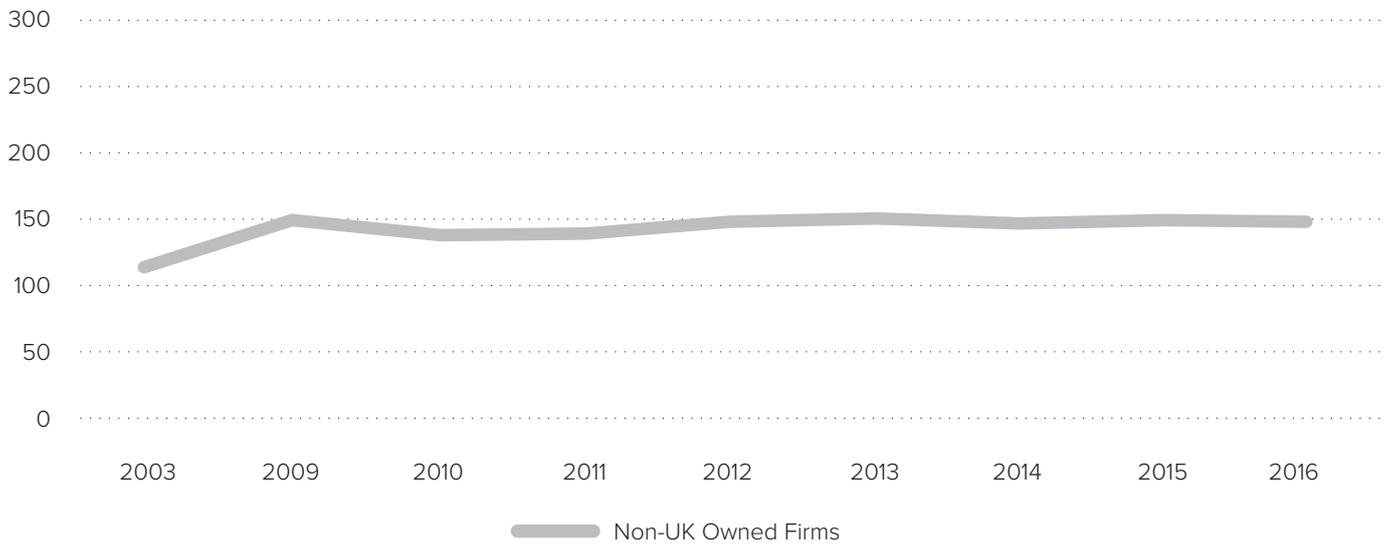
<sup>3</sup> WDA. 1997. *Investing in Wales* [Online]. Available at: <http://web.archive.org/web/19970413155726/http://www.wda.co.uk/investng/index.htm> (accessed 23rd August 2017).

<sup>4</sup> Welsh Government. 2016. *Inward Investment in Wales continues at record levels* [Online]. Available at: <http://gov.wales/newsroom/businessandconomy/2016/160613-inward-investment/?lang=en> (accessed 23rd August 2017).

<sup>5</sup> Statistics for Wales. 2016. *Size Analysis of Welsh Business 2016* [Online]. Available at: <http://gov.wales/docs/statistics/2016/161129-size-analysis-welsh-business-2016-en.pdf> (accessed 23rd August 2017)

This is also true in terms of raw numbers of jobs, with employment in foreign owned companies in Wales remaining flat since 2003 and creating limited additional jobs.

Graph 3: Employment<sup>6</sup>



This is not to discredit the need for foreign direct investment (FDI). However, much of the effort that has gone in to attracting FDI has been about replacing activity of fleet-of-foot capital moving in to Wales (often with government support) before leaving when more attractive government-financed offers become available elsewhere in the world. This approach leaves very little room for genuine economic development as the Welsh Government spends a high amount of energy running to stand still.

Instead, the question should become one about how we maximise the benefit from inward investment to drive domestic economic growth through the generation of sustainable middle-sized firms. This requires an approach aimed at embedding as much as generating foreign direct investment.

Indeed, research carried out by FSB and the Centre for Local Economic Strategies on public procurement suggested that money spent with smaller local firms generated a multiplier of 63p for every pound spend, whilst larger firms returned only 40p per pound to the local economy. With this in mind, increasing the position of local firms in the supply chain of Wales' existing foreign owned companies could produce significant economic benefit and help develop the missing middle.<sup>7</sup>

**Welsh Government economic policy has relied too heavily on attracting foreign direct investment, which has limited evidence of impact in terms of the development of the Welsh economy.**

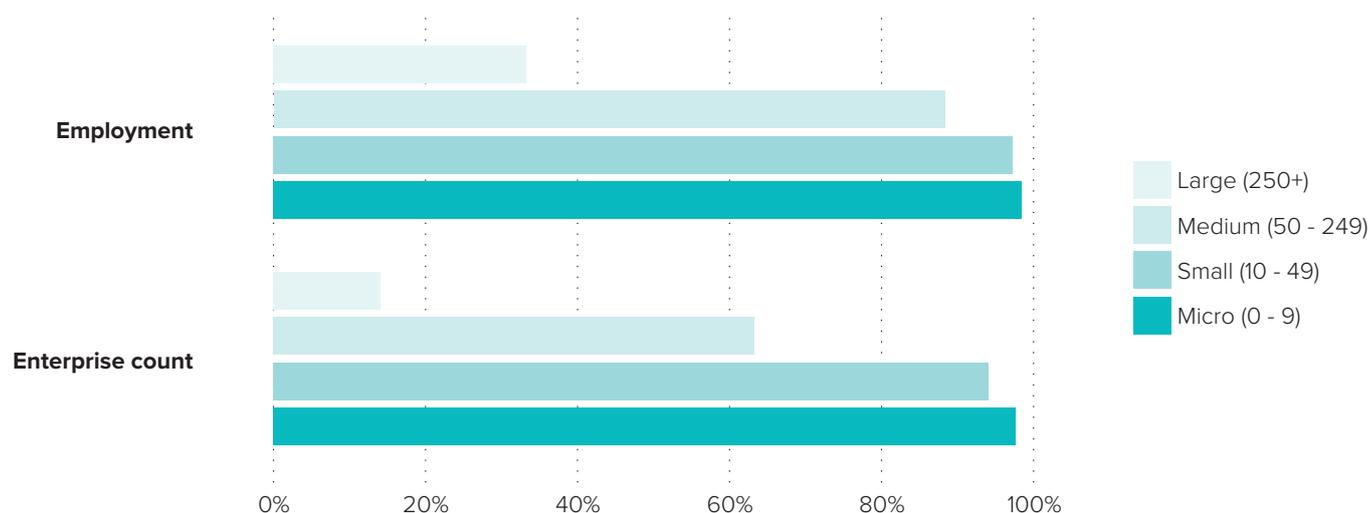
When we turn to the breakdown of Welsh-headquartered businesses by firm size it is clear to see that those businesses in the large category are usually non-Welsh headquartered. There is limited data in this area,

<sup>6</sup> Statistics for Wales. 2016. *Size Analysis of Welsh Business 2016* [Online]. Available at: <http://gov.wales/docs/statistics/2016/161129-size-analysis-welsh-business-2016-en.pdf> (accessed 23rd August 2017)

<sup>7</sup> FSB. 2013. *Local Procurement: Making the most of small business one year on* [Online]. Available at: <http://www.fsb.org.uk/docs/default-source/fsb-org-uk/policy/assets/local-procurement-2013.pdf?Status=Master&sfvrsn=1> (accessed 23rd August 2017).

with the latest figures available from 2006 (by now 11 years old) for number and percentage of firms with Welsh headquarters showing a meagre 14 per cent of large firms are indigenous. This suggests that the vast majority of large businesses in Wales are a smaller part of a larger entity with decision making around research and development, and investment often being carried out elsewhere and significantly a large proportion of economic value leaving the country.

Graph 4: Welsh Headquartered 2006<sup>8</sup>



A notable feature here is that those large firms that are Welsh-headquartered have a disproportionate impact on employment in the large firm category. So from the 14 per cent of Welsh-headquartered firms Wales derived 33 per cent of large firm employment. This is also true of medium-sized firms, with 63 per cent being Wales headquartered providing 88 per cent of medium firm employment.

From this we can conclude that domestically-grown medium and large firms have a more significant impact on employment than activity resulting from FDI. We can also conclude that employment opportunities driven by FDI have limited additional impact and that those firms tend to be part of a larger global operation with decision making largely taken outside of Wales.

This suggests that the inward investment *zeitgeist*, though motivated by reasonable assumptions, is not enough to secure economic development for Wales. It also highlights the vulnerability of Wales' economy in that a large proportion of our economic activity is subject to decisions taken elsewhere. This is particularly pertinent in a period of economic uncertainty such as after the economic crisis or during the current negotiations around the UK's exit from the European Union.

**There is a paucity of statistics available on Welsh-headquartered firms. What evidence is available suggests large-size firms in Wales are overwhelmingly headquartered elsewhere in the world, meaning Welsh operations are on the periphery when it comes to investment and research decisions.**

<sup>8</sup> Stats Wales. 2006. *Welsh headquartered enterprises by size-band and variable* [Online]. Available at: <https://statswales.gov.wales/Catalogue/Business-Economy-and-Labour-Market/Businesses/Business-Structure/Technical-2006-Data/Businesses-with-Welsh-Headquarters/WelshHeadquarteredEnterprises-by-SizeBand-Variable> (accessed 23rd August 2017).

## DEVELOPING THE GROWTH CYCLE

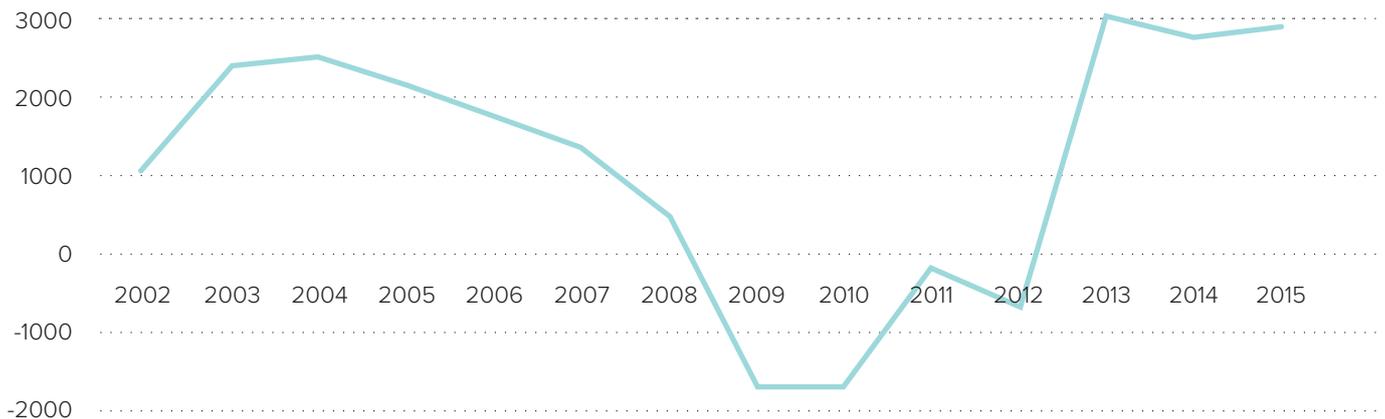
If the answer to our economic development question lies in the development of more medium-sized businesses, the question follows – where are these businesses going to come from?

### An entrepreneurial nation

There can be no doubt that Wales is an entrepreneurial nation. Between 2003 and 2016 around 80,000 businesses have been created, the vast majority of which were micro-businesses, trading in areas across Wales and in every sector of the economy.<sup>9</sup> These businesses account for a steadily growing proportion of employment with growth in jobs of over 36 per cent between 2003 and 2016, creating around 104,000 jobs over the period.<sup>10</sup>

Indeed, looking at start-up rates in Wales (see graph 5 and 6), it is clear that Wales' micro-business sector has recovered from the great recession, adding consistently to the number of active enterprises in Wales (based on the number of PAYE registered entities).

Graph 5: Net Firm Creation<sup>11</sup>



### Wales has developed a thriving micro-business scene with policy succeeding in the generation of new businesses and with it economic activity in Wales.

Welsh Government's support policies undoubtedly play a role in this. For instance, Business Wales provides a number of support services including start-up advice and support, tendering support and business planning.<sup>12</sup> This provides a solid stock of firms from which to grow small and medium-sized businesses, however the evidence around progression and survival is less clear.

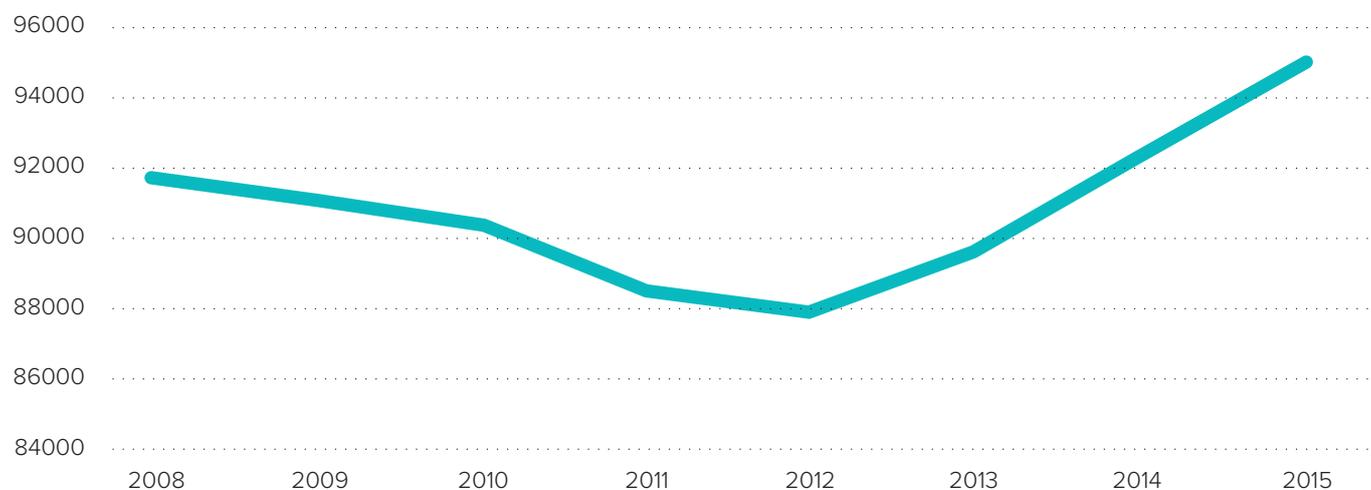
9 Statistics for Wales. 2016. Size Analysis of Welsh Business 2016 [Online]. Available at: <http://gov.wales/docs/statistics/2016/161129-size-analysis-welsh-business-2016-en.pdf> (accessed 23rd August 2017)

10 IBID

11 Stats Wales. 2017. Business births, deaths and active enterprises in Wales by industry (SIC 2007), variable and year [Online]. Available at: <https://stats.wales.gov.wales/Catalogue/Business-Economy-and-Labour-Market/Businesses/Business-Demography/businessbirthsdeathsactiveenterprisesinwales-by-industry-variable-year> (accessed 23rd August 2017).

12 Business Wales. 2017. Business Wales [Online]. Available at: <https://businesswales.gov.wales/business-wales> (accessed 23rd August 2017).

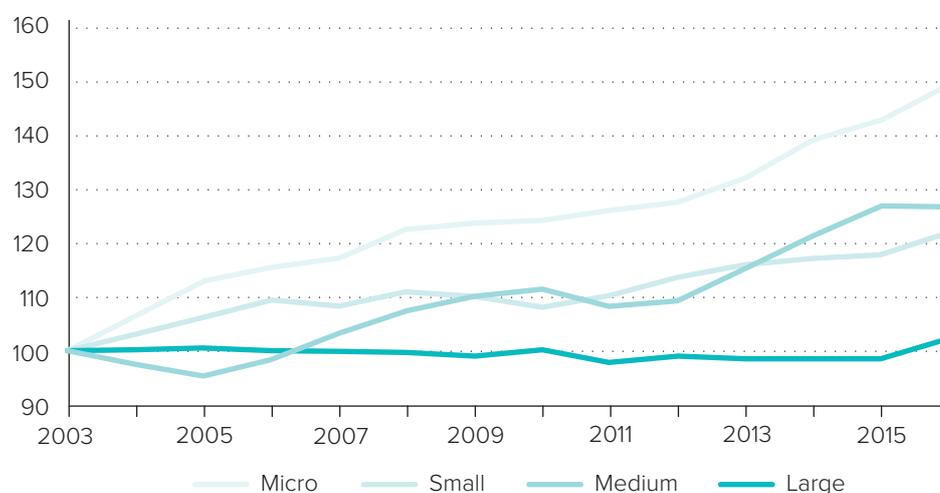
Graph 6: Active Enterprises<sup>13</sup>



Indeed, business survival rates in Wales appear to be below their pre-recession average suggesting a higher churn in businesses. For instance, the 1 year survival rate between 2002 and 2007 averaged 94.5 per cent, whereas between 2008 and 2014 it was 91.3 per cent. Furthermore, the three year survival rate averaged 64.2 per cent between 2002 and 2007 and 58.9 per cent between 2008 and 2012. This suggests that many of these firms are not able to survive and grow beyond the micro-business stage. Whilst this isn't necessarily a negative (allowing firms that aren't competitive to exit the market is sometimes reflective of a healthy economy) it does suggest there are difficulties in terms of the pipeline of firms that can grow to be medium-sized companies and these distinctive difficulties preventing growth need to be understood.<sup>14</sup>

The broader picture around micro-firm dynamism is further borne out by the Welsh Government's business size statistics. While micro businesses grew significantly in terms of their number, employment footprint and turnover, the rate of growth for small and medium-sized firms was much slower (with large firms being significantly behind).

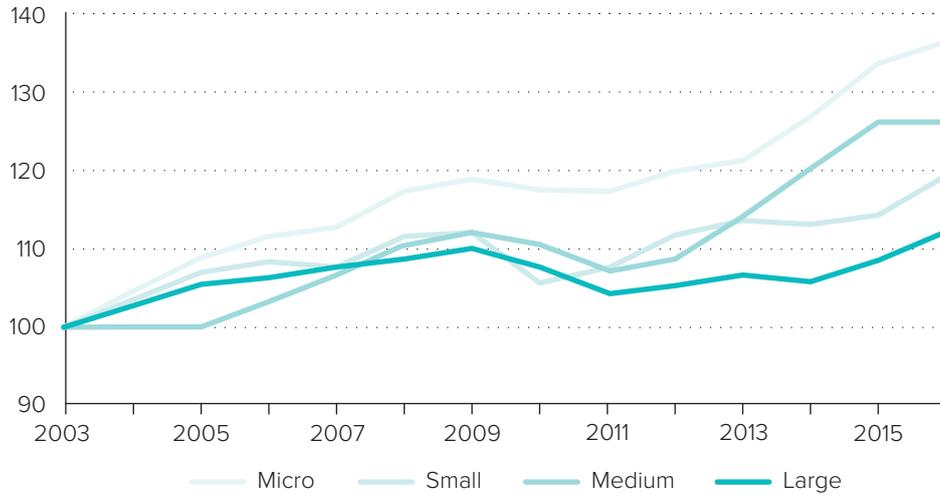
Graph 7 – Number of enterprises active in Wales by employee size band, 2003-2016 (2003=100).



<sup>13</sup> Stats Wales. 2016. *Active Business Enterprises by area and year* [online]. Available at: <https://statswales.gov.wales/Catalogue/Business-Economy-and-Labour-Market/Businesses/Business-Demography/activebusinessenterprises-by-area-year> (accessed 23rd August 2017).

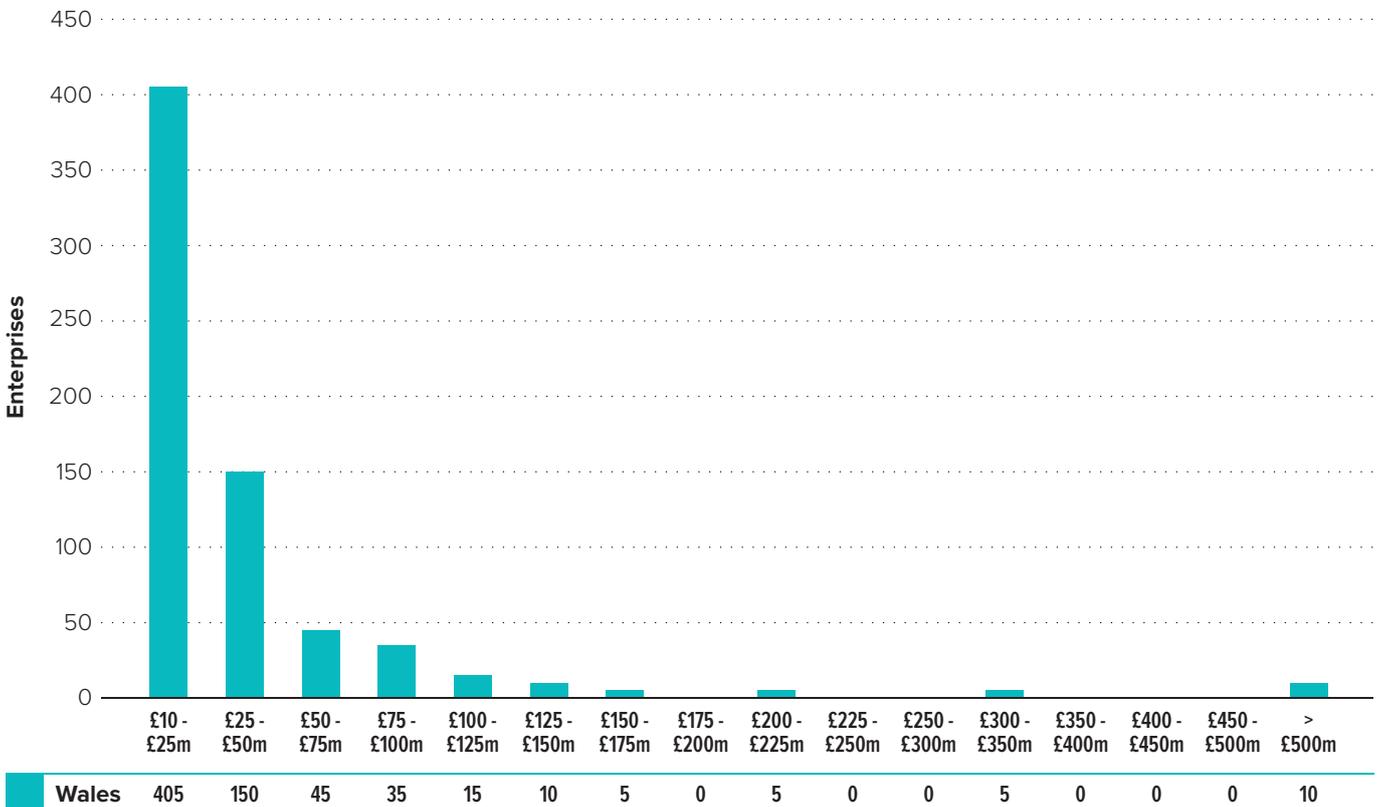
<sup>14</sup> Stats Wales. 2017. *Business Survival Rates in Wales by survival year and birth year* [Online]. Available at: <https://statswales.gov.wales/Catalogue/Business-Economy-and-Labour-Market/Businesses/Business-Demography/businesssurvivalratesinwales-by-survivalyear-birthyear> (accessed 23rd August 2017).

Graph 8 – Employment in enterprises active in Wales by employee size-band, 2003-2016 (2003=100)



Data gathered by the UK Government’s former Department of Business, Innovation and Skills in 2014 through a work-stream on medium-sized businesses paints a better picture in terms of the numbers of businesses there are in the pipeline in Wales. Graph 9 shows the number of enterprises in Wales by turnover-band. What’s clear is there is a significant number of firms at the lower end of the turnover scale, however once we get above a turnover of £125m the figure drops off significantly. There is a notable absence of firms in Wales with a turnover of between £200m and £500m, before reaching a total of 10 firms earning more than £500m in turnover.

Graph 9: Enterprise numbers by turnover band<sup>15</sup>



<sup>15</sup> Department for Business, Innovation and Skills. 2012 *Collection: Mid-sized businesses* [Online]. Available at: <https://www.gov.uk/government/collections/mid-sized-businesses> (accessed 23rd August 2017).

Combining the strong start-up and micro business base in Wales, with the weaker business survival rates post-recession, a picture emerges of the need to support businesses transition from their early phase of growth towards becoming sustainable medium-sized businesses. This is going to be key to Welsh Government policy going forward if we are to fill the missing middle and develop a strong, Wales headquartered strata of companies that are globally facing and rooted to their communities.

## **Despite the strength in the micro-business sector in Wales, too few firms survive to become small or medium sized businesses capable of filling the missing middle.**

### **Preventing Exit**

At the other end of the spectrum, Wales' existing stock of medium-sized firms often find themselves in a position of choice. As Bo Burlingham's book *Small Giants* sagely notes "*If the business survives, you will sooner or later have a choice about how far and how fast to grow*".<sup>16</sup>

Whilst Burlingham was referring to a number of firms in the USA his comments are just as aptly applied to Wales. Medium-sized firms that are successful often have pressures to change their ownership model. This includes becoming a publicly-listed company (and accepting the notion of shareholder value), looking for angel investors or even selling the business in its entirety to a larger entity. All of these options have profound implications for Wales' missing middle with the key question being; will the next owner represent a safe pair of hands?

In our recent research collaboration with the University of Manchester's Centre for Research on Socio-Cultural Change (CRESC) a number of these examples were highlighted in the Welsh context. For instance, Avana Bakeries a business founded in Aberafan in 1890 provides a useful example.

The company experienced steady growth through much of its early years before moving to its current site in Rogerstone, near Newport. In 1987 the company was purchased by Rank Hovis McDougall which signalled the first in a series of acquisitions by other companies. This accelerated in 2007 when Premier Foods acquired the Rank Hovis Group. At this point, a large portion of Avana's work become focused around a small number of large contracts as part of a wider group. The company was then sold to the 2 Sisters Food Group and came under financial difficulty. It was again sold to Food Utopia in 2014 and recently has been earmarked for closure as a loss-making entity.

This case study illustrates a number of things. Firstly, that there was a natural moment of choice where the owner decided to sell to a bigger group or company. The reasons for this are unclear, however it does highlight the choice many business owners face around growth and lifestyle aspirations. Secondly, a string of owners resulted in decision making about the bakery shift away from its own locality and made it a branch operation of a larger whole, changing its growth profile and ambitions. Finally, a reliance on a small number of significant contracts as part of a larger group company undermined the sustainability of the operation.

<sup>16</sup> Burlingham, Bo. 2005. *Small Giants: Companies that choose to be great instead of big*. Penguin; London. P.5

It is worth pointing out here that this example is not always how this process plays out and there are many firms that have succeeded as part of wider multi-national investment. However, if we are to grow the missing middle in Wales, it will be necessary to incentivise owners to continue their local ownership to ensure their growth aspirations are to the benefit of economic development in Wales.

By doing this, Wales will create a diverse domestic *stock of medium-sized firms* pursuing their own sustainable growth aspirations. This will ensure the Welsh economy is able to capitalise on global trends rather than be adversely affected by them.

**Often Wales' existing medium-sized firms face a choice around whether to sell their business to larger multi-national entities or to pursue sustainable domestic growth. This leads to an uncertain future for many of Wales' growing firms.**

## WALES' MISSING MIDDLE OR THE MISSING MIDDLE OF WALES?

While it is useful to look at Wales' economy as a whole, this only tells us part of the story about the missing middle. Indeed, while we have spoken so far about a missing middle in terms of firm size, we could equally talk about the missing middle of Wales. The emerging narrative around regional economic development in Wales based on the three proposed city deals has highlighted the spatial variations of regional economic development.

As table 1 demonstrates, the economic outlook of each region varies significantly. For instance, employment with medium sized firms is less than 10 per cent in mid Wales, whilst medium sized firm turnover is larger as a percentage of total turnover in North Wales than it is in the Swansea Bay City Region, despite having similar economic profiles.

Table 1<sup>17</sup>

Region	Population	GVA (£million)	GVA Per Capita	Active Enterprises	Number of medium sized firms	% of employment with medium sized firms	% of turnover with medium sized firms
Mid Wales	207,284	£3,509	£16,972	29,805	175	9.9%	12.8%
North Wales	694,473	£12,822	£18,462	63,065	515	12.1%	16.4%
Swansea Bay City Region	691,961	£11,415	£17,004	55,260	500	12.1%	7.8%
Cardiff Capital Region	1,505,368	£28,043	£18,532	108,045	1215	12.6%	13.3%

Perhaps the most notable figure from table 1 is the sheer number of medium sized firms. It's clear that bulk of such firms are in the Cardiff Capital region (1215) with equal proportions then in North Wales (515) and the Swansea Bay City Region (500). Mid Wales has only 175 medium sized firms, meaning for a significant portion of Wales' geography there is very little in terms of economic activity in this category.

However, it is often forgotten that the variation within these regions is almost as significant as the variation between them. For instance, the largely rural economy of Bangor contrasts hugely with the industrial base at Deeside. Likewise, post-industrial Treorchy bears little resemblance to Cardiff's financial and professional services enterprise zone.

It is therefore crucial that these emerging regional bodies grasp the nettle of spatial economic development, recognising the differing needs of their internal economies.

**The emerging economic regions need to focus on the spatial impact of their policies on their internal economies. City regions must be relevant to medium sized firms in all regions of Wales.**

<sup>17</sup> Stats Wales

## SMALL GIANTS

In order to better understand the journey to becoming a medium sized business in Wales and the challenges these firms face, FSB Wales interviewed 10 of its members across a range of business sectors and geography which were either in the medium size category or relatively short term aspirations to be so. All case studies have been anonymised. These small giants had varied concerns and operated in a number of sectors and markets. However, a number of key themes emerged from the case studies.

### Ambition

One thing that all firms highlighted was their ambition for the future. This manifested itself in a number of different ways. For instance, for a construction firm in South West Wales growing the company to a turnover of around £25m was the clear ambition. Likewise a training and skills provider in the South Wales Valleys had similar financial motivations with a target of £10m turnover in the near term. This emphasis on growth was common across all firms if not explicitly articulated but was often (though not always) gauged in 'sustainable' rather than 'rapid' growth terms.

For others firms interviewed, such as a childcare provider in South East Wales, ambition was more about the quality of the offering and the educational ethos of the business. The construction company referred to above also had a clear focus on quality as well as quantity of work, and wanted to be market leaders in more niche elements of construction activity such as conservation and heritage projects.

Finally, a third set of firms had their ambitions on less tangible but more socially focused outcomes. For instance, a craft brewer interviewed in South East Wales had the ambition to retain the sense of fun and innovation that led them to start the business whilst a waste management company in North West Wales had very strong environmental ambitions, with hopes of becoming a market leader in this respect.

These case studies show that all the firms interviewed had ambition in common, particularly the ambition to grow sustainably. It also shows that wider social impacts of the businesses in question often go hand in hand with this growth.

### Place/community

Another core theme that emerged in nearly every interview was the role of their local community. Every business we spoke to saw the success of their local community as being fundamental to the success of their business, whether that be through the young people they were able to attract into their industry or through economic conditions more generally. For instance, a building firm in Mid Wales interviewed was set up and anchored in Newtown with a clear aim to provide jobs locally. Likewise, the brewery in South East Wales was explicit in its aim of retaining its headquarters and centre of activity in its local area, despite significant growth opportunities elsewhere.

Community and place can also have a negative impact. For instance, a cosmetics manufacturing firm we spoke to in the Heads of the Valleys area felt that a shift towards opencast coalmining in the area could potentially undermine the aesthetic of its area which in turn would undermine the appeal of their business. This had tipped the balance away from investment in that particular community.

Place, and more specifically communities, matter to medium sized businesses. They are invested in the areas they represent and see their vitality as going hand in hand with the vitality of their communities, in an almost symbiotic relationship.

## Welsh Government Business Support

Experiences of business support and the perceived importance of government in our medium sized firms' success was mixed. For some, such as a waste management company in North West Wales, government finance through organisations such as Finance Wales had provided a lifeline in enabling investment to proceed. Likewise, a building firm in Mid Wales we interviewed felt that government support had been significant particularly around leadership and management in the early and growth stages of the business.

On the other hand, a number of the firms we spoke to saw business support as irrelevant to their business or had poor experiences. For instance a cosmetic manufacturing firm in the Heads of the Valleys felt that the focus of Finance Wales support was on equity investment rather than on patient capital that could be invested in machinery. They felt an SME Development Fund with affordable finance over long terms would be more beneficial.

A number of the firms interviewed also felt that businesses like theirs were not the subject of economic development policies. Indeed, they felt there had been too much focus on inward investment rather than showing an interest in growing domestic firms.

## Recruiting talent

For a number of the interviewees the importance of talented staff to the success of the business came through strongly. For instance, a construction company in South West Wales had deliberately made their company a difficult place to get a job by requiring high, professional standards and skill levels and ensuring good compensation in return. In this case, staff loyalty was high and turnover low.

For a childcare provider in South East Wales, routes into the business were important with apprenticeships being a particular strength. For this company regular engagement with schools to highlight the attractiveness of the sector (as well as challenging issues such as gender stereotyping) were seen as a wider part of their social obligations as a business. Indeed, this company runs a campaign to encourage young men to enter the childcare sector feeding in to a wider ambition to increase the future sustainability of the sector.

Two of the businesses interviewed also had novel ways of engaging staff. For a building firm in Mid Wales, staff were able to take part in an employee ownership project, giving part of the business over to employees thereby increasing their ownership of their roles and the destiny of the company. For the craft brewery in South East Wales, this took the form of new products (i.e. beer branding and names) being suggested by staff. Both secure loyalty and staff retention in return.

Also common to many of the businesses was the desire to aid progression of their staff with a number highlighting instances where staff had started at entry level but had over time become senior managers or directors in their companies.

## Innovating

There was a significant degree of innovation in almost all the firms examined, although in very different forms. For instance two firms (the waste management firm in North West Wales and the childcare provider in South East Wales) had developed new processes that impact on their business model in response to regulatory changes.

In a more a traditional sense, another three of the firms interviewed were engaged in product innovation. For instance, a retailer of sports products had recently launched its own brand of clothing aimed at balancing quality and durability with family finances while the brewery we interviewed was constantly innovating in terms of taste and quality of their products.

Finally, the cosmetic manufacturing firm we interviewed undertook more traditional research and development-type activities with investment in new product lines taken a more structured approach.

In all senses these firms were seeking to bring something new to the sector in which they worked and often this reflected the type of business they wanted to run.

## Ownership and personality

The final theme that emerged from the interviews was around the personality of the owners themselves. This took a number of forms. Firstly, a large number of those interviewed saw their business as a wider extension of their family with many emphasising the 'family' feel to the business and how maintaining this close relationship between owners and staff was intrinsic to their business success.

The second theme that emerged around ownership was the limitations of the business owner in taking forward the company. For instance, both the training firm in South East Wales and the building firm in Mid Wales had owners that were aware of their own limitations and either embarking on leadership and management training to help ameliorate their weaknesses or bringing in new staff with strengths to complement their own. One firm in particular felt that having better networked business owners (irrespective of sector) was important for personal development and this appears to be a theme consistent with the German concept of *Mittelstand*.

Finally, a significant number of firms spoke about succession or business exit in some way. For the sports retailer we spoke to, this was an immediate concern and a reluctance to sell the business (and lose the family ethos and local feel) was being balanced with a desire to plan for retirement. Furthermore, the childcare provider we spoke to had dealt with a succession planning issue as one partner left the business by using significant Business Wales leadership and management support. Finally, the bakery firm we spoke to in North East Wales had experienced a generational change as older members of the family business retired. For them, this had brought challenges in terms of changes in processes but also opportunities through different ways of thinking about the business.

## A NEW ECONOMIC DEVELOPMENT AGENDA

Combining the evidence around Welsh Government's existing approach to economic development with the experiences of many of Wales' smaller and medium-sized firms we can begin to build a picture of a new agenda for economic development policy. Fundamental to this approach must be an acceptance that all policy interventions are inherently spatial and therefore areas of priority need to vary depending on the economies of place under consideration across the nation.

For instance, the Cardiff Capital City Deal's investment in the recent compound semi-conductor centre (and the associated catapult) is a positive move in economic development terms. However it is one based on the knowledge economy and will therefore focus on parts of Wales where universities and sector clusters can interact (in this case along the M4 corridor)<sup>18</sup>. By comparison, investment in the development of manufacturing firms is more likely to have an impact in areas that have historically strong manufacturing presence (such as the Valleys or Deeside) whereas economic development focus on the foundational economy can impact on a wide spectrum of communities across Wales.

The key point to recognise here is these spatial impacts and to develop a range of economic development policies that can relate to all parts of Wales.

- **Building on our assets** – Welsh Government's new economic development policy should focus on building on our assets and finding the missing middle. This may mean a shift in emphasis from inward investment at all costs towards the growth of domestic firms and their supply chains.
- **Economies of place** – All economic development policies have a spatial impact. A new economic strategy would recognise the spatial impact of decisions and seek to build a range of economic development policies that are relevant to different the economies of different places.

### Business Support and the value chain

As the earlier section of this report demonstrates, the Welsh Government has been successful in creating a thriving micro-business scene with the numbers of firms starting up growing significantly over previous decades. Business support through organisations such as Business Wales have undoubtedly played a role in this. Moving forward, Welsh Government needs to increase its efforts to ensure those firms that start out as micro-businesses are able to develop through to small and ultimately medium-sized businesses if we are to find the missing middle. In its new economic development strategy, the Welsh Government should consider the following:

- **Breaking down the barriers to steady growth** – The Welsh Government should commission further research into the barriers for steady, sustainable growth for micro and small companies. This should be an early priority for the recently-announced Intelligence Unit of the Development Bank for Wales. This work would inform the creation of the Development Bank of Wales and help to refine Business Wales offer with a view to targeting those companies that can achieve sustainable growth.

<sup>18</sup> Cardiff Capital Region City Deal. 2017. *Cardiff Capital Region City Deal Leaders Agree to Invest £379 Million in Compound Semiconductor Cluster in South-East Wales* [Online]. Available at: <http://www.cardiffcapitalregioncitydeal.wales/city-deal-agree-investment-semiconductor-cluster.html> (accessed 11th August 2017).

- **Mapping our assets** – It's clear from the analysis above that there is insufficient data on ownership of businesses in Wales and the assets they possess. Welsh Government needs to replicate its 2006 business demography exercise on an annual basis so we know how many firms are headquartered in Wales, by size and sector. Over time, this should help us to map the growth trajectories of indigenous small firms to help them on their path towards filling the missing middle.
- **Targeting supply chains** – A significant proportion of production in Wales forms part of larger UK, EU or global supply chains. Welsh Government has two main levers in this respect; its own procurement spend and its influence with large foreign companies already in Wales, particularly those in the foundational economy or indeed those classed as 'anchor companies'. With a deeper analysis of supplier voids, business support could target companies in existing supply chains with a view to moving them further up the value chain. This would mean helping them to develop new products and services in what may be niche markets.
- **Debt finance** – As we have highlighted above, Welsh ownership of firms decreases as the size of firms increase. This is often caused by issues in obtaining finance. Indeed existing funding mechanisms present in Wales have in some senses exacerbated this situation. For instance, equity investment from Finance Wales whilst undoubtedly welcome has caused a situation where Finance Wales exit often means investment from external investors and therefore a reduction in local control. In the feasibility study for the Development Bank of Wales it was suggested that an expansion and growth capital debt fund be created. This would help transition the equity held by Finance Wales into debt whilst furnishing additional finance for stable growth.<sup>19</sup> The study notes that these companies are likely to be those with intellectual property fitting with the missing middle archetype.
- **Preventing early exit** – There are other reasons for ownership churn. The *What Wales Could Be* report commissioned by FSB Wales highlighted the diversification of family assets and succession planning as key issues as well as financing growth. The new Development Bank for Wales should consider how it can help with financial pressures at these business stages. Potential answers could include wider financing of Management Buyouts (MBO) or even using other forms such as Employee Ownership Trusts. Importantly, these methods free up finance for investment without significant amounts of control of the company being lost in the process.
- **A trade and investment strategy for Wales** – Many of the middle-sized firms identified in this report are locally-anchored but globally-facing. Exporting their products and intellectual property is therefore key to sustainable growth. Welsh Government has increased its support for export through overseas offices and trade missions but this lacks strategic direction. The creation of a trade and investment strategy would allow Welsh Government to articulate its vision in this area and provide a clear picture to firms with exporting aspirations of the support available to them. A trade and investment strategy could further inform a position as to whether a specific body or vehicle is required to take this approach forward, and champion a newly-articulated Wales 'brand'

<sup>19</sup> Prof Dylan Jones-Evans. 2015. *A Feasibility Study into the Creation of a Development Bank for Wales* [Online]. Available at: <http://www.senedd.assembly.wales/documents/s38941/EBC4-10-15%20p.2%20A%20feasibility%20study%20into%20the%20creation%20of%20a%20Development%20Bank%20for%20Wales.pdf> (accessed 23rd August 2017). P60.

## Building the infrastructure to succeed

Wales finds itself on the geographical periphery of an island on the edge of Europe. The largest markets for our products and services in terms of proximity are the rest of the UK, Europe and then the wider world. How our firms get their products to market is therefore crucial and Welsh Government has a key facilitating role to play in creating in enabling this to happen. By dint of the devolution settlement, the focus has traditionally been on routes via road. However, there is a growing appreciation that infrastructure means something much wider. Indeed, with many products and services being sold online digital infrastructure is becoming just as important as physical infrastructure. Welsh Government's economic development strategy should examine the following:

- **A thirty year vision for infrastructure** – The proposed National Infrastructure Commission for Wales should be a well-resourced, independent body. Its first action should be to undertake a comprehensive review of infrastructure in Wales including roads, rail, energy and digital infrastructure. This should provide an assessment over future needs over the next 30 years and should then be used to inform infrastructure investment decisions.
- **Investing in routes to market** – There has been significant investment in Wales' infrastructure from Welsh Government over previous years. For instance, £425m has been invested in superfast broadband through Superfast Cymru leading to a transformation in broadband availability in Wales. However, many areas still lag behind with Wales attracting a meagre 1 per cent of UK rail investment funding over previous years.<sup>20</sup> Thought now needs to be given to how levels of investment in infrastructure can be increased drawing on Welsh Government's borrowing powers, limited exposure to debt and the expertise to be developed through the National Infrastructure Commission.
- **Exploiting Wales' infrastructure** – Building the necessary infrastructure is a vital part of facilitating the growth of medium-sized firms. However, the way infrastructure is used is just as important to allow firms to attain the productivity gains they need. For instance, Welsh Government Superfast Business Wales project is helping firms to exploit superfast broadband laid through Superfast Cymru. A similar approach needs to be taken with mobile infrastructure as well as physical infrastructure that is being delivered to ensure wherever possible Wales medium-sized firms can capitalise on new routes to markets.

<sup>20</sup> WalesOnline. 2017. *Control and funding of railway tracks in Wales will not be devolved, says UK Government* [Online]. Available at: <http://www.walesonline.co.uk/news/politics/uk-government-slams-door-shut-12821960> (accessed 23rd August 2017).

## Innovation

Many of the medium sized firms we spoke to were engaged in innovation, often in a variety of different ways. This included innovation around new processes, new products, innovative organisational models and accessing new markets. It was clear that innovation was essential to these firms in terms of their position in supply chains and in terms of future growth prospects. Whilst research and development-based innovation is important, there has historically been a lack of emphasis on social innovation and its role on improving the viability of businesses and this was evident in our case studies.

Welsh Government's policy in this area *Innovation Wales* details a number of issues in relation to Welsh innovation and says;

*"Levels of R&D in Wales are nowhere near as high as we would like, and we do not win a large enough share of available competitive funding. We have strengths in our academic base and there are many large global companies with a presence here, but business R&D is particularly low compared to other parts of the UK and well below that of other developed nations."*

To take this further, Welsh Government should:

- **Commit to an increased investment in innovation, research and development** – The recently published UK Government Industrial Strategy pledged to increase funding for research and development by 20 per cent, worth £4.7bn by 2021.<sup>21</sup> A significant proportion of this will be delivered by the Industrial Strategy Challenge Fund which is worth £1bn over four years and through a further £100m investment on building links between businesses and universities. While a number of aspects of this policy area are not devolved, Welsh Government should show similar ambition and seek to increase its Science and Innovation budget (which is currently £10.5m for the 2017/18 financial year) by at least 20 per cent by 2021.<sup>22</sup> The Reid Review of innovation funding should further examine how increased funding levels can lead to better levels of innovation between businesses in Wales and universities.
- **Deliver a National Innovation Body for Wales** – The Welsh Government's Innovation Advisory Panel has carried out research support by Nesta around a national innovation body for Wales.<sup>23</sup> Such a body would focus on building on existing networks and ensuring the impact of funding is maximised by drawing existing programmes together and facilitating their further development. FSB Wales believes Welsh Government should seriously consider this proposal and task such a body with increasing the levels of innovation and research and development in Wales undertaken between businesses and academics through Knowledge Transfer Partnerships. Such a body should also focus on other more granular types of innovations, moving beyond research and development funding alone.
- **Recognise businesses as social innovators** – As well as conventional knowledge-based innovations, many smaller firms make social innovations that have a significant impact. For instance, one of our companies interviewed suggested the influence of business mentors and peers had a positive impact on their business plan and innovations within it. Welsh Government needs to help

<sup>21</sup> UK Government. 2017. Building Our Industrial Strategy [Online]. Available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/611705/building-our-industrial-strategy-green-paper.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/611705/building-our-industrial-strategy-green-paper.pdf) (accessed 23rd August 2017).

<sup>22</sup> Welsh Government. 2016. Final Budget Main Expenditure Groups [Online]. Available at: <http://gov.wales/docs/caecd/publications/161220-action-en.pdf> (accessed 23rd August 2017).

<sup>23</sup> NESTA/Cardiff University. 2015. Options for a National Innovation Body for Wales. [Online]. Available at: [https://businesswales.gov.wales/expertisewales/sites/expertisewales/files/options\\_for\\_developing\\_a\\_nib\\_for\\_wales.pdf](https://businesswales.gov.wales/expertisewales/sites/expertisewales/files/options_for_developing_a_nib_for_wales.pdf) (accessed 23rd August 2017).

foster links between companies and can start by ensuring its mentoring schemes are well resourced and are seen as part of the wider business support landscape.

- **Link innovation with the Development Bank** – The proposed Development Bank of Wales should also have a clear role around the financing of innovation activities among Welsh firms. In particular, this should be focused on supporting firms to develop new products or to reposition in value chains by providing patient finance at reasonable rates over a long period.

## Labour/Skills

The ability to attract and retain skilled staff, particularly at medium to high skill levels, was a concern raised by a number of the firms we interviewed. Evidence gathered through FSB's BREXIT research series suggests changes in access to labour as a result of BREXIT will result in firms either absorbing the costs of immigration or refocusing their efforts to train and retain domestic staff.<sup>24</sup> We also know that Wales has a 'brain drain' problem with many of our brightest graduates leaving our country to work elsewhere, often never to return despite significant investment in their education by the Welsh Government.<sup>25</sup>

To ensure Wales can grow its medium-sized firms, the Welsh Government should:

- **Market Wales as a place to work for medium and high skilled individuals** – A number of sectors report difficulties in attracting medium and high skilled workers to Wales. For instance, the NHS has long had an issue around the recruitment of doctors to parts of Wales. To remedy this, Welsh Government introduced a marketing campaign to highlight the benefits of living and working in Wales to doctors. A similar scheme should be considered with a cross-sectoral reach highlighting why Wales is great place to work for medium and high skilled individuals, particularly those that have left Wales due to a perceived lack of economic opportunities. Consideration could also be given to a location fund.
- **Linking skills with growing firms** – Many of the firms we spoke to saw investment in education and skills as key to the success of their business. Evidence gathered by FSB in England suggests that there is a strong link between firms that are growing or are looking to grow and apprenticeship recruitment.<sup>26</sup> Drawing on this, support provided by Welsh Government could be targeted at those firms that are growing in order to position apprenticeships as a solution to training for growth businesses.
- **Recognising the value of vocational and academic education** – Businesses in different sectors often have vastly different recruitment needs. For instance, many businesses use apprenticeships as their prime recruitment mechanism while others tend to recruit graduates. Welsh Government's proposed new skills funding body, the Tertiary Education Commission, should be given a statutory responsibility to promote parity of esteem through its establishing legislation. This would ensure its evidence-based funding decisions take issues such as this into account when deciding on the balance between funding for higher education, further education and work-based learning.

<sup>24</sup> FSB. 2017. *A Skilful Exit: What small firms want from Brexit* [Online]. Available at: <https://www.fsb.org.uk/docs/default-source/fsb-org-uk/a-skilful-exit--what-small-firms-want-from-brexit.pdf?sfvrsn=0> (accessed 23rd August 2017).

<sup>25</sup> WISERD. 2011. *Welsh Graduate Migration* [Online].

Available at: <http://www.wiserd.ac.uk/research/education/completed-projects/welsh-graduate-migration/> (accessed 23rd August 2017).

<sup>26</sup> FSB. 2016. *Make or Break: Getting Apprenticeship Reform Right for Small Businesses*. P.34

## CONCLUSION

With the Welsh Government actively examining a new approach to economic development in Wales, it is important now more than ever that we refocus our approach towards the growth of a stock of medium sized Welsh businesses. This means making difficult decisions around the balance between a focus on inward investment and supporting domestic firms. However, the evidence shows that inward investment has yet to provide the game-changing impact many of its supporters advocate.

It is clear that growing this distinct cohort of businesses requires particular analysis and intervention not just by Welsh Government but education providers, funders and a range of other players. Effort is needed now to bring these together to define a particular approach to supporting those businesses already classed as medium-sized businesses but to inspire and support smaller firms to reach that size.

This report has hopefully shown that such a new approach is possible, one that seeks to anchor inward investment activity with the growth of Wales' smaller indigenous firms. It has also suggested key areas that need to be prioritised to allow this to happen, including focusing business support on supply and value chains, as well as ameliorating general economic conditions and seeking to incentivise domestic ownership of Welsh firms. By doing so, we believe Welsh Government can help make Wales a more economically vibrant place.



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