

SMALL BUSINESS FINANCE MARKETS

2014



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FOREWORD

KEITH MORGAN
CEO, BRITISH BUSINESS BANK

THE BRITISH BUSINESS BANK HAS BEEN ESTABLISHED TO UNLOCK FINANCE FOR SMALLER BUSINESSES

Helping smaller businesses access the finance they need to prosper and grow will make a vital contribution to the UK economy.

And understanding the current state of smaller business finance markets is an essential step towards establishing the strategic priorities for the British Business Bank and setting out where we should be operating.

I am therefore pleased to introduce “Small Business Finance Markets 2014”, the British Business Bank’s first comprehensive analysis of the state of the small business finance market. This report draws on newly commissioned data on SME finance markets, as well as a wide range of external analysis and data sources.

Our assessment confirms the importance of the British Business Bank delivering on its strategic objectives and building on the successes of the programmes it has inherited.

The report places small business finance markets in the context of the wider economic recovery and considers some of the structural

market failures affecting supply and demand in small business finance markets. Our analysis looks at how both debt and equity markets are meeting the demand for finance from smaller businesses, and three key themes arise:

- More smaller businesses will seek finance for growth
- A more diverse and vibrant supply of finance is needed
- Awareness and understanding of the range of finance options is not yet comprehensive enough

The detailed analysis contained in the report will be used to inform the development of the British Business Bank’s business plan for the coming year, helping us to identify how to best deploy our resources. I hope this report also provides a useful source of evidence and analysis on smaller business finance markets for a wider audience.

EXECUTIVE SUMMARY

The UK has enjoyed seven quarters of economic growth with forecasters suggesting this will continue, despite continuing global downside risks. This is reflected in the increasing and evolving appetite for finance among smaller businesses.

The importance of smaller businesses to this recovery is paramount, accounting as they do for almost half of turnover in the private sector and 60% of all employment. Increasingly, these companies expect to grow: our new 2014 SME Journey Survey found that 46% intend to grow turnover in the next year, suggesting there is optimism about future prospects.

The government established the British Business Bank to bring together a number of programmes that have played an important role in unlocking finance for smaller businesses. Our Strategic Plan, published in June 2014, provided information on all those programmes. The stock of lending and investment provided by British Business Bank programmes stood at £2.7bn as at end of September, with over 38,000 businesses supported.

But as the economy continues to recover the financing needs of smaller businesses will grow, and structural issues remain in the supply of finance, suggesting there is more to be done.

This report seeks to capture the current state of the changing market for small business finance and to highlight the environment in which the British Business Bank is operating.

More smaller businesses will seek finance for growth

As smaller businesses seek to grow, and investment begins to pick up, the demand for finance is likely to revive

External finance is important for funding business start-ups, investment and growth despite being used by a minority of businesses. With OBR forecasts showing investment growing at an average rate of 6.7% over the next four years, access to appropriate sources of external finance will be essential for start-ups, growth firms, and viable but underfunded businesses alike.

In the UK, smaller businesses account for a smaller share of total business investment (38%) than in other major European economies. But, evidence from our new SME Journey Survey suggests that demand for finance is likely to increase in the future.

Use of finance has been shifting from working capital to funding fixed assets

New evidence shows that the profile of demand for finance changed between 2012 and 2014. While 45% of businesses who sought finance two years ago did so to fund working capital, that figure fell to 33% this year. Now 43% of those seeking finance are looking to purchase fixed assets (up from 33%). The proportion seeking funding for expansion also increased to 11% from 6% in 2012.

For businesses with high growth potential, gaps remain in the supply of finance

Many smaller businesses seeking to grow will succeed, but many will not. For example, over 40% of new business close within three years of starting up. For some of those with the potential to succeed, traditional loans and overdrafts are not suitable for all their financing needs. This underlines the importance of continued diversification of the range of financial products used by smaller businesses, reflecting

the growth and risk profiles of individual businesses. These products are likely to be supplied by many providers including banks, other existing providers and new entrants.

Access to growth capital for high growth potential businesses matters. New private equity market data collated for the British Business Bank & BIS finds that visible equity investment in SMEs increased from £1bn in 2010, to £1.6bn in 2013 due to strong seed and growth activity, with more deals unreported. However the evidence suggests that the well-known equity gap persists, especially at the venture stage.

Private debt funds also fund growth but they generally aim to invest in lower risk companies than equity or venture funds. Nonetheless, they are still a source of support for growing businesses. There are a limited number of these funds investing in smaller businesses due to a number of structural market failures. Mezzanine finance may also help to fill the gaps between senior debt and pure equity finance for growing firms, but market gaps exist in this area.

The increase in investment has also been reflected in asset finance markets - with an estimated £13bn of gross flows of asset finance to SMEs in 2013. But specific market failures exist, as well as potential imperfect competition in funding markets, which may act to constrain supply.

A more diverse and vibrant supply of finance is needed

Traditional bank lending remains the predominant source of finance in the UK

The majority of businesses are able to access finance for their day-to-day needs without difficulty, but this disguises the fact that supply of finance to young and growing firms is constrained. This is due to structural information failures and lack of diversity of supply.

As shown on page 9, flows of bank lending are much larger than other forms of finance. The recession saw a tightening in credit conditions which disproportionately affected lending to smaller businesses. And while the decline in traditional loans and overdrafts to SMEs has slowed, any recovery is tentative.

A wider range of finance sources would offer more options to smaller businesses

Challenger banks have entered the market in recent years, but lending to SMEs is still concentrated. In addition, refinancing SME loans through capital market techniques, including securitisation, could play a role in increasing the supply of finance to SMEs in future.

New sources of finance which serve to improve diversity of supply exist and are growing, but from a low base

Online technology has enabled the emergence of Fintech companies, an example being Online Platforms (e.g. peer-to-peer lending and crowdfunding platforms), with lenders and investors able to meet the finance demands of small businesses in innovative ways.

Business financing through those platforms has grown significantly, with recent research from Nesta-University of Cambridge indicating that gross financing will total around £1.7bn this year, a 161% increase from 2013.

However it should be noted that this is exponential growth from a low base and the footprint of Online Platforms remains very small compared to more established forms of finance. Current volumes on these platforms are less than 2% of bank lending.

Despite their current small scale, these platforms also have the potential to diversify small business finance markets, by competing on non-price aspects.

Awareness and understanding of the range of finance options is not yet comprehensive enough

Awareness among smaller businesses of the full range of external finance options is limited

Most small businesses are not aware of the full range of external finance options. This varies significantly across different types of finance. 85% are aware of leasing or hire purchase, but the figures are much lower, although rising, for alternative funding sources, with 32% aware of crowdfunding and 35% aware of peer-to-peer lending.

Discouragement is still an issue for a significant number of smaller businesses

While businesses are beginning to view finance as less difficult to obtain (26% viewed it as very difficult in 2014 compared to 43% in 2012), there remains a gap between perceptions of the chances of obtaining finance and actual approval rates. The proportion of businesses discouraged from applying for finance remains significant and recent data from the SME finance monitor suggested the number of SMEs in this bracket could be as large as 160,000.

Furthermore, evidence suggests that smaller businesses fail to sufficiently shop around or plan ahead when seeking finance - potentially limiting their ability to obtain finance.

Conclusion

In summary, the market analysis presented in this report confirms the continued importance of the strategic objectives of the British Business Bank. The following table relates the main themes identified in the report to the objectives and key performance indicators of the Bank.

Report theme	British Business Bank Objective	KPI
More smaller businesses will seek finance for growth as the economy recovers. Demand will grow and gaps remain in the supply of finance	To increase the supply of finance available to smaller business in areas where markets do not work well	Up to £10bn stock of finance facilitated through our programmes over 5 years Clear demonstration that activities are focused on market imperfections
A more diverse and vibrant supply of finance is needed - offering more choice of suppliers and products to small businesses	To create a more diverse finance market for smaller businesses	Over 50% of finance facilitated through providers other than the 4 largest banks over 5 years Clear demonstration that a broad range of options and providers has been supported
Awareness and understanding of the range of finance options is patchy with some small businesses discouraged from applying	To help ensure better provision of information in the market connecting smaller businesses and finance providers	Evidence that information about finance options has improved

INTRODUCTION

The British Business Bank published its Strategic Plan in June 2014 setting out the programmes it inherited, and its plans for the future. As part of that Strategic Plan we committed to producing our view of the state of SME finance markets. This report delivers on that commitment, setting out the evidence on the importance of smaller businesses to the overall economy, and the ways in which finance markets support economic activity.

Our understanding of the functioning of SME finance markets, both in terms of smaller business demand and the finance providers' supply, is essential in shaping our business planning and the design of our programmes and products.

New evidence

To help inform our analysis we have commissioned new data on SME finance markets. In particular:

- The 2012 BIS SME Journey Survey was repeated in Autumn 2014 to give fresh insight into smaller businesses' experience in accessing finance
- The British Business Bank & BIS have commissioned the collation of new private equity market data which focuses on visible smaller business equity deals
- A series of interviews conducted for the British Business Bank by the University of Cambridge have helped improve our understanding of Online Platforms. These included discussions with the platforms themselves, smaller business users and investors. We have also drawn on British Business Bank discussions with a wide range of market participants in small business finance markets.

Structure of the report

Chapter 1 summarises the macroeconomic context and the important role which smaller businesses play within the economy. Recognising that cyclical demand for finance is likely to rise during the recovery, new evidence characterising the profile of demand for finance amongst smaller businesses is examined.

Chapter 2 presents an analysis of external finance types that are appropriate for growing firms. Some of the issues faced by business start-ups are discussed here, followed by a consideration of the role that equity markets, debt-funds and mezzanine finance, and asset finance play in supporting growing smaller businesses.

Chapter 3 looks at trends in bank lending and considers alternatives enabled by internet technology, which help to diversify the supply of finance.

Finally, chapter 4 examines firms' awareness of the finance options available to them, and how they tend to seek finance.

01 DEMAND – THE TRANSITION TO GROWTH FINANCE

Smaller businesses have an essential role to play in the economic recovery

The economic recovery is now well underway, despite continuing global downside risks; the UK economy has grown for the last seven consecutive quarters and is forecast to continue to do so.

The importance of smaller businesses to this recovery is paramount. These firms account for almost half of turnover in the private sector and 60% of all employment. They are expected to remain an important source of job creation and growth in the economy.

In addition nearly half (46%) of smaller business intend to grow over the next year suggesting there is optimism about future prospects.

As smaller businesses seek to grow, and investment begins to pick up, the demand for finance is likely to revive

External finance is important for funding business start-ups, investment and growth, despite only being used by a minority of businesses. With OBR forecasts showing investment growing at an average rate of 6.7% over the next four years, access to appropriate sources of external finance will be essential for start-ups, growth firms, and viable but underfunded businesses alike.

In the UK, smaller businesses account for a smaller share of total business investment (38%) than in other major European economies. However, evidence from our new SME Journey Survey suggests that demand for finance is likely to increase in the future.

Use of finance has been shifting from working capital to fixed assets

New evidence shows that the profile of demand for finance changed between 2012 and 2014, with a switch from funding working capital to financing fixed asset purchases. There is some evidence that funding for expansion may begin to grow.

'Core' banking products are the most commonly used sources of external finance by smaller businesses, but other types of finance are growing

Consistent and comprehensive data outlining the value of the aggregate stocks and flows of all forms of external finance to smaller businesses do not exist. However, the table below brings together the latest data from a range of sources on the volume and value of various types of finance provided to smaller businesses in recent years.

While not directly comparable, the data shows that bank lending remains the predominant form of external finance for smaller businesses. The stock of bank loans and overdrafts was estimated at £171bn at September 2014, and the gross flows of bank loans (new loans, excluding overdrafts) in the year to September 2014 were £38bn.

In contrast, new data commissioned by the British Business Bank shows that the value of new equity deals with known amounts was around £1.1bn in the first half of 2014. And, data from the Finance and Leasing Association shows that new asset finance business among its member banks and other providers was £13.1bn in 2013. The stock of invoice finance outstanding at end of June 2014 totalled £18.9bn, the majority of which was to smaller businesses.

The figure for invoice financing is not included in the table, as the share accounted for by smaller businesses is not precisely quantified. Similarly it was difficult to quantify the value of smaller business financing from debt funds, although this is an important source of finance.

The various gross flows of lending via Online Platforms remain small in comparison, although the value of these non-bank sources of finance has been increasing.

The table below does not cover all possible sources of external finance, but survey evidence supports the conclusions on relative usage. The SME Finance Monitor survey shows that across all SMEs, 'core' bank products, including loans, overdrafts and credit cards, are the most popular form of external finance (30% in the year to Q2 2014 compared with 17% for other forms of finance). However, over time, the proportion of SMEs using core products has fallen, while those using any other form of finance remains stable.

While there is no data available on the value of the stocks and flows of credit card lending to smaller businesses, survey evidence suggests that around 15% of smaller businesses use credit cards. Furthermore, only around 7% of SMEs just use credit cards, and most of these pay off the full balance each month – as such, it represents more of a payment method than a source of external finance for these firms. Of non-bank sources of finance, invoice finance is only estimated to be used by 2% of smaller businesses.

The following chapter considers the economic context and then considers the evidence on the demand for external finance, including new survey evidence commissioned by the British Business Bank.

ESTIMATES OF THE FLOWS OF SELECTED TYPES OF EXTERNAL FINANCE FOR UK SMES ^(a)

		2011	2012	2013	2014	
Bank Lending Stock	Outstanding Amount ^(c)	189	176	166	171	to Sept
<i>Source: Bank of England ^(b)</i>						
Bank Lending	Net flows £ billions ^(d)	-	-8	-4	-3	to Sept
<i>Source: Bank of England ^(b)</i>						
	Gross flows £ billions ^(e)	-	38	43	38	to Sept
Other Gross Flows of SME Finance						
Private external Equity £ billions		1	1.3	1.6	1.1	H1 only
<i>Source: Beauhurst ^(f)</i>						
	of which Equity Crowdfunding	0.0016	0.0027	0.019	0.024	H1 only
	No. of Reported Deals	383	619	860	545	H1 only
	No. of Deals (Known Amounts)	277	432	611	418	H1 only
Asset Finance £ billions		-	12.5	13.1	-	
<i>Source: FLA ^(g)</i>						
Peer-to-Peer Business Lending £ billions		0.02	0.06	0.25	0.55	to Oct 14
<i>Source: AltFi Data ^(h)</i>						
Peer-to-Peer Invoice Financing £ billions		0.003⁽ⁱ⁾	0.04	0.10	0.22	to Oct 14
<i>Source: AltFi Data ^(h)</i>						

(a) The information contained in this table should be viewed as indicative, as data and definitions are not directly comparable across different sources. There can be some double counting across estimates in different parts of the table. Flows data are cumulative totals for the year or to the date stated. Non seasonally adjusted. All numbers are in billions and have been rounded appropriately.

(b) Statistics taken from Bank of England Bankstats Table a8.1 – Available: www.bankofengland.co.uk/statistics/Pages/bankstats/2014/sep.aspx

(c) Amounts outstanding data include overdrafts and loans in both sterling and foreign currency, expressed in sterling. Non seasonally adjusted. Movements in amounts outstanding can reflect breaks in data series as well as underlying flows. For further details see www.bankofengland.co.uk/statistics/Pages/iadb/notesiadb/Changes_flows_growth_rates.aspx. For changes and growth rates data, please use the appropriate series or data tables from Bankstats, available at www.bankofengland.co.uk/statistics/Pages/bankstats/current/default.aspx.

(d) Data includes overdrafts and loans in both sterling and foreign currency, expressed in sterling. Net flows does not always reconcile with change in stock due to differences in statistical reporting. The reported stock can include other adjustments made by banks but not detailed when reported, whereas flows data does not include these adjustments.

(e) Data excludes overdrafts.

(f) Beauhurst is a market data provider that records visible equity deals including crowdfunding deals. Data will be available in forthcoming British Business Bank/Beauhurst publication.

(g) The Finance & Leasing Association (FLA) whose members make up 90-95% of the market. Data obtained from FLA Asset Finance Confidence Survey.

(h) Data obtained from AltFi Data. AltFi obtain data directly from the Platforms, working with them to improve consistency. Further details on the Platforms covered can be found on their website.

(i) Peer-to-Peer Invoice Financing 2011 figure excludes January as records began in February.

1.1

ECONOMIC CONTEXT
FOR SMALLER BUSINESSES

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- Smaller businesses form a large part of the UK economy and make an important contribution to economic growth
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- The UK has enjoyed seven quarters of economic growth with forecasters suggesting this will continue, despite continuing global downside risks
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- There are a number of areas of concern, with smaller businesses having low levels of business investment, productivity and exports

The role that smaller businesses play in the UK economy, the current macroeconomic environment and the economic performance of the smaller business sector are all important context for understanding the finance markets. This section summarises recent economic developments with a focus on smaller businesses.

Smaller businesses form a large part of the UK economy and make an important contribution to economic growth

Smaller businesses¹ are an important part of the UK economy. They:

- employ an estimated 15.2 million people which forms more than half of total UK employment (60%); and
- account for almost half of UK private sector turnover (47%).²

Smaller businesses have been increasing their share of total employment year-on-year between 1998 and 2010.³ For instance, existing small firms with fewer than 50 employees and new business start-ups contributed approximately one third each to a total of 2.61mn jobs created on average each year between 1998 and 2010. Smaller businesses also play a vital role in raising productivity growth in the UK economy by spurring new innovation, by facilitating 'productive churn' through business entry and exit, and by stimulating stronger competition.⁴

Given that only 16% of UK early stage entrepreneurs have high growth expectations (see page 24), this may suggest a need to increase the number of UK smaller businesses aiming to grow, and the capacity of medium sized businesses to become global businesses, so that they have an even greater economic impact.

The UK has enjoyed seven quarters of economic growth with forecasters suggesting this will continue, despite continuing global downside risks.

The 2008 financial crisis caused the worst recession in recent UK history, with the time taken to recover lost output being markedly longer than the 1970s, 1980s and 1990s downturns. GDP measures now suggest the UK surpassed its pre economic downturn peak level of output (Q1 2008) in Q3 2013.⁵

Following volatile quarterly GDP growth through 2011 and 2012, the recovery is underway. Quarterly growth in Q3 2014 was 0.7%, marking the longest positive run since the financial crisis (7 consecutive quarters). In Q2 2014, the UK economy was 3.2% larger than a year earlier – stronger than other industrialised countries including Italy (-0.3%), Germany (1.3%), France (0.1%) and the United States (2.6%).⁶

The UK remains an entrepreneurial economy. For instance, GEM data shows that one fifth of working age individuals in 2013 were engaged in entrepreneurial activity or intended to start a business within the next three years.⁷ Furthermore, for most of the last decade, the UK economy has been a net creator of businesses, with the business birth rate exceeding the business death rate.⁸ During, and since the recession, business start-ups have been resilient.

The labour market was also relatively resilient over the course of the recession and has performed strongly during the recovery, resulting in record employment levels.

Outlook

According to HM Treasury's average of independent forecasts, the UK economy is forecast to grow by 3% in 2014 and 2.5% in 2015.⁹ However, risks remain in the global economy. According to the IMF, "(Global) Growth is uneven and still weak overall and remains susceptible to many downside risks."¹⁰ The economic recovery in the Euro area, a key export market, is particularly fragile, with IMF growth forecasts for 2015 just 1.3% compared to 2.7% for the UK and 3.1% for the US.

Business confidence has been on an upward trend since 2012, and is now relatively high by historic standards. However, some business confidence surveys have begun to show a softening in confidence.¹¹

There are a number of areas of concern with smaller businesses having low levels of investment, productivity and exports

Business investment is improving, but UK SMEs underinvest compared to their European counterparts

Business investment¹² is a key driver of economic growth, both in the short run through its contribution to demand, but also in the long run through its impact on productivity. However, the UK has one of the lowest business investment to GDP ratios across the whole of the OECD, as measured by gross capital formation. For instance, the UK has a ratio of 8% compared to over 10% for the USA, Germany and France. However, it is important to acknowledge that the UK performs better on investment in intangible assets.¹³

In addition to the overall figures being disappointing, smaller businesses underinvest to a greater extent than larger businesses. Eurostat figures show SMEs only contributed 38% of the total tangible business investment in the UK in 2011, a lower share than in other EU countries.¹⁴

Business investment in the UK declined during the economic downturn, falling nearly 20% between Q2 2008 and Q4 2009. It is widely acknowledged that business uncertainty over future demand has been a major factor influencing the lack of business investment since the recession,¹⁵ combined with funding constraints that particularly affected SMEs.

FIG 01

Source: ONS

UK REAL GDP GROWTH, QUARTER-ON-QUARTER AND QUARTER ON SAME QUARTER A YEAR AGO, CONSTANT PRICES, SEASONALLY ADJUSTED, %

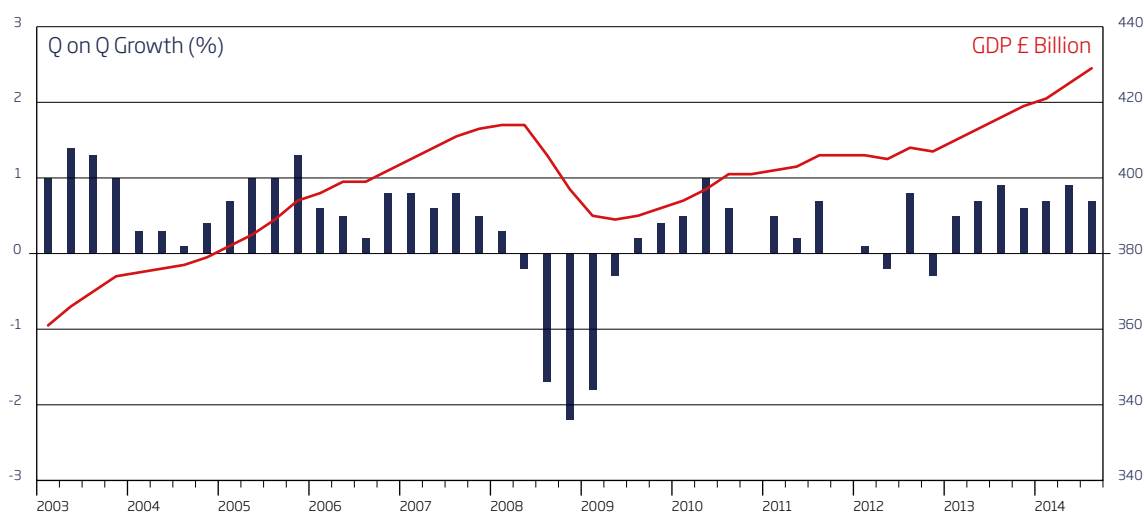
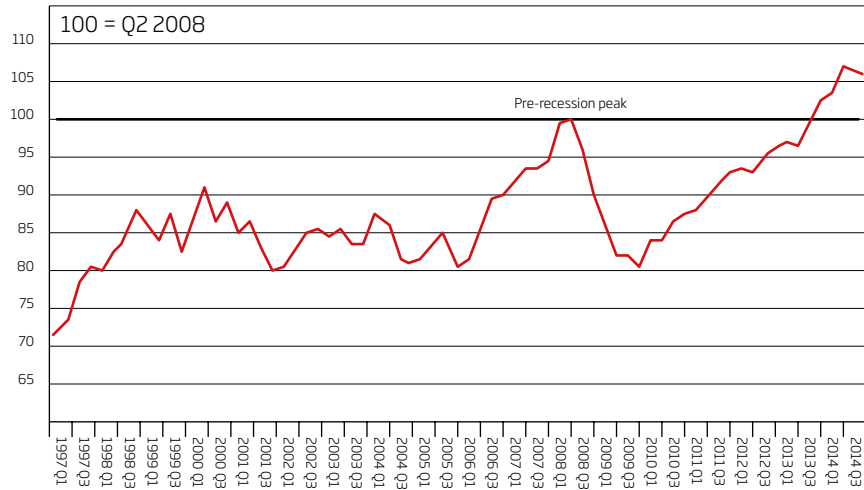


FIG 02

Source: ONS

UK BUSINESS INVESTMENT**Notes**

Business investment variable: NPEL, indexed to Q2 2008.

Does not include expenditure on dwellings, land and existing buildings and costs of ownership transfer of non-produced assets. The value for Q2 2005 has been interpolated so as not to include the large spike in this period attributed to the transfer of nuclear reactors from BNFL to the NDA. For more information see point 3 here: <http://www.ons.gov.uk/ons/rel/bus-invest/business-investment/q3-2014-provisional-results/stb-bi-q3-2014.html#tab-background-notes>

However, business investment is now showing signs of recovery. In Q3 2014 business investment grew by 6.3% compared with the same quarter a year ago and yearly growth has been sustained over five consecutive quarters. Business investment in Q3 2014 was £2.6bn higher than the pre-downturn peak (Q2 2008).¹⁶

A number of business surveys now show businesses' investment intentions are increasing, including in smaller businesses. For instance, a recent FSB survey shows a net balance of 25% of smaller businesses expect to increase their investment over the next 12 months, a similar level from the previous two quarters, but significantly higher than the levels seen in 2012.¹⁷

Business investment may increase further in the future, as a lower proportion of SMEs are now reporting excess capacity. The FSB reports a net balance of 46% of small businesses with spare capacity in Q3 2014. This is down from 49% in Q3 2013, and continues a downward trend since the start of 2013.

OBR predict that business investment is due to grow at an average rate of just over 6.7% between 2015 and 2019.¹⁸ Whilst some of this additional investment will be funded through internal savings, there is evidence to suggest SMEs will require substantial external finance as the demand for capital for expansion and business investment grows.

Labour productivity has not recovered and export performance may be constraining the recovery

UK productivity fell back sharply over the recession. After almost recovering to pre-crisis levels in 2011, it is now 2.2% lower than in Q1 2008.¹⁹ In 2013, the output per hour in the UK was around 17 percentage points lower than the G7 average.²⁰

This is particularly a concern for smaller businesses that, on average, tend to have lower levels of productivity than larger firms. Whilst SMEs' productivity growth surpassed larger firms between 2000 and 2005,²¹ there is a large amount of evidence suggesting productivity had fallen more in smaller businesses than in larger businesses over the course of the recession.

For instance, IFS identify a 11.7% fall in labour productivity among small firms relative to their pre-recession trend, compared to 5.9% fall for medium-sized firms and 2% for large firms.²² The report's authors suggest that small firms appear to be more likely to hoard labour than larger firms. Of course, access to finance is only one of the factors affecting SME productivity.

A lack of export activity remains a key concern within the UK economy. Growth in the value of exports has been relatively flat since mid-2011 due to the continuing difficulties in many economies. The Eurozone is the UK's biggest export market²³ and the UK remains exposed to a prolonged period of subdued activity there.²⁴

SMALLER BUSINESSES THAT EXPORT

A majority of smaller businesses do not export, but most exporters are smaller businesses...

According to the BIS Small Business Survey, in 2012, 19% of UK SME employers were exporters. Medium-sized businesses were more likely to export (40%), than small (26%) and micros (17%), and just 12% of businesses with no employees exported. Since 2010, there has been a decline in the proportion of SME employers that export, driven by smaller SMEs.

While smaller businesses have a lower propensity to export than larger ones, SMEs made up over 90% of all UK exporters in 2012. However, by value just over 35% of total UK exports came from businesses with less than 250 employees.²⁵ While this proportion has declined significantly since 2009 (when it was over 50%), according to the February 2014 SME Business Barometer,²⁶ 38% of SME exporters expected their overseas sales to increase in the next 12 months. And the Small Business Survey suggested that less than 5% of those not exporting planned to do so in the following twelve months.

Exporting SMEs are high growth...

The Small Business Survey found that there were lower levels of exporters among new businesses - 15% vs 19% among established business. However, more of these had plans to export. Growing firms were much more likely (37%) to be exporters than average (19%).²⁷

Exporting is not suitable for all, but some firms may not be fulfilling their potential...

Exporting may not be suitable for all businesses - around 65% of smaller businesses not exporting reported they did not have a product or service suitable to export. However, there is evidence that some smaller businesses are not fulfilling their potential:

- A significant proportion of businesses do not have the desire to export: around 20% of non-exporters said it was not part of their business plan, and just over 10% stated that they had sufficient business in the UK already. In some cases this could hold back firms' growth potential.
- Fewer than 10% of SMEs not currently exporting had received enquiries or orders from overseas, but only 10% of these expected to see export sales as a result.

Access to finance is not generally considered a major barrier to exporting...

According to the February 2014 SME Business Barometer, 6% of SMEs not exporting said that they did not have the finance to enable exporting, and 4% were put off by cash flow issues.

Only a small proportion of SMEs sought advice about exporting, and awareness of export finance is relatively low...

A very small proportion of SME employers sought advice (3%) or information (1%) on exporting in 2012 - although only 2% stated that they did not have knowledge of how to export.²⁸

According to SME Journey data, 31% of SMEs were aware of export/import finance, 14% were aware of who to approach for export/import finance, but fewer than 1% reported using export/import finance in the previous 3 years.

Market failures may prevent firms from fulfilling their potential...

There are a range of market failures that affect UK firms trying to export to foreign markets. Information asymmetries in particular are addressed by the activities of UKTI, which works with UK-based businesses to ensure their success in international markets. In addition, a range of Government schemes provide support and advice to smaller businesses, many of which are exporters.

Well known information asymmetries - meaning that viable businesses are sometimes denied finance, or charged higher prices than their true risk profile should reflect - can be amplified for firms looking for external finance for exporting.

UK Export Finance (UKEF) re-entered short-term export finance markets in 2011 to help address market failures in credit supply to exporters

Recognising some specific export finance related market gaps where SMEs have difficulty getting finance from banks or other providers, UKEF provides specialist support through a range of products tailored to meet the needs of exporters and their overseas buyers. The products are designed to help mitigate a number of common issues that occur in relation to export transactions. Principally these are:

- The risk that an exporter will not be paid or will incur financial loss due to a contract being frustrated or a contract bond unfairly called.
- The need for exporters to offer credit terms for larger contracts, whilst they would prefer to receive payment as the contract is performed.
- The need for exporters to have sufficient working capital to perform export contracts or to issue contract bonds that are required by their buyer.

The full range of UKEF's products is available to exporters of any size; however, a number of its products are targeted at, and particularly utilised by, SMEs (in 2013/14 overall, 92 out of the 130 companies directly supported were SMEs). These are:

- Export Insurance Policy (EXIP): insurance provided to exporters to protect them against the risk of not being paid by an overseas buyer.
- Bond Support Scheme: risk sharing with banks that issue Contract Bonds on behalf of exporters that help to free-up an exporter's cash flow.
- Export Working Capital Facility: risk sharing with banks that provide export working capital facilities to exporters that add capacity to an exporter's financial resources to fulfil particular export contracts.



EXPERT VIEW

GRAEME FISHER
HEAD OF POLICY, FEDERATION
OF SMALL BUSINESSES

OUR SMALL BUSINESS CONFIDENCE INDEX HAS HIT AN ALL-TIME HIGH

Forward-looking indicators on investment and employment remain firmly in positive territory, boding well for next year.

Since the recession, business formation has accelerated rapidly and as the economy improves, we are seeing increased levels of ambition among small firms: the FSB undertakes a quarterly survey of our membership and our confidence index recently hit an all-time high.

As the high levels of business formation would suggest, conditions for entrepreneurship in the UK are favourable. At a regional level, the South East and especially London have led in terms of business formation and growth. Our more recent surveys have indicated that other regions have narrowed the gap but it is clear that a concerted, long-term effort is required for the UK to achieve a more balanced distribution of activity. Investment in regional infrastructure and broadband has a crucial part to play in providing firms access to markets. A more coordinated effort is required too to develop regions, ideally drawing on the knowledge base in our world class universities that can encourage innovation and new product development.

As the role of start-ups and small business in economic activity, in particular job creation where they are responsible for the majority of new jobs, has become increasingly recognised,

so policy has responded. Oversight of regulation has been tightened, to ensure costs are not disproportionate and public procurement is finally being opened up to smaller firms.

As the recovery has taken hold and these interventions have taken effect, access to finance has improved and costs have fallen, with the rates asked for finance facilities easing back. Nonetheless, challenges remain in the area, notably around signposting to the appropriate provider and the persistent finance gaps in the UK market.

Better access to and awareness of different financing options is vital as it can help address an important issue: the ability to scale-up businesses, an area where the UK has lagged its competitors. Part of the reason why scale-up has been hampered is the long recognised finance gap in the UK, particularly equity finance.

As well as simply access to capital, equally important for growth prospects is the expertise of the investors and their network. Supportive investors, ideally not with a short-term investment horizon, can catalyse firms' expansion through the introduction of such expertise not currently available within the firm. Looking at the regional picture noted earlier, London in particular appears to offer that to ambitious firms. The trick is to replicate those conditions more widely across the UK.

On the demand side, the quality of leadership and management is critical to attract more sophisticated forms of investment. Again, it is an area where the UK is found to lag behind its competitors and one requiring more focus. A deeper pool of management talent would encourage private investors to back companies and convert more new UK businesses into sustainable growth success stories.

1.2

DEMAND FOR FINANCE

-
- Smaller businesses reduced their use of external finance during the recession, but there is evidence that demand for finance will increase in the future
-
- Use of finance has been shifting from funding working capital to funding fixed assets
-
- Only a minority of businesses (46%) use external finance, but it is important for funding business start-ups, investment and growth
-
- Although a variety of different financial products exist, many smaller businesses are largely reliant on banks for their external finance

Outcomes in finance markets result from the interactions between demand for and supply of finance. Demand for finance is derived from demand in the real economy. So as economic conditions improve, and demand for goods and services pick up, the demand for external finance will revive. As such, this chapter considers survey evidence which provides indications of the profile of demand for external finance from smaller businesses. The supply side is considered in more detail in later chapters.

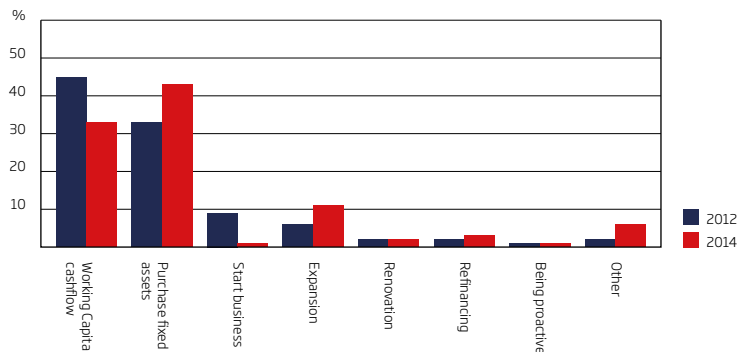
Unless otherwise stated, the figures quoted in this chapter are from the 'SME journey towards raising external finance: 2014 survey', which asked smaller businesses about the motivations and steps they go through when seeking external finance.²⁹ The survey was undertaken by BMG Research and was specifically commissioned by the British Business Bank to see how the market has changed since 2012.³⁰

Small businesses reduced their use of external finance during the recession, but there is evidence that demand for finance will increase in the future

It is well documented that demand for external finance from smaller businesses reduced during the recession, as businesses have become cautious about taking on additional debt and have scaled back their expansion plans. In addition, some have used sources outside the financial sector such as personal funds, family and friends or trade credit. The 2014 SME Journey survey shows the trend has continued, with only 12% of SMEs having sought external finance products in the previous 12 months. This is 6 percentage points lower compared to the 2012 survey, driven predominantly by businesses with 0-9 employees.

FIG 03

Source: BMG, SME Journey Survey

MAIN REASON FOR SEEKING FINANCE (LAST OCCASION IN LAST THREE YEARS)

The balance in the use of finance has begun to change from funding working capital to fixed assets

In spite of this, there is evidence to suggest a change in the profile of demand for finance, shifting away from finance for working capital to finance to fund fixed assets. This is possibly due to better economic conditions and greater business confidence (as highlighted in chapter 1.1), meaning businesses may be more likely to undertake investment. In 2012, the main reason SMEs sought finance was for working capital/ cash flow. This has declined in the latest survey and there has been an increase in businesses seeking finance to purchase fixed assets, now the main reason for seeking finance.

There is evidence to suggest business confidence is increasing, with a higher proportion of businesses planning to expand: nearly half (46%) of small businesses plan to grow their turnover in the next 12 months, with 17% of these expecting to fully or part fund this expansion with external finance.

However, it is important to acknowledge that according to the SME journey data, the majority of businesses intending to grow (74%) expect to fund this through internal cash flow only. Whilst this may suggest some businesses are still reluctant to use external finance, the use of internal funds over external funding is widely acknowledged in the “pecking order of finance”.³¹

Only a minority of businesses (46%) use external finance, but it is important for funding business start-ups, investment and growth³²

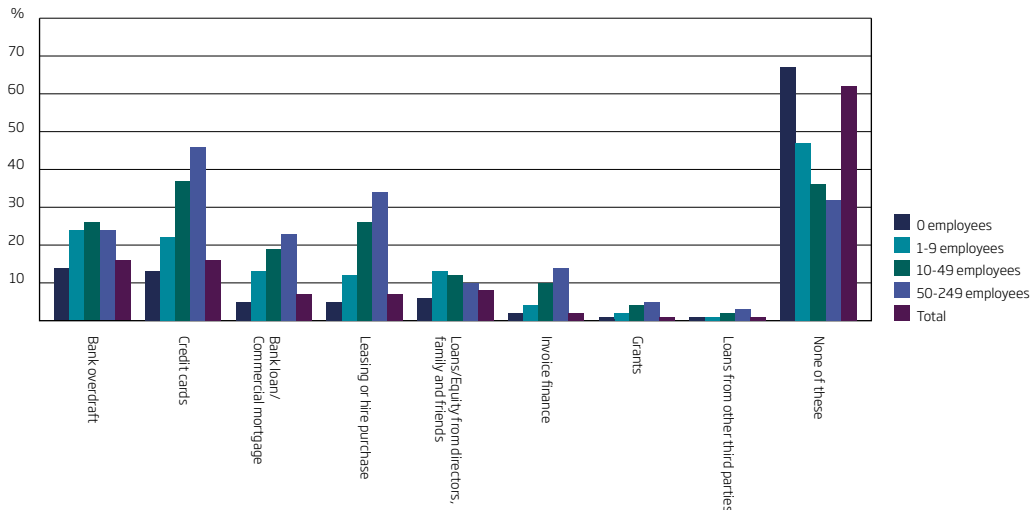
The ability of businesses to obtain external finance is fundamental for funding business investment, ensuring businesses reach their growth potential, and for facilitating new business start-ups. A lack of finance can constrain cash flow and hamper businesses’ survival prospects.

However, over half (around 54% of smaller businesses) do not use formal sources of external finance, instead relying on trade credit from their suppliers or retained earnings. Trade Credit is a very important source of funding for smaller businesses, and it is estimated that the total amount of trade credit outstanding is more than 1.2 times the total amount of lending from the financial sector.^{33, 34, 35}

It is also important to acknowledge the role that personal finance plays in funding many SMEs, especially smaller ones. SME Finance Monitor evidence shows 17% of small businesses used a personal account for their business banking, although use of a personal account does not necessarily mean that personal funds are used to support the business.³⁶ Furthermore, 35% of those with an overdraft, loan or credit card facility report that one or more of these facilities was in their personal name, which is the equivalent to 10% of all small businesses holding one or more of these facilities in a personal name.³⁷

FIG 04

Source: SME Finance Monitor, Year to Q2 2014

EXTERNAL FINANCE USED BY SMES

Although a variety of different financial products exist, small businesses are largely reliant on banks for their external finance

Overall, 'core' bank products, especially overdrafts and credit cards are the most common forms of finance used by smaller businesses. External private equity finance is less commonly used with only around 1% of SMEs using this type of finance in the last three years. Similarly, finance from peer-to-peer lending platforms and crowdfunding are currently very low at less than 1% each. Considering the value of external finance flows, the prevalence of bank lending is amplified. The table on page 9 estimates the flows of some types of finance for UK SMEs, showing that the gross flows of bank lending remain considerably larger than flows from other sources of finance.

The use of the various forms of external finance varies by business size. For instance, while around 7% of SMEs reported that they currently use leasing or hire purchase, medium-sized businesses were much more likely to do so – leasing or hire purchase is the second most popular form of finance for medium-sized businesses, after credit cards. The Mid-sized business survey (British Business Bank, Ipsos MORI, 2013) also showed that over half of mid-caps use asset finance.

Different types of finance exist because business needs vary, for instance by the amount of finance and length of term required, as well as the risk profile of the business and use of finance. Therefore, the SME Journey survey shows the main reason for seeking finance influences the type of finance products being sought, with larger businesses more likely to be seeking larger amounts of finance:

- Businesses seeking finance for working capital reasons are more likely to use bank overdraft (43%), loans (31%) and credit card finance (9%) and are seeking a mean value of £92,000 (median £10,000). Working capital is largely used to cover a short term funding gaps (53%), or as a safety net (32%), but it is also used to fund general growth (27%).
- Those looking to purchase assets most commonly seek bank loans (41%), followed by leasing or hire purchase (39%) and are seeking £34,000 on average (Median £10,000).
- Businesses looking to expand most commonly seek bank loans (63%), followed by overdrafts (33%) and are seeking £230,000 on average (Median £12,000).

The pattern of SME finance across the regions and nations of the UK varies, and the following section provides a review of business start-ups, bank lending and the use of equity finance around the UK.

REGIONAL VARIATIONS IN SMALL BUSINESS FINANCE MARKETS

London is the largest and most active smaller business finance market, in part due to its large business population

Here we consider some of the trends on business start-ups, bank lending, as well as new data on private external equity finance by region. Regional comparisons of smaller business finance markets are limited to some extent by the granularity of the available data.

London is the region with the highest number of business start-ups (102,000) as well as the highest start-up density: 151 business start-ups per 10,000 adults. As shown opposite (fig 05), there is a fair degree of disparity between regions.

The North East for instance, has a start-up density of just 64 per 10,000 adults.

As such, the concentration of smaller businesses varies across the UK. The 2014 Business Population Estimates show that London also had the largest number of SMEs, even when controlling for population. The disparity of business concentration is naturally reflected in the relative sizes of regional SME finance markets.

Fig 06 shows that the lending stock and gross flows of loans was largest in London in the year to Q3 2014. However, net lending was also most heavily negative in London. Scotland and the West Midlands are the two regions which have seen net lending rise to a positive figure in the last year.

As noted in section 1.2, external private equity finance is only used by a small proportion of SMEs. By region, the largest share of deals and investment can be found in London, where strong increases are observable year-on-year. The predominance of London is persistent at the seed, venture and growth stages; the capital benefits from being the home of a number of major equity investors, and a pool of ambitious entrepreneurs and dynamic businesses with growth potential - in other words, both supply and demand are relatively strong.

Most other UK regions and countries saw a pick-up in activity between 2011 and 2013, suggesting recent increases in equity investment are not just limited to London or Southern England.

FIG05

Source: BankSearch business start-ups and ONS mid-year population estimates in 2013

BUSINESS START-UP DENSITY BY REGION, GB

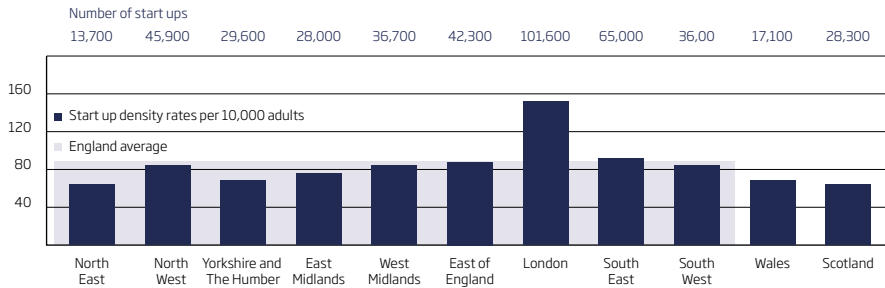


FIG06

Source: BBA SME Statistics

BANK LENDING TO SMALLER BUSINESSES BY REGION, GB

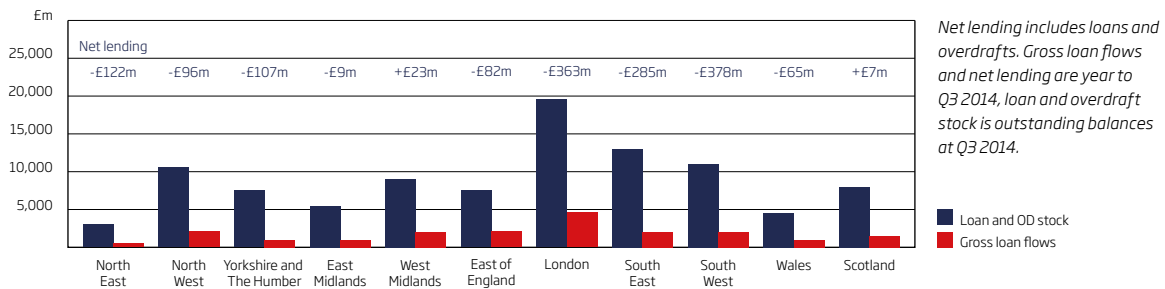
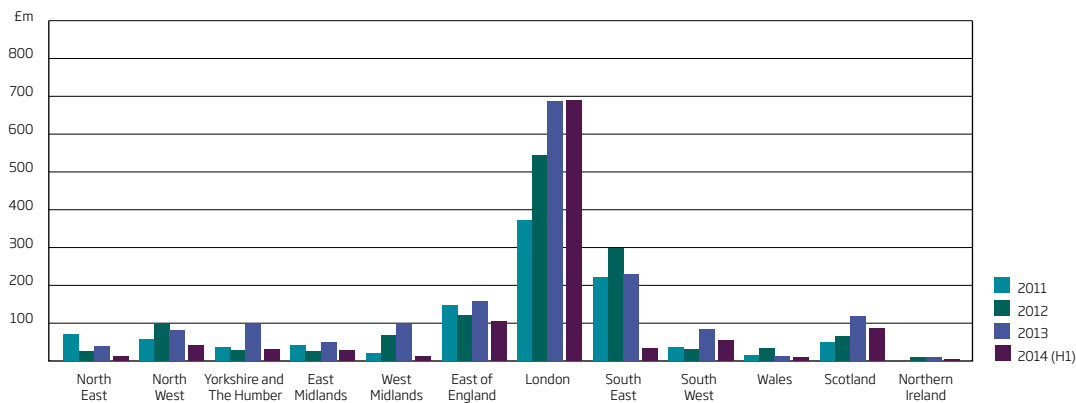


FIG07

Source: Beauhurst

EQUITY INVESTMENT BY REGION



02 GROWTH FINANCE – GAPS REMAIN

Government programmes, now run by the British Business Bank, have long provided finance to support early stage and high-growth firms. For example, Enterprise Capital Funds have invested more than £260mn in over 200 companies since their launch in 2006. The British Business Bank Investment Programme, building on its forerunner, the Business Finance Partnership, addresses long-standing gaps in growth finance, by helping finance debt funds and lease finance companies. The financing environment has also benefitted from Government action in the form of investment tax reliefs. However, with nearly half of SMEs expecting to grow in the coming year, further support for businesses with high growth potential will be needed.

For businesses with high growth potential, gaps remain in the supply of finance

Many smaller businesses seeking to grow will succeed, but many will not, for example over 40% of new businesses close within three years of starting up. For some of those with the potential to succeed, traditional loans and overdrafts are not suitable for all their financing needs. This underlines the importance of continued diversification of the range of financial products used by smaller businesses, reflecting the growth and risk profiles of individual businesses. These products are likely to be supplied by many providers including banks, other existing providers and new entrants.

For potential high-growth firms, external equity finance is an important source of finance. Despite this, less than 1% of smaller firms have used new third party equity finance in the last 3 years. New equity market data collated for the British Business Bank and BIS finds that visible equity investment in SMEs increased from £1bn in 2010, to £1.6bn in 2013, due to strong seed and growth activity. However, the evidence suggests that the equity gap persists, especially at the venture stage.

Private debt funds have similar characteristics to equity funds, in that they are more prepared to fund growth, but these funds

generally aim to invest in lower risk companies than equity or venture funds. Nonetheless, they are still a source of support for growing businesses. There are very few of these funds investing in smaller businesses due to greater administrative costs and a number of structural market failures. **Mezzanine finance** may also help to fill the gaps between senior debt and pure equity finance for growing firms.

The increase in investment has also been reflected in **asset finance** markets – with an estimated £13bn of gross flows of asset finance to SMEs in 2013. The retail market for asset finance is characterised by diversity of supply and strong competition in the low-medium risk part of the market. But specific market failures exist, as well as potential imperfect competition in funding markets which may act to constrain supply.

The previous chapter identified the importance of smaller businesses to the growth of the economy. Business start-ups account for a significant part of that growth so this chapter begins by considering the pattern of start-ups and the extent to which they use finance.

Although businesses with growth potential use a wide variety of types of finance, equity is particularly suitable given the risk profile of high growth firms. Section 2.2 therefore provides an overview of equity finance, and the gaps that exist in those markets. This includes new data commissioned by the British Business Bank on flows of private equity to SMEs. Section 2.3 then considers the potential role of debt funds and mezzanine finance in supporting companies with growth potential.

Finally, as discussed in the previous chapter, rising business investment is resulting the demand for finance from smaller businesses switching towards the financing of fixed assets. Asset finance is a particularly important means of funding for fixed assets, so the functioning of asset finance markets is considered in more detail in section 2.4.



EXPERT VIEW

JUDE OWER
FOUNDER, PLAYMOB

THE ASPIRE FUND HAS HELPED SET PLAYMOB UP FOR GROWTH

I was introduced to the British Business Bank by one of my existing investors, while conducting a second funding round for Playmob.

I founded Playmob after realizing the potential gaming has to raise funds for charity. Our goal is to raise \$1bn (£637.9mn) through play, linking online actions and items to charities and global causes.

At the time of our second funding round, we had good links with quite a lot of UK and European games studios, publishers and charities, but not in the US, which we knew would be a big market for us. That round, with support from the Aspire Fund, allowed us to incorporate and hire a general manager in the US, which was always going to be expensive. We're now working with big industry names on the developer and charity side, including EA, Rovio, Miniclip, Pixelberry and Jagex. The second seed round made that possible and helped us focus on growing both sides of the business.

Since we completed that round last September, the business has matured significantly: at that stage we had raised around \$50,000 (£31,899) for charities and we're now at ten times that level, around \$512,000 (£326,655). We've developed the product to make our campaigns more efficient and have been looking outside the gaming market to where else we can apply our platform.

One of the key things when we got the investment from the Aspire Fund was putting in place more structures and processes to help the business run better. We sat down with British Business Bank right at the beginning and talked to them about how other companies our size operate and what we could learn from them, which was extremely helpful. We had board and management meetings before, but bringing in an external investor like the Aspire Fund gave us a much broader perspective on how to set up for growth.

As well as the capital to invest into our US operation, marketing and sales, it gave us the right people around the table, a bigger support network and new contacts. When growing a business, there are certain things you can't do without the right funding or support available.

We thought about alternative options like crowdfunding, but because of our business model and the inherent level of innovation and complexity, we decided it was much better to have investors we could sit down with face-to-face and get to know. The important thing in my view is smart money: not just capital for its own sake, but the right support network and advice to help you grow.

I also liked that the Aspire Fund focuses on female-led businesses: I've always worked in the games industry, which is male dominated, although diversity is improving. It's quite refreshing to be amongst other female founders and for some women it could make a massive difference, especially if it's a first-time run at a business or they feel that they can get extra support.

2.1 BUSINESS START-UPS

- There are around 450,000 business start-ups per year in the UK
- 'Real estate, professional services and support activities' is the sector with the highest number of start-ups
- The high level of business churn, with over 40% of business having closed within three years, may explain why a high proportion of start-ups are refused funding
- Only a small proportion (16%) of business start-ups have high growth ambitions, and a smaller proportion achieve high growth
- More people use personal savings to start their business than use external sources, with banks forming only a minority of funding

There are around 450,000 business start-ups per year in the UK

BankSearch statistics³⁸ of new business bank account openings shows that there were 447,000 new business start-ups in Great Britain during 2013.³⁹ Following an increase from 417,000 in 2008 to 508,000 in 2011, the number of business start-ups has fallen back.

The main reason for starting a business continues to be opportunity entrepreneurship, where individuals are motivated to start a business because of a new opportunity rather than because they have no other employment options available to them, although necessity entrepreneurship has also increased. For instance, GEM data shows 5.8% of the working age adult population were opportunity-motivated early-stage entrepreneurs in 2013, compared with 5.1% in 2010.⁴⁰ However, 1.2% of entrepreneurs in 2013 were identified as necessity-driven early-stage entrepreneurs, and this has increased significantly from 0.7% in 2010.

'Real estate, professional services and support activities' are the sector with the highest number of start-ups

The sector with the highest number of business start-ups in 2013 was the 'Real estate, professional services and support activities' with 137,000 starts-ups, which amounts to around 30% of the UK total. The next highest sector was 'wholesale and retail' with 74,000 business start-ups in 2013.

The high level of business churn, with over 40% of business closing within three years, may explain why a high proportion of start-ups are refused funding

In 2012, there were 255,000 businesses in the UK deregistering for VAT/PAYE due to business closure or because they declined in size below the VAT/ PAYE threshold.⁴¹ Business churn rates are high, with over 40% of businesses that registered for VAT/ PAYE in 2009 having deregistered within three years.⁴² On these metrics, the business survival rate has declined slightly over time due to the effects of the recession. The number of new VAT registrations that had deregistered within three years fell from 63% for businesses that registered in 2007, to 60% for businesses that registered in 2009.

The high business failure rate may explain why financial institutions are cautious about lending to start-ups. For instance, approval rates for bank overdraft applications for businesses less than 2 years old is 39% (compared to 74% for all SMEs), and for loans the approval rate is just 34% (53% for all SMEs).⁴³

FIG 08

Source: ONS

BUSINESS SURVIVAL RATE FOR BUSINESSES REGISTERING FOR VAT/PAYE BETWEEN 2007 AND 2011

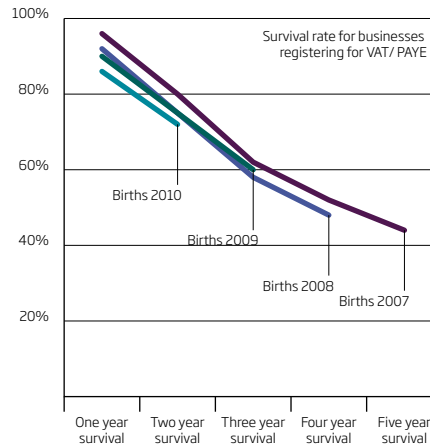
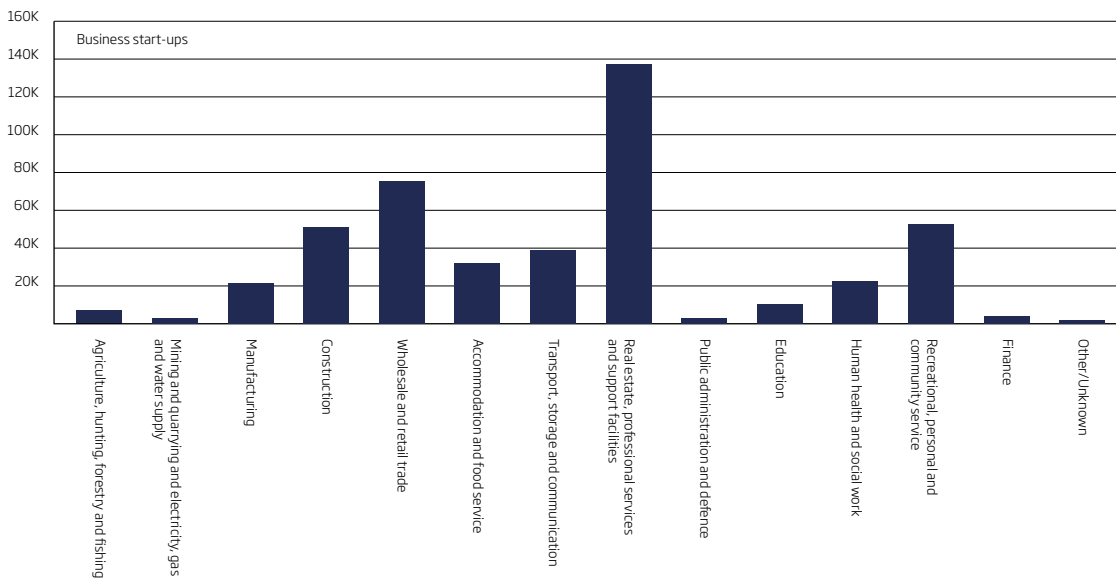


FIG 09

Source: BankSearch

BUSINESS START-UPS BY BROAD INDUSTRY SECTOR, 2013



Only a small proportion (16%) of business start-ups have high growth ambitions, and a smaller proportion achieve high growth

Only 16% of UK early stage entrepreneurs in 2013 had high growth expectations (measured by early stage businesses that had already created more than 10 jobs but forecast job creation to exceed more than 50% in 5 years). This proportion has changed very little since 2007.⁴⁴ However a smaller proportion of businesses actually achieve high growth. High growth businesses formed 6.6% of businesses with 10 or more employees in 2010-2013, equivalent to roughly 10,000 businesses.⁴⁵

The proportion of early stage entrepreneurs in the UK with high growth expectations is the same as in France (15.9%), but is lower than Germany (16.4%) and the US (22.3%).⁴⁶ However, GEM identifies that business owners in the UK who employ people are just as likely to be as ambitious as their counterparts in the US. This suggests the issue may lie among the self-employed in the UK who are not looking to expand.

More people use personal savings to start their business than use external sources, with banks only forming a minority of funding

Over three quarters of businesses used personal savings to start their business, with only 12% using a loan from a bank.⁴⁷ 24% of businesses used finance from friends and family, showing this is an important source of external finance for start-up businesses.

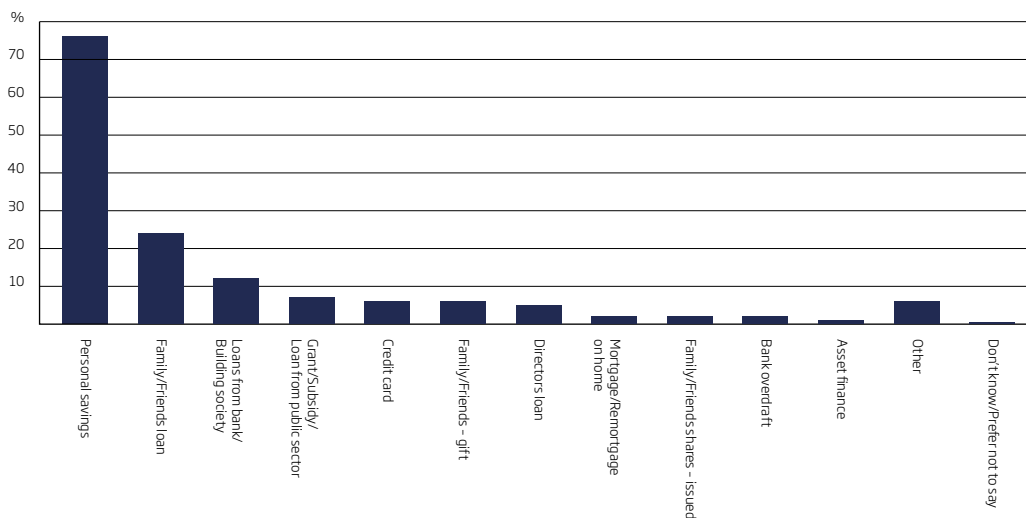
Just 12% of business start-ups used a loan from a bank to establish their business. The mean amount of finance sought for establishing the business was £25,700, although the amount sought by non-employer businesses was smaller.

The evidence suggests that entrepreneurs looking to start a business may benefit from finance being made available at an early stage of the development of the business. Such entrepreneurs may also increase their chance of success if they receive advice on business planning, and mentoring support, as well as finance. The Start Up Loans company provides such support. The opposite page provides a case study of a start-up that has received support.

FIG 10

Source: BMG, SME Journey Survey

FUNDS USED TO START BUSINESS, 2012





CASE STUDY

JESSICA MCLEAN

BAGGERS ORIGINAL START UP LOAN RECIPIENT

A START UP LOAN PUT US IN A POSITION TO LAUNCH THE BUSINESS

Jessica took out a Start Up Loan to develop her business, Baggers Originals.

She graduated from Northumbria University in 2007 with a degree in Fashion Marketing. After gaining some entrepreneurial experience, Jessica decided to take the plunge and set up Baggers Originals. The company will sell adaptations of fun, fashionable practical rainwear sets for children that her mother sold when Jessica was aged five. She knew how popular her mother's creations were and was confident that she could re-create this buzz by producing rainwear and swimwear sets for children and adults.

After undertaking a great deal of market research, Jessica was at the stage where she was in need of funding to develop Baggers Originals. She first turned to banks in a bid to obtain a business loan. Baggers Original's loan applications were repeatedly rejected due to the fact she was a start-up with no assets to secure the loan against. After looking into alternative funding options on the internet, Jessica came across The Start Up Loan Company and applied for a loan through Delivery Partner PNE.

Her business plan impressed and she secured a £2,500 loan to develop Baggers Originals website as its key strategy is to sell online. Jessica found the whole process simple and straightforward.

PNE have since been extremely supportive of Jessica and invited her to present her business to Sir Richard Branson. This presentation has resulted in discussions with Virgin Atlantic about the possibility of selling Baggers Original products.

Jessica had been in talks with angel investors and since securing the Start Up Loan and being able to demonstrate the support and avenues that The Start Up Loan initiative can offer, Baggers Originals have now secured a £100,000 investment to launch Baggers Originals.

The young Baggers Originals team have been since working hard to source manufacturers, build its customer database through social media sites, secure orders and ensure that everything was in place for the launch earlier this month. The company has already secured an order from a major global retailer which will be fantastic to raise brand awareness. In March 2014, they also secured an order with Monsoon, this is the first time the high street chain has stocked an outside brand in its 40 year history.

Jessica says "The Start Up Loan Initiative has enabled our business to develop the website and be in a position to be ready for our launch. The connections that we have made through The Start Up Loans Company has given our investors' confidence in funding Baggers Originals - we are thrilled and excited about the future."

2.2 EQUITY MARKETS

- Private equity is an important source of finance for companies with growth potential
- Overall equity investment is increasing, thanks to strong seed and growth activity
- There is a particular weakness observed for venture investment
- Structural issues in the market create the well-known equity gap, which extends to larger deal sizes

This section provides a brief overview of the effectiveness of equity markets in supporting high growth firms. The issues covered in this section will be explored in more detail in a forthcoming report on equity market issues that the British Business Bank is producing for the Department for Business, Innovation & Skills.

Private equity is an important source of finance for companies with growth potential

Equity is a form of finance used only by a minority of small businesses, but is particularly important for those with high growth potential. The SME Finance Monitor shows that around 1% of businesses currently use equity from third parties (such as venture capital funds or business angels), and less than 1% apply in a given twelve month period.⁴⁸ Analysis by Ares & Co estimates that, by value, equity accounts for around 5% of total external financing used by smaller businesses.⁴⁹

Where equity is used appropriately, financing businesses with the right risk-reward profile, it can offer significant additional benefits over debt finance. There may be no such thing as a “typical” firm receiving business angel or venture capital investment, but those businesses are more likely than normal to be:

- Small, young and at an early stage of development (early or even pre-trading);
- A risky proposition lacking assets to use as collateral;
- Developing a disruptive product or business model; and
- Either growing rapidly, or with the potential for rapid growth.

As such, equity funding provides finance to firms too risky for the banks and other debt providers but with potential to contribute strongly to innovation, productivity and economic growth. By investing in return for an equity stake, investors provide a more patient form of funding, which gives entrepreneurs space to develop their businesses without the pressure of making regular repayments, and the interests of both are well aligned towards maximising the value of the company.⁵⁰

The business can benefit from the experience and know-how of the investor, who often takes a seat on the board; this also means the investor can closely monitor the actions of management,⁵¹ reducing the likelihood of principal-agent problems.

There are various types of equity finance available to, or most appropriate for, a business, and this tends to depend on its size and stage of development.

Overall equity investment is increasing, thanks to strong seed and growth activity

New data from Beauhurst, commissioned by the British Business Bank and BIS indicate an increase in the volume and value of visible investments over time. Given that these are increasing at a similar rate, the average deal size has changed relatively little over the past 4 years. In 2014 Q2, Beauhurst recorded 298 deals, worth £572mn in total.⁵²

Deals are not spread uniformly across regions or sectors. In the first half of 2014, the technology sector featured in more than three-quarters of deals, and the majority of activity was focused around London (43% of deals worth 64% of investment in first half of 2014).⁵³

Performance has been stronger at seed and growth stage (as the largest component of overall investment, growth investment drives the overall series). In contrast, the value of investment at venture stage declined between 2011 and 2013. Although 2014 is looking like an improvement on 2013 for venture, the overall trend is at best flat, whereas investment is clearly on an upward trajectory at the seed and growth stages. Further detail on how investments are classified by stage is provided in Fig 12 (below).

The growth stage shows increasing investment, with an increasing share of funding provided in deals of £10mn+ from traditional private equity firms. Institutional funding is much more significant than Government backed funding at this stage. The implication is that many private equity funds and their traditional investors have moved on from venture to the growth stage, where deal sizes are larger and businesses more stable.

The strong performance in seed deals is indicative of a lively funding environment at the seed stage, with angels and funds involved, backed by significant support from Government in the form of EIS and SEIS tax reliefs. Fundraising data from the European Venture Capital Association (EVCA) also shows a strong recovery at the "early-stage"⁵⁴ (largely for seed investment) in 2012 and 2013. Market participants report VC funds and angels increasingly investing alongside each other, and also getting involved in crowdfunding deals.⁵⁵

There is a particular weakness observed for venture investment

The total value of VC investment in UK companies recorded by EVCA⁵⁶ fell sharply in 2009, as the financial crisis took its toll on private equity, and has continued declining since. By 2013, investment was around £475mn, down from a peak of over £1,200mn in 2008.⁵⁷ The sharp decline in 2009 was due mainly to later stage (venture) investment; this category kept falling, and in 2013 was around one-quarter of the 2008 high.⁵⁸

FIG 11

Source: Beauhurst

NUMBER OF EQUITY DEALS AND VALUE OF INVESTMENT OVER TIME

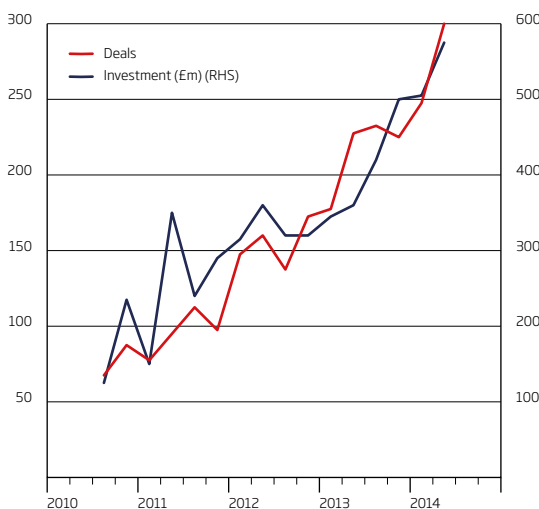
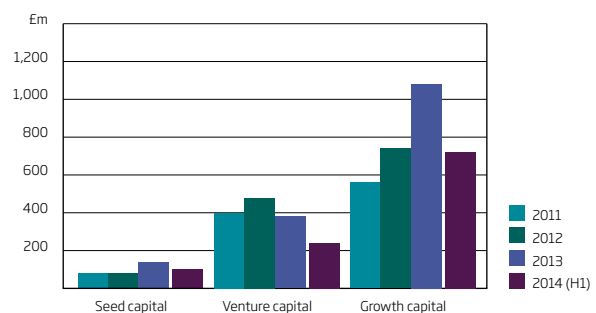


FIG 12

Source: Beauhurst

INVESTMENT BY STAGE



INVESTMENT STAGE CLASSIFICATIONS

Beauhurst divides the market into three stages: seed, venture and growth. Buyouts and public market deals are not included, as the focus is on early stage, growing companies. The classification of deals by stage is a matter of judgement rather than specific rules: each deal is looked at by a Beauhurst analyst, who reaches a decision with the help of a set of proprietary guidelines. These guidelines consist of a set of around 50 criteria which are believed to provide an indication of the company's stage, such as age, trading status, revenues, development and use of intellectual property.

The relatively simple breakdown by stage used by Beauhurst differs from organisations such as EVCA and BVCA, which tend to distinguish between seed and start-up, and between early and late stage venture. The reasons for using the simpler taxonomy are:

1. In some cases there is not enough information to decide on a principled basis which of the two seed or venture subgroups a company lies in
2. The simpler taxonomy can be used for all sectors, whereas a more complicated one would be more difficult to apply consistently across sectors.
3. A less detailed breakdown reduces "noise" in the data resulting from smaller numbers of deals being categorised into narrower stages - the small base sizes can lead to large swings in reported investment from one quarter to the next.

The following table summarises the differences between the Beauhurst taxonomy and the more detailed classifications of investment stage used by EVCA and BVCA, and offers some broad descriptors of the types of activity and company supported in each case.

Beauhurst classification	EVCA classification	Detailed breakdown (BVCA)	Broad descriptors; finance used for
Seed	Seed	Seed	R&D; initial concept
	Start-up	Start-up	Product development; initial marketing; pre-revenue
Venture	Later stage venture	Early stage	Post-product development; supporting commercial sales; pre-profit
		Late stage venture	Expansion of operating company which may or may not be profitable; already been backed by VCs
Growth	Growth Capital	Growth/Expansion	More developed, profitable companies looking to expand/enter new markets

Source: Beauhurst; EVCA; BVCA

FIG 13

Source: EVCA

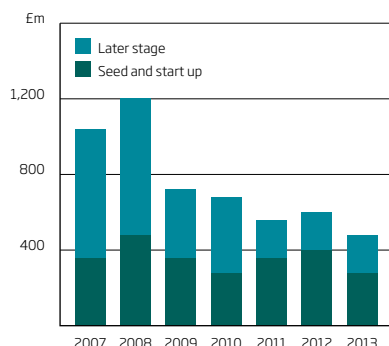
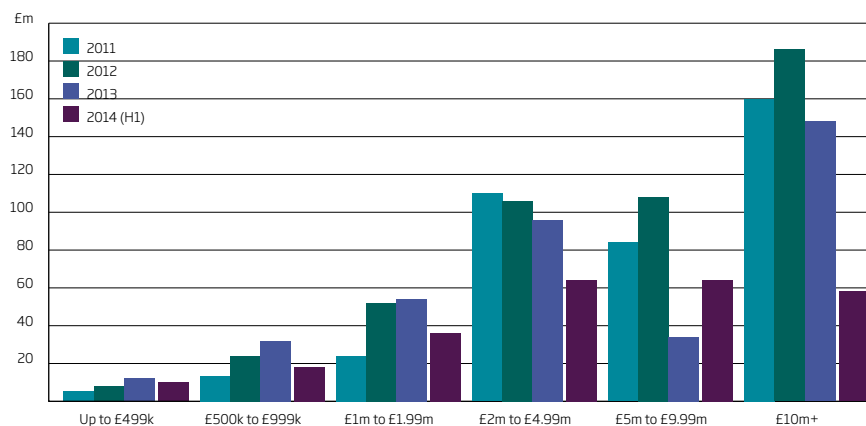
VC INVESTMENT BY STAGE, £MN

FIG 14

Source: Beahurst

VENTURE INVESTMENT BY DEAL SIZE

Although venture-stage investment spans a range of deal sizes, value is concentrated at the larger end. Investment has increased year on year for deals below £2mn; deals above £5mn investment increased in 2012 but fell in 2013. Investment has, however, fallen year-on-year in the £2mn-£5mn bracket – between the previous limit of the Enterprise Capital Fund programme and the level at which most market participants place the upper boundary of the equity gap. The increase in the upper limit for Enterprise Capital Fund investments should help combat this trend.

A likely reason for the relative outperformance at deal sizes below £2mn is the consistent Government support provided in this space. A look at the number of venture-stage deals by investor type shows the increasing role of Government. It is notable that those investors who have made a growing number of deals – angel networks, private investors and the crowd, as well as Government – are those that might be expected to invest at the “smaller” end of venture, in terms of investment amounts, whilst private equity has been relatively stagnant.⁵⁹

This analysis nonetheless understates the importance of Government to the market: the data captures only the entity which invests in the company, without reference to the investors providing the capital. As much of the support is delivered through funds that are co-financed with the private sector (in the case of British Business Bank programmes and VCTs) or through individual investors (EIS and SEIS), these groups will be over-represented compared to Government.⁶⁰

In terms of investment values, private equity declined in 2013, and there were also declines for corporates and private investors. Government-led investment held up, though, whilst angel networks and crowdfunding platforms – likely supported by EIS and SEIS reliefs – increased their investment. In addition to this, data from the EVCA also suggests that since 2007, the contribution of what can be broadly defined as institutional investment⁶¹ has declined significantly, whilst that of Government has increased. Sovereign Wealth Funds and private individuals/family offices have also taken up some of the slack from institutions.

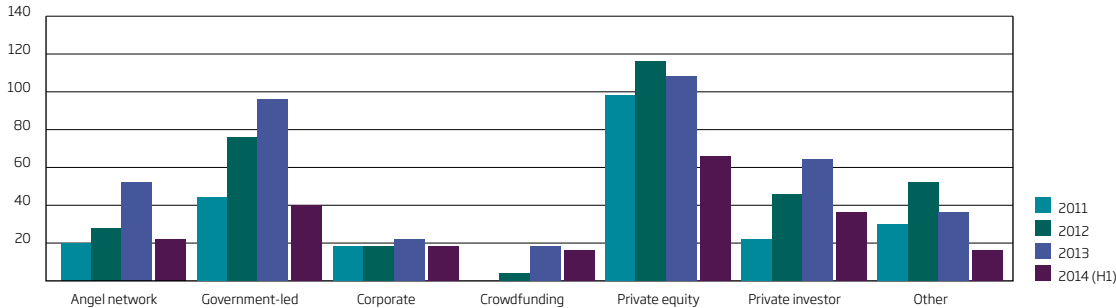
These trends suggest that the weakness in venture investment is now more concentrated at the later stage. EIS and SEIS mainly serve seed and early stage investment,⁶² whilst the previous ECF investment limit had restricted the programme below the later stage.⁶³ The UK Innovation Investment Fund (UKIIF) was able to invest in this space, but the fund closed back in 2009 and is now fully committed, although the new Venture Capital Catalyst Fund is now beginning its disbursement of funding.

Structural issues in the market create the well-known equity gap, which extends to larger deal sizes

The market for early stage equity finance is beset by a number of problems, both structural and cyclical, that result in a sub-optimal provision of funding to smaller businesses with growth potential. Cyclical patterns exacerbate market failures; a slack economy and poor historical returns lead to a tough environment for raising funds and exiting investments through trade sales or IPOs.

FIG 15

Source: Beauhurst

NUMBER OF VENTURE DEALS BY INVESTMENT TYPE

Structural failures in the market are well-established and understood. The informational asymmetry⁶⁴ between business and investor necessitates costly due diligence in advance of any deal; this cost is relatively fixed, meaning it accounts for a greater share of smaller deals, which drives funds toward larger deal sizes and larger/less risky firms. This gives rise to the classic “equity gap”, first identified in the Macmillan Report as long ago as 1931. Recent assessments summarised in our forthcoming equity paper not only confirm its continued existence, but show the gap to be widening and extending to larger investments.⁶⁵

Aside from the traditional equity gap, a market failure arises from the difference between private and social returns to equity investment. Investment generates positive externalities, or spill-overs, to the rest of the economy in the form of innovation or knowledge transfer.⁶⁶ These spill-overs are particularly significant for smaller firms, which find it more difficult to appropriate the value of their new knowledge, and high-tech firms, which rely more on innovation for their profitability.⁶⁷ The external benefits are not taken into account in the decision-making of private investors, resulting in an under-provision of equity finance in societal terms as projects which are unprofitable to private investors but generate significant social benefits are not undertaken.

While existing Government programmes have been effective in funding successes at earlier stages, it is important to emphasise that increased funding availability at these stages does not mean the equity gap has diminished; the market is to a large extent supported by Government support of one form or another, for example Enterprise Capital Funds, the Angel CoFund, EIS and so on, but the underlying structural weakness remains.

The equity gap is generally thought of as being at the venture stage: the reason it has always had a lower bound above zero is because of the presence of business angels to serve the market at the smaller end.

Business angels tend to operate with a lighter touch in terms of due diligence than VC funds,⁶⁸ and are more constrained in investment sizes by their own financial resources.⁶⁹ As a result, angels are a mainstay of the seed investment market segment.

Issues that relate to information and awareness are more prevalent for angels – both in terms of encouraging wealthy individuals to invest, and of a lack of awareness by smaller businesses of angel investment as a finance source, as well as ensuring a good “standard” of investment. It is difficult to gauge how this is developing for the market as a whole, but for the visible segment at least the indications are of growing levels of syndication, with angels working together more formally on more and bigger deals. As the angel market grows and matures, a greater degree of this sort of syndication, which the Angel CoFund encourages, is desirable.

EIS and SEIS are a major part of the angel space, providing a strong incentive for what is a risky activity, and along with the Angel CoFund they enable larger investment sizes – which stretches the reach of angels and allows them to make investments in traditional “equity gap” territory. This is a large degree of Government involvement, but one which is justified in encouraging investment into viable, risky, high-potential SMEs that might otherwise not receive the funding they need, and in building a market for, and culture of, angel investment.



EXPERT VIEW

EILEEN BURBIDGE
PARTNER, PASSION CAPITAL

THE ENTERPRISE CAPITAL FUND PROGRAMME IS A UNIQUE AND VALUABLE SCHEME

We could never have launched Passion Capital without the Enterprise Capital Fund (ECF) programme: it's a unique and extremely valuable scheme, incentivising significantly greater amounts of private investment than would otherwise be available.

ECFs are particularly important in the tech and digital space, where early-stage companies find it difficult to get financing because they often don't have turnover or tangible assets. When Passion Capital launched in 2011 we were unusual in our approach and stage focus, especially in the tech sector, but the London and UK community has matured.

I have been in the UK for a decade and the pace of change of the past 3-4 years has been outstanding. There is increasing interest from overseas investors, from the US, across Europe and Asia, which is great validation of the growth and maturity of the UK small business economy.

The situation has already improved dramatically and funding opportunities will continue to grow, helping to establish London and the UK as one of the best places in the world to start a business. More equity finance is now available to small companies and as a funding route for ambitious small businesses it is very much here to stay. It's a logical approach to getting finance into a company and is important in stimulating

growth and innovation. I think we are going to start seeing an increasing number of options for equity funding and that's very healthy for the market and the growth prospects of small companies.

The British Business Bank backed Angel CoFund, is also boosting the supply of equity finance to growing companies. It can be as important in creating a culture of angel investment in the UK as the Enterprise Investment and Seed Enterprise Investment Schemes have already proven. We work very closely with a wide range of angel investors and they are extremely encouraged by what the fund is trying to do.

Backing the judgment of angel syndicates allows private investors to be the ultimate judge of a company's merits and that is one of the attractive elements of the Angel CoFund as well as the ECF programme. It's a much better model of government support to stimulate smaller business growth, by investing in the fund managers, giving weight to their expertise.

By supporting and incentivising private sector investors, the British Business Bank is making the best possible contribution to the UK's thriving growth culture.

2.3

DEBT FUNDS AND
MEZZANINE FINANCE

-
- Since the recession, tighter credit conditions have led to debt funds becoming more established in Europe, offering a variety of flexible debt products to growth orientated companies

-
- Private debt is becoming a recognised asset class that is attractive to institutional investors, but their allocations to this asset class are limited

-
- There are very few debt funds focusing on investing in smaller businesses due to structural market failures

-
- Private debt funds play an important role in expanding the sources of funding available to growing businesses

Debt funds provide businesses with bespoke debt finance that offers an alternative source of debt funding to banks. Debt funds do not replace banks, as they generally do not provide working capital facilities like overdrafts, but instead focus on providing flexible finance for 'event driven' growth orientated companies.⁷⁰

While private debt funds are similar to funds in the private equity industry, (using similar fund structures), they deploy debt based instruments. Debt funds generally aim to invest in lower risk businesses than equity funds, and so the expected financial returns tend to be lower, but fund higher risk companies than banks are currently willing to lend to.

Most debt funds offer a range of debt solutions, and can structure their investments in a number of ways to balance the risk-reward profile - including secured senior debt, unsecured senior, uni-tranche, second lien, mezzanine and PIK (Payment in Kind) debt. The margins charged on private debt tend to be higher than the finance offered by a bank due to its bespoke nature and its role in funding riskier businesses. The greater the variable returns component including any non-amortising repayment features and the subordinated ranking of the security, the closer these forms of debt finance resemble the characteristics of equity. This shows mezzanine finance, defined as a hybrid of debt and equity financing, helps fill the gaps between senior debt and pure equity finance.

To a large extent, deal flow comes from Private Equity houses through sponsored deals where private debt is used in leveraged buyouts to fill gaps between financing needs of the borrower and maximum thresholds (measured by various leverage metrics) of senior secured lenders. However, this is beginning to change with direct lending (unsponsored deals) becoming more established for businesses looking for growth capital.

FIG16

Source: Deloitte LLP

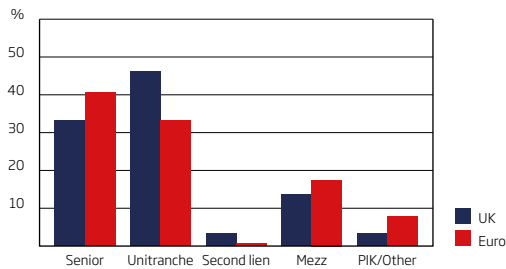
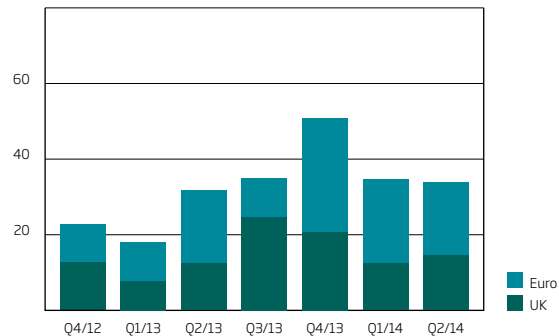
PRIVATE DEBT DEAL STRUCTURES

FIG17

Source: Deloitte LLP

NUMBER OF DEALS COMPLETED

Since the recession, tighter credit conditions have led to debt funds becoming more established in Europe, offering a variety of flexible debt products to growth orientated companies

Debt funds are more prevalent in the US, and have a longer history. This is partly due to the establishment of the Small Business Investment Company (SBIC) programme in 1958 by the Small Business Administration (SBA) to address funding gaps in the US economy.

European businesses are more dependent on bank finance than those in the US. Approximately three quarters of all credit intermediation in the UK comes from banks, compared to only around 25% in the US.⁷¹ As discussed in chapter 1 the majority of external finance to smaller businesses in the UK comes from banks.

Historically, the private debt market did not develop in the UK as banks met the funding needs of the majority of businesses up to the mid-2000s with narrow margins on lending.⁷² However, due to changes in the availability of bank lending, partly resulting from tighter banking regulations and also reductions in returns from investing in other assets, there has been new entry by private debt funds into the European market from 2010 onwards. The British Business Bank Investment Programme has supported some of the debt funds active in the UK.

While the total volume of capital raised for private debt in Europe is relatively low, there has been a large increase in the number of funds investing in businesses. The Deloitte Alternative Lender deal tracker shows the private debt market is becoming firmly established with 67 deals in 2013.⁷³ The UK remains the largest market for private debt funds in Europe with 47% of the transactions, followed by 25% in France and 12% in Germany.

Private debt is becoming a recognised asset class that is attractive to institutional investors, but their allocations to this asset class are limited

Private debt is becoming a standalone asset class with risk-reward profile that is attractive to investors.⁷⁴ In the current low interest rate environment, private debt offers the potential for yield with some downside protection. Potential returns for investors are perceived to be sufficiently attractive to compensate for reduced liquidity of the asset class as loans to mid-sized corporates offer relatively low liquidity compared to other asset classes.

Pension funds, insurance companies, private wealth investors, banks and sovereign wealth funds are the main investors in private debt funds. However, private debt is generally a small part of institutional investor portfolios (5.6% on average).⁷⁵ Only 27% of institutional investors have a target allocation to private debt, suggesting their investment strategy is more opportunistic, reflecting current funding conditions. European investors are generally choosing lower risk fund strategies compared to US investors,⁷⁶ which affects the types of investments occurring in the market.

There are very few debt funds focusing on investing in smaller businesses due to structural market failures

Whilst there has been a lot of new entry in the private debt market in Europe over the last few years, these funds have targeted investments in larger corporate businesses -with deal sizes in excess of £10-20mn. There has been limited entry by private sector debt funds specifically targeting smaller businesses with deal sizes of less than £10mn. There is only a small number of private sector debt funds focused on providing private debt to smaller businesses.⁷⁷

Operating a debt fund focused on solely investing in SMEs is more difficult, due to administrative and monitoring costs forming a larger proportion of the fund's capital. Fund managers also report smaller deals require additional resources for building up an extensive referral network (e.g. regional offices), which makes it less attractive than undertaking a smaller number of larger deals. It is also widely acknowledged by private debt fund managers that smaller finance deals are higher risk than larger deals due to their higher probability of default and lower recovery of assets should things go wrong.

In addition, there are also a number of market failures affecting the provision of private debt finance:

- Given that, in relative terms, more information is readily attainable on the viability and potential returns of larger businesses, the cost of due diligence tends to be a higher proportion of the deal size for smaller businesses. This can make investments in smaller businesses less commercially viable.
- Private debt is a relatively new asset class and has not developed a long term track record. Institutional investors are typically unwilling to invest capital or a greater amount of capital in private debt until it has a 15 year track record of generating financial returns, and so private debt currently remains a small part of their overall portfolios.
- There are information failures on the demand side: smaller businesses are largely unaware of the existence of private debt funds and mezzanine finance. Many businesses also do not fully understand the status of security when it is subordinated behind a senior lender, and the complex deal structures used for mezzanine finance can confuse some business owners.
- There are also co-ordination failures affecting the private debt asset class. Institutional investors can only invest in large private debt funds (of £10mn or more), which in turn invest in larger deals. Smaller funds focusing on investments in SME cannot obtain funding from institutional investors, and require funding from alternative sources.

Private debt funds play an important role in expanding the sources of funding available to growing businesses

There is evidence to suggest that the supply of funding available from the traditional banking sector has been constrained (see section 3.1), generating a strong case for alternative capital market solutions, including from private debt funds.⁷⁸ Private debt funds offer unique products which differ to the offerings of banks, so businesses can get funding that might not have otherwise been provided. In addition, encouraging non-bank sources of finance may also 'crowd-in' alternative sources of capital (e.g. from insurers) so that there is additional funding available to businesses in the economy.

The existence of viable businesses not getting finance for growth alongside evidence of structural market failures restricting the development of smaller private debt funds provides justification for the British Business Bank to facilitate this market. The Business Finance Partnership (later the Investment Programme), was launched in April 2013 with the aim to promote diversity of lending supply through supporting a variety of potential finance providers including private debt and mezzanine funds. Alongside a mid-cap tranche funding larger mid-cap businesses, a number of commercial debt funds focusing on SMEs have been supported including Beechbrook, BMS Finance, Boost, Praesidian and European Capital. To date the average investment size per company has been around £3.5mn, with over three quarters of investments going to businesses that meet the SME definition (turnover less than £25mn), indicating the programme is facilitating greater diversity in the supply of debt finance to smaller businesses.

Forthcoming British Business Bank research also reveals a funding gap for mezzanine finance deals. The British Business Bank is currently looking at options to facilitate the supply of mezzanine finance to smaller businesses. Whilst there is currently low awareness and demand for mezzanine finance amongst small business owners, there are indications that businesses will require additional finance to help support their growth. However, many businesses will also have experienced adverse trading conditions in the recession, which may have blemished their credit history. The establishment of specialist debt providers able to assess the viability of non-standard businesses should be encouraged as part of an overall funding environment.



EXPERT VIEW

MARTIN LING
DIRECTOR, BMS FINANCE

WE SUPPORT BUSINESSES THAT CANNOT EASILY SECURE BANK DEBT

We set up BMS Finance in 2003 when we saw an opportunity to lend to businesses that weren't being supported by banks.

In particular there was a gap for companies with strong intangible assets such as intellectual property and customer relationships. Banks have always found these types of assets difficult to assess but we have always considered them to enhance the enterprise value of these businesses.

What BMS Finance provides is a bespoke debt finance package that meets the needs of earlier stage businesses which are at or approaching profitability. They have experienced management teams and proven business models and need appropriate funding to grow. Not every company with growth potential can present a balance sheet that will encourage traditional providers to lend: we saw a gap for businesses that required support but could not easily secure bank debt. Other funders are operating in our market but this tends to be crowdfunding at the sub £500k end and challenger banks in the £5mn plus deal range whereas our average customer will be seeking to borrow £1.5-4mn (although our mandate allows us to lend between £500k and £5mn).

We are seeing significant demand for funding: small businesses that have come through the recession, with good management teams,

who are now looking to invest in assets and personnel to grow and expand. There is more demand now than we have ever seen and from right across the spectrum: for working capital, acquisitions and management buyouts.

When we launched, our main market was technology companies but that has significantly diversified: our first deployment using the match funding from British Business Bank was in a traditional painting and decorating firm from Birkenhead, for instance. We are increasingly looking to do more with businesses across the UK and beyond London and the south east. There are traditional engineering and industrial businesses in the Midlands and North of England for example with the same financial needs and challenges as more service or technology-oriented companies in the South East.

The recent investment in BMS from the British Business Bank, allowing us to complete a new £30mn fund, has been a significant boost. It gives us certainty of capital and the ability to go out and tell businesses that there is money available if the right deal can be reached. What businesses want above all is certainty of funding: many have spent months waiting to hear on loan applications from traditional lenders, ultimately receiving a negative response, and these businesses just want certainty of execution through dealing with the individual who is actually part of the decision making committee.

British Business Bank is enabling funders like us to tell businesses that there is capital out there and that deals can be done. That in turn allows us to meet the needs of a segment of businesses that are increasingly looking to move from subsistence into a growth phase, which can only benefit employment and the economy at large.

2.4

ASSET BACKED FINANCE

-
- The asset backed finance market has been growing at an average annual rate of 6% since the financial crisis with around £13bn of asset finance used by smaller businesses in 2013

-
- It is a widely used form of external finance, particularly for mid-sized businesses and capital intensive sectors

-
- Although a high percentage of businesses who apply for asset backed finance are successful in obtaining it, there are some viable businesses that are unable to secure asset finance as a result of market failures.

-
- There is a diversity of supply in the provision of asset backed finance to SMEs, with more than 80 lenders

-
- Price competition is more prevalent at the low risk end of the market, whilst the high risk end of the market sees more non-price competition

-
- Small providers of asset finance are more likely to face funding constraints due to a potential lack of competition in funding sources

The expected growth in business investment means that asset backed finance will play an important role in small business finance markets in the future. This section provides an overview of the UK's asset finance market based on results from recent business surveys, data from the Finance & Leasing Association (FLA), broader literature and discussions with asset finance market participants.

Invoice trading represents an additional type of finance where smaller businesses secure an advance against debt. This is sometimes known as asset based finance, and it is important to make a distinction between these two different types of finance. Data from the Asset Based Finance Association (ABFA)⁷⁹ shows an outstanding balance of pure invoice financing of £15.3bn at the end of June 2014 giving an indication of its relevant importance to business financing. Almost a third (31%) of total asset financing, i.e. asset based lending plus pure invoice financing, is for smaller businesses with a turnover of less than £50mn.

Invoice based financing is therefore a significant source of finance for smaller businesses. It takes two forms, invoice discounting where the finance company lends money against unpaid invoices and factoring where the finance company manages the sales ledger and collects money direct from the finance company

Invoice discounting offers advantages for smaller businesses, for example in that it can be arranged confidentially so that customers do not know that you are borrowing against their invoices, but also disadvantages, for example that there will be some loss in profit in order to bring forward the cash flow, and it may reduce the ability to raise other forms of finance, as the discounted invoices will no longer be available as security.

The rest of this section concentrates on asset backed finance. This is more likely to be useful for small businesses seeking to finance the purchase of productive assets for investment purposes. However invoice financing remains an important source of financing for small businesses seeking to manage cash flows for working capital purposes.

The asset finance market has been growing at an average annual rate of 6% since the financial crisis with around £13bn of asset finance used by smaller businesses in 2013

Figures from the Finance & Leasing Association show the asset finance new business amongst its bank and non-bank membership fell by a third from peak (2007) to trough (2009), from £26bn to £17bn (fig 18). This was likely to be driven both by reduced demand and constrained supply. As business confidence in the economy and investment has picked up since 2009, so has new asset finance business. The first nine months of 2014 have seen sustained growth for deals up to £20mn, up 13% on the equivalent period in 2013. This growth in asset finance during the recovery contrasts with traditional lending where the recovery has been tentative.

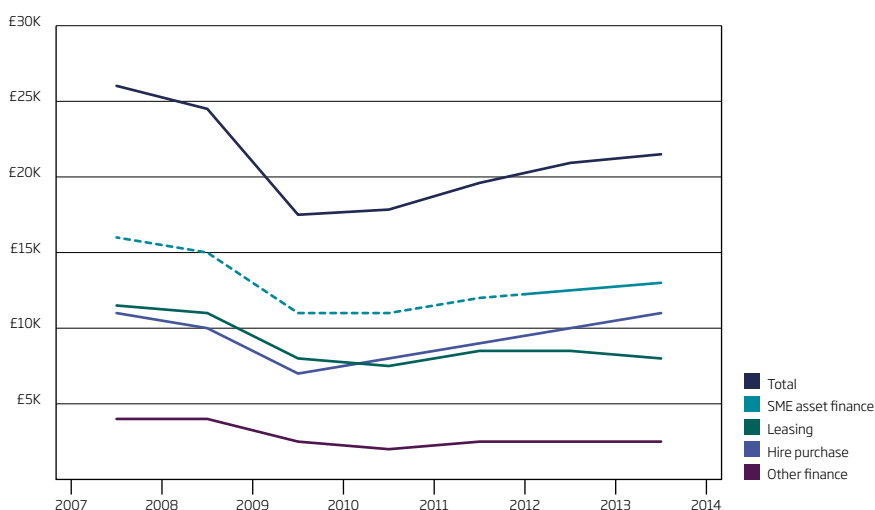
The FLA Asset Finance Confidence Survey estimates that SME asset finance accounted for approximately 60% of the total value of new business written in 2012 and 2013 - meaning £13bn of asset finance was used by SMEs in 2013. Recent trends have also shown a shift towards hire purchase since the financial crisis.

Brokers play a significant role in the asset finance market. As well as serving a valuable matching and coordination function between lessors and lessees, many brokers also provide some amount of 'own book' finance - i.e. direct lending. The FLA data shows that annual broker-generated business in 2012 was £4bn, up by more than 60% on its recession low in 2009. Despite the withdrawal of a major player from the broker-introduced asset finance market in the final quarter of 2012, this market reported new business growth of 18% in the twelve months to September 2014. Asset finance is part of the investment recovery story as it can affect a firm's propensity to invest. Penetration rates (total asset finance new business over investment) show the share of investment financed by asset finance has remained relatively steady over the last 4 years, although rates declined by approximately 10 percentage points from 2007 to 2010.

FIG 18

Source: FLA, British Business Bank. New business written by FLA members, deal size up to £20m

SIZE OF UK ASSET FINANCE MARKET FOR BUSINESSES 2007-2013



Notes: SME asset finance before 2012 is assumed to be 60% of the total size of the asset finance market

It is a widely used form of external finance particularly for mid-sized businesses and capital intensive sectors

Approximately 7% of smaller businesses reported that they currently use leasing or hire purchase; this is similar to the rate of usage of loans as a form of external finance (BRDC). Medium sized businesses are more likely to be using leasing, hire purchase and vehicle finance over 'traditional' bank loans.

The Mid-sized business survey showed that over half of mid-caps use asset finance.⁸⁰ This compares to a usage rate of less than 10% for micro businesses (SME Finance Monitor, 12 months to Q2 2014).

Business surveys point to a number of advantages from the use of asset financing, where investment in tangible capital is required. Leasing provides a less capital intensive funding option for equipment, rather than purchasing outright. One lender noted; *"businesses don't pay for staff 4 years in advance, why should they pay for assets upfront, when they can spread those costs over a longer time period."*

The chart opposite (fig 19) sets out the main reasons mid-sized businesses (turnover between £10mn and £500mn) said they use asset finance. Price ranks relatively high for larger businesses within the survey population, whilst cash flow management is the most cited reason irrespective of size. This reflects the benefits of leasing in facilitating cash flow for a business and reducing short term balance sheet risks. Flexibility and maintaining up-to-date equipment are

also cited as key reasons - where firms intend to change their capital assets frequently, leasing allows them to use assets for an agreed time period after which they can switch to more up-to-date assets without incurring further capital outlays.

Asset finance is most popular in capital-intensive sectors such as, transport, agriculture and manufacturing. This is likely to be linked to the appropriateness of leasing/hire purchase for the financing of equipment that tends to be used at a sector level.

Asset finance is used to finance a wide variety of asset types. Overall, vehicles and industrial equipment account for over 80% of all asset finance. The majority of plant and machinery is made up of construction and agricultural plant equipment, also reflected in higher overall usage rates in these sectors. Despite its relative high use as a form of finance, the British Business Bank consultation with asset finance providers highlighted that lenders were concerned small businesses lacked awareness of asset finance and its associated benefits. The 2014 SME Journey survey suggests awareness rates of leasing and hire purchase as a form of external finance are high on average at 85%, but that only 54% are aware of specific suppliers to approach for this type of finance. This limited understanding may point to demand side constraints due to imperfect information for businesses seeking finance.

WHAT IS ASSET FINANCE?

Two forms of asset finance are **lease financing** and **hire purchase**. In addition to securing finance against physical assets, businesses may also make use of invoice finance where they secure funding against unpaid invoices that they have issued.

Hire purchase allows the business to take ownership of the asset at the end of the contract. The finance company buys the asset on behalf of the customer, who then pays an initial deposit. The remaining balance, plus interest, is then paid over an agreed period. During this period, ownership rests with the finance company, which is effectively hiring use of the asset to the customer. Once the final payment is made, ownership transfers to the customer.

Leasing is a contractual agreement where a leasing company (lessor) makes an asset it owns available for use by another party (a lessee), for a certain time period in exchange for payment.

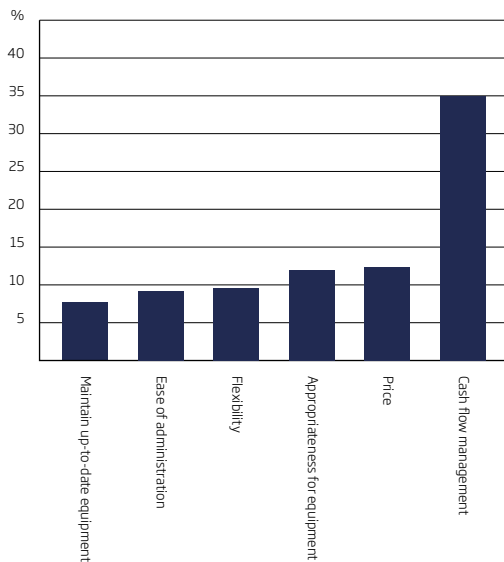
Two forms of lease financing are **finance leases** and **operating leases**. Under a finance lease, the finance company owns the asset throughout and the agreement covers a set period - either the full economic life of the asset or a term acceptable to the lender. Often, there is an option to continue leasing at the end of the contracted period.

An **operating lease** runs for less than the full economic life of the asset, and the lessee is not liable for the financing of its full value. The lessor carries the risk associated with the residual value of the asset at the end of the lease. This type of lease is often used when the asset is likely to have a resale value and by companies that frequently update or replace equipment (e.g. vehicles, aircraft).

FIG 19

Source: British Business Bank, *How medium-sized business access finance (2013)*

MAIN REASONS FOR USE OF ASSET FINANCE FOR MID-SIZED BUSINESSES



Although a high percentage of businesses who apply for asset based finance are successful, there are market failures that result in some viable businesses being unable to secure asset finance

The structural market failure of asymmetric information between businesses and lenders can act to constrain the supply of lending. As asset finance allows lessors to retain ownership of the assets, against which a business can raise finance, the assets act as collateral. This to some extent circumvents the problem of asymmetric information, which is otherwise prevalent in the unsecured lending market.

Leasing could thus be described as a market solution to a market failure in the small business lending markets as the item being financed acts as the security, i.e. in the event of a default the asset finance provider can reclaim the asset back. This seems to be corroborated by the wider literature on asset finance – Chigurupati and Hegde (2010) find that 'lessee firms with higher information asymmetry rely more on lease financing'.⁸¹

This is reflected in success rates for small businesses applying for asset finance which are higher than any other forms of finance. The British Business Bank Mid-sized business survey (2013) found that 94% of businesses described themselves as having had 'no difficulty' getting approval for leasing or hire purchase, success rates for SMEs outlined by the SME Finance Monitor are at 91% (12 months to 2014). This survey finds lower success rates for smaller SMEs (see fig 20).

Lower rejection rates for asset finance compared to other external finance implies that the pool of underserved businesses seeking asset finance is much smaller than other types of finance. However, based on information provided by lenders on the criteria considered when assessing an application for asset finance, it is apparent that younger firms with limited ability to fund deposits and where assets are of low value and with a limited secondary market, will face greater difficulty in accessing asset finance.

This is only a market failure where businesses are viable and unable to obtain finance, as a result of information asymmetries between the lender and borrower. Where it is a 'hard asset' that requires funding (e.g. wheeled assets such as vehicles), an asset that is business critical (e.g. barrels in a brewery) or a revenue generating asset (e.g. coffee machine), with strong secondary markets, less importance tends to be placed on wider criteria (i.e. track record, deposit), as the asset acts as collateral for the finance provided.

Market failures as discussed in the chapter may act to constrain the asset finance market. The British Business Bank is working on an estimate of the 'unmet demand' for asset finance, based on unsuccessful asset finance applications. Discouraged and latent demand, as a result of a lack of awareness, are also important in potential demand for asset finance.

There is a diversity of supply in retail provision of asset finance, with more than 80 lenders

The asset finance market is a complex arrangement of lenders and intermediaries, working to cover different spaces of the market - the FLA represent more than 80 lenders that supply businesses with asset finance. There are also a large number of intermediaries who broker deals on behalf of lenders, some of whom lend directly to businesses. The type of services and products offered by lenders at different ends of the price / risk spectrum varies substantially. The chart opposite (fig 21) illustrates varying risk appetites for lenders in the UK asset finance market. For simplicity, asset finance providers are split into 3 tiers - this stylised representation is in reality more of a spectrum of asset finance providers, offering differing rates dependent on risk profile of recipient and the lenders funding structure.

Tier 1 comprises banks and large non-bank asset finance providers. Deals in this tier are a minimum of £10k and are £40k on average. Borrowers with strong repayment capacity and track record are targeted and assets that are typically 'hard' such as wheeled assets are sought. There is some degree of concentration in the supply of asset finance in tier 1, with the top 5 lenders accounting for just over half of the total value of annual new business. However, FLA analysis of the number of new asset finance agreements in 2013 showed a significant percentage (40%) were written by non-banks.

Tier 2 comprises lenders with a broad range of appetites from those focusing on near prime deals to lenders with specific specialisms in asset classes or market segments. There are also providers of wholesale funding to smaller lenders.

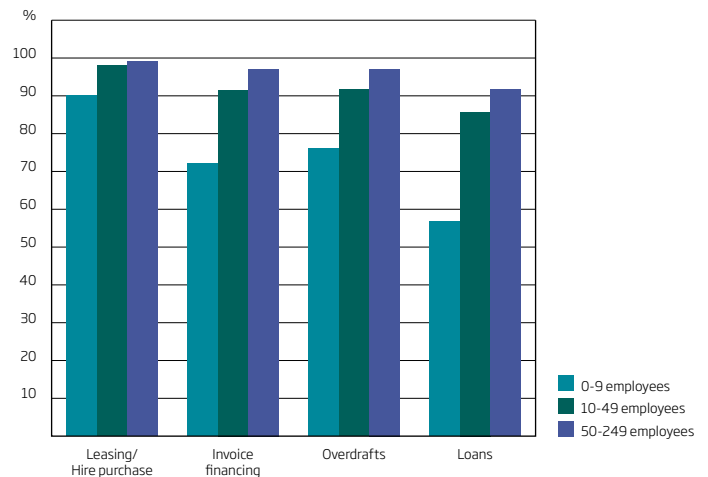
Tier 3, the 'non-prime' end of the market is the smallest in value terms, as deal sizes tend to be smaller. These lenders are more likely to serve businesses funding 'soft' assets such as catering equipment, software and fixtures and fittings (i.e. with limited resale value) and with weaker balance sheets/ track record. Despite operating in the higher risk end of the market, asset finance providers in this tier report low default rates in the current economic climate, at around 2%.

In the UK more than three-quarters of mid-sized businesses that had used leasing or hire purchase say they sourced it from a non-bank (fig 22).

FIG 20

Source: SME Finance Monitor, 12 months to Q2 2014 (not based on application date)

PERCENTAGE OF SME APPLICANTS WHO SUCCESSFULLY APPLIED FOR ASSET FINANCE BY SIZE OF FIRM



Price competition is more prevalent in the low risk end of the market, whilst the high risk end of the market sees more non-price competition

Price competition is stronger for tier 1 firms. Funding routes are low cost, particularly where the firms are funded by deposits (if they are a bank or have a parent bank). A number of companies in this space indicated that prices offered to businesses had reduced in recent years by 2-3%, because of intense price competition due to the low cost of borrowing and the availability of cheaper funding e.g. as a result of the Bank of England Funding for Lending Scheme.

Moving up the risk-price spectrum, price competition becomes less intense and companies compete on non-price factors such as service or specialisation. Non-price factors can include lenders providing ancillary services (e.g. maintenance of assets) or direct assistance with applications for finance. At this end of the market, businesses seeking finance are relatively less price sensitive as their funding options tend to be more limited. Some providers will specialise in certain asset classes, using their knowledge of asset values and routes to re-sell, to give them a competitive edge.

Recent trends have also revealed a reasonable level of entries and exits by lenders. This is suggestive of lower barriers to entry and exit, necessary to foster a competitive market. Whilst larger banks in particular withdrew from SME leasing in a 'flight to quality and safe assets', new entrants across all tiers in the last 5 years picked up some of the slack left with exits and withdrawal by some market participants.

FIG 21

Source: British Business Bank

STYLISTED REPRESENTATION OF THE ASSET FINANCE MARKET

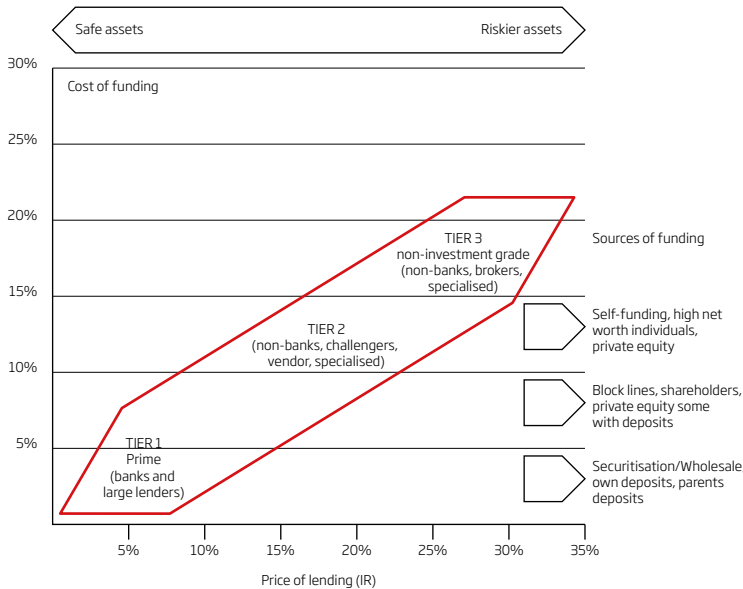
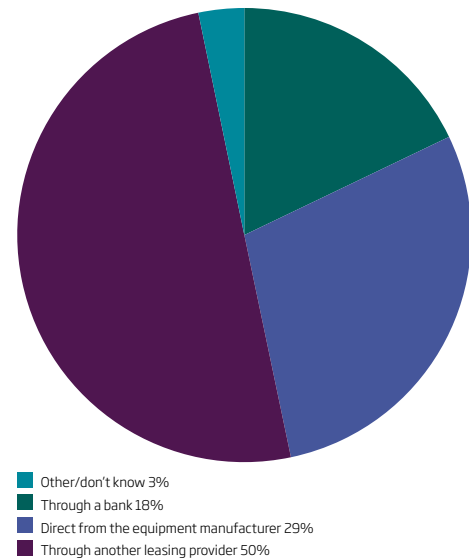


FIG 22

Source: British Business Bank, How medium-sized business access finance (2013)

SOURCES OF LEASING AND HIRE PURCHASE FOR MID-SIZED BUSINESSES



Small providers of asset finance are more likely to face funding constraints due to a potential lack of competition in funding sources

Despite diversity of supply in the retail provision of asset finance to SMEs there is some degree of concentration in the sources of funding for asset finance providers who primarily rely on finance from other lenders. Mid-sized / smaller non-bank providers of asset finance that are reliant on funding from other lenders, such as banks, may encounter terms and conditions which limit the type of on-lending permissible, according to the risk appetite of the funder. This may signal a lack of competition in the funding market for these financiers resulting in reduced capacity to lend to business. For instance, terms and conditions imposed on block discounting agreements place restrictions on the types of assets and businesses that are funded to suit the risk appetite of any given funder. This may limit the scope for some tier 2 lenders to extend lending to businesses that they may deem to be viable but do not meet the funders' criteria.

Furthermore, constraints may exist for smaller non-bank providers of asset finance in the higher risk/higher price space, due to a less diverse mix of funding sources for lenders. Alternative sources of funding can be limited in availability and more expensive. These limitations in the funding market for smaller providers of asset finance may therefore hamper competition at the high risk end of the market.

Given the importance of asset finance to small businesses and the implications for business investment, the British Business Bank has a strong interest in ensuring this market functions well and that viable businesses across all industry sectors and stages, but especially younger and underfunded businesses, have sufficient opportunity to source the finance they need to meet their growth aspirations.



EXPERT VIEW

MARK PICKEN
MD, SHIRE LEASING

NOT ENOUGH SMEs REALISE HOW ASSET FINANCE CAN BENEFIT THEM

Through a recession in which many businesses complained of a struggle to find funding, asset finance companies continued to invest in SMEs by making funds available to them to replace aging business assets.

Yet there remains a twofold problem for our industry. Firstly, not enough SMEs know that asset finance exists and how it can benefit them. Secondly, many SMEs still lack confidence to take on debt having just survived the worst recession in living memory. Some of those businesses are now “happy non-borrowers”, content to self-finance their growth. Yet for others, external finance will play an important role and that is where asset finance can come in.

The reality is asset finance, that is leasing and hire purchase, is and has been available for generations. It provides for a managed investment programme for any business that needs to acquire or replace business assets and is keen to preserve cash in the business by not sinking it into those depreciating assets. The assets concerned can be anything from a truck and trailer to IT systems, vending machines and virtually anything in-between. This facility is relevant to all businesses but particularly SMEs who often rely on the latest equipment

to maintain their fleet of foot approach to their market. If these assets age then the competitiveness of the business deteriorates accordingly.

Asset finance provides a fixed interest rate facility that secures the new equipment now and spreads the payment over the useful life of the asset. Think about when you hire an employee. You wouldn't pay your new colleague 3 years' salary up front. You pay them monthly. To buy your new IT or telephone system outright on day one makes no more sense than it would to pay a new hire up front for the duration of their contract. Spread the payments over 3 years and fix the interest rate today. That is a message we need to get into the small business community at large.

During the recession, availability of capital was very restricted and that is easing now, with new sources of capital becoming available. Private equity, hedge funds, venture capitalists and institutional investors are now seeing asset finance as a respectable investment opportunity where the risk equals the reward. Our own ability to lend money into the SME market is determined by how much capital is available in the market. Having the British Business Bank match our other investors pari passu to the tune of £80mn in total is a magnificent boost for us. Our current customer base is 97% SME under the government definition, but we have only scratched the surface. This extra investment allows us to extend our reach in the market and serve the UK SME businesses that will be the engine room of this country's growth.

03

FINANCE MARKETS –
FURTHER DIVERSITY NEEDED

The British Business Bank has been active in supporting greater diversity in the supply of finance to smaller businesses. The majority of British Business Bank support (61% in 2013/4), is channelled through new, emerging or smaller providers. And schemes such as the Enterprise Finance Guarantee encourage lending to viable smaller businesses that would otherwise be declined for lacking collateral, with over 2,750 smaller businesses benefiting from this scheme in the year to Sept 2014. But even greater diversity would give smaller businesses a wider range of options in terms of financial products and suppliers, to meet their financing needs.

Traditional bank lending remains the predominant source of finance in the UK

The majority of businesses are able to access finance without difficulty, however structural information failures meaning that young or small viable businesses are denied finance persist.

As evidenced in the table on page 9, flows of bank lending are much larger than other forms of finance. The recession saw a tightening in credit conditions which disproportionately affected lending to smaller businesses. And while the decline in bank lending to SMEs has slowed, any recovery is tentative at best.

A wider range of finance sources would offer more options to smaller businesses

Challenger banks have entered the market in recent years, but lending to SMEs is still concentrated with the four largest banks accounting for almost 90% of business loans by volume.

In addition, forthcoming research by NIESR for the British Business Bank suggests that the securitisation market for SME loans is small but could play a role in increasing the supply of finance to SMEs in future.

New sources of finance which serve to improve diversity of supply exist and are growing, but from a low base

Online technology has enabled the emergence of Fintech companies, an example being Innovative Online Platforms, with lenders and investors able to meet the finance demands of small businesses in innovative ways.

Business financing through these platforms has grown significantly, albeit from a low base, but remains very small compared to more established forms of finance. Despite their current small scale, these platforms also have the potential to diversify small business finance markets, by competing on non-price aspects.

The following chapter presents trends in bank lending to smaller businesses, followed by an analysis of Innovative Online Platforms that enable lending to smaller businesses.

3.1

BANK LENDING TO SMALLER BUSINESSES

- The recession had a severe impact on SME lending, as the risk taking capacity of lending institutions reduced
- More recently, gross lending to SMEs has increased but so have repayments resulting in net lending remaining negative
- A large proportion (up to 30%) of flows of bank lending are to the commercial real estate sector, which has dragged on net lending
- Despite some new entrants, including challenger banks, the UK banking sector for smaller businesses remains a concentrated market
- SME lending is capital intensive and regulation has increased banks' capital requirements

Chapter 1 showed that bank lending remains the dominant form of lending to smaller businesses. As such, it has a large effect on smaller business finance markets more generally. This chapter explores recent trends in bank lending, and considers competition, and regulation to improve financial stability – both of which have an impact on the level and diversity of supply of finance to smaller businesses.

The recession had a severe impact on SME lending, as the risk taking capacity of lending institutions reduced

Following the recession, the SME loan stock fell back sharply as credit conditions tightened, leading to less new lending to smaller businesses.⁶² The tightening in credit since 2008-09 disproportionately affected lending to small businesses – there were significantly higher rejection rates for smaller businesses, reflecting constraints to the supply of credit, and suggestive of a partial withdrawal from smaller business lending as an asset class.⁶³ Cyclical impacts accentuated the effects of longer term structural issues that mean viable small businesses are underserved. These structural market failures have been a concern in the UK since the Macmillian Committee (1931) and the Wilson Committee Report (1980) identified difficulties faced by smaller businesses in raising finance.

Under tightened credit conditions, viable firms which could afford to service debt but have limited track record or insufficient security are more likely to be denied bank loans or overdrafts, because they are less able to demonstrate their viability to banks. A restricted supply of finance to viable businesses, caused by this information failure, is likely to lead to lower levels of investment, which may lead to lower levels of output and employment in the short and long term.

FIG 23

Source: BoE Trends in Lending, April 2014. BBA SMEs and BoE SMEs updated by authors

ANNUAL GROWTH IN SMALL BUSINESS AND SME LENDING STOCK (a)**Notes:**

- (a) Non seasonally adjusted. Includes loans and overdrafts. BBA Small Businesses series (2004-2011) applies a different definition of business size than other sources.
- (b) Lending by seven UK lenders to commercial businesses with an annual bank account debit turnover of up to £1mn. The growth rate prior to September 2009 is presented on a quarterly frequency and monthly thereafter. Sterling. The survey terminated in June 2011.
- (c) Source: monthly BIS survey and Bank calculations. Lending by four UK lenders to enterprises with annual bank account debit turnover less than £25mn. Data cover lending in both sterling and foreign currency, expressed in sterling terms. The survey has been terminated.
- (d) Lending by UK monetary financial institutions to UK SMEs with annual debit account turnover on the main business account less than £25mn. Data cover lending in both sterling and foreign currency, expressed in sterling and are to February 2014.
- (e) Lending by a BBA panel of lenders to SMEs in Great Britain. SMEs are defined as businesses with turnover up to £25mn. Data cover lending in both sterling and foreign currency, expressed in sterling and are to December 2013.

More recently, gross lending to SMEs has increased but so have repayments

Since 2013, the growth in the stock of loans and overdrafts has become less negative.⁸⁴ However, the bank loan and overdraft market has not yet recovered. As mentioned above, NIESR research found that approval rates declined as a result of the recession. And while long-run consistent data is not available, business survey data suggests that they have been generally stable since 2011, although there is variation within this. For instance, nearly all renewals are approved, however, smaller and younger SMEs, and those applying for their first facility were less likely to have been successful in applications for overdrafts or loans.⁸⁵

According to the Bank of England (BoE) bank lending data, the gross flow of loans (exc. overdrafts) increased to its highest quarterly level in Q3 2014 since the start of the data series in April 2011. However, as repayments of loans by firms also increased, net lending was negative, estimated at -£473mn in Q3 2014. More timely monthly data suggests that the gross flow of loans to SMEs increased further in October 2014, contributing towards a positive net loans figure in that month.

Data from the British Banking Association (BBA) suggests that the quarterly net flow of loans (excluding overdrafts) to SMEs was less negative in Q3 2014, at -£42mn. This was also because the value of new loans increased slower than the value of repayments between Q2 and Q3 2014.⁸⁶

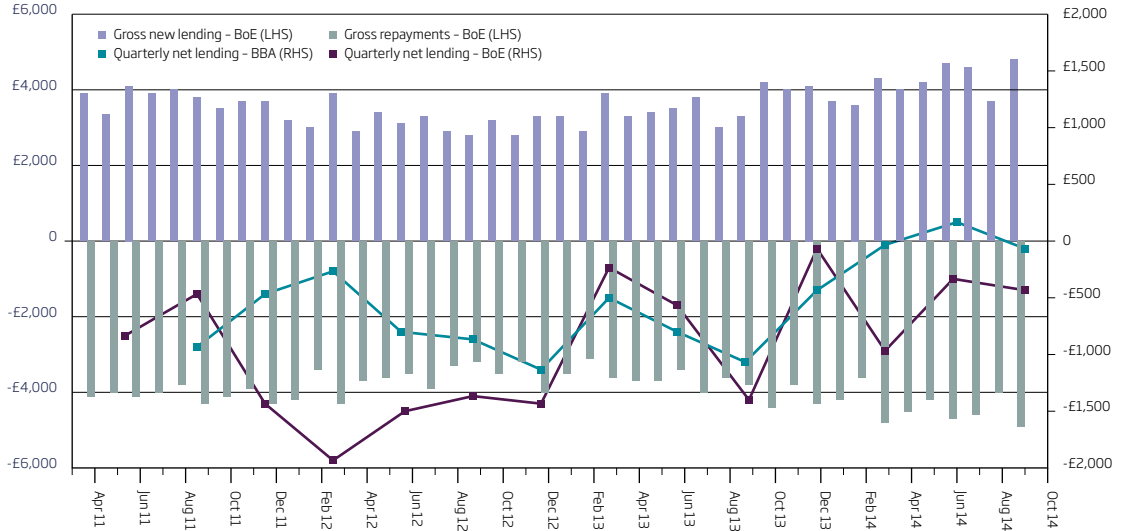
BBA data, which allows a more disaggregated view to the BoE's data suggests that recent improvements have been seen among medium, rather than small businesses. In addition, the value of approved loans for medium sized businesses has been increasing, and reached its highest value since the end of 2011 in Q2 2014, although it fell back slightly in Q3 2014. This has remained relatively stationary for small businesses in recent periods.

The value of outstanding overdrafts has been decreasing over time (see fig 25), as SMEs reduce their levels of debt – contacts of the BoE's network of Agents continued to report that many SMEs preferred to repay debt in the recent period⁸⁷ and Q3 2014 SME Finance Monitor data shows that 68% of SMEs agreed that they aimed to pay down debt and then remain debt free. In contrast, the stock of overdrafts held by large businesses (non-SMEs) has been increasing since 2012, and has increased particularly quickly since spring 2014.⁸⁸

FIG 24

Source: Bank of England Bankstats and BBA SME Statistics

GROSS AND NET FLOWS OF BANK LOANS TO SMES (£MILLIONS)



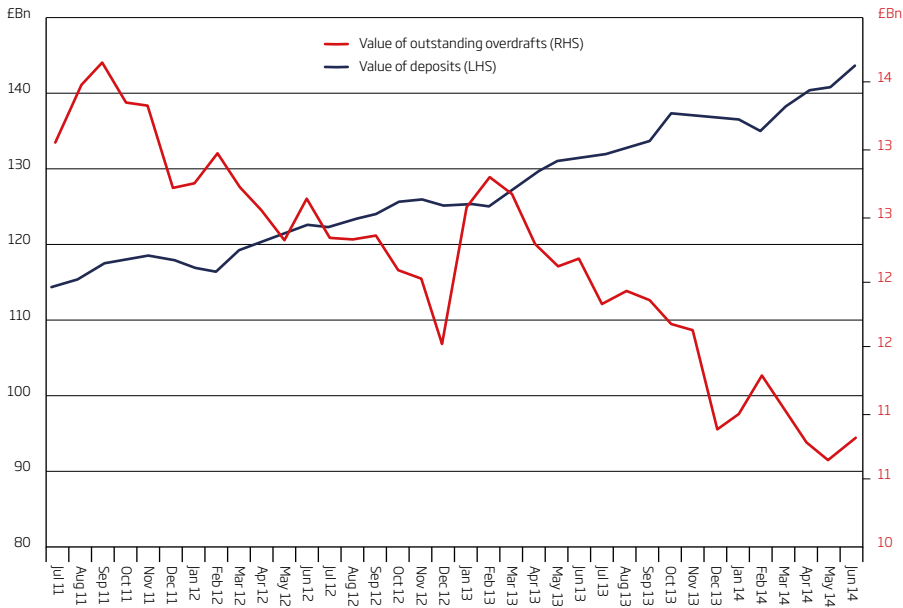
Notes:

All figures exclude overdrafts. There are various coverage and methodological differences between BoE and BBA data which help to explain the difference in net lending figures. Further detail is outlined in report footnotes.

FIG 25

Source: BBA SME Statistics

STOCK OF OVERDRAFTS AND VALUE OF DEPOSITS, ALL SMEs

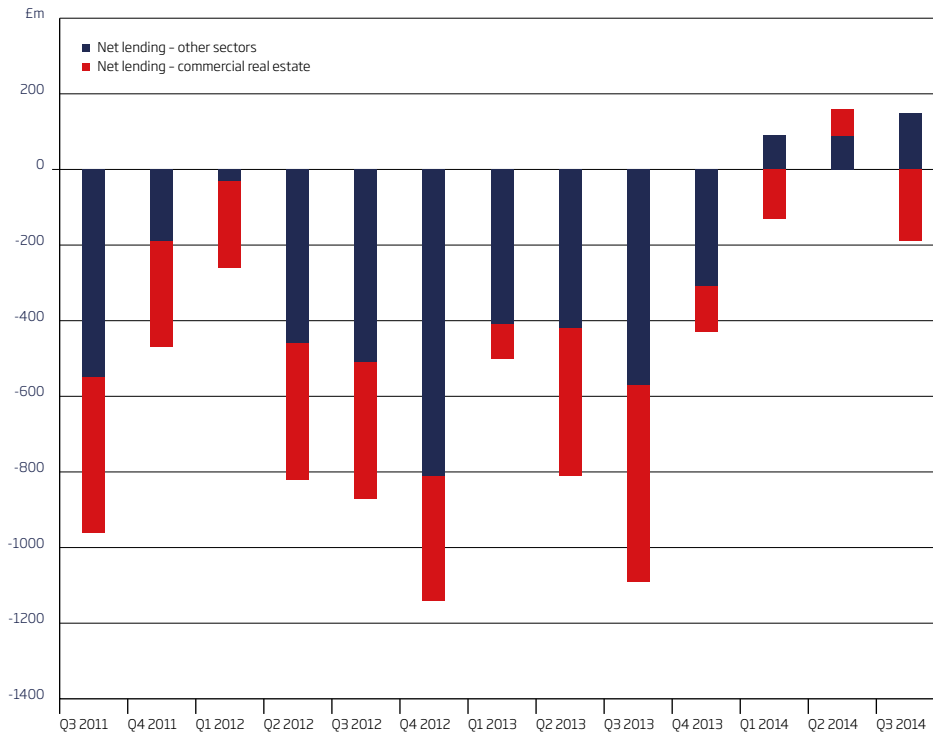


Notes:

Deposits include both current accounts and deposit accounts

FIG 26

Source: BBA SME Statistics

NET LENDING TO THE COMMERCIAL REAL ESTATE SECTOR

Notes:

Loans exclude overdrafts. Commercial real estate sector refers to SIC code 10a in BBA statistics: Buying, selling & renting own or leased real estate.

According to SME Finance Monitor, in Q2 2014 18% of SMEs had an overdraft, compared with 26% in 2011, and applications as well as renewals of overdraft facilities by SMEs have declined since 2011.⁸⁹ This decline has coincided with a significant increase in cash deposits held by banks on behalf of SMEs. This is an increase of 30% since the series began, much higher than the 6.7% increase in CPI inflation, or the 6.4% increase in the GDP deflator over the same period. SME deposit levels now exceed borrowing by more than £48bn. The BBA judges that this increased stockpile of cash among SMEs is contributing towards a reduction of demand for external finance among SMEs.⁹⁰ And according to SME Journey data, the vast majority of SMEs that intended to grow (74%) planned to fund this from internal cash flows only.

Interventions through partial guarantee schemes, such as the Enterprise Finance Guarantee Scheme, have encouraged lending to viable smaller businesses that would otherwise be declined for lacking collateral. Within the last year the EFG scheme supported lending to over 2,750 smaller businesses.

A large proportion of flows of bank lending are to the commercial real estate sector, which has dragged on net lending

According to the BBA, the commercial real estate sector (CRE) accounts for 25-30% of smaller business lending.

The Bank of England has reported⁹¹ that the commercial real estate sector has acted as a drag on growth in the stock of bank lending to all businesses. Data from the BBA suggests that this argument applies to some extent for smaller businesses. Fig 26 shows that the net flow of loans to smaller businesses in the commercial real estate sector has generally been a large negative contributor to the overall net lending position.

Despite some new entrants, including challenger banks, the UK banking sector for smaller businesses remains a concentrated market

There have been numerous reviews that focus on competition in the UK SME banking sector.⁹² Previous conclusions include:

- The SME banking market was highly concentrated in 2002, although in 2007 the OFT suggested that competition may have increased slightly with a small increase in market share from challenger banks;⁹³
- The UK banking sector was found not to be as competitive as it should, and that retail and business customers alike were often denied sufficient choice or access to enough information to exercise effective judgement;⁹⁴ and
- The Vickers review (2011) made recommendations to separate retail and investment arms of banks to improve financial stability, as well as concluding that banks should make it easier to switch bank accounts and recommending that the sector should be referred for a competition investigation.

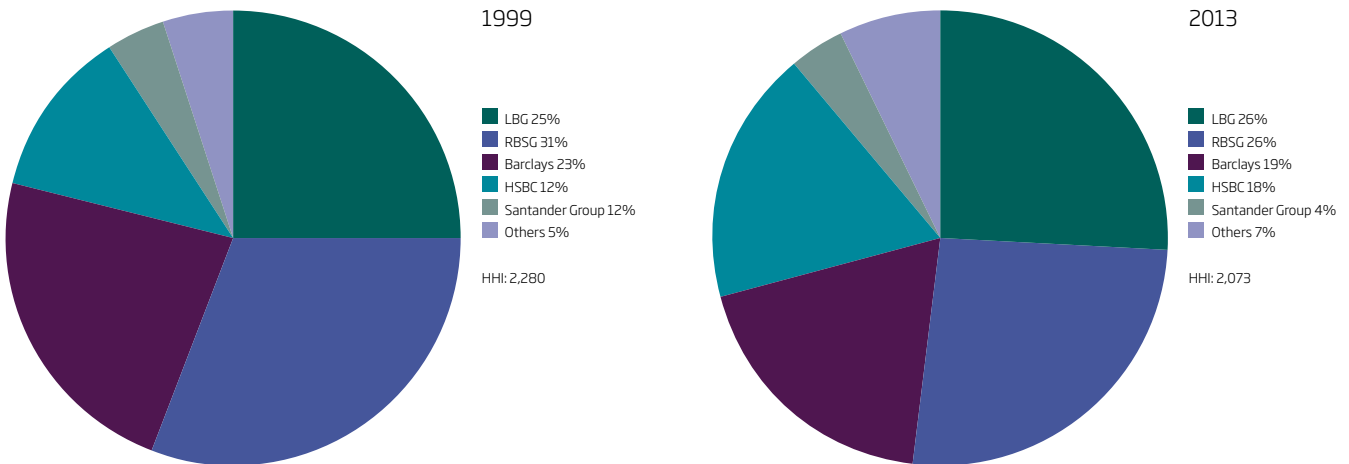
Following a consultation earlier this year, the Competition and Markets Authority (CMA) has announced the launch of an in depth market investigation in to the SME retail banking sector, as well as conducting a review of the competition undertakings put in place following the Competition Commission's 2002 report. The CMA and FCA's most recent market study suggested that the UK market for business loans and business current accounts is concentrated among a small number of large banks: In England, Wales (Fig 27) and Northern Ireland, the four largest providers of business loans by volume had a market share of around 90%, whereas in Scotland the three largest providers served around 90% of the market. According to the CMA, these levels of concentration do not differ significantly across SMEs with different levels of turnover.

While concentrated markets do not necessarily imply a lack of competition, the CMA suggests that the SME banking sector does not exhibit many of the characteristics of a well-functioning sector, and many of the conclusions from previous studies remain relevant today. In addition, poor competition is likely if there are also high barriers to entry and expansion. The CMA's market study suggests that despite recent banking developments such as use of online and mobile banking (which in theory could reduce barriers to entry), significant barriers to entry and expansion remain.

FIG 27

Source: CMA market study; 1999 figures from CC, 2013 figures from Charterhouse release Q1 2013

VOLUME SHARES OF BUSINESS LOANS IN ENGLAND AND WALES, YEAR TO Q1 2013



Notes:

Percentages may not sum to 100 because of rounding. All banks in the 'others' as a single entity for the purposes of calculating the HHI in 2013. However, if others were treated separately and it was assumed that they each had a market share of less than 1%, then the HHI figure would drop to 2,057. There are methodological differences between the calculations made in 1999 and 2013, including the inclusion of commercial mortgages in the 1999 figures.

As new entry, or potential new entry, is one of the key competitive constraints encouraging existing providers to compete on price, service and innovation, such barriers result in a reduced incentive on the largest banks to compete. The report also found that the SME banking sector has low rates of switching compared with other sectors, which can mean that there are insufficient profitable customers to incentivise new entrants to the market or smaller providers.

A recent BoE discussion paper on the availability of UK credit data⁹⁵ also identifies that when credit data are not adequately shared between lenders, it can create barriers to new entrants, inhibit the effectiveness of existing challengers by restricting their ability to assess the creditworthiness, and reduce the degree of competition between incumbents.

A number of challenger banks have emerged since the financial crisis – not all of these have large business banking arms. These include new entrants to the market, divestments from large banks following Government bail outs and existing smaller banks buying viable parts of failing competitors.

A number of policies are being introduced with the aim of improving competition in the small business banking sector. The Small Business, Enterprise and Employment Bill (SBEE) includes provisions to require banks to share information on their SME customers with other lenders through Credit Reference Agencies (CRAs), and to require those CRAs to provide equal access to that data for challenger banks and alternative finance providers. The Bill also includes provisions to require banks to forward on information on the SMEs they reject for finance (where consent is given) to Online Platforms that will help match them with alternative finance providers. The SME appeals process allows smaller businesses that are declined any form of lending to appeal that decision and the transparency brought by the publication of postcode lending data helps alternative finance providers and challenger banks identify under-banked areas.

The impact of challenger banks on the supply of bank lending to SMEs is an issue that will be considered as part of the Competition & Markets Authority in-depth investigation into the personal current account and SME retail banking announced on 6th November.

Uncompetitive markets can result in inefficient allocation of resources, usually reflected in prices that do not reflect their true market value and are often characterised by a lack of supply, or diversity of options for consumers. This is a sub-optimal outcome for consumers, and improvements in competition can lead to increases in business efficiency and economic welfare.

SME lending is capital intensive and regulation has increased banks' capital requirements

Regulatory changes motivated by the need to improve financial stability are, of course, important. Our aim here is to assess the impact of these on smaller businesses.

Following the financial crisis new macro-prudential policy regimes have been constructed across the globe, including the UK, under which minimum capital ratio requirements for banks will be employed to control the supply of bank credit. The raising of capital requirements has two main effects on financial resilience: first, it improves the capital position of banks. Second, to the extent that the capital requirement increase reduces future aggregate supply of credit, it may prevent credit-driven asset bubbles from forming in the first place.

It might be expected that banks pass on the impact of regulation to their customers via price increases or by decreasing the supply of finance to less profitable sources. A recent Financial Policy Committee (FPC) paper summarised a range of studies that analyse the quantitative impact of increases in capital requirements on banks' lending behaviour.⁹⁶ Most of the studies find that an increase in regulatory capital requirements leads to a modest tightening in credit conditions. A 1 percentage point increase in capital requirements is estimated to lead to an increase in the interest rate on bank loans of between 4.5 and 25 basis points and a decline in aggregate bank lending of between 0% and 3.6% relative to baseline, except for one study which finds a somewhat larger impact on bank lending. The OECD have estimated that the medium term impact of Basel III implementation is a small but negative impact on OECD GDP growth, due to an increase in bank lending spreads as banks pass on the cost of increased capital requirements.⁹⁷ Recent evidence suggests that the interest rates charged on lending to SMEs in the UK has been coming down.⁹⁸

The Funding for Lending Scheme is designed to reduce bank funding costs and provide participants with strong incentives to boost their net lending to businesses. In 2013, it was extended and refocused to provide stronger incentives to lend to SMEs.

Capital market techniques such as securitisation can help to diversify the supply of funding to lenders, although there can be risks. Currently securities backed by smaller business loans are only a small portion of the UK securitisation market. The box that follows considers the role of securitisation in further detail.

ROLE FOR SECURITISATION IN INCREASING DIVERSITY OF SUPPLY IN FUNDING OPTIONS FOR SME FINANCE⁹⁹

Securitisation: an example of a funding and risk management technology

Securitisation is an example of a financial technology used by lenders to raise funds and manage their risk exposures. Assets, which are often illiquid individually, are pooled together and are used to back different “tranches” of debt securities issued to investors. Tranching enables issuers to create various classes of financial instruments with different risk and reward profiles. The majority of risk is concentrated in “junior” tranches that yield higher returns, while “senior” tranches are more insulated but offer lower returns. This allows issuers to use their existing assets to access funding or transfer risk, and to tap a broad range of investors.

Mortgages and credit cards lead the way

Many financial institutions in the UK are active issuers of securitisation transactions. However, they tend to use their residential mortgage and credit card portfolios for that purpose. That is primarily driven by the fact that both of these asset classes are characterised by relatively high levels of homogeneity. Thus, the risks embedded in them are easier to analyse than the risks in some of the less traditional asset classes such as small business loans. That is attractive to investors, who are prepared to accept lower returns on mortgage or credit card-backed securities. As a result, many lenders find it more economical to use these well-understood types of receivables in their transactions.

Small business loan securitisation has attracted considerable level of attention in the recent times from different bodies and institutions interested in improving funding conditions for smaller companies. It is believed that securitising SME loans could help lenders to increase their business funding activities, and to create an indirect link between small business borrowers and institutional money. Many large investors would be attracted to SME debt-backed securities due to their relatively higher spreads¹⁰⁰ and potential for diversifying their portfolios. However, it is debatable whether in the near future small business loan securitisation could gain a significant market share versus other asset classes given that from the issuers’ perspective SME securitisations is still a relatively expensive funding source.

A funding tool for specialised lenders

Even if SME securitisation does not become as “mainstream” as mortgage securitisation, more niche lenders that cannot rely on traditional assets as their sole sources of liquidity may turn to small business debt for an alternative. Indeed, we have recently seen Investec, a specialist bank, successfully securitising its asset finance receivables twice. As the economy improves and appetite for financing from businesses grows, it is likely that other smaller lenders, including non-bank financial institutions, will seek to access secured capital markets. Whether they succeed will depend on many factors, including the availability of sufficiently large portfolios and the associated verified historic performance data.

Risk mitigation technique for lending portfolios

Securitising small business loans may also prove helpful for capital management purposes. As discussed above, risk associated with small business lending tends to be not only higher than that linked to, say, mortgage lending, but it is also arguably more difficult to analyse. Therefore, financial institutions allocate relatively more capital to SME lending activities, a practice that is further enshrined in bank capital regulations. As a result, small business lending sometimes does not offer very high risk-adjusted returns and may consume comparably high amounts of available capital. One way to overcome this issue is for banks to purchase protection on certain tranches of their portfolios to effectively insure themselves from credit risk exceeding a certain level. This may shift portion of SME portfolio exposure to investors that provide the protection, and free up banks’ capacity to make more loans.

3.2 ONLINE PLATFORMS

- Internet technology has enabled the emergence of Online Platforms, a subset of FinTech

- Financing through Online Platforms has grown significantly, but remains less than 2% of bank funding

- The emergence of new Platforms has seen a rise in the proportion of business lending

- SME awareness of Online Platforms is increasing

- Businesses most often seek financing to fund expansion/growth plans and working capital, with speed and ease of use attracting them to Platforms

- Online Platforms have the potential to diversify the finance markets for smaller businesses, despite current small scale

- Strict credit controls are often imposed by Platforms, meaning viable businesses without a track record may still be missing out on finance

- Risks expected due to developing nature of market, but Platforms are optimistic about the future, particularly given the UK's prominence in this area

The mainstream high street banking sector has faced numerous challenges in the wake of the financial, and then economic, crisis. Banks were deleveraging their balance sheets, restricting the supply of finance. Adapting to these challenges, the financial landscape has changed, seeing the emergence of alternative forms of finance. As this landscape continues to develop, the range of alternative finance options- those arising outside of the traditional banking sector - has increased.

Internet technology has enabled the emergence of Online Platforms, a subset of FinTech

One channel of alternative financing that has grown significantly in recent years is Online Platforms. They are enabled by online technology, meaning they form a subset of FinTech,¹⁰¹ and act as a means of connecting parties wishing to obtain finance with those wishing to provide it, i.e. the funds pass from lender to borrower without passing through the balance sheet of a financial institution. They therefore fall outside of the traditional banking sector and are highly innovative, with each platform aiming to differentiate themselves from their competition. AltFi,¹⁰² a data provider for this rapidly growing sector, notes that, "There are almost daily innovations as Platforms seek to carve out new niches and come up with new ways of financing."

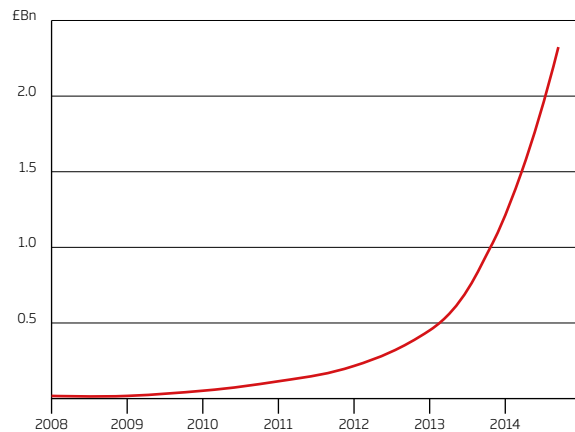
Some types of Online Platform are detailed below. The content of this section predominantly focuses on P2P business lending and debt based crowdfunding (sometimes referred to collectively as P2P business lending).

- **Peer-to-Peer (P2P) Lending**
 - P2P Consumer Lending - individuals lend money to other individuals (consumers) in return for interest and capital repayments
 - P2P Business Lending - lenders lend money to businesses in return for interest capital repayments
- **Investment Crowdfunding**
 - Debt (or Loan)-based Crowdfunding - lenders buy a security, normally a form of bond, in return for interest and capital repayments
 - Equity-based Crowdfunding - investors buy shares in early stage businesses with the expectation of capital growth and dividends
- **Invoice Finance Platforms** - lenders buy invoices at a discount, then sell them back to firms at a profit
- **Reward-based Crowdfunding** - individuals give money in return for a reward or recognition, product or service

FIG 28

Source: Liberum AltFi

LIBERUM ALTFI VOLUME INDEX (CUMULATIVE FINANCING VOLUMES)



Financing through Online Platforms has grown significantly, but remains less than 2% of bank funding

Zopa, the world's first P2P platform was established in 2005, with loans focused on the consumer. Since then, there has been a notable expansion in the number of platforms operating, as well as the finance they facilitate.

The value of finance originated through Online Platforms has grown exponentially over recent years, with latest figures from the Liberum AltFi Volume Index indicating that £2.3bn of financing had been arranged as at the end of October 2014 (data collection began in 2008). AltFi estimate that roughly c£0.7bn worth of transactions occurred in 2013, with transaction values at the end of October 2014 totalling c£1.3bn (already outstripping the 2013 total).

A recently published report by Nesta and the University of Cambridge¹⁰³ estimates that gross financing flows through Platforms will total c£1.7bn in 2014. The Nesta-University of Cambridge data covers a broader sub-set of Online Platforms than the Liberum AltFi Volume Index, albeit the additional Platform types covered by Nesta-University of Cambridge represent a relatively small proportion of total financings.

Both data sets point to high growth of the sector, with Nesta-University of Cambridge data pointing to a 161% increase in the size of the market between 2013 and 2014. AltFi Data suggest that year-to-date totals for 2014 already show growth of around 90% compared with 2013 figures.

The emergence of new Platforms has led to a rise in the proportion of business lending

P2P consumer lending dominated until 2010, which saw the emergence of P2P business lending, and later, invoice financing and equity-based crowdfunding. Subsequently, the market share of consumer lending has decreased notably, with the proportion of total transaction volumes originated through business-focused Platforms rising.

The Nesta-University of Cambridge data echoes this trend. They report that the average growth rate of P2P business lending between 2012 and 2014 was 250% compared with 108% for P2P consumer lending. Invoice trading and equity crowdfunding have also shown strong growth (174% and 410% respectively).

Data providers covering Online Platforms are emerging. However, granular data on the market is not readily available, meaning it is difficult to identify the exact amount of finance provided to smaller businesses. For example, it is possible that some P2P consumer lending is being used to finance business ventures, with the owner taking out the loan in a personal capacity. Equally, within the P2P business lending, invoice finance and crowdfunding channels, the proportion of funding provided to smaller versus larger companies is not clear.

Bank of England data show gross flows of lending to SMEs, which was circa £24.8bn for the first half of 2014, excluding overdrafts. AltFi Data suggest that the value of loans originated through P2P business lending and invoice finance

for the first half of 2014 was £0.4bn. On this basis, funding provided to smaller businesses sourced through Online Platforms represents less than 2% of that sourced through the traditional banking sector, when using these figures as approximations for comparable funding provided to smaller businesses, where granular data is not available.

SME awareness of Online Platforms is increasing

SME journey data indicates that awareness of P2P lending and crowdfunding has increased significantly since 2012: 35% of SMEs were aware of P2P lending (24% in 2012) and 32% were aware of crowdsourcing (13% in 2012).

By broad sector, awareness of both finance channels is highest amongst business services companies and lowest amongst construction companies. Awareness is also higher amongst younger businesses (those aged 0-5 years), particularly for P2P lending.

Despite rising awareness, the SME Journey data shows extremely low usage of both forms of finance by SMEs in the previous three years. Only 1% of smaller businesses obtained financing through a P2P platform during that period. All sources of equity investment totalled 1%, with the use of crowdfunding in this category very low.

FIG 29

Source: AltFi data

ALTFI DATA SHOWING MARKET SHARE BY PLATFORM TYPE (BASED ON 12-MONTHS TO OCTOBER)

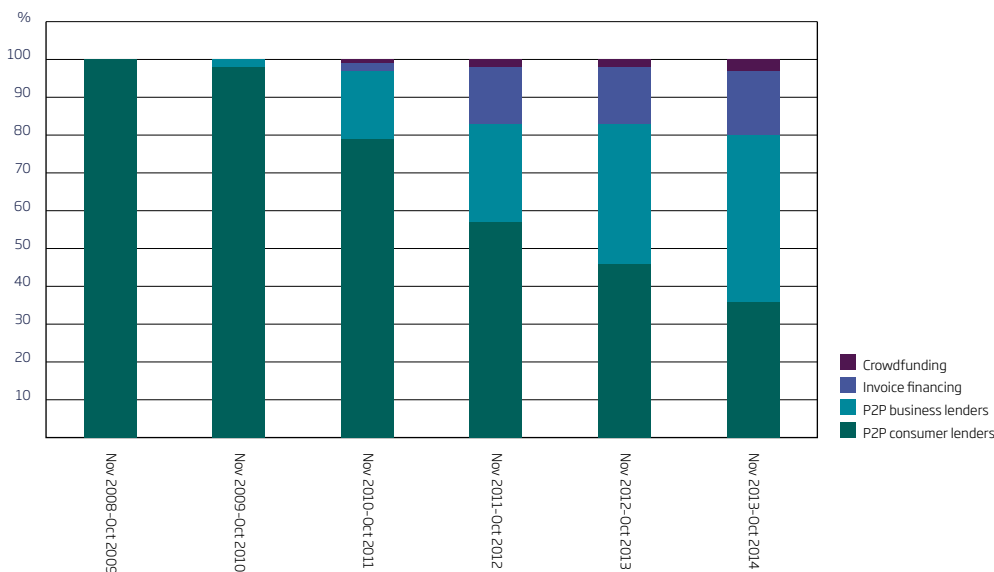
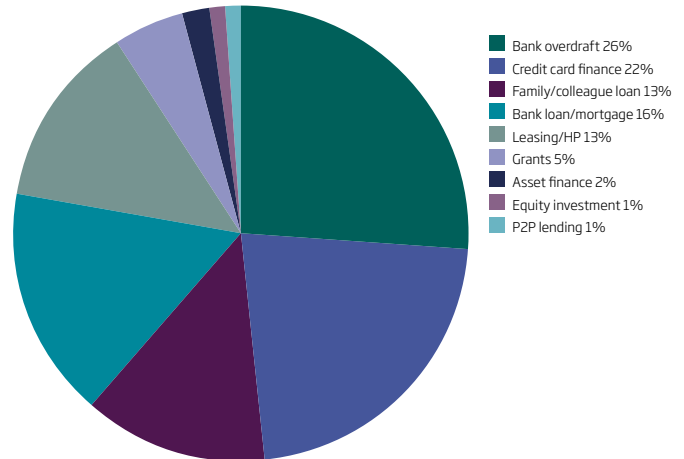


FIG 30

Source: BMG, SME Journey Survey

EXTERNAL FINANCE USE BY BUSINESSES THAT USED EXTERNAL FINANCE IN THE PREVIOUS 3 YEARS, 2014



Businesses most often seek financing to fund expansion/growth plans and working capital, with speed and ease of use attracting them to Platforms

The British Business Bank has collaborated with Bryan Zhang of the University of Cambridge (who with Nesta produced a recent report on alternative finance) on a series of 110 qualitative interviews with Platforms, smaller businesses and lenders/investors.

The aim of the research was to obtain more granular insight into the sector and assess the underlying motivations of those businesses using Online Platforms. This is supplemented by survey data collected by Nesta-University of Cambridge, where available. The predominant focus of the interviews is on P2P business lending (which also covers debt-based crowdfunding).

Nesta-University of Cambridge data indicate that, where businesses are pursuing funding through a P2P lending platform, the top reasons for applying were to fund 'expansion/growth', 'working capital' and 'asset purchases'. Invoice trading platforms also provide debt funding to businesses, estimated at £270mn in 2014 by NESTA-University of Cambridge, and are likely to skew motivations towards finance for working capital.

The Nesta-University of Cambridge data indicates why the popularity of Online Platforms continues to gain traction. Respondents (those who had already approached a Platform, whether that be successfully or unsuccessfully) were asked to state the importance of a number of factors in their decision to approach a P2P business lending platform.

When combining responses of 'very important' and 'important', the top factors influencing businesses to approach Platforms were ease of use and speed. This was followed by the perception that it is easier to obtain funding through Platforms than through more traditional sources and the transparency provided by the Platforms.

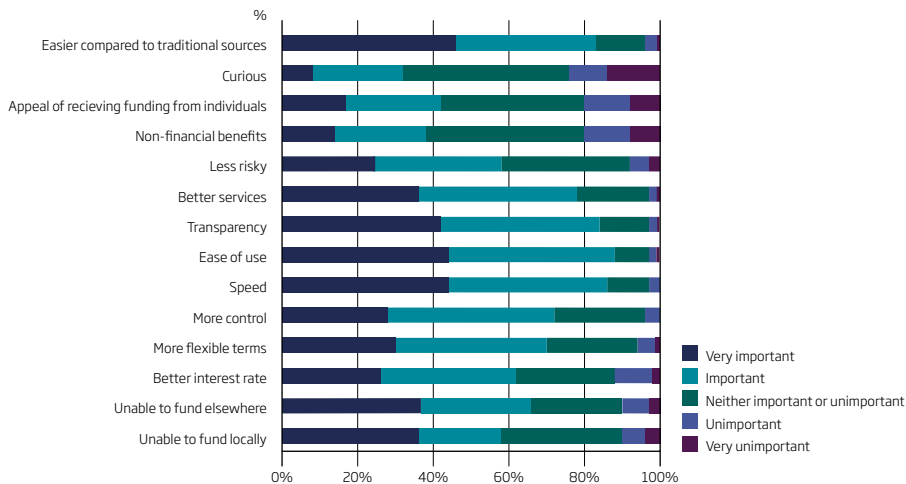
Similarly, for those respondents successful in obtaining funding through a P2P business lending platform, 87% reported that the registration process was easy or very easy and 82% reported that the application process was either easy or very easy.

Exploring this further, the University of Cambridge qualitative research notes that, "SMEs interviewed reported that the fundraising process with banks is normally long, complicated and unpredictable, with lending decisions not normally made in their local branches but far away or outsourced with strict conditions attached to them."

FIG 31

Source: Nesta-University of Cambridge

MOTIVATIONS FOR APPROACHING AN ONLINE PLATFORM FOR FINANCE



Online Platforms have the potential to diversify the finance markets for smaller businesses, despite current small scale

The Competition & Markets Authority (CMA) notes that, "Effective competition to provide SMEs with high quality and responsive banking services, at the lowest possible cost, is critical in ensuring that SMEs are able to get what they need from their banks."

Early evidence suggests that Platforms are emerging as an alternative provider of debt finance for smaller businesses, despite not providing the day-to-day services offered by mainstream banks. Interestingly, it is the key motivations for usage, e.g. speed, ease of use, that provide the main source of competition and not a perceived desire of smaller businesses to source cheaper finance. The wider Nesta-University of Cambridge research indicates that interest rates for smaller businesses are typically around 8-9% (17-18% for higher risk loans), meaning that the cost of funding through Platforms is likely to be comparable to bank finance, rather than a cheap source of finance for many borrowers.

The trend in the contribution that Platforms can make in terms of diversifying options and choices for smaller businesses is positive, albeit scale would need to increase for this impact to be more significant. The University of Cambridge interviews with investors and smaller businesses indicates that both groups welcome the emergence of Online Platforms, noting that they provide, "Viable, healthy and necessary competition to the status-quo." Both groups expect Platforms to continue to grow, but do not expect them to displace traditional sources of finance.

Strict credit controls are often imposed by Platforms, meaning viable businesses without a track record may still be missing out on finance

Emerging evidence from the University of Cambridge would suggest that smaller businesses receiving finance through the P2P lending platforms generally have, "Good business track records, strong credit ratings and, sometimes, sizeable fixed assets."

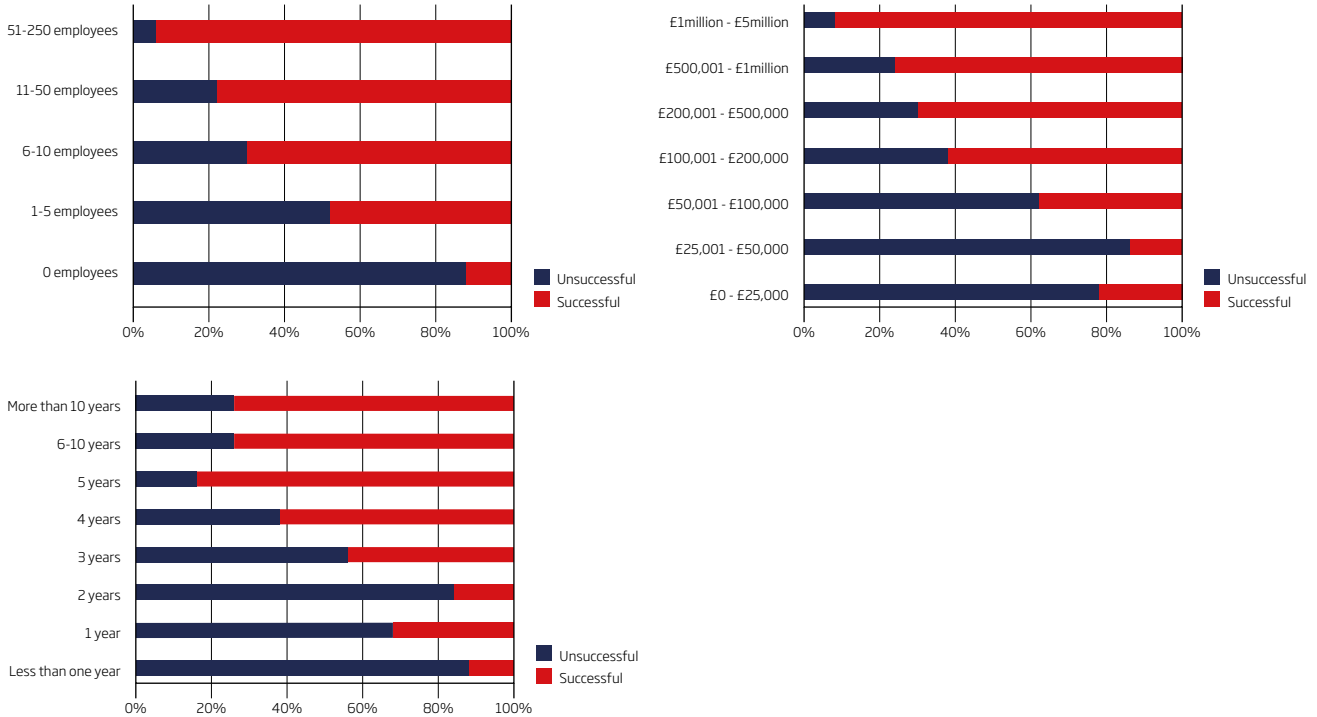
Further data obtained from the Nesta-University of Cambridge highlights these borrower characteristics. Looking at data on number of employees, turnover in 2013 and age of business, we can see that as a proportion of respondents in each category:

- Sole traders were more likely to be unsuccessful in obtaining funding through a P2P business lending platform. However, those with 6 and more employees were more likely to be successful (with the likelihood increasing with the number of employees).
- Businesses with higher turnover (above £100,000) were more likely to be successful in obtaining funding.
- Businesses that had been trading for 4 years or more were more likely to be successful in obtaining funding. Those who had been trading for two years or less were more likely to be unsuccessful in obtaining finance.

FIG 32

Source: Nesta-University of Cambridge

APPLICATIONS TO ONLINE PLATFORMS - PROPORTION SUCCESSFUL/UNSUCCESSFUL BY NUMBER OF EMPLOYEES, TURNOVER AND AGE OF BUSINESS



Anecdotal findings from the small sample of users of P2P lending and crowdfunding identified through the SME Finance Monitor echo these findings. Initial analysis suggests that users are less likely to be sole traders and appear more likely to be planning to grow and more likely to have someone in charge of finances who is qualified.

Typically, viable businesses without a demonstrable track record or collateral will find it more difficult to obtain funding from banks, due to the higher credit risk that they present.

The qualitative interviews conducted with Online Platforms emphasised that the credit processes they put in place are often designed to be conservative and approve the highest quality credits. This is not altogether surprising; Platforms are businesses operated for profit, where management teams are often experienced in credit assessment and want to establish a stable business.

Processes that ensure only viable businesses obtain funding are important for the longevity of the Platforms and for the protection of investors. However, if viable businesses are being turned down, then it is possible that access to finance market failures evidenced in the traditional banking sector are also prevalent for businesses trying to obtain funding through Online Platforms.

Initial analysis of the Nesta-University of Cambridge data on borrowers through P2P business lending and debt-based crowdfunding platforms suggests that roughly 65% of respondents had attempted to gain funding from a bank prior to approaching a Platform, although only 16% were successful in receiving finance from a bank. However, this relationship is complex, as anecdotal evidence derived from the interviews suggests that as Platforms become more established, borrowers have been more inclined to approach them first, without previously applying to a bank.¹⁰⁴

A more rigorous and robust investigation would be required to examine whether market failures exist for smaller businesses trying to obtain funding through P2P business lending and debt-based crowdfunding platforms.

Nonetheless, due to the array of Online Platforms existing, there are sources of finance available for younger businesses or start-ups, albeit with financing volumes at a smaller scale, for example, equity-based and reward-based crowdfunding platforms. The major advantages of both these types of Platforms are the potential networks of supporters and customers gained, testing through the crowd of demand for their products or services, and verification of the business, which can be useful for future funding requirements.

Risks expected due to developing nature of market, but Platforms are optimistic about the future, particularly given the UK's prominence in this area

Anecdotal evidence received from the qualitative interviews suggests that Platforms are optimistic about the potential for growth in the sector. There are good opportunities in the domestic market, with anecdotal evidence suggesting that Platforms are increasingly seen by businesses as a 'first choice' when considering debt finance options. The perceived advantages of the P2P business lending and debt-based crowdfunding platforms, with regards to speed and ease of use, are unlikely to be eroded in the near term. Furthermore, the UK is seen as a leader in its development of Online Platforms, opening up opportunities to export models elsewhere.

There are, however, a number of risks that could impede the growth or stability of Online Platforms. Firstly, in line with the emerging nature of this finance channel, many Platforms are yet to establish a robust track record. As previously discussed, many Platforms enforce stringent credit checks on applicants for finance, although it is acknowledged through responses to the interviews, that a 'rogue' Platform could damage the reputation of the industry or reduce investor confidence, which could restrict growth.

The Platforms rely on new investment and financing requirements in order to grow. A number of the Platforms interviewed noted the need to promote awareness, both amongst investors and smaller businesses, to ensure that high-quality borrowers continue to request funding and that there is a sufficient network of lenders to meet this demand.

Attractive default rates presented by Platforms are, in some instances, based on limited trading periods. If these were to increase over time, the perceived risk-reward payoff for lenders may change and impact on their investment decisions. This is particularly true for equity-based platforms, where it may take a number of years to determine the proportion of deals that are successful and earn returns, versus those that fail. Related to this, it is important that Platforms play their role in protecting the position of investors, particularly in equity deals, to ensure that they receive the expected share of returns when these arise.

Aligned with the increase in the number of Online Platforms, we would also expect there to be some turbulence among operators, where competition will potentially drive some

out of business, with the more successful models surviving. Alternatively, there may be consolidation in the market. Both these factors may create some instability in the market that may impact negatively on investor confidence.

The emergence of associations such as the Peer 2 Peer Funding Association (P2PFA) and the UK Crowdfunding Association (UKCFA) mean that member Platforms work in accordance with certain rules or codes of practice. The P2PFA states that, "Members of the P2PFA are required to meet our robust rules and operating principles for the transparent, fair and orderly operation of P2P lending." These may help to improve consistency of standards amongst operators. Additionally, as data providers for the sector continue to develop, they may work with operators to standardise data across the sector and improve transparency.

Furthermore, some of the Platforms are putting in place measures to increase liquidity of investments, should this be required, through secondary trading markets or similar. Some are also looking at ways to reduce the impact of bad debt on investors through, for example, contribution funds that act as an insurance policy if a borrower is unable to repay a loan.

In addition, FCA regulation of Crowdfunding came into effect in April 2014. These regulations also help to protect investors. The FCA regulates two types of activity:

- Loan-based crowdfunding platforms - P2P lending typically falls under this category. The P2PFA notes, "The regulation requires peer-to-peer lenders to have minimum operation capital requirements, meet client money requirements and adhere to a disclosure based regime."
- Investment-based crowdfunding platforms - debt- and equity-based crowdfunding typically falls under this category.

Invoice trading and reward-based crowdfunding is currently not regulated. More information on the FCA regulation can be found on their website.¹⁰⁵



EXPERT VIEW

JAMES MEEKINGS
CO-FOUNDER, FUNDING CIRCLE

WE SEE OURSELVES AS A NEW INFRASTRUCTURE FOR LENDING

The market for small business finance is diversifying and innovative platforms such as Funding Circle have grown incredibly in the past three to four years.

You often hear that demand for finance among small businesses is low, but while it may be less than before the recession, we do see it in the market, especially for business loans that are relatively painless to access.

The British Business Bank has played an important role in helping draw attention to the alternatives out there. It has been bold in not just supporting banks and existing infrastructure, but working to build a diverse and competitive market.

By supporting platforms such as ours, British Business Bank is not supporting one lender but over 30,000: all types of people, from individuals to family offices, local councils and pension funds. We want to get more people lending to businesses, increasing the supply from a small handful of players to a much broader range. British Business Bank's support has been instrumental in helping us create a more diverse set of investors.

As a marketplace lender, not taking deposits but facilitating the flow of money on a risk basis, we can support lending to more and different types of businesses. We see ourselves as a new infrastructure for funding, with thousands of people and players using us.

In the next decade, we expect alternative lending to account for as much as 20% of the overall market, but there's a journey to get there. A better functioning market will mean clear signposting so businesses know what type of finance to go for and where to look. We need to educate businesses and show them the range of opportunities available and our challenge is to market what we are doing and the benefits it offers.

People talk about increasing competition in the banking sector, but effecting wholesale change will be difficult given the size of institutions, even with the growth of the challenger banks. A healthy market will be one where the banks service current accounts and some loans, while working in harmony with innovative non-bank lenders, who help lending but don't compete for banking customers.

There needs to be a flow between traditional banks and non-bank lenders, which is what we are seeking to achieve through our partnership with Santander, who refer customers they will not consider for a loan to Funding Circle. Clearer indications of the different options available are what will help create a harmonious marketplace and one that gives small businesses the best possible chance of obtaining the funding they need to succeed and grow.



EXPERT VIEW

RHYDIAN LEWIS
FOUNDER AND CEO, RATESETTER

THE UK HAS BEEN AHEAD OF THE CURVE IN DEVELOPING ONLINE FINANCE PLATFORMS

The great benefit of peer-to-peer lending is its dynamism: it offers an open exchange where lenders and borrowers can transact, resulting in better value for both parties.

The fact that we were able to launch in Australia this year is indicative of a growing appetite for this form of finance: people are starting to identify that this model can be a game-changer for their businesses. It is going to accelerate enormously – there is currently just over £100mn in new lending every month in this market, and that is a figure only set to rise.

Although the default option for businesses is still to approach their bank when seeking finance, that is starting to change. There is still an important role for banks to play in delivering funding to larger companies, but small business owners are now seeing the benefits that Online Platforms can offer: ultimately I would expect to lose the ‘alternative’ finance tag altogether.

The challenge for the peer-to-peer sector is credibility. You can't shortcut your way to trust – credibility is something you have to earn, and we have gone a long way down that road.

Westminster has helped in this by supporting and raising awareness of Online Platforms. It is great to see that they are promoting choice for borrowers – so important for small business borrowers. More broadly, the UK has been ahead of the curve in supporting the growth and development of online finance platforms: creating a regulatory framework and potential tax incentives such as an ISA for people who lend through peer-to-peer platforms.

Small businesses are the posterchild of economic recovery and growth and the British Business Bank has a crucial role to play in encouraging their growth. Getting finance to small businesses, micro-businesses, and sole traders is difficult, but with the support of British Business Bank we are delivering funding where it is most needed. British Business Bank's partnership model, working through providers such as RateSetter is the right one: what businesses want is to deal with institutions that they recognise and can work at the grassroots level.

04 AWARENESS - NOT YET COMPREHENSIVE

Awareness amongst smaller businesses of the full range of external finance options available is limited

Most smaller businesses are not aware of the full range of external finance options available to them, and are instead reliant on finance provided by banks. For instance, 93% of smaller businesses are aware of credit cards and 85% are aware of leasing or hire purchase as types of finance available. The figures are much lower for alternative funding sources, with 32% aware of crowdfunding and 35% aware of peer-to-peer lending, but they are increasing over time.

Discouragement is still an issue for a significant number of smaller businesses

While businesses are beginning to view finance as less difficult to obtain (26% viewed it as very difficult in 2014 compared to 43% in 2012), there remains a gap between perceptions of the chances of obtaining finance, versus true approval rates. In addition, the proportion of businesses discouraged from applying for finance remains significant.

Furthermore, evidence also suggests that smaller businesses do not tend to shop around, and many do not plan ahead when seeking finance - potentially limiting their chances of obtaining finance.

Taken together, this demonstrates serious deficiencies on the demand side, providing compelling evidence that the British Business Bank must also focus on demand side factors in parallel with improving supply, in order to improve the overall functioning of SME finance markets.

The following chapter presents new data on how aware smaller businesses are of their finance options, and how they go about seeking finance.

4.1 AWARENESS OF FINANCE OPTIONS

- Awareness of alternative sources of debt finance outside banks is not yet comprehensive enough, however in 2014 there was an increased awareness of new platforms
- Awareness issues and business investment readiness also impact on demand for equity finance

For finance markets to work, both the supply and demand side need to interact efficiently. Awareness of the finance options available, and how to access them, is essential for smaller businesses to be able to effectively signal their demand to suppliers of finance.

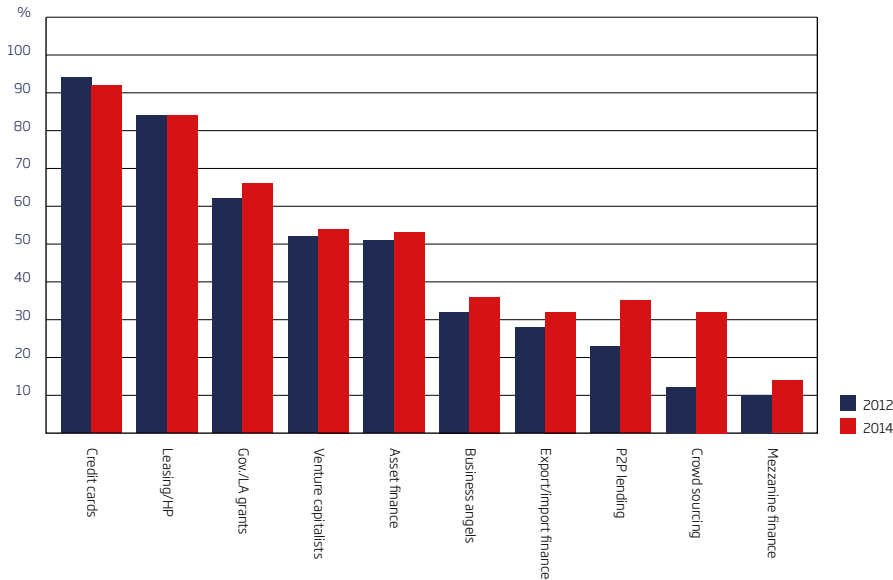
Awareness of alternative sources of debt finance outside banks is not yet comprehensive enough, however in 2014 there was an increased awareness of new platforms

Although awareness of bank finance is high, awareness of other forms of finance from non-bank sources is lower. The vast majority of small businesses were aware of credit card finance (93%), and leasing/hire purchase is known by 85% of small business. Only around a third of SMEs were aware of business angels, peer-to-peer lending, and crowdfunding, but the data suggests a significant increase from 2012. This has not translated into higher usage of these types of finance, which remains low compared to other sources. Between 2012 and 2014 there has also been an increase in the proportion of businesses aware of mezzanine finance.

Awareness of which suppliers to approach for different forms of finance was much lower than awareness of the existence of the types of finance (between 10 and 35 percentage points lower). That said, awareness of who to approach for peer-to-peer and crowdfunding platforms have shown significant rises compared to 2012.

FIG 33

Source: BMG, SME Journey Survey

AWARENESS OF DIFFERENT FORMS OF EXTERNAL FINANCE

Awareness issues and business investment readiness also impact on demand for equity finance

Demand side issues appear more acute in businesses seeking equity finance. For instance, Mason et al. (2010) acknowledge that the high rejection rates of applications to business angels and venture capital funds “clearly indicates that most businesses that seek external finance do not meet the requirements of external investors”.¹⁰⁶ However, this also reflects the model equity finance providers use of looking for high growth potential businesses in order to generate a financial return.

Smaller business owners are often unwilling to seek external equity finance as they do not want to give up control of their businesses to third parties.¹⁰⁷ For viable high-growth businesses this can prevent their full growth potential from being reached, in some cases resulting in lower long-run returns for the business owner compared to their share of the returns, had they obtained equity finance.

The SME Journey survey also suggests that many smaller business owners lack information on how equity finance works and where to obtain such finance – 55% of smaller businesses are aware of venture capital but only 20% are aware of a specific supplier to approach.

Many smaller business owners are unaware of what equity investors are looking for in investment propositions and therefore do not sufficiently promote themselves and their businesses to potential investors, for example because of poorly written business plans.¹⁰⁸

Supply and demand side factors for SMEs raising external equity finance can interact, leading to a ‘thin market,’ where a limited number of investors and high growth firms have difficulty finding and contacting each other at reasonable cost.¹⁰⁹ This friction in the market can lead to inefficient matching and consequently, an economically inefficient allocation of equity finance.

4.2

BUSINESS CONFIDENCE
IN OBTAINING FUNDING

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- Businesses underestimate the likelihood of obtaining finance. In addition, a small but significant proportion are discouraged from seeking finance

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- Most smaller businesses (66% of those seeking finance) only approach one finance provider. Many smaller businesses do not plan more than a week ahead and do not spend much time on their application, which may impede their chances of obtaining finance

-
- Increased information available to businesses could help to make SME finance markets work more efficiently

A lack of accurate information can act as a barrier to the market working efficiently. Given that there are costs (both time and money) associated with applying for finance, misconceptions of the likelihood of success can lead to viable businesses not seeking finance when they need it. Furthermore, business finance applicants not supplying the right information or presenting it in a poor way can lead to finance providers miscalculating the risks, and potentially denying finance to viable businesses.

Businesses underestimate the likelihood of obtaining finance. In addition, a small but significant proportion of businesses are discouraged from seeking finance

There remains a general perception amongst smaller businesses that banks are not lending, 58% of businesses perceive that it is fairly, or very difficult to obtain funding. However, attitudes towards obtaining finance have improved since 2012. In 2014 smaller businesses perceived that (on average) 42% of those that apply for bank finance were successful in getting it, up from the 32% reported in 2012. This is despite the majority (around three quarters) of smaller businesses that actually applied for finance in the three years prior to 2014 getting the full amount requested from the first provider they approached.

These conclusions are broadly supported by other survey data. According to SME Finance Monitor, 43% of smaller businesses planning to seek finance were very, or fairly confident that a bank would lend to them in Q2 2014. Confidence of success was higher for renewals than for new money.¹¹⁰ However, this data also shows a gap between confidence levels and actual approval rates for loan and overdraft finance from a bank - the 'confidence gap' was around 34 percentage points for new money from banks and 37 percentage points from renewals.

The improvements in attitudes are a positive development. However, a mismatch in perception remains and is likely to be a barrier holding some businesses back from applying for finance.

There is a range of potential reasons why smaller businesses may not apply for finance when they need or want to. SME Finance Monitor survey data estimates that around 5% of all SMEs are 'would-be seekers'.¹¹¹

A small but significant proportion of these smaller businesses are discouraged from applying for finance. SME Finance Monitor estimates this to be around 3% of all SMEs, or around 160,000 thousand if we apply this to the estimated 5.2m businesses population. This estimate is based on those that either made informal enquiries to the financial institution, or were put off or because they thought they would be turned down by the financial institution so did not ask. Fraser (2014)¹¹² estimated that 63% of discouraged borrowers might have actually obtained bank finance if they had applied, which shows a potential missed opportunity for business growth.

Most smaller businesses (66% of those seeking finance) only approach one finance provider. Many smaller businesses do not plan more than a week ahead and do not spend much time on their application, which may impede their chances of obtaining finance

The latest SME Journey survey shows 66% of businesses seeking finance contacted just one provider on the last occasion finance was sought, usually because they had a longstanding relationship with them. Furthermore, in their last finance application just under half of businesses (49%) only contacted one of the four largest banks (i.e. Barclays, HSBC, Lloyds or RBS) when seeking finance. Some businesses did not need to go elsewhere because the first provider they approached gave them what they wanted. Others felt it was too much hassle to shop around, or did not have time to shop around because they needed the finance quickly.

This is broadly supported by evidence from SME Finance Monitor: Over half (57%) of businesses that sought finance in the past 3 years went directly to their main bank as soon as they identified that they had a need for external finance, rather than investigating their finance options.

The limited shopping around when seeking finance is a concern raised by the recent CMA study.¹¹³ The CMA acknowledges there is currently a relatively weak demand side, with SME customers not obtaining, assessing and acting on information to ensure that they get the best possible deal.

Not only do many businesses not shop around for external finance, some may not be maximising their chances of being approved. Many businesses do not plan ahead and instead, seek finance as soon as they need it. For instance;

- 40% of SMEs apply for finance a week before needing it or after it is needed.
- The median time spent completing application forms or otherwise preparing to apply for finance remains at about one hour.

Although it declines with the size of the business, in most cases (82%) it is the business owner themselves, who is responsible for seeking finance on behalf of the business rather than a dedicated finance manager. Whilst it is not surprising that business owners will have competing demands on their time, it is also important to recognise some finance applications, particular for smaller amounts are completely credit scored, with minimal amounts of information required from the applicant.

Increased information available to businesses could help to make SME finance markets work more efficiently

Information is needed for SME finance markets to work effectively. Only a minority of SMEs (18%) seek external advice when applying for finance, but of those that do, the vast majority (95%) of SMEs find the advice they receive to be useful. Accountants and financial advisors are the most common sources of advice used, with accountants in particular being viewed as a trusted source of information.

The majority of those not seeking advice (75%) say that they do not need it. However:

- 45% of SMEs perceive finance providers do not give sufficient information on products to be able to effectively judge them.
- Fewer SME owners report that they are confident in their own capabilities in raising external finance compared to other aspects of running a business, like people management and introducing new products and services.

Whilst 58% of SMEs report that they know what providers look for when assessing finance applications, 19% do not.



EXPERT VIEW

DAVID PETRIE

HEAD OF CORPORATE FINANCE, ICAEW

IMPROVED INFORMATION WILL HELP BUSINESSES ACCESS THE FINANCE THEY NEED

We are now seeing a far greater variety of finance options available for businesses than in the period immediately after the financial crisis.

Still, it should not be forgotten that the vast proportion of support for small business funding comes from the High Street banks although there are signs that the banks are becoming keener to lend as the economy improves.

Conventional bank lending is increasingly being supported by forms of finance that have been around for a very long time. In the past a business might have sought to increase its overdraft, now they are much more likely to consider a switch to asset finance. The third quarter of 2014 was the biggest on record for the use of asset based finance, with £19.3bn of funding in use, up 12% on the £17.2bn in use a year earlier, according to the Asset Based Finance Association (ABFA), the body representing the asset based finance industry in the UK and Republic of Ireland.

The ICAEW has found that an increasingly popular option is equity finance, a good means of funding additional growth within a business, made more attractive by the tax benefits offered via the Enterprise Investment Scheme and Seed Enterprise Investment Scheme.

As more options become available for smaller businesses, it becomes increasingly important that the right information is available. The Corporate Finance faculty at the ICAEW has worked with the British Business Bank and 17 of the UK's leading financial and business institutions to create and distribute the Business Finance Guide, a free publication that sets out the range of possible routes for businesses seeking to raise funding. Copies can be downloaded from www.icaew.com/bfg or www.british-business-bank.co.uk/bfg

It was unprecedented to have so many industry bodies working together on the same initiative and engagement has been very high. The Guide certainly allows businesses to consider a wider variety of forms of finance and we also want to encourage businesses to get in touch with chartered accountants and finance providers, look for more information and understand how the different options will work for them.

Greater availability of information plays a vitally important role in helping businesses access the finance they need to grow and create jobs. So the role of professional advice cannot be underestimated. There is no real substitute for getting the right advice and figures from the SME Finance Monitor show that only 22% of companies seek advice before applying for a loan, although this is up on prior years where the percentage had been as low as 18%. The British Business Bank data also shows that companies who do so are more successful in their applications for bank finance, most often because they have provided more information.

People can be reluctant to take advice, which is why the ICAEW has introduced the Business Advice Scheme, providing free consultation to micro and small businesses not yet supported by a chartered accountant via 4,136 offices throughout the UK.

FOOTNOTES

- 1 Smaller businesses comprise of businesses with less than 250 employees. An alternative definition of small business that is used by some financial institutions is based on businesses having an annual turnover of less than £25mn.
- 2 BIS (2014) 'Business population estimates 2014' www.gov.uk/government/uploads/system/uploads/attachment_data/file/377934/bpe_2014_statistical_release.pdf
- 3 BIS (2011) 'Job Creation and Destruction in the UK: 1998-2010' (Anaydike-Danes, Bonner and Hart-Aston Business School) www.gov.uk/government/uploads/system/uploads/attachment_data/file/32244/11-1326-job-creation-and-destruction-uk-1998-2010.pdf
- 4 BIS (2011) 'Productivity and the Economic Cycle' www.gov.uk/government/uploads/system/uploads/attachment_data/file/32108/11-772-productivity-and-the-economic-cycle.pdf
- 5 ONS (2014) 'Quarterly National Accounts, Q2 2014' www.ons.gov.uk/ons/dcp171778_376723.pdf
- 6 ONS (2014) 'Gross Domestic Product Preliminary Estimate, Q3 2014' www.ons.gov.uk/ons/dcp171778_381573.pdf
- 7 Global Entrepreneurship Monitor (2014) 'United Kingdom 2013 Monitoring Report' www.gemconsortium.org/docs/download/3371
- 8 ONS (2013) 'Business Demography 2012'. The ONS business demography dataset shows business births and deaths over time based on businesses registering or de-registering for either VAT and/or PAYE. Whilst this misses the majority of the smallest start-ups until the business take on an employee or have a level of turnover that means they need to register for VAT, but offers a consistent approach for assessing trends. www.ons.gov.uk/ons/dcp171778_340530.pdf
- 9 HM Treasury, 'Forecasts for the UK economy: October 2014' www.gov.uk/government/statistics/forecasts-for-the-uk-economy-october-2014
- 10 IMF (2014) 'World Economic Outlook (WEO) Legacies, Clouds, Uncertainties: October 2014' www.imf.org/external/pubs/ft/weo/2014/02/pdf/c2.pdf (p45)
- 11 See for example, ICAEW/ Grant Thornton (2014) 'Shifting UK economic sands: Perspectives on the next decade' www.icaew.com/~media/Files/About-ICAEW/What-we-do/business-confidence-monitor/special-reports/bcm-10-years.pdf
- 12 Business investment includes investment by the private sector in transport, information, technology and communications (ICT) equipment and other machinery and equipment, cultivated assets, intellectual property products (IPP, formerly known as intangible assets), and buildings and other structures.
- 13 OECD (2012) 'Non-residential Gross Capital Formation 2011' (Data accessed 2013) stats.oecd.org/Index.aspx?QueryId=48249
- 14 European Commission (2014) 'Annual Report on European SMEs' (Database for the Annual report) ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/supporting-documents/2014/annual_report_database.zip
- 15 CBI (2014) 'Invested interest: The long-term investment challenge facing the UK economy' www.cbi.org.uk/media/2873813/bizinvestmentbrf_05_5.pdf
- 16 ONS (2014) 'Business Investment, Q2 2014 Revised Results' www.ons.gov.uk/ons/dcp171778_379064.pdf
- 17 FSB (2014) 'Voice of Small Business Index: Q3 2014' www.fsb.org.uk/policy/assets/sbi_q3_2014.pdf
- 18 OBR (2014) 'Economic and Fiscal outlook: December 2014' budgetresponsibility.org.uk/economic-fiscal-outlook-december-2014/
- 19 ONS (2014) 'Labour Productivity, Q2 2014' www.ons.gov.uk/ons/dcp171778_374636.pdf
- 20 ONS (2014) 'International Comparisons of Productivity - First Estimates, 2013' www.ons.gov.uk/ons/dcp171778_380091.pdf
- 21 BIS (2010) 'Internationalisation of Innovative and High Growth SMEs' 'Economics Paper No.5' web.archive.nationalarchives.gov.uk/20121212135622/bis.gov.uk/assets/biscore/economics-and-statistics/docs/10-804-bis-economics-paper-05.pdf
- 22 IFS (2013) 'Firms' productivity, investment and training: what happened during the recession and how was it affected by the national minimum wage? A Report to the Low Pay Commission' https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/227302/r76.pdf
- 23 Although the US is the biggest individual country, European countries comprise of seven out of the top ten export destinations
- 24 ONS (2014) 'UK Trade: August 2014' http://www.ons.gov.uk/ons/dcp171778_377784.pdf
- 25 Eurostat (2012) 'International Trade by Enterprise Characteristics Statistics' http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/International_trade_by_enterprise_characteristics
- 26 BIS (2014) 'SME Business Barometer February 2014' https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298773/bis-14-p75a-sme-business-barometer-february-2014.pdf
- 27 Young firms: those trading less than 3 years. Growing firms: those that had increased employee numbers or turnover by at least 5% in the last year. Data available here: <https://www.gov.uk/government/collections/small-business-survey-reports>
- 28 BIS (2013) 'Small Business Survey 2012: SME Employers: A report by BMG Research' https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193555/bis-13-p74-small-business-survey-2012-sme-employers.pdf
- 29 It is important to acknowledge key differences between this survey and the SME Finance Monitor survey. The SME journey survey covers all external finance types, whilst the SME Finance Monitor is mainly focused on term loan and overdraft finance from a bank. Therefore, the figures on demand for finance and approval rates are not directly comparable as they are assessing different things.
- 30 A copy of the survey findings is available on the British Business Bank website.
- 31 See URS (2010) 'The City's Role in Providing for the Public Equity Financing Needs of UK SMEs' www.strath.ac.uk/media/departments/huntercentre/research/researchreports/Col-URS_final_report.pdf
- 32 Use of external finance in last three years (SME Journey towards raising external finance survey)
- 33 BDRG Continental (2014) 'SME Finance Monitor Q2 2014' www.bdr-continental.com/EasySiteWeb/GatewayLink.aspx?allid=8049
- 34 The latest SME Finance Monitor data reports that 32% of SMEs regularly use trade credit
- 35 Wilson (2014) 'Trade Credit in the UK Economy (1998-2012): An exploratory Analysis of Company Accounts', papers.ssrn.com/sol3/papers.cfm?abstract_id=2491095
- 36 BDRG Continental (2014) 'SME Finance Monitor Q2 2014' www.sme-finance-monitor.co.uk/
- 37 BDRG Continental (2014) 'SME Finance Monitor Q2 2014' www.sme-finance-monitor.co.uk/
- 38 BankSearch (2014) banksearch-consultancy.com/
- 39 BankSearch is the best source of information on new business start-ups as it is based on the opening of new business bank accounts. It is therefore not subject to delays between businesses starting up and then registering for VAT and PAYE, and the fact that some businesses never grow large enough to register for VAT or take on employees.
- 40 Global Entrepreneurship Monitor (2014) 'United Kingdom 2013 Monitoring Report' www.gemconsortium.org/docs/download/3371
- 41 ONS (2013) 'Business Demography, 2012' www.ons.gov.uk/ons/dcp171778_340530.pdf
- 42 In practice the number of new business start-ups that close within 3 years of starting-up is likely to be even higher, as VAT/ PAYE registered businesses tend to be more established
- 43 BDRG continental (2014) 'SME Finance Monitor Q2 2014' www.sme-finance-monitor.co.uk/ Does not include applications for finance made on a personal basis (e.g. personal credit cards)
- 44 Global Entrepreneurship Monitor (2014) 'United Kingdom 2013 Monitoring Report' www.gemconsortium.org/docs/download/3371
- 45 Enterprise Research Centre (2014) 'Moving on from the 'Vital 6%'' enterpriseresearch.ac.uk/wp-content/uploads/2014/02/ERC-Insight-No_3.pdf
- 46 Using a three year rolling average
- 47 Previously unpublished figures from 2012 SME Journey towards raising finance (2013)
- 48 BDRG Continental (2014) 'SME Finance Monitor Q2 2014' www.sme-finance-monitor.co.uk/
- 49 Ares & Co, 2012, SME Financing: Impact of regulation and the Eurozone crisis. Report prepared for TheCityUK. This estimate includes small cap public markets in addition to early stage equity deals in private markets, which limits comparability with the SME Finance Monitor figures: www.thecityuk.com/research/our-work/reports-list/sme-financing-impact-of-regulation-and-the-eurozone-crisis/
- 50 Equity investors only make a financial return on their investment when they exit their investment at a greater value than they paid, with a trade sale or IPO being favoured exit routes
- 51 Investors also have detailed information and control rights in the investment contract
- 52 Beahurst is a provider of market data on equity investment. They were contracted to develop the equity tracker following an open tendering process. about.beahurst.com/ for more information.
- 53 Individual deals can be recorded in more than one sector, if applicable. For example a media company with a technology element would be recorded as both "media" and "technology". The technology element is a very common feature, although it has been declining in significance since 2011.
- 54 It is important to note that fundraising stages are different to the investment stages described above. EVCA defines "Early stage" in this case as "funds focused on investing in companies in the early stages of their lives" - in other words, covering seed as well as some early stage venture investment.
- 55 Initial findings from UKBAA "Nation of Angels" research campaign: www.ukbusinessangelsassociation.org.uk/news/12-new-emerging-angel-market-trends
- 56 Figures from EVCA are used in preference to those from BVCA; the former capture all investment into UK companies from EVCA members, regardless of where the funds are based, whereas the BVCA statistics only cover investment by UK-based funds. The EVCA statistics are therefore a better gauge of overall funding availability for UK firms.
- 57 Note that EVCA publishes its data in euros: these have been converted to sterling for this report using exchange rates published by the ECB: sdw.ecb.europa.eu/quickview.do?SERIES_KEY=120.EXR.A.GBP.EUR.SP00.A
- 58 As seen above, the EVCA "later-stage venture" definition is most similar to the venture category used by Beahurst
- 59 Beahurst classifies as "private equity" any independent investment fund. In other words, VC funds are classed as private equity by this definition; at the venture stage most of the recorded investment is likely to come from VC funds rather than pure private equity, as the deal sizes are generally too small for the latter.
- 60 In practice, this means that most of the "Government" category is made up of funds operated by local and devolved Government, which are more direct in their approach to investing in the market. In contrast, activities of the British Business Bank would be counted in the investor category of the partner delivering the scheme, not central Government. For example, the ECF programme is classed as private equity, as it is private funds which make the investments.

- 61 insurers, pension funds, fund-of funds, other private equity sources and capital markets
- 62 Although the EIS investment limit is now £5m, most angel deals will be smaller than that as they are limited by the financial capacity of the participating investors
- 63 The investment limit was increased from £2m to £5m in Autumn 2014, with the first fund launched under the new rules in November 2014 (IQ Capital II)
- 64 It addition to asymmetric information, there is a related failure that arises from an absence of information on the likelihood of success for seed and early stage businesses, especially for 'ground breaking' technology or products/processes that are completely new to the market.
- 65 See forthcoming equity paper for more detailed discussion
- 66 Even where a business or investment fails, there is residual value in the form of physical and intangible capital, skills and know-how that are not destroyed but spread to other parts of the economy, as was observed in forthcoming British Business Bank research into ECFs and the Capital for Enterprise Fund.
- 67 Oxera (2005) "Innovation market failures and state aid: developing criteria", available at: www.pedz.uni-mannheim.de/daten/edz-h/gdb/06/innovation_market_failures_and_state_aid.pdf
- 68 due to their sector specialisms and/or more detailed knowledge of particular markets/technologies
- 69 Also, many angels have a different motivation to VC funds, in that they invest for their own enjoyment as well as to make a return. This lends itself to lighter-touch investing based more on enthusiasm for a business or project, and potentially also less following-on once a business has become established.
- 70 One recent interesting market development is that UK banks are strategically looking to partner up with private debt funds to fund mid-market deals. For instance, Barclays has partnered with BlueBay Asset Management's Direct Lending Fund to facilitate unit-tranche loans. www.ft.com/cms/s/0/445b5f56-7884-11e3-b31c-00144feabdc0.html#axzz3Gzj6lMJH
- 71 Financial Stability Board (2011) 'Shadow Banking: Strengthening Oversight and Regulation' www.financialstabilityboard.org/publications/r_111027a.pdf
- 72 Evain (2013) "European Direct Lending – an Attractive Risk/Return Opportunity for Investors?" www.icgplc.com/SiteCollectionDocuments/2013-Preqin-Investor-Network-Global-Alternatives-Report.pdf
- 73 Deloitte (2014) 'Deloitte Alternative Lender Deal Tracker September 2014' www2.deloitte.com/content/dam/Deloitte/uk/Documents/about-deloitte/deloitte-uk-deloitte-alternative-lender-deal-tracker-23-Sep-2014-public.pdf
- 74 Mercer (2013) 'Private Debt Makes Its Way Into Institutional Portfolios' www.mercer.com/content/dam/mercer/attachments/global/investments/private-debt-makes-its-way-into-institutional-portfolios-mercer-august-2013.pdf
- 75 Preqin (2014) "Preqin Special Report: Private Debt: The New Alternative?"
- 76 European investors are looking for returns of 7-13% compared to 9-15% for their US counterparts
- 77 EIF (2014) estimates there are 31 SME debt funds in Europe representing 33% of all debt funds. See also, page 29.
- 78 EIF (2014) 'Institutional non-bank lending and the role of Debt Funds' www.eif.org/news_centre/publications/eif_wp_25.pdf
- 79 Asset Based Finance Association Quarterly Statistics (2014) www.abfa.org.uk/members/statistics.asp
- 80 British Business Bank (2013) 'Lessons for tomorrow's medium-sized businesses' british-business-bank.co.uk/performance/british-business-bank-research-medium-sized-businesses-access-finance-lessons-tomorrows-medium-sized-businesses/
- 81 See also Slotty (2009)
- 82 Bank of England (2014) 'Trends in Lending April 2014' www.bankofengland.co.uk/publications/Documents/other/monetary/trendsapril14.pdf
- 83 NIESR (2013) Evaluating Changes In Bank Lending to UK SMEs over 2001-12 – Ongoing Tight Credit? www.gov.uk/government/uploads/system/uploads/attachment_data/file/193945/bis-13-857-evaluating-changes-in-bank-lending-to-uk-smes-2001-12.pdf
- 84 Bank of England (2014) 'Trends in Lending April 2014' www.bankofengland.co.uk/publications/Documents/other/monetary/trendsapril14.pdf
- 85 BDRC Continental (2014) 'SME Finance Monitor Q2 2014' www.sme-finance-monitor.co.uk/
- 86 The BoE bank lending data and BBA's data differ in a variety of ways which can help to explain why their estimates differ. The BoE capture data from 19 lending institutions with banking licences including some leasing and invoice finance providers. This is then grossed up to generate an estimate for the whole market. In contrast, the BBA publishes aggregated data from 7 of the largest banks with a broader range of variables than the BoE data.
- 87 Bank of England (2014) 'Trends in Lending October 2014' www.bankofengland.co.uk/publications/Documents/other/monetary/trendsoctober14.pdf
- 88 Bank of England (2014) 'Bankstats' www.bankofengland.co.uk/statistics/Documents/bankstats/2014/oct/tab08.1.xls
- 89 BDRC Continental (2014) 'SME Finance Monitor Q2 2014' www.sme-finance-monitor.co.uk/
- 90 British Banking Association (2014) 'Bank Support for SMEs – 2nd Quarter 2014' www.bba.org.uk/news/statistics/sme-statistics/bank-support-for-smes-2nd-quarter-2014/#.VHyh2LcpV9A
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- 92 Donald Cruickshank's review of retail banking (2000), Competition Commission investigation of SME banking (2002), the Vickers review (2011), the Parliamentary Commission's report on Banking Standards (2013), the Large review (2013).
- 93 House of Commons Treasury Committee (2011) 'Competition and Choice in Retail Banking: Ninth report of session 2010/2011' www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/612/612i.pdf
- 94 House of Lords/House of Commons (2013) 'Changing Banking for Good' www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf
- 95 Bank of England (2014) 'Should the availability of UK credit data be improved?' www.bankofengland.co.uk/publications/Documents/news/2014/dp300514.pdf
- 96 www.bankofengland.co.uk/financialstability/documents/fpc/policystatement140113.pdf
- 97 OECD (2011) 'Macroeconomic Impact of Basel III' www.oecd-ilibrary.org/economics/macroeconomic-impact-of-basel-iii_5kghwnhkkjs8-en
- 98 FSB (2014) 'Voice of Small Business Index: Q3 2014' www.fsb.org.uk/policy/assets/sbi_q3_2014.pdf
- 99 The Business Bank asked the National Institute of Economic and Social Research (NIESR) to look into the viability of a UK SME securitisation market. This box has been drawn from their initial findings, the full results will be published in a forthcoming Paper.
- 100 While it is difficult to ascertain where an SME securitisation would price due to the shortage of issuance, it is estimated that AAA-rated tranches backed by small business loans command spreads which are circa 15-25 bps higher than spreads on residential mortgage-backed securities.
- 101 In a broad form, this refers to innovation in financial services, where technology is a key enabler.
- 102 AltFi provides news and commentary on the alternative finance industry. They have created an index that monitors the value of transactions originated through New Innovative Platforms. They obtain data directly from the Platforms, working with them to improve consistency. Further details on the Platforms that are covered in the index can be found on their website.
- 103 Nesta (2014) 'Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014' www.nesta.org.uk/publications/understanding-alternative-finance-uk-alternative-finance-industry-report-2014
- 104 Nesta (2013) 'Banking on Each Other: The rise of peer-to-peer lending to businesses' www.nesta.org.uk/publications/banking-each-other-rise-peer-peer-lending-businesses
- 105 Financial Conduct Authority www.fca.org.uk/
- 106 Mason and Kwok (2010) 'Investment Readiness Programmes and Access to Finance: A critical review of Design Issues' www.strath.ac.uk/media/departments/huntercentre/research/workingpapers/WP_version.pdf
- 107 British Business Bank (2013) 'SME journey towards external finance' (BMG Research) british-business-bank.co.uk/wp-content/uploads/2013/10/SME-Journey-Towards-Raising-Finance.pdf
- 108 Mason and Kwok (2010) 'Investment Readiness Programmes and Access to Finance: A critical review of Design Issues' www.strath.ac.uk/media/departments/huntercentre/research/workingpapers/WP_version.pdf
- 109 NESTA (2009) 'From Funding Gaps to Thin Markets: UK Government Support for Early Stage Venture Capital' www.nesta.org.uk/sites/default/files/from_funding_gaps_to_thin_markets.pdf
- 110 It is important to note that the survey questions comparing attitudes and approval rates are not directly comparable between the SME Journey and SME Finance Monitor due to differences in the way the questions was asked. For instance, the SME Finance Monitor focuses on loans and overdrafts from banks, whilst the SME Journey survey covers all types of external finance.
- 111 SMEs that had not had a borrowing event and said that something had stopped them applying for a loan or overdraft in the previous 12 months
- 112 Stuart Fraser (2014) 'Back to Borrowing? Perspectives on the arc of discouragement' enterpriseresearch.ac.uk/wp-content/uploads/2014/03/ERC-White-Paper-8-Discouragement-Stuart-Fraser-Full-March-2014.pdf
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GLOSSARY

Asset-backed finance	External finance to fund the purchase or use of physical assets, where the assets in question are used as security. See Hire purchase and Lease financing.	Discouragement	Businesses which would like to borrow but which do not apply for bank finance because they either feel they would be turned down ('indirectly discouraged'), or they've made informal enquiries but not proceeded with their application because the bank seemed reluctant to lend ('directly discouraged').
Bank capital requirements	Standardized requirements for banks, whereby they must hold liquid assets for a certain level of total assets. These are enforced by regulatory authorities.	Equity gap	A segment of the equity market which is underserved by private sector Venture Capitalists due to the existence of transaction costs making smaller deals commercially less attractive compared to undertaking larger deals in later stage companies.
Business Angels	High net-worth individuals who invest their own wealth into companies they are attracted to.	External finance	Money obtained from lenders or investors outside of the business and its directors.
Business churn	The rate at which businesses close down and start-up over a specified period of time. In a competitive economy, business churn can help to facilitate economic growth as inefficient businesses close down and are replaced by efficient ones.	Fintech	Where technology and innovation is applied to the financial services industry.
Capital markets	The market where debt and equity instruments, such as stocks and bonds, are issued, bought and sold. Institutions and some businesses can use primary capital markets to raise funds by issuing bonds and equity.	Flows of Finance	The Gross flow of finance is the movement of money from lenders or investors to businesses or individuals (businesses only in this report) over a period of time. The net flow refers to the gross flow, net of repayments over the same time period. For instance the gross flows of bank loans refers to the value of new loans issued over a certain period, whereas the net flow of bank loans is the value of new loans minus the value of repayments over the same period. In theory, the net flow of bank lending over a certain period should equal the change in the stock over the same period, excluding any other adjustments.
Challenger banks	Smaller banks which provide competition to the largest and established banking groups.	Growth capital	Equity investment used for more developed, profitable companies looking to expand or enter new markets.
Core bank lending products	More traditional forms of external finance which include: Bank loans, overdrafts and credit cards.	Hire Purchase	When a finance company buys the asset on behalf of the customer, who then pays an initial deposit. The remaining balance, plus interest, is then paid over an agreed period. During this period, ownership rests with the finance company, which is effectively hiring use of the asset to the customer. Once the final payment is made, ownership transfers to the customer.
Crowdfunding/ Crowdsourcing	Fundraising for businesses and projects, often where relatively small amounts of money are lent or invested by large numbers of individuals. Debt crowdfunding is where lenders buy a security in return for interest and capital repayments, equity crowdfunding is where investors buy shares in early-stage businesses and start-ups with the expectation of capital growth and dividends. This is generally facilitated by Online Platforms.		
Debt funds	A limited liability fund structure which uses debt instruments. Debt funds provide businesses with bespoke debt finance that is often focused on providing flexible finance for 'event driven', growth orientated companies.		

Institutional investors	These are typically large organisations that invest across different assets as the fundamental part of its business. For example, investment banks, insurers, pension funds and hedge funds.	Peer-to-peer lending (P2P)	Where individuals lend money to other individuals or businesses in return for interest and capital repayments. This is often achieved via an Online Platform that facilitates the matching of differing lenders and borrowers via a network of peers.
Invoice Finance	When a third party agrees to buy a business's unpaid invoices for a fee. There are two types of invoice financing; Factoring and Discounting. Factoring is when the third party gives a percentage of the invoice and once the initial customer pays out, the rest is paid to the businesses. This incurs fee and/or interest charges. Discounting is when a third party lends against the businesses unpaid invoices. The third party then receives the money and allows the business to borrow more, up to an agreed percentage of the total unpaid invoices.	Principal-agent problems	Sub-optimal outcome as a result of asymmetric information and misaligned incentives between the principal and the hired agent. For instance, moral hazard and adverse selection.
Lease financing	A contractual agreement where a leasing company (lessor) makes an asset it owns available for use by another party (a lessee), for a certain time period in exchange for payment.	Securitisation	A financial technology which pools individual illiquid assets into liquid financial securities that can be sold on. It is used by lenders to raise funds and manage their risk exposure. See page 50 for further details.
Market failure	A situation whereby the allocation of resources via the free market is not efficient. Failures result in a loss of both social and economic welfare which could be captured if the market was structured differently.	Seed capital	Equity investment generally used for R&D, and initial concept or product development. Usually businesses receiving the investment are pre-revenue.
Mezzanine finance	A form of debt-finance finance that combines features of both debt and equity in a single instrument. Whilst there is no single model, mezzanine debt usually contains three distinct features: cash coupon; payment-in-kind or PIK, which is only paid at the maturity of the loan; and, warrants or a share in the profits or growth of the company.	SME/Smaller Businesses	These terms are used interchangeably in this report. This typically refers to businesses which have less than 250 employees. An alternative definition is businesses which have an annual turnover of less than £25m.
Non-Amortising	Payments which only the interest on a loan or the minimum payments are met, meaning the value of the original amount does not decrease until the maturity of the loan.	Sovereign Wealth Funds	A state-owned investment fund.
Online Platforms	Peer-to-peer lending, crowdfunding and invoice finance websites where the majority of transactions take place online. These facilitate the matching of lenders/ investors and borrowers.	Stock of lending	The total value of outstanding debt at a given point in time.
		Trade credit	An agreement where the buyer of goods can delay the payment for an agreed period of time.
		Venture capital	Venture Capital is equity investment into young high growth potential businesses, which are also high risk. Venture Capital funds invest institutional investors' capital in order to generate a financial return and Venture capital is a sub-set of the wider Private Equity industry.
		Working capital	Money available for the day to day operations of a company.

NOTES

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ABOUT BRITISH BUSINESS BANK

The government established the British Business Bank to bring together a number of programmes that have played an important role in unlocking finance for smaller businesses. Our Strategic Plan published in June this year, provided information on all those programmes. The stock of lending & investment provided by British Business Bank programmes stood at £2.7bn as at end of Sept, with over 38,000 businesses supported. But as the economy continues to recover the financing needs of smaller businesses will grow, suggesting there is even more to be done.

The British Business Bank makes finance markets for smaller businesses work better, enabling the sector to prosper, grow and build economic activity.

Its objectives are to:

- Increase the supply of finance available to smaller businesses where markets don't work well.
- Create a more diverse and vibrant finance market for smaller businesses, with a greater choice of options and providers.
- Build confidence in the market by increasing smaller businesses' understanding of the options available to them.
- Achieve this while managing taxpayer resources efficiently and within a robust risk management framework.

Our route to market is through established or newly emerging finance market providers. In total we work through more than 80 finance partners in the market, and we will unlock up to £10bn of new finance and bring greater choice and information on finance options to smaller businesses. Our programmes are designed to bring benefits to smaller businesses that are start-ups, high growth, or simply viable but underfunded.

For more information visit www.british-business-bank.co.uk

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[@BritishBBank](https://twitter.com/BritishBBank)

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Unlocking finance for smaller businesses