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 *Source: Bank of England [b]*	Outstanding Amount [c]	189	176	166	171	to Sept
Bank Lending *Source: Bank of England [b]*	Net flows £ billions [d]	-	-8	-4	-3	to Sept
	Gross flows £ billions [e]	-	38	43	38	to Sept
Other Gross Flows of SME Finance						
Private external Equity £ billions *Source: Beauhurst [f]*		1	1.3	1.6	1.1	H1 only
	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 *Source: FLA [g]*		-	12.5	13.1	-	
Peer-to-Peer Business Lending £ billions *Source: AltFi Data [h]*		0.02	0.06	0.25	0.55	to Oct 14
Peer-to-Peer Invoice Financing £ billions *Source: AltFi Data [h]*		0.003 [i]	0.04	0.10	0.22	to Oct 14

(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 differnet 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

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

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

- 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 businesses[1] 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 investment[12] 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, %

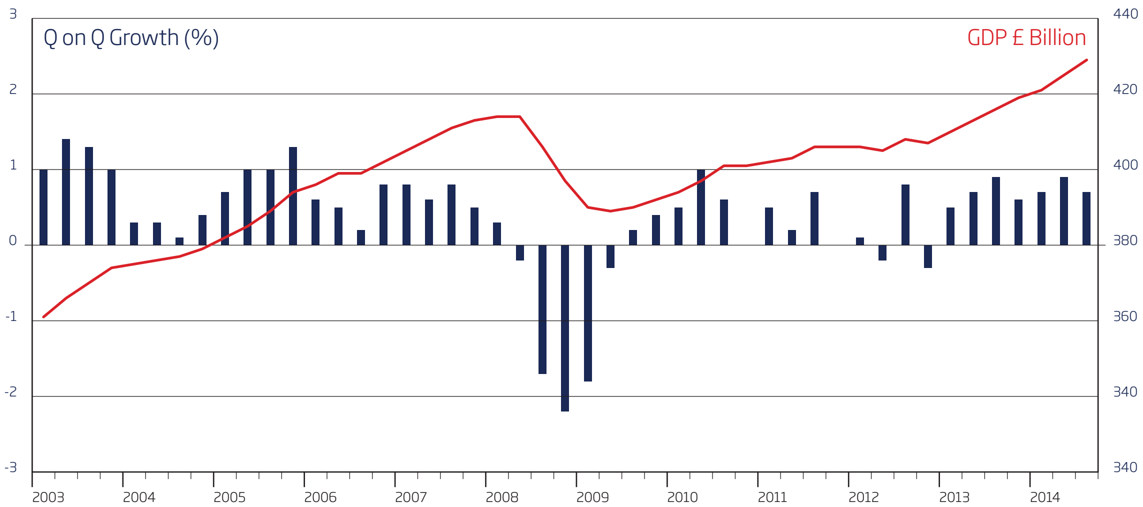
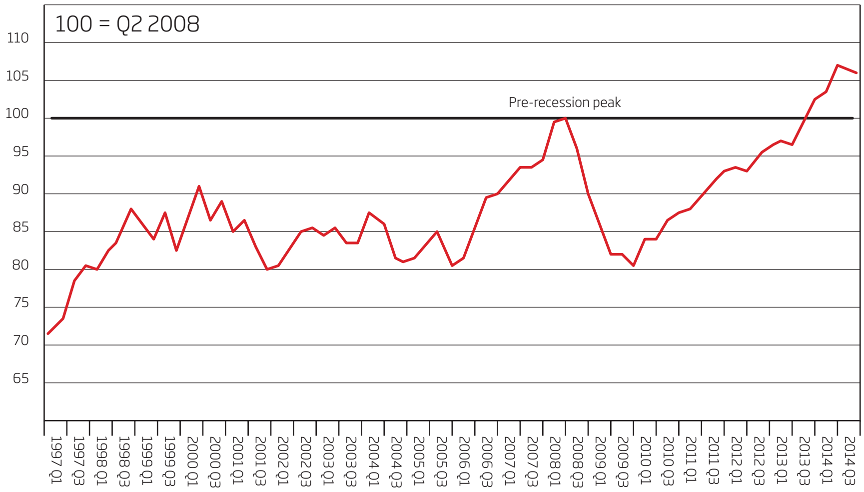


FIG 02 *Source: ONS*

UK BUSINESS INVESTMENT



Notes

Business investment variable: NPEL, indexed to Q2 2008.
Does not including 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 market[23] 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.

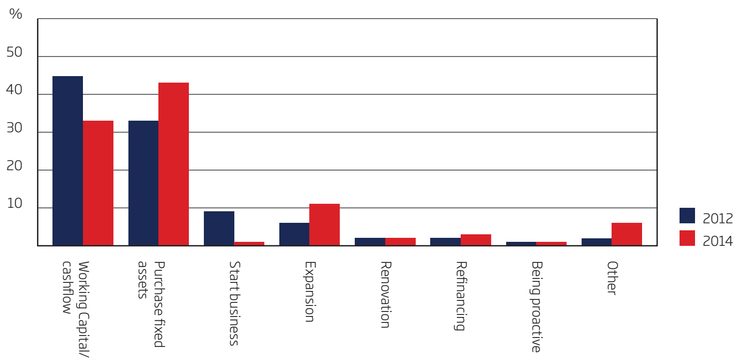
Unless otherwise stated, the figures quoted in this chapter are from the 'SME journey towards raising external finance: 2014 survey', which asked smaller businesses about the motivations and steps they go through when seeking external finance.[29] The survey was undertaken by BMG Research and was specifically 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 growth[32]

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.

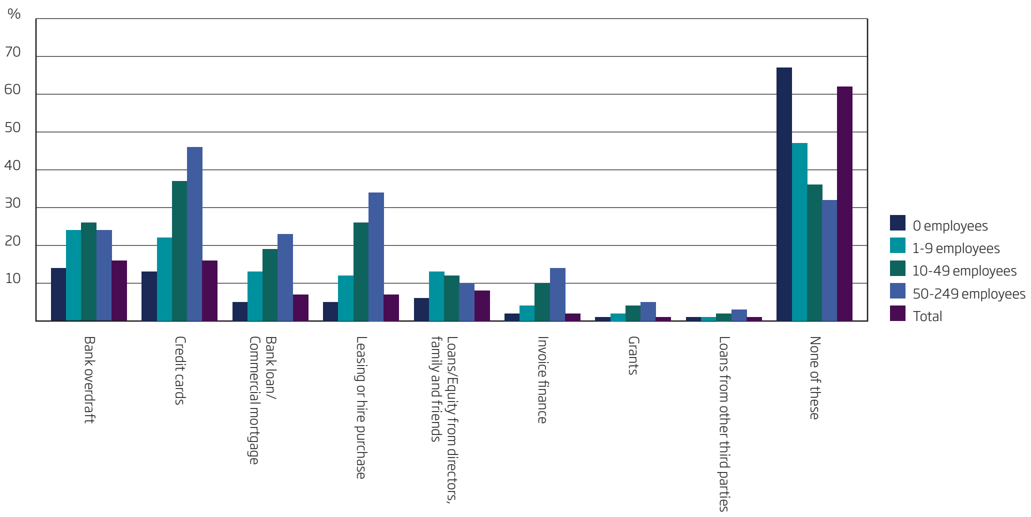
However, over half (around 54% of smaller businesses) do not use formal sources of external finance, instead relying on trade credit from their suppliers or retained earnings. Trade Credit is a very important source of funding for smaller businesses, and it is estimated that the total amount of trade 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.

FIG 05 *Source: BankSearch business start-ups and ONS mid-year population estimates in 2013*

BUSINESS START-UP DENSITY BY REGION, GB

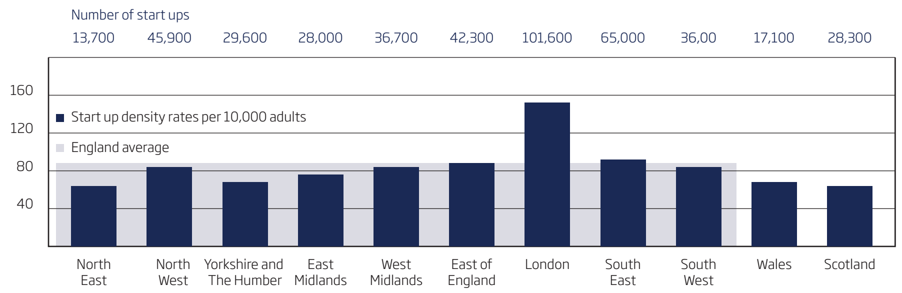
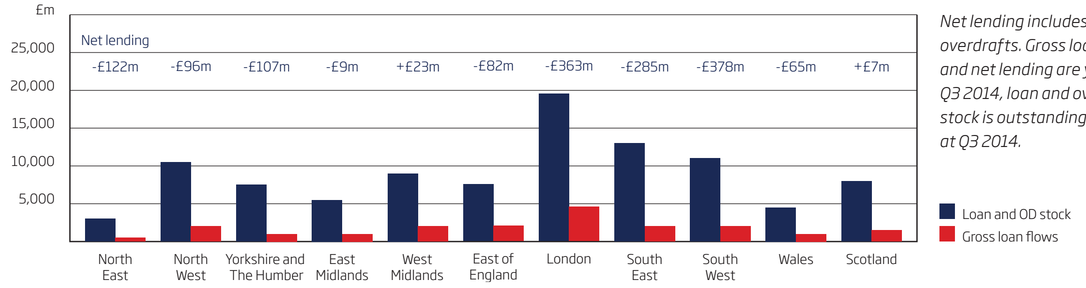


FIG 06 *Source: BBA SME Statistics*

BANK LENDING TO SMALLER BUSINESSES BY REGION, GB



Net lending includes loans and overdrafts. Gross loan flows and net lending are year to Q3 2014, loan and overdraft stock is outstanding balances at Q3 2014.

FIG 07 *Source: Beauhurst*

EQUITY INVESTMENT BY REGION