British Business Bank

Small Business Finance Markets 2022/23

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Foreword

The British Business Bank aims to drive sustainable growth and prosperity across the UK, and to enable the transition to a net zero economy, by supporting access to finance for smaller businesses. Our research, insight and analysis, combined with our market intelligence and active participation in finance markets is a vital part of helping us achieve that aim as we focus on our four strategic objectives; Driving Sustainable Growth, Backing Innovation, Unlocking Potential and Building the Modern, Green Economy.

Our annual Small Business Finance Markets report, now in its ninth iteration, examines in detail the funding landscape for smaller businesses. Our analysis provides policy makers and the market with a comprehensive, independent assessment of finance trends throughout 2022. This year's report also provides an in-depth analysis of the market related to two of our strategic objectives – Backing Innovation – with a particular emphasis on the funding of such innovation in smaller businesses and how it supports Building the Modern, Green Economy.

There is no doubt that 2022 has been a challenging year for the UK's 5.5m smaller businesses, with high energy prices and inflation causing issues for many.

Gross bank lending saw a significant rise of 12.8% to £65.1bn. While such a rise would ordinarily be most welcome, in 2022 this was accompanied by a fall in the number of smaller businesses accessing external finance, with only a third of businesses doing so compared to 44% in 2021. This suggests that the increase in gross bank lending is due mainly to larger average loan sizes. Further, repayments of Covid-19 loans contributed greatly to a fall in net lending while smaller business equity markets also slowed considerably from Q3 2022.

One of the most striking findings in this year's report is that challenger and specialist banks accounted for over half of gross lending in 2022, their highest ever share. Alongside strong growth in asset finance, this is encouraging to see as one of the British Business Bank's founding objectives has been to create more diversity of supply in finance markets.

Looking ahead, there are some grounds for optimism that we may be turning the corner. Recent falls in inflation and energy prices mean that more smaller businesses can now begin to look once again to how they might grow rather than merely survive. Equity markets are already responding to growing demand for investment in green innovation, with promising growth in net zero sector deals. Since I've become CEO of the British Business Bank, I've certainly been inspired by the determination of the smaller business owners I've met to drive their businesses forward, introduce new products and find new opportunities.

In this year's report, we have examined the issue of innovation amongst smaller business in greater depth. Innovation is central to the long-term growth of the economy, and is a clear priority for the Government in supporting its ambitions for scale up Britain and establishing the UK's role as a science superpower.

We explore two types of innovation, which are both needed to drive economic growth. First, new-to-market technologies, most often produced by scaleups that have the potential to become the globally successful businesses of tomorrow. The UK, as a global leader in universities and many areas of science and research has a good track record of supporting this kind of innovation, with the British Business Bank's programmes, in particular British Patient Capital, playing a pivotal role in its funding.

The second aspect is new-to-business innovation, where business adopt new technologies or processes to become more productive. Availability of funding and the cost of finance are cited as significant barriers, meaning the Bank's programmes will be equally important for this type of innovation as businesses look to increase their productivity and grow sustainably in a challenging economic climate. There is more to be done, however, as the UK's proportion of innovative businesses lags behind the best of the G7 economies.

I'm determined that we will work alongside our delivery partners, policy makers and government so that the UK's smaller businesses have the greatest opportunity to fulfil their potential. This report highlights many of the challenges and opportunities ahead, and I hope it serves as a valuable resource to help address both in equal measure.

Louis Taylor
CEO, British Business Bank

Executive summary

During the Covid-19 pandemic use of external finance by smaller businesses hit new highs, supported by the Covid-19 emergency loan schemes. It helped businesses to manage and even grow during a global pandemic. Since then, smaller businesses have moved from one challenge to another, but external finance remains an important resource for businesses as they navigate through uncertain times.

In this year's Small Business Finance Markets report we examine businesses' evolving relationship with external finance as they faced a new set of challenges and opportunities in 2022. Looking forward, we identify where finance can help capitalise on opportunities to innovate, increase productivity, and reduce carbon emissions.

1

Innovation is central to long-term growth and often requires finance

The 2022 Global Innovation Index ranks the UK 4th overall, and 2nd in the G7, due to its position as a global leader in universities, science and research. At the same time the UK still has progress to make with around 43% of UK small businesses found to be innovative compared to an average 51% across the G7. Against this backdrop the Government set out measures to boost UK economic growth by investing in innovation in its Autumn Statement.

Innovation needs both new-to-market (NTM) technologies and wider new-to-business (NTB) adoption to make meaningful economic impact at scale. NTM innovations are often associated with start-ups, but data suggests that only 11% of NTM innovations were introduced by businesses up to 5 years old. Policy makers wishing to incentivise NTM innovations, therefore, may find that established SMEs could play an important role.

The UK performs well in producing frontier shifting innovating businesses. Larger gaps are more prevalent between the most and least productive businesses. To minimise this, greater levels of innovation could be brought about by reducing the lag between 'Early Majority' and 'Laggard' NTB innovators.

Around 66% of SME innovators use finance compared to 58% of all businesses. Those seeking finance to innovate are particularly attracted to grants as their first choice in the pecking order and are also more likely to use equity than those that do not innovate. The presumption that NTM innovators only benefit from equity finance, however, is not supported by the data. Debt finance clearly plays an important role for the majority of innovating small businesses including NTM innovators.

Despite its potential role as an enabler, evidence suggests access to finance for innovation purposes is still difficult. Availability of finance (9%) and cost of finance (8%) were two of the most important barriers to innovation cited by small businesses, below Covid-related issues. These finance barriers are consistently ranked as the most important barriers over time.

2

Equity flows are supporting smaller businesses to develop net zero solutions

Continued innovation in climate solutions will propel the UK to achieve its net zero objectives, particularly if it helps develop viable low-carbon alternatives where none currently exist. Driving eco-innovation is not just about investing in technological breakthroughs and inventions. It is also about supporting eco-innovators that are working towards making climate solutions more reliable, affordable, scalable, and widely accessible to businesses across the UK economy.

Evidence suggests that the equity market is now supporting a more diverse range of net zero deals. Despite the market slowdown, the number of net zero equity deals outpaced the wider equity market in 2022. Net zero deal numbers rose by 33% in the first three quarters of 2022 compared with the same quarters in 2021, making up 12% of all announced SME equity deals, compared with 5% in 2018.

Growth was particularly strong in Energy Reduction Technology and Other Clean Technology, with slower but still healthy growth in Clean Energy. Investment values are also on the rise, soaring to a new record level of £1.7bn – reflecting a 184% increase on the first three quarters of 2021.

Ensuring climate solutions have broad reach across the economy and society is essential for an inclusive transition to net zero. Evidence suggests around 19% of SMEs prioritising environmental solutions saw access to finance as an important barrier. Indeed, more than a third of those SMEs who sought but were unable to obtain finance for their business agreed that this had a negative impact on their ability to innovate.

3

Lending volumes grew in 2022 but there are increasing signs of difficulties in accessing finance

After UK economic recovery in 2021, real GDP growth lost momentum in the second half of 2022. Weaker economic activity driven by 30-year high rates of inflation, higher borrowing costs, and squeezed household incomes set a challenging backdrop for smaller businesses to operate in 2022.

Despite this, SME bank lending rose by 12.8% to £65bn in nominal terms. Whilst these figures suggest resilient demand for debt finance, in real terms it was only £2bn higher than 2019.

Smaller businesses holding large deposits, repaying government loans, and those facing higher borrowing costs all put downward pressure on demand. This is reflected in the 33% of smaller businesses estimated to be using any external finance – the lowest share since the data series began in 2011.

There were also signs of supply constraints with increasing signs of reductions in loan approval rates. Declining approval rates are likely driven by a number of factors including concerns about businesses' ability to repay debts given deteriorating economic conditions.

The big five banks who traditionally dominate smaller business lending were overtaken by challenger and specialist banks in 2022. The latter's share rose to a record-high 55%. Market intelligence suggests the latter are finding new opportunities, for example in lending to sectors most severely affected by the pandemic.

Asset finance markets reported a large increase in new business of 11% in 2022 to £22.5 billion, partly driven by easing supply chain challenges. Invoice and asset-based lending saw the value of advances continuing to recover as they neared pre-covid levels, however, the number of SMEs using this type of finance is still 11% below pre-pandemic levels.

Conditions were not easy for smaller banks and non-bank lenders given their heightened exposure to increased funding costs. Higher interest rates led to a 50% rise in the cost of wholesale funding for many marketplace lenders, asset finance providers and Community Development Financial Institutions.

4

Equity markets began strongly but performance deteriorated midway through the year

UK SME equity markets began 2022 with strong investment growth but this slowed substantially from July. Initial momentum meant that cumulative capital invested in UK SMEs totalled £14.8bn up to 22Q3. This is a 10% increase over the same period in 2021.

In isolation 22Q3 saw £2.4bn invested across 520 announced SME equity deals. This is a reduction of 51% in investment and 11% in deal numbers compared to 21Q3, suggesting UK SME equity markets are at a turning point.

Venture and growth stage investment fell in Q3 but seed stage investments remained more stable. Given the concerns about the early stage of the UK equity ecosystem in recent years and early-stage investment being most susceptible to increased economic risks, the resilience observed in seed stage investment so far is encouraging.

In terms of regional spread, London remained the hotspot for UK equity activity in 2022, receiving 52% of all UK equity deals during the first three quarters, accounting for 61% of total UK equity investment. At the same time areas outside London have seen an increase in their equity investment in 2022 compared to the same quarters in 2021; Yorkshire and Humber (96%), South West (46%) and Scotland (26%)..

UK mid-market private debt deals and investment increased substantially in 2021, but there were signs of decline in 2022 due to greater economic uncertainty. In total there was a 66% reduction in the number of UK mid-market deals in 2022. This is consistent with international debt markets which saw numbers declining by 63% in Europe, and 37% in the US.

5

Developments in sustainable finance

Breaking down barriers to finance facing businesses owners and entrepreneurs is a key element of the British Business Bank's strategic framework. Around 5–8% of UK smaller business are led by an individual or team identifying as being from an Ethnic Minority background with around half of them based in London. Around 20%–22% of the UK's business population is female-led.

Ethnic Minority-led businesses are more prepared to take risks and have stronger growth ambitions with Asian and other Ethnic Minority-led businesses more willing to use finance to achieve this growth.

The economic environment does appear to be affecting female-led business behaviour. Although they are as ambitious as male-led businesses, they were less likely to use external finance and less prepared to take risks due to future uncertainty. Further increases in the cost of credit would again dampen their likelihood of applying for finance. Taken together, the evidence suggests female-led businesses are more price-sensitive to the cost of external finance and see the application process and time and/or effort involved as a barrier.

Access to finance across owner characteristics is mixed. Ethnic Minority-led businesses were more likely to be turned down for finance, consistent with the longer-term trends. This could be indicative of structural frictions within the market, such as the lack of collateral being a particular issue amongst younger Ethnic Minority-led businesses.

Momentum remained strong for net zero priorities in the second half of 2022 with the 27th annual COP conference. Evidence suggests the economic environment has somewhat tested smaller businesses' ability to pursue environmental sustainability, but commitment remains high given the wider challenges they are facing. Two thirds of SMEs that prioritise environmental sustainability identified the economic environment as a key obstacle in becoming more environmentally sustainable this year, yet half of all SMEs still regard this as a priority. Removing barriers in smaller business access to external finance remains key for accelerating the decarbonisation of the UK economy.

6

British Business Bank response

In responding to these market developments, the Bank is committed to making finance markets work better, driving business growth, getting finance to the UK's most innovative businesses, backing business-led ground-breaking solutions to climate change and breaking down barriers so that finance is accessible for all entrepreneurs. Using our suite of products across both debt and equity, our programmes will continue to support growth and prosperity across all parts of the UK and in all parts of our society.

Introduction

This is the ninth annual British Business Bank Small Business Finance Markets report, analysing the latest developments in smaller business finance markets and assessing the outlook for the period ahead.

Our mission is to drive sustainable growth and prosperity across the UK, and to enable the transition to a net zero economy by improving access to finance for smaller businesses. To deliver this mandate requires an understanding of the current state of smaller business finance markets. By sharing this analysis we aim to give all those who play in these markets more insight into the latest developments and trends.

New evidence and analysis

The British Business Bank has continued to refine and improve the evidence and analysis used in this report. For this edition:

- We have refreshed our Business Finance Survey and combined it with our survey of finance market intermediaries to gather a wider range of robust survey evidence.
- We have continued to evolve Part B of the report to give more insight into how finance supports sustainable growth for smaller businesses. For example, this year we have included two new chapters exploring female and Ethnic Minority entrepreneurs' access to finance as well as trends in finance for environmental sustainability.
- We have made continued use of the Bank's management information and market contacts.

This report also references a wide range of evidence drawn from academic, government and market research. We are keen to further increase the range of researchers we work with.

Structure of the report

As usual the report is split into two sections to allow both consideration of broader trends and issues in smaller business finance markets, and to explore specific segments of the market in detail.

Part A of this year's report is dedicated to exploring the role of finance in supporting smaller businesses to innovate and pursue wider government net zero objectives. The first chapter in Part A lays the groundwork in establishing what innovation means within a business context and how finance is used to support innovation. The second chapter evidences how finance contributes to innovating businesses who are developing net zero solutions.

Part B examines sustainable finance and the smaller business population. It then considers in more depth the markets for different types of debt and equity finance most widely used by smaller businesses, identifying the drivers of the latest trends.

Aggregate flow and stock of smaller business finance

Bank lending in 2022 was the second highest on record in nominal terms

Asset finance new business reached a new high in 2022

Equity finance remained exceptionally strong during H1 2022 but Q3 marked a deterioration in market conditions with declining investment and deal activity

This section brings together the latest data from a range of sources on the volume and value of various types of external finance provided to smaller businesses in the UK. Consistent and comprehensive data outlining the value of the aggregate stocks and flows of all forms of external finance is not readily available. However, the summary table below provides a reasonable snapshot. The table has been revised from previous years to include a breakdown of total bank stock by lending and overdrafts.

While flows of different types of finance are not directly comparable, the data shows that bank lending is still the single largest form of external finance for smaller businesses.

Figure 1

Estimates of the flow & stock of external finance for UK SMEs (£ billions) (a)

		2017	2018	2019	2020	2021	2022
Bank lending flows Source: Bank of England	Gross flows (b)	57.3	57.8	56.9	104.9	57.7	**65.1**
	Net flows (c)	0.7	0.6	2.1	46.6	-8.0	**-8.4**
Bank lending stock Source: Bank of England	Outstanding Amount (d)	153	154	156	205	200	**188**
Bank overdraft stock Source: Bank of England	Outstanding Amount (e)	12.5	11.9	11.4	8.3	8.7	**8.9**
Total bank stock Source: Bank of England	Outstanding Amount (f)	165	166	168	213	209	**197**
Other gross flows of smaller business finance							
Private external equity Source Beauhurst (g)		6.9	7.2	8.3	9.6	18.1	**14.8** (Q1-Q3)
	Number of announced deals	1841	1899	2002	2244	2601	**1932** (Q1-Q3)
Asset finance flows Source: FLA (h)		19.3	19.8	20.6	16.3	20.3	**22.5**

(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, except number of reported equity deals, and have been rounded appropriately.

(b) Data exclude overdrafts and covers loans in both sterling and foreign currency, expressed in sterling. The total may not equal the sum of its components due to rounding.

(c) 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.

(d) Movements in amounts outstanding can reflect breaks in data series as well as underlying flows.

(e) Movements in amounts outstanding can reflect breaks in data series as well as underlying flows.

(f) Movements in amounts outstanding can reflect breaks in data series as well as underlying flows.

(g) Beauhurst is a data provider that records visible equity deals including crowdfunding deals.

(h) The Finance & Leasing Association (FLA) whose members make up 90–95% of the market.

Bank lending in 2022 was the second highest on record in nominal terms

Gross lending excluding overdrafts to small and medium-sized enterprises (SMEs) by all banks in 2022 was £65.1bn, according to data from the Bank of England. This was up 12.8% from 2021 and higher than in every year between 2012, when records began, and 2019. However, it remained below the record high of 2020 (£105bn), which was largely driven by government-guaranteed Covid-19 loans. The rise in 2022 was mainly due to increased lending by challenger and specialist banks.

However, the stock of bank lending fell as many of the SMEs with Covid-19 loans were required to start repaying them. At end-2022 the bank lending stock was £188bn, down from £200bn in late 2021 and the lowest since the pre-Covid level at end-2019 (£156bn). In contrast, the stock of bank overdrafts rose as higher input costs increased SMEs' demand for working capital products. In late 2022 the overdraft stock totalled £8.9bn, up from £8.7bn at end-2021 but still below the level in late 2019 (£11.4bn). Consequently, total bank stock (lending and overdrafts) at end-2022 was £197bn, down from £209bn a year earlier and the lowest since end-2019 (£168bn).

Asset finance new business reached a new high in 2022

SME asset finance new business increased 11% in 2022 to £22.5bn, according to Financing & Leasing Association data. This was the highest level on record and 9% above the pre-pandemic total in 2019. It followed a rise of 24% in 2021. The increase highlights the continued rebound in the level of new business as the economy reopened following the Covid-19 lockdowns.

Equity finance remained exceptionally strong during H1 2022 but Q3 marked a deterioration in market conditions with declining investment and deal activity

£14.8bn of equity was invested into UK SMEs over the first three quarters of 2022. This was up 10% on the £13.5bn invested in the same period in 2021. Equity investment remained exceptionally strong in the first half of 2022 but slowed considerably in Q3. This is in line with the business environment becoming more challenging in the UK and globally during the year amid rising interest rates and high inflation. With one quarter to go, 2022 in aggregate is still likely to be a strong year for equity investment in the UK, with the exceptionally strong first half obscuring a weaker second half of the year.

The number of equity deals completed in UK SMEs over Q1-Q3 2022 was 1,932. This is only 2% lower than the number of deals conducted in the same period in 2021. Similarly, the number of equity deals in the first half of the 2022 remained high but declined in Q3.

Macroeconomic developments

UK economic growth lost momentum and broadly ground to a halt during 2022

Business investment recovered from the impact of the pandemic

A sharp rise in inflation squeezed household income

Official forecasts predict a recession in 2023 and inflation eases

Forecast weakness in business investment has the potential to reduce smaller businesses' demand for finance

UK economic growth lost momentum and broadly ground to a halt during 2022

The UK economy experienced a combination of major challenges in 2022. The Russian invasion of Ukraine, the Bank of England Bank Rate rising to 3.5%, the reaction to the government's mini-Budget in September, the lingering impact of the Covid-19 pandemic, and ongoing trade frictions with the European Union all weighed on the economy.

Economic growth slowed sharply in the first half of the year. Real GDP grew 0.5% in Q1, down from 1.4% in the previous quarter. In Q2 real GDP grew only 0.1%.

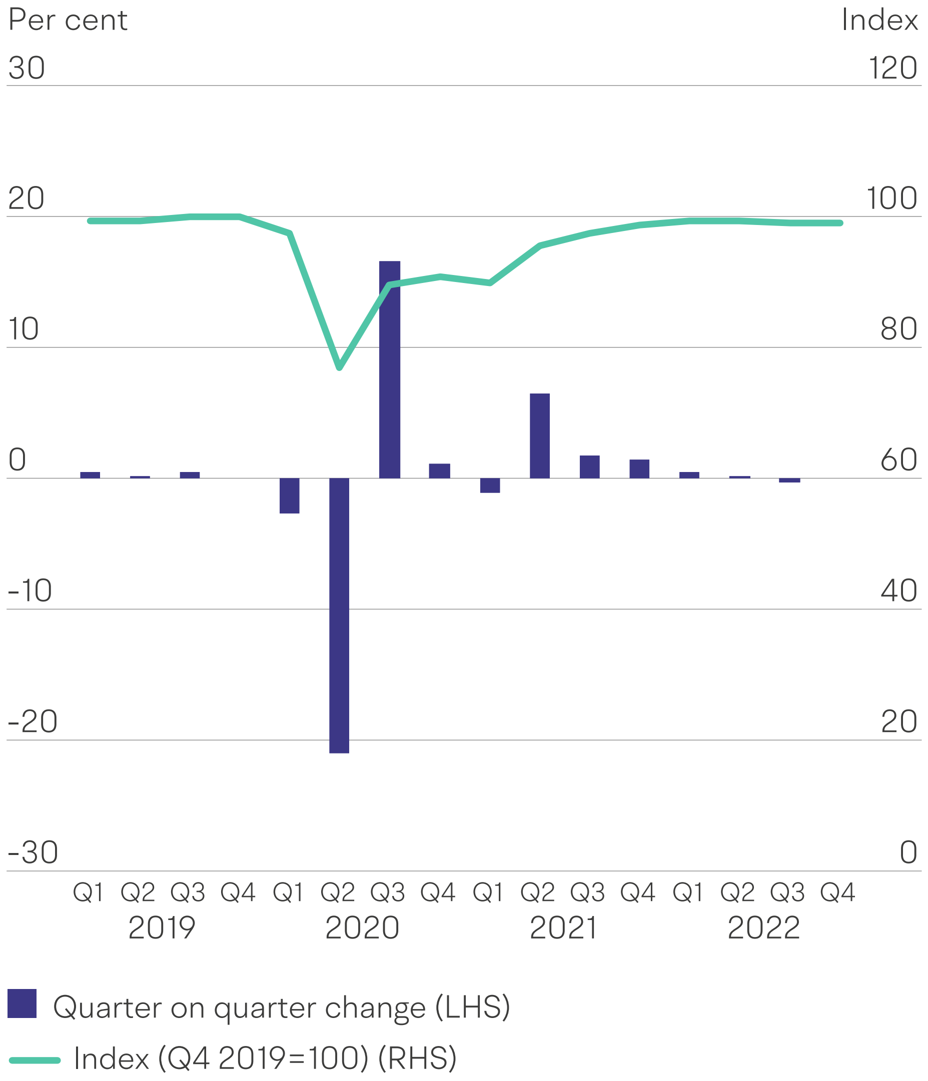
The economy faltered in the latter half of 2022. Real GDP fell 0.2% in Q3. This was the first contraction since Q1 2021 amid the third national Covid-19 lockdown. It was also the third fall in real GDP since Q1 2020 and the fourth since Q4 2012. In Q4 2022 real GDP was flat (Figure 2).

In the final quarter of 2022, the UK economy had broadly recovered from the impact of the pandemic.[1] The level of real GDP was 0.8% below that in Q4 2019, the last quarter before the Covid-19 outbreak in the UK.[2]

Figure 2

Real GDP, seasonally adjusted

Source: ONS



Business investment recovered from the impact of the pandemic

In early 2022 the recovery of business investment from the impact of the pandemic resumed. Business investment grew 4.5% in 22Q1 after falling 2.7% in 21Q4. In Q2 the pace of growth picked up to 6.9%.

The breakdown of the data showed the growth was largely driven by increased business investment in transport equipment. This is in line with reports that pandemic-related shortages in the supply of transport equipment eased. Also, some businesses taking advantage of the government's super-guarantee deduction ahead of it ending in March 2023 may have contributed to the growth.[3]

The recovery stalled again in the third quarter of 2022, with business investment falling 3.2%. In Q4 business investment rose 4.8%. The increase was driven by contributions from ICT equipment and other machinery and equipment, transport equipment and other buildings and structures.

By late 2022 the level of real business investment had recovered to that in Q4 2019 (Figure 3). This compares to real GDP being 0.8% below its pre-pandemic level.

The pickup in business investment during 2022 highlights that it was rebounding from a low base following a large fall in 2020 due to the pandemic. Business investment has been subdued for the past two decades.

Unlike business investment, business confidence weakened during 2022. This is consistent with the pick up in business investment being driven by it rebounding from a pandemic-related low base. The FSB small business confidence index fell in Q4 for the third consecutive quarter to the lowest since Q4 2020 amid the second national lockdown (Figure 4). However, excluding 2020 and 2021, the index was the lowest since it started in 2010.[4]

Figure 3

Business investment, seasonally adjusted

Source: ONS

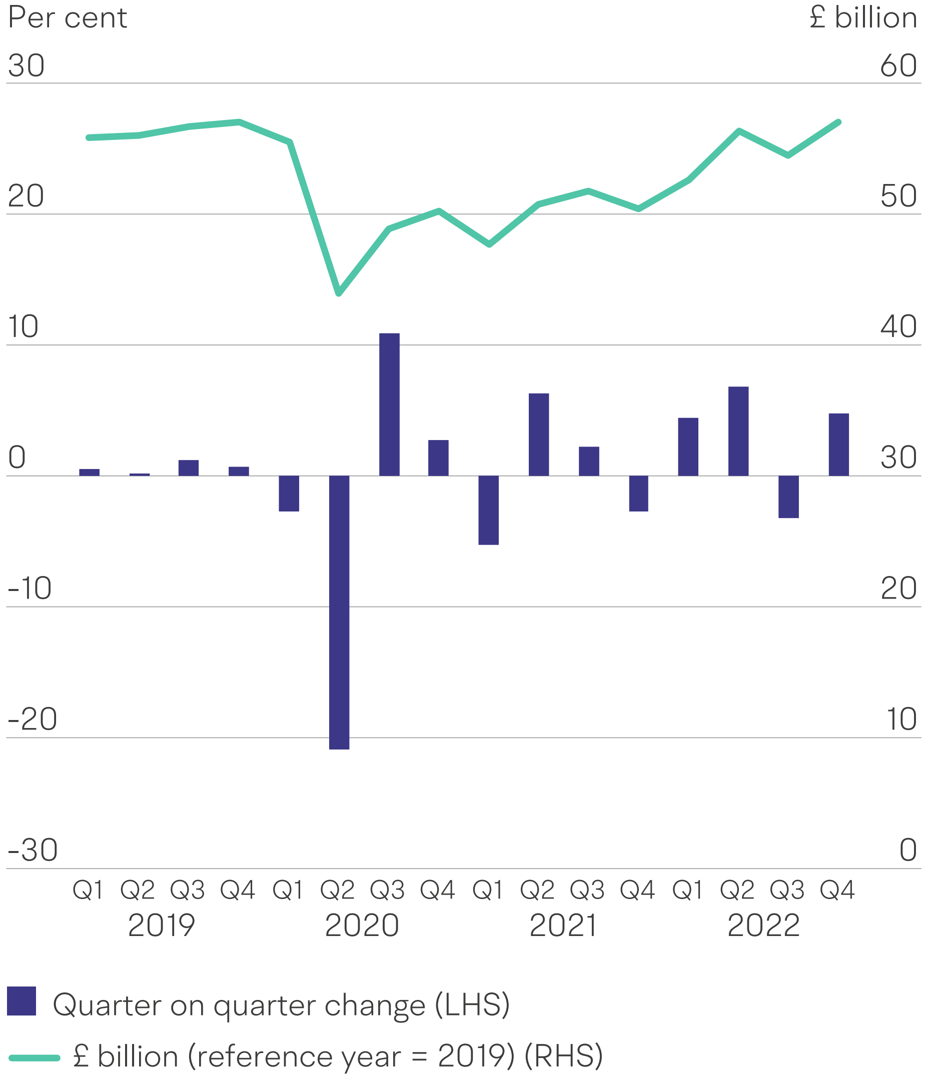
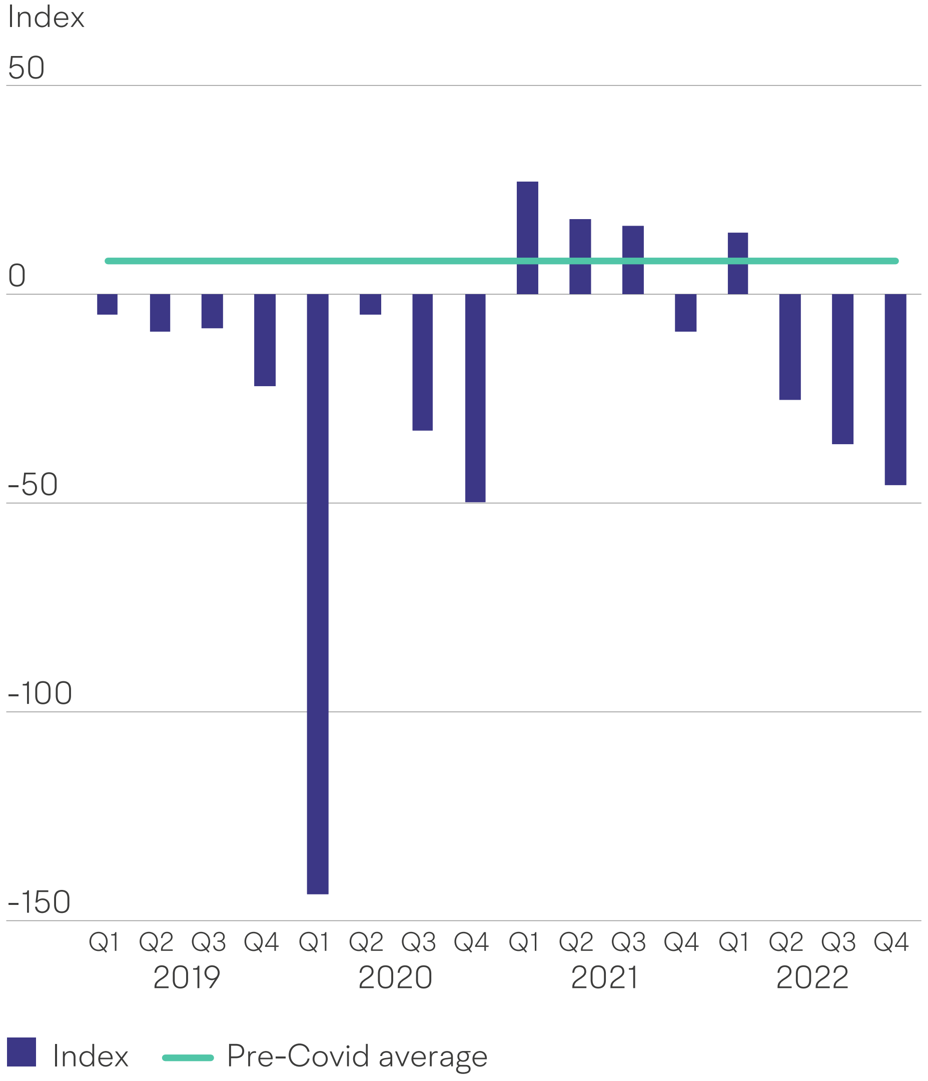


Figure 4

Voice of small business confidence index

Source: FSB



A sharp rise in inflation squeezed household income

The consumer price index (CPI) rose 9.1% in calendar year 2022. This was the highest rate since the data series began in 1989 and up significantly from 2021 (2.7%) (Figure 5). However, during the year, the CPI rose 11.1% in the 12 months to October 2022. The ONS noted its indicative estimates suggest this was the highest in 40 years.

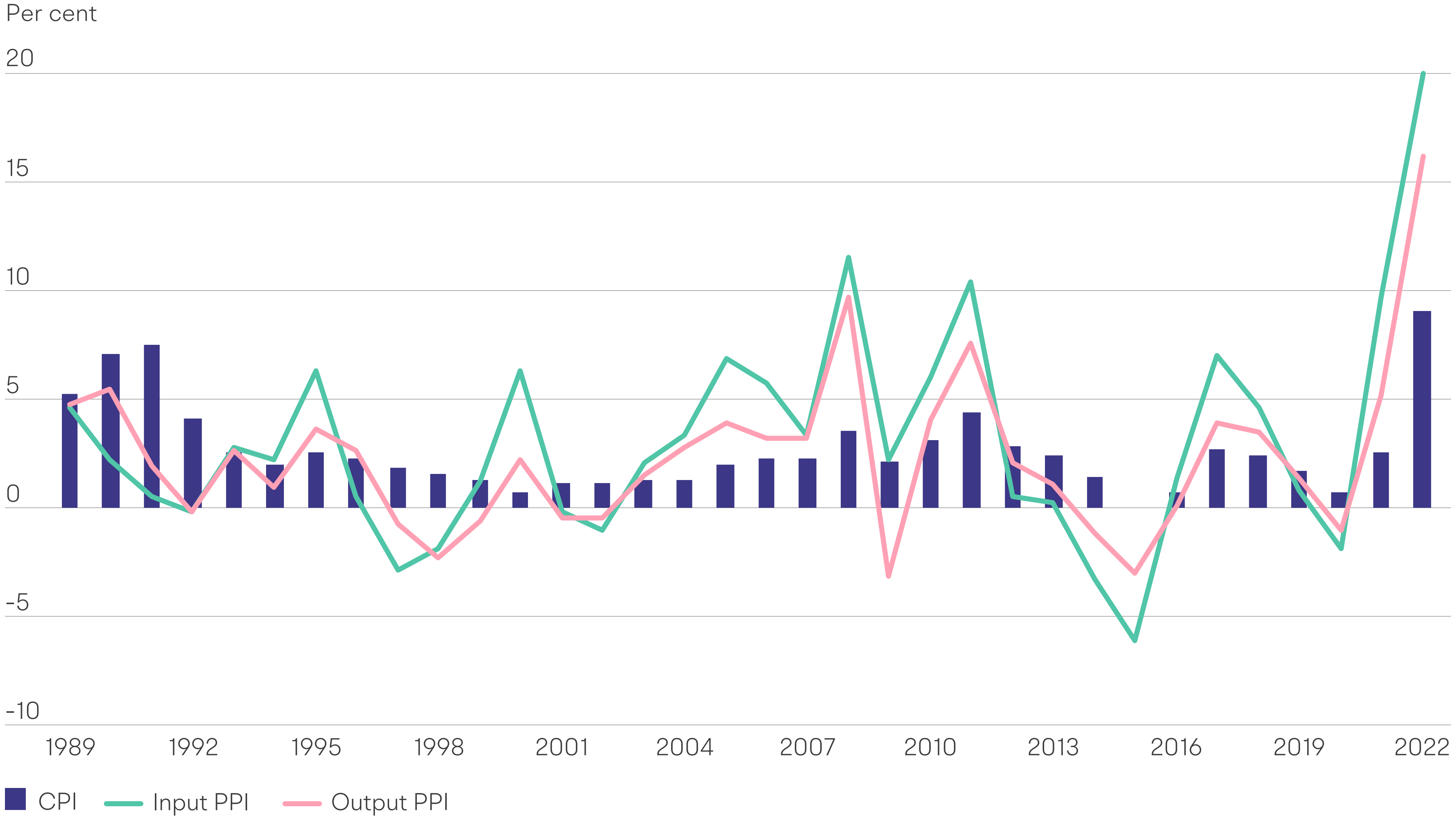
The sharp rise in inflation was initially triggered by pandemic-related disruption to global supply chains. Many major economies including the UK lifted most of their Covid-19 restrictions in the first half of 2021. This led global demand to exceed supply, causing shortages that pushed up the prices of commodities, tradable goods, and labour.

The situation was exacerbated by Russia's invasion of Ukraine and ongoing Covid-19 restrictions in some countries. The war in Ukraine led to a sharp rise in the prices of key global commodities including natural gas, crude oil, nickel, and wheat.

Figure 5

Consumer and producer price inflation

Source: ONS



The impact of the higher natural gas price was greater in Western European countries including the UK than other parts of the world. This reflects the relatively high reliance of Western Europe on Russian natural gas.

The higher prices resulting from the war in Ukraine and lingering impact of Covid-19 led to a large increase in the cost of business inputs. Producer price inflation for manufacturing inputs reached 20% in 2022. This was more than double that in 2021 (9.8%) and the highest since records began in 1985.

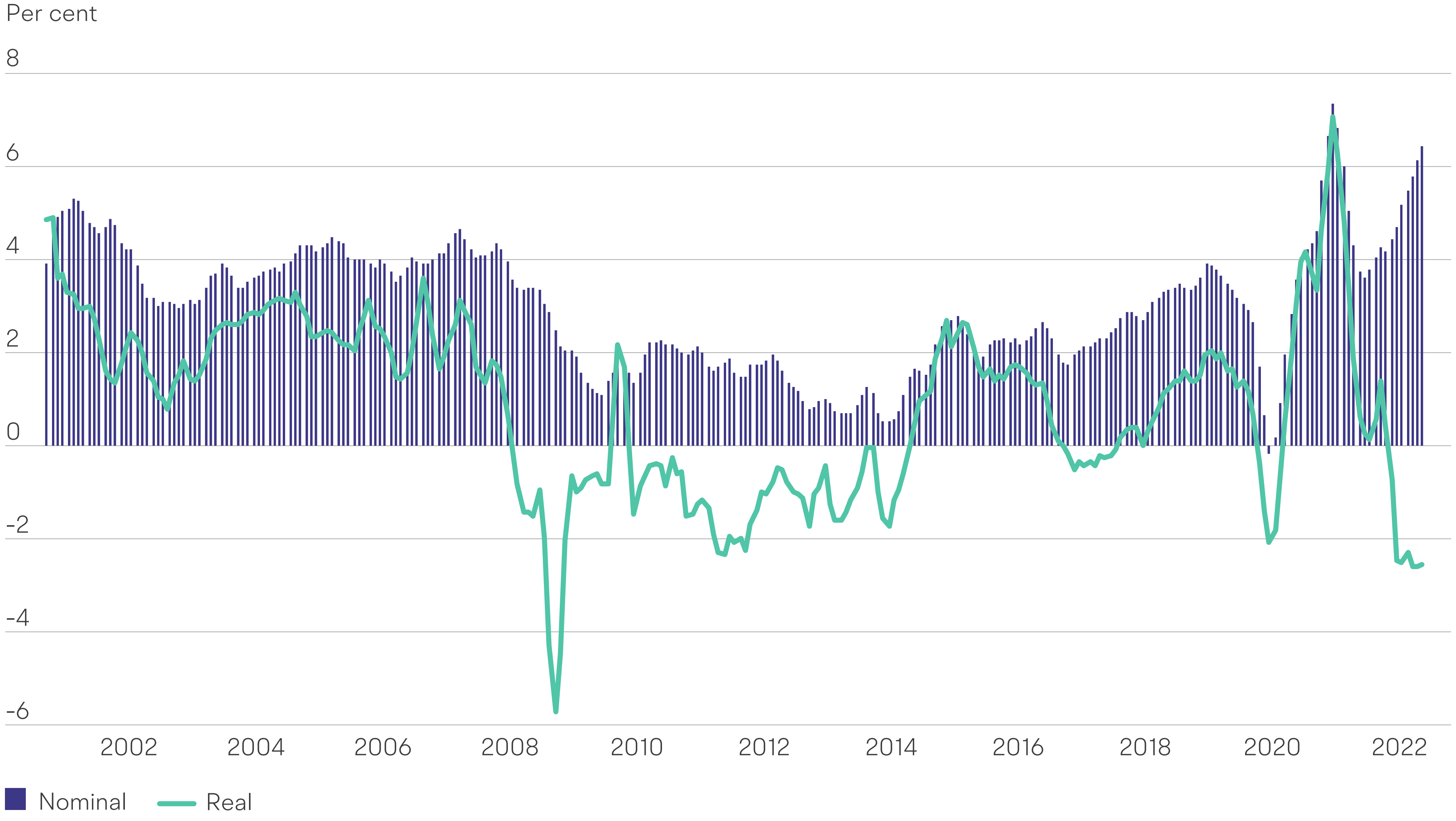
The higher input costs squeezed cash flow and profit margins. To protect margins, firms passed on some of the higher input costs to customers i.e., consumers and other businesses. Producer price inflation for manufacturing outputs rose 16.3% in 2022. This was the highest since 1977 (18%) and up from 5.2% in 2021. The pass-through of some of the higher input costs to consumers contributed to the rise in the CPI.

The high CPI squeezed the disposable income of households in real terms. This typically resulted in consumers cutting back their spending, particularly on discretionary goods and services.

Figure 6

Nominal and real regular pay, annual change in 3-month average

Source: ONS



The squeeze on real household disposable income largely reflected falls in real regular pay. Nominal regular pay growth picked up during 2022 because the labour market was tight. However, nominal pay growth lagged the rise in CPI, leading to a reduction in real terms. The fall in real regular pay in the three months to November 2022 compared to the same period in 2021 was the largest since April 2009 (Figure 6).

The lower real wages led many workers to seek a pay increase as compensation. Consequently, the number of industrial disputes increased, particularly in the latter half of 2022. Preliminary ONS data showed the number of stoppages in November reached a 44-year high. Similarly, the number of workers involved and working days that were lost were the highest in more than a decade.[5]

Official forecasts predict a recession in 2023 and inflation eases

The latest forecast by the BoE, published in February, shows the UK economy is expected to be in recession throughout 2023 and Q1 2024. Similarly, the most recent OBR forecast, published in November, predicted a recession from Q3 2022 to Q4 2023. Both the BoE and OBR expect the recession to be shallow.

The OBR, BoE and HMT comparison of independent forecasts all expect the economy to contract around 1% in 2023.

There is less consensus about 2024. The BoE expects the economy to contract 0.3%. In contrast, the OBR predicts the economy to grow more than 1%. The divergence reflects the economic outlook is highly uncertain and that the OBR forecast was prepared three months before the BoE's (Figure 7). At the time of writing the HMT comparison did not provide forecasts for 2024.

The forecasts also show inflation is expected to ease in 2023. The OBR and Oxford Economics predict the CPI to rise around 7.5%.[6] The BoE forecast is lower at just over 4%. All the forecasts assume energy prices fall somewhat.

Inflation is forecast to continue to ease in 2024. Oxford Economic predicts the CPI to rise slightly more than 2% while the OBR and BoE expect an increase of less than 2% (Figure 8). The forecasts of Oxford Economics are used here because the HMT comparison does not provide calendar year CPI forecasts.

Figure 7

Official and independent forecasts of change in real GDP

Sources: OBR, BoE, and HMT comparison of independent forecasts

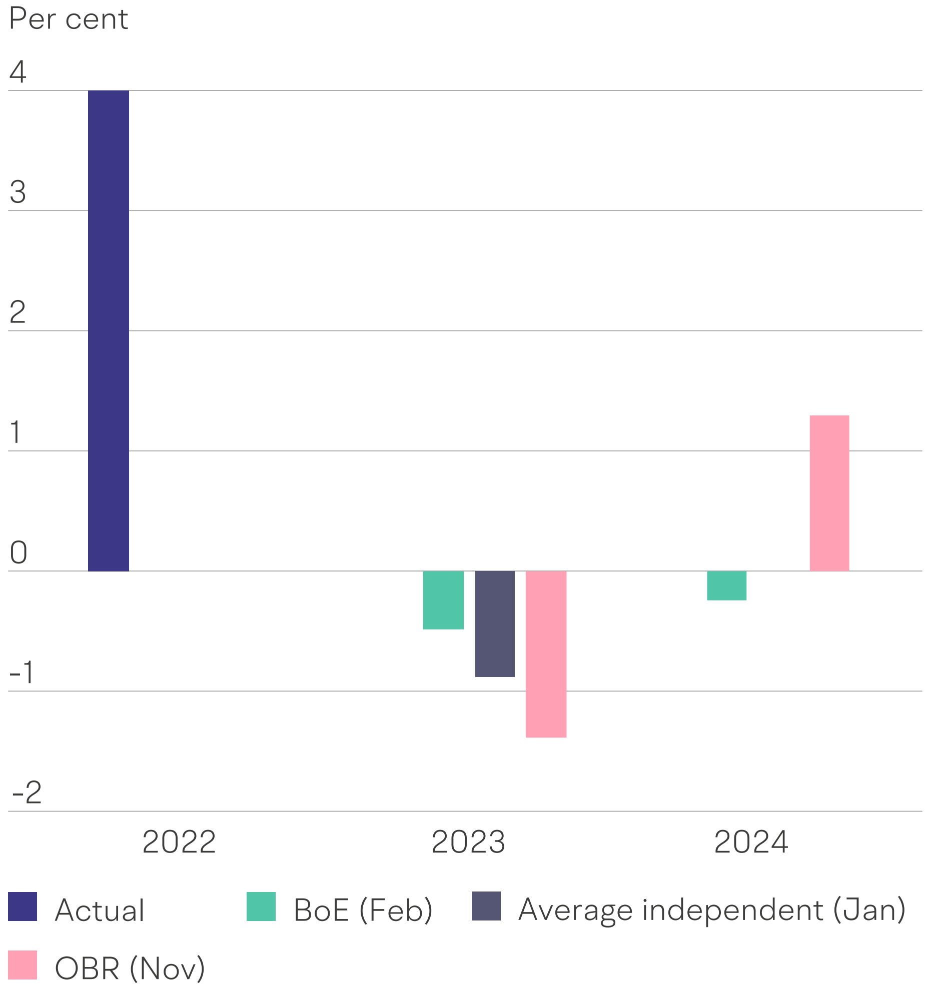
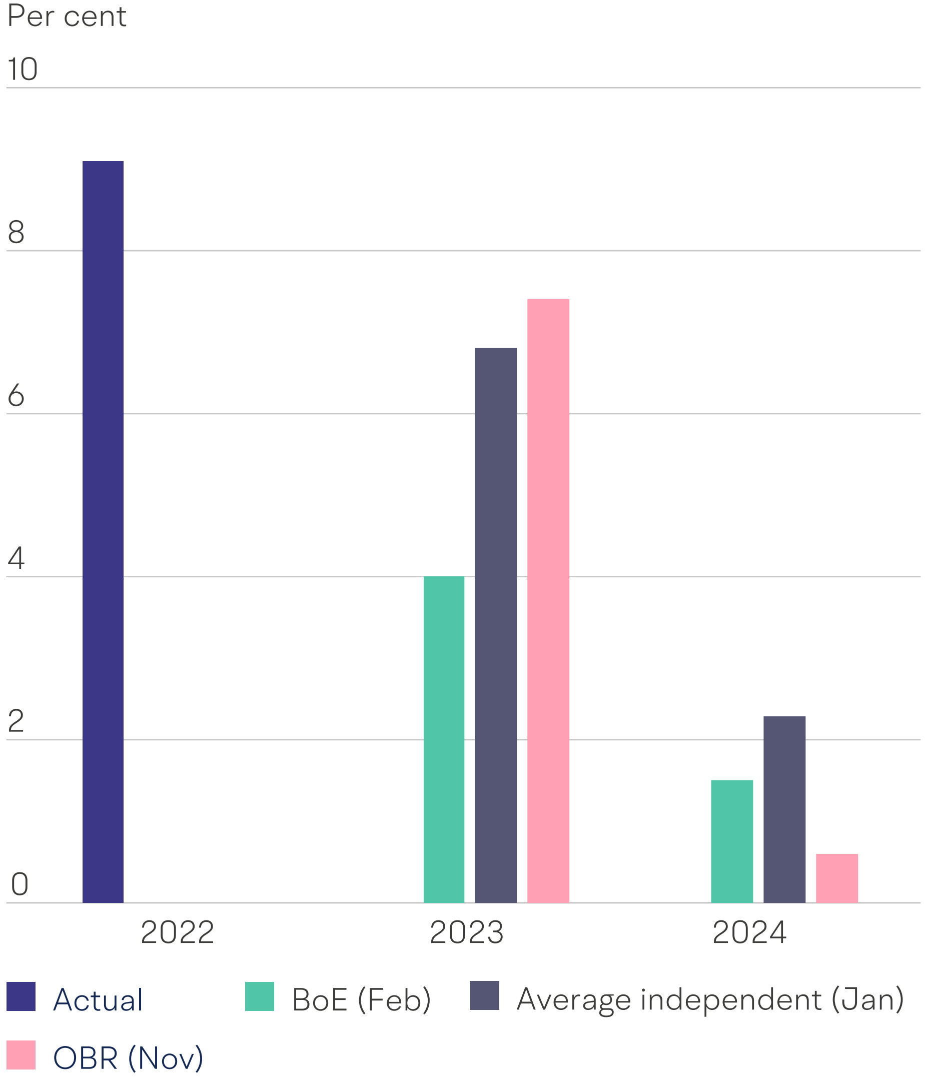


Figure 8

Official and independent forecasts of change in CPI

Sources: OBR, BoE and Oxford Economics forecasts



Forecast weakness in business investment has the potential to reduce smaller businesses' demand for finance

The official and independent forecasts predict business investment to weaken in 2023. The BoE expects business investment to fall around 6%. This compares to the HMT comparison of independent forecasts seeing a decline of about 4% and the OBR predicting a drop of 2%.

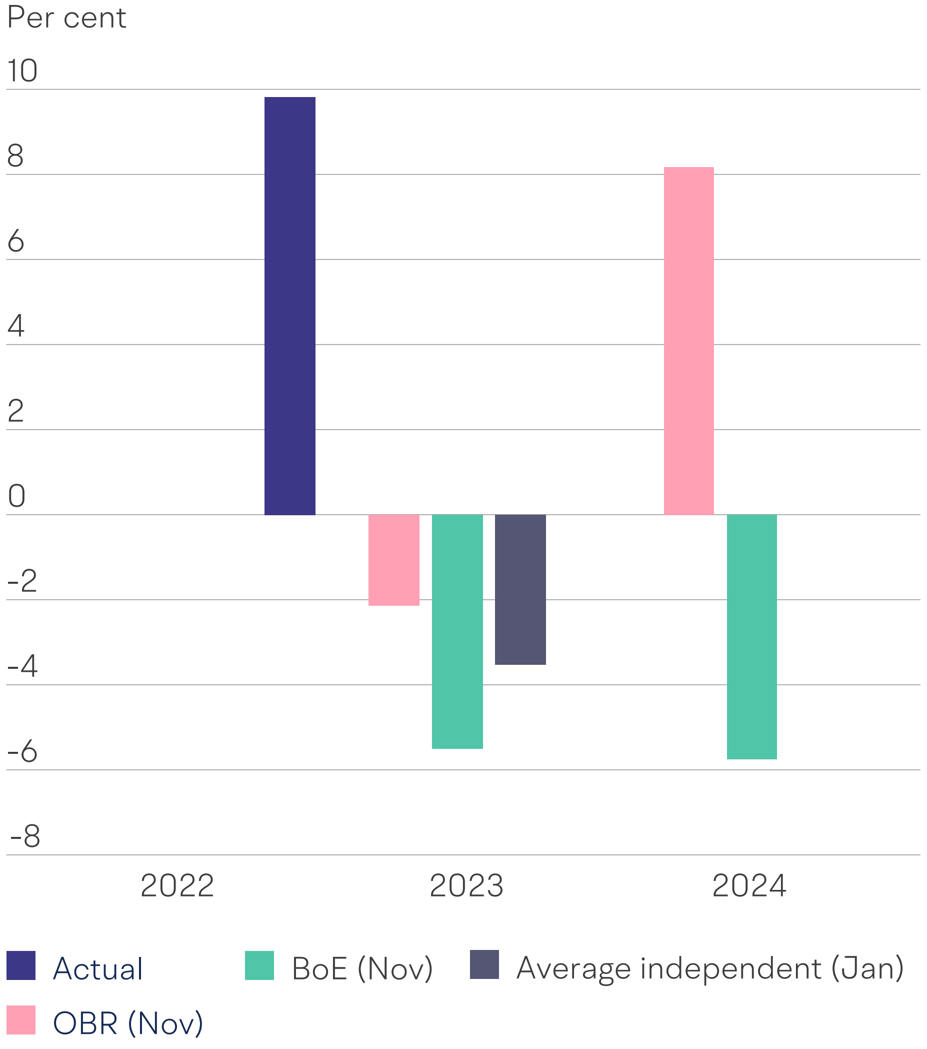
The forecast fall in business investment reflects that the predicted UK recession is likely to reduce revenue, squeezing profit margins. In addition, the expected drop in business investment is consistent with the higher Bank Rate increasing the cost of new borrowing. The BoE, HMT comparison and OBR forecasts were all published after the government announced in October that the corporation tax rate will rise in April 2023.[7]

There is again less consensus about 2024. The BoE predicts business investment to fall around 6% while the OBR expects it to grow 8% (Figure 9).

Figure 9

Official and independent forecasts of business investment

Sources: OBR, BoE, and HMT comparison of independent forecasts



Since the OBR forecast was produced in November, there has been a material fall in the price of natural gas. While many challenges to the UK economic outlook remain, the lower gas prices suggest inflation may ease slightly faster than in the OBR forecast. This may lead the Bank Rate to peak earlier and at a lower level than was expected.

The forecast weakness of business investment has the potential to reduce demand of smaller firms for finance to grow their business. It also does not bode well for productivity, which has been subdued since 2008 in the wake of the financial crisis. Consequently, the expected weakness of business investment may constrain business innovation rates (see Part A for more details), dragging on the UK economic recovery.

Part A

Innovation

Part A of this year's Small Business Finance Markets report is dedicated to exploring the role finance has in supporting innovation.

The two main sections provide an overarching review of how smaller businesses interact with finance for innovation and where finance can support innovation to achieve net zero objectives.

1.1

Financing smaller business innovation

Innovation is an important driver of productivity and economic growth

Innovation can be implemented across firms and industries in a multitude of ways

UK SMEs lag behind other G7 nations in their adoption of innovations

Economic growth requires both new-to-market and new-to-business innovation to flourish

Both new-to-business and new-to-market innovating businesses are greater users of external finance than non-innovating businesses

SMEs applying for finance to innovate are most likely to seek grants, but other finance products are also commonly sought

Lack of finance and funding can hold back companies from developing and commercialising innovation

The Bank's programmes help to facilitate finance to innovative businesses

The UK economy grew at a sluggish rate of c.1% per annum on average between 2008 and 2021.[8] Economic commentators consistently point to the UK's low rate of productivity as the main contributory factor behind these trends. Between 1974 and 2008, UK productivity grew at an average annual rate of c.2.3%, a much higher rate than the c.0.5% between 2008 and 2020.[9] To help reverse these trends, the 2022 Autumn Statement made clear the intention of HMG policy to capitalise on innovation to unlock business performance and generate higher rates of productivity. This chapter explores what it means for UK smaller businesses to innovate, how finance plays a role for innovating businesses, and highlights areas of further work for policymakers to consider.

Innovation is an important driver of productivity and economic growth

This chapter begins with a brief summary of the evidence outlining why innovation is so important for economic and productivity growth whilst creating opportunities for employment and higher value jobs.

Innovation has contributed to global increases in living standards over time, both through improvements in productivity but also through increasing the availability of goods and services and improvements in life expectancy. Empirical evidence across European countries between 1989 and 2014 confirms increased innovation in an economy (as measured across a range of indicators such as patents, R&D expenditure, and journal article citations) is associated with higher long run economic growth per capita.[10] Innovation is also important for finding solutions to help address current global challenges, such as climate change and sustainable development. The capacity to innovate and to bring innovation successfully to market at scale is a crucial determinant of global competitiveness.[11]

One mechanism by which innovation increases economic growth is through its contribution to increasing business productivity, which then contributes to overall productivity at the macro economy level. This can occur through businesses introducing improved processes leading to greater efficiency within the company. Investments in intangible assets such as computerised databases, R&D, design, brand equity, firm-specific training, and organisational efficiency contributed to around one third of UK labour productivity growth between 2000–2013, a similar proportion as in the US and EU.[12]

Empirical research shows that firm turnover and employment increases are higher in firms receiving R&D grants compared to those that do not.[13] Businesses participating in research projects funded by UK Research Councils grew their turnover 7.6% faster in the three years following funding and 23% faster six years after, relative to similar firms that did not receive support. For employment, the growth was 4.8% and 21% higher in the short and medium term, respectively.

While investment in new to market technologies and innovation bring benefits, many more businesses benefit from productivity improvements when they adopt (and adapt) existing technologies to their business delivery. Enterprise Research Centre research showed business productivity in micro businesses was between 7% to

18% higher three years after adopting a range of digital technologies such as cloud-based computing, Computer Aided Design (CAD) or Customer Relationship Management (CRM) systems.[14]

A 2014 literature review found that private rates of return from undertaking R&D investment are around 30% on average or 20%-25% for the median return.[15] In addition to the private returns from undertaking R&D investment, there are also wider benefits (known as positive externalities or social returns) benefitting other firms and individuals in the economy (e.g. through improved productivity outcomes). These social returns, based on spillover benefits from R&D, are typically between two to three times larger than the private returns.[16] A recent study using US firm level data concluded that the ratio of marginal social returns to private returns for R&D investment is a factor of 4.[17] Wider society benefits also include enhanced health outcomes from innovative new treatments, improved environmental quality, energy efficiency, and the general advancement of knowledge. These social returns provide a strong rationale for continued government investment in innovation.

Innovation can be implemented across firms and industries in a multitude of ways

The evidence on innovation is extensive but shows how there are different measures and ways of interpreting innovation. For transparency, this chapter follows the definition outlined by the OECD in which, at the most fundamental level, a firm is said to innovate when it implements something significantly new to its existing business. In more formal language, the OECD's Oslo Manual[18] defines business innovation as **"a new or improved product and/or business process that differs significantly from the firm's previous products or business processes and that has been introduced on the market or brought into use by the firm"**.[19]

This definition allows for a myriad of ways through which businesses can innovate. Importantly, it also includes businesses adopting innovating products and processes from other businesses. As long as an improvement is new to the business, it is classed as an innovation for that firm regardless of novelty. Figure A.1 sets out a business innovation taxonomy aligned to OECD-defined characteristics.

Eight categories sit under Product and Process Innovation including Goods, Services, Distribution and Logistics, and Marketing and Sales. Businesses can innovate along dimensions such as quality, reliability, and efficiency for each category. A single innovation can also involve varying combinations of each type of innovation.[20]

Finally, not every change is an innovation. Routine changes or updates, simple capital replacement, minor aesthetic changes, prototypes, and an extension in the range of products offered (unless involving significant changes) would all not meet the definition of innovation.

Figure A.1

Business innovation implementation taxonomy

Source: OECD, Oslo Manual 2018

Product innovation		Process innovation					
Goods	**Services**	**Production of goods & services**	**Distribution & Logistics**	**Marketing & Sales**	**ICT Systems**	**Admin & Management**	**Product & Business Process Development**
- Includes tangible objects and some knowledge-capturing products over which ownership rights can be established	- Intangible activities produced and consumed at the same time - Services can also include some knowledge-capturing products	- Activities that transform inputs into goods or services (eg engineering) - Constitutes the core function - Other five functions comprise ancillary activities to support production	- Includes transport, service delivery, warehousing, and order processing - Example: online ordering system	- Includes advertising, direct marketing research and activities to develop new markets - Pricing strategies, sales and after-sales activities	- Maintenance and provision of ICT systems - Includes hardware and software, and data processing - Web-hosting and other computer-related information activities	- Strategic and general business management, corporate governance - Accounting, and other financial or insurance activities, HR, procurement, managing relationships with suppliers	- Activities to scope, identify, develop, products/ processes - Can be undertaken in a systematic or ad hoc basis - Example: adoption of new methods

UK SMEs lag behind other G7 nations in their adoption of innovations

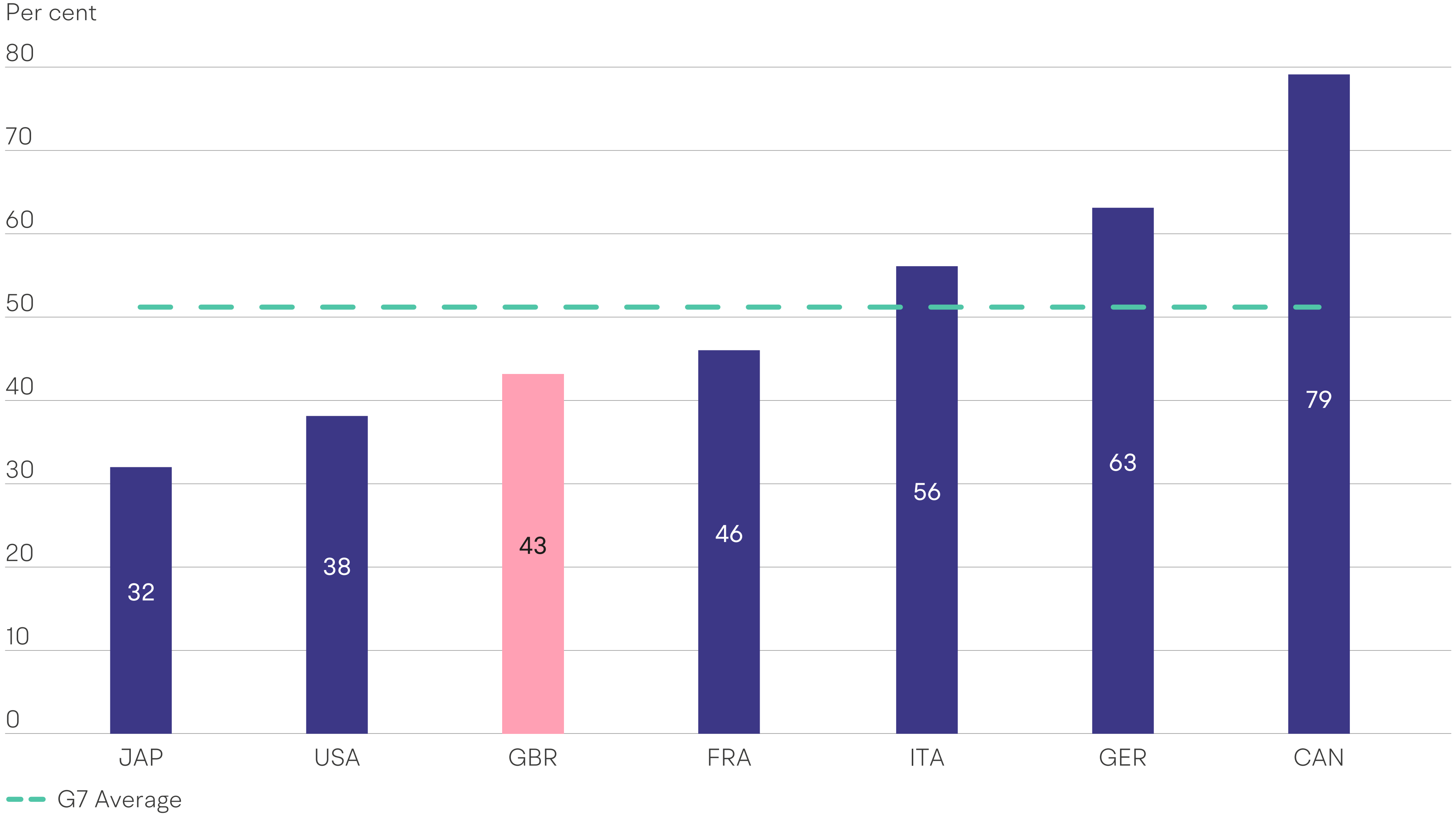
The UK generally performs well on innovation when measured across a variety of metrics. For instance, the 2022 Global Innovation Index (GII)[21] ranks the UK 4th behind Switzerland, United States, and Sweden. Based on the report, the UK stands out as a global leader in universities, science, research, and start-up formation. Additionally, Cambridge and Oxford are found to be two of the most intense science and technology clusters in the world.

The proportion of innovative UK SMEs, however, ranks in the bottom three (Figure A.2) relative to other G7 nations ahead of Japan (32%) and USA (38%) but behind France (46%), Italy (56%), Germany (63%), and Canada (79%). Acknowledging limitations in comparing international innovation rates[22] the UK would require an eight-percentage point increase in the share of innovative SMEs to match the latest estimated G7 average. This is equivalent to an additional c.440k SMEs (c.19% increase).

Figure A.2

Proportion of SMEs that are innovative, OECD country comparison

Source: OECD, 2021 Innovation Indicators



The OECD defines these **"Innovative"** firms as businesses who report innovations over a given period. This in contrast to **"Innovation-active"** firms which are businesses engaged in activities to develop or implement innovations. The key difference between these groups is implementation. "Innovative" firms implement innovative initiatives in their business whilst "Innovation-active" firms undergo activities to develop innovations, but they may not always come to fruition. These activities include R&D, engineering, design, marketing, and IP-related activities. Note that R&D is neither a sufficient nor necessary condition for either innovation activity or innovation to occur - for something to be regarded as an innovation it must involve implementation.

Similar innovation figures are reported in more recent data, such as the 2022 Q2 UK Finance/BVA BDRC SME Finance Monitor (an annual independent survey of c.18,000 SMEs) which found c.40% of UK SMEs had either developed a new product/service or significantly improved an aspect of the business in the past 3 years.

This reflects a noticeable increase on pre-pandemic rates of c.35% on average between 2015–2019 (Figure A.3).

Innovation rates increase with firm size with 36% of zero employee firms cited to have innovated compared to double that for 50–249 employees (72%). This is the largest gap in absolute terms since the data series began in 2012 and suggests supporting small microbusinesses (0–9 employees) to innovate may offer substantial benefits.

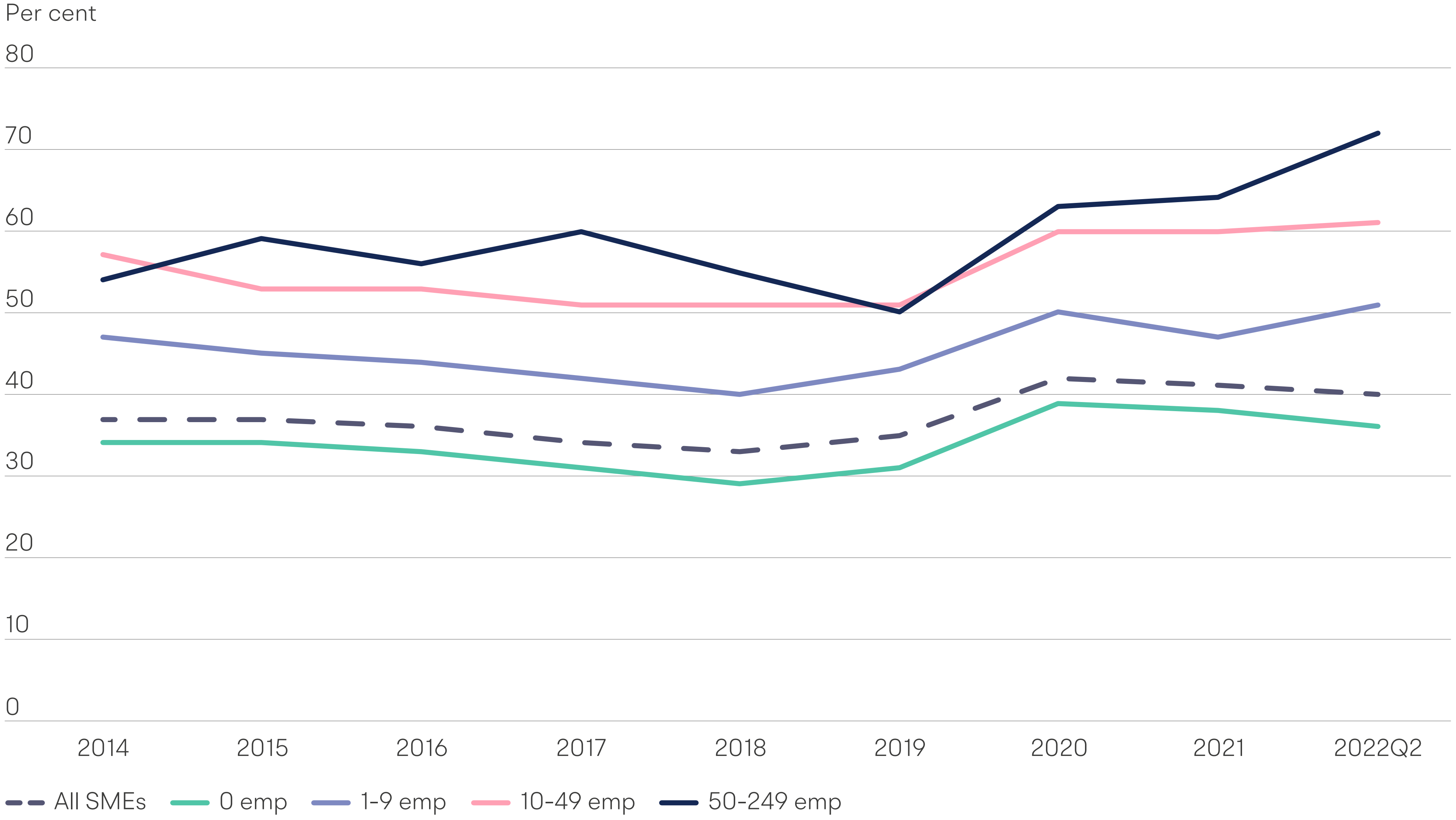
Whilst the GII report suggests the UK is an innovation world leader, the OECD and SME FM analysis suggests the UK has a fair amount of catching up to do. As illustrated in the GII report, the UK performs poorly on gross capital formation (ranked 109th). This reflects a relatively low rate of investment in capital and fixed assets such as machinery, equipment, inventory, and other aspects of infrastructure. This suggests the UK suffers from a suboptimal rate of innovation adoption by smaller businesses.

This view is supported by other thought leaders. The Council for Science and Technology suggested that the UK does not suffer from a lack of companies operating at the cutting edge (i.e. the "frontier") but rather a longer

Figure A.3

Proportion of UK SMEs undertaking innovation, by business size

Source: UK Finance/BVA BDRC SME FM 21Q4 and 22Q2



tail of less productive firms relative to other countries. Therefore, promoting higher rates of technology adoption will help to enhance UK productivity rates.[23]

Andrew Haldane (then Chief Economist at the Bank of England) presented complementary evidence to support focusing on innovation adoption for the long tail of less productive firms.[24] The success of upper tail UK companies relative to international competitors is noted to be built on world-leading innovation and research. The more pressing issues arise instead from a materially longer lower tail of UK companies, productivity-wise, relative to the likes of Germany and France. For instance, the bottom 25% of UK companies had levels of productivity around 80% or more below the UK median compared to around 60% for German and French counterparts.

Economic growth requires both new-to-market and new-to-business innovation to flourish

Frontier-shifting technologies often result from R&D activities where stimulation of ideas eventually develop into innovative new tangible devices and products. These form the basis for breakthroughs in science and technology resulting in products and processes not currently in use by any other business. These innovations are known as "new-to-market" (NTM).

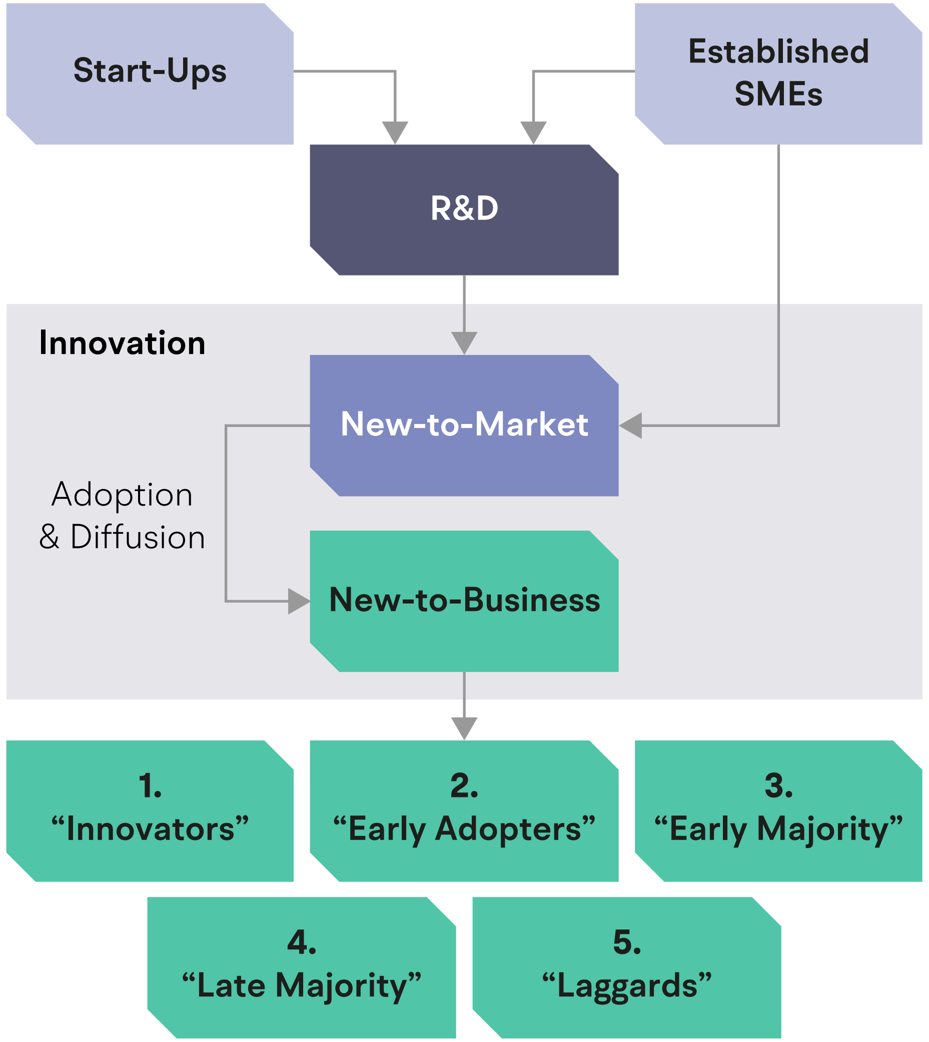
Note that whilst R&D-based innovations are often NTM, not all NTM innovations necessarily result from R&D.

The supply of NTM innovations alone is not enough to make meaningful economic impact. As highlighted earlier, business adoption and diffusion of innovations are just as important for scaling up UK productivity rates. Innovation diffusion can generate substantial economic and social value. While investment in technologies bring benefits, many more businesses benefit when they adopt existing technologies. Businesses adopting innovations developed by other businesses are associated with "new-to-business" (NTB) innovations. Figure A.4 illustrates a stylised overview of how smaller businesses contribute to NTM and NTB innovations within an economy.[25]

Smaller businesses introducing NTM innovations are often associated with start-ups. Their business and fundraising journey is well known and documented within the literature. Start-up businesses looking to introduce NTM innovations are often referred to as "Pre-Seed" and "Seed" stage businesses at their inception. These businesses are often not yet generating any

Figure A.4

Stylised pathways for smaller business new-to-market and new-to-business innovations



revenue, so their main focus is on undertaking research to ensure their technology works and can be applied commercially.[26] Over time those that are successful raise funding to drive further research, products, and eventually profits. Out of this pool, the best performing businesses continue to grow and penetrate multiple markets such that their innovations are ready to be adopted by other businesses at mass scale (i.e. NTB).

Start-ups, however, are not the only type of business to introduce NTM innovations. The BEIS Longitudinal Small Business Survey (LSBS) 2021 found that 11% of NTM innovations were introduced by businesses up to 5 years old (Figure A.5). A further 56% were introduced by businesses between 6–20 years old, whilst 33% were more than 20 years old. Policy makers wishing to incentivise NTM innovations, therefore, may find that established smaller businesses could play an important role.

Once commercialised NTM innovations are launched they become suitable for wider adoption. Figure A.4 segments NTB innovating firms using the framework originally set out by Rogers[27] and also discussed in the UK Innovation Strategy.[28]

This framework groups firms based on when they adopt innovations relative to the rest of the business population.

The first two groups are referred to as “Innovators” and “Early Adopters”. Given the risks involved, these firms are more comfortable in making “wrong” decisions from adopting unprofitable innovations. They play an important role in filtering out unsuccessful innovations thereby reducing uncertainty for smaller businesses to learn from.

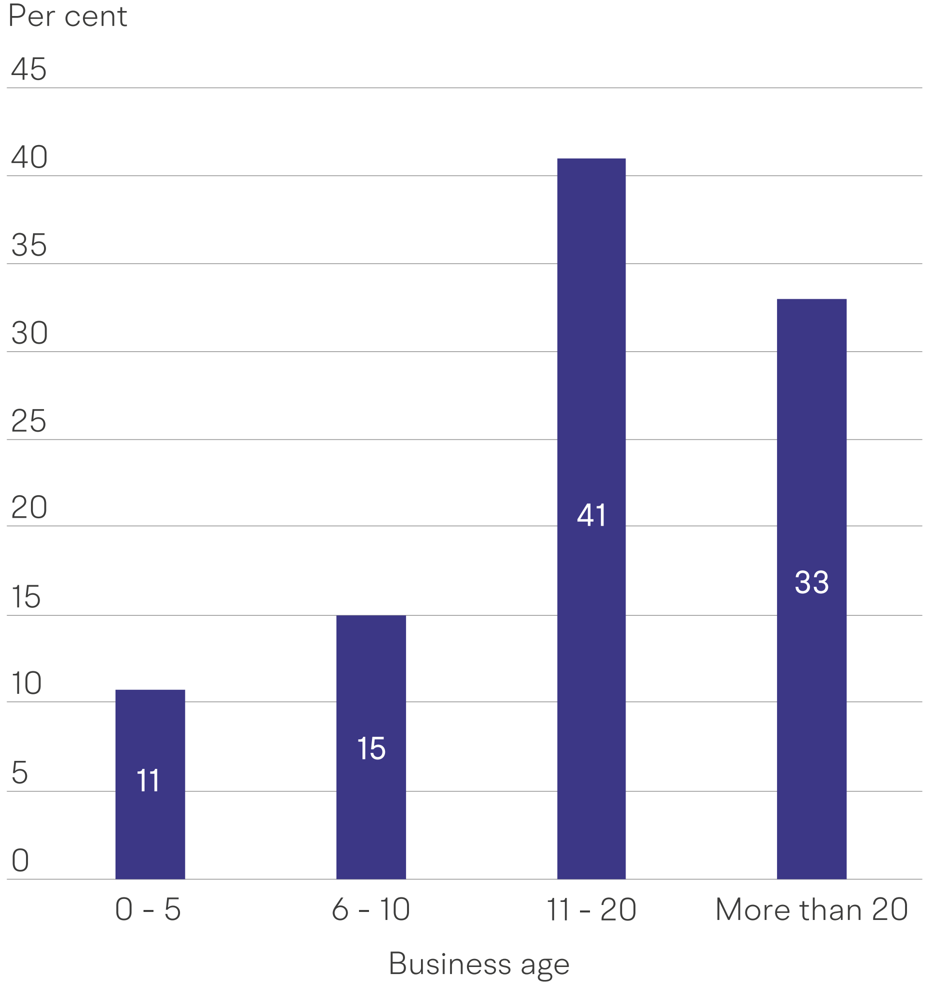
Most smaller businesses are likely to be found in the “Early Majority” and “Late Majority” groups. The former deliberately adopt innovations relatively early. Late Majority businesses tend to wait to adopt due to scepticism but are incentivised to eventually do so to maintain market competitiveness.

The final group of businesses, “Laggards”, have limited resources, lack awareness/ knowledge of innovations and adopt a much more cautious mindset. They only adopt innovations after most other businesses have done so, often in response to regulatory requirements or to ensure business survival.

Figure A.5

Age profile of smaller businesses introducing new-to-market innovations

Source: Bank analysis of BEIS Longitudinal Small Business Survey, 2021, n=744



Quicker and more efficient adoption of innovations can stimulate productivity and economic growth at relatively low cost.[29] Supporting smaller businesses to progress through these stages of adoption, therefore, may help to narrow the gap between the highest and lowest performing businesses. Note that the Rogers framework does not include the c.60% of UK SMEs estimated to not innovate at all. Barriers experienced by these businesses are explored in later sections of this chapter.

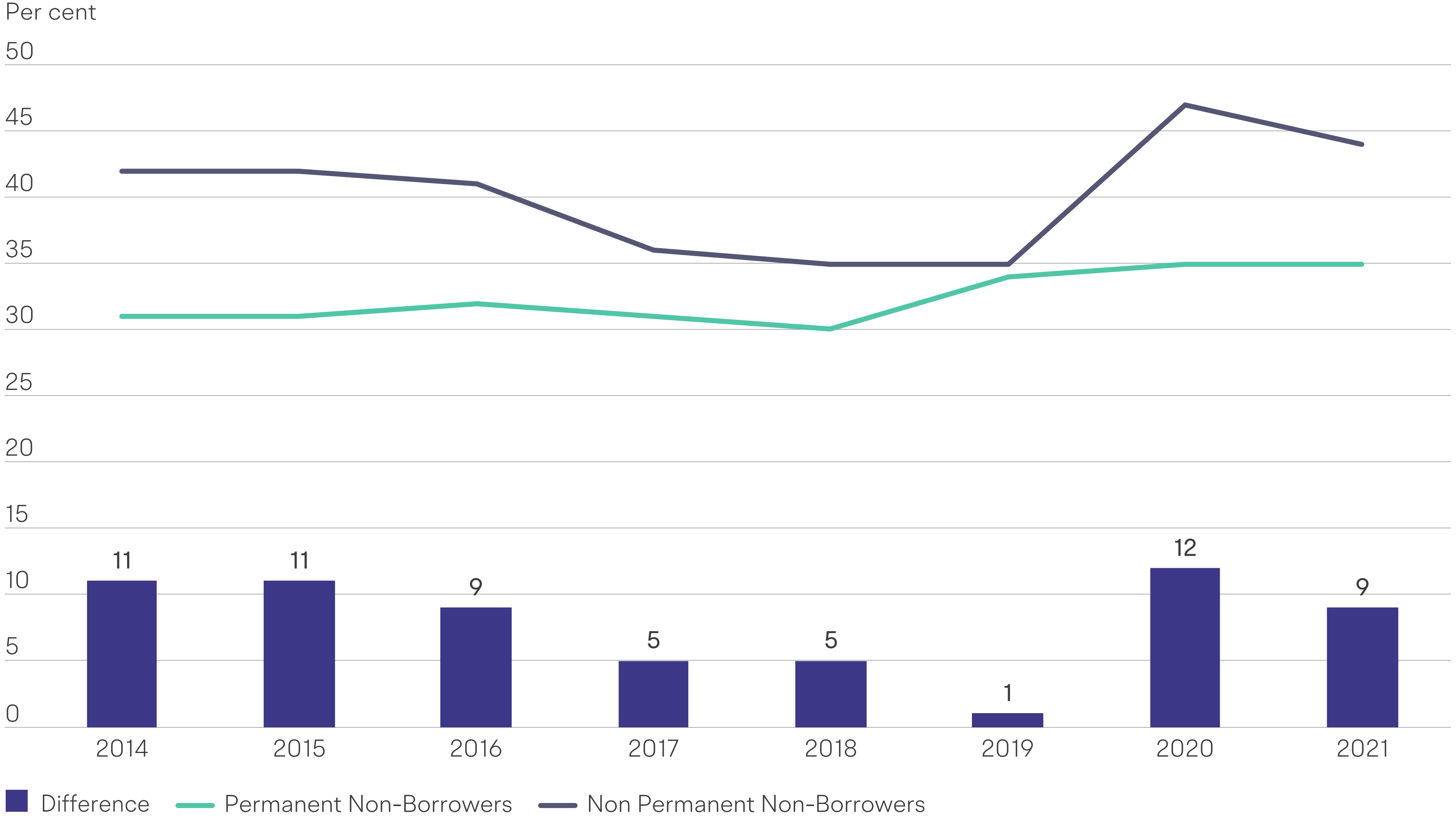
Both new-to-business and new-to-market innovating businesses are greater users of external finance than non-innovating businesses

The UK has a well-developed and mature financial sector offering a range of products for businesses to use. Evidence suggests businesses are more likely to develop new products and improved processes if they are users of external finance than non-users of finance. For instance, whilst 35% of permanent non-borrowers (PNBs)[30] in 2021 were found to be innovative, this proportion increased to 44% for Non PNBs[31] (Figure A.6).

Figure A.6

SME propensity to innovate, by use of finance characteristics

Source: UK Finance/BVA BDRC SME Finance Monitor 2021Q4



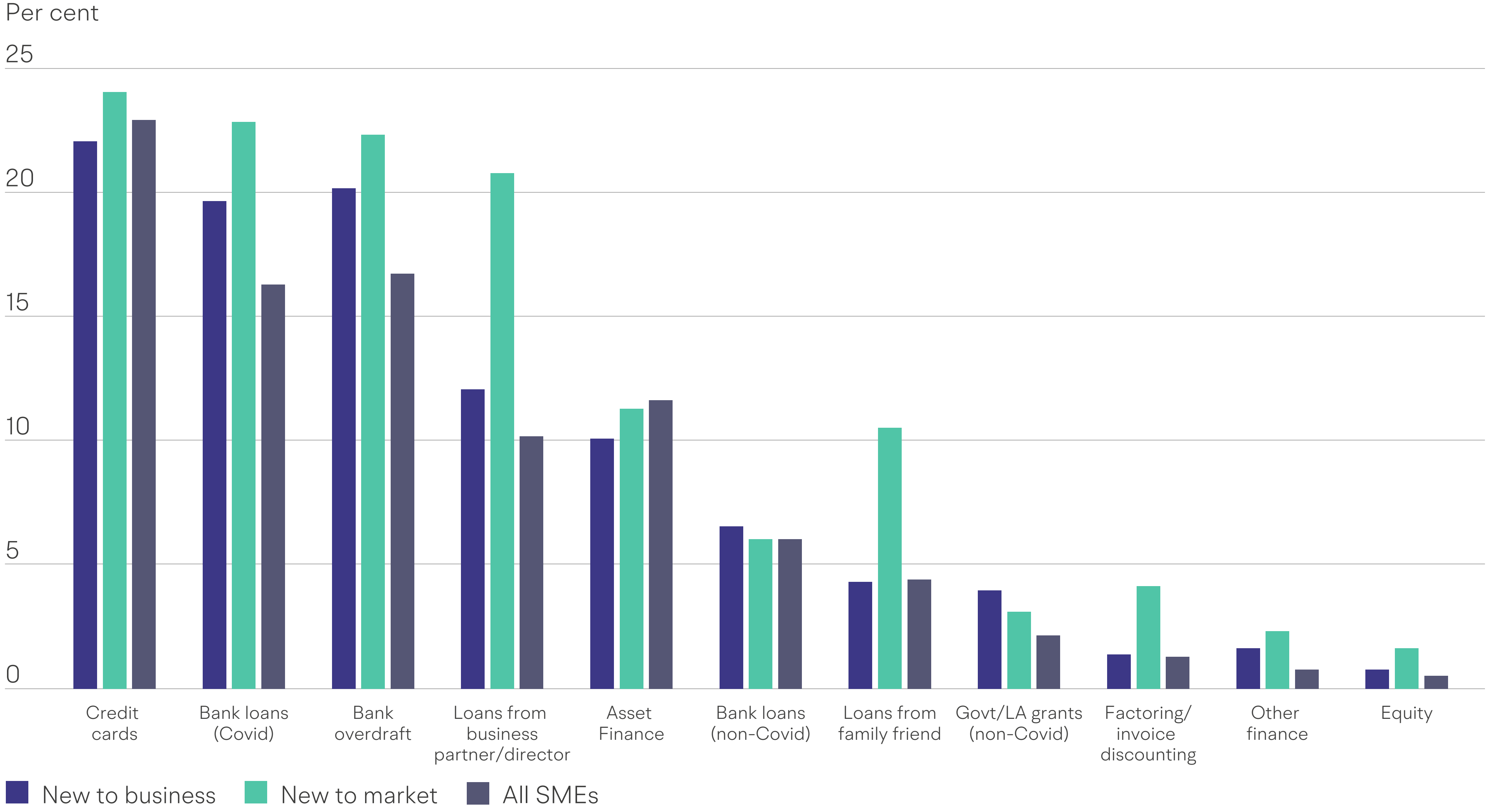
The difference between PNB and Non PNBs innovation rates narrowed between 2014 and 2019 from 11 percentage points to 1. The gap then widened again with the onset of the pandemic to 12 percentage points in 2020 - the largest difference recorded since the series began. This could suggest that use of finance has a material influence on businesses' ability to innovate in times of economic turbulence or that innovation becomes less of a priority for those averse to external finance.

In general, innovating SMEs are statistically significantly more likely to use external finance than other SMEs. Overall, two thirds of innovators (65%) used some form of external finance, compared to 58% of non-innovators.[32] Within the group of innovators, use of finance is higher amongst those that have introduced NTM innovations with 70% of NTM using some form of finance, compared to 63% of NTB. Figure A.7 goes on to break down common types of finance currently in use by NTB and NTM[33] innovators. All SMEs (including non-innovators) are included as a comparator group.

Figure A.7

Use of finance for selected products, by innovation status

Source: British Business Bank analysis of UK Longitudinal Small Business Survey, 2021, n=9,308, of which 744 NTM innovators, 2,062 NTB innovators and 6,502 other SMEs



Pre-seed and seed stage start-ups looking to introduce NTM innovations generally rely on finance from owners' pockets, friends and family, and R&D grants. More developed start-ups with high growth potential may see equity finance from angel or Venture Capital investors as options. Figure A.7 supports this as it demonstrates NTM innovators are just over twice as likely to be using equity finance (1.7%) than NTB innovators (0.8%) and almost three times as much as all SMEs (0.6%) with the latter being statistically significantly different. We would expect this difference to be even greater if the NTM sample was restricted to start-ups alone.

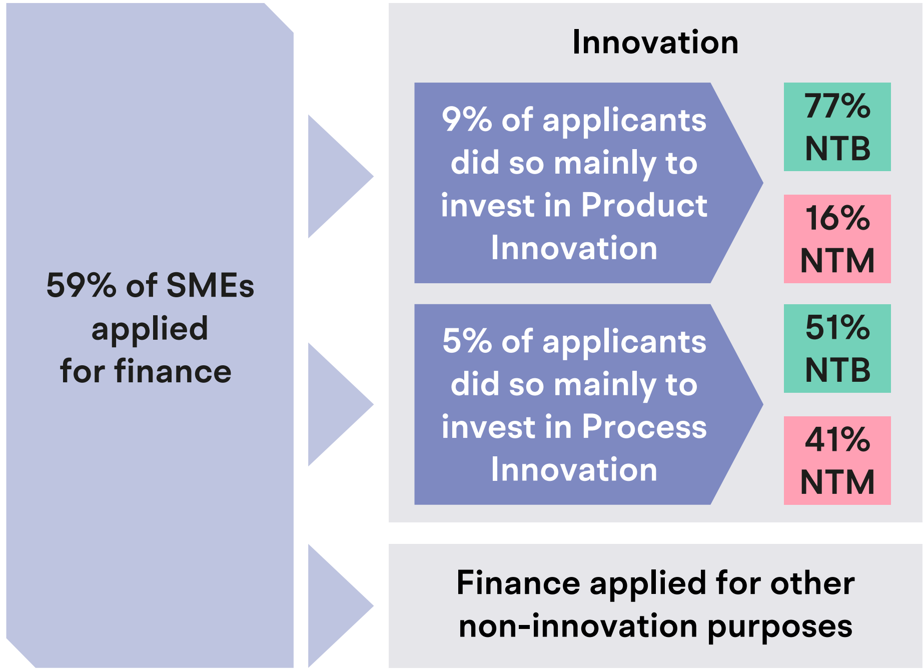
Similarly, c.11% of NTM innovators use loans from family and friends compared to c.4% of NTB and all SMEs, also statistically significant. NTM innovators are the greatest users of loans from directors at 21% which is their second most common source of finance. This compares to 12% for NTB innovators and 10% for all SMEs.

This could potentially highlight differences in risk profile between NTM and NTB innovations with NTM innovations exposed to greater technology and market risks than NTB innovations. This may lead to NTM innovators relying more on internal sources of funding to support innovation.

Figure A.8

Share of SMEs seeking finance to introduce new-to-market and new-to-business innovations

Source: British Business Bank Business Finance Survey – Ipsos MORI, Base = all businesses (n = 913 in 2021)


59% of SMEs applied for finance
Innovation
9% of applicants did so mainly to invest in Product Innovation
77% NTB
16% NTM
5% of applicants did so mainly to invest in Process Innovation
51% NTB
41% NTM
Finance applied for other non-innovation purposes

The presumption that NTM innovators benefit only from director loans and equity finance, however, is not found in the data. NTM innovating businesses use (non-Covid related) bank loans at a similar rate to NTB businesses (c.6.5%). Across the board, both NTB and NTM-innovating businesses access a range of finance including bank loans, asset finance, bank overdrafts, and credit cards. Debt finance clearly plays an important role for all innovating small businesses either as a direct enabler of innovation or in a supporting role (e.g. working capital).

SMEs applying for finance to innovate are most likely to seek grants, but other finance products are also commonly sought

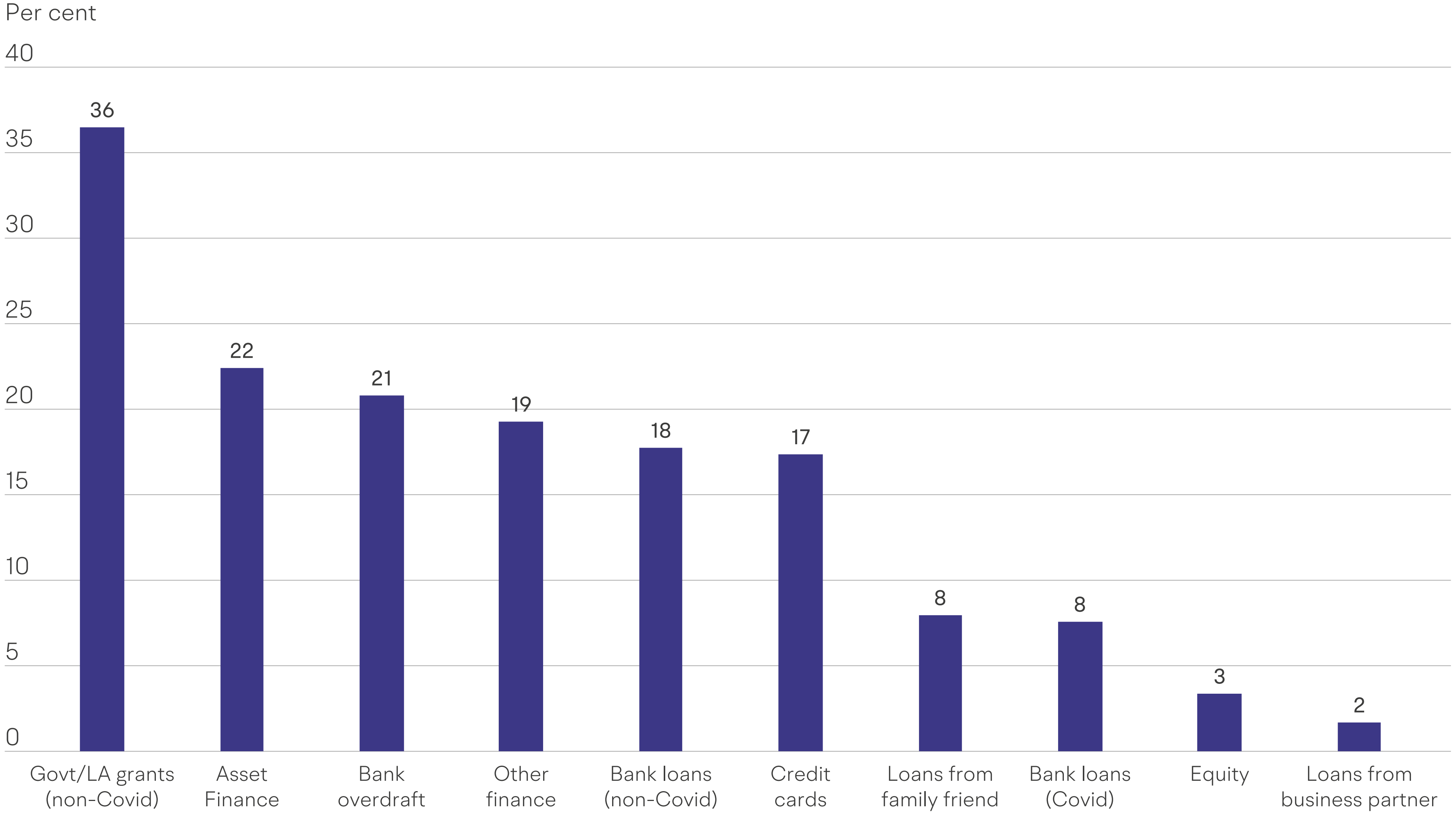
Since 2014 innovative smaller businesses were consistently around twice as likely to have introduced innovative processes (33% of all SMEs on average) than innovative products (16% of all SMEs on average).[34] On both accounts these innovations were more likely to be NTB than NTM (c.75% NTB and c.25% NTM for both).[35]

For finance, however, smaller businesses were more likely to apply to introduce product innovations than process innovations. Out the estimated 59% of SMEs who applied for finance between 2019–2021[36] approximately 9% did so to mainly invest in product innovation and 5% to invest in process innovation[37] (Figure A.8).

Figure A.9

Smaller business finance application profile for innovation purposes

Source: BBB analysis of UK Longitudinal Small Business Survey, 2021



77% of SMEs seeking finance for product innovations were NTB compared to 16% NTM.[38] There was a more even split for SMEs seeking finance for process innovation with 51% intending to introduce NTB innovations compared to 41% NTM innovations. Policy makers may wish to consider how finance could be more effectively provided to increase supply-side boosting process innovations.

The Longitudinal Small Business Survey allows analysis of finance products applied specifically for innovation purposes. Careful interpretation must be applied, however, due to small sample sizes. Figure A.9 suggests that on average, SMEs seeking finance specifically to innovate are most likely to apply for grants (36%), asset finance (22%), and perhaps surprisingly bank overdrafts (21%). Other finance (19%) is a notably high source of innovation finance, but this cannot be broken down further in the data.

Due to low base sizes, small businesses seeking finance to innovate were statistically significantly more likely to apply for just three products, namely equity (3% vs 0.4%), non-covid grants (37% vs 6%) and other finance (19% vs 6%). Overall, the data points to a wide range of finance products that businesses apply for to support the introduction of innovations. A diverse and efficient financial market, therefore, plays an important role supporting small business innovation.

Box 1: Debt burdens and innovation

There are ongoing risks that debt burdens may constrain smaller businesses from investing in innovation. A combination of economic pressures coupled with rising interest rates is likely to weigh on companies' abilities to service existing and take on new debt. The Bank of England published an analysis of corporate debt vulnerabilities which found they were likely to increase in the near term.[39] The British Business Bank's 2021 Business Finance Survey also looked at SMEs' concern about their ability to make repayments. Figure A.10 segments SMEs' concerns about debt repayments by innovation status. The data indicates that 25% of SMEs who applied for finance to invest in innovation in 2021 were concerned about their ability to make debt repayments compared to 17% of SMEs who sought finance for other reasons. This points to a positive relationship between innovation and debt repayment concerns.

The link between SME risk rating and innovation may help to understand these figures. Up until 2020, minimally risk-rated SMEs traditionally innovated more than riskier SMEs by around six percentage points (42% compared to 36% on average, Figure A.11). In 2021, however, that difference was largely wiped out due to both an increase in innovation rates by the highest risk SMEs and reduction by lowest risk. In fact, the riskiest SMEs were the only types to innovate more in 2021 than in 2020.

Across these two analyses, interpretation should be treated with caution due to small sample sizes. On the basis of this simple analysis, however, it may suggest that (a) more businesses in recent times are having to innovate to survive and (b) firms potentially captured by debt burdens are still willing to use finance to pursue this innovation. Further work is required to robustly explore these relationships.

Figure A.10

SME finance applicant concerns about ability to make full debt repayments, by innovation status

Source: British Business Bank Business Finance Survey – Ipsos MORI, Base = all businesses (n = 298 in 2021)

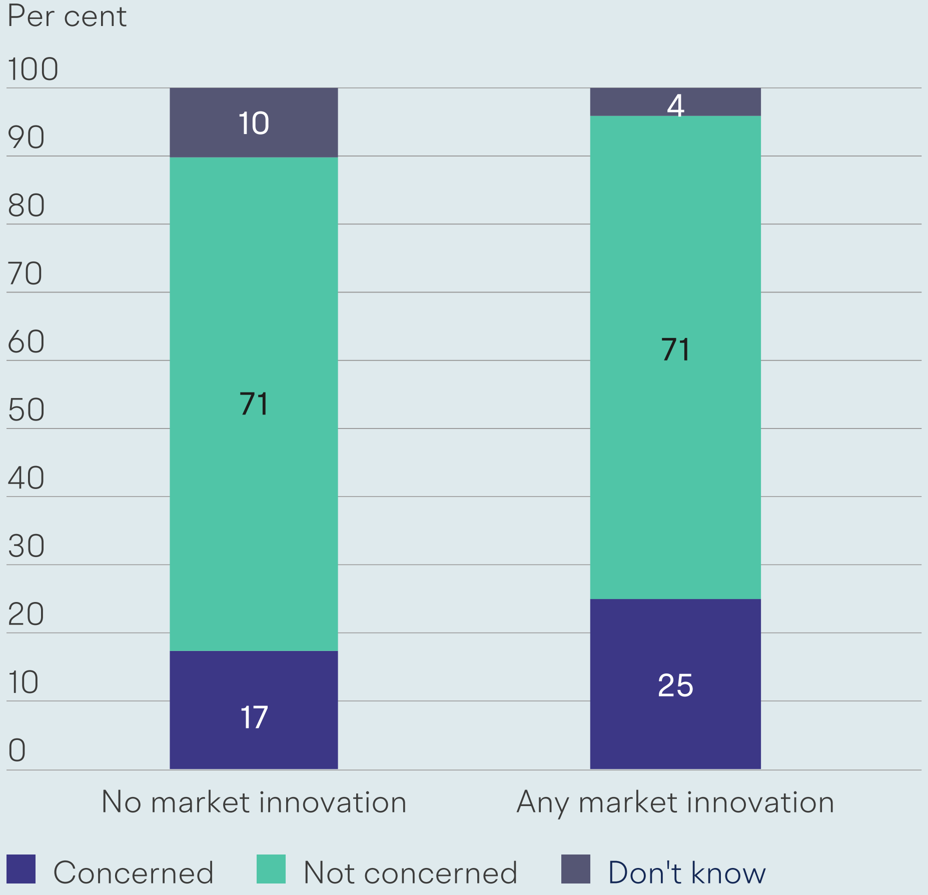
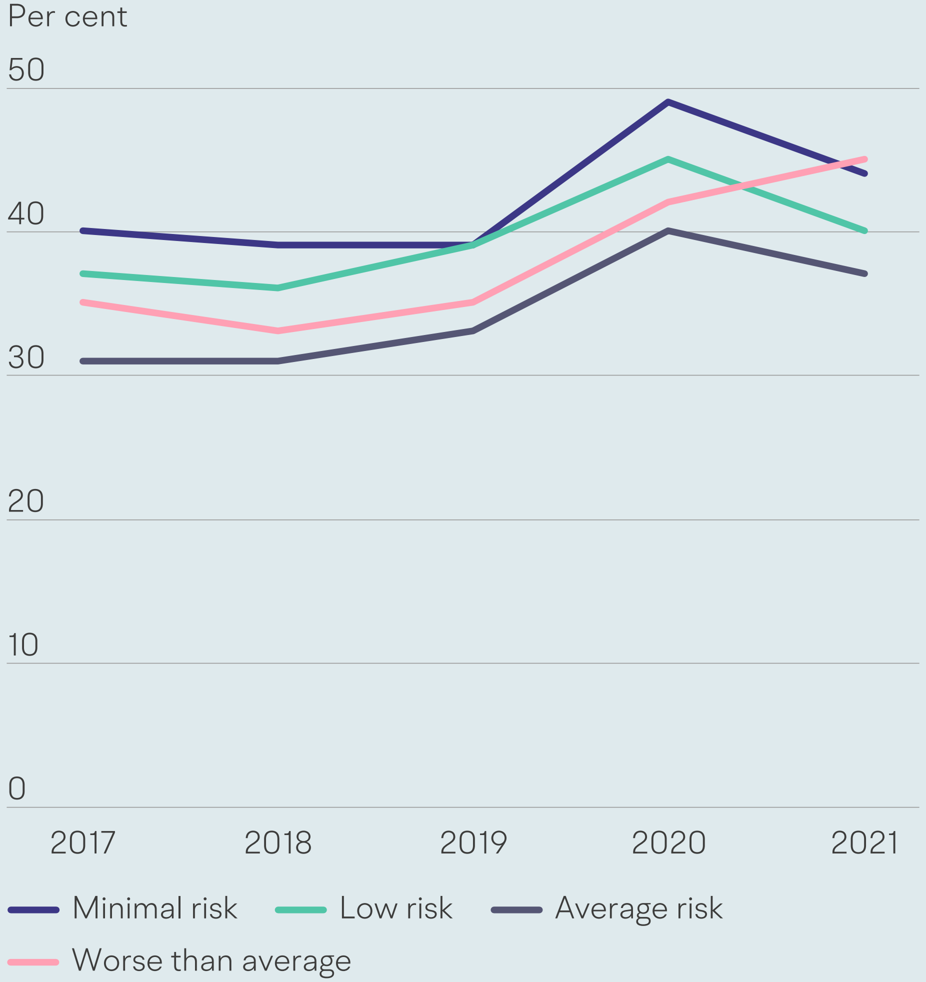


Figure A.11

Proportion of innovative SMEs by external risk rating

Source: UK Finance/BVA BDRC SME Finance Monitor 2021Q4



Lack of finance and funding can hold back companies from developing and commercialising innovation

An important question for policy makers is how to address innovation barriers faced by smaller businesses. Some of the key barriers to innovation adoption are set out in the Global Innovation Index. These include skills shortages, economic uncertainty, and increases in capital costs. Market intelligence gathered by the Bank's UK Network from finance intermediaries suggests access to finance is ranked as the second most important factor for businesses taking forward their ambitions to be more innovative, behind access to skills and talent.

To further assess the barriers faced by non-innovating UK businesses we can refer to the most recent UK Innovation Survey covering the periods 2018–2020. Figure A.12 ranks "non-broader" innovating businesses' responses to their most important potential barriers to innovation.[40]

Each barrier is found to be more important to SMEs than large businesses. This corroborates earlier findings showing innovation rates increasing with firm size.

Clearly the impact of Covid-19 had a significant detrimental effect on businesses' ability to innovate with c.20% of SMEs stating that this was an important barrier. Beyond that, however, the next two most important barriers relate to finance. Availability of finance (9%) and cost of finance (8%) are second and third ranked barriers respectively. The time series data shows that availability and cost of finance have consistently scored high as potential barriers to innovation. The Bank's analysis suggests these finance-related barriers could be preventing up to c.270k SMEs from innovating per annum.

Whilst access to finance and cost of finance are two possible barriers for businesses undertaking innovation, it is important to acknowledge that there are a range of other barriers affecting the innovation ecosystem. This includes regulations, perceived economic risks, high costs of undertaking innovation and a lack of qualified personnel amongst other factors.

There are several reasons why finance markets under supply finance to innovative companies. Banks typically look for tangible sources of collateral to act as security for loans and struggle to value intangibles such as intellectual property.[41] This can hold back some innovative companies from raising debt finance.

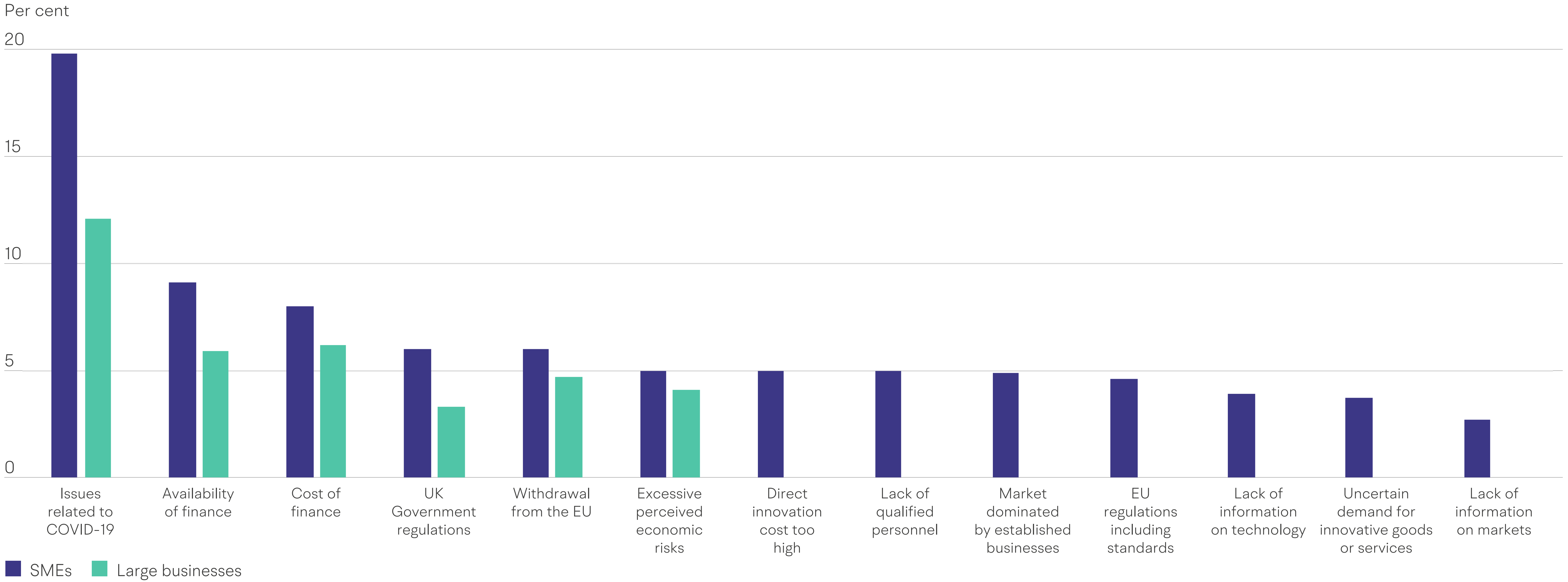
There are also problems on the availability of equity finance to innovative deep tech companies. Deep tech covers a broad range of different technologies including Artificial Intelligence (AI), clean tech and quantum computing, but the common theme is on the development of new ground-breaking technology that has the potential for a wide range of applications, some of which are currently unknown. The Bank also includes life sciences in its definition of R&D intensive sectors. These companies have additional difficulties raising equity funding compared to software companies because of their complex nature, long development times and large amounts of financing required.[42] As a result, investing in these companies also requires specialist technical and regulatory knowledge – adding an extra step of scientific due diligence. This makes it harder for deep tech and R&D intensive companies to access sufficient capital compared to other sectors.

Whilst the UK VC market is the third largest market behind the US and China,[43] the UK has a lower proportion of VC investment going to deep tech and

Figure A.12

Proportion of “non-broader innovators” rating potential barriers to innovation as “highly important”

Source: UK Innovation Survey, 2022



R&D intensive companies than other countries.[44] The Bank's 2022 Equity Tracker report shows 19% of the UK's total VC investment between 2019 and 2021 went to companies in the R&D intensive sector. This is much lower than most other comparator countries including China (35%), US (24%), Israel (31%) and Sweden (41%). Therefore, the observed overall UK-US VC funding gap is largely caused by differences in funding going to these deep tech and R&D intensive sectors. Increasing the amount of VC funding going to early-stage companies in these innovative sectors will help close the overall UK VC funding gap with the US.

This chapter illustrates just how broad innovation is. The role of policy amidst all of this should be to carefully develop solutions based on appropriately defined objectives. Likewise understanding the specific size and scope of innovation barriers can allow policies to better target market failures at their root cause.

The Bank's programmes help to facilitate finance to innovative businesses

Access to public and private sources of external finance has been shown to be an important enabler in funding innovative start-ups and businesses looking to commercialise their innovation. A lack of available external finance can be a barrier for businesses looking to undertake innovation.

As the UK's economic development bank, the Bank's debt and equity finance programmes have an important role in the wider finance market for facilitating finance to innovative companies so that they can develop new products and processes but also for companies to adopt new processes to improve their business capabilities.

This is demonstrated by our recent research published in July 2022, where the Bank collaborated with Innovate UK and UK Research and Innovation (UKRI) to understand the linkages between the organisations' products and services in terms of the businesses we support.

Innovate UK, which is part of UKRI, is the UK government's innovation agency responsible for programmes that drive business innovation across businesses of all sizes and sectors. Our research showed there is a natural crossover between recipients of UKRI (including Research Councils and Innovate UK) innovation programmes and British Business Bank's finance programmes.[45] 828 companies supported by the Bank's equity programmes are also 'research council spinouts' (204) or have received funding for R&D projects from Innovate UK (750) or both (126). This is equivalent to 19% of the Bank's equity portfolio. This demonstrates there is a strong overlap in the companies being supported by UKRI including Innovate UK and the Bank's contribution to facilitating access to finance for these innovative companies enabling them to commercialise and scale up their activities.

Evaluation evidence confirms the Bank's equity programmes are facilitating innovation in early-stage companies. The Enterprise Capital Fund (ECF) programme has helped fund substantial expansion in R&D activity in early-stage companies. The average number of R&D workers employed by firms receiving investment rose from 5 at time of investment to 19, while annual spending on R&D activities rose from £0.2m to £1.8m.[46]

The Bank's commercial subsidiary, British Patient Capital (BPC)[47] is focused on increasing the availability of later stage Venture Capital and has an important role in supporting the commercialisation and scaling up of innovative companies. The beneficiary survey of businesses funded by BPC-backed funds found 92% of recipients reported increased R&D investment, 88% reported progress in developing new or improved products or services, 83% reported commercialisation of new or improved products or services and 77% had introduced new/ improved processes or practices within the firm. Many of these products or services introduced are new-to-market (rather than new-to-business), which suggests novel innovations are being successfully commercialised. Almost all respondents (96%) thought that their business had become more "commercially ready" due to receiving finance from the BPC-backed fund. i.e., the company was more willing, able or prepared to expand products, services or processes.

Our "Backing innovation led business" report also found the Bank's debt programmes are funding a high number of innovative companies. There are a similar number of companies that have received funding through the Bank's debt programmes (778) as from the Bank's equity programmes (828). These companies were either spinout companies that have arisen from Research Councils investments in research (42), companies that had received funding from Innovate UK (762) or both (26). However, proportionally, this is much lower than the equity side, at 1% of the Bank's UK debt portfolio.

Whilst it is often thought that early-stage innovative companies often receive grants first, before subsequently raising commercial sources of debt and equity funding, the sequencing flow of support from UKRI (including Innovate UK) and the Bank is more complex in reality. For businesses that have received support from both the Bank and Innovate UK, there is no standard sequencing of events. Almost as many businesses received support from the Bank prior to securing Innovate UK grant funding (46%) as they did afterwards (54%), across recipients of both the Bank's debt and equity programmes.

The role of the Bank in supporting R&D activity is not solely providing risk capital to very high growth potential businesses, but also enabling R&D and wider commercial activity in more established companies through the provision of debt finance. This is confirmed by the interim evaluation of the Northern Powerhouse Investment Fund (NPIF) programme. As a result of NPIF funding, 68% of debt recipient respondents reported the introduction of more efficient processes, 65% introduced new products or services to market and 53% increased investment in R&D.[48] Similar findings were also encountered for debt recipients of the Midlands Engine Investment Fund, which provides further evidence on the important role the Bank's programme have in supporting innovative companies.[49]

1.2

Financing smaller business net zero innovators

Rapid investment in SME-led green innovation can mitigate the challenges and expand the opportunities of the transition to net zero

Despite slowing down, growth in the number of net zero equity deals outpaced the wider equity market in 2022, with deals getting much larger in investment size

Smaller businesses are active in many innovation areas that can accelerate the transition to net zero

Smaller businesses face diverse barriers to green innovation, including access to finance

The Bank already supports net zero innovators and will look at opportunities to further align programmes with sustainability goals

Meeting the UK's net zero target[50] implies fundamental shifts in the way businesses operate across the economy. Only a thriving green innovation system can enable these shifts, by delivering the technological breakthroughs and new business models needed to fully decarbonise the UK economy.

Green innovation is also an essential driver of sustainable economic growth for UK businesses, boosting the productivity of workers and infrastructure and creating green jobs and new business opportunities. According to the Office for National Statistics, the UK's Low-carbon and Renewable Energy Economy (LCREE) generated turnover of £4.21 bn in 2020; we calculate that 41% of this was generated by businesses with fewer than 250 employees, who were also responsible for 64% of the 207,800 jobs supported by LCREE businesses in the same year.[51]

Smaller businesses thus have a vital role to play in green innovation. According to OECD, smaller firms, as new entrants to the market, are more likely to pioneer radical and disruptive innovations by exploiting the market opportunities that are neglected by larger firms or may challenge their existing business models.[52] With their strong connection to local communities, smaller businesses are also well placed to help strengthen local resilience and adaptation to climate change.[53]

In this chapter we look at the latest UK equity investment data to understand how finance markets are supporting smaller businesses working on climate solutions. In doing so, we explore the specific technology areas that characterise SME participation in equity markets, which will inform our thinking on how we support our net zero mission.[54]

Rapid investment in SME-led green innovation can mitigate the challenges and expand the opportunities of the transition to net zero

Green innovation – a term we use to refer to innovative activities that address climate challenges - can be costly, time-consuming, and involve significant risk. It therefore relies heavily on innovators' ability to secure the capital needed to speed up and de-risk the development of climate solutions. Access to equity capital is particularly important as these innovations move closer to the market.

Smaller businesses working on climate solutions have seen a welcome surge in equity investment levels in recent years.[55] This is a sign that the market is adapting to growing demand for investment in smaller business-led green innovation, including in the UK. Nevertheless, this also means the UK faces greater competition from other nations in the global race to attract and nurture the most promising green innovative businesses (including via subsidies).[56]

Businesses seeking finance for this purpose continue to face significant barriers. Some of these barriers are familiar, since they are experienced by smaller businesses in other innovation areas. For example, the fact that investors may not fully consider the economic and societal benefits of innovation, or may lack sufficient information to evaluate the potential of certain technologies, can be an obstacle to raising capital for many kinds of innovative businesses. However, access to equity finance can be particularly challenging for small eco-innovators. In a global production and infrastructure system that relies so heavily on fossil fuels, markets often overestimate the costs and risks of investing in lower-carbon alternatives, at the same time underestimating those associated with continuing on the current emission path.[57]

The Climate Change Committee[58] has suggested that we need investment in green innovation to rise faster than it has in the past, given the unprecedented scale and nature of climate challenges ahead, and the irreversible costs of delaying climate action. In particular, there are two important reasons why it is essential to unlock further investment in green innovative SMEs for the UK to reach net zero sustainably.

First, while many emission reduction technologies are already available to businesses, there are still many sectors and activities where viable solutions simply do not exist. For example, high-emission industrial processes such as cement and steel production cannot be fully decarbonised or replaced using existing technologies. In these circumstances, businesses not only need low-emission alternatives that are proven to work at the required scale; they might also need access to "bridge" technologies which help them remove emissions from hard-to-decarbonise processes and sectors while more permanent solutions are developed.[59] These investment requirements are underserved by financial markets at the moment.[60]

Second, even when emission reduction solutions exist, there are many challenges preventing their widespread adoption across the economy (as also noted in the previous chapter). Green innovation is not just about technological breakthroughs and inventions; progress also relies on the lessons learned by early adopters and the knowledge gained as a technology diffuses more widely into the marketplace.[61] This is often the case for digital technologies, for example, which in turn have the potential to widen the applicability of climate solutions. We therefore need to ensure capital flows to smaller companies that are working towards making climate solutions more reliable, affordable, scalable, and widely accessible to businesses across the UK.

Alongside these challenges, the transition can also unlock opportunities for the UK economy, if backed by a financial ecosystem that supports smaller businesses effectively. Opportunities could arise in green innovation areas where investment need is high and the UK is well placed to become an R&D leader,[62] such as offshore wind energy and battery technology. Investing in these areas not only helps green the UK economy faster, but also to support the development of a thriving, internationally competitive net zero innovation ecosystem, bringing additional benefits beyond decarbonisation.

In addition, investment in SME-led green innovation can be harnessed to tackle social and regional growth objectives. Evidence suggests the impacts of climate change and the costs and benefits of the transition will not be equally distributed across the UK economy and society. Some regions and social groups will be disproportionally affected; these also tend to face more significant economic and social challenges,[63] which may constrain their capacity to minimise the cost and maximise the opportunities generated by the changing climate. If equity investment patterns do not align with the widely shared benefits of inclusive, green-led regional growth, the UK economy might be missing out on synergies between environmental sustainability and local economic growth goals.

The rest of this section looks at SME equity investment trends and what these can tell us about the challenges and opportunities discussed above. This analysis draws on Beauhurst data on announced equity deals from UK SMEs up to end of September (Q3) 2022. Later in the year, our Equity Tracker report will provide a more definitive picture of 2022, as sufficient time will have passed for most deals to be disclosed.

Box 2: Net zero-related equity deals - methodology

The analysis in this section mainly draws on Beauhurst data covering equity deals that relate to net zero sectors. We define these as deals in the Beauhurst database that have been assigned any of the following sector tags or buzzwords:

- Clean tech (which in turn encompasses Clean Energy; Energy reduction technology; Other clean tech).
- Artificial meat and meat substitutes
- Biomass and biofuels
- Smart energy
- EV and hybrid vehicles

To generate more granular analysis on the specific focus of Clean tech deals, we developed additional tags using a dual approach:

- Aggregating existing Beauhurst sectors and buzzwords in a way that highlights the specific technology developed or its relevance to net zero-related goals.
- Creating new tags based on an analysis of net zero-related keywords included in deal descriptions. For instance, "Solar and photovoltaic technologies" is a bespoke category we created which encompasses all announced SME deals since 2018 that mention this keyword; we take this as an indication that those deals are very likely to relate to solar energy generation solutions.

While this more granular analysis draws on the Beauhurst data, it was developed independently by the British Business Bank, and does not form part of the Beauhurst sector matrix or current list of buzzwords tracked by the dataset.

The net zero data is also based on unweighted sector counts and so differs to the sector data presented in the Equity Tracker report which is based on weighted counts. Therefore, a company may be in more than one sector.

Despite slowing down, growth in the number of net zero equity deals outpaced the wider equity market in 2022, with deals getting much larger in investment size

Over the past five years, Beauhurst recorded 813 announced net zero-related deals involving SMEs, with a total value over £6 billion. As can be seen in Figure A.13, 2022 has seen continued growth in both the number and the value of net zero-related deals involving SMEs.

The number of net zero deals rose by 33% in the first three quarters of 2022 compared with the same quarters in 2021. This suggests investor appetite in this area is holding up. While growth in the number of net zero-related deals is below the record rate seen between 2020 and 2021 (+48%), in 2022 it outperforms the wider UK equity market, where the number of deals declined by 2% compared with the first three quarters of 2021. This is even more remarkable considering that net zero-related deals were growing less than the wider equity in the previous year.[64] As a result, net zero-related deals currently make up 12% of all announced SME equity deals, compared with 5% in 2018.

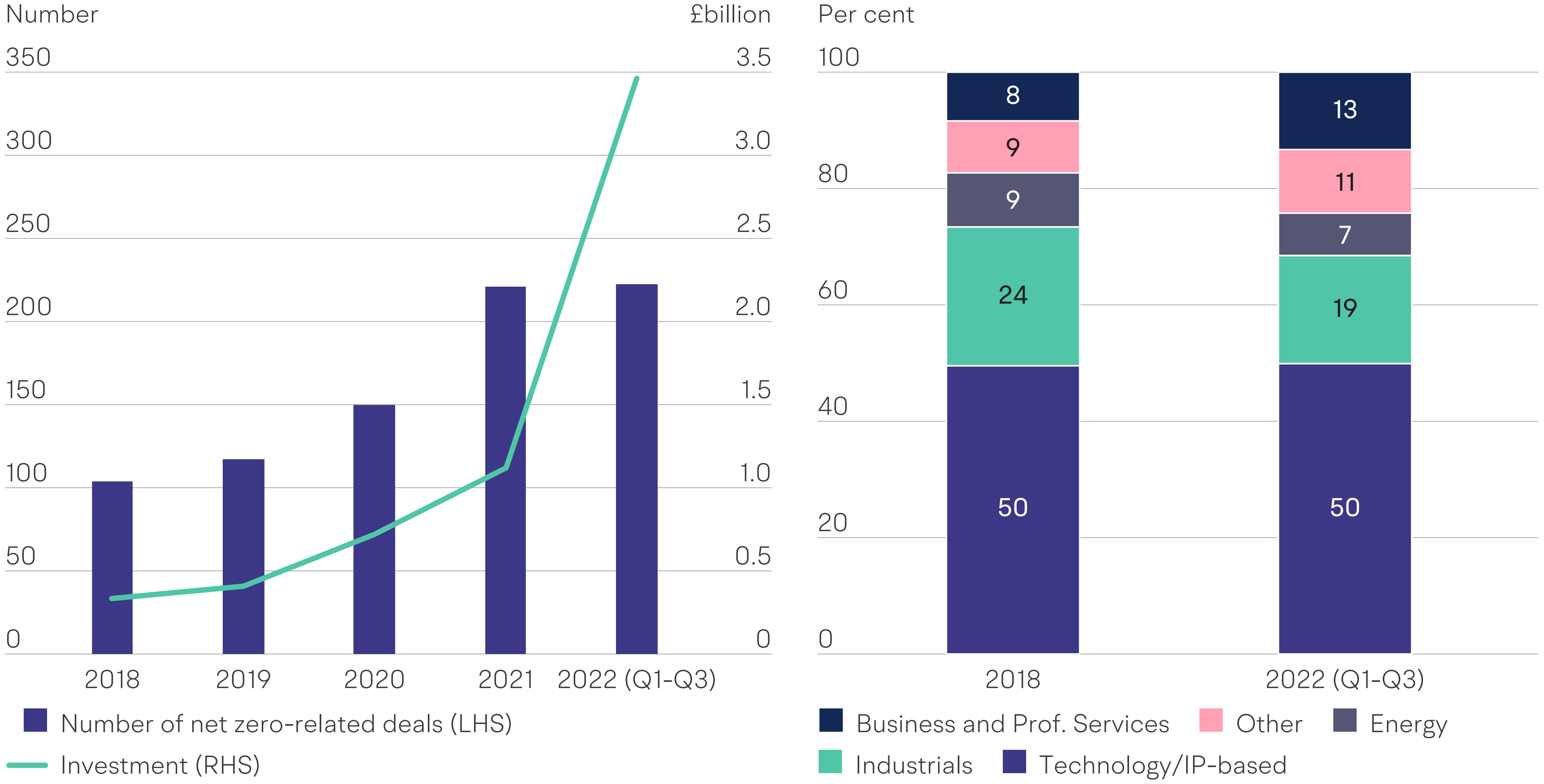
There was much stronger growth in the investment value of net zero-related deals, which rose by 457% to £3.5 billion in the first three quarters of 2022 (Figure A.13). This was driven in part by a £1.7 billion announced funding round in the battery manufacturer Britishvolt, which has since gone into administration. When that deal is removed, the investment value of net zero-related deals still show strong growth of 184% over the first three quarters of 2022, soaring to a new record level of £1.7 billion. Again, this exceeds the growth in investment value seen in the wider equity market (+10%) compared to the same quarters in 2021. On its own, the Q1-Q3 2022 value accounts for around 40% of the total value invested in net zero-related deals (excluding the above mentioned 2022 Britishvolt deal) since 2018.

This exceptional growth was driven by the rising number of large deals (>£10 million) taking place in 2022, which was over three times the corresponding Q1-Q3 2021 figure. The average net zero-related deal size also grew strongly as a result, going from £2.8 billion to £5.3 billion between Q1-Q3 2021 and Q1-Q3 2022 (excluding megadeals i.e. deals with investment value over £100 million).

Figure A.13

Net zero-related SME equity deals: number and value over time, 2018-Q3 2022; % by top-level sector (based on number of deals)*

Source: British Business Bank analysis of Beauhurst data



* the 2022 Q1-Q3 investment value is reduced from £3.5 billion to £1.7 billion if the 2022 Britishvolt deal is removed.

The sectoral distribution of net zero-related deals since 2018 (Figure A.13) shows that the lion's share is made up by just four sectors: Technology/IP-based businesses, Industrials, Business and Professional services, and Energy, with Other sectors featuring in only 11% of net zero-related deals. While the share of Technology/IP-based businesses has stayed constant since 2018, remaining at around half of all net zero-related deals in the first three quarters of 2022, Business and professional services and Other sectors have increased their share at the expense of Energy and Industrials. This is a preliminary indication that the market is now supporting a more diverse range of net zero-related deals than in previous years, which could be promising for expanding small eco-innovators' access to equity finance.

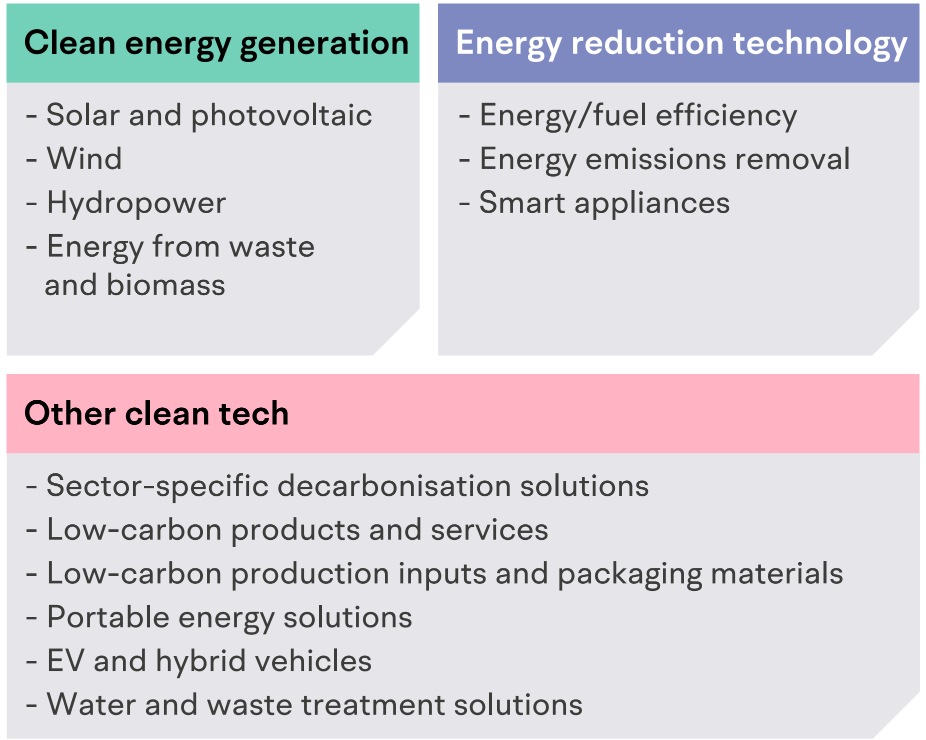
Smaller businesses are active in many innovation areas that can accelerate the transition to net zero

The market for net zero-related small business equity finance is therefore increasingly diverse, which matches the diversity of expertise and know-how contributing to technological progress on climate solutions. This can

Figure A.14

Clean tech sectors in the Beauhurst database and selected examples

Source: British Business Bank analysis of Beauhurst data



Clean energy generation

- Solar and photovoltaic
- Wind
- Hydropower
- Energy from waste and biomass

Energy reduction technology

- Energy/fuel efficiency
- Energy emissions removal
- Smart appliances

Other clean tech

- Sector-specific decarbonisation solutions
- Low-carbon products and services
- Low-carbon production inputs and packaging materials
- Portable energy solutions
- EV and hybrid vehicles
- Water and waste treatment solutions

Figure A.15

Number and value of SME equity deals by Clean tech sub-sector, 2018-Q3 2022

Source: British Business Bank analysis of Beauhurst data

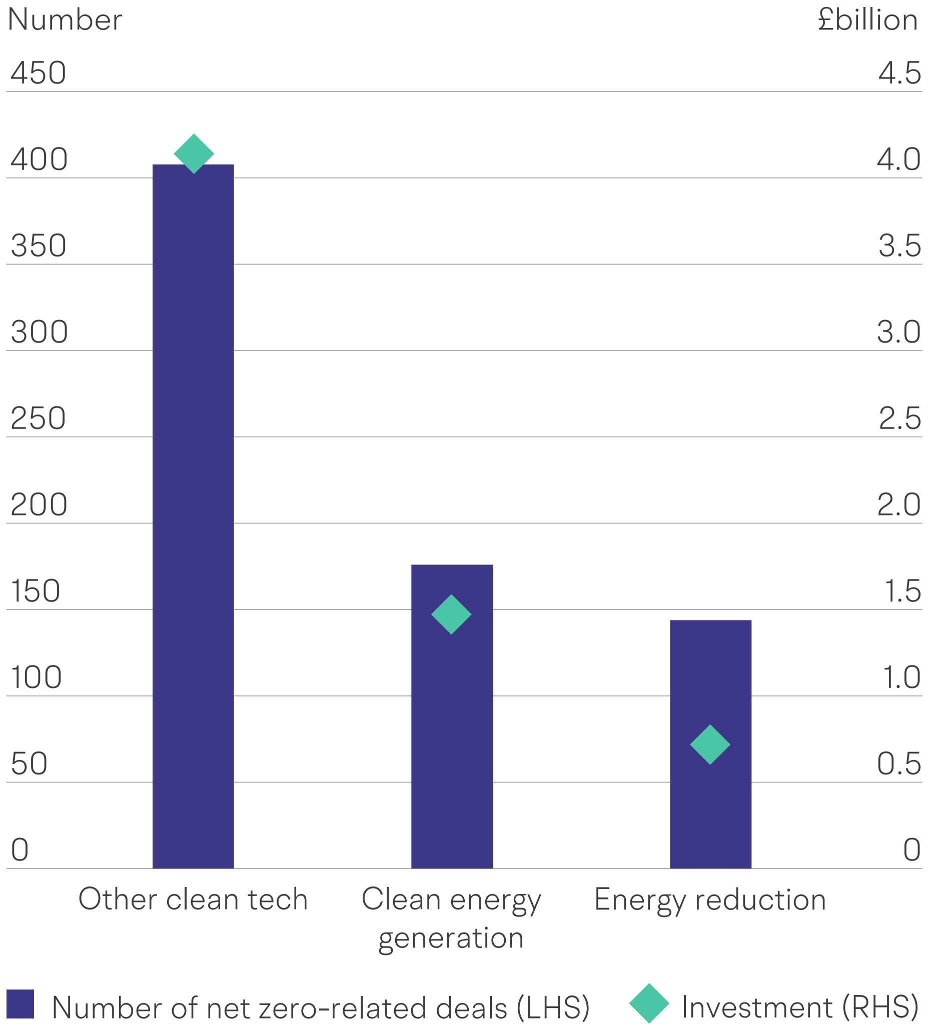
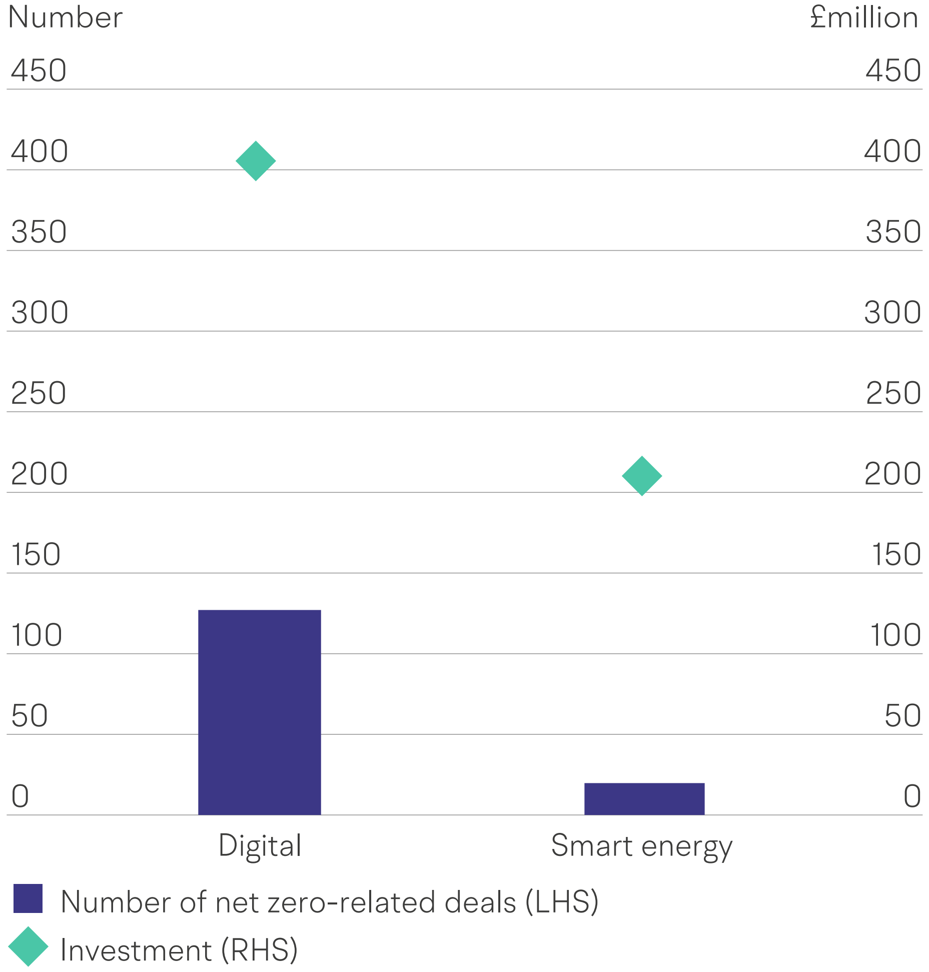


Figure A.16

Number and value of SME equity deals for selected categories - Energy Reduction technology, 2018-Q3 2022

Source: British Business Bank analysis of Beauhurst data



also be seen by exploring the more detailed composition of deals under the Technology/Other IP-based sector. A key area in this context is Clean tech, which in turn encompasses deals relating to three main technology areas that are crucial for decarbonising the UK economy. These are shown in Figure A.14, alongside some examples of relevant technological solutions.

As shown in Figure A.15, SMEs receiving Clean tech-related equity investment in the UK over the past five years focused on a wide range of priorities. Over one in five (22%) net zero-related deals announced since 2018 covered Energy reduction technologies and 18% Clean energy generation, with around half referencing Other clean tech. This is not surprising since energy, as the main contributor to greenhouse gas emissions, is a high priority area for speeding up emission reductions. Yet, even though deal numbers in Clean energy generation grew by a healthy 24% in Q1-Q3 2022 (relative to Q1-Q3 2021), both Energy reduction technology and Other clean tech rose much more significantly (by 80% and 53%, respectively).

Examples of Energy reduction-related deals

- Grid Edge develops software that uses artificial intelligence to interact with a buildings' electrical and mechanical systems in order to manage and reduce energy consumption.
- EcoSync develops a cloud-based temperature control system for buildings, aiming to reduce energy usage in unused rooms.
- Deep Branch Biotechnology develops carbon storage technology that converts carbon dioxide into single cell proteins.

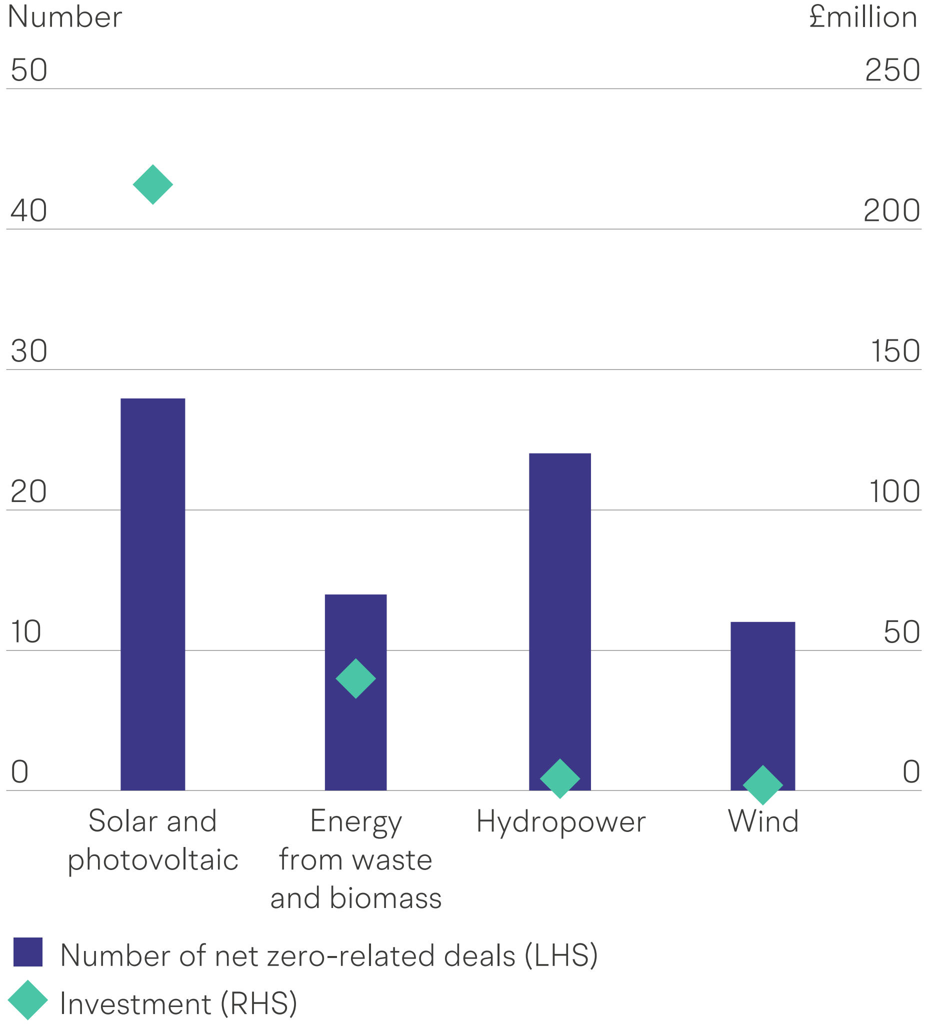
SME deals that related to Energy reduction technology (Figure A.16) were also frequently associated with the digital sphere, highlighting the role of software/hardware, online platforms and digital technologies such as artificial intelligence in enabling the diffusion of decarbonisation solutions. Smart energy – a buzzword encompassing smart heating, lighting, cooling and refrigeration solutions – was also represented among SMEs' Energy reduction technology-related deals.

Across Clean energy generation-related deals (Figure A.17), Solar and photovoltaic technologies were the most prevalent both in terms of number of deals and investment value. Our analysis also found frequent mentions of other renewable sources of energy, particularly Wind power (off-shore and on-shore), Hydropower (including tidal energy generation) and Energy from waste and biomass.

Figure A.17

Number and value of SME equity deals for selected categories – Clean energy generation, 2018-Q3 2022

Source: British Business Bank analysis of Beauhurst data



Examples of Clean energy generation-related deals

- Gaia-Wind builds small and quiet wind turbines, approximately the size of a large tree, to operate in areas of moderate winds.
- Celtic Renewables produces biofuels from by-products from the whisky industry.
- Power Roll develops flexible solar film, that it claims will be cheaper, lighter and more effective than the traditional materials.

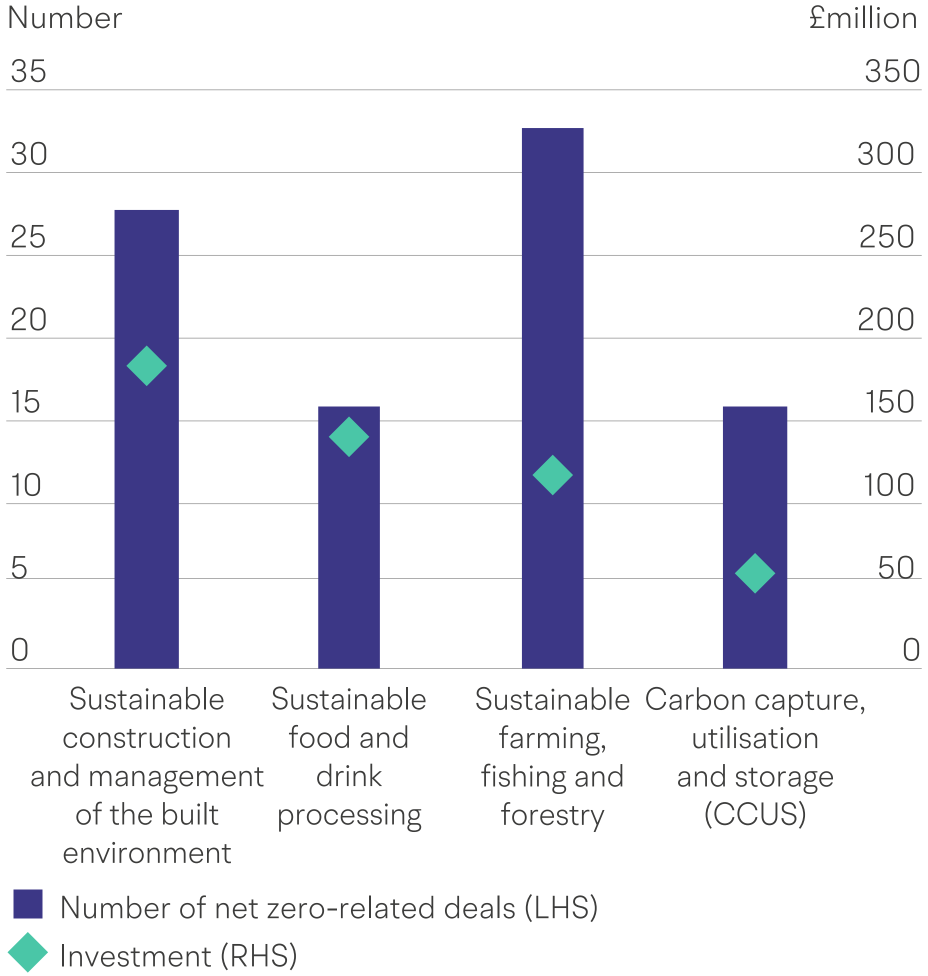
Other clean tech deals encompass small businesses working on a wide variety of technology-based climate solutions. Our analysis of deal descriptions (Figure A.18) suggests that many deals within this category relate to companies working on sector-specific decarbonisation solutions, as well as carbon capture, utilisation and storage (CCUS) technologies. For example, over the last five years there were 33 deals relating to Sustainable farming, fishing and forestry, and 28 relating to Sustainable construction and management of the built environment, with smaller numbers covering Sustainable food and drink processing and CCUS as well.

Another prominent technology area under Other clean tech concerns low-carbon mobility, and in particular electric and hybrid vehicles (Figure A.19), as well as Fuel cells and portable energy solutions – which describe technologies that improve users' ability to store and/or access (clean) energy on the go. The latter is a particularly important enabling technology for decarbonisation, since it can broaden the applicability and use of other low-carbon products and services (including electric vehicles) in situations where the lack

Figure A.18

Number and value of SME equity deals for selected categories – Other Clean Tech (Sustainable sectors and processes), 2018-Q3 2022

Source: British Business Bank analysis of Beauhurst data



Examples of Other clean tech-related deals

- Mimicrete develops 'self-healing' concrete to lengthen the lifespan of concrete structures and prevent unnecessary overuse of concrete.
- Airponix develops an enclosed farming system, that's designed to create fog to support plants without the need for soil.
- ENOUGH produces mycoprotein, a sustainable alternative to meat, which can be used in animal and human food manufacturing.

of an appropriate charging infrastructure remains a barrier. Related to this, there are also several deals that refer specifically to Battery technology, addressing a rising need for enhanced battery performance in electric vehicles and other electricity-enabled low-carbon products.

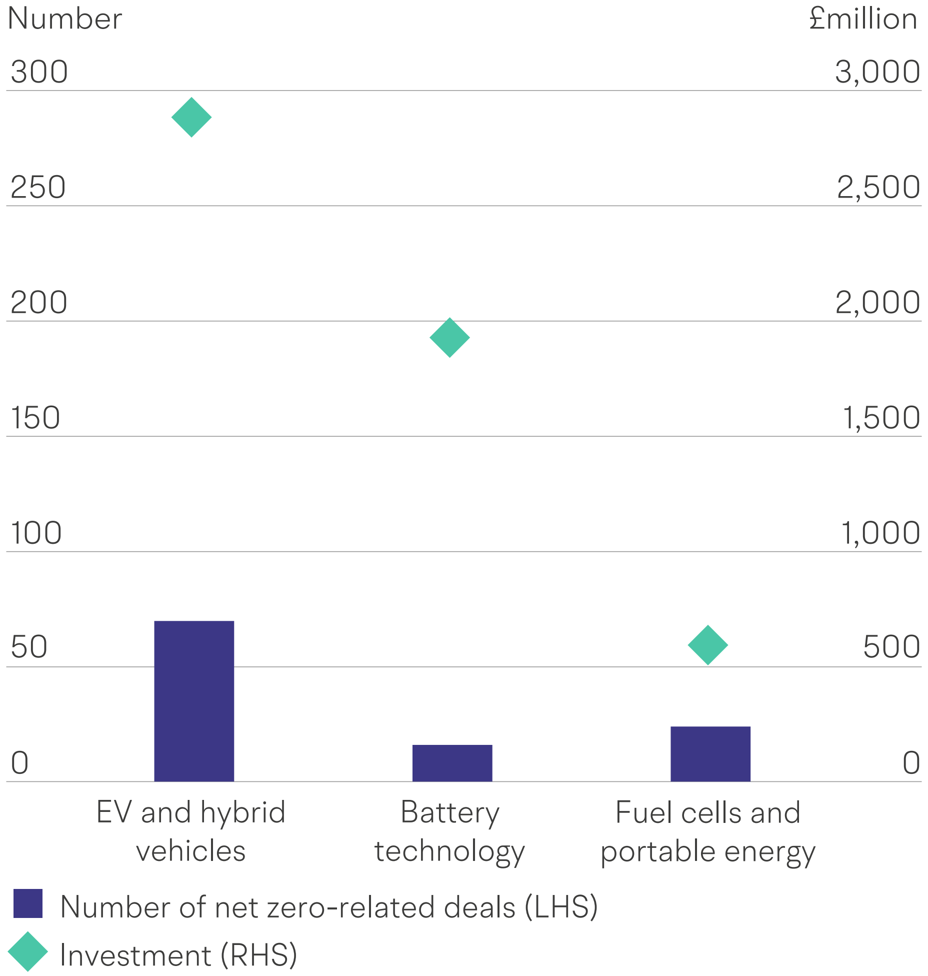
In addition, many deals related to Other clean tech address crucial challenges in the management of waste, recycling and depleted natural resources like water. As can be seen below in Figure A.20, Waste management accounted for 40 deals worth over £250 million in the last five years, with a considerable number also focussing on Recycling and remanufacturing technologies. Solutions supporting sustainable use of water (including water efficiency and water treatment/decontamination solutions) were also referenced in a number of deals.

Finally, there was a wide range of deals within Other clean tech which focused on net zero-related product and service innovation (Figure A.21). For example, there were more than 10 deals over the last 5 years relating to

Figure A.19

Number and value of SME equity deals for selected categories – Other Clean Tech (Mobility)*, 2018-Q3 2022

Source: British Business Bank analysis of Beauhurst data



Examples of mobility-related deals

- Kleanbus develops technology which allows for the conversion of diesel-fueled buses into zero-emission electric vehicles.
- Circuitree provides environmentally friendly saltwater batteries for on- and off-grid use in homes and businesses.
- H2GO Power develops fuel cells that safely store hydrogen in a solid form, and can be used as a portable energy source with potential applications in smartphones and EVs.

*The figures relating to battery technology exclude the £1.7 billion Britishvolt megadeal announced in 2022, for the reasons outlined on p. 48

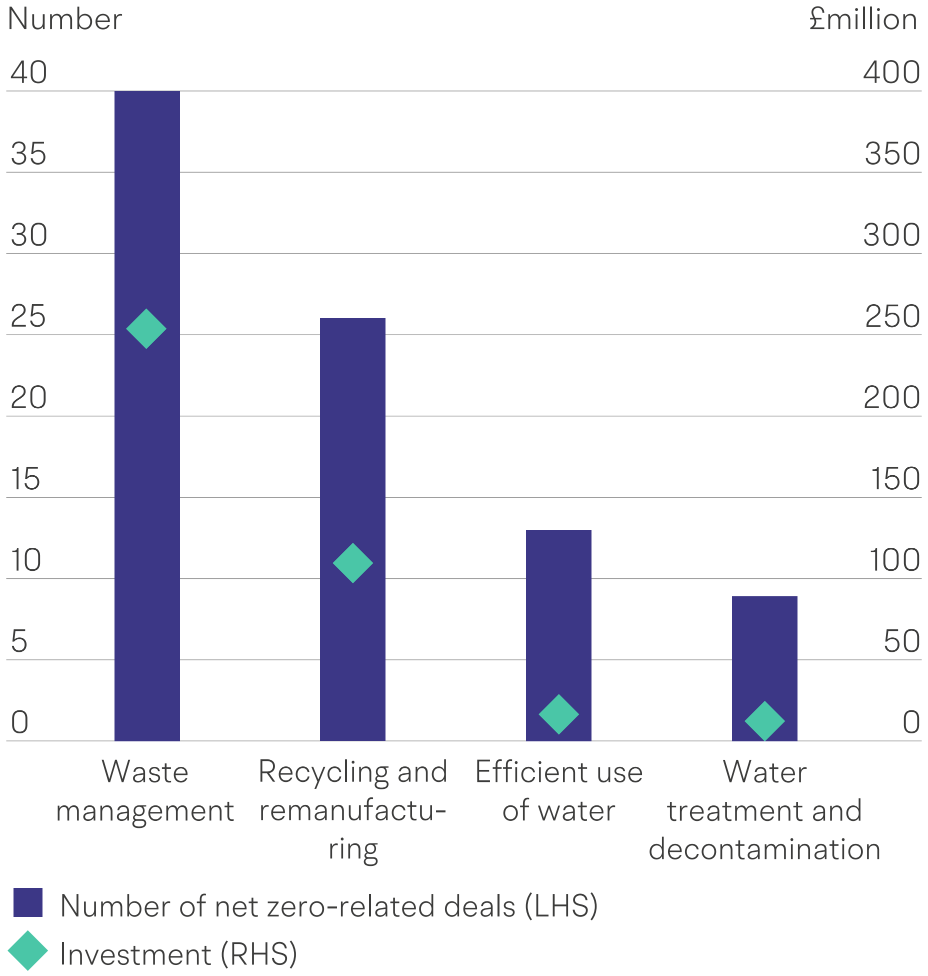
the development of Energy-saving and biodegradable products. Alternatives to plastics related to only 9 deals, but had a more significant overall investment level of £143 million in total. Again, digital technologies play a crucial enabling role within Other Clean tech too, accounting for almost a third of deals (126) and 10% of the investment value (around £408 million).

Some of the sectors covered by the Beauhurst data can be broadly matched with the Office for National Statistics Low Carbon and Renewable Energy Economy (LCREE) data to shed light on how equity activity since 2018 compares to the size of these sectors (as proxied by average business counts and turnover between 2018 and 2020). This comparison is presented in Figure A.22. This indicates that Fuel cells and portable energy and EV and hybrid vehicles both relate to considerable equity activity, both in terms of the number of deals and investment value. Solar and photovoltaic technologies receive significant investment, but account for a

Figure A.20

Number and value of SME equity deals for selected categories – Other Clean Tech (Waste and water), 2018-Q3 2022

Source: British Business Bank analysis of Beauhurst data



Examples of Waste and water-related deals

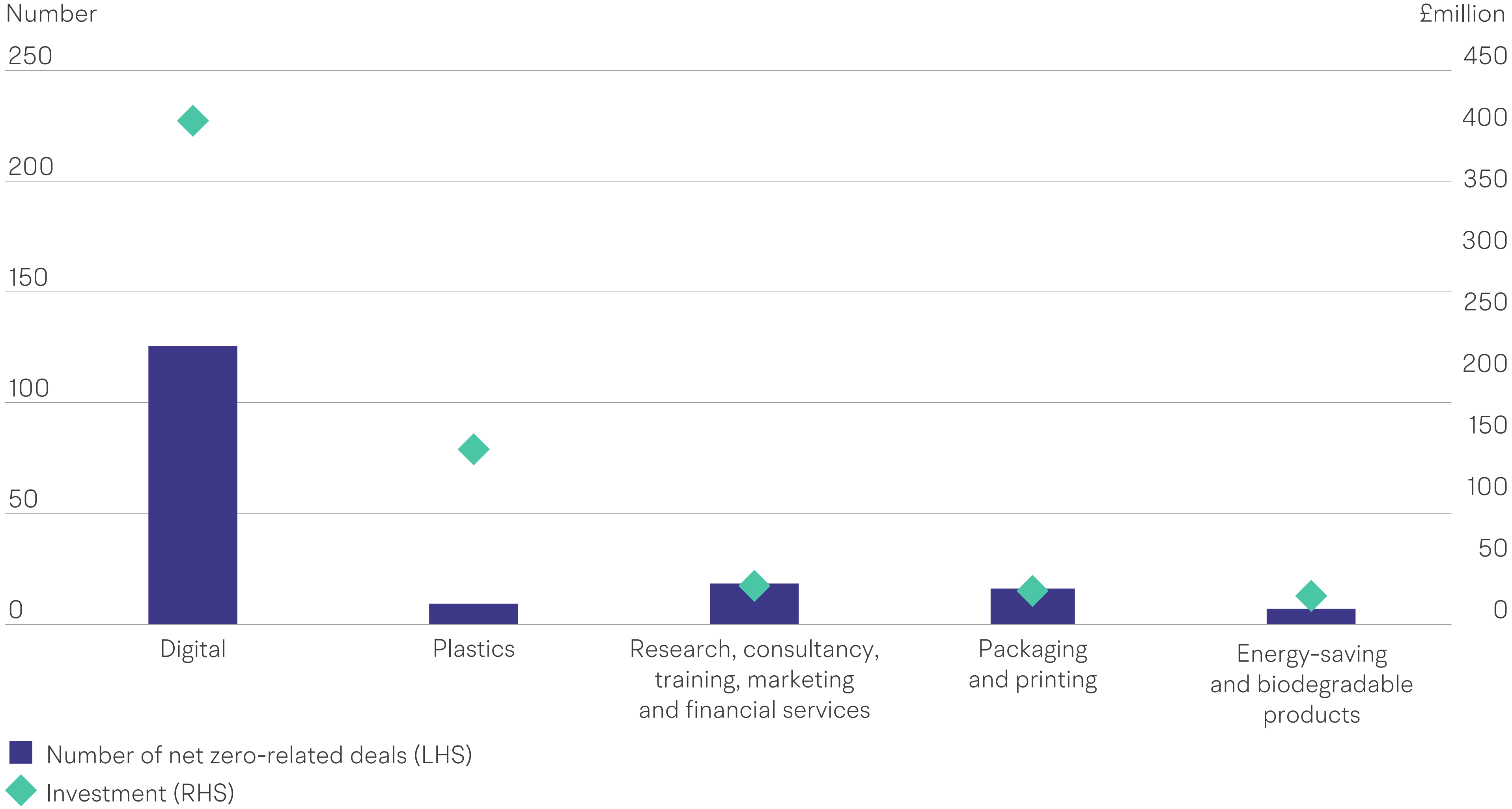
- Industrial Phycology develops chemical free water treatments that uses algae to extract nutrients from wastewater.
- Elemental develops food ingredients, edible fats and fertiliser from food waste, with the aim of reducing waste in the livestock industry.
- Aceleron recycles used lithium-ion batteries from the automotive and consumer electronics industries into second life battery packs.

relatively small number of SME equity deals per 1,000 businesses; this could reflect the fact that deals in this sector tend to be fewer, but larger in investment size on average than the previous two sectors. Hydropower and Low-carbon services, by contrast, have large number of SME equity deals per 1,000 businesses, but relatively low value per £m turnover. This is not surprising in the case of services, since low capital intensity and the use of relatively mature technologies could mean the sector has a lower requirement for large-scale investments. The other three sectors – namely, Wind, Energy-saving and biodegradable products, and Energy from waste and biomass – show low SME equity activity compared to their size. Again, this could depend on structural factors, such as high technology maturity, but it could also point at some gap in the demand or supply of technologies in these areas.

Figure A.21

Number and value of SME equity deals for selected categories – Other Clean Tech (Sustainable products and services), 2018-Q3 2022

Source: British Business Bank analysis of Beauhurst data



Examples of Sustainable products and services-related deals

- Dodo develops software that integrates with existing accountancy software to calculate and analyse carbon emissions across companies and to advise on emissions reduction and offsetting.
- CLUBZERØ; produces recyclable packaging material that is used for food and drinks, using Internet of Things technology to track its usage.
- Plastic Energy operates a chemical plastic recycling company, which uses end-of-life plastics to make products.

Smaller businesses face diverse barriers to green innovation, including access to finance

Ensuring climate solutions have broad reach across the economy and society is essential for an inclusive transition to net zero, which opens up growth opportunities for entrepreneurs and their local communities no matter where they are and who they are. Yet, the data in Figure A.23 further confirms that net zero-related equity investment is more highly concentrated across the UK compared with the distribution of low-carbon sector companies. In particular, London accounts for 36% of net zero-related deals nationally and a third of the investment value, compared to a share of low-carbon sector turnover of just 9% (the lowest of all regions in the South and East of England). In this respect, the distribution of net-zero related deals broadly matches the high concentration that characterises the wider equity market. The North East of England – and, to a lesser extent, the South East of England and Scotland – also account for a greater share of net zero-related deal counts or investment value relative to their share of low-carbon sector turnover. However, the North East's large share of net zero-related investment value is mainly driven by the 2022 Britishvolt megadeal; once this is excluded, its share drops to just 4%, meaning the North East is actually underrepresented in equity investment compared with its share of low-carbon sector turnover. All other nations and regions of the UK – including the Midlands, Yorkshire and the Humber, the South West and the East of England, and Wales and Northern Ireland – are underrepresented in the net zero-related deals data compared with their share of low-carbon sector turnover.

There is further evidence that access to suitable finance opportunities remains a challenge for smaller green innovators, wherever they are. In the most recent Longitudinal Small Business Survey, obtaining finance was an important barrier for around 1 in 5 (19% of) SMEs that see offering solutions to environmental problems as important for their business.

Figure A.22

Number and value of net zero-related SME equity deals per 1,000 businesses and per £million of turnover – selected categories, 2018-Q3 2022*

Source: British Business Bank analysis of Beauhurst and ONS LCREE data

Low-carbon and renewable energy sector (LCREE)	SME equity deals per 1,000 LCREE businesses	Investment value per £m turnover
Fuel cells and portable energy	28.8	£1,943,125
Electric and hybrid vehicles	37.6	£450,167
Solar and photovoltaic	1.2	£135,011
Research, consultancy, training, marketing and financial services	9.5	£49,610
Hydropower	24	£9,846
Energy from waste and biomass	2.7	£9,003
Energy-saving and biodegradable products	0.2	£1,260
Wind	1.7	£280

*The data presented excludes the 2022 Britishvolt deal, for the reasons outlined on p.48

Only 10% of these businesses identified a finance need in 2021, and the proportion that actually sought external finance was even lower (7%). In over a third of SMEs that were unable to obtain finance for their business, this had a negative impact on product or process innovation (Figure A.24).

The Bank already supports net zero innovators and will look at opportunities to further align programmes with sustainability goals

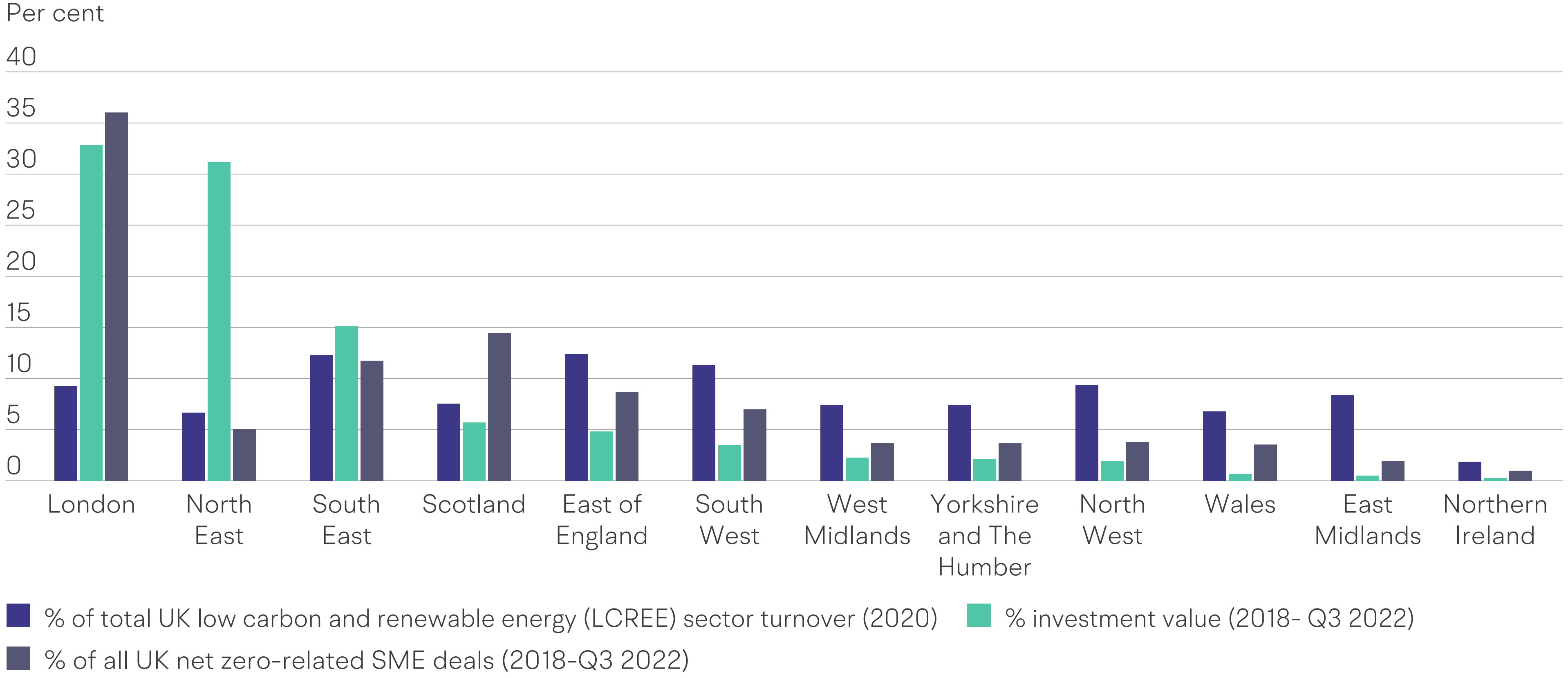
The Bank has an objective to support the UK's transition to net zero, including via enabling SME-led green innovation. The Bank's programmes have already supported £376 million in Clean tech investment between Q4 2014 and Q2 2022, benefitting over 4,000 companies. The two biggest components of this investment are the UK Innovation Investment Fund and the regional programmes, which altogether account for 58% of the total.

This year, the Bank is also beginning its path to report and set targets on its environmental sustainability performance in line with recognised industry practice. In June 2022, the Bank committed to signing up to the Principles of Responsible investment (PRI), the United Nations Global Compact (UNGC) and to reporting in line with the Taskforce for Climate Related Finance Disclosures (TCFD) in our annual report and accounts. This complements a previously made commitment to publishing science-based emission reduction targets later in 2023.

Figure A.23

UK nations and regions' share of the total UK number and value of net zero-related SME equity deals (2018-Q3 2022) vs estimated regional/national share of low carbon and renewable energy economy (LCREE) sector turnover*

Source: British Business Bank analysis of Beauhurst and ONS LCREE data



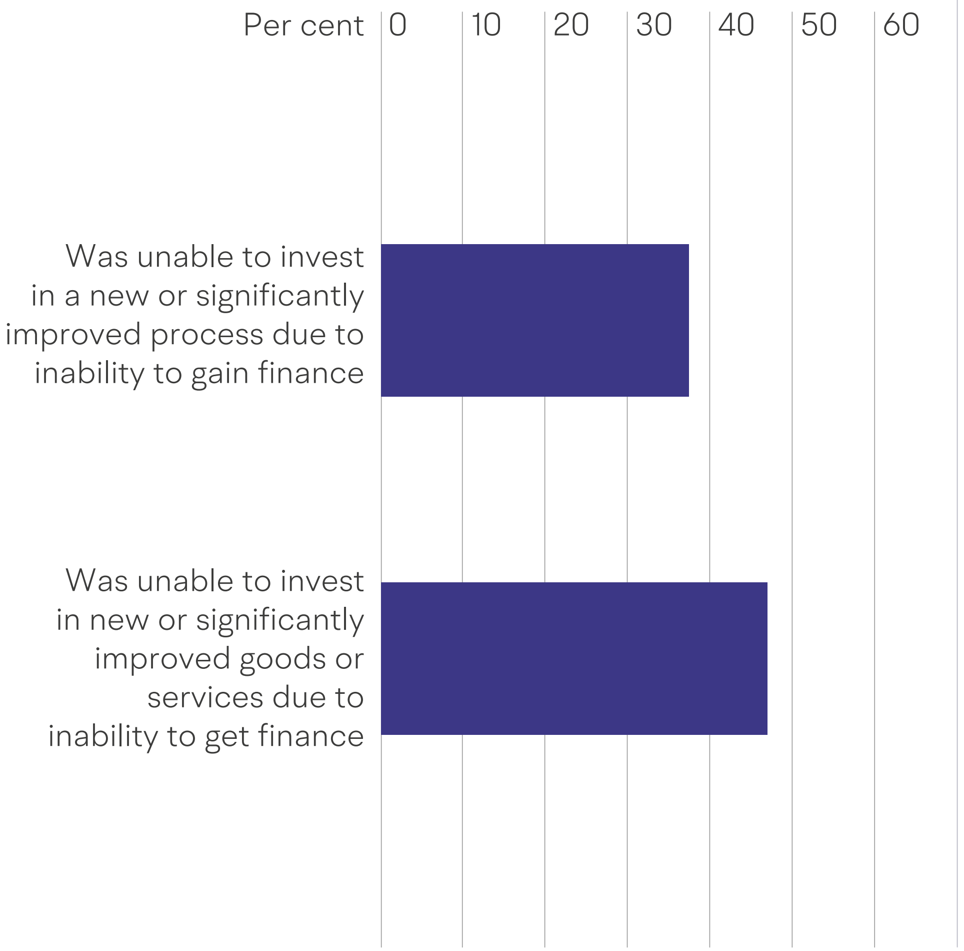
* the % investment value represented by the North East is reduced from 31% to 4% if the 2022 Britishvolt deal is removed. This increases the share represented by London and the South East, but does not materially affect the share held by other UK nations and regions

Meeting these commitments will require the Bank to gather more and better data from its delivery partners (i.e. the finance providers that facilitate the delivery of British Business Bank programmes) on the environmental performance of its investments and supported businesses. In doing so, it will ensure appropriate support is available to the smaller delivery partners, who face the most significant challenges in reporting their financed emissions, and thus risk their own capital funding becoming more expensive, but who provide diversity to markets and a significant amount of funding to smaller businesses.

Figure A.24

Finance access and challenges for SMEs that see offering solutions to environmental problems as important to the business

Source: British Business Bank analysis of the BEIS Longitudinal Small Business Survey, 2021, n=318



We therefore continue to invest in supporting delivery partners to successful meet the changing data requirements and market expectations associated with investing in green innovation. We also continue to engage with adjacent industry groups and net zero-focused initiatives, such as Bankers for net zero, on the issues of transition reporting and data collection.

Part B

Market Developments

2.1 The smaller business population

2.2 Use of external finance

2.3 Access to finance for female and Ethnic Minority entrepreneurs

2.4 Finance for environmental sustainability

Equity and Private Debt

2.5 Equity finance

2.6 Private debt

Bank lending

2.7 Bank lending

2.8 Challenger and specialist banks

Alternative lending and debt products

2.9 Alternative finance

2.10 Asset finance

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2.1

The smaller business population

The number of UK businesses fell around 1.5% to 5.5 million at the start of 2022 driven by a reduction in unregistered zero employee firms

The rate of change in the stock of firms across the UK varied substantially by geography and sector

At the start of 2022 SMEs had a workforce of 16.4 million, including 4.4 million working proprietors

Business dissolutions may be substantially outpacing incorporations by year end 2022, signalling further negative impacts beyond 2022

One in five (19%) SME employers are led by women and one in seventeen (6%) are Ethnic Minority-led businesses

This chapter reviews the current stock of UK businesses and the components of change over time incorporating insights from the Department for Business, Energy and Industrial Strategy (BEIS) business population estimates[65] and Office for National Statistics (ONS) business demography.[66]

The number of UK businesses fell by 1.5% to 5.5 million at the start of 2022 driven by a reduction in unregistered zero employee firms

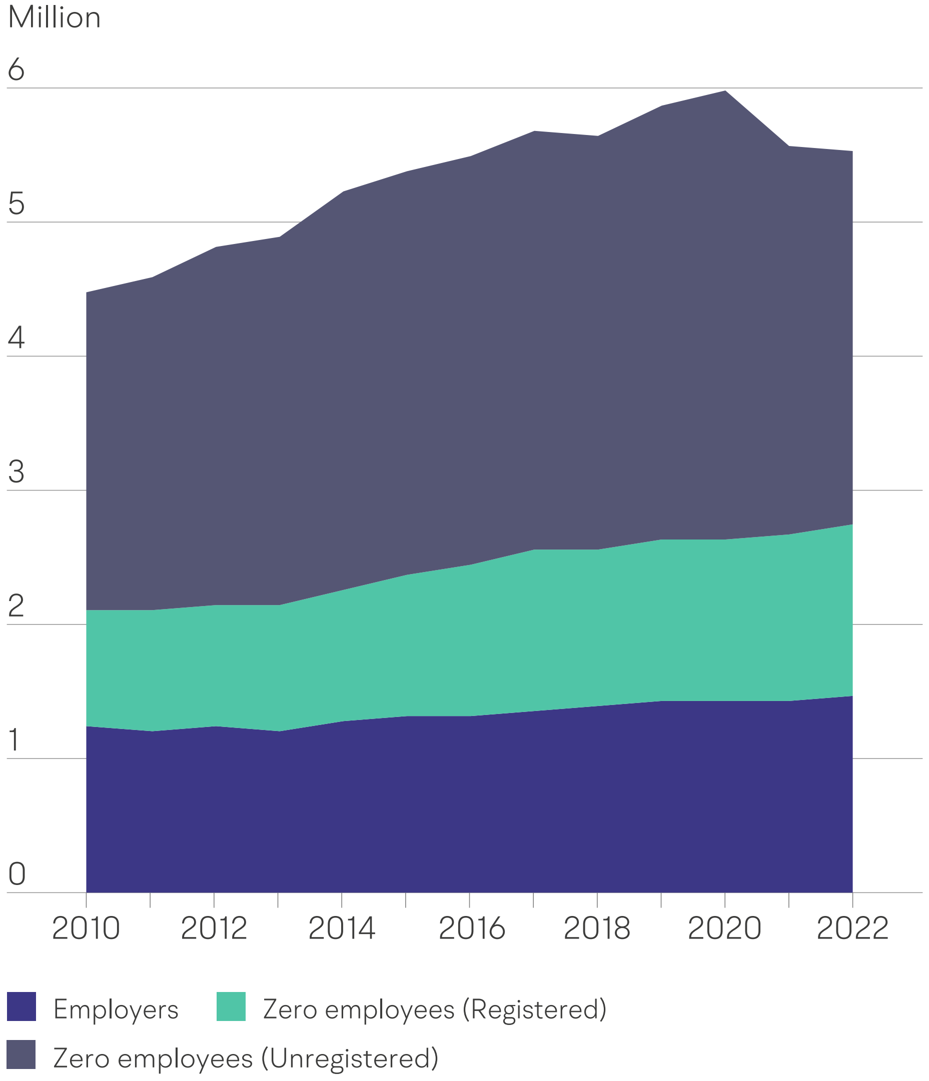
There were an estimated 5.5 million UK private sector businesses at the start of 2022, a 1.5% reduction on the total reported at the start of 2021.[67] This is the second consecutive year of decline in the UK business population but a smaller drop than the 6.5% between 2020 and 2021. The latter was the largest fall in the business population since the series began in 2000. Overall, the current scale of the reduction has taken the stock of businesses back to a level last seen at the start of 2016.

Figure B.1 shows these impacts were not evenly distributed by type of firm. There were almost 3.4% fewer unregistered zero employee firms at the start of 2022 compared to the previous year. Numbers for these unregistered firms[68] are estimated by BEIS and do not feature in the ONS business birth and death rates data covered later in the chapter. In contrast, zero employee registered firms[69] and small and medium sized employers (1–249 employees) showed a net increase to the start of 2022 by 2.9% and 2.4% respectively.

Figure B.1

UK business population, 2010–2022

Source: BEIS Business population estimates 2022



The fall in the business population between 2021 and 2022 was driven by small businesses with no employees, the largest category of UK businesses. The decrease in the population of self-employed individuals during the coronavirus pandemic is reflected in the fall of businesses without any employees. Data from the Labour Force Survey by the ONS shows a 15% reduction in the number of self-employed workers in the first quarter of 2022 compared to the first quarter of 2020. According to the ONS, some of this decrease can be attributed to people altering their survey responses during the pandemic. For instance, some business owners who were paying themselves through PAYE began to identify as employees in order to qualify for the Coronavirus Job Retention Scheme.[70]

Figure B.2 shows the distribution of businesses per head of population varies across regions. The average number of businesses for the entire UK is 1,014 per 10,000 resident adults. London has the highest density of businesses per 10,000 adults, with a rate of 1,452. Other regions that exhibit relatively high rates include the South West (1,152), South East (1,134), and East of England (1,075).

However, the North East of England stands out with the lowest business density rate of any English region or UK country, with a rate of 704 per 10,000 adults. Additionally, the regions of Northern Ireland (855), Wales (839), and Scotland (749) also exhibit relatively low business density rates compared to the UK average.

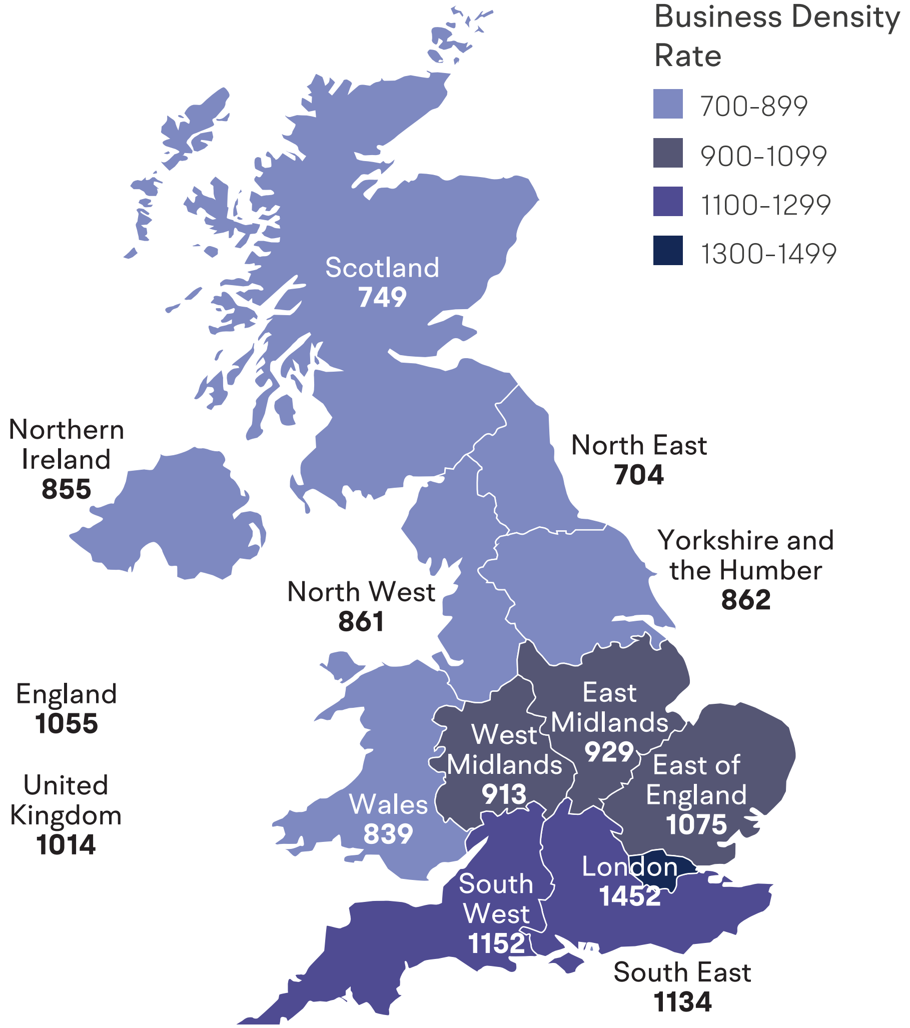
The rate of change in the stock of firms across the UK varied substantially by geography and sector

Between 2021 and 2022, seven regions and nations in the UK experienced a decline in total business stock. While the rate of decline varied among these regions and nations, the spread of the changes narrowed compared to the previous year. The regions and nations with the steepest declines in business population were Yorkshire and the Humber (-6.7%), followed by East of England (-4.4%) and South East England (-3.6%). In contrast, Wales (5.4%), Northern Ireland (3.6%) and South West (2.9%) saw the largest increases in business population. It is worth noting that in the previous year, Northern Ireland experienced the highest decline of any

Figure B.2

Number of businesses in the UK private sector per 10,000 adults, UK region and country, start of 2022

Source: BEIS business population estimates 2022


Business Density Rate
700-899
900-1099
1100-1299
1300-1499
Scotland 749
Northern Ireland 855
North East 704
Yorkshire and the Humber 862
North West 861
England 1055
United Kingdom 1014
East Midlands 929
West Midlands 913
East of England 1075
Wales 839
South West 1152
London 1452
South East 1134

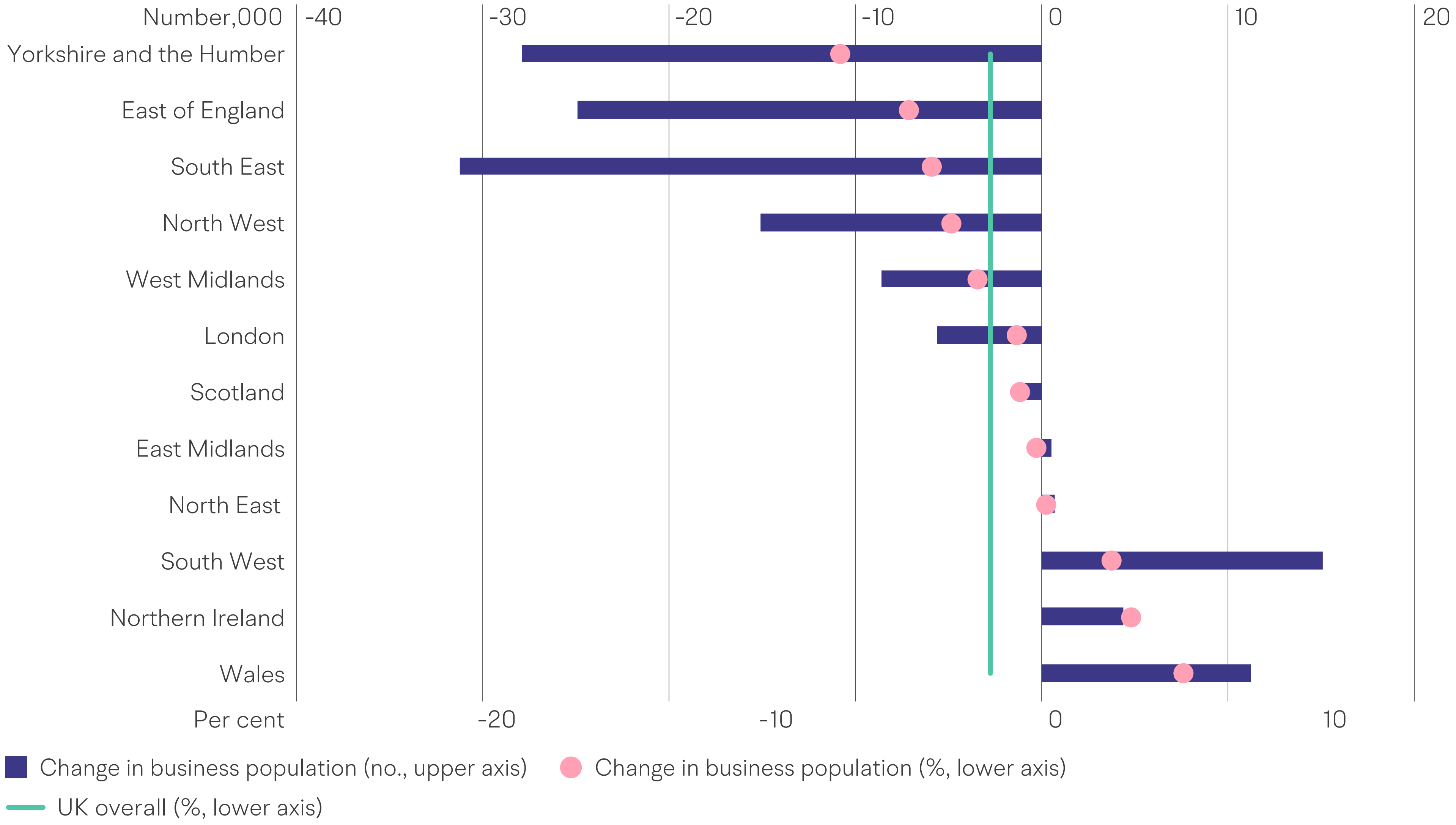
UK region or nation (-16.6%), while Wales and Yorkshire and the Humber had the least marked declines at -0.7% and -2.1% respectively.

The drivers of these variations across the UK are not immediately obvious. However, it is clear that the effects of the pandemic and subsequent economic barriers have been much more severe in certain regions and sectors. For more information on the barriers that SMEs are facing please see Chapter 2.2 Use of External Finance. This is also confirmed by analysis of the change in business stock by sector where variations are even more substantial than those by geography (Figure B.3).

Figure B.3

Change in UK business population by nation and region, 2021–2022

Source: BEIS business population estimates 2022

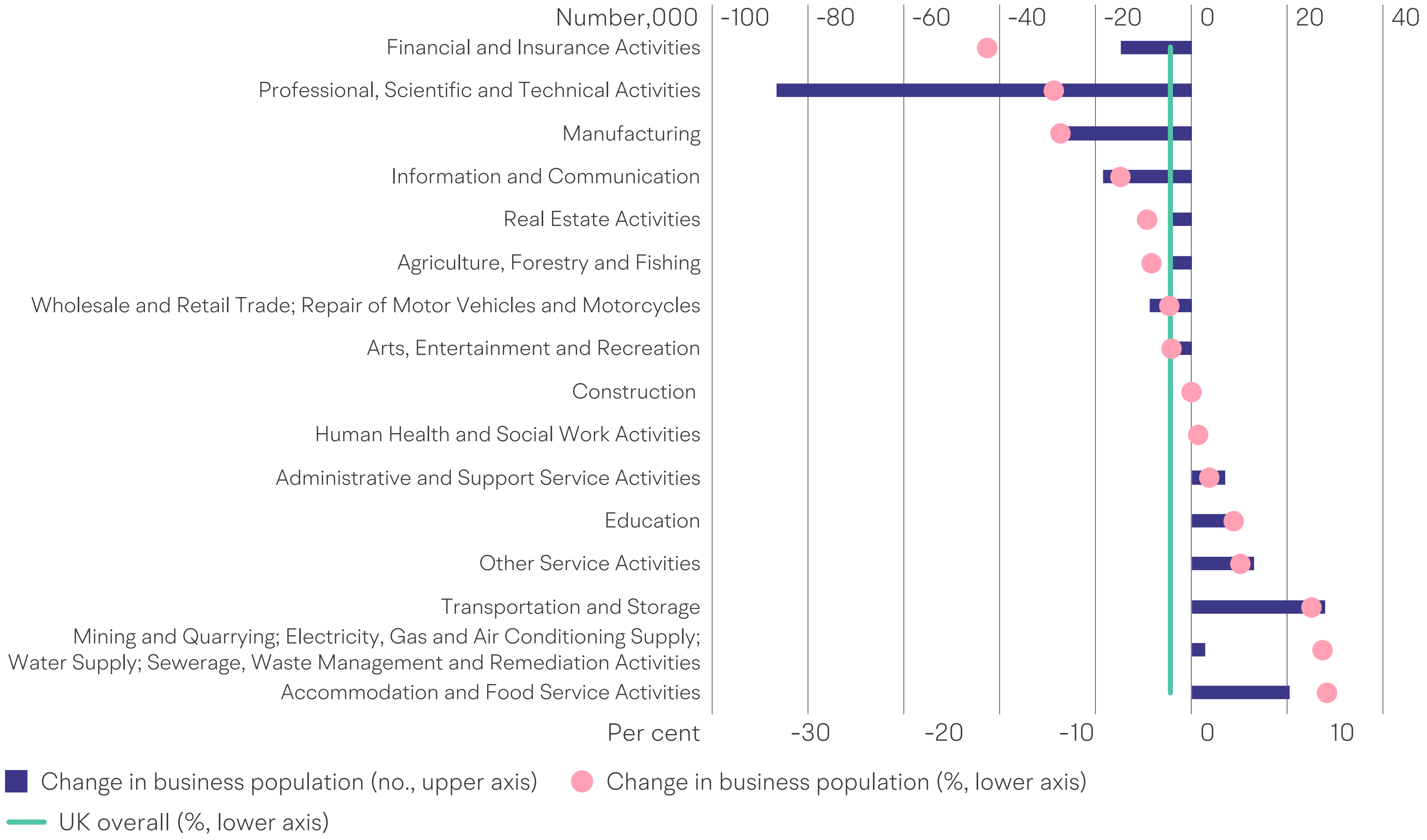


Eight out of the 16 sectors experienced a decline. The sectors with the largest percentage declines were the Financial and Insurance Activities (-15.1%), Professional, Scientific, and Technical Activities (-10.2%), and Manufacturing (-9.6%). On the other hand, several sectors saw an increase in business population. The Accommodation and Food Service Activities sector saw the largest percentage increase (10.2%), followed by the Mining and Quarrying; Electricity, Gas and Air Conditioning Supply; Water Supply; Sewerage, Waste Management and Remediation Activities sector (9.9%), and the Transportation and Storage sector (9.0%).

Figure B.4

Change in UK business population by ONS SIC section, 2021–2022

Source: BEIS business population estimates 2022



At the start of 2022 SMEs had a workforce of 16.4 million, including 4.4 million working proprietors

Despite the continuous scale of the reduction set out above, there were 4.1 million zero employee firms in the UK at the start of 2022 and a further 1.4 million small and medium sized employers (firms with a headcount of between 1 and 249 employees). Collectively, these smaller firms comprised an employed workforce of 61% of the total employment (16.4 million) and contributed 51% (£2.1 trillion) to UK private sector turnover over the course of 2021.

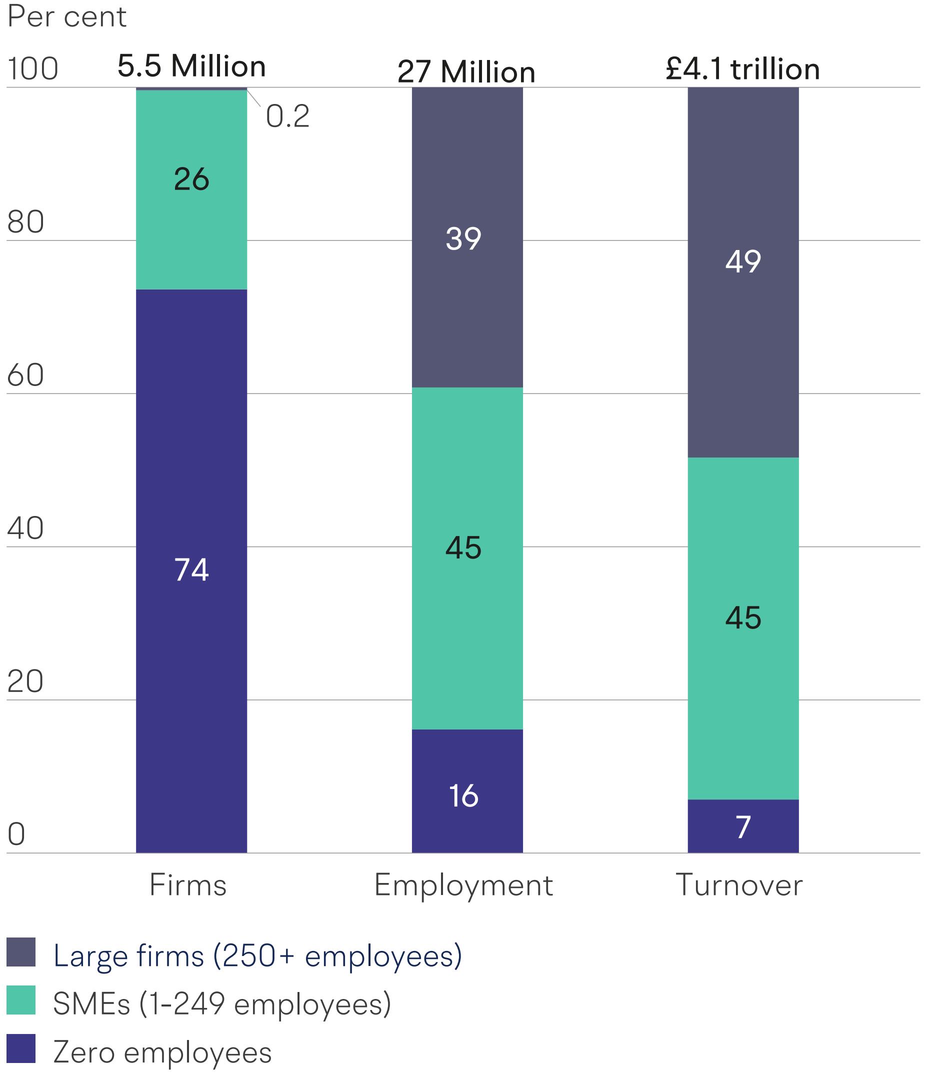
However, there is a substantial variation in the scale of contribution to turnover by firm headcount. BEIS estimate zero employee firms supported 4.4 million working proprietors at the start of 2021 and contributed just over £277 billion to UK private sector turnover in the previous year. Collectively, micro, small and medium sized employers had an employed workforce of 12.3 million and contributed just over £1.8 trillion to UK turnover. Whilst there were fewer than 8,000 large private sector firms (with 250 employees or more), they employed a collective headcount of 10.6 million employees and contributed just over £2.0 trillion to UK turnover in the year to 2022.

The latest official ONS experimental business demography data permits the tracking of births and deaths for UK registered businesses up to and including Q3 2022.[71] The statistic represents the number of new firms and closures as a proportion of business population. In Q2 2021 the data shows the business death rate of registered businesses surpassed the birth rate and has remained net negative since then. While the difference narrowed to fewer than 1,000 business deaths in Q1 2022, the net negative change expanded to its highest level of over 20,000 business deaths since Q2 2022 due to increased global economic uncertainty and higher costs. This indicates a significant net reduction by the end of the year.

Figure B.5

UK businesses, employment, and turnover, 2022

Source: BEIS Business population estimates 2022



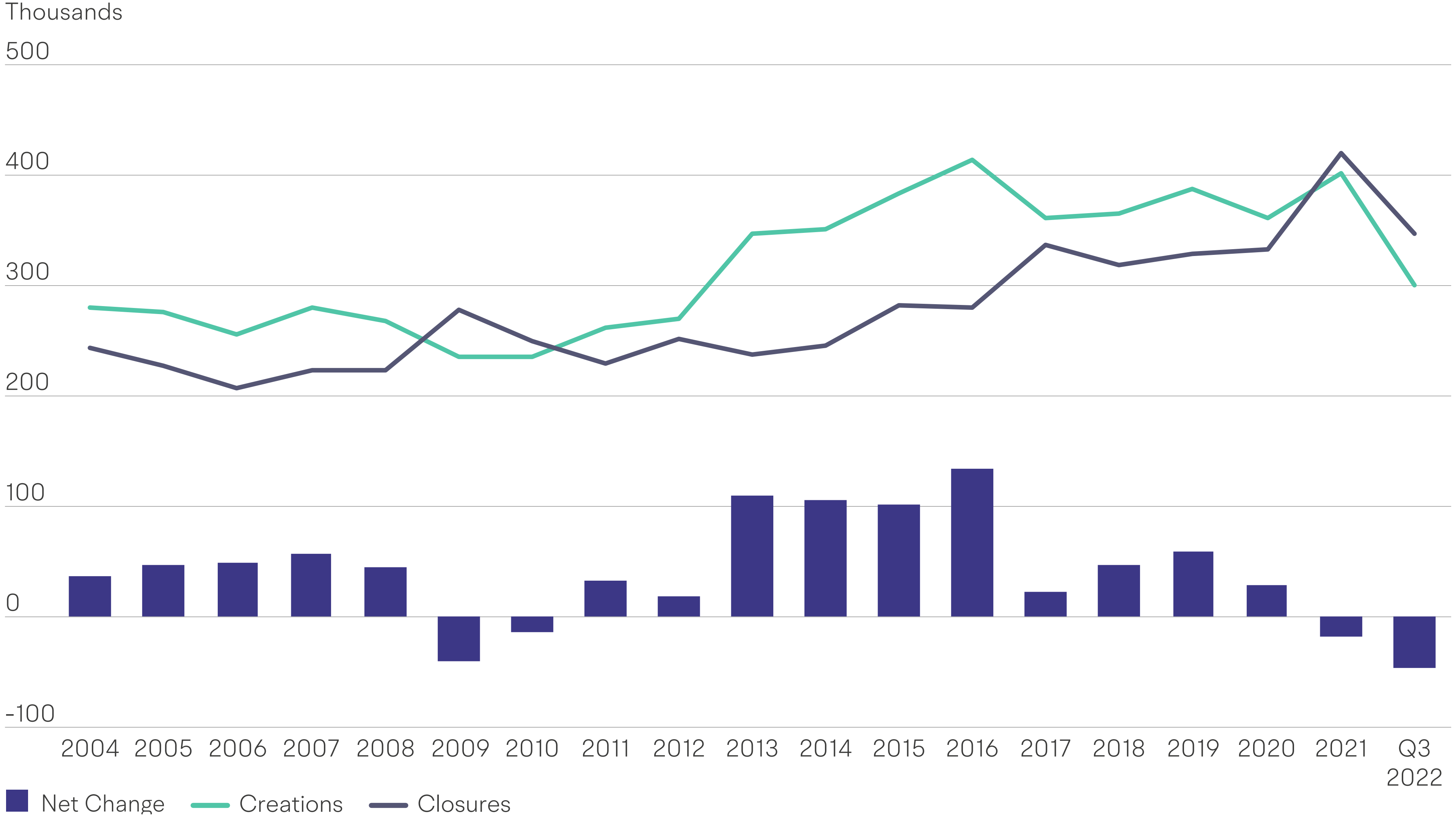
Overall, as figure B.6 shows, there were just over 300,000 business births in 2022 and over 340,000 deaths, leading to a net decrease of around 46,100 UK registered businesses by year end.[72]

Despite the easing of the impact of Covid-19, small businesses continue to face challenges, including rising costs, a challenging economic climate, a tighter labour market, and the new trading arrangements with the EU. Historically, looking back to the Global Financial Crisis (GFC) in 2007/2008, registered business deaths did not outweigh births until 2009 and 2010, before recovering in 2011, suggesting the negative impacts of the present crisis are likely to persist beyond 2022.

Figure B.6

UK business births and deaths, 2004–2022Q3

Source: ONS Business Demography, 2020 and Business Demography, Quarterly Experimental Statistics, 2022



Business dissolutions may be substantially outpacing incorporations by year end 2022, signalling further negative impacts beyond 2022

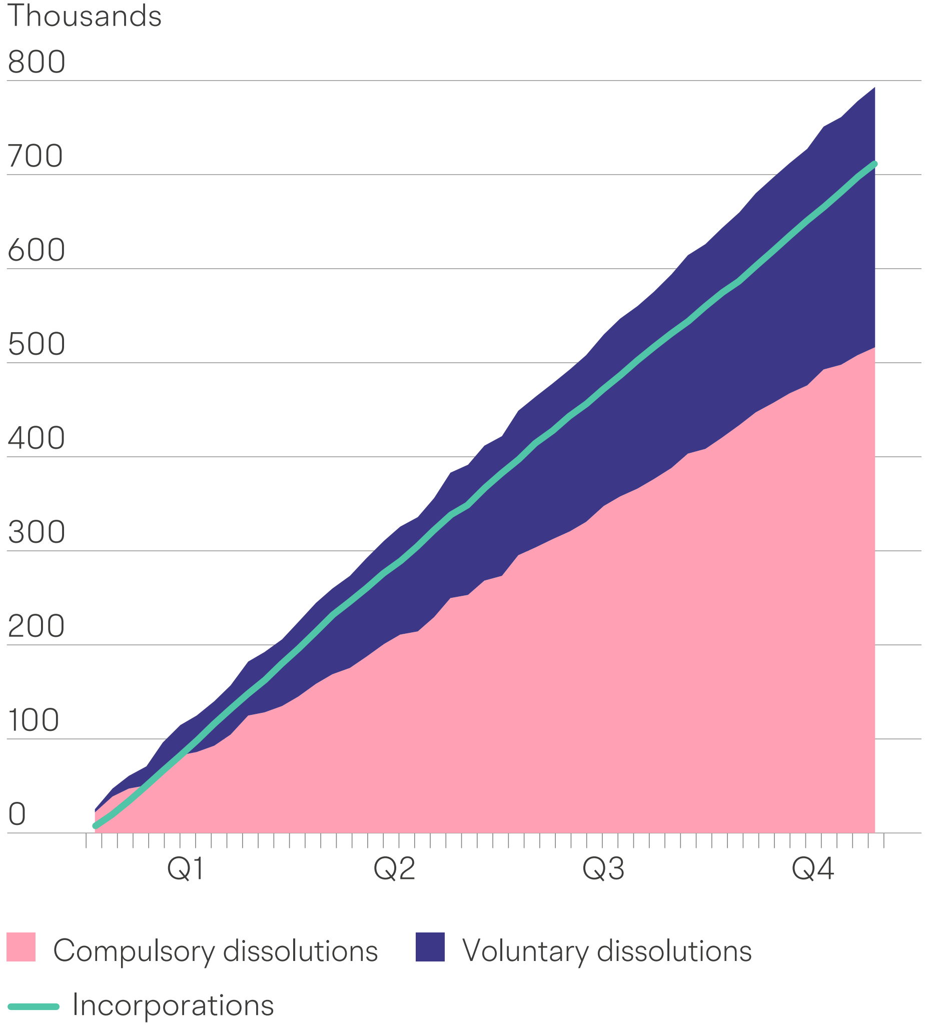
A further indication that long term trends of net business growth have stalled is provided in figure B.7 which shows incorporations alongside compulsory and voluntary dissolutions in 2022. Compulsory and voluntary dissolutions are not entirely mutually exclusive as some firms that are undergoing compulsory winding up opt for a voluntary dissolution. However, both voluntary and, more especially, compulsory dissolutions in 2022 are trending above 2021 levels. Moreover, collectively they had risen above the number of incorporations by Q1 2022 with the gap widening by year end if present trends continue.

The pandemic has affected the processes at Companies House in the UK, causing delays in the issuing of compulsory dissolution first Gazettes (a notice issued by Companies House indicating their intention to remove a company from the register) for some companies. Companies House extended filing deadlines and temporarily paused the strike off process to give companies time to update their records. The release of these paused dissolutions began in March 2021 and were issued at a faster rate to clear the backlog of companies. When interpreting the figures, it is important to keep in mind that the increase in the number of first Gazettes may seem like more companies are going out of business but it is just due to Companies House clearing the backlog.

Figure B.7

UK company incorporations, compulsory and voluntary dissolutions in 2022

Source: ONS, Business insights and impact on the UK economy



One in five (19%) SME employers are led by women and one in seventeen (6%) are Ethnic Minority-led businesses

The annual Small Business Survey conducted by BEIS provides valuable insights into the characteristics of small business leaders with fewer than 250 employees. The survey examines the representation of female-led businesses and businesses led by individuals from Ethnic Minority-led businesses across various industries. It defines a female-led business as one in which a person from that gender is in sole control or the management team is at least 50% composed of women. Similarly, an Ethnic Minority-led business is one in which a person from an Ethnic Minority group is in sole control or the management team is at least 50% composed of individuals from that group. For more details on the use of finance by gender and ethnicity see section 2.3 Access to finance for female and Ethnic Minority entrepreneurs.

According to the 2021 survey, 19% of SME employers were led by women, while 24% were 'equally-led', meaning they had an equal representation of men and women in the management team.

The representation of female-led businesses varies across industries, with the highest percentage being in the education sector at 44%, and the lowest in the construction sector at 9%. Additionally, 20% of self-employed people are female-led SMEs, which is one percentage point lower than the previous year but one percentage point higher than the proportion of female-led SMEs with employees. The majority of female-led SMEs with no employees were found in the Health and Social Care sector (58%) and Accommodation and Food sector (56%).[73]

The 2021 survey also revealed that 6% of SME employers were Ethnic Minority-led businesses, with the highest representation found in the health sector (10%), administration (9%), information and communication sector (8%), food and accommodation sector (8%), and transport (8%). London had the highest proportion of Ethnic Minority-led SMEs compared to other English regions and the devolved nations at 20%, while the North East and the South West had the lowest proportion at 2%. Among SMEs without employees, 5% were Ethnic Minority-led businesses in 2021. The most likely ethnicity of the leaders of Ethnic Minority-led SMEs were Indian, and they were most likely to be in the other services sector (10%), IT and communication (8%), accommodation and food (7%), and education (7%) sectors and least likely to be in primary sectors (1%).[74]

The Global Entrepreneurship Monitor (GEM) Consortium also reported a disparity in the rate of entrepreneurship between men and women.[75] The UK 2021/22 monitoring report stated that the male Total early-stage Entrepreneurial Activity (TEA) rate was 13.2%, while the female rate was 9.7%.[76] This results in a ratio of female to male entrepreneurship of around 3 to 4, or 73%. The report also highlighted that the ratio varies across different regions in the UK, with Wales having the highest ratio at 92% and Northern Ireland having the lowest at 65%. It is worth noting that the TEA rate is calculated as the percentage of the working age adult population (aged 18–64) who are early-stage entrepreneurs.

Additionally, the report showed a significant difference in the TEA rate between non-white and white ethnic populations. The TEA rate for non-white populations was 20.4%, while it was only 10.1% for white ethnic populations. This trend has been consistent in previous years as well. However, the report does not specify a breakdown of the non-white population.

2.2

Use of external finance

More SMEs were permanent non-borrowers than using finance in 2022

The proportion of SMEs using loans and grants is lower in 2022

A higher proportion of SMEs were considering more than one finance provider

Almost four in 10 SMEs currently use trade credit, reducing the need for external finance in some businesses

This section highlights smaller firms' current usage of, and demand for, external finance and reviews their attitudes to finance during the pandemic. It draws on data from the UK Finance/BVA BDRC SME Finance Monitor, the British Business Bank's Business Finance Survey, and UK Network Intermediary Survey.[77] External finance covers a wide range of debt, equity and grant products.[78] This definition excludes trade credit, which is discussed separately at the end of the chapter.

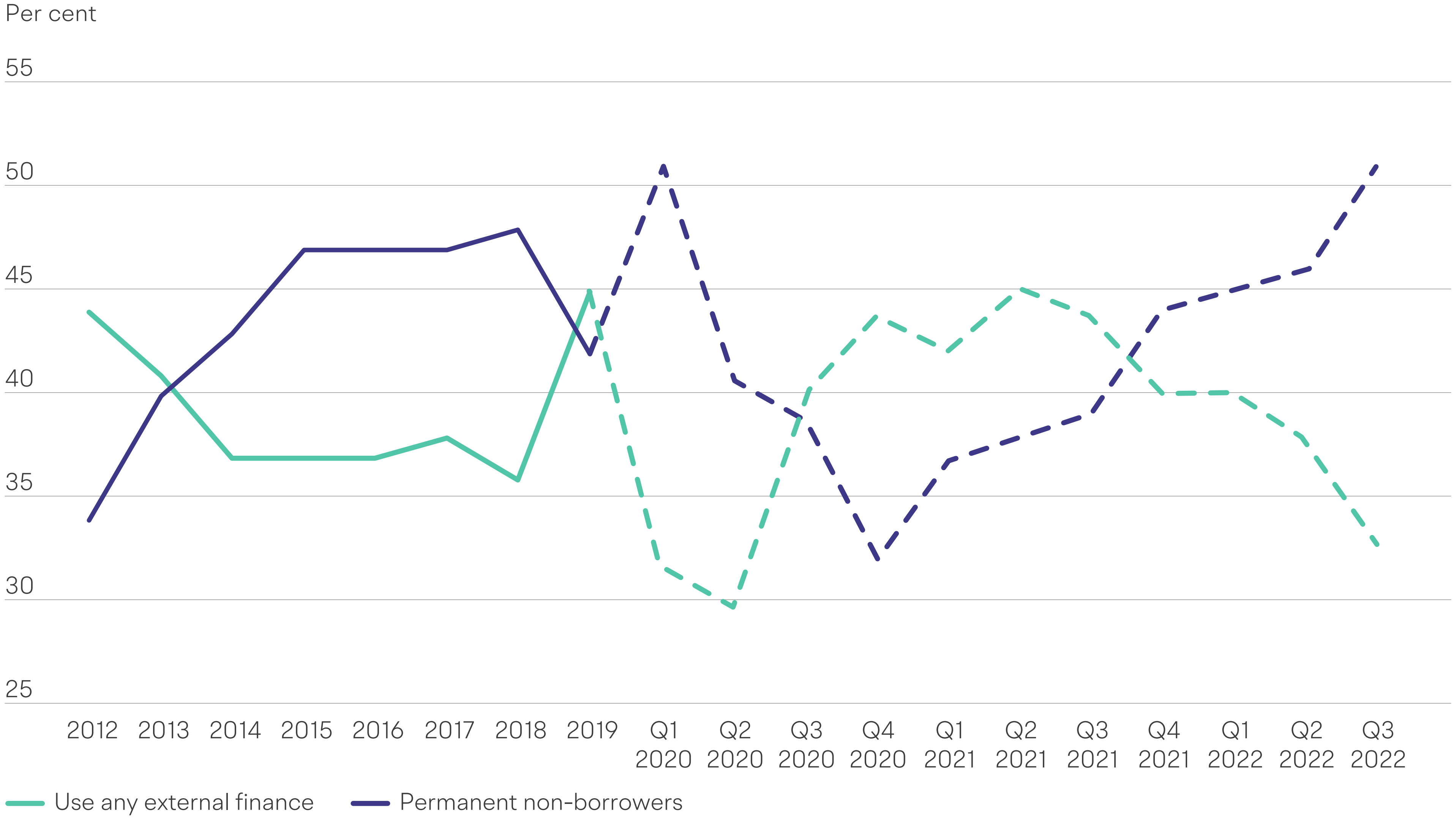
More SMEs were permanent non-borrowers than using finance in 2022

The share of businesses using external finance was 33% in Q3 2022. This was a significant drop from 44% in Q3 2021 and the lowest level since the start of the pandemic in the first half of 2020. Over the same period, the share of the 'Permanent Non-Borrowers' (PNBs)[79] increased from 39% to 51%, which is the highest level since the start of the start of the pandemic in 2020. There have been fewer SMEs using external finance than meeting the definition of a PNB since Q4 2021. Moreover, since the last quarter of 2021 the gap between use of finance and PNBs has widened every quarter reaching 18 percentage points in Q3 2022, the widest seen to date, see Figure B.8.

Figure B.8

SMEs using external finance and permanent non-borrowers (%)

Source: UK Finance/BVA BDRC SME Finance Monitor, 3 months to October 2022[80]



The Bank's own survey conducted in the second half of 2022 shows that the proportion of smaller firms who sought finance fell in comparison to H2 2021, from 59% to 39%. This likely reflects the increasing set of barriers and uncertainty that small businesses have been experiencing in 2022 - for more information see part A of this report.

In the SME FM the decrease in use of finance since the start of the 2022 was seen most prominently amongst medium-sized firms (50–250 employees). The latest available data shows that the share of medium-sized businesses using finance decreased from 48% in Q1 2021 to 33% in Q3 2022.

Small enterprises have been beset by a multitude of obstacles in the last few years. As the Covid-19 pandemic took hold in the second quarter of 2020, nearly three-quarters (68%) of SMEs identified it as a significant hindrance to their operations. As the pandemic's effects have dissipated, now only 15% cited it as a barrier. The two primary barriers to business for SMEs in Q2 2022 were "increasing costs" (34% in Q4 2021 to 40% in Q2 2022) and the "current economic climate" (21% in Q4 2021 to 30% in Q2 2022). Followed by around one in five SMEs' concerns about legislation (20%), supply chain (19%) issues, and an increasing concern about staff (13%) that remained higher than previously seen. In the most recent quarters, concern about the economic climate has been growing at a faster rate than that for increasing costs. Although these impacts are correlated, the latter remains the top barrier across all sizes of SME.

These results differ from the intermediary views. When their top three most mentioned barriers of SMEs are added together, the results show that lack of awareness of finance options available (70%) is seen as the greatest obstacle for SMEs, followed by access to the supply of finance (58%). Only 43% of intermediaries responded that cost of finance is seen as a barrier for small businesses.

In terms of specific sectors, increasing costs were the main barrier for all but notably Agriculture (74%) (which was also more concerned about the economic climate) and Hospitality (64%). Those in Health (37%) or Property/Business Services (42%) were least likely to see the economy or increasing costs as a barrier. When viewed across import/export status and use of finance increasing costs were a barrier most notably for Import-only SMEs (63%), which were also more concerned about the economic climate, and those using external finance (59%). There was relatively little variation regarding the impact of the pandemic, with the exception of the PNBs (42%).

In H1 2022, 21% of employers reported that recruiting and retaining staff was a major barrier to their operations. This figure was even higher among employers in the Health (31%), Hospitality (27%), and Construction (26%) sectors, with around three out of ten reporting this as an issue. Across all sectors, the challenges of recruiting and retaining staff have increased since 2019, though the increase has been more modest in the Wholesale/Retail sector with 16% of respondents.

Respondents to the UK Network Intermediary Survey made it clear that 77% agree that demand for finance in their regions or nations varies considerably between the business sectors they work with. This chimes with the SME FM data where there was no clear pattern in the use of finance among different sectors of SMEs. Use of finance dropped notably in the Hospitality and Wholesale/Retail sectors, remained stable in Manufacturing, and increased in the Other Community sector. In H1 2022, 49% of the Other Community sector and 46% in Manufacturing were using finance, compared to 28% in the Health sector (32–41% elsewhere).

The proportion of SMEs using loans and grants is lower in 2022

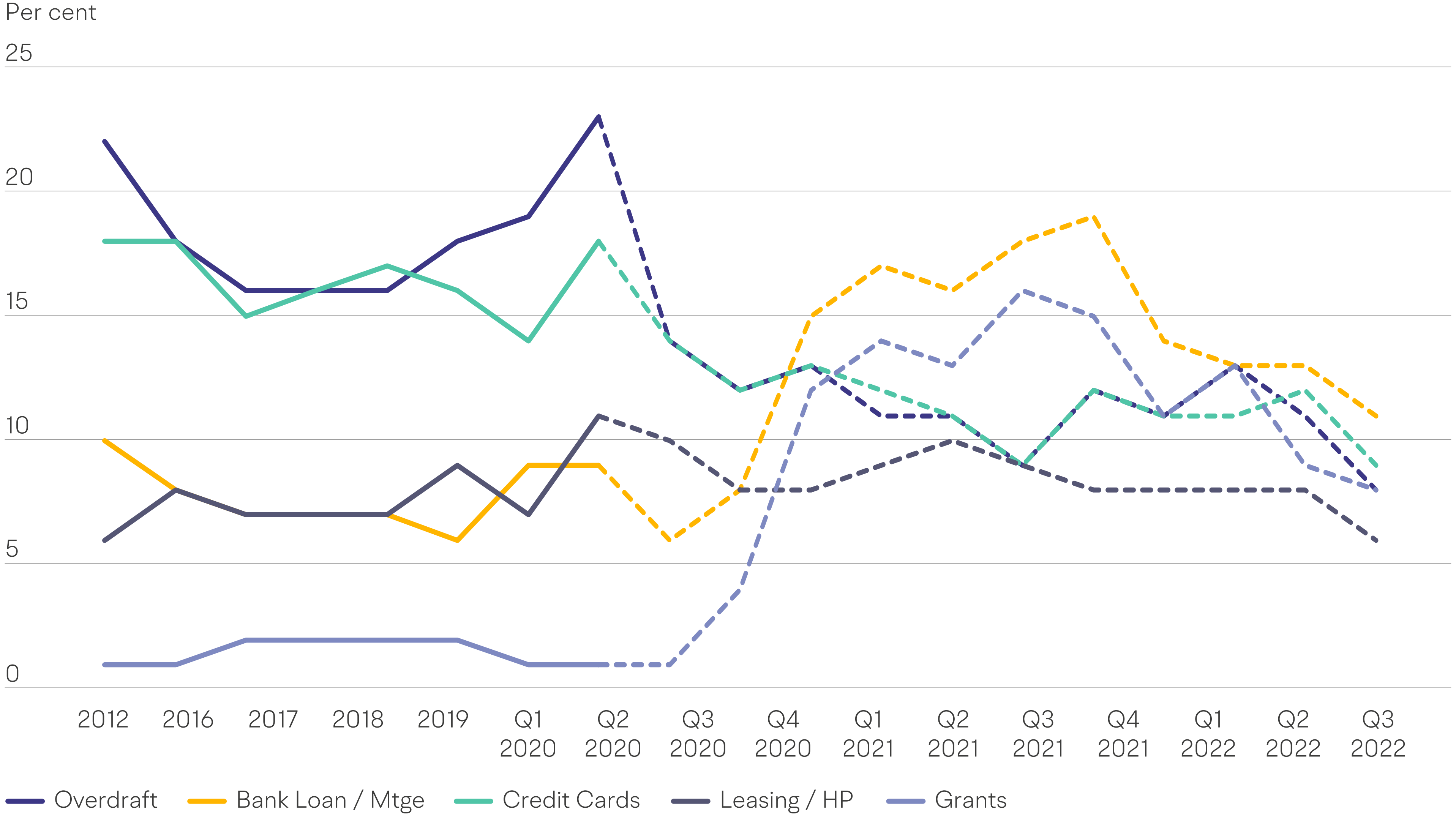
Use of 'core'[81] forms of finance increased from a record low in Q2 2020 of 25% to a peak of 32% in Q3 2021. However, it fell four percentage points in Q2 2022 to 28%, still lower than the 2019 pre-pandemic of 39%. The increase from Q2 2020 to Q2 2021 was driven by take up of the government guaranteed loan schemes, reflected in an increase in the use of term loans which almost doubled from 9% in 2019 to 18% in Q3 2021, the highest levels since the series began.

Take up of 'other' forms of finance increased from a historic low of 13% in Q2 2020 to reach to almost one in three users in Q2 2021 (27%). This was an increase of 14 percentage points and was driven by the increased use of grants which increased from 4% to 16% in same period.[82] However, it fell by six percentage points to 21% in Q2 2022.

Figure B.9

SMEs using forms of core finance, leasing/hire purchase products and grants in 2022 (%)

Source: UK Finance/BVA BDRC SME Finance Monitor, 3 months to October 2022



The mix of finance used has changed, with a marked increase in the use of loans in 2021 as government-backed finance became available and grants were offered. Overall use of finance was further boosted by 14% of SMEs receiving grants in 2021 and 11% in H1 2022 (compared to 1–2% pre-pandemic) (Figure B.9).

The Bank's Business Finance Survey, undertaken in Q4 2022, provides further colour on SMEs demand for external finance. Almost two in five small businesses (39%) had sought external finance in the last three years - a decrease from 59% in 2021 and the pre-pandemic 2019 results of 44%. Of those SMEs which sought external finance, 35% had sought non-government-backed finance. Interestingly, SMEs with no employees were less likely to have sought external finance (35%) or non-government-backed finance (31%) compared to SMEs with employers (50% and 47% respectively). This could be because of the extra resources and expertise that employers have at their disposal, compared to businesses without any employees. Overall, the number of SMEs who did not seek any form of external finance went up from 41% in 2021 to 61% in 2022.

However, with the end of the government loan schemes businesses have started to increase their usage of non-government loans. The proportion of smaller firms using a combination of government-backed and non-government-backed repayable external finance decreased markedly from 26% to 12%. Meantime, SMEs relying solely on non-government-backed finance increased from 15% in 2021 to 23% 2022 (Figure B.10).

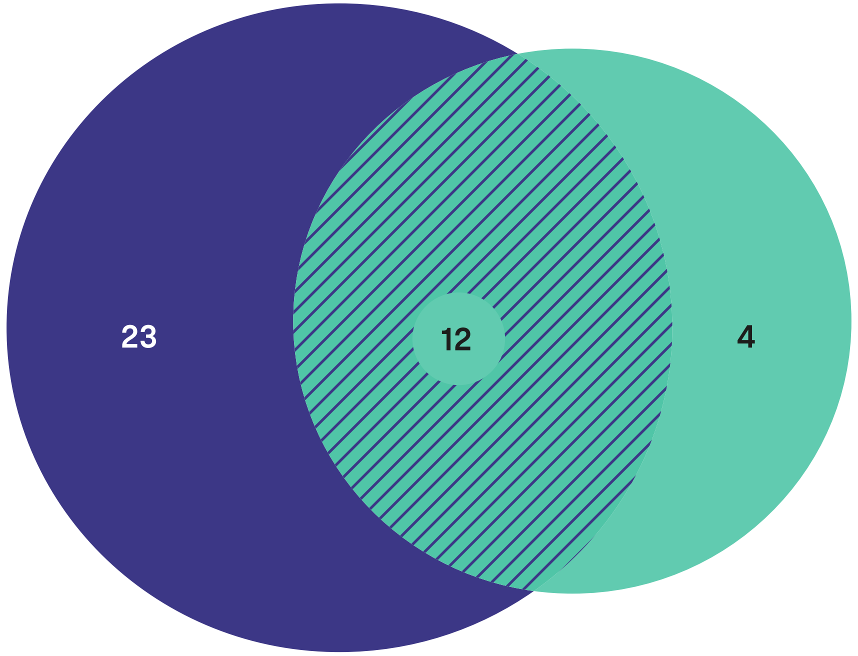
In 2022 the most sought finance form was bank loans (or term loans) (13%) followed with bank overdraft, loans from directors and leasing or hire purchase all of which had a response of 11%. Bank loans and bank overdrafts were not commonly sought by young businesses, with just 4% of SMEs younger than 2 years using bank loans and 3% using bank overdrafts.

The SME FM also found that in the UK working capital, to cover short-term funding gaps or to help during difficult trading conditions, has been the dominant driver of funding needs since Q2 2020. Many smaller businesses faced heightened cashflow issues since the start of the Covid-19 pandemic. Of the 7% of SMEs interviewed in H1 2022 that reported a need for funding in the previous 12 months, 74% said support for cashflow (including coping with impact of Covid-19)[83] was the

Figure B.10

SMEs use and non-use of government-backed finance in 2022 (%)

Source: British Business Bank Business Finance Survey – Ipsos MORI. Base = all businesses (n=2,213 in 2022, n=2,804 in 2021) *Note: may not sum due to rounding



- ■ External finance (excluding government-backed finance and grants)* (15% in 2021)
- ▨ Both government-backed and non-government-backed finance (26% in 2021)
- ■ Government-backed finance and grants only (19% in 2021)

reason for requiring funding in first half of 2022, down from 81% in 2021. A drop of respondents in this category can also be seen in the Bank's 2022 Business Finance Survey: around five out of ten respondents (53%) said they were seeking finance to help with cashflow and working capital, compared to 87% in the previous year. This was followed by purchase of fixed assets (27%) and investment in business growth (27%). Additionally, 23% of businesses reported that finance was mainly sought for the purpose of recovery (Figure B.11).

The Bank's UK Network Intermediary Survey in 2022 found that 75% agreed that SMEs in regions or nations are not well-equipped to reduce their debt burden over the next 12–18 months. The survey results show that more than half of intermediaries, at 60% believe that SMEs who have obtained financial assistance due to the Covid-19 crisis are aware of the additional repayment burden on their businesses. This percentage increases to 69% when intermediaries were asked about SMEs' overall financial health in the face of the challenging economic conditions resulting from the pandemic. These findings clearly indicate the significant impact of the pandemic on SMEs and underline the need for possible continued financial support to help them weather the economic uncertainty.

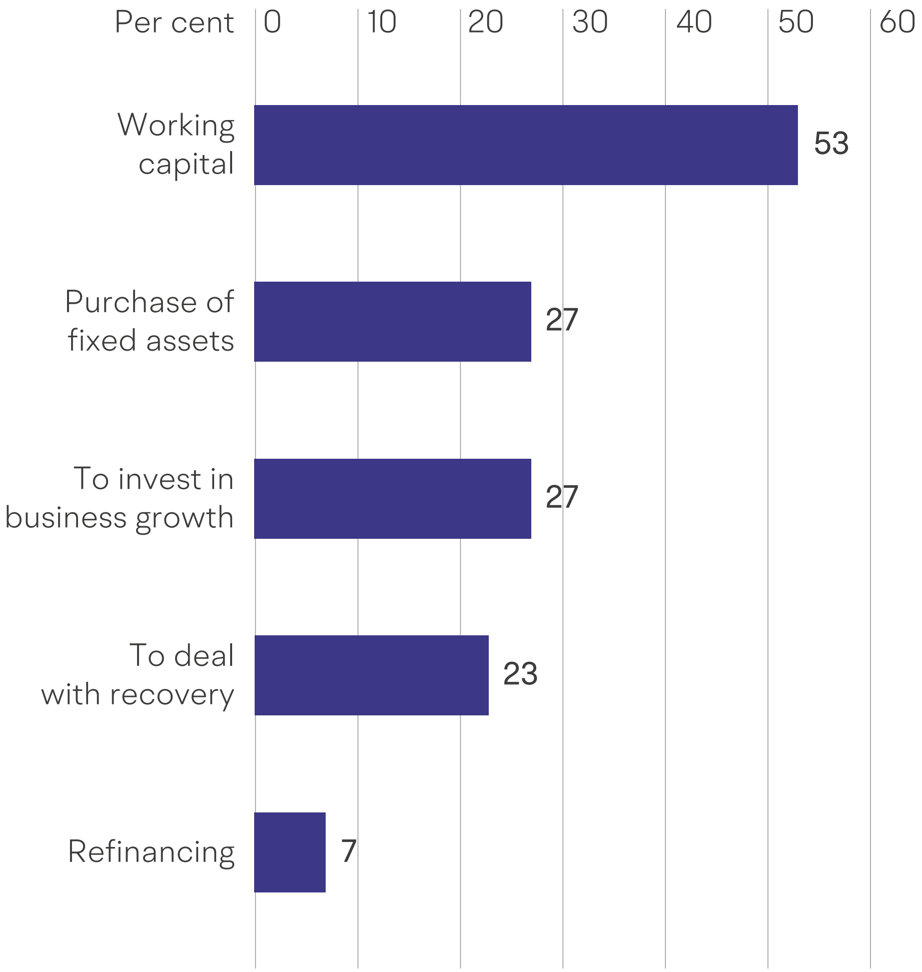
Moreover, in the Bank's Finance survey comparing the size of small (10–49 employees) and medium (50–249 employees) firms with the overall average, it was found that these firms were less likely than average to seek finance for working capital (33% and 39% respectively), but more likely to seek it for purchasing fixed assets (45% and 48% respectively). This highlights the importance of finance for small and medium enterprises in the UK, as it provides them with the necessary resources to grow their businesses.

A significant proportion of SMEs which sought out non-government-backed financial assistance have already utilised their entire funding. Of those surveyed, 31% have completely used their funds while 13% have used more than half of the funding they were granted. This reveals that SMEs need external financial support to continue their operations and keep up with growing demands.

Figure B.11

Main reasons for seeking finance in 2022 (%)

Source: British Business Bank Business Finance Survey – Ipsos MORI. All who applied for non-government-backed* finance in 2022 (n=200). Reasons given for 5% or below not shown
*Changed in 2022



A higher proportion of SMEs were considering more than one finance provider

Smaller businesses have historically demonstrated a tendency towards limited consideration of various options when obtaining finance. The onset of the pandemic and the availability of government loan schemes have further accentuated this trend. In 2020, a significant proportion of smaller firms, at 75%, only considered a single provider, however, this figure decreased to 65% in 2021, and further to 59% in 2022, indicating a return to pre-pandemic levels observed in 2019 (Figure B.12).

Our survey finds a decreasing number of SMEs have been able to acquire the full amount of finance they require from a single provider, compared to previous years. Historically, over 80% of SMEs reported obtaining the entire amount of finance requested from their initial provider, however, this figure dropped for the first time to 64% in 2022. This trend may also explain the increased tendency of SMEs to seek financing from multiple providers, at 32%.

In 2022, the median value of financing sought increased. Companies that anticipate substantial growth of 20% or more in the next 12 months tend to seek higher levels of financing, with a median value of £20,000, compared to the overall median value of £14,000. Medium-sized businesses are the highest requesters of finance, with a median value of £300,000, compared to small and micro firms, which have median values of £50,000 and £24,000, respectively. This suggests, businesses with employees remain more likely to seek higher values than those with no employees.

Almost four in 10 SMEs currently use trade credit, reducing the need for external finance in some businesses

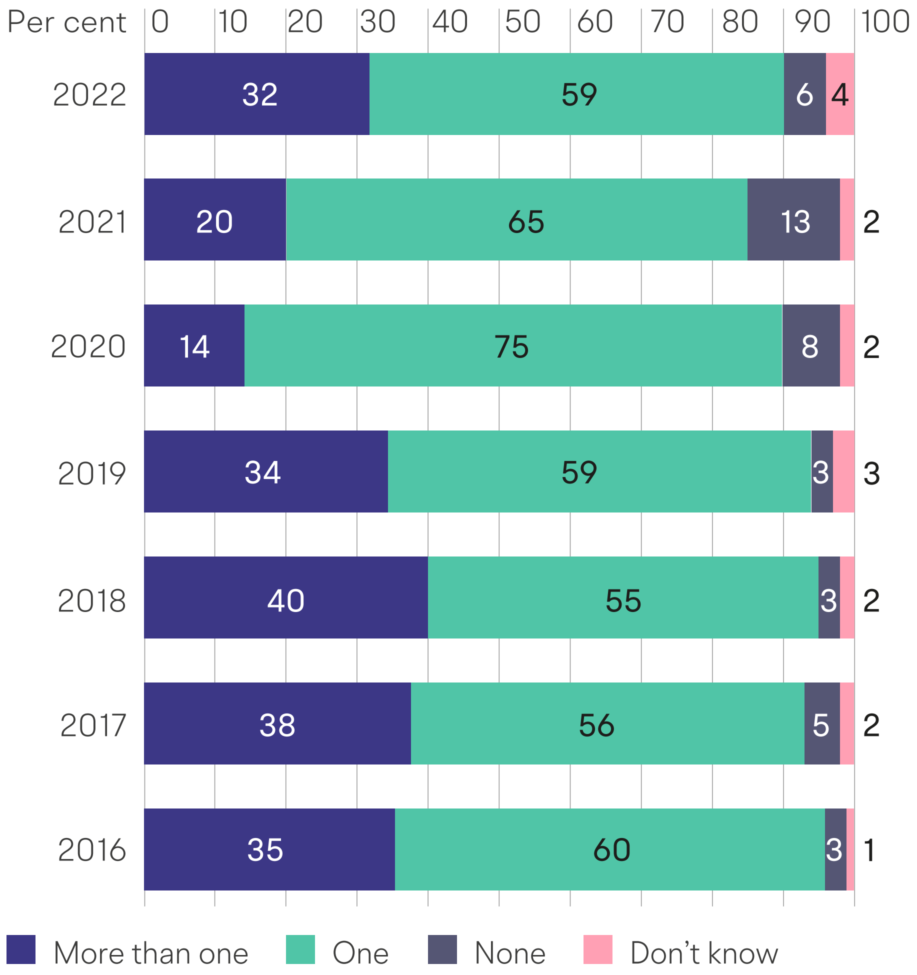
Trade credit is an agreement between a buyer and seller, whereby the buyer of the goods or service can delay the payment for an agreed period of time. Trade credit can help the buyer to manage their cashflow but is not included in the SME Finance Monitor definition of external finance.

The use of trade credit remained stable in the first half of 2022 (38%) in comparison to the previous year. A fifth (21%) of all SMEs said trade credit reduced their need for finance. However, trade credit and external finance

Figure B.12

Number of providers considered from 2016–2022 (%)

Source: British Business Bank Business Finance Survey – Ipsos MORI. All who sought non-government-backed* finance in the last 3 years (n=498)
*Changed in 2022



are increasingly being used to complement each other with almost two out of 10 (18%) smaller businesses using both trade credit and external finance (Figure B.13).[84]

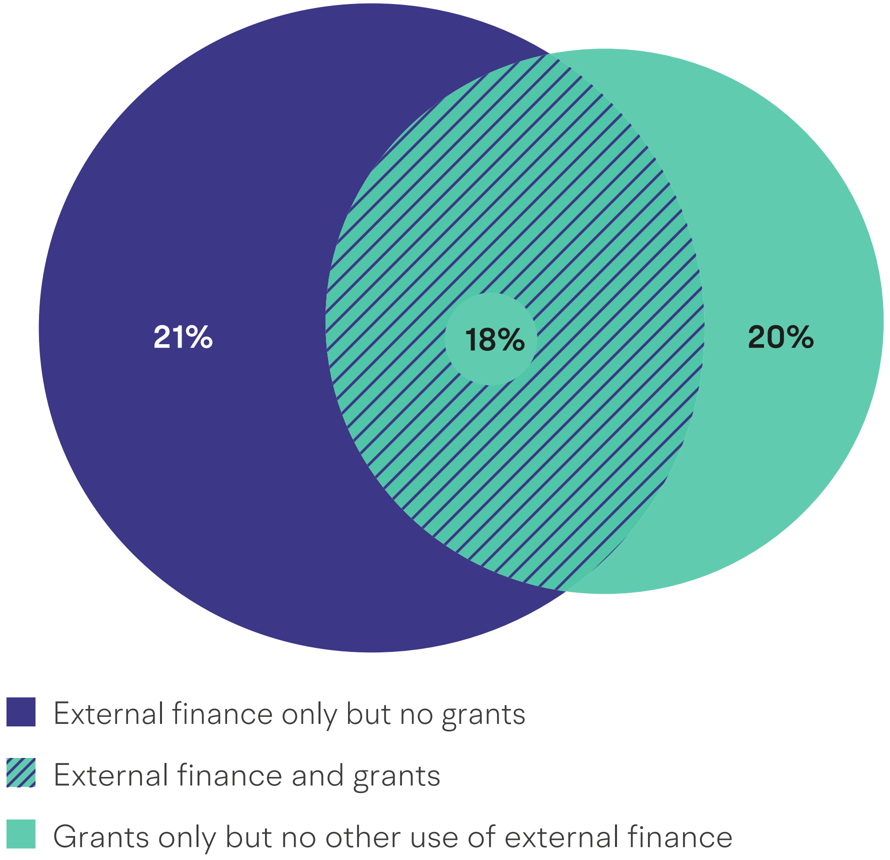
While the SME Finance Monitor showed the use of trade credit overall has remained largely stable overall, there are variations by size of business. Medium sized firms (50–249 employees) increased their trade credit usage in Q2 2022 to 68%, from 64% in 2021. In the same period small firms (10–49 employees) decreased their trade credit usage by three percentage points to 72%.

In the 2022 Q4 of the Bank of England's Agents' summary of business conditions[85] (based on consultations with companies including SMEs) noted that trade credit insurance cover tightened for companies in more vulnerable sectors, such as Retail, Leisure, and Construction. The SME Finance Monitor also shows that firms in both Retail, and Construction and Manufacturing sectors were the highest users of trade credit with 51% respectively. In the access to finance ecosystem trade credit remains for many SMEs an important source of finance as it can act either as a substitute or complement for external finance.

Figure B.13

SMEs receiving trade credit and external finance in H2 2022

Source: British Business Bank analysis of UK Finance/BVA BDRC SME Finance Monitor, Q2 2022, n=1,184



2.3

Access to finance for female and Ethnic Minority entrepreneurs

Expectation of rejection and concerns over cost of finance prevent some Ethnic Minority-led and female-led businesses from applying

Challenges faced by Ethnic Minority and female entrepreneurs in accessing finance have led to difficulties in investing in their businesses or needing to draw on personal funds

Ethnic Minority-led businesses are more likely than other businesses to consider applying for finance over 2023

The Bank is improving its reporting on diversity in its programmes to better measure its reach and impact, and is encouraging partners to do the same

Sustainable finance is the inclusion of environmental, social, and governance (ESG) factors in financial decision-making. It covers the use of finance to fund environmentally and socially sustainable projects, supporting the transition to a more equitable economy, while generating financial returns for investors. It is increasingly important, as governments, businesses and investors seek to address sustainability challenges. The focus of sustainable finance in existing literature and research is the environmental aspect in ESG, but according to research the social and governance aspects are also highly correlated.[86]

The following chapters combine aspects of social and environmental considerations in access to finance and look at the relationship between owner/manager characteristics and sustainability. Challenges faced by smaller businesses are highlighted, with a particular focus on gender and ethnicity, reflecting data availability. The Bank recognises that a wider range of factors including socioeconomic background, place, age, disability, education, income, working hours and caring responsibilities can influence or exacerbate access to finance challenges. Previous Bank research has highlighted that intersectionality of these characteristics can compound disparities in outcomes, for example female entrepreneurs from Ethnic Minority backgrounds.[87]

We have followed definitions adopted within our source survey data to ensure consistency between datasets. Where sample size allows, we have reported results for grouping of ethnicities such as 'Black', 'Asian and other Ethnic Minority' and 'White', reflecting definitions adopted for our Alone, Together research.[88] We recognise the imperfect nature of grouping diverse entrepreneurs and businesses along these lines and welcome further engagement on data collection to reflect diversity.

Expectation of rejection and concerns over cost of finance prevent some Ethnic Minority-led and female-led businesses from applying

Around 5–8% of smaller businesses are led by an individual or team identifying as being from an Ethnic Minority background,[89] but around 18% of the population are from an Ethnic Minority background.[90] Research suggests Ethnic Minorities in the UK are more entrepreneurial than the White population, but are less likely to run older, established firms that generate stable income.[91] Combined with issues around survey definitions and design,[92] and self-reporting/identification of ethnicity, this is likely to account for the difference between the business and wider population. Ethnic Minority-led business are more likely to be in the information/communication or other services sectors and around half of Black-led and Asian and other Ethnic Minority-led businesses are London-based. Ethnic Minority-led businesses are more likely to be younger or smaller businesses, with 86% of Black-led businesses being sole trader/zero employee firms.[93]

Around 20%-22% of the UK's business population is female-led. Female-led businesses are more likely to be in retail, hospitality, business/support services, health/social work, education, arts/entertainment and other services sectors.[94]

Black and Asian and other Ethnic Minority-led businesses are more prepared to take risks and have stronger growth ambitions than White-led businesses (Figure B.14). Asian and other Ethnic Minority-led businesses are more willing to use finance to achieve this growth.

Female-led businesses are as ambitious as male-led businesses but are slightly less prepared to take risks and less willing to use external finance to help grow their business. This may reflect concerns over uncertainty and affordability: more female-led businesses agreed they were being cautious with business plans because the future felt uncertain. 58% agreed that a further increase in the cost of credit would reduce their likelihood of applying for finance (51% of male-led businesses).[95] Women entrepreneurs face higher barriers in accessing wider institutional and family support, possibly contributing towards different attitudes to risk and finance use.[96]

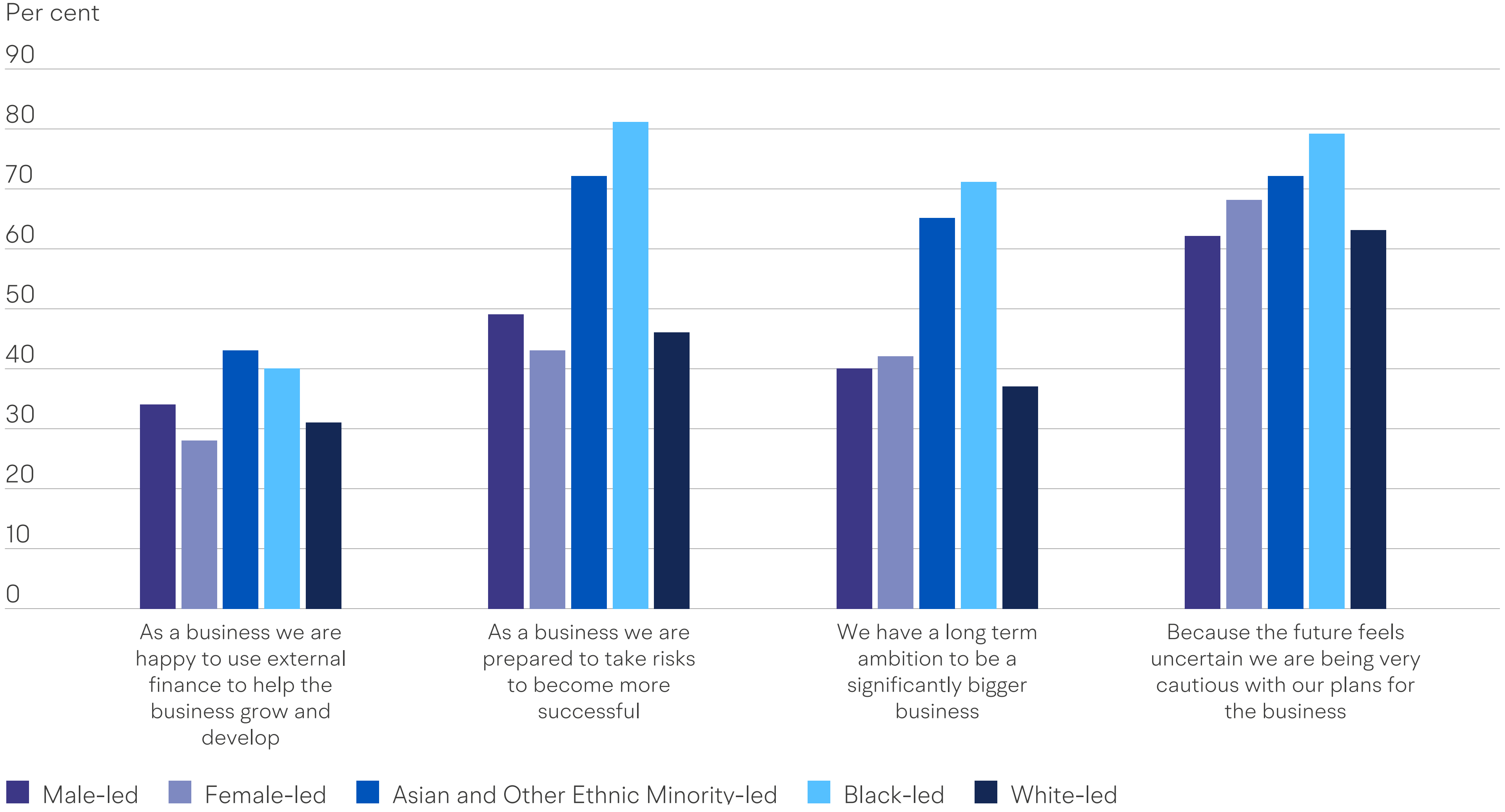
Despite greater willingness to use finance, half of Black-led businesses thought it would be difficult for their business to get finance in the year ending Q2 2022 (51%, compared with 38% of Asian and other Ethnic Minority-led businesses and 31% of White-led businesses).[97] This is similar to previous year (53% in the year ending Q2 2021) but highlights the differences between different Ethnic Minority groups.

Black, Asian and other Ethnic Minority-led businesses were around three times as likely to see access to finance as a barrier to running their business compared

Figure B.14

Willingness to use finance to grow, willingness to take risks, growth aspirations and caution around business plans by ethnicity and gender of business owner/partner(s)

Source: UK Finance/BVA BDRC SME Finance Monitor, 4 quarters to Q2 2022, n=12,608 with known ethnicity, n=16,094 with known gender



to White-led firms (31%, 27% and 10% respectively) (Figure B.15). This represents a wider gap than in previous years, when Ethnic Minority-led businesses were around twice as likely to see finance as an obstacle compared with other businesses (23% and 12% respectively).[98]

Female or Ethnic Minority-led businesses have typically been more likely to say they had needed finance or wanted to apply over the past year, but something stopped them applying.[99] Estimates for the year ending Q2 2022 suggest 8% of Ethnic Minority-led businesses said something stopped them from applying, compared to 2% of White-led businesses, with no significant difference by gender.[100]

BEIS' Longitudinal Small Business Survey suggests discouragement could be even higher, at 17% of Ethnic Minority-led firms and 11% of female-led firms in 2021. Of businesses that needed finance but didn't apply, concerns over cost and expectation of rejection were significantly higher for Ethnic Minority-led businesses (Figure B.16). 64% of Ethnic Minority-led businesses cited cost as a reason for not applying in 2021, an increase from 50% in 2020, while 57% said they thought they would be rejected, compared to 46% in 2020.[101] Concerns over cost of credit, likelihood of rejection and credit history were particularly common for zero employee, Ethnic Minority-led businesses.[102]

Female-led businesses were less likely to report some reasons for discouragement, but significantly more likely to think the decision would take too long. Female-led businesses were significantly more likely to say cost was their main reason for not applying. Evidence from the SME Finance Monitor also suggests female-led businesses are more hesitant to go through the application process or are more reluctant to lose control of their business.[103]

The evidence suggests female-led businesses could be more price-sensitive to the cost of external finance and more likely to see the application process as a barrier. Higher operating costs and interest rates could be contributing to reluctance to apply for finance among smaller businesses and exacerbating discouragement issues for female-led businesses. Discouragement from applying could act as a growth constraint to businesses that want or need finance. The consequences of unmet demand for finance are discussed in the next section.

Figure B.15

Access to finance is an obstacle to running the business as they would want over the next 12 months, by ethnicity or gender of business owner/partner(s)

Source: UK Finance/BVA BDRC SME Finance Monitor, 4 quarters to Q2 2022, % share that answered 6–10 on a scale of 1–10 where 1 means not an obstacle at all and 10 is a major obstacle

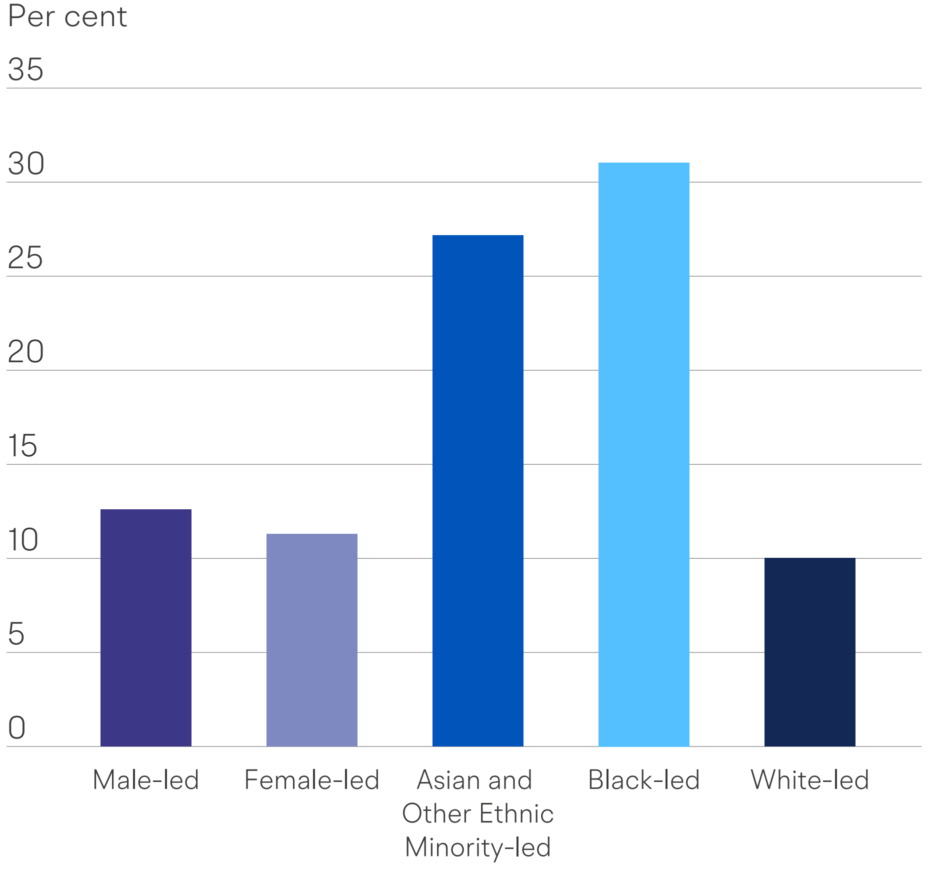
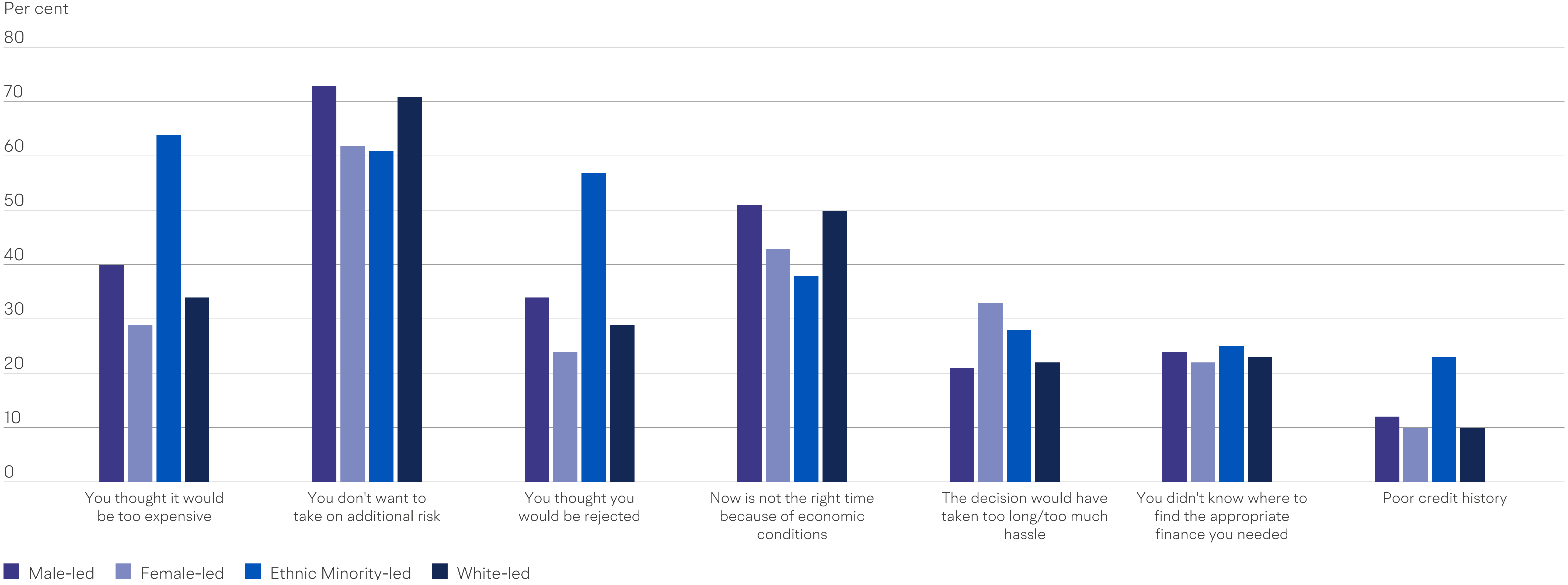


Figure B.16

Reasons for discouragement amongst businesses that needed finance but didn’t apply, by gender or ethnicity of business owner/partner(s)

Source: BEIS Longitudinal Small Business Survey, 2021, n=752



Challenges faced by Ethnic Minority or female entrepreneurs in accessing finance have led to difficulties in investing in their businesses or needing to draw on personal funds

As in the broader market, application rates for Ethnic Minority and female-led businesses peaked in 2020–21 and have since returned to lower levels (14% for both).[104] Fewer female-led businesses went straight to their main bank with a finance need and more considered more than one provider.[105]

In terms of success rates for applications, it should be noted that there has been a period of significant change in this market. The introduction of government-backed loan schemes in Q2 2020 resulted in a period of significant borrowing activity, followed by the closure of these schemes in Q2 2021. It is likely that wider changes in the market, including the end of the Bounce Back Loans and Coronavirus Business Interruption Loans schemes, are playing a role in lower success rates amongst all smaller businesses over this period.

In the 10 quarters to Q2 2022, Ethnic Minority-led businesses were more likely to be turned down for finance, a continuation of the trend highlighted in the 2021/22 Small Business Finance Markets report. Due to low base sizes, it is difficult to pinpoint which factors could contribute to differences and surveys are unable to capture influential factors like presentation of applications and providers' willingness to lend. Risk, age of business and track record play a role in lending decisions.[106] Younger and smaller businesses face higher rejection rates and Ethnic Minority-led businesses are typically younger and smaller than their White-led counterparts.[107] There were no significant differences by gender.[108]

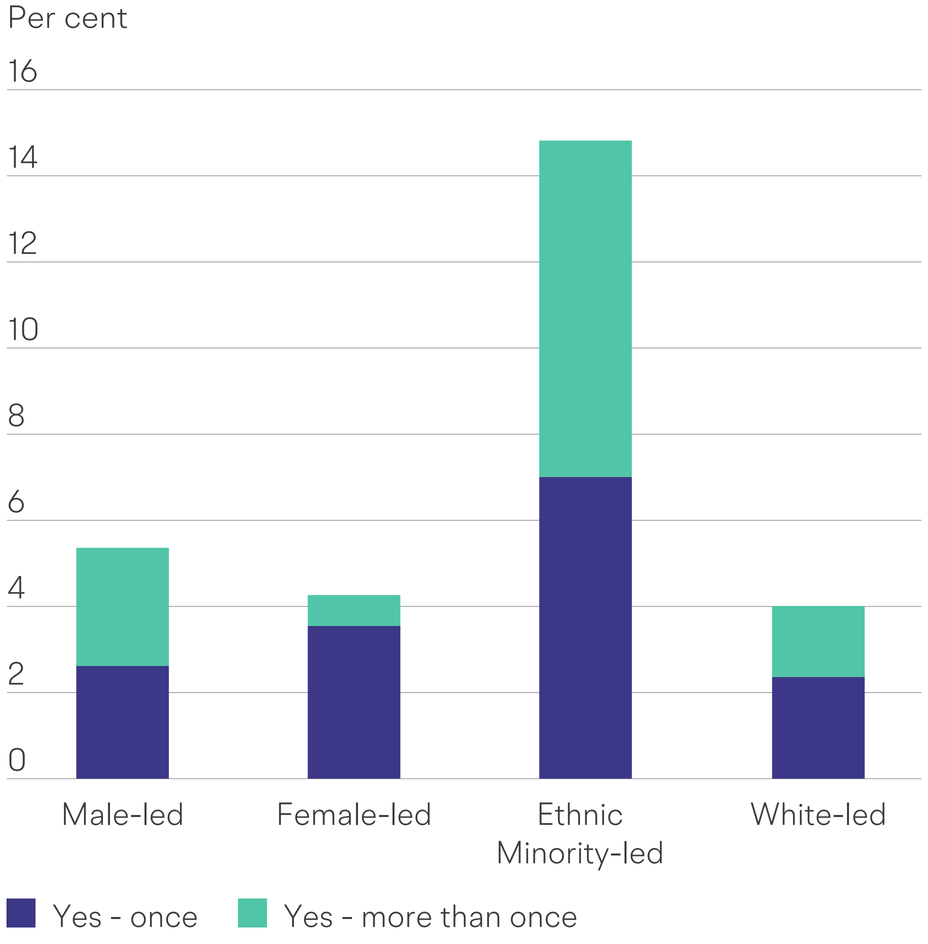
Differences in application outcomes have persisted over time. Ethnic Minority-led businesses were significantly more likely to report having their application rejected over the past ten years: 15% had been rejected at least once, compared to 4% of other businesses (Figure B.17). Female-led, Ethnic Minority-led businesses were significantly more likely to have been rejected for finance.[109]

More Ethnic Minority-led businesses reported being rejected due to low credit rating (51% compared to 23% of other businesses) or insufficient security (45% compared to 18% of other businesses). Some Ethnic Minority-led businesses could lack the collateral required for secured lending or other types of finance.[110]

Figure B.17

Share of smaller businesses with finance application rejected in the past ten years, by gender or ethnicity of business owner/partner(s)

Source: BEIS Longitudinal Small Business Survey, 2021, n=4,567, of which n=287 Ethnic Minority-led



Ethnic Minority-led businesses that didn't receive all the finance they sought for cashflow were more likely to say they paid suppliers late or increased use of existing credit cards or overdrafts.[111] Of businesses that were unable to access finance or were discouraged from applying, Ethnic Minority-led businesses were more likely to highlight consequences of this unmet demand in terms of investment, working capital, marketing and staff recruitment and development (Figure B.18). Female-led businesses were more likely to highlight implications for other investment in their business.[112]

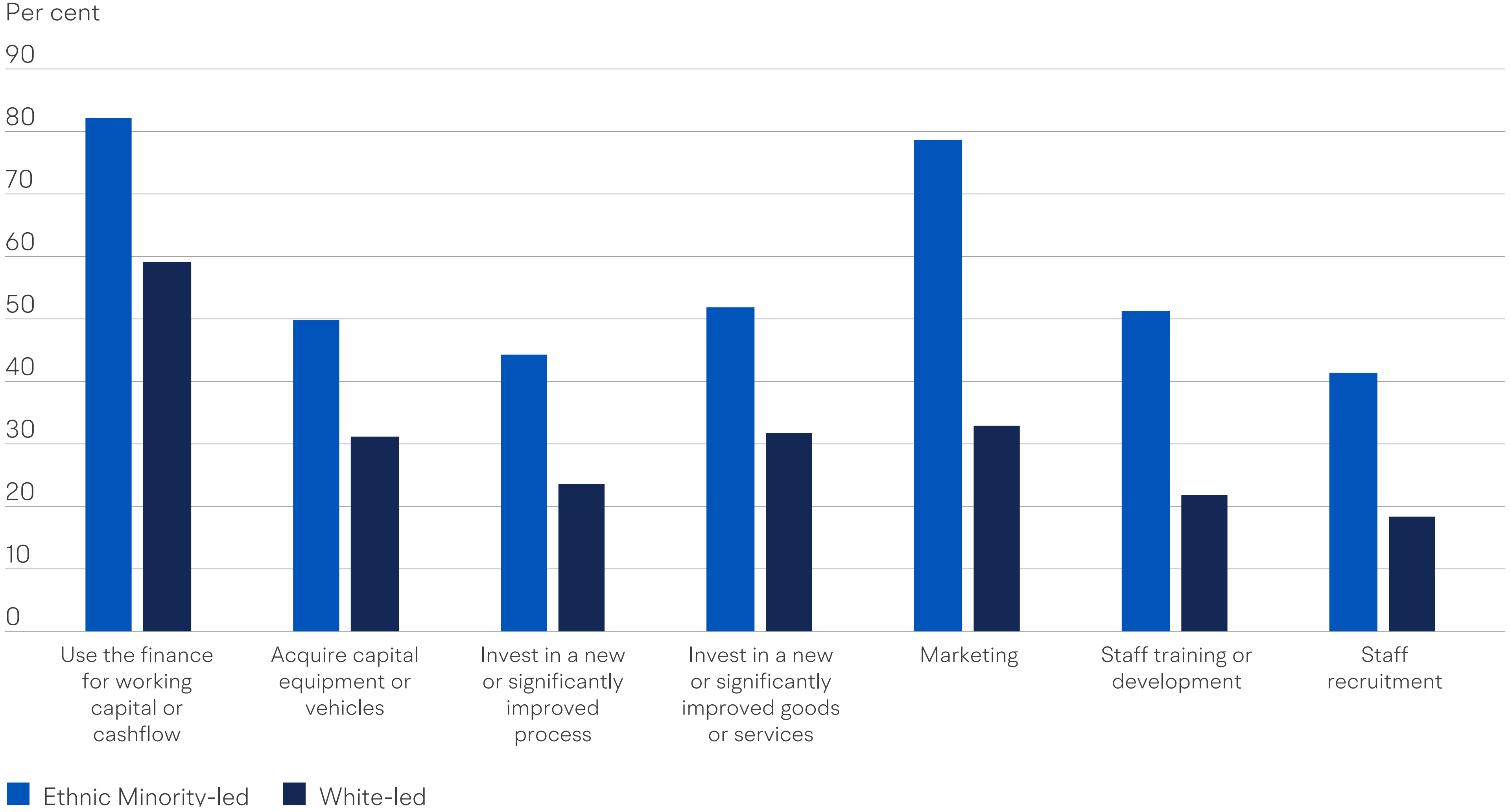
Use of finance by Ethnic Minority-led businesses and female-led businesses is at similar levels to their counterparts.[113] Asian and other Ethnic Minority-led businesses are more likely to use loans from directors or friends or family. 10% of Ethnic Minority-led businesses had sought only government-backed finance only in the past three years, compared with 3% of White-led firms.[114] Female-led businesses are more likely to be using grants.[115]

The share of equity investment into mixed gender teams has grown, but the share of investment and deals going to all female teams remains low, at 2% and 7%

Figure B.18

Inability to invest or spend on the business, as a share of those unable to access finance, by ethnicity of business owner/partner(s)

Source: BEIS Longitudinal Small Business Survey, 2021, n=846. Nb. only significant differences shown



respectively.[116] This is a particular issue in follow-on funding and at larger deal sizes. The share of VC investment going to Ethnic Minority founders remains unknown, with some estimates placing this at less than 1%.[117]

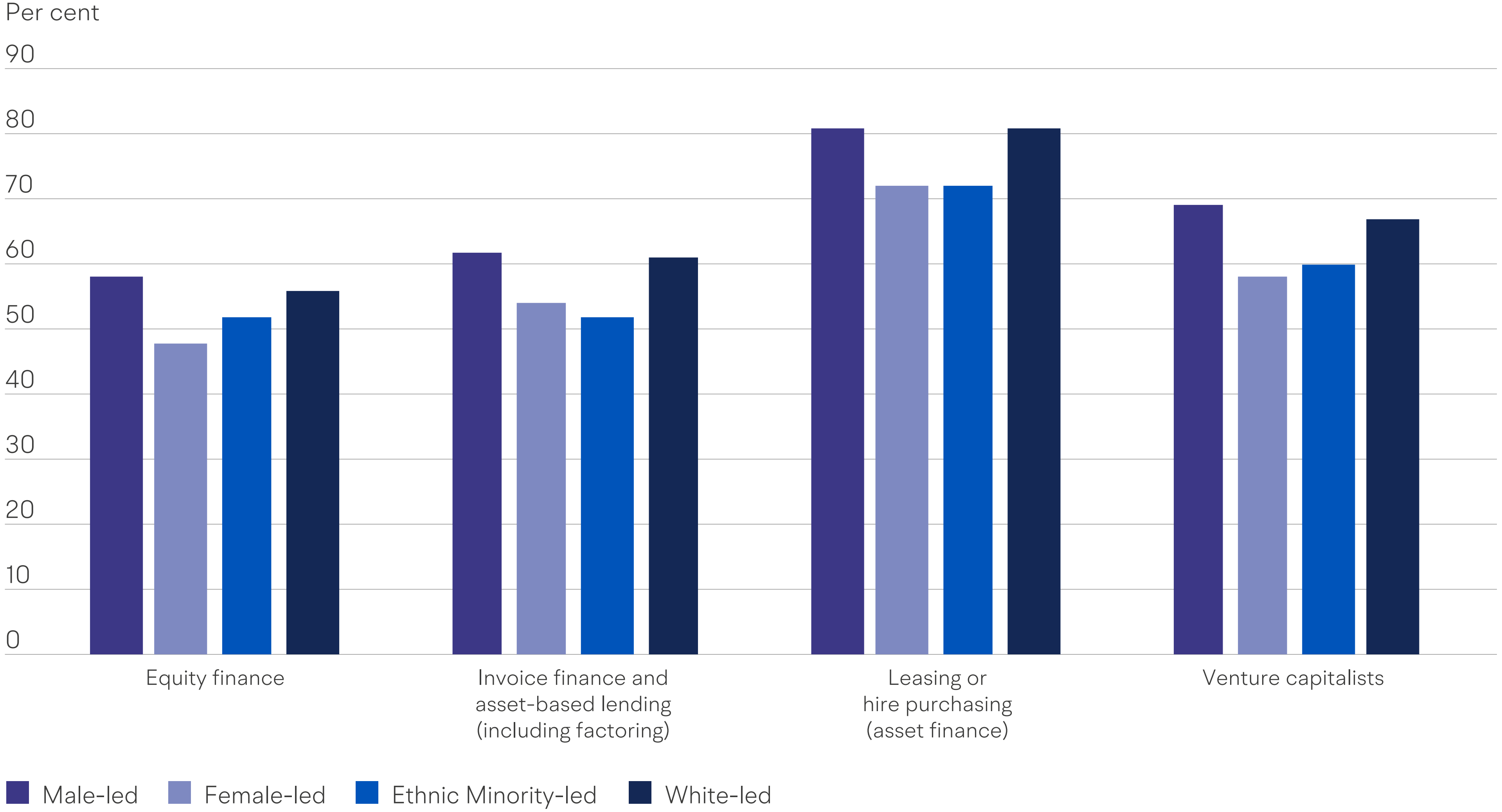
Different levels of awareness could play a role (Figure B.19): female-led businesses have lower awareness of some alternative finance types. For Ethnic Minority-led businesses, the differences are not significant, possibly reflective of lower base sizes. Of businesses aware of equity, Ethnic Minority-led businesses were slightly more willing to consider applying.[118] In the year ending Q2 2022, Ethnic Minority-led businesses were more likely to apply for equity to third parties (3.1% of all those that applied for any finance, compared to 0.1% of White-led businesses, asked of companies only).[119]

Once in the pipeline, data suggests that diverse founder teams may have a lower chance of receiving funding. A third (34%) of Investing in Women Code (IWC) signatories' deals were in teams with at least one female founder and 9% were in all female teams, outperforming the wider market. In contrast to earlier evidence, progression rates for female teams from investment committee to receiving funding were lower than for

Figure B.19

Awareness of selected alternative finance types, by gender or ethnicity of business owner/partner(s)

Source: British Business Bank Business Finance Survey – Ipsos MORI, Base = all businesses (n=2,213 in 2022)



other teams in 2021, so we will monitor this trend to see whether it continues.[120]

Differences persist for other groups too. Just 17% of disabled entrepreneurs said they were treated equally to non-disabled entrepreneurs when seeking investment, with 84% believing they don't have equal access to the same opportunities and resources as other entrepreneurs. Half (50%) said they didn't have the same access to investors as non-disabled entrepreneurs.[121]

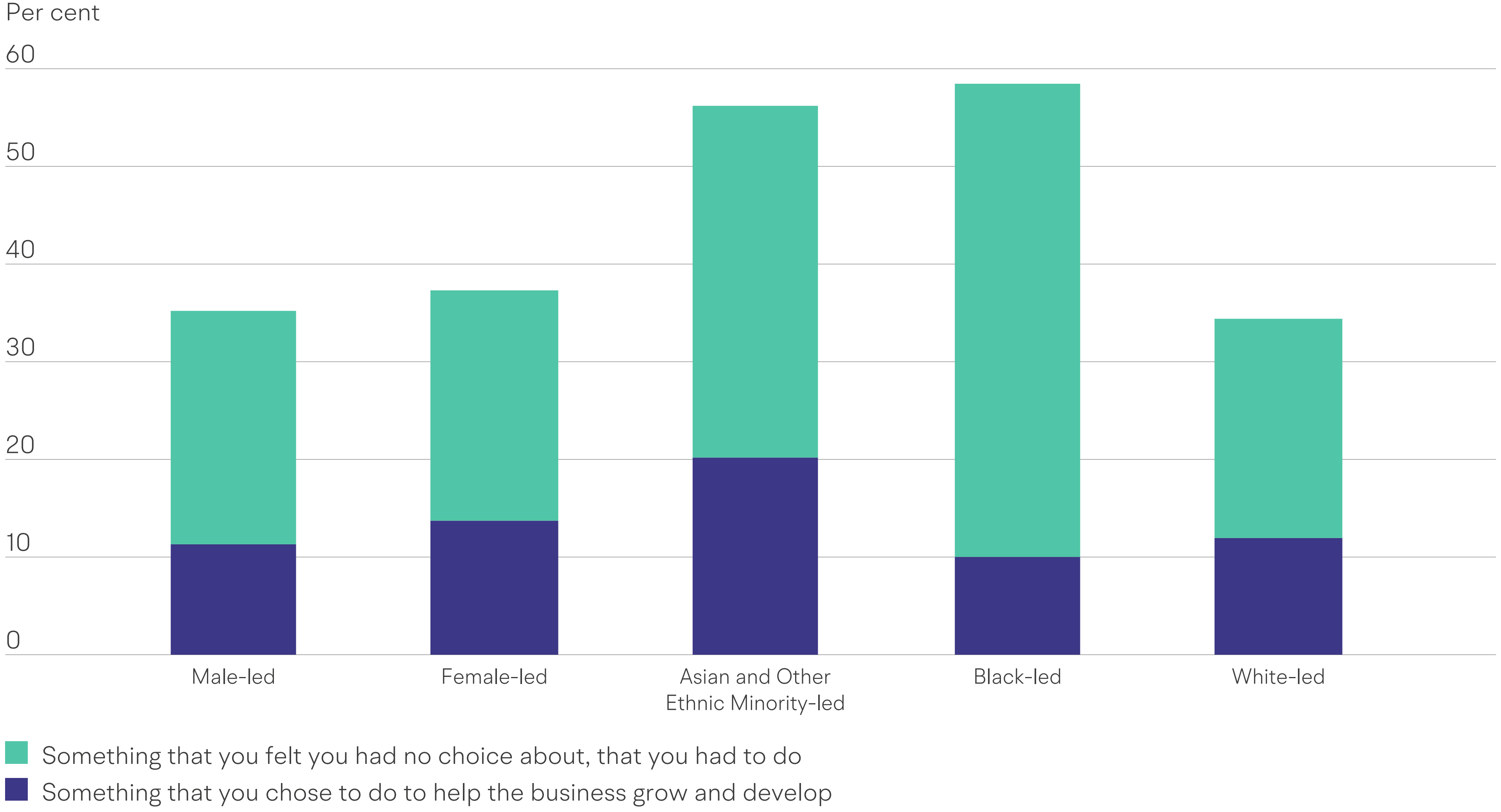
Perhaps reflecting challenges in accessing external finance, more Black and Asian and other Ethnic Minority owners/managers have put their own funds into their businesses than other smaller businesses. Half (49%) of Black-led businesses and a third (36%) of Asian and other Ethnic Minority-led businesses felt they had no choice and had to do so (Figure B.20).

Drawing on personal funds might not be a possibility for some entrepreneurs, particularly those with lower incomes. Previous Bank research has highlighted the link between lower income and coming from an Ethnic Minority background, leading to worse entrepreneurial outcomes.[122] For some businesses, their characteristics, status or location may contribute towards challenges in funding their business, whether through their own

Figure B.20

Reasons for injecting personal funds in the business, by gender or ethnicity of business owner/partner(s)

Source: UK Finance/BVA BDRC SME Finance Monitor, 4 quarters to Q2 2022, n=12,608 with known ethnicity, n=16,094 with known gender



resources or accessing external finance. This acts as a constraint on the growth and the survival of their business. The Bank has commissioned research to identify actions that finance providers and investors can take to allocate more funding to underrepresented founders.

Ethnic Minority-led businesses are more likely than other businesses to consider applying for finance over 2023

Significantly more Asian and other Ethnic Minority-led businesses and Black-led businesses expected to have a need for (more) finance in the next 3 months, apply for more finance or inject personal funds than White-led businesses (Figure B.21) (note, responses are from July 2021 to June 2022 so relate to funding needs up to September 2022). There were no significant differences in future appetite for finance by gender.

In the Bank's Business Finance Survey, conducted between October 2022 and January 2023, Ethnic Minority-led businesses were more likely to say they were considering applying for any finance over the next 12 months (54% compared to 40% of White-led firms)

Figure B.21

Plans to fund business in the next 3 months, by gender or ethnicity of business owner/partner(s)

Source: UK Finance/BVA BDRC SME Finance Monitor, 4 quarters to Q2 2022

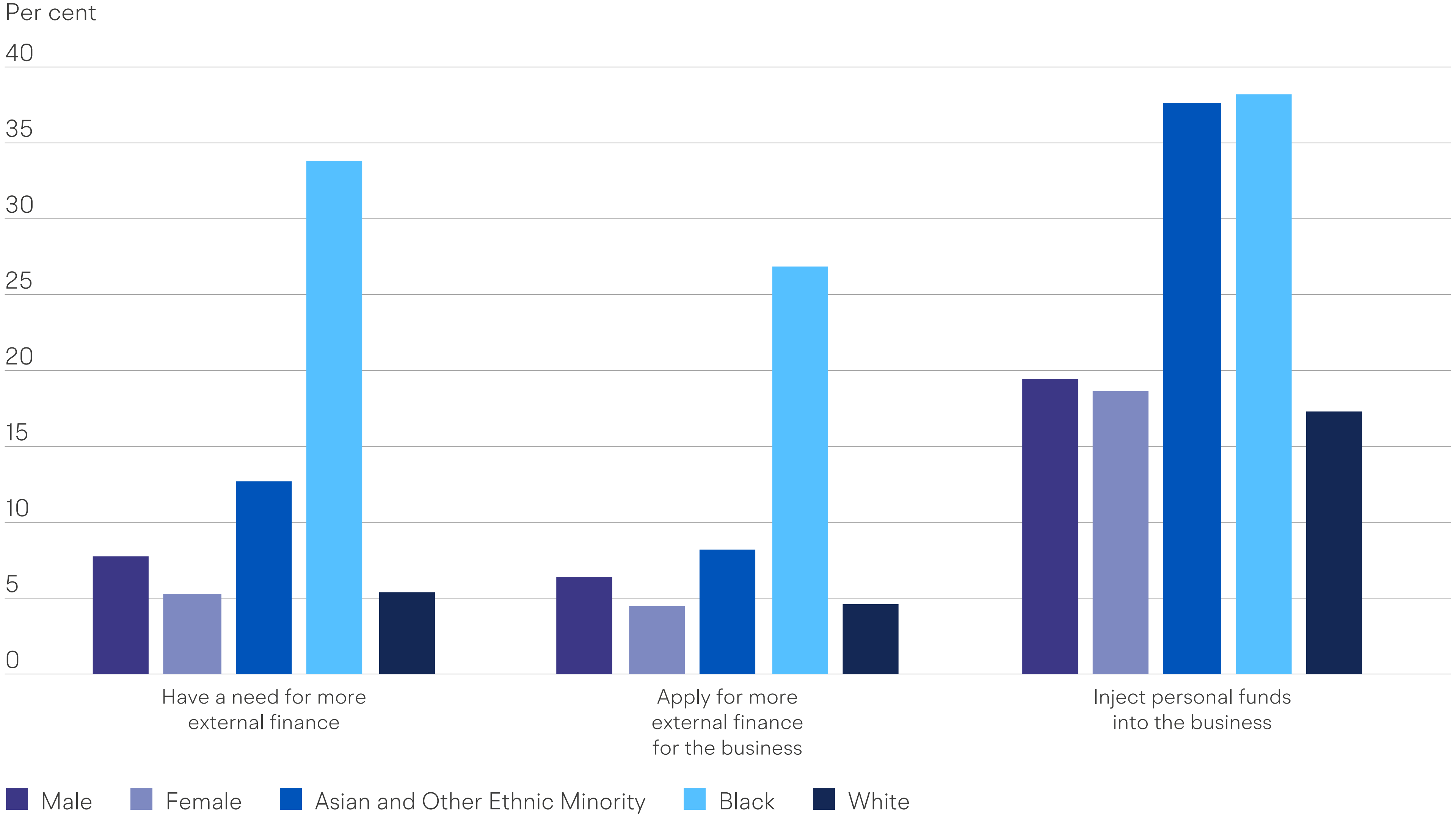
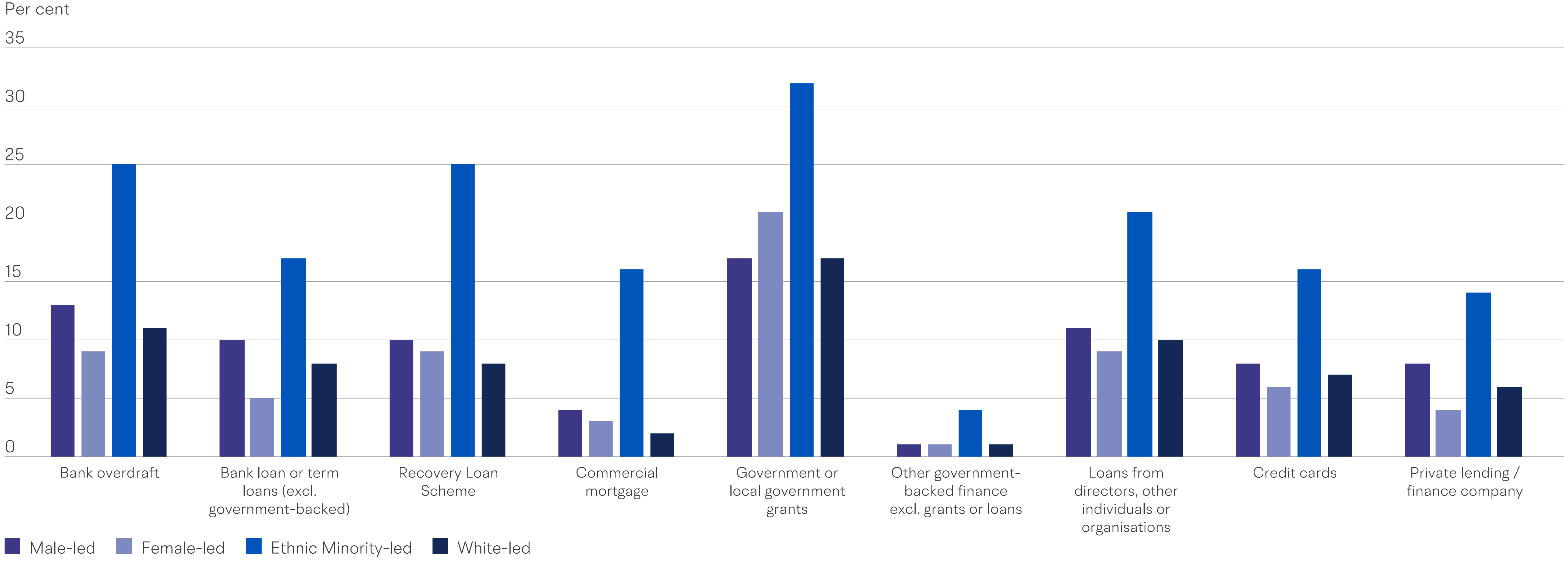


Figure B.22

Considering applying for in next 12 months, by gender or ethnicity of business owner/partner(s)

Source: British Business Bank Business Finance Survey – Ipsos MORI, Base = all businesses (n=1,169 in 2022) *Nb. Only those finance types with significant differences for Ethnic Minority-led businesses compared to White-led businesses are shown



and more likely to consider most finance types (Figure B.22), with no significant differences for female-led firms. This is similar to 2021, where 49% of Ethnic Minority-led firms planned to apply for one or more forms of external finance, compared to 33% of White-led firms.[123]

More broadly, over the next 12 months, 21% of Ethnic Minority-led businesses planned to use government-backed finance (compared to 8% of White-led businesses) and 34% planned to draw on personal cash reserves (20% of White-led businesses). It's likely that increasing cost pressures, along with a higher interest rate environment, could lead to more smaller businesses needing additional funding in 2023.

The Bank is improving its reporting on diversity in its programmes to better measure its reach and impact and is encouraging partners to do the same

The Bank is strengthening its own efforts in collecting and reporting on diversity, as a signatory to the Principles for Responsible Investment, to help detail the reach of Bank programmes to underserved markets. Our equity programmes are increasing reporting diversity characteristics of fund managers and portfolio company staff. Start Up Loans will be enhancing the information collected on a wider range of protected characteristics in order to continue to provide an inclusive and accessible service, and remove barriers to finance. Alongside measuring economic impact, recent programme evaluations have measured the share of funding to female-led and Ethnic Minority-led smaller businesses.

The Bank is also taking steps to improve the accessibility of programmes: through our partnerships with the Royal National Institute of Blind People (RNIB) and SignLive, we are ensuring that all the Bank's customer-facing channels are accessible to people with sight and hearing loss. More information is available on the Bank's website.

The Bank recognises there is more to be done in ensuring that talented entrepreneurs can access finance regardless of their background or characteristics. To inform and shape these efforts, the Bank has commissioned research on the effectiveness of actions focussed on improving diversity in the VC industry.

The Bank continues to work with delivery partners to encourage participation in the Investing in Women Code and report on signatories' investments by gender, with around a third (34%) of deals going to teams with at least one female founder.[124] VC and angel signatories are also given the opportunity to report ethnicity data to help inform ongoing plans for data collection in the industry. There are over 130 VC signatories to the Code, and over 190 in total.

2.4

Finance for environmental sustainability

Economic headwinds are testing smaller businesses' ability to become more environmentally sustainable, but their engagement remains high

Demand for external finance is relatively high among smaller businesses that prioritise environmental sustainability, highlighting the importance of aligning finance supply with the net zero agenda

Female and Ethnic Minority founders and owners have social and environmental goals and prioritise these more

The Bank is improving its reporting on environmental sustainability in its programmes to better measure its reach and impact, and is encouraging partners to do the same

Smaller businesses' demand for sustainable finance is tempered by awareness gaps, particularly on how and where to start their net zero journey, alongside capacity and resource constraints. On the supply side, finance providers need ESG data to integrate sustainability factors in their decisions, requiring new data collection processes that may be challenging for smaller businesses.

In 2021, the Bank's data showed the majority of SMEs demonstrated reasonable awareness of environmental sustainability, and saw this as a business priority.[125] Our analysis also showed a significant share of SMEs were taking – or planning to take - emission-reducing actions, particularly in priority areas such as energy efficiency. Consistent with this, more than one in five said they would consider using external finance to support future actions.

The business environment for smaller businesses has become more challenging since then. Soaring inflation, energy market turmoil and continuing supply chain disruptions (see the Chapter dedicated to Macroeconomic Developments) have put huge pressure on operating costs, at the same time dampening business investment and consumer confidence. Rising interest rates also meant a steep rise in borrowing costs for both households and businesses.

Using our latest Business Finance survey results, in this section we explore whether there have been any changes in smaller businesses' attitudes and progress on environmental sustainability over the past year, as well as consider their implications on demand for sustainable finance.

Economic headwinds are testing smaller businesses' ability to become more environmentally sustainable, but their engagement remains high

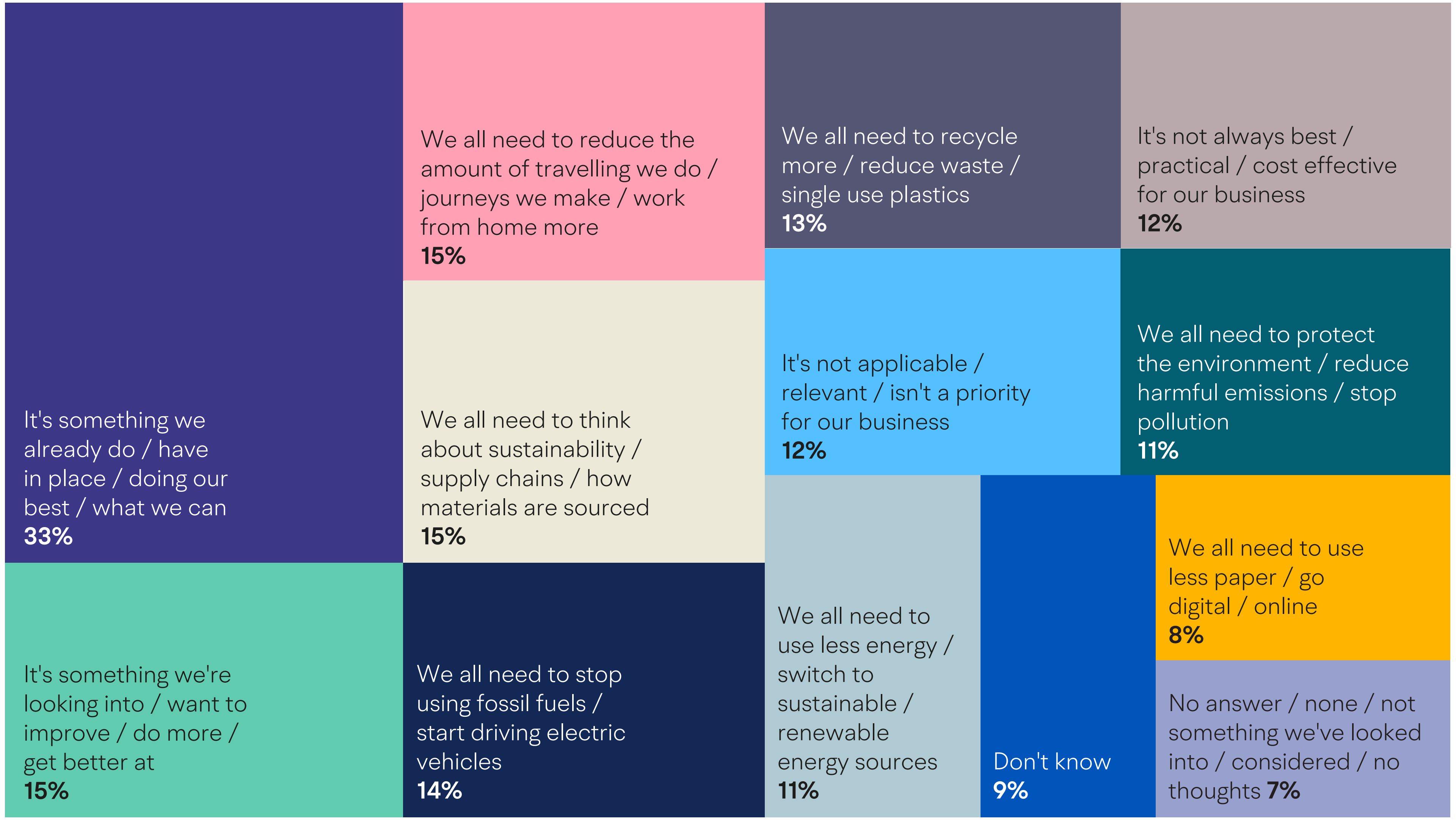
Access to environmentally sustainable finance is closely connected with businesses' perceptions and awareness of, and their commitment to, taking action on environmental sustainability. When asked about their thoughts on environmental sustainability (Figure B.23), most SMEs continue to view this as an important issue. Many are aware that they need to step up their efforts to properly address climate challenges – in fact, 15% recognise this is something they need to do more of/get better at – but around a third believe they are already doing what they can. By comparison, the proportions of SMEs that express negative views on environmental sustainability are relatively small, with only 7% stating they have not looked into this issue and 12% considering it as not important, or something that might not be best/practical/cost-effective for their business.

Despite this, in 2022 we see a noticeable dip in the share of businesses that say they know a lot or fair amount about the government's net zero target and the implications of climate change for their business compared with 2021 (Figure B.24). This could be due to economic conditions forcing many businesses to spend less time on environmental sustainability and refocus on other priority areas, which could make them feel less confident about their awareness of this issue.

Figure B.23

SMEs' thoughts and feelings about environmental sustainability – top answers (>5%)

Source: British Business Bank Business Finance Survey – Ipsos MORI, Base = all businesses (n=1,169 in 2022)

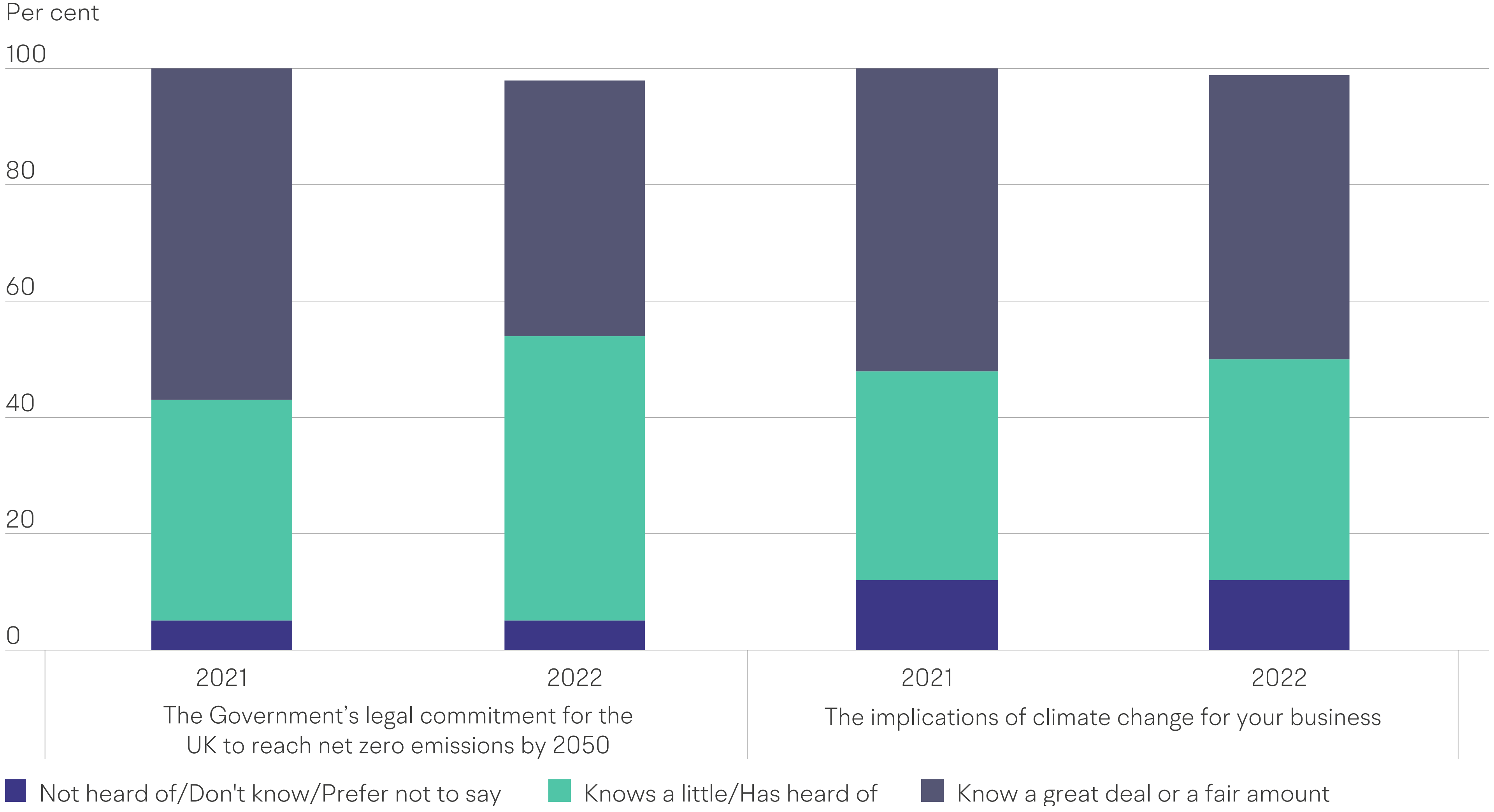


This is also matched by the change in the share of SMEs that say environmental sustainability is a priority, which has declined more sharply than awareness between 2021 (57%) and 2022 (46%). On one hand, this confirms that current economic headwinds are testing smaller business' commitment to environmental sustainability. On the other, it is encouraging that commitment levels remain relatively high, with roughly half of smaller businesses continuing to consider environmental sustainability as a key priority. In a survey of SMEs completed in July 2022, there was no noticeable change in this share compared to the previous year;[126] by contrast, further survey evidence collected in Q3 of 2022 indicates that three quarters of businesses of all sizes believed increasing costs had somehow impacted them. This proportion rose to more than 8 in 10 among businesses with 10–249 employees.[127]

Figure B.24

SMEs' awareness of the UK government's net zero target and the implications of climate change

Source: British Business Bank Business Finance Survey – Ipsos MORI, Base = all businesses (n=1,169 in 2022 and n= 1,323 in 2021)



Declining SME awareness and prioritisation of environmental sustainability is consistent with SMEs' current perceptions of the main obstacles to achieving this. In 2022, the prime concern for smaller businesses - irrespective of their age or size - was the economic conditions of the country and the impact these were having on them (Figure B.25). Two thirds (67%) of SMEs that prioritise environmental sustainability identified this as a key barrier. This was a particularly common view among businesses with turnover of less than £50k annually (76%).

In addition, almost a third (32%) said their ability to make changes to premises, buildings or suppliers was a challenge in their journey to environmental sustainability; this is often linked to external constraints that limit their autonomy to implement changes, such as rental/leasing agreements (for those that do not own their premises) or a lack of alternative lower-carbon suppliers for specific production inputs.

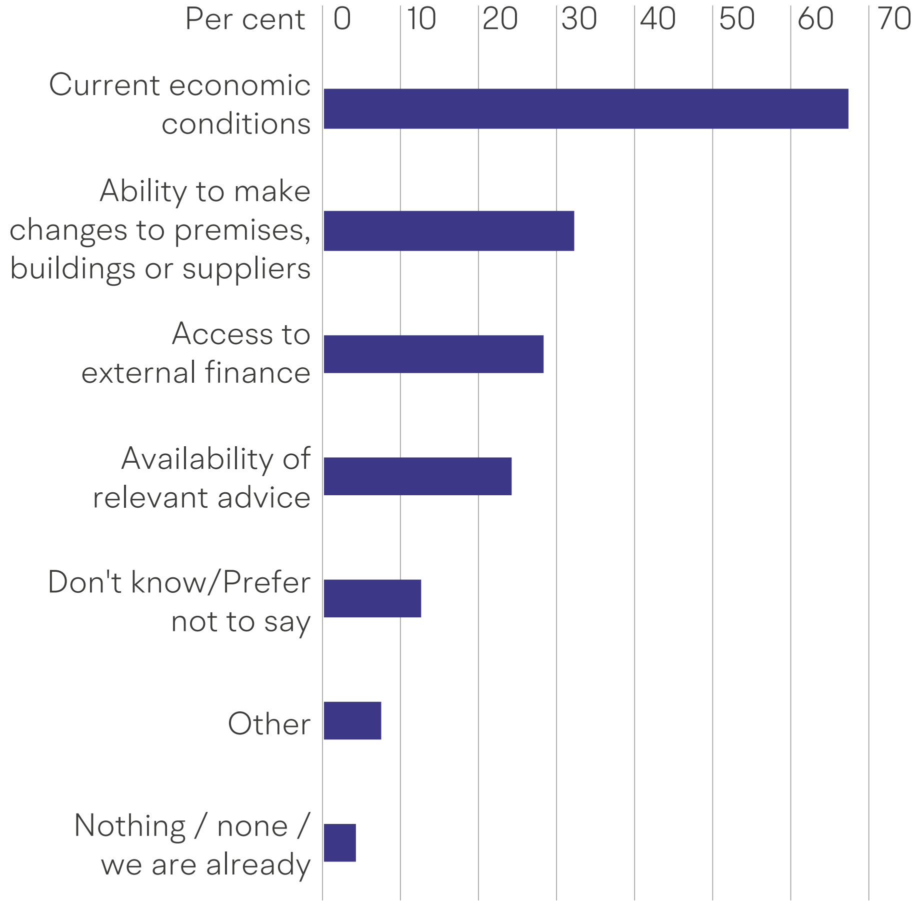
Access to external finance was also mentioned as a barrier by over one quarter (28%) of SMEs that prioritise environmental sustainability. Of these, nearly half were high growth firms established up to 5 years ago.

In terms of SME actions to reduce business emissions, the Bank's 2021 research on smaller businesses and net zero suggested that many were already taking or planning relevant steps, although most had opted for the less complex and resource-intensive actions (such as recycling).[128] This year we collected new data on SME emission-reducing actions, focusing specifically on energy efficiency-related steps, to understand if there had been any change in uptake following the energy market turmoil over the past year. This data (Figure B.26) suggests that more than a third of SMEs have achieved or planned some actions that will deliver progress on energy efficiency. Purchasing more efficient IT and office equipment is still one of the top action areas for SMEs, with 54% having done, doing, or planning to do so. Nevertheless, when we compare SME uptake of selected actions between 2022 and 2021 (which was possible for all actions except purchasing more energy efficient appliances and machinery), this is generally lower than the previous year.

Figure B.25

Main obstacles faced by businesses in trying to become more environmentally sustainable in the next 12 months

Source: British Business Bank Business Finance Survey – Ipsos MORI, Base = all businesses that consider environmental sustainability as a priority (n=542 in 2022)

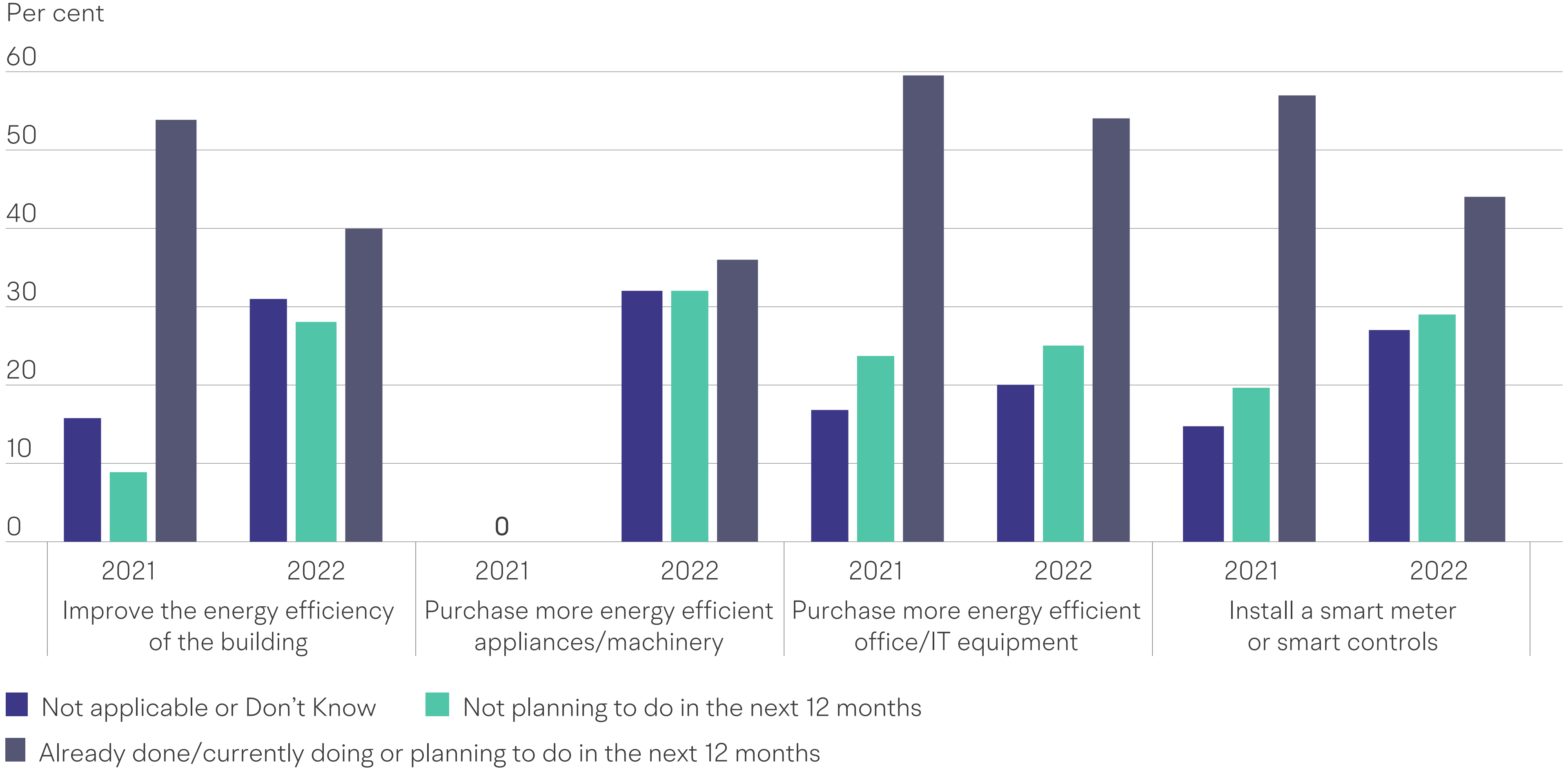


Overall, it is clear that environmental sustainability is becoming more difficult for SMEs to pursue in a more uncertain business environment. Yet, given these challenging circumstances, it is reassuring to see many continue to prioritise environmental sustainability and take any steps they can to achieve progress. The situation in the energy market is also continuing to evolve, with the latest data suggesting price inflation is starting to ease across G7 economies.[129] Therefore, it remains to be seen whether the energy market turmoil of 2022 will leave lasting effects on smaller businesses' demand for sustainable finance.

Figure B.26

Energy efficiency actions taken or planned by SMEs, 2021 vs 2022*

Source: British Business Bank Business Finance Survey – Ipsos MORI, Base = all businesses (n=1,169 in 2022); BBB net zero SME survey, Base = all businesses with separate physical premises (n=1,062 in 2021)



*Values for the category "Purchase more energy efficient appliances/machinery" are set at 0 in 2021 due to a lack of comparable data for that year.

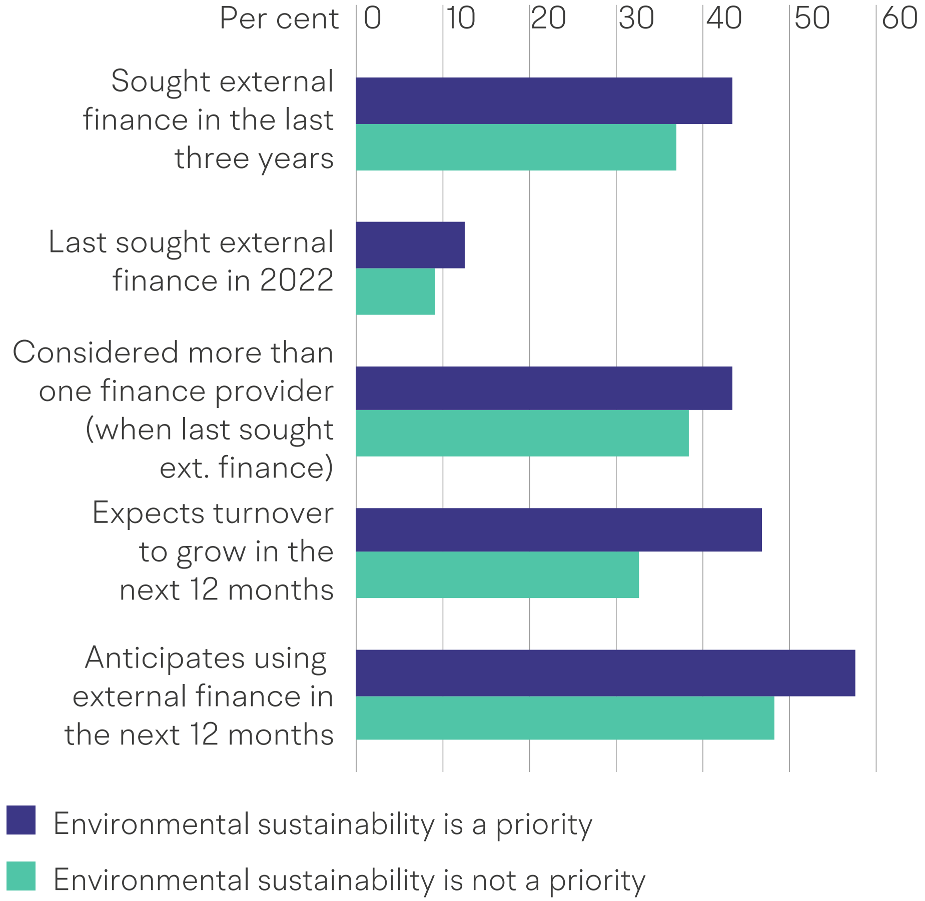
Demand for external finance is relatively high among smaller businesses that prioritise environmental sustainability, highlighting the importance of aligning supply with the net zero agenda

Our 2022 data on finance attitudes and use (Figure B.27) suggests SMEs that prioritise environmental sustainability used external finance in slightly greater proportions that those that do not prioritise this goal, including in the last year, and when doing so, considered more than one provider. These businesses are also more likely than the latter to expect turnover growth and to anticipate a need for finance in the next 12 months, which highlights the importance of continuing to monitor and facilitate SME access to suitable sustainable financing options. Compared with 2021, proportionally fewer SMEs in this category say they sought finance, or anticipate using it in the next 12 months; this simply reflects an overall decline in the demand for finance affecting the whole SME population (see 2.2 Use of external finance).

Figure B.27

Attitudes to finance and future growth expectations of SMEs that consider environmental sustainability a priority, compared with those that do not

Source: British Business Bank Business Finance Survey – Ipsos MORI, Base = all businesses (n=1,169 in 2022 and n= 1,123 in 2021)



Female and Ethnic Minority founders and owners have social and environmental goals and prioritise these more

Business owner-manager characteristics play a role in environmental and social attitudes. Female-led businesses are more likely to have social priorities, including generating social and/or community benefits, compared to male-led firms (30% compared with 18% respectively). 29% of Ethnic Minority-led businesses have social priorities compared to 23% of other businesses.[130]

Female or Ethnic Minority-led smaller businesses are significantly more likely to perceive specific types of social goals as being important (Figure B.28). Finding solutions to environmental problems was seen as important by more Ethnic Minority-led businesses, with no significant differences between female-led and male-led businesses.

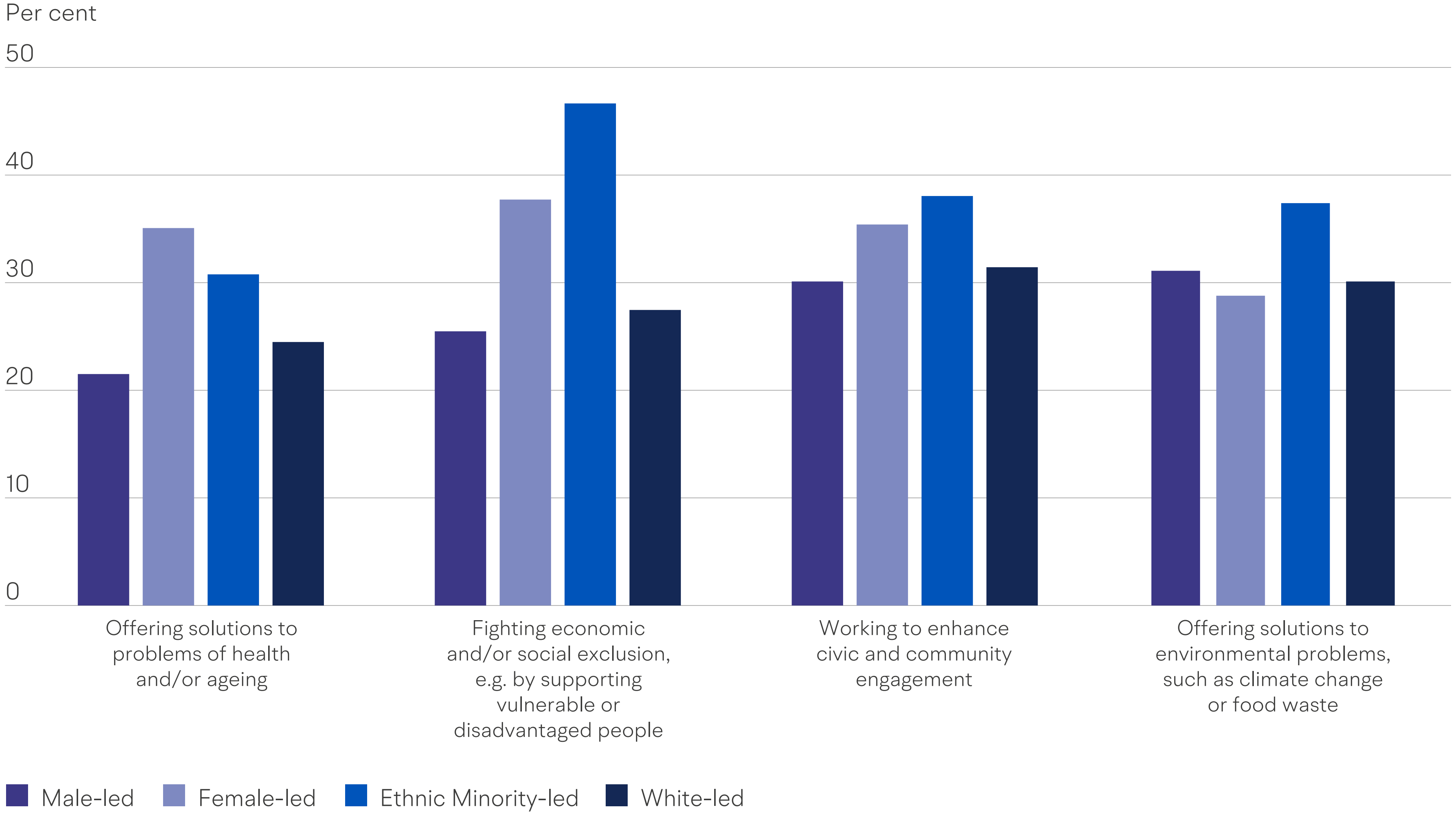
Female-led businesses were more likely to cite social and environmental goals as equal to financial or other goals for their business (36% compared to 29% of male-led businesses). This pattern has persisted over time: in 2019, female-led and Ethnic Minority-led businesses were more likely to say addressing health/ageing problems or enhancing community engagement was of high importance to their business. Ethnic Minority-led businesses were also more likely to say fighting economic or social exclusion was a high priority in 2019.[131]

Ethnic Minority-led businesses are significantly more likely to have undertaken steps to reduce their environmental impact (75% compared to 65% of other businesses). Most (88%) Ethnic Minority-led businesses considered social factors in business decisions (compared to 79% of other businesses) and over half

Figure B.28

Importance of goals to the business

Source: BEIS Longitudinal Small Business Survey, 2021, n=9,308



(59%) had taken steps to generate social benefits for people and communities (44% of others). This is consistent with stronger consideration of community amongst Ethnic Minority-led businesses.[132]

Female-led businesses were slightly more likely to have taken steps to reduce their environmental impact (69%, compared to 64% amongst other businesses).[133] Looking ahead, 55% of female-led businesses prioritise becoming more environmentally sustainable over the next 12 months, significantly higher than non-female led businesses (42%).[134]

Around one in five smaller businesses saw difficulties in accessing finance as a barrier to taking environmental action, even amongst those that have taken such action.[135] Understandably, barriers such as the Covid-19 pandemic and cost of meeting regulations or standards were more frequently cited. Availability of external funding also influences businesses' consideration and actions on social efforts, particularly medium-sized businesses.[136]

The Bank is improving its reporting on environmental sustainability in its programmes to better measure its reach and impact, and is encouraging partners to do the same.

The Bank is integrating ESG factors throughout the investment lifecycle and across all our funding programmes (see previous section). As of April 2023, the Bank's integration of ESG factors will be complete for all the Bank's live funding programmes, ensuring that no new funds will be deployed after this date without ESG factors being taken into account. In parallel, we continue to engage with several collaborative initiatives that are working towards greening the finance system, including through better data collection, reporting and decision-making (see Chapter 1.2).

The Bank is strengthening its own efforts in collecting and reporting environmental sustainability data, as a responsible investor and signatory to PRI, TCFD and SBTi (see Chapter 1.2), to help detail the reach of Bank programmes to underserved markets and understand how it can best support its delivery partners in funding the transition to net zero. Alongside measuring economic impact, recent programme evaluations have looked at the environmental impact of funding to smaller businesses. Since raising finance, 24% of CBILs/CLBILs borrowers, 21% of Future Fund recipients and 17% of BBLs borrowers had undertaken actions to reduce their businesses' carbon emissions (including R&D related to the environment).[137] Recent evaluations of the Bank's regional programmes also highlight how these investments are contributing to smaller businesses' progress on environmental sustainability. Sixty-two per cent of firms supported by the Northern Powerhouse Investment Fund have increased their investment in R&D, and over half of these (52%) expected this investment to generate environmental benefits.[138] Firms supported by the Midlands Engine Investment Fund also report positive environmental outcomes, including improved environmental practices within the firm (75%), adoption of low-carbon technologies, more research to identify how the firm can reduce its environmental impact (59%) and the development of a net zero plan (27%).[139]

The Bank recognises there is more to be done to support smaller businesses' transition to net zero. To inform and shape these efforts, the Bank is working with independent experts to refine and progress its approach to net zero.

2.5

Equity finance

UK SME equity finance remained exceptionally strong during the first half of 2022, but 22Q3 marked a deterioration in market conditions with declining investment and deal activity

While venture and growth stage investment fell in 22Q3, seed stage investment remained more stable

Increased competition for deals had led to larger deal sizes and higher valuations over the last few years, however these measures have declined in 22Q3 as investors consider their positions

London’s concentration of equity deals increased in 2022, but areas outside of London received greater investment

VC financial returns increased in 2021 due to strong exit activity, but market conditions put pressure on fund valuations in 2022

Despite more difficult VC fundraising conditions in 2022, there remains record levels of dry powder to deploy in high growth companies in 2023 and beyond

British Business Bank programmes have an important role in increasing the availability of equity finance to SMEs

This chapter provides an overview of the UK's SME equity finance market over the first three quarters of 2022, using data from Beauhurst on announced equity deals.[140] Deals involving institutional investors are more likely to be announced than deals involving other types of investors like business angels. Business angels often use the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS), which provide an alternative measure of angel activity in the UK. Between 2020 and 2021, these schemes helped 5,820 companies raise £1.8 billion, demonstrating the importance of business angels and their contributions to the UK equity ecosystem.[141]

UK SME equity finance remained exceptionally strong during the first half of 2022, but 22Q3 marked a deterioration in market conditions with declining investment and deal activity

The Bank's 2022 Equity Tracker[142] report revealed that 2021 was an exceptional year for UK SME equity finance, with record levels of both deal numbers and investment. This trend continued during the first half of 2022; 22Q1 in particular was a record quarter with a total of £7.5 billion invested into UK SMEs. In 22Q3 investment activity slowed considerably, although this may represent a return to more sustainable levels of investment in contrast to the exceptional levels of activity seen in the previous 18 months.

Atomico's State of European Tech report[143] confirms that 2022 was a "tale of two halves" for the European VC market. The record-breaking levels of investment activity that defined 2021 carried over into the first half of 2022. Investment levels in the first quarter of 2022 were more than 50% higher than in 21Q1 and, by June, the amount of total capital invested was 4% higher than in the same time period in 2021. The report notes that "July, however, marked the month when the investment frenzy of the last 18 months began to cool off". In August and September, the extent of the slowdown in the European markets became even more apparent, as investment levels dropped to levels last seen in 2018.

Figure B.29 shows that the UK SME equity finance market experienced a similar trend to the wider European VC market. In terms of cumulative investment over the year, 2021 stands out as an anomaly compared to the previous three years. This strong investment growth continued during the first half of 2022 – driven in part by a £1.7bn announced funding round in the battery manufacturer Britishvolt in 22Q1. It is important to note that Britishvolt has since gone into administration and is likely to have not received the equity investment.

The 2022 data in Figure B.29 is therefore presented with and without the Britishvolt deal included. In both cases the first half of 2022 saw record levels of investment, despite 2021 already being an exceptional year for equity finance. However, compared to the previous year, investment began to slow substantially from July onwards in 2022. Based on 22Q3 investment data, it is currently unclear whether total yearly investment in 2022 will be higher than 2021 as it depends on performance over 22Q4.

In aggregate, 2022 is likely to still appear as a strong year for equity investment in the UK overall, because of the exceptionally strong first half obscuring a weaker second half of the year. In the first three quarters of 2022, the cumulative capital invested was £14.8bn. This marks a 10% increase on the £13.5bn invested over the same period in 2021.

Figure B.29

Cumulative monthly equity investment by year

Source: British Business Bank analysis of Beauhurst data

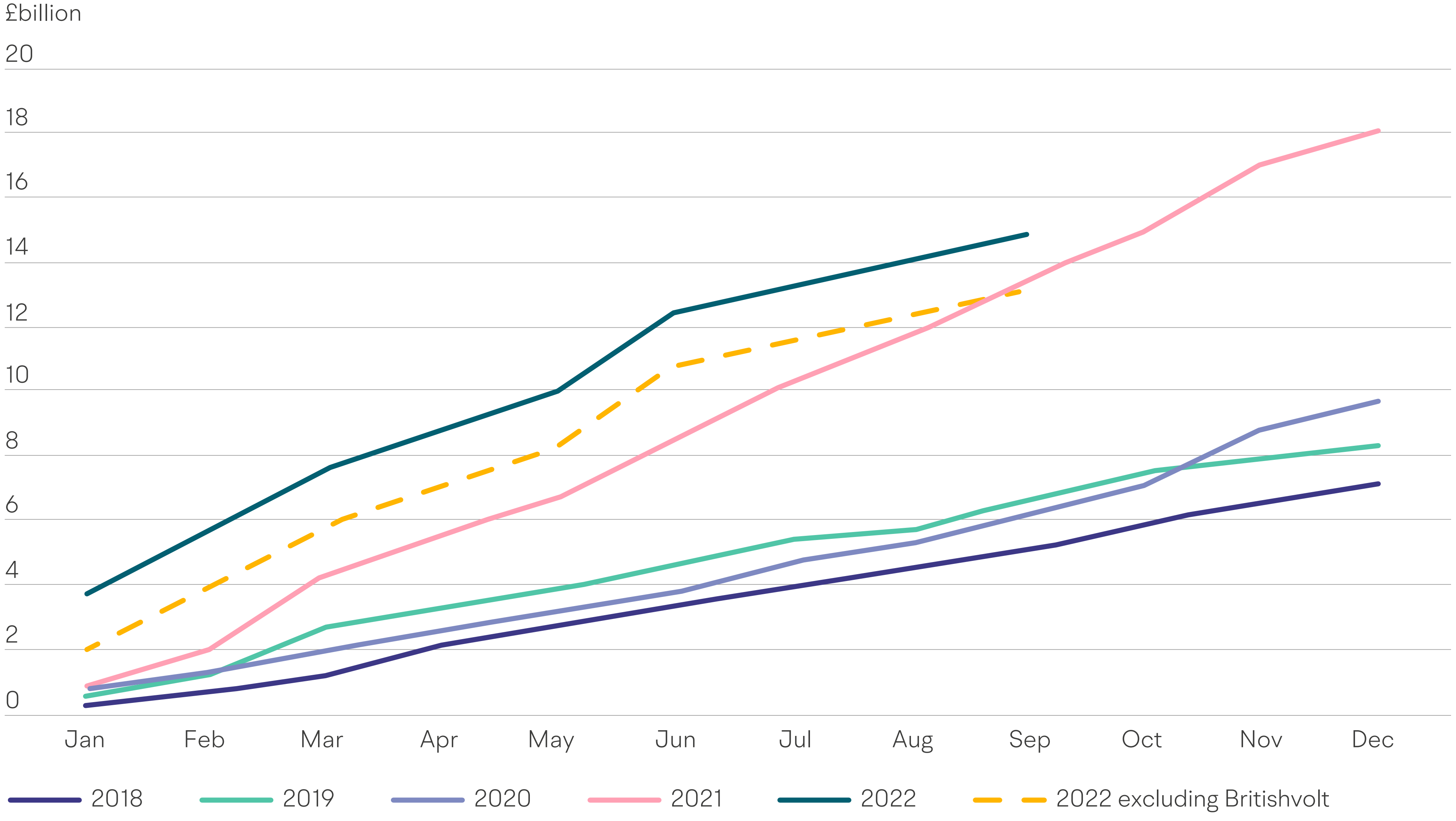


Figure B.30 shows that, alongside greater investment levels, deal numbers have also remained high. Between 22Q1-Q3 a total of 1,932 UK SME equity deals were announced. This figure is only 2% lower than the number of deals conducted in the same three quarters of 2021.

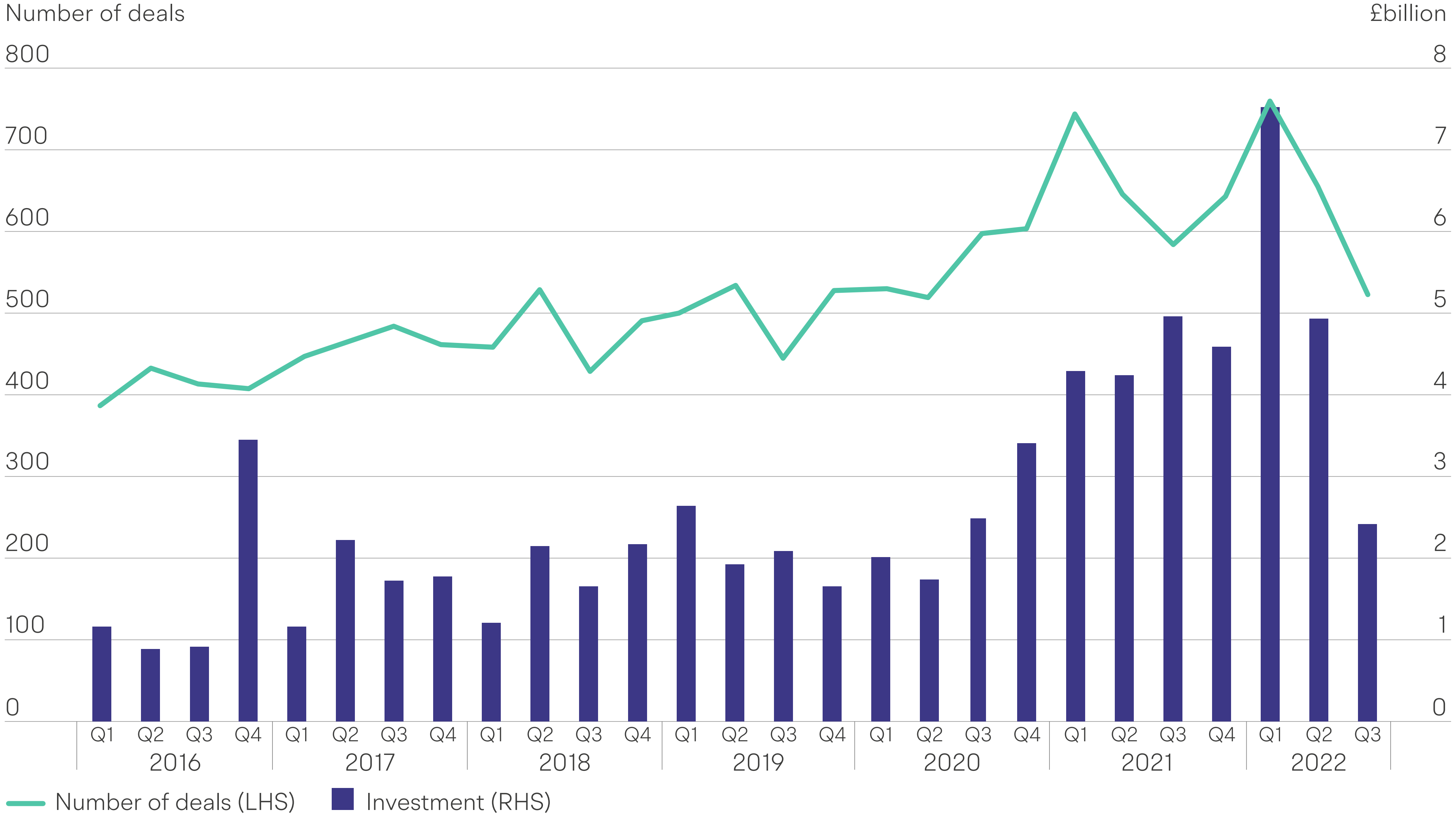
In 22Q3 a total of £2.4bn was invested across 520 announced SME equity deals. This is a decline of 51% in investment and 11% in deal numbers compared to 21Q3. Whilst quarterly numbers can be volatile due to the impact of a small number of very large deals, equity investment reached a nine-quarter low in Q3 this year.

Market intelligence gathered by the Bank's UK Network from finance intermediaries suggests SMEs have found it harder to access new funding in 22Q3. 41% of respondents reported that they expect the supply of early-stage finance to decrease in the next 12 to 18 months, whilst 35% expected a decrease in the supply of growth stage finance. This suggests UK SME equity markets could now be at a turning point, and it will be interesting to see how the final quarter of the year performs.

Figure B.30

Number and value of equity deals

Source: British Business Bank analysis of Beauhurst data



Despite the large quarterly declines in the number of deals and investment in 22Q3, on both these measures UK equity activity remains above the quarterly average for 2016–2020. In this context equity investment in UK SMEs is still high by historical levels and can also be viewed as returning to longer term trend levels following a year and a half of exceptional activity.

The UK SME equity market is influenced by national developments but also tends to follow global trends in VC. A shift in macroeconomic factors this year and Russia's invasion of Ukraine have led to rising interest rates, inflation, and an energy crisis. This has created a challenging business environment across the globe, meaning many of the trends seen in the US and European VC markets over 2022 were also reflected in the UK.

PitchBook's Q3 2022 Venture Monitor[144] reports that, in 22Q3, the US experienced a nine-quarter low of $43bn invested in VC deals across all stages. PitchBook's Q3 2022 European Venture Capital report[145] confirms a similar picture for European VC markets, where deal value fell to its lowest level since 20Q4. Even though the figures remain relatively high on a historical basis, the fall in dealmaking activity in Q3 indicates increasing investor reluctance and a greater emphasis on business fundamentals.

The release of PitchBook's Q4 Venture Monitor in January provides an early indication of the full year VC trends in the US and shows a continuation of the slowdown.[146] In 22Q4, $36.2bn was invested across all deal stages, the lowest quarterly total since 19Q4. On an annual basis $238.3bn was invested in 2022, down 31% from $344.7bn in 2021. The angel and seed investment stage proved the most resilient, receiving a record $21bn.

While venture and growth stage investment fell in 22Q3, seed stage investment remained more stable

Beauhurst classifies equity deals into four stages: seed, venture, growth and established. These stages reflect product development, commercialisation, sales, and profitability levels in the recipient company. As in previous reports, we combine the growth and established stages for simplicity, which we refer to collectively as the 'growth' stage.

As illustrated in Figure B.31, the decline in later stage investment became noticeable a quarter before a reduction was detected in seed stage rounds. Total growth stage investment in the first three quarters of 2022 amounted to £8.4bn, which is 3% higher than during the same period in 2021. The overall increase however was driven by an unusually strong first quarter. Growth stage investment in 22Q2 was 1% lower than in the same quarter last year, with investment in 22Q3 declining by 71% compared to 21Q3. While the growth stage has been the main driver of overall investment in the past few years, it experienced the largest drop in both percentage and absolute terms.

Equity finance trends in the venture stage followed a similar course. During the first three quarters of 2022, total investment equalled £4.9bn, 22% higher than the same period in 2021. However, investment in 22Q3 declined by 10% compared to the level in 21Q3.

Seed stage investment between 22Q1-Q3 was up by 23% compared to the first three quarters in 2021 and reached £1.5bn. The value of investment in 22Q3 was 14% lower compared to 21Q3. The seed stage investment value for 22Q1-Q3 is currently £0.2bn below the full year total in 2021. This means that 2022 is likely to set a new record for annual seed stage investment.

Investments in seed stage businesses are considered to carry the greatest risk for investors due to uncertainties regarding technology, product development, and the market fit for these early-stage companies. The amount invested into seed stage companies in 2022, however, has so far been resilient, suggesting that these concerns have not yet materialised. Market feedback from fund managers the Bank has engaged with highlights that seed stage can be seen as a refuge from the wider market uncertainty, as it is less exposed to current public market and exit conditions compared to later stage companies.

There were contrasting trends in the number of equity deals by stage in the first three quarters of 2022 (Figure B.32). Whilst the number of seed stage deals increased by 3% over the first three quarters of the year compared to the same period in 2021, the number of venture deals declined by 3% and the number of growth deals declined by 8%. All stages saw a decline in 22Q3 compared to the previous quarter.

The decline in investment in 22Q3 across all three business stages was linked with declines in later stage deal numbers. The number of announced SME equity deals at growth stage saw the largest decline, with the

Figure B.31

Value of equity investment by stage

Source: British Business Bank analysis of Beauhurst data

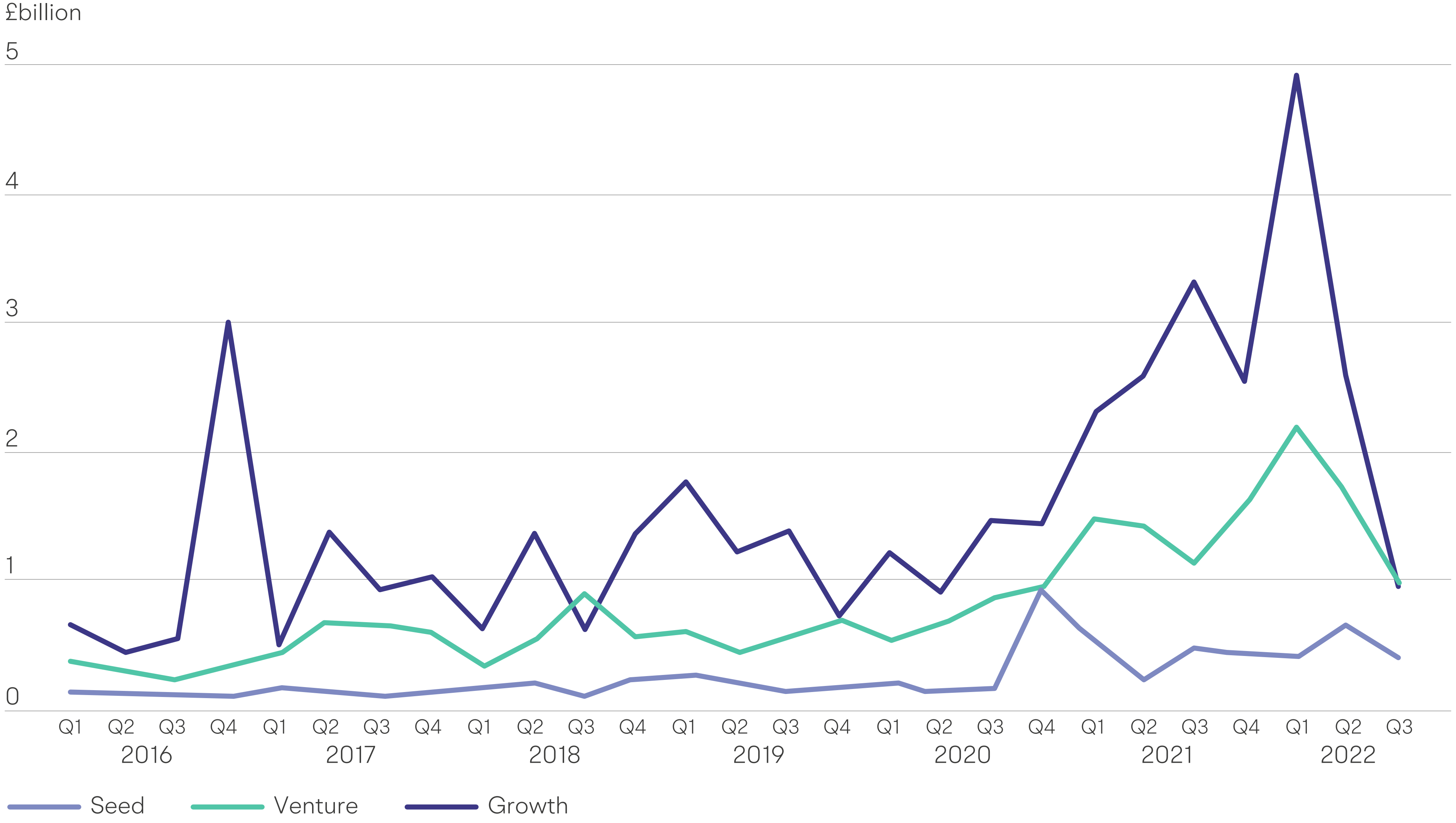
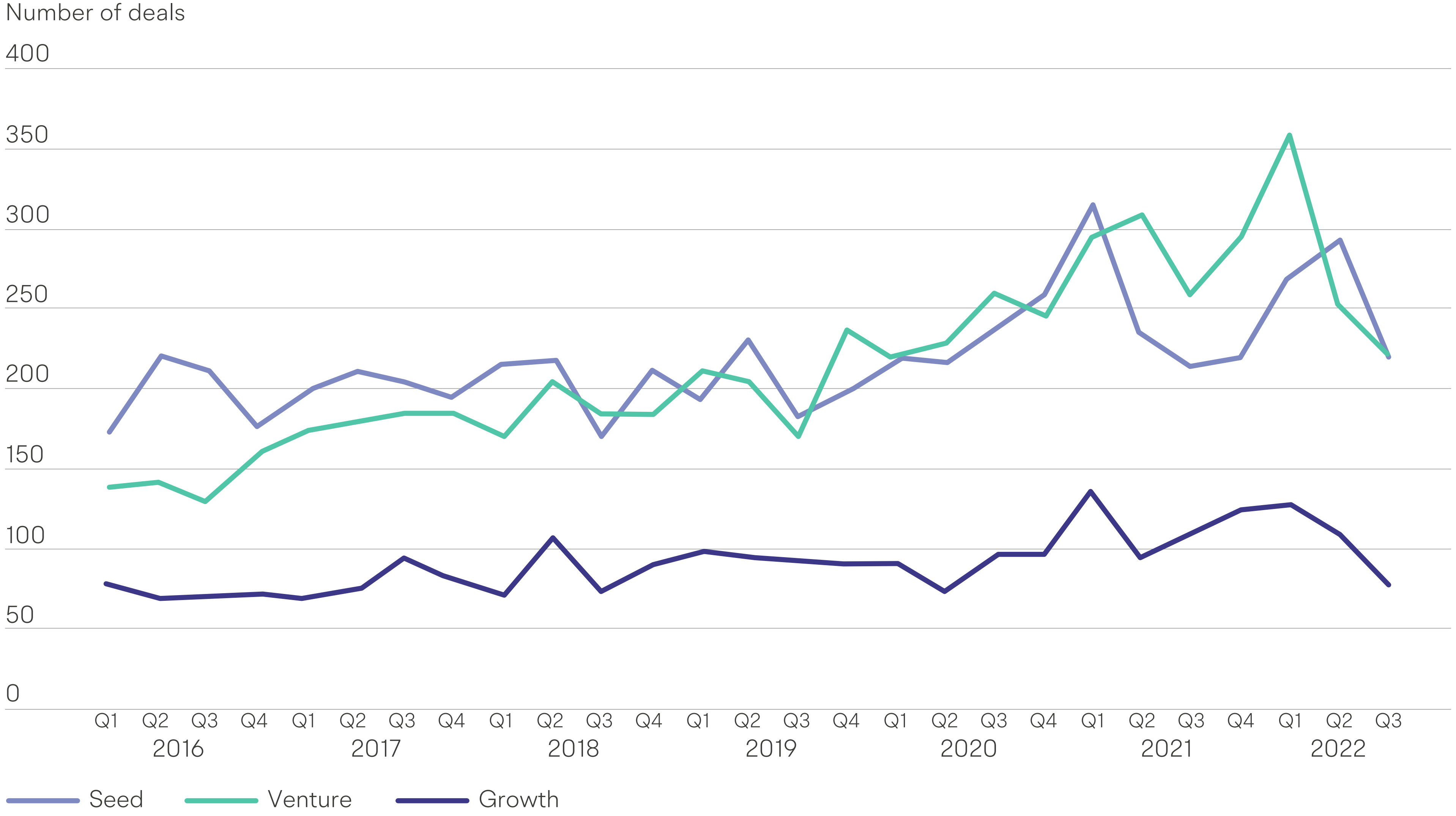


Figure B.32

Number of equity deals by stage

Source: British Business Bank analysis of Beauhurst data



22Q3 total down 31% compared to the same quarter in 2021. Deal activity in the venture stage declined by 14%, though the number of seed stage deals rose marginally by 4%.

Venture and growth stage deals as a percentage of the total number of deals have declined in 2022, with the proportion of growth deals declining the most. The proportion of deals in the seed stage increased from 38% of all deals in 2021 to 41% in 2022. This is because the number of seed stage deals remained relatively stable, whilst the number of growth and venture stage deals declined.

Increased competition for deals had led to larger deal sizes and higher valuations over the last few years, however these measures have declined in 22Q3 as investors consider their positions

Average deal sizes have increased over the last five years, driven by increases in growth stage deals due to increased amounts of capital available and the number of later stage companies moving down the investment pipeline.

Last year's Equity Tracker and VC Returns reports noted there has been increased competition amongst VC fund managers for deals, especially from non-traditional investors and overseas investors. Overseas investors were involved in 24% of announced deals between 22Q1-Q3, with the figure remaining unchanged from the year before.

The first quarter of 2022 saw a record number of deals from overseas investors, with 190 deals at an average deal size of £21.9m. Overseas investment activity in the UK market closely followed the trend of domestic investors, with strong activity during the first two quarters of the year declining in Q3 to just 112 deals. The scale of the decline between 21Q3–22Q3 was much greater for deals involving overseas investors compared to deals only involving UK investors, with a 33% decline compared to a 1% decline, respectively.

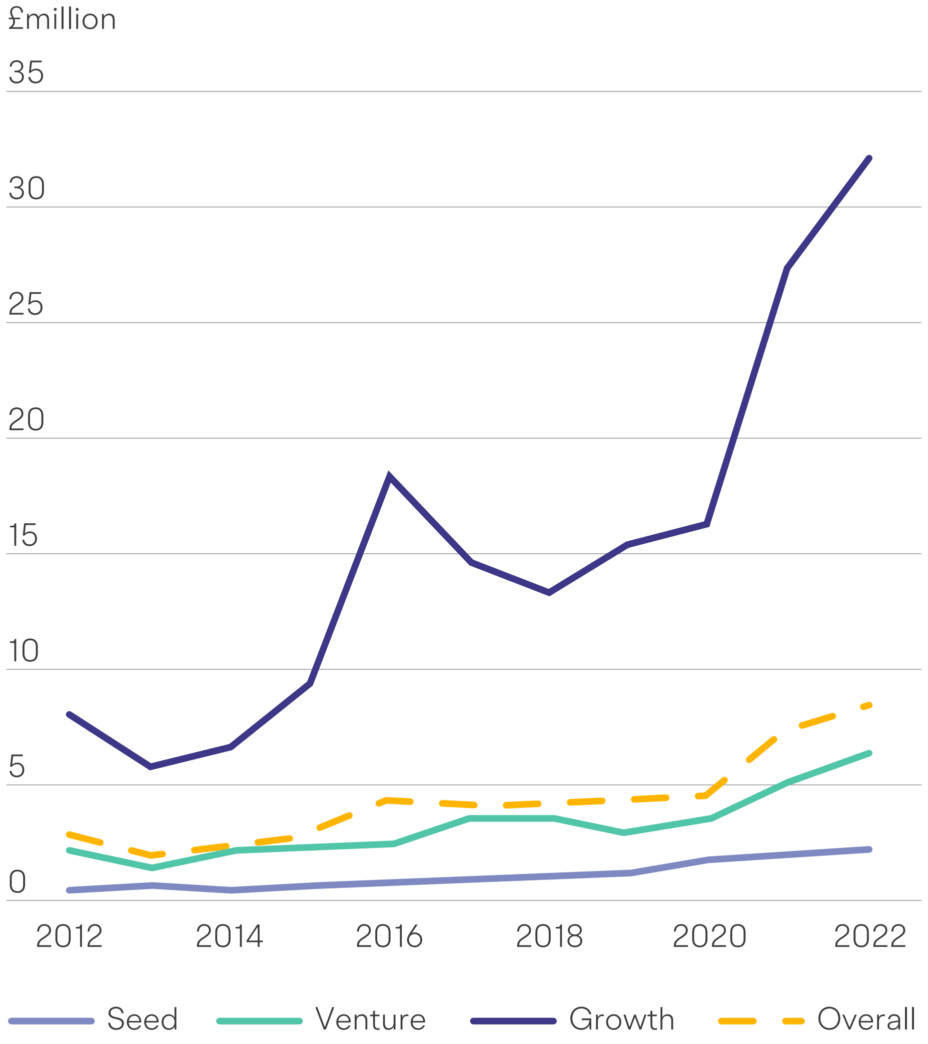
As illustrated in Figure B.33 overall average deal sizes reached £8.4m in 2022, a 12% increase compared to 2021. When comparing the first three quarters of each year, 2022 figures were higher for each business development stage.

22Q1 broke another record for the average deal size at growth stage, reaching £47.1m. However, by 22Q3 the average growth stage deal dropped by 69% to £14.8m. This latest level was more in line with average growth stage deal sizes seen during 2020 (£16.3m) and 2019 (£15.6m), before the surge in market activity experienced during 2021. Average venture stage deal sizes also fell in 22Q3 to £5.0m, which was slightly below the overall year average seen in 2021 (£5.1m).

Figure B.33

Average equity deal size by business stage

Source: British Business Bank analysis of Beauhurst data
*2022 data up to Q3 only



The average seed stage deal size was equal to £2.0m in 2022, higher than the £1.8m figure in 2021. Additionally, average seed deal sizes experienced the smallest drop of less than 15% (from £2.4m to £2.0m) between 21Q3 and 22Q3.

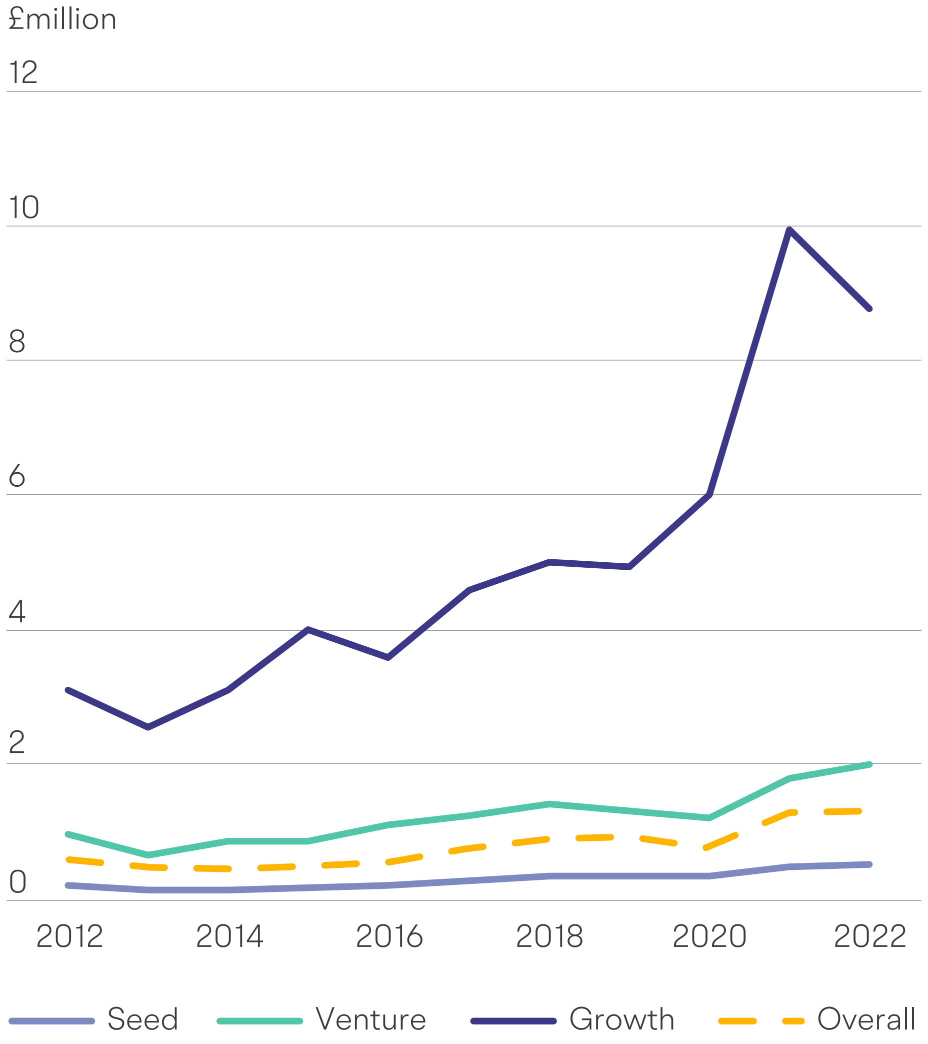
Average deal sizes can be distorted by a small number of very large deals and so it is also informative to also look at the median deal size. Figure B.34 shows annual median deal sizes by stage. While on an annual basis the overall median deal sizes decreased by only 3% between 2022 and 2021, comparing Q1 with Q3 of 2022 alone shows a different picture.

The median growth stage deal size decreased by 74% in 2022, falling from £14.3m in 22Q1 to £3.8m in 22Q3. The median venture stage deal size also declined by 28% over the same period. The median deal size at seed stage, however, has not yet seen a significant decline in

Figure B.34

Median deal size by business stage

Source: British Business Bank analysis of Beauhurst data
*2022 data up to Q3 only



2022 unlike in other categories. The median seed stage deal was £0.6m in 22Q3, higher than in 22Q1 and any of the four quarters of the previous year.

The number of mega deals (i.e. deals worth more than £100m) during 22Q1-Q3 remained unchanged compared to the same period last year at 24 deals. However, the total value of these deals increased by 33%, reaching £5.3bn between 22Q1-Q3. This is again the result of an unusually strong first quarter where the total value of £100m+ deals reached £3.6bn. This figure dropped to £1.3bn in 22Q2 and £410m in 22Q3.

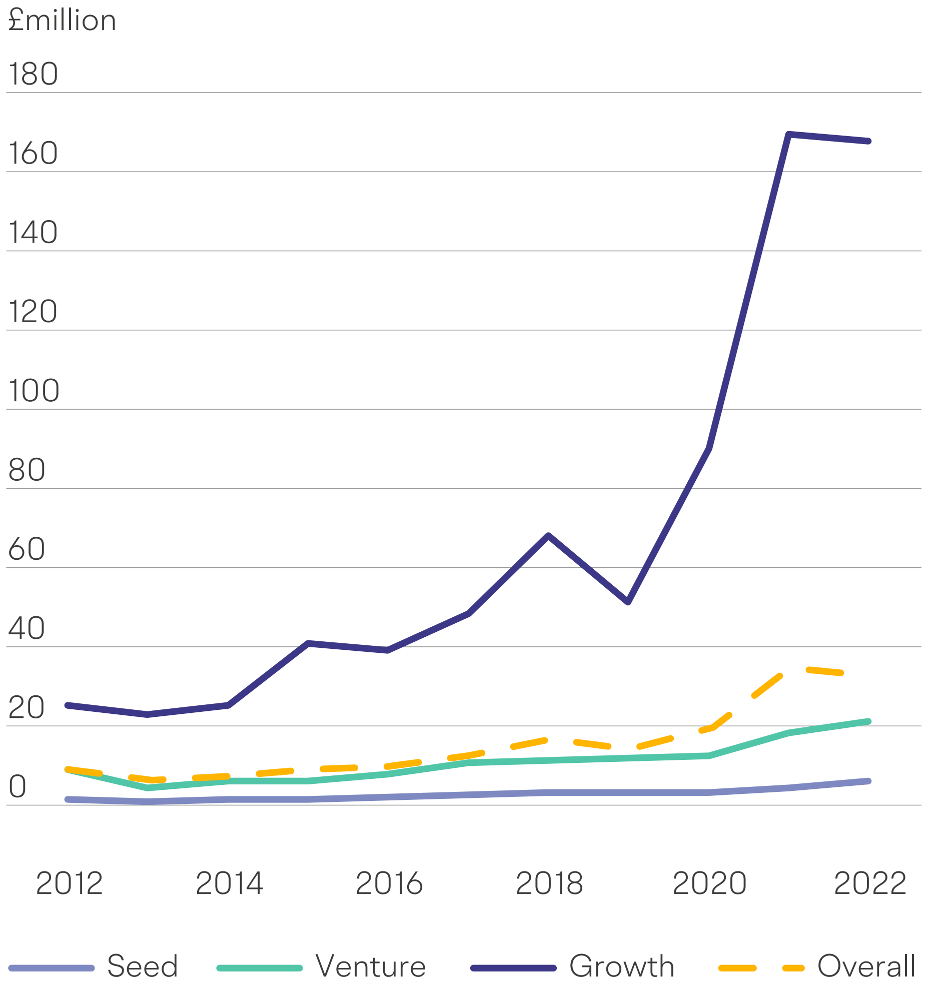
Further, seed stage equity financing remained strong during the first three quarters of 2022, with the number of £1m+ seed rounds increasing by 20% compared to last year, reaching 287 deals. This is only nine deals short of the full year total in 2021.

Average company pre-money valuations, which reflect a company's valuation excluding the funding it receives, have seen a decline of 4% in 2022 compared to 2021. The average pre-money valuation in 2022 was equal to £32.8m (as shown in Figure B.35). Companies in the growth stage have experienced a decline of 1% in average pre-money valuation, while venture and seed stage valuations increased by 15% and 38% respectively.

Figure B.35

Average company pre-money valuation by business stage

Source: British Business Bank analysis of Beauhurst data
*2022 data up to Q3 only



Market feedback from fund managers the Bank engages with indicates lower valuations at later stages are partly resulting from public markets seeking profitability over growth, and VC-backed IPOs continuing to perform poorly.

The 2022 annual average pre-money valuations are propped up by high valuations seen in 22Q1. Comparing 21Q3 and 22Q3 alone, average pre-money valuations are down by 51%, with growth stage deals declining the most by 59%. On the other hand, the pre-money valuations of seed stage companies have increased by over 19% between 21Q3 and 22Q3.

The trend of growth stage companies experiencing the largest decline in valuations is consistent with other markets. Atomico's State of European Tech report[147] found that European Series C valuations are down by 60% from their peak at the end of 2021. Average seed stage pre-money valuations have followed this trend with a two-quarter delay, which means that valuations could fall in 22Q4.

Figure B.36

Number and value of equity deals by nation and English region

Source: British Business Bank analysis of Beauhurst data

Region	Number of equity deals (Q1-Q3 2022)	Q1-Q3 2021–2022 % change number of deals	Proportion of deals (Q1-Q3 2022)	Investment £m (Q1-Q3 2022)	Q1-Q3 2021–2022 % change investment value	Proportion of investment value (Q1-Q3 2022)
London	1,013	6%	52%	£9,043	0.3%	61%
South East	160	-19%	8%	£1,103	-18%	7%
Scotland	151	-15%	8%	£525	26%	4%
East of England	123	0%	6%	£778	-1%	5%
South West	112	13%	6%	£528	46%	4%
North West	108	-5%	6%	£482	-35%	3%
Yorkshire and The Humber	67	3%	3%	£214	96%	1%
Wales	51	4%	3%	£68	-4%	0.5%
North East*	50	-12%	3%	£1,838	1400%	12%
West Midlands	43	-17%	2%	£166	-47%	1%
East Midlands	30	-23%	2%	£49	-60%	0.3%
Northern Ireland	23	-28%	1%	£43	-35%	0.3%
UK	**1,932**	**-2%**	**100%**	**£14,840**	**10%**	**100%**

* figures include Britishvolt

London's concentration of equity deals increased in 2022, but areas outside of London received greater investment

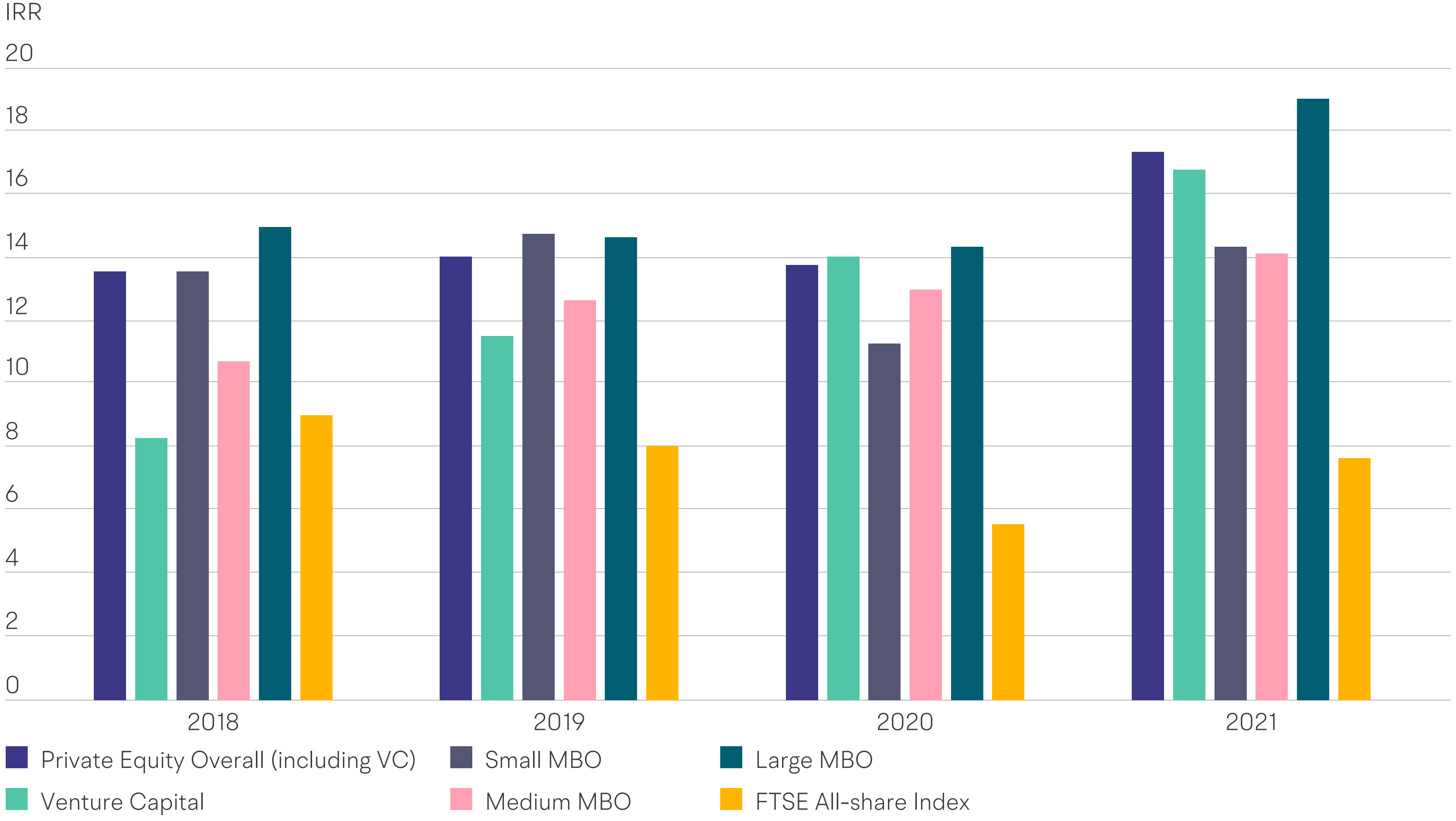
London remained the hotspot for UK equity activity in 2022, receiving 52% of all UK equity deals during the first three quarters and accounting for 61% of total UK equity investment (Figure B.36). This is up from 49% of deals, but down from 67% of all investment in 2021, mainly due to a small number of large investments made in the North West, North East and the South East during 2022. In the North East, Britishvolt announced a £1.7bn investment round during 22Q1, accounting for a large majority of total investment in the region in 2022. The number of deals in 22Q1-Q3 compared to the same quarters in 2021 only increased in four regions (London, South West, Wales and Yorkshire and the Humber).

However, non-London regions have seen a 30% increase in the value of equity investment in 22Q1-Q3 compared to the same period last year due to larger average deal sizes. This is despite deals numbers in the regions declining by 9 percent.

Figure B.37

Ten year horizon performance IRRs for selected investment strategies by reporting year

Source: BVCA Performance Measurement Survey 2018, 2019, 2020, and 2021



VC financial returns increased in 2021 due to strong exit activity, but market conditions put pressure on fund valuations in 2022

UK VC returns data is backwards looking generally covering fund performance over 2021, which was a relatively strong year for portfolio company exits. The presented data therefore does not fully capture the changing economic conditions occurring in 2022 with rising energy prices, higher inflation and increasing interest rates.

The latest BVCA Performance Measurement Survey[148] reports that as of 31st December 2021 the 10-year horizon Internal Rate of Return (IRR), which measures fund performance adjusting for the rate at which returns are achieved, is 17.5% for VC funds established since 1996 (Figure B.37). This is a 3.6 percentage point increase on the December 2020 position, reflecting increased valuations and strong exit activity in 2021 which has supported substantial capital distributions to Limited Partners (LPs).

VC returns still lag the returns achieved by large management buy-out (MBO) funds, but the 10-year horizon VC returns exceed the performance of small and mid-size private equity funds. As of December 2021, the 10-year horizon IRR's for small, medium and large MBO funds are 14.5%, 14.2% and 19.2%, respectively.

Buyout deals are generally lower risk than VC deals due to their shorter holding periods and focus on more established companies with proven technologies and markets. This means VC returns need to exceed those of MBOs to attract LPs to this asset class. Therefore, it is encouraging for the VC industry that returns now exceed the performance of medium and smaller MBO funds. Many buyout funds also use leverage to increase their returns. VC returns continue to be higher than the returns from investing in public markets, with the 10-year horizon IRR from the FTSE all-share index at 7.7% in 2021.

The improvement in VC returns is further demonstrated in the Bank's latest VC returns report. Our report uses different return measures, and a different data cut-off period covering up to the end March 2022, but also showed UK VC returns have been resilient to date. As of 31st March 2022, UK VC funds with a 2008 to 2013 vintage[149] have generated a pooled TVPI multiple of 2.20, which is 0.11 points higher than a year ago.[150]

There is widespread expectation from market stakeholders that fund valuations will decline over the next 12 months due to lower portfolio company valuations and reduced exit opportunities. This is also likely to result from economic factors such as increased interest rates, which raise the risk-free rate of return and therefore weigh upon VC fund valuations.

Exits ultimately generate financial returns and provide liquidity to LPs, freeing up capital for re-investment. The three main exit routes for VC-backed companies are buyouts, mergers and acquisitions, and Initial Public Offerings (IPOs).

Figure B.38

Number and value of UK VC-backed company exits

Source: British Business Bank analysis of user defined PitchBook search. Results may differ from PitchBook's own published figures (data as at 02/01/2022)

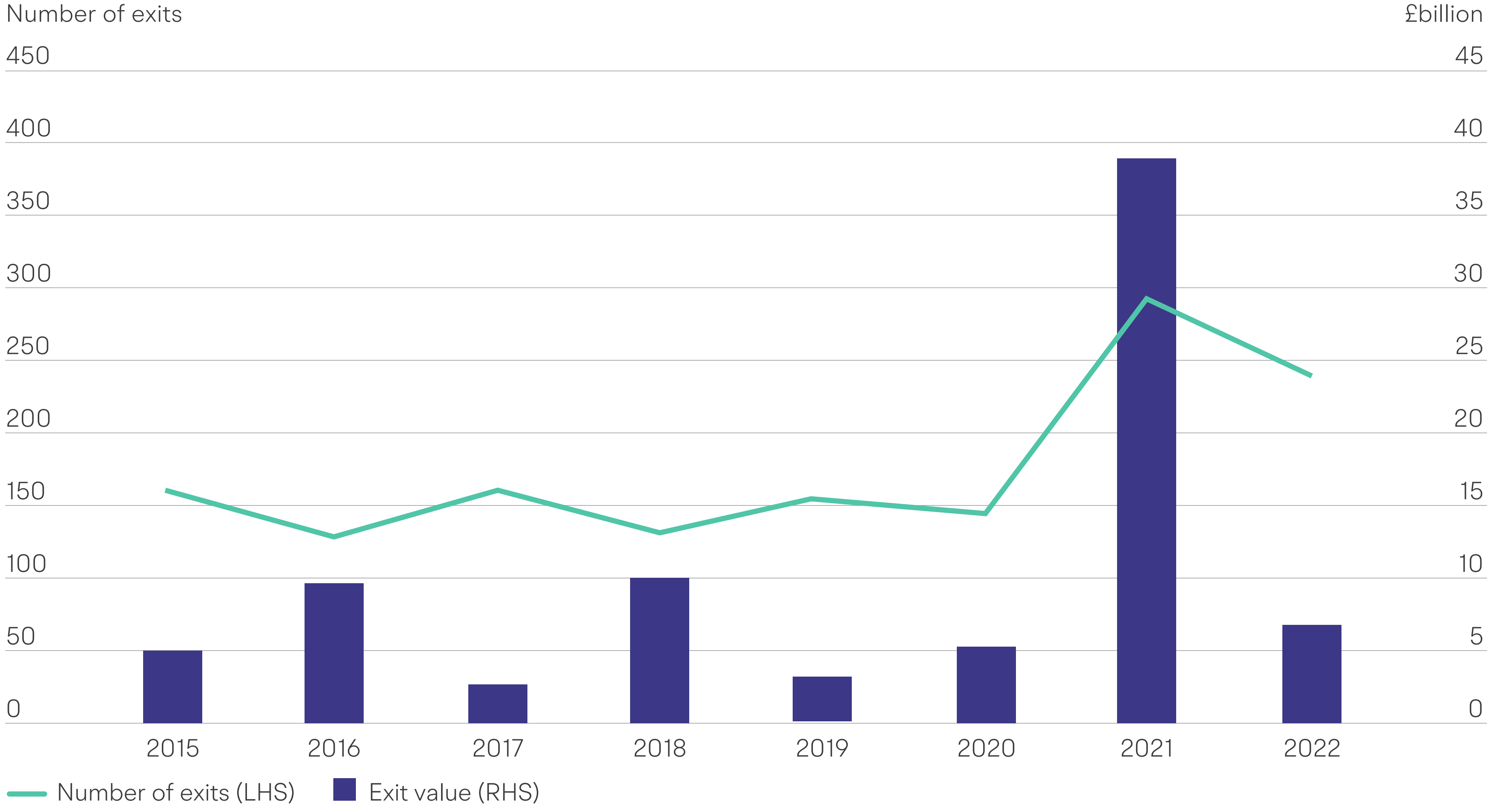


Figure B.38 shows that VC-backed company exit activity in 2022 was lower than in 2021, which was a particularly strong year. The number of VC-backed exits decreased by 17% to 241, whilst exit value[151] decreased by 83% to £6.7bn.[152] IPOs accounted for two thirds of exit value in 2021, delivering over £25bn of investor returns, by far the largest annual amount on record. Former unicorns Deliveroo, Darktrace and Oxford Nanopore Technologies were among the 29 VC-backed companies undertaking an IPO in 2021.

Whilst IPO markets performed strongly in 2021, they closed rapidly in 2022 due to wider economic uncertainty and a global decline in public equity market valuations. The MSCI All Country World Index declined by more than 20% in 2022, suggesting global public equity share prices had their worst performance since the 2008 financial crisis, but the technology focused NASDAQ, a frequent exit route for VC-backed technology companies, fell even further.[153]

Just seven UK VC-backed companies publicly listed in 2022, with a combined total IPO value of £180m. The number of IPOs in 2022 is broadly in line with the average annual number of IPOs between 2015 to 2020 (nine IPOs per year), but exit value is considerably smaller than historical IPO values, reflecting lower market confidence. Difficult exit conditions are confirmed by the Bank's fund manager survey.[154] Around half of fund managers consulted reported the market to be currently poor or very poor in terms of exit opportunities for their companies. Nearly three quarters (ten out of 14 fund managers) reported that the market conditions for successful exits for portfolio investments have deteriorated in 2022 compared to 2021.

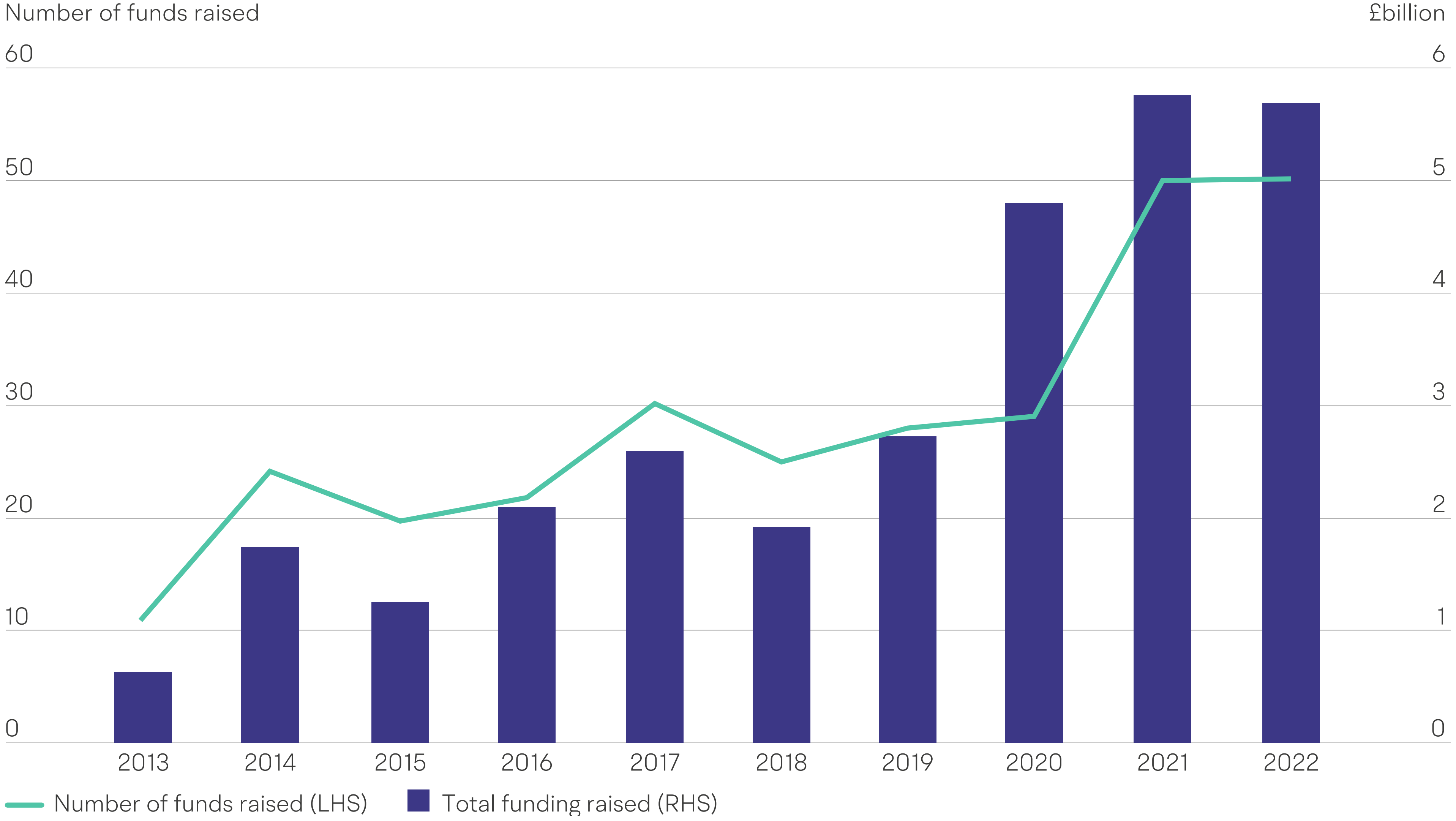
Despite more difficult VC fundraising conditions in 2022, there remain record levels of dry powder ready to deploy in high growth companies in 2023 and beyond

Global VC fundraising conditions have been strong in recent years. Low interest rates have encouraged capital allocations toward VC in search of higher returns. Consequently, strong UK VC fundraising activity over the past several years means there is a substantial amount of dry powder (which refers to committed but undeployed capital) available to invest in high growth companies.

Figure B.39

Number and value of UK-based VC funds raised

Source: British Business Bank analysis of Preqin Ltd (data as at 30/01/2023)



Preqin data shows that, as of December 2022, UK VC funds had £10.8bn available to invest, 83% higher than the £5.9bn available at the end of 2021. Preqin data also shows record levels of dry powder for wider European and US VC funds.

There has been a long-term increase in the number and amount of UK VC funds raised, showing the market has developed over the last decade. Figure B.39 shows that 50 UK VC funds closed in 2022 raising £5.7bn, up from 11 VC funds closing in 2013 raising £0.6bn.

It is widely acknowledged that VC fundraising conditions have remained resilient despite increased economic uncertainty. PitchBook's Annual European Venture Report 2022[155] notes that "bear markets emerged in 2022; however, capital raised landed in a similar position to its performance in the past three years, illustrating that GPs were still able to attract sizeable LP commitments and close substantial VC funds".

The latest Preqin fundraising data indicates that the UK VC market may be performing more resiliently than across Europe, with the number of funds closed and amount raised in 2022 at a similar level to 2021. Average fund sizes have also increased from £123m in 2021 to £146m in 2022.

PitchBook reports "multiple factors could be influencing fundraising figures and time lags could be in effect. For example, funds closing in recent weeks may have been open for several months". Whilst there are record amounts of dry powder available, this will not necessarily translate into increased dealmaking activity. "Investors have the option to sit on recent capital commitments, possibly in expectation of lower prices. LPs may also insist on a slower pace if, say, their portfolios are overallocated to VC following stock market declines."[156] Factors such as this 'denominator effect' could lead to challenges for UK VC fundraising in 2023.

The Bank's fund manager survey undertaken in Autumn 2022 does suggest that market conditions are tighter than they were in 2021.[157] 64% of fund managers responding to the Bank's VC returns survey report fundraising conditions in 2022 to be worse than in 2021. Only 7% of fund managers currently report VC fundraising conditions to be good, with 29% reporting it to be poor. A total of 57% are reporting them to be "neither good nor poor". Therefore, a clearer picture on the continued attractiveness of VC as an asset class will emerge as 2023 progresses.

British Business Bank programmes have an important role in increasing the availability of equity finance to SMEs

This report has found that later stage equity finance has been particularly impacted by the recent market volatility in 2022. With IPO markets currently restricted, companies will need to stay private for longer, suggesting British Patient Capital (BPC) supported funds will have an important ongoing role in the market.

The Bank's Equity Tracker 2022 report[158] also showed that the UK has lower levels of investment going to deep tech and R&D intensive companies compared to the US and other comparative countries. The Bank's Future Fund: Breakthrough programme aims to support these companies raising later stage funding rounds.

The high concentration of deals and investment in London in 2022 highlights the continued market need of the Bank's regionally focused programmes including the Regional Angel Programme (RAP), Northern Powerhouse Investment Funds (NPIF), Midlands Engine Investment Funds (MEIF) and Cornwall and Isles of Scilly Investment Funds (CIoSIF). These programmes play an important role in increasing the supply of finance in all areas of the UK.

The Enterprise Capital Funds (ECF) programme is increasing the availability of early-stage equity finance to high potential UK companies. This will be very important for any future decline in early-stage funding.

The Bank will monitor equity market conditions very carefully and stands ready to adapt our programmes accordingly. The forthcoming 2023 Equity Tracker report, covering full year 2022 data, will provide a more in-depth assessment of the trends affecting UK equity finance.

2.6

Private debt

Private debt funds are an important funding source for businesses that fall outside commercial banks' risk appetite but have growth potential

UK mid-market private debt deals and investment increased substantially in 2021, but the market show signs of a decline in 2022 due to greater economic uncertainty

The Bank's Small-Cap private debt funds portfolio continued to grow in the first half of 2022, with increased investment compared to the same period in 2021

UK private debt fundraising increased in 2022 driven by a small number of larger funds, but global private debt fundraising is slowing down

The British Business Bank is committed to continue supporting SME private debt markets

Private debt funds are an important funding source for businesses that fall outside commercial banks' risk appetite but have growth potential

Private debt covers a range of lending to firms through loans made by non-bank organisations, often structured as Limited Partnership (LP) funds, much like equity funds. Private debt investment strategies range from growth-focused deals worth below £250,000 to Private Equity-backed leveraged buyouts of large corporates.

Whilst these larger, sponsored deals account for the majority of investment value, SME-focused private debt funds are a vital part of the finance ecosystem for smaller, growth-orientated companies which fall outside of high street banks' typical risk appetite. Transactions in this SME-focused segment do not typically involve a Private Equity (PE) sponsor and aim to unlock growth in the business.

Private debt funds generally target established, profit-generating companies seeking finance to implement step-change growth plans. Private debt loans are tailored to the needs of the borrower and typically involve more flexible repayment schedules than traditional bank loans. Due to the additional flexibility, private debt funds fill an important role in the market. Firms that are over leveraged can restructure their existing debt, decreasing the interest rate burden impacting on their survival or growth prospects.

Large multi-billion pound funds operated by established fund managers making loans in excess of £100m dominate private debt markets. This means leading industry publications such as Preqin's Global Private Debt Report,[159] Deloitte's Private Debt Deal Tracker,[160] and the Alternative Credit Council's Financing the Economy report,[161] almost exclusively focus on mid-market deals and also tend to not be UK-specific. Our analysis of the UK private debt market trends draws on industry publications that focus on the mid-market, and data from the Bank's management information on its Small Cap private debt portfolio.

UK mid-market private debt deals and investment increased substantially in 2021, but the market show signs of a decline in 2022 due to greater economic uncertainty

After a strong recovery in 2021 following the Covid-19 pandemic, mid-market private debt deal activity experienced a sharp slowdown in 2022. Preqin data for the full year 2022 shows a 66% decline in the number of UK mid-market deals compared to 2021. Other private debt markets have experienced a similar decline with deal numbers falling 63% in the rest of Europe, and by 37% in the US over the same period. Whilst there might be a slight delay in deals being announced, the wider economic uncertainty affecting global equity markets has also had an adverse effect on private debt markets, leading to lower deal activity in 2022.

Buyouts continued to be the main type of deal in the UK mid-market, representing 39% of all deal activity in 2022. Growth capital deals, which are intended to fund organic company growth, and "add-on" deals, which involve the funded company acquiring smaller companies to integrate into its business, made up 30% and 24% of private debt deal types respectively.

These proportions have stayed relatively consistent over the last four years. Despite the proportion of buyout deals remaining broadly similar to previous years, the number of UK private debt buyout deals fell by 68%, from 57 in 2021 to 18 in 2022. At the same time the total value of global buyout transactions declined by 40% year-on-year according to Reuters.[162] Mid-market private debt funds are highly reliant on private equity funds for identifying deals, and M&A activity is likely to remain suppressed.[163]

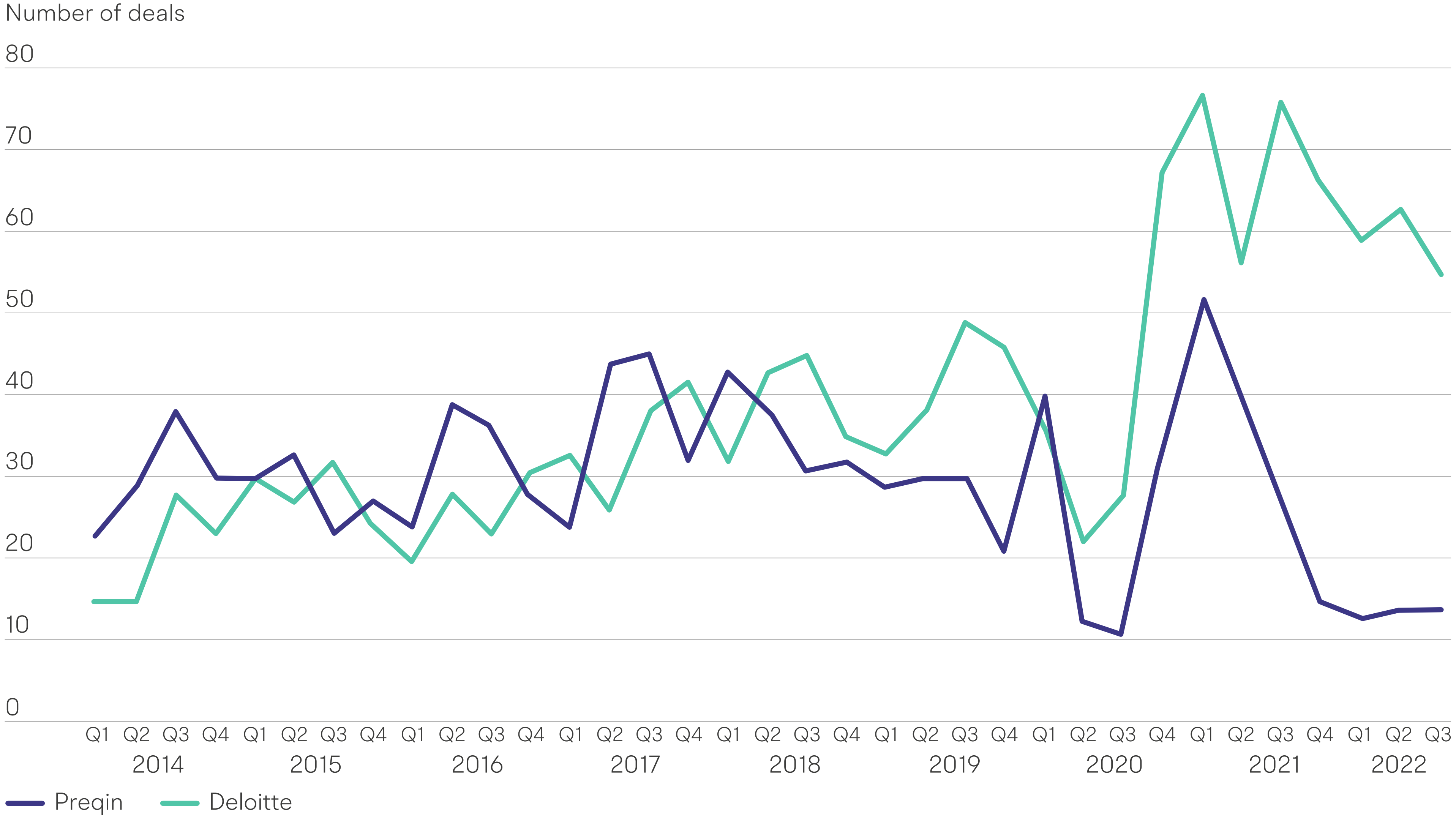
PitchBook's Quantitative Perspectives report notes that tighter credit conditions this year have "shut off" the leveraged loan market, a primary source of deals for buyout funds.[164] Wider credit spreads, the Bank of England interest rate increasing, and expectations of further interest rate hikes[165] have all raised the risk of liquidity issues for funded companies, especially in the case of a future decline of earnings. As a result of this, banks have reduced their risk appetite.

PitchBook[166] suggests 2023 is likely to be a challenging year for the industry, but "investors still view private debt as attractive because of the asset class's ability to generate contractual returns, produce a higher yield

Figure B.40

Number of mid-market UK private debt deals by data source

Source: British Business Bank analysis of Preqin Ltd and Deloitte



premium in a rising-rate environment and offer a suite of diversified strategies that can work under varied market conditions”. This is because there is a range of private debt strategies that can be deployed, including distressed debt. PitchBook notes investors will want more downside protections for their private credit investments, which is likely to lead to more stringent deal terms for companies.

Figure B.40 shows the quarterly number of mid-market private debt deals as measured by Preqin and the Deloitte Private Debt Deal Tracker. Both data sources show broadly similar trends with 2022 deal numbers lower than 2021, although the Deloitte data consistently identifies a higher number of deals from mid-2020 onwards.

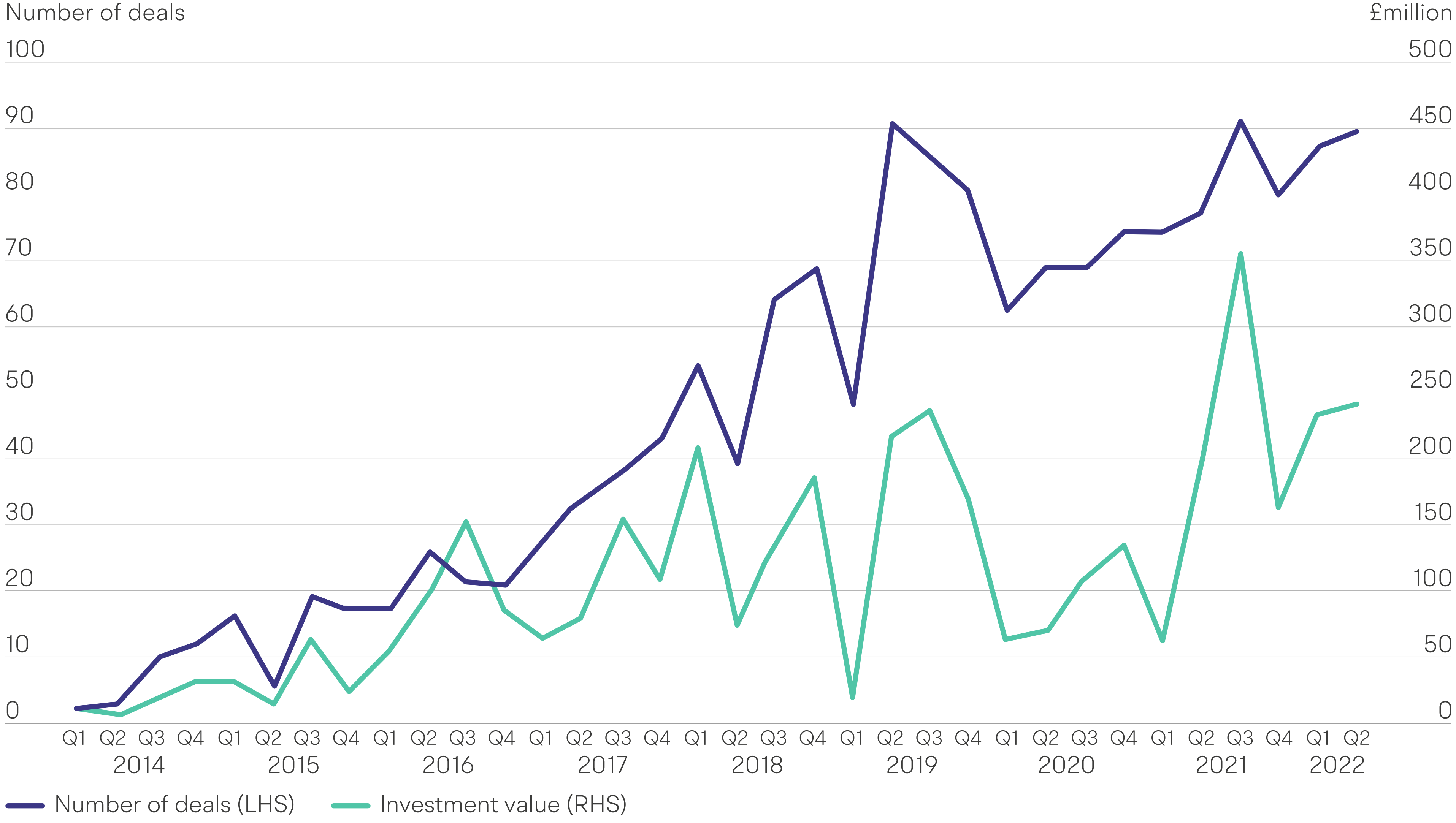
The Bank’s Small-Cap private debt funds portfolio continued to grow in the first half of 2022, with increased investment compared to the same period in 2021

As mentioned previously, both Deloitte and Preqin data sources mainly cover deals in mid-market companies with limited coverage of smaller deals in SMEs and

Figure B.41

Number and value of deals by British Business Bank Small-Cap private debt funds

Source: British Business Bank Management Information



smaller mid-cap companies. Small cap companies are generally defined as having an annual turnover of up to £100m. Consequently, the Bank's Management Information (MI) on the Small-Cap private debt fund portfolio has been used to assess the extent to which these primarily mid-market findings reflect the trends at the lower end of the market. This data covers 33 SME focused debt funds that the Bank's commercial subsidiary (British Business Investments) has invested in since 2013 through the Business Finance Partnership (BFP) and Investment Programme (IP).

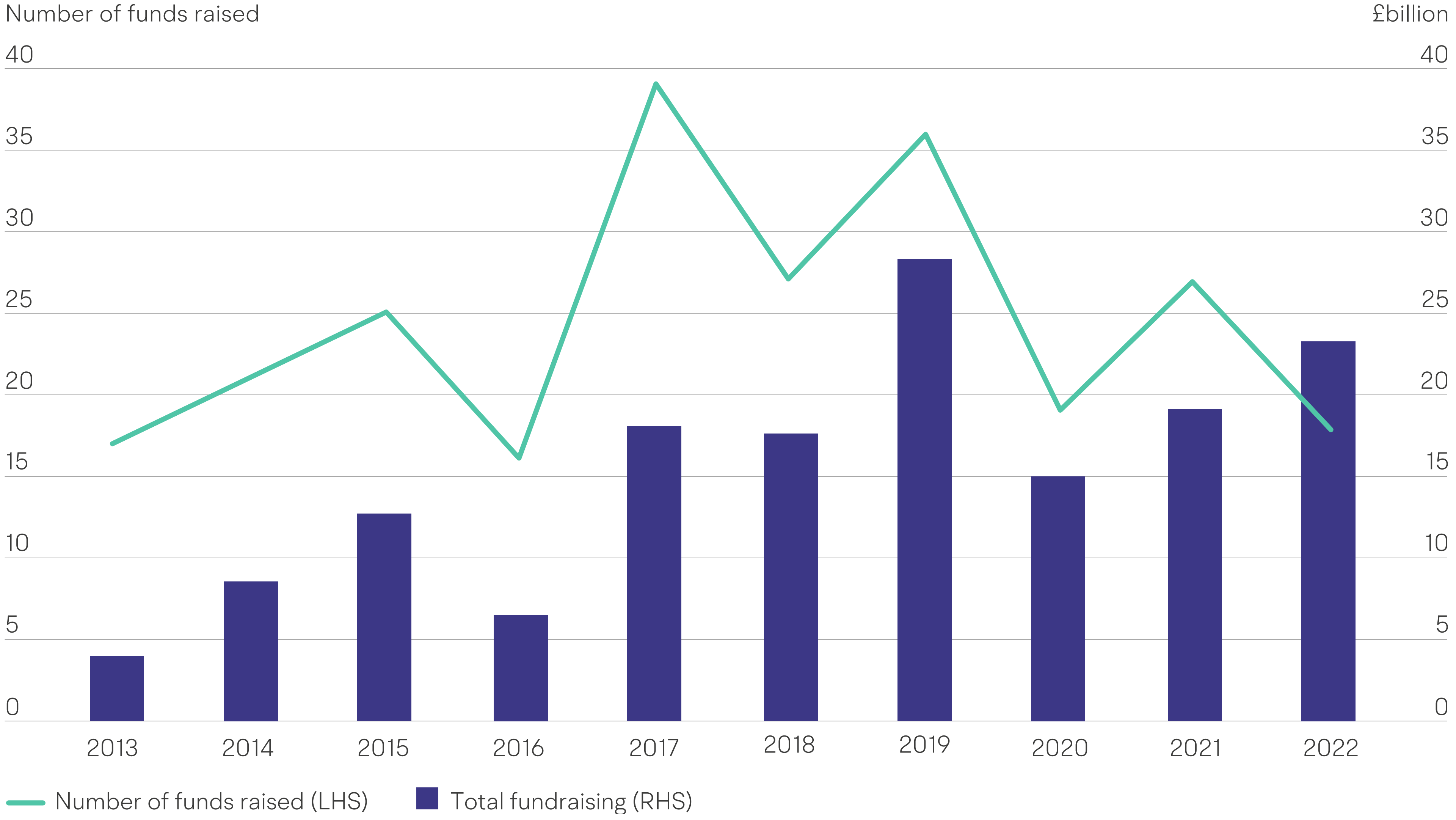
Whilst the mid-cap market experienced a decline in the number of deals in 2022 due to greater economic uncertainty, Figure B.41 shows an increase in small-cap private debt fund activity in the first half of 2022. This trend was a continuation of the recovery seen in 2021, following the market disruption of 2020 resulting from the Covid-19 pandemic.

In the first half of 2022, deal numbers increased by 17% to 176 deals and investment grew by 89% to £474m, compared to the same period in 2021. However, compared to second half of 2021 the number of deals was up only 3%, while investment fell by 8%. Due to time lags in collecting the data it is not possible at this

Figure B.42

Number and value of UK-based private debt funds raised

Source: British Business Bank analysis of Preqin Ltd



stage to see whether 22Q3 will show a decline in SME private debt deal activity, as seen in wider SME equity markets and mid-market private debt markets.

UK private debt fundraising increased in 2022 driven by a small number of larger funds, but global private debt fundraising is slowing down

Private debt as a global asset class has increased over the last decade. Figure B.42 shows the number of UK mid-market private debt funds that have closed over time and the amount raised. 18 UK-based private debt funds closed in 2022, raising a total of £23.3bn. In comparison, 27 funds closed in 2021 raising a total of £19.1bn. While this marks a 33% decline in the number of funds closing, total fundraising in 2022 was up by 22% year-on-year. However, fundraising in 2022 was largely driven by two outlier funds (both operated by ICG) which collectively raised £13.5bn, nearly 60% of the total investment raised in 2022. Without the contribution of these two funds, total UK private debt fundraising would have declined by around 50% compared its 2021.

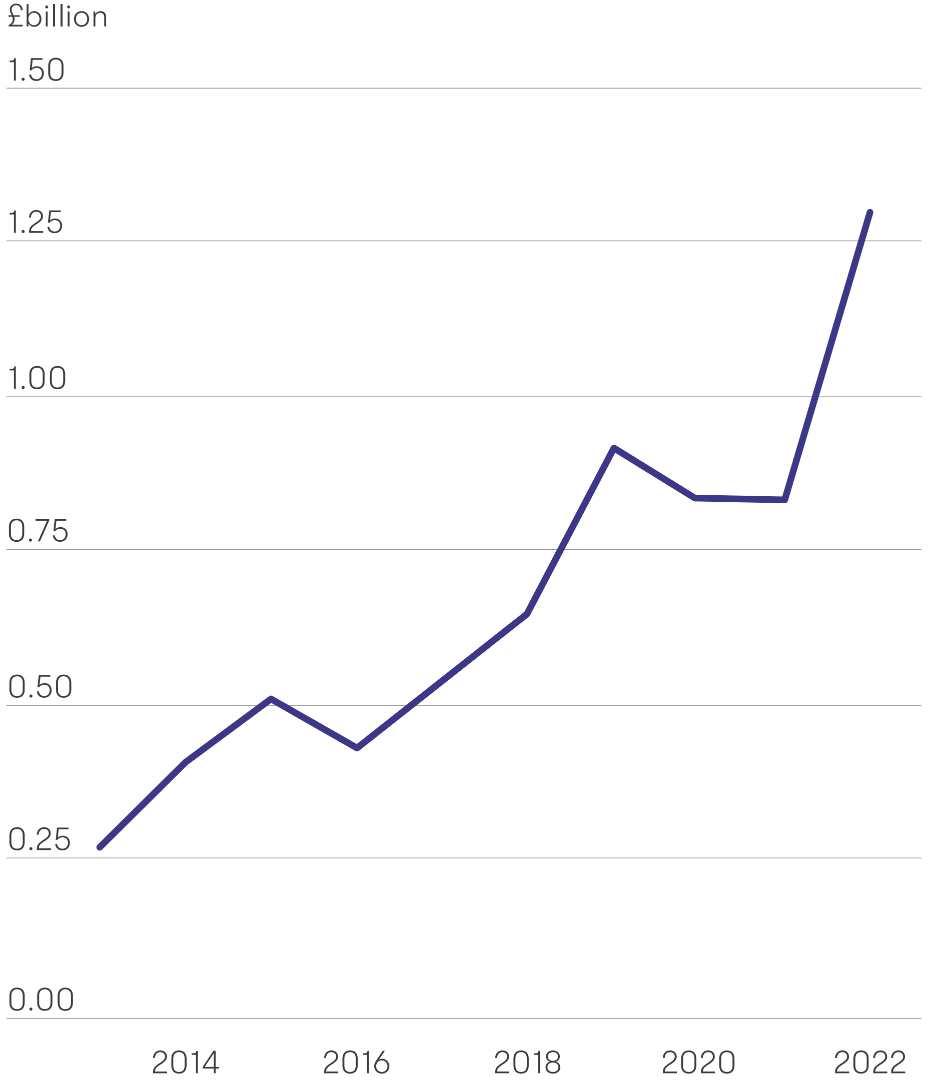
While fewer private debt funds closed in 2022, more money was raised in 2022 overall due to a large increase in the average fund size. In its publication 'Preqin Global Report 2023: Private Debt', Preqin note that the recent decline in the number of private debt funds "...suggests investors remain positive on the asset class but are becoming more discerning in their allocations, with larger commitments going to fewer managers". Whilst UK and European private debt fundraising increased in 2022, Preqin data shows global private debt fundraising fell 5% in 2022, predominantly driven by a decline in the US market.[167]

The Bank's Investment Programme plays a pivotal role in establishing smaller and emerging private debt fund managers. In the first three quarters of 2022 the Investment Programme made six commitments worth £148m to SME-focused fund managers, up from the five funds committed in 2021.[168] The role of SME-focused private debt funds within finance markets becomes even more important during periods of economic uncertainty, as commercial bank lending becomes more cautious and more risk averse. In the absence of these smaller private debt funds, smaller businesses across the UK would not have access to the same types of flexible, growth-orientated capital that larger companies can use.

Figure B.43

Average size of UK-based private debt funds raised

Source: British Business Bank analysis of Preqin Ltd



The trend for fewer but larger private debt funds raised can be seen in average fund sizes (Figure B.43). The average UK private debt fund size increased from £270m in 2013 to £1.3bn in 2022. The average fund size was £833m in 2021.

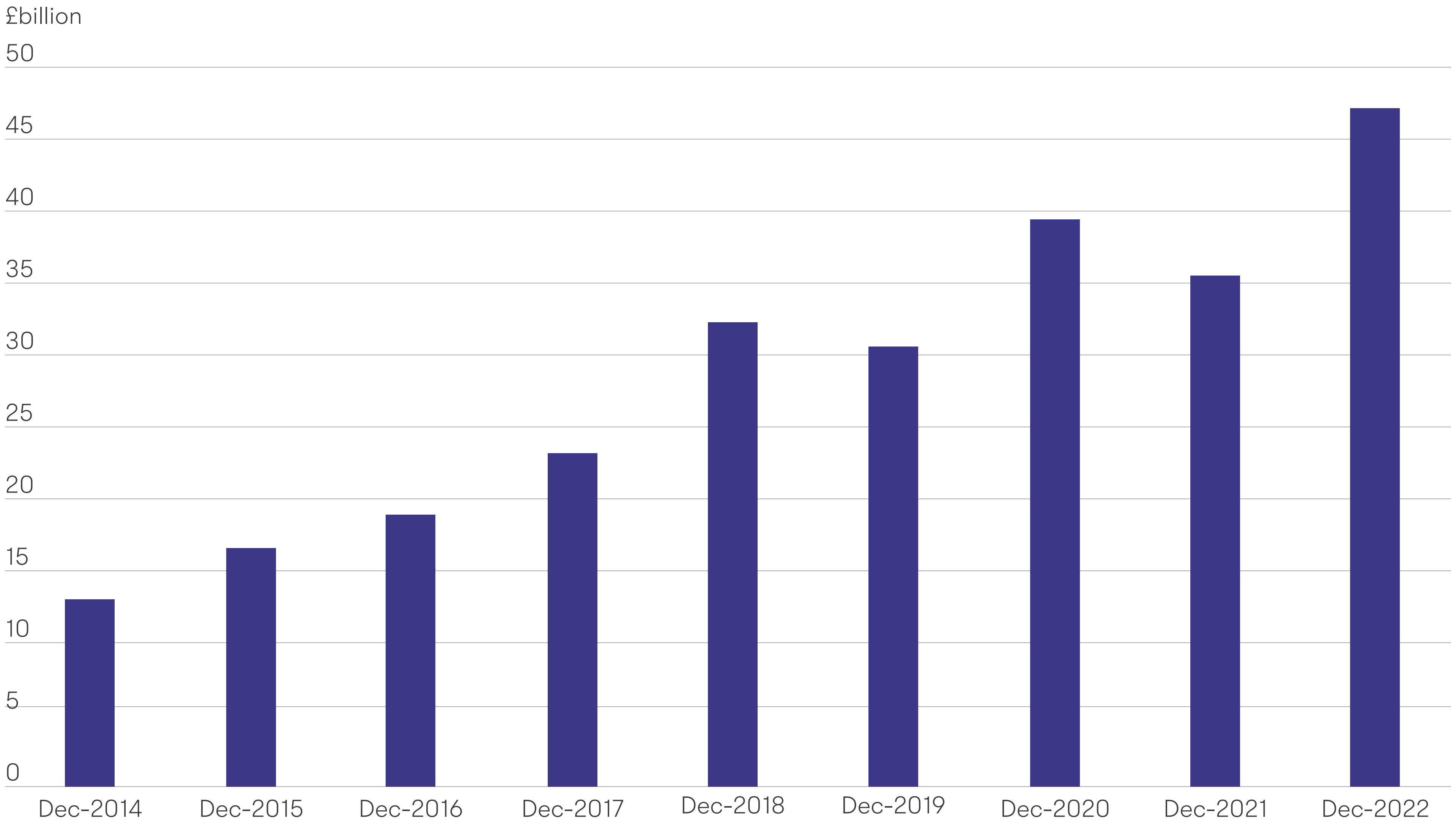
In 2022 five funds raised more than £1bn each, compared to six funds that each raised over £1bn in 2021. There were also six funds smaller than £250m that closed in 2022, and these funds represented 33% of all funds that closed during the year.

An increase in private debt fundraising and lower deployment in 2022 has led to an increase in the amount of dry powder,[169] which has reached record highs in 2022. Figure B.44 shows as at the end of December 2022, UK private debt funds had accumulated dry powder of £47.2bn, up from £35.5bn in December 2021 and more than double the amount in 2017.

Figure B.44

UK-based private debt funds dry powder

Source: British Business Bank analysis of Preqin Ltd



The British Business Bank is committed to continue supporting SME private debt markets

UK mid-market deal activity slowed down in 2022, but SME focused funds supported by the British Business Bank continued to invest over the first half of 2022 despite wider economic uncertainty. The wider market shows capital consolidating towards larger, more established fund managers at the expense of smaller funds. Longstanding structural market issues continue to create barriers for new private debt fund managers to enter the market, with investors preferring to write fewer, larger cheques to established private debt fund managers.

Smaller fund managers, and by extension the SMEs they invest in, may find it increasingly difficult to raise capital. Therefore, the Bank's Investment Programme (IP) continues to play an important role in the market, committing £148m across six funds in 2022.[170] The Bank often cornerstones smaller private debt funds, writing substantial commitments which help leverage additional capital into the asset class.

Companies with high growth potential can be found across the whole UK. Private debt is also an important tool supporting the government's aim of levelling up the economies of the regions and Nations of the UK. 92% of companies funded and 67% of investment from the Bank's Investment Programme and debt funds within the Bank's regional programmes went to companies located outside of London. This shows the geographic distribution of private debt investment is more regionally diverse than venture capital markets.

The flexibility of private debt also means it is well-suited to support viable smaller businesses over the entire economic cycle, helping them to restructure and fund their expansion during uncertain economic times.

2.7

Bank lending

Gross bank lending in 2022 was the second highest on record

Gross repayments rose to a record high

The demand for working capital products including overdrafts increased

The British Business Bank continues to support bank lending to smaller businesses across the UK

This section analyses developments in the UK banking market for smaller businesses in 2022. It draws on the most recent data from sources including the Bank of England (BoE), UK Finance and the British Business Bank.

Gross bank lending in 2022 was the second highest on record

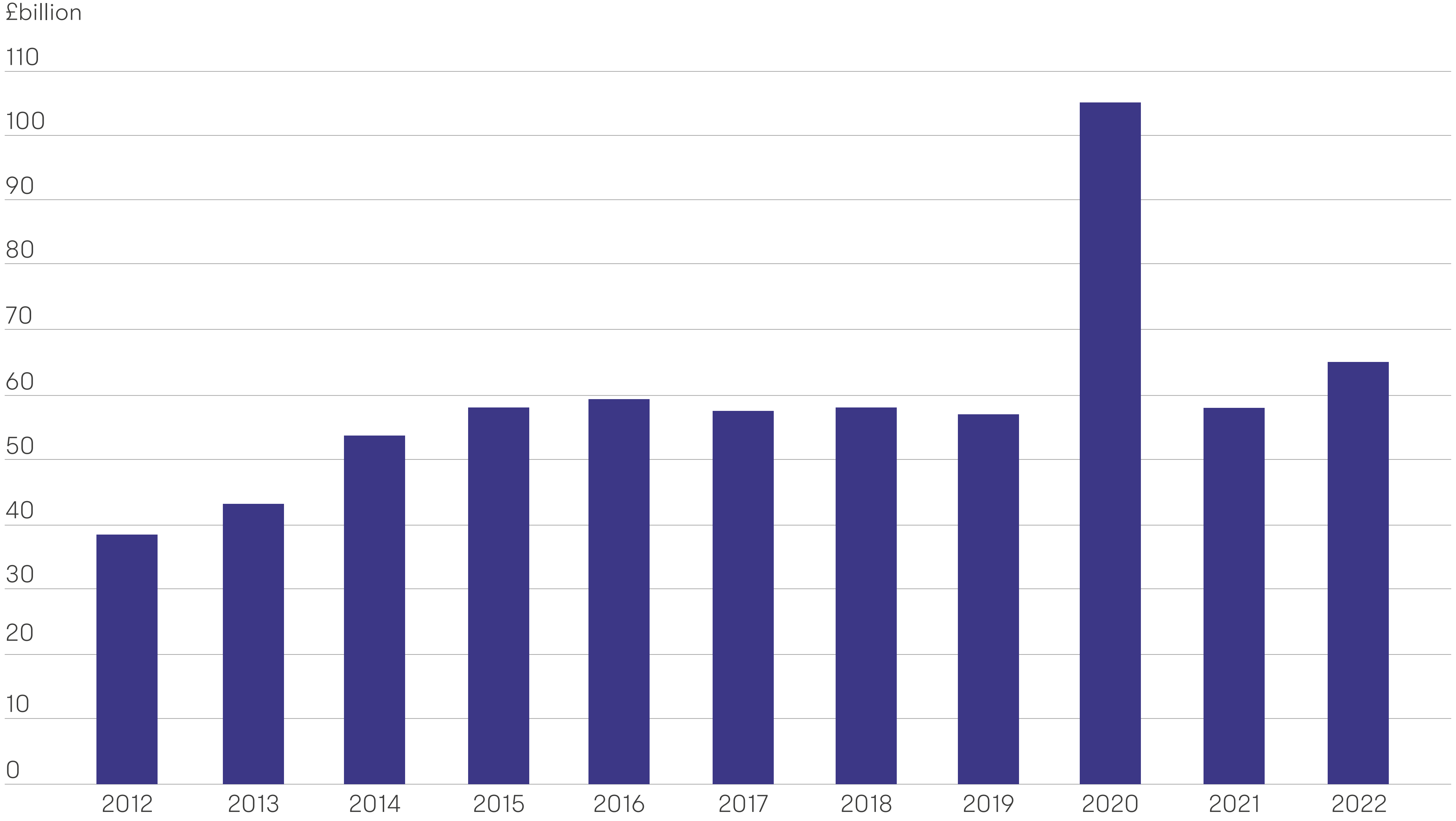
Nominal gross bank lending excluding overdrafts to small and medium-sized enterprises (SMEs) in 2022 totalled £65.1bn, according to BoE data.[171] This was up 12.8% from 2021 and higher than in every year from 2012 to 2019. However, it remained below the record high of 2020 (£105bn), which was largely driven by government-guaranteed Covid-19 loans (Figure B.45).

While gross bank lending in 2022 was the second highest on record in nominal terms, this was not the case when accounting for inflation. In real terms, gross lending in 2022 was £62.3bn. This was up from 2021 (£57.7bn) but only £2bn higher than in 2019. It was also the sixth

Figure B.45

Annual gross bank lending to SMEs

Source: BoE Bankstats



highest year after 2020 (£105bn), 2016 (£66.3bn), 2015 (£66.1bn), 2017 (£63bn) and 2018 (£62.5bn).

Market-based lending, which is gross lending excluding government-guaranteed loans, in 2022 was £63.8bn.[172] This was the highest on record and excludes drawdowns from banks under the Recovery Loan Scheme (RLS).

For context, gross lending in 2021 included drawdowns under the Coronavirus Business Interruption Loan Scheme (CBILS), Bounce Back Loan Scheme (BBLS) and RLS. CBILS and BBLS were significant due to a large increase in applications in the months leading up to both schemes closing in March 2021. Gross lending in 2021 excluding CBILS, BBLS and RLS was £49.7bn. This was up from 2020, when gross lending excluding CBILS and BBLS was £48.1bn.

The quarterly breakdown shows gross lending trended higher in 2022. It rose in Q3 for the fourth consecutive quarter to £17.4bn, seasonally adjusted. This was the highest since Q4 2020 (£18.2bn). In the final quarter of 2022 gross lending fell modestly but remained higher than in the first half of the year (Figure B.46).

The big five banks have traditionally been the main driver of gross lending.[173] However, this was not the case in 2022 for the second year in a row, with challenger and specialist banks accounting for a higher share of total gross lending than the big five banks (see B.2.8 Challenger and specialist banks for more details).

The British Business Bank's market contacts report the rise in gross lending in 2022 partly reflects that some SMEs restructured their debt. There were instances of SMEs that struggled to service multiple large bank loans agreeing to consolidate them and redraw the finance on different terms. The gross lending figures would have captured when the finance was redrawn.

The gross lending measure consists of term lending, credit card lending and can include other products such as asset finance but the BoE does not provide the breakdown (for a discussion of developments in asset finance see B.2.10 Asset Finance).

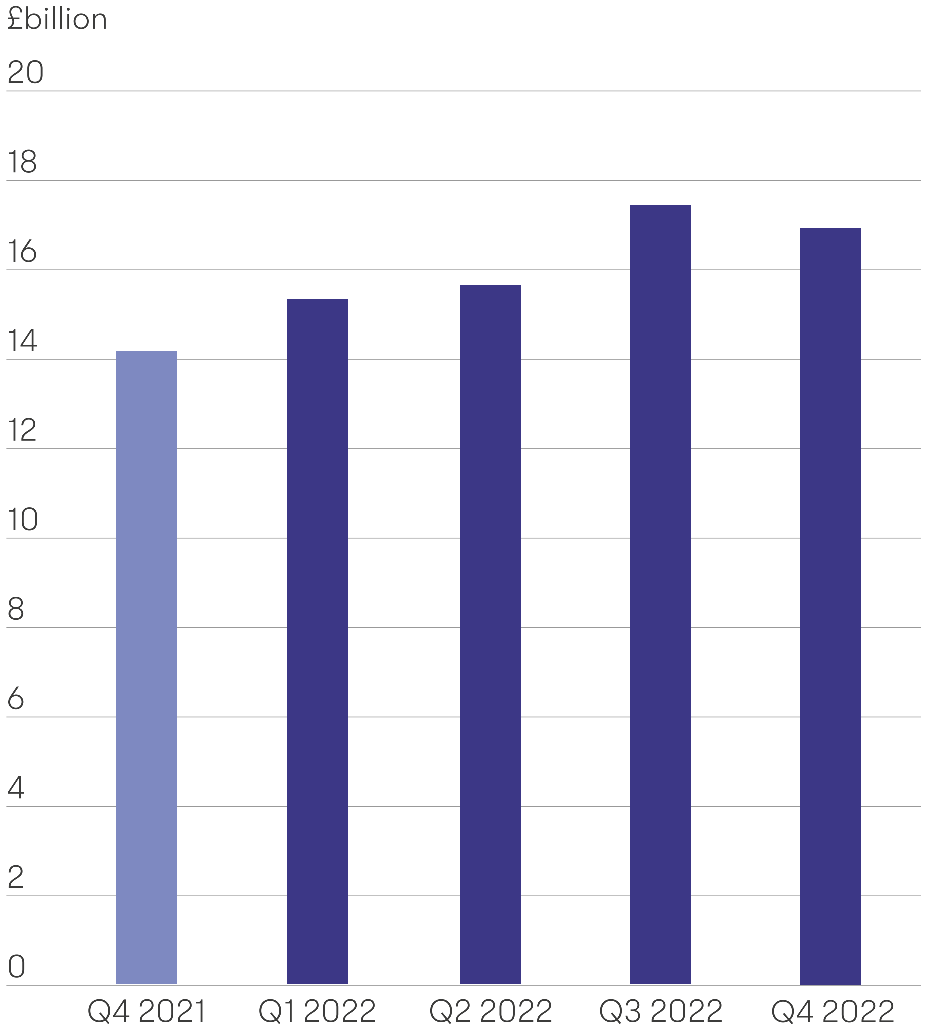
Our market intelligence also suggests that demand for term lending is mixed. This was attributed to some smaller businesses holding large deposits while others are focused on repaying debt or face higher borrowing costs.

The total value of SMEs' deposits held by the major banks during 2022 was very high. At the time of writing

Figure B.46

Quarterly gross bank lending to SMEs

Source: BoE Bankstats



the latest data from UK Finance, which covers the seven largest banks, showed SME deposits totalled £265bn in Q3 2022.[174] This was down slightly from the record high in Q4 2021 (£272bn). However, it was still higher than in every quarter from when the series started in Q3 2011 to Q1 2021 (Figure B.47)

The focus of some smaller businesses on repaying debt reflects the large take-up of government loans during the pandemic. This led the current total level of smaller business debt to be high (see 2.2 Smaller businesses and their debt positions in the Small Business Finance Markets report 2021/22 for more information).[175] The British Business Bank's Business Finance Survey reported in 2022 that 38% of smaller businesses cited "avoid additional debt" as the reason why they did not apply for finance. This was the second most cited response after "too expensive" (52%).[176]

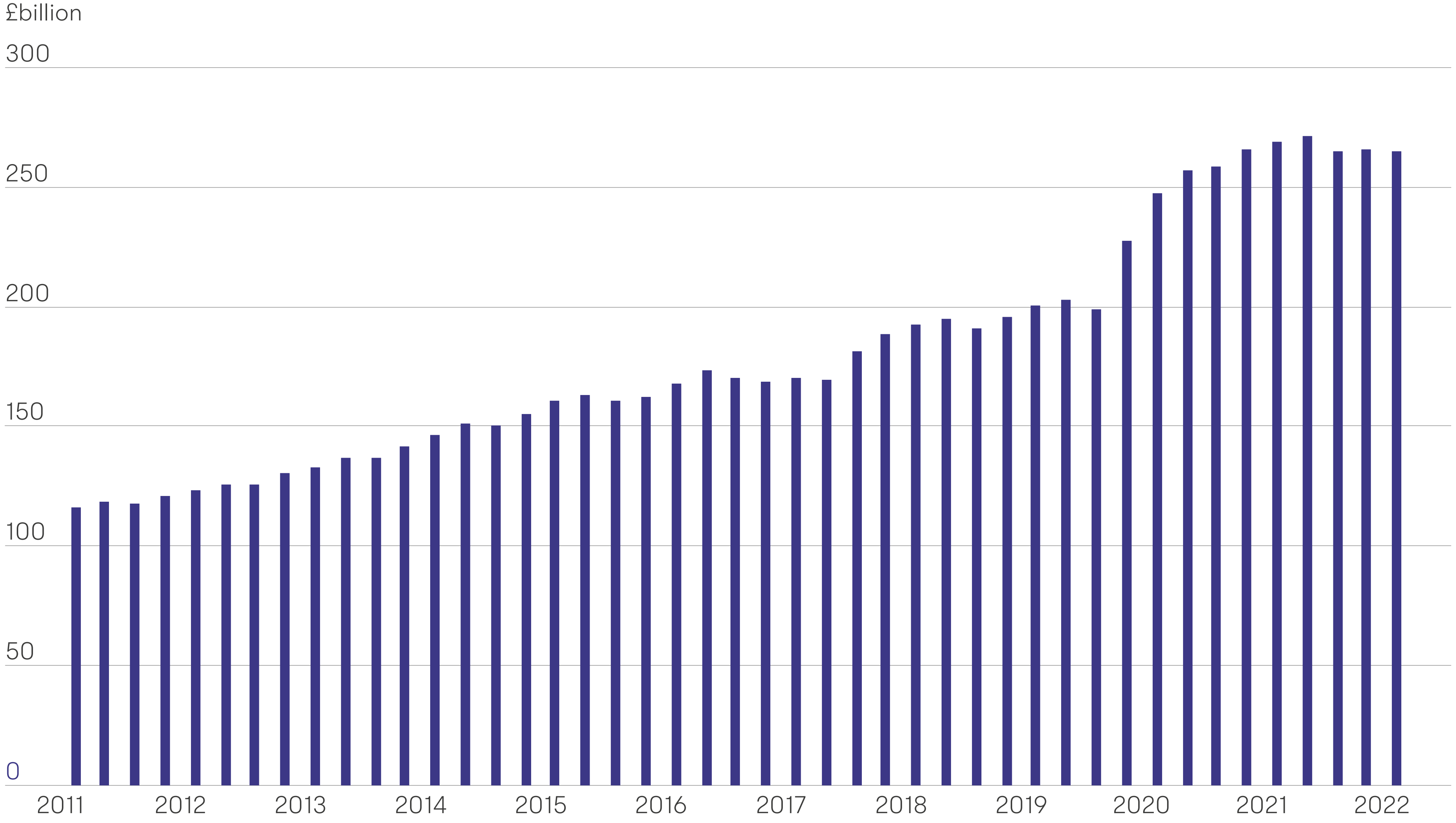
The higher borrowing costs facing SMEs reflect that the interest rates on new fixed and floating loans during 2022 reached the highest level since records began in 2016 (Figure B.48).

In relation to the demand for credit card lending, the Bank's market contacts report it was subdued. This is in line with a BoE survey of banks and building societies

Figure B.47

SME deposits held with the seven largest UK banks

Source: UK Finance



showing the demand of small businesses for credit card lending was weak in Q4 2022 for the fourth consecutive quarter.[177] As for term lending, the weakness was attributed to some smaller businesses holding large deposits.

The BoE agents reported that businesses said credit conditions eased in Q1 2022.[178] A probable explanation for the easing was the improving economic outlook as the UK recovered from the impact of the pandemic. However, the agents subsequently reported credit conditions for SMEs started to tighten in Q2 and continued to do so in the second half of the year.[179]

Similarly, the BoE survey of banks and building societies reported the proportion of loan applications from small business being approved fell sharply in Q2 2022. This likely reflects that the Russian invasion of Ukraine in February led to a sharp rise in input costs, particularly for energy, which weighed on the UK economic outlook. The proportion of loan applications approved was broadly unchanged in Q3 but fell sharply again in the final quarter of the year.

Our market intelligence is that banks now require more information from smaller business applicants. One of the drivers has been the need to determine whether the firm can afford the loan given the higher energy prices. Banks are looking at what energy tariff a firm is on, when it is due to expire and profit after energy bills. Another driver has been ongoing transformational requirements on lenders due to regulation such as Know Your Customer/Anti-Money Laundering.

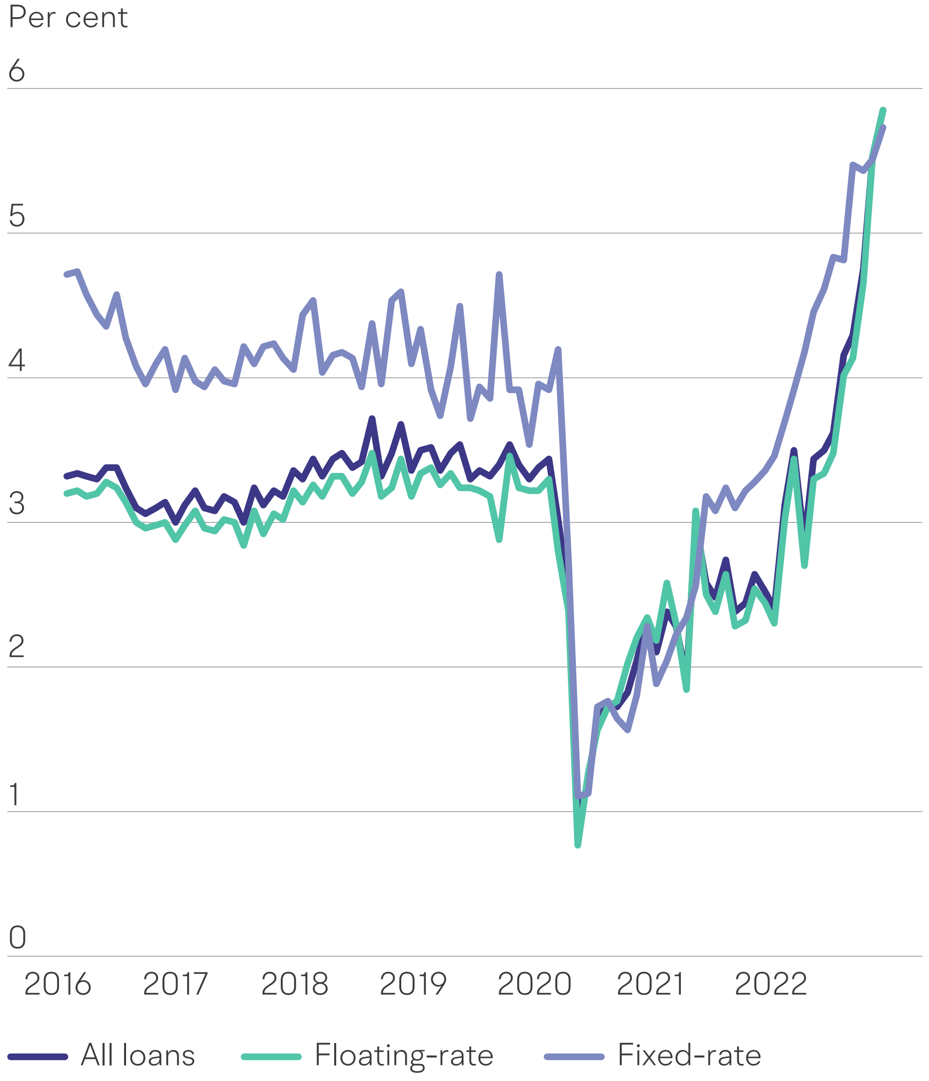
During 2022 all the big five banks introduced or increased provisions for loan losses. These were expected to result from the impact of the war in Ukraine and high inflation on the UK economy. The most recent trading reports at the time of writing were for Q3. They indicated loan defaults had risen modestly but remained relatively low.

According to our market contacts, another factor in the mix is the UK government's target for the economy to be net zero by 2050. Banks are now considering the target when looking at applications for business loans. For example, they are considering whether the value of diesel-driven machinery may need to be depreciated in a shorter time frame than previously.

Figure B.48

Effective interest rates (new business) for SMEs

Source: BoE Bankstats



Gross repayments rose to a record high

Nominal gross repayments from SMEs in 2022 totalled £73.6bn. This was up 11.9% on 2021 and the highest on record (Figure B.49). In real terms, gross repayments in 2022 totalled £70.9bn. This was also the highest on record.

The record level of nominal and real repayments was mostly driven by the one-year holiday on paying back the principal and interest on BBLS ending for those SMEs that took the last opportunity to draw them down. Such SMEs were required to start repaying the principal and interest by December 2022 at the latest.

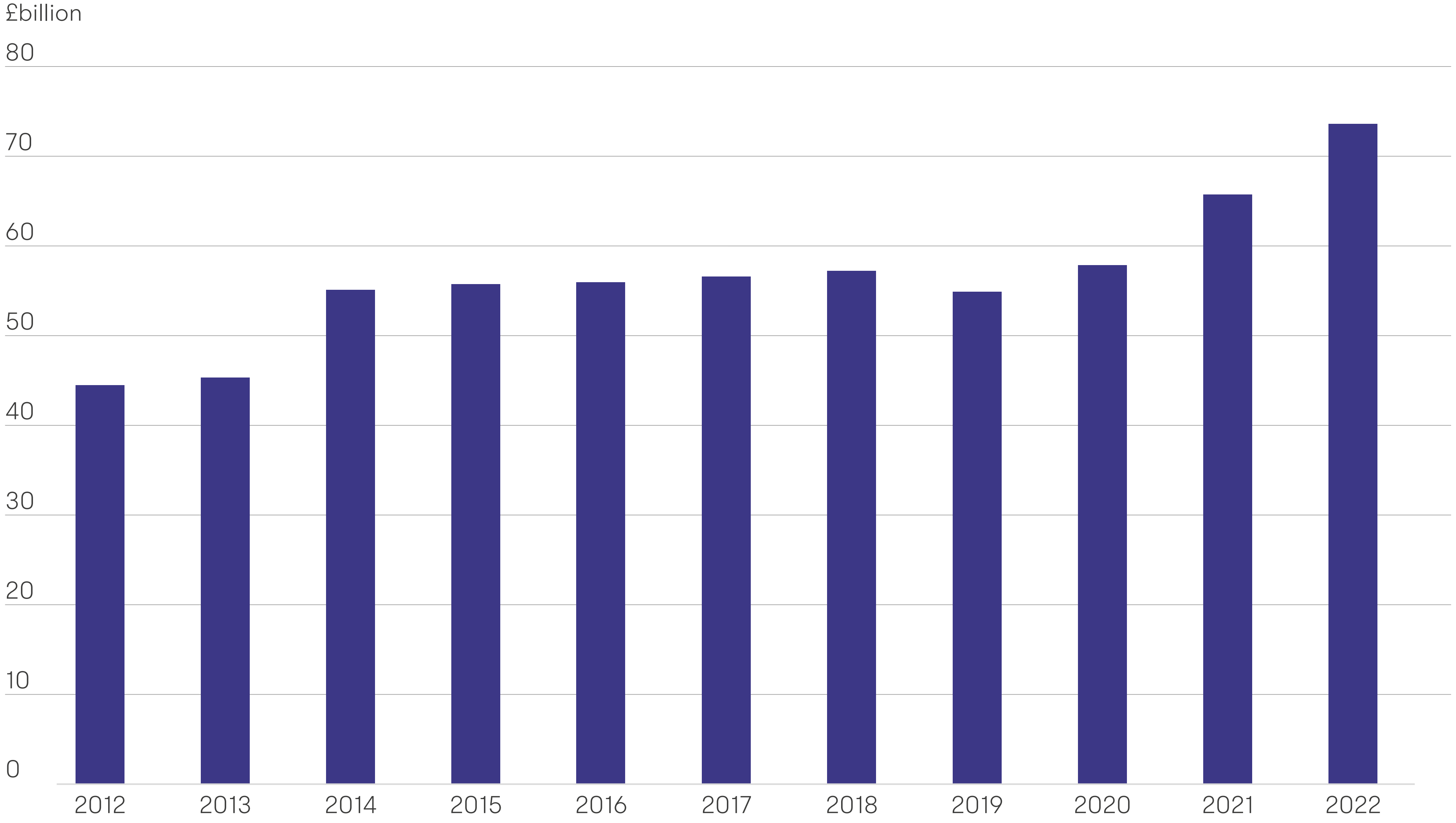
Also, some SMEs that had not used the funds paid them back in full prior to the end of the one-year holiday. British Business Bank monthly data showed the total value of BBLS that had been fully repaid rose sharply in mid-2022.

Similarly, repayments were boosted by the one-year holiday on paying interest on CBILS ending for those SMEs that had taken the last opportunity to draw them down.[180] In addition, the principal and interest paid by SMEs that drew down RLS facilities during 2022 contributed to repayments.

Figure B.49

SME gross repayments

Source: BoE Bankstats



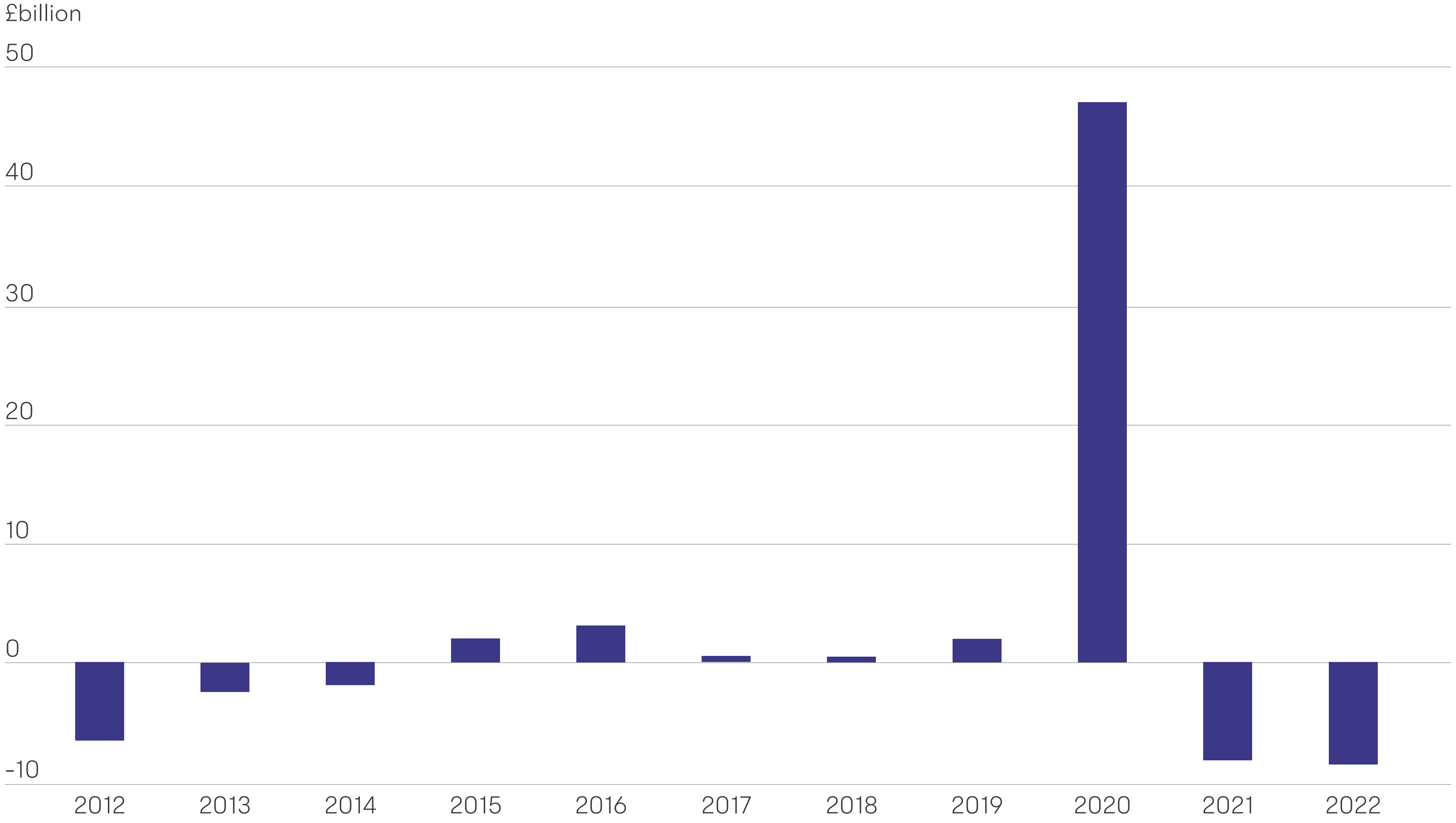
The Bank's market contacts report the rise in repayments also reflects that, as mentioned earlier in this section, some SMEs restructured their debt. The gross repayment measure would have captured when the multiple bank loans were refinanced and consolidated.

The BoE measure of nominal net lending in 2022 was a negative £8.5bn. This compares to a negative £8bn in 2021. Due to the impact of some SMEs restructuring their debt, our market intelligence suggests net lending may be a better measure of underlying bank lending than gross lending (Figure B.50). In real terms, net lending in 2022 was a negative £7.7bn. This was slightly narrower than the negative £8bn in 2021, which was the largest on record.

Figure B.50

SME net lending

Source: BoE Bankstats



The demand for working capital products including overdrafts increased

2022 was a year of increased demand for working capital finance as businesses struggled with higher input costs and lower revenue (see the section on Macroeconomic developments for more details).

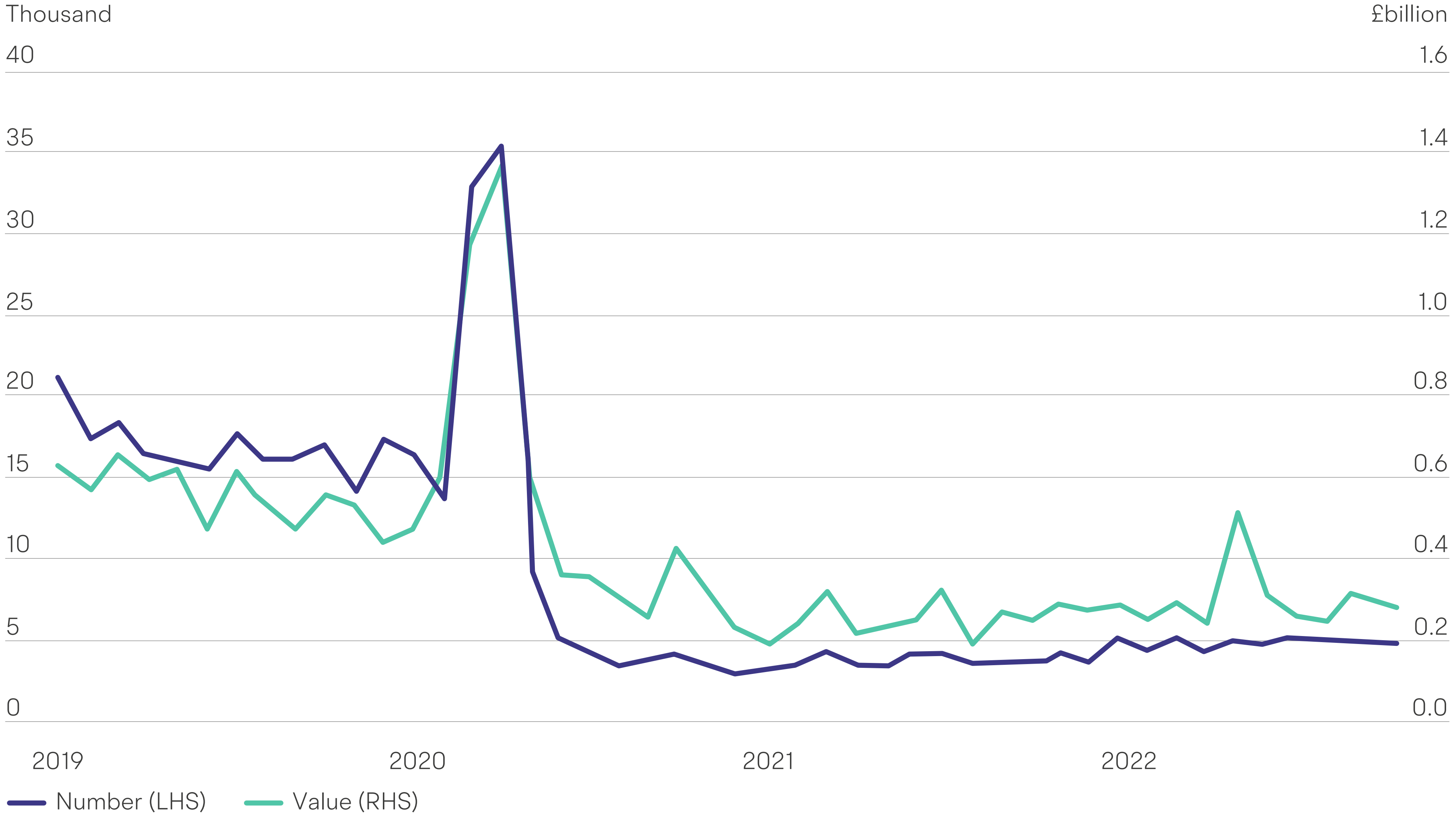
The BoE agents reported in Q4 2022 that the demand of businesses for working capital finance had increased. This was the sixth consecutive quarter it had done so. Similarly, our Business Finance Survey showed that 53% of SMEs said the main reason for seeking finance was working capital in 2022. This was the main reason cited by far, followed by the purchase of fixed assets (27%) (see 2.2 Use of external finance for more information).

Working capital products include overdrafts. UK Finance data shows the number and value of SME applications to the seven largest banks for overdrafts in the first 10 months of 2022 was higher than in 2021. However, it remained below pre-pandemic levels (Figure B.51). This is in line with the Bank's market contacts reporting the demand for overdrafts is weaker than for other working capital products such as invoice finance. They attributed this to overdrafts being relatively expensive.

Figure B.51

SME applications to the seven largest UK banks for overdrafts

Source: UK Finance



Similarly, BoE data shows the stock of SME overdrafts with all UK banks trended higher during 2022 but remained below pre-pandemic levels (Figure B.52).

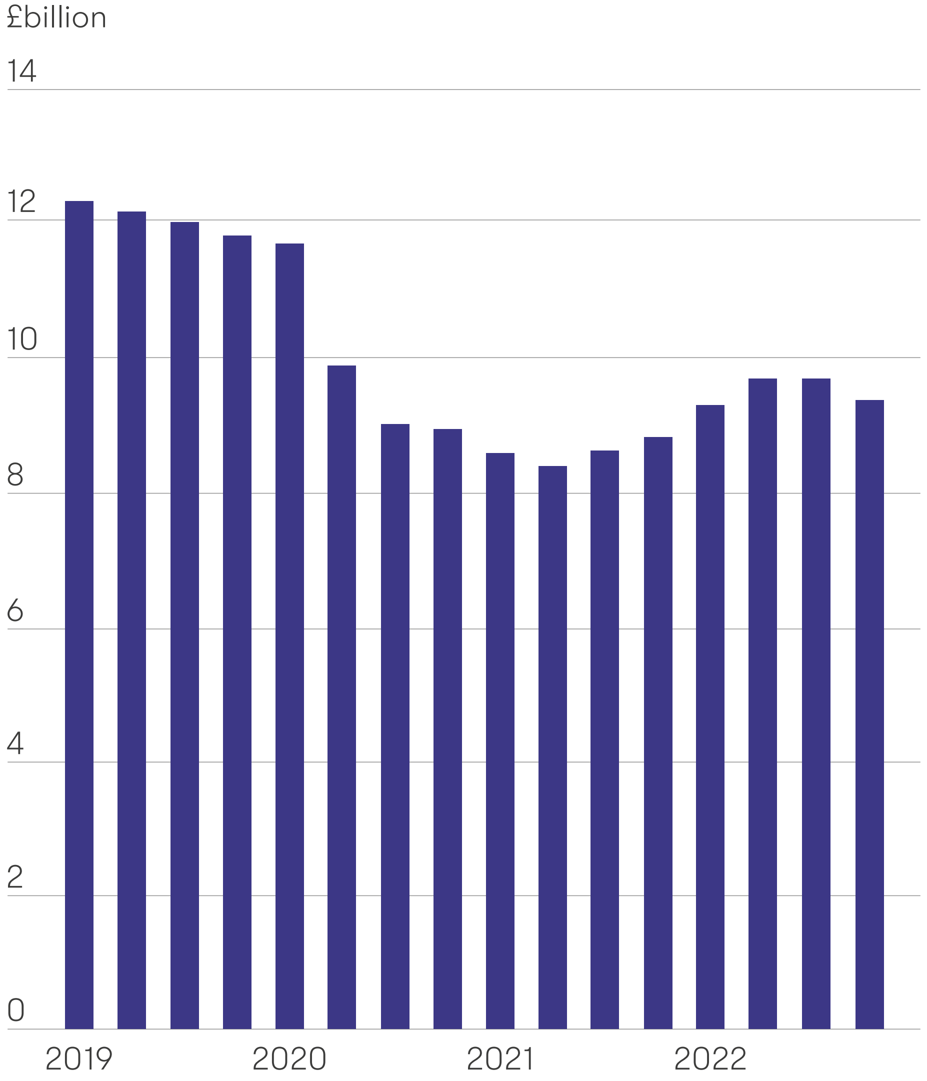
At the same time, surveys indicate that many businesses saw their revenue weaken during 2022. This is in line with UK economic growth losing momentum and broadly grinding to a halt during 2022.

The Bank's market contacts also attributed the increased demand for working capital products to increased late payments. This reflects that, to support cash flow, more firms failed to pay their suppliers on time.

Figure B.52

SME overdraft stock, seasonally adjusted

Source: BoE Bankstats



The British Business Bank continues to support bank lending to smaller businesses across the UK

In a trading environment of subdued economic activity and high inflation, it is crucial for the banking sector to provide smaller businesses with the finance that they need.

The British Business Bank stands ready to support bank lending to smaller businesses through its existing programmes including RLS (which includes facilities that help maintain cash flow), the ENABLE Guarantee programme and the ENABLE Build programme.

2.8

Challenger and specialist banks

Gross lending by challenger and specialist banks rose in 2022 to the highest on record

Challenger and specialist banks' share of total gross lending also reached a record high in 2022

There are signs challenger and specialist banks have followed a range of approaches amid a testing year

Specialist banks are more exposed to the increased cost of funding than the big five

Some challenger and specialist banks struggled to raise capital

Four start-up banks were granted UK banking licences in 2022, of which two lend to smaller businesses

This section analyses developments in 2022 for the challenger and specialist banks that serve smaller businesses. It draws on data from sources including the Bank of England (BoE), the financial reports of challenger and specialist banks and the British Business Bank.

Gross lending by challenger and specialist banks rose in 2022 to the highest on record

Nominal gross lending excluding overdrafts to small and medium-sized enterprises (SMEs) by challenger and specialist banks in 2022 was £35.5bn, according to BoE data. This was the highest since records began in 2012.

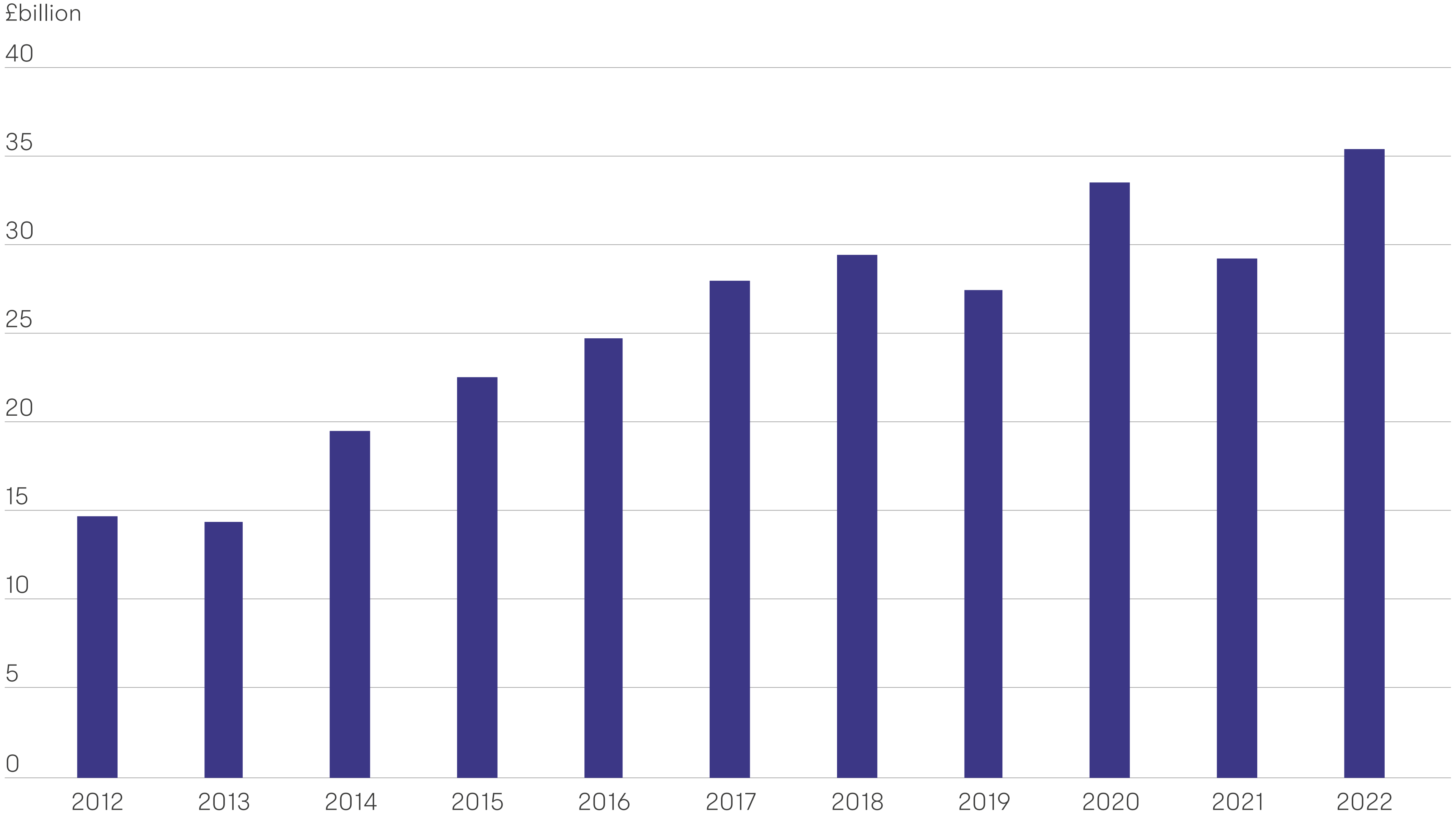
The record high in 2022 was up 21% from 2021 (£29.2bn). It was 29% above the pre-pandemic level in 2019 (£27.5bn) and 6% higher than in 2020 (£33.6bn) when challenger and specialist banks lent £6.9bn through Covid-19 government-guaranteed loan schemes (Figure B.53).

Although gross lending by challenger and specialist banks reached a record high in 2022 in nominal terms,

Figure B.53

Gross lending to SMEs by challenger and specialist banks

Source: BoE



this was not the case when inflation is taken into account. In real terms, challenger and specialist banks' gross lending was £33.5bn. This was up from £29bn in 2021 but the second highest on record after 2020 (£33.9bn).

Market-based lending by challenger and specialist banks in 2022 was £34.7bn. This excludes drawdowns under the Recovery Loan Scheme (RLS). It was above market-based lending in 2021 of £25.5bn, which excludes the Coronavirus Business Interruption Loan Scheme (CBILS), Bounce Back Loans (BBLS) and RLS. Similarly, it was above market-based lending in 2020 of £7.1bn, which excludes CBILS and BBLS.

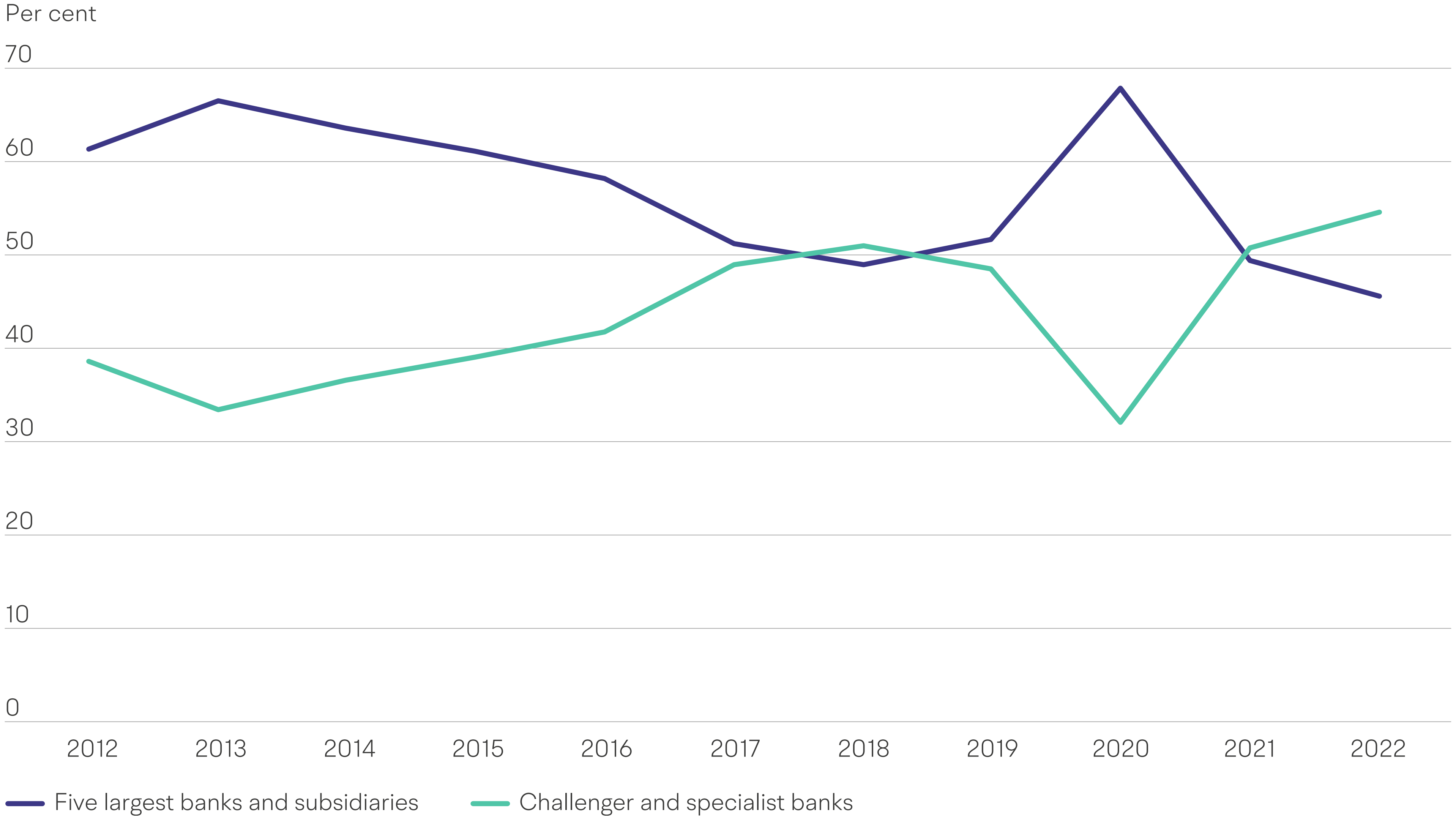
Challenger and specialist banks' share of total gross lending also reached a record high in 2022

The share of total gross lending to SMEs by challenger and specialist banks in 2022 was 55%. This was up from 51% in 2021 and the highest on record. It also marked the second consecutive year in which the challenger and specialist banks' share exceeded that of the big five banks (Figure B.54).

Figure B.54

Share of total gross bank lending to SMEs

Source: BoE



The record-high share was solely driven by the previously mentioned 21% rise in gross lending by challenger and specialist banks in 2022. Gross lending by the big five banks in 2022 was £29.6bn, up only 4% from 2021 (Figure B.55).

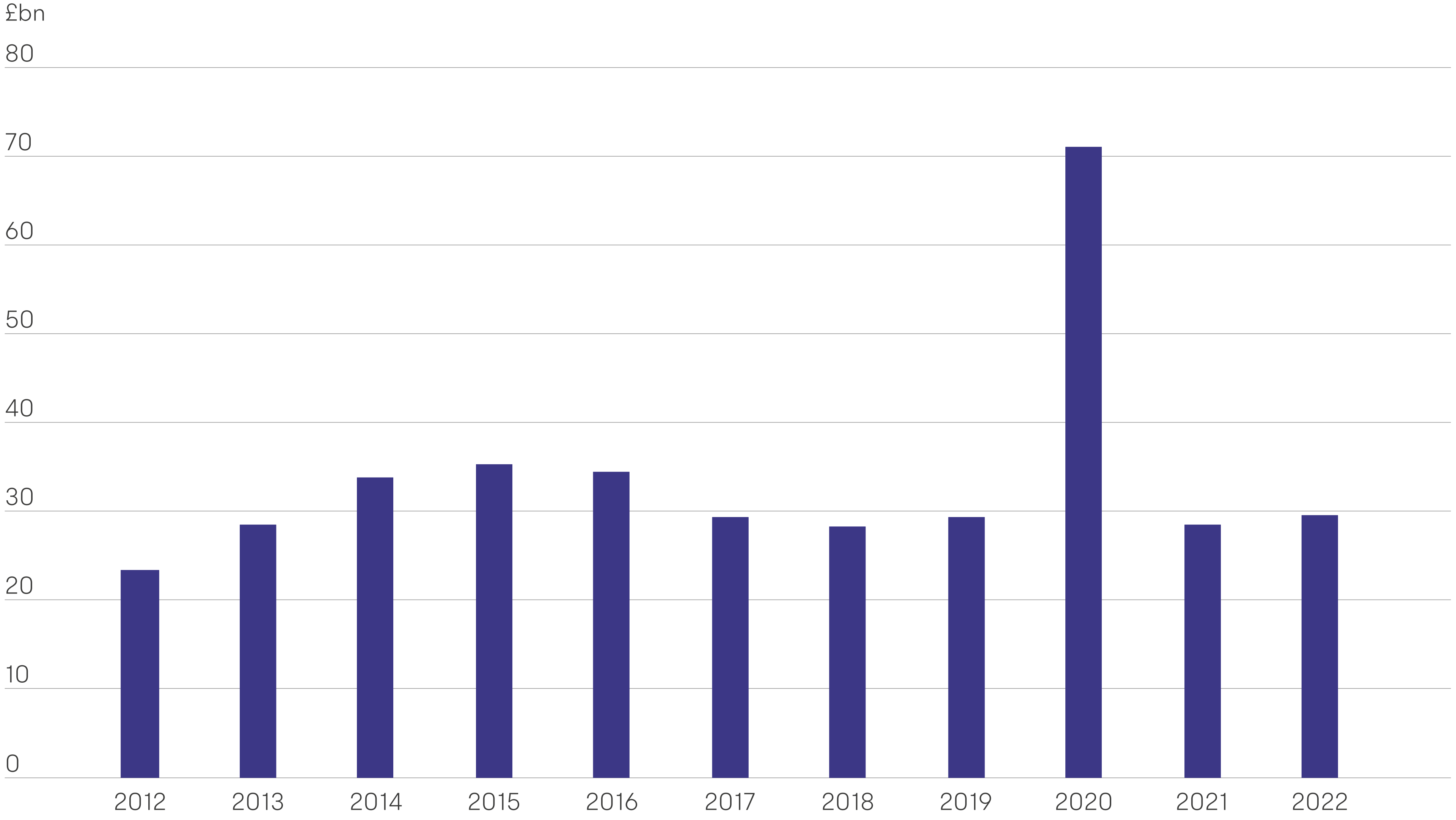
Quarterly data shows gross lending by challenger and specialist banks in Q4 2022 was larger than that by the big five banks for the seventh consecutive quarter. This is the longest period it has been so on record. The start of the period (Q2 2021) is consistent with CBILS and BBLS closing to new applications at the end of Q1 2021 (Figure B.56).

The higher share of gross lending by challenger and specialist banks is broadly in line with the British Business Bank's Business Finance Survey showing the proportion of SMEs that considered more than one finance provider in 2022 (32%) was the highest since 2019 (34%).[181] The survey also showed the proportion of SMEs that were successful in obtaining all the finance they needed from the first provider in 2022 (64%) was significantly lower than in 2021 (80%) and the three years prior to that.[182]

Figure B.55

Gross lending to SMEs by the big five banks

Source: BoE



Challenger and specialist banks provided a larger proportion of government-guaranteed loans than the big five banks in 2022. The total value of RLS drawn down from banks in 2022 was £1.3bn. Of this, challenger and specialist banks accounted for £0.8bn (around 60%) while the big five banks provided £0.5bn. This contrasts with challenger and specialist banks providing a smaller proportion of facilities under the government loan schemes than the big five banks in the previous two years. In 2021 challenger and specialist banks comprised £2.8bn (35%) of CBILS, BBLS and RLS drawn down from banks. In 2020 they accounted for only £3.7bn (6%) of CBILS and BBLS.

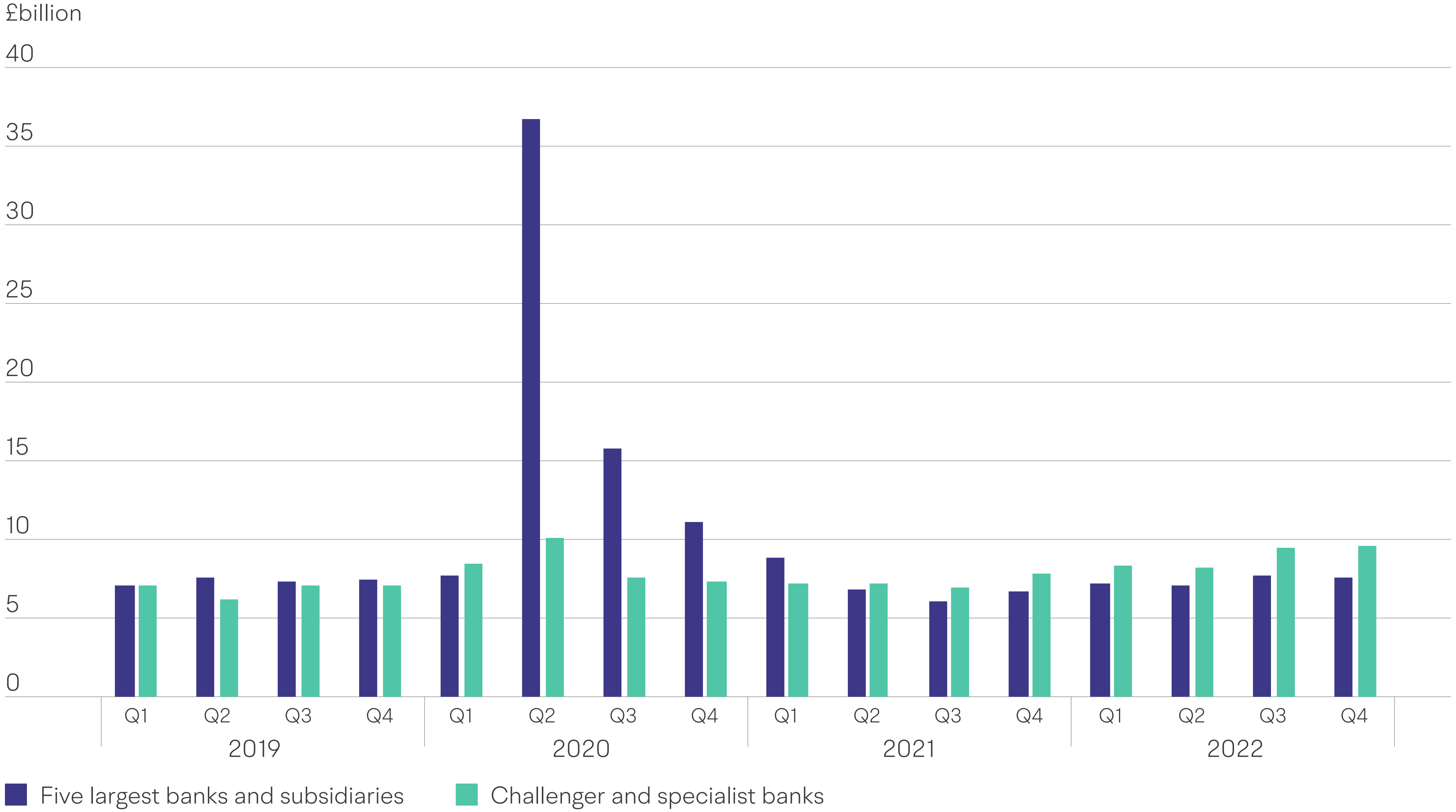
The Bank's market contacts report that challenger and specialist banks are operating where the big five banks are not. This is in line with the BoE agents reporting in early 2022 that businesses said challenger banks were more willing than the major banks to lend to companies in sectors that had been most severely affected by the pandemic.[183]

Our market intelligence also suggests that the pricing of products and services offered by challenger and specialist banks is risk-based. This reflects that challenger and specialist banks typically have higher

Figure B.56

Gross lending by the big five banks and challenger and specialist banks

Source: BoE



funding costs than the big five banks. It also reflects they often lend to riskier segments of the market or propositions that have a higher probability of default. However, some challenger and specialist banks have a more robust relationship management approach to lending.

There are signs challenger and specialist banks have followed a range of approaches amid a testing year

At the time of writing, none of the individual challenger and specialist banks had reported full year lending figures for 2022. However, a handful had reported data covering part of the calendar year.

Among the handful of reports there was no common trend in their loan books. Some reduced their exposure to real estate and buy-to-let lending while others grew their lending. This suggests there were multiple strategies at work between different challenger and specialist banks. The diversity of approaches, along with that of lenders, signals smaller businesses that needed finance were still able to get it.

Specialist banks are more exposed to the increased cost of funding than the big five

The cost of funding faced by UK banks increased in 2022. There were two drivers. One was the rising Bank Rate, which raised the cost of the interest paid on customer deposits. The other was the higher yield on gilts boosting the cost of wholesale funding.

Smaller banks such as specialists typically offer higher interest rates on savings accounts than the big five banks to attract deposits. In contrast, the big five banks retain large deposits without offering higher interest rates because customers tend to stick with them due to factors including brand recognition and convenience.

At the time of writing, comparison tables for easy access savings accounts showed specialist banks ranked among the top. One showed Shawbrook Bank was the third highest, while another ranked Paragon Bank second.[184,185]

Many smaller banks rely on wholesale funding. Our market contacts report the cost of wholesale funding trended higher during 2022. It rose sharply shortly after the mini-Budget in September to the highest since the financial crisis in 2008. The cost of wholesale funding subsequently trended downward but ended the year somewhat above the levels it was at prior to the mini-Budget. This is broadly in line with a BoE survey showing the net balance of banks and building societies that reported the spreads on other funding (ie non-retail deposits) to the appropriate reference rate increased in the three months to November for the fifth consecutive quarter.[186]

The UK specialist banking market is diverse. Different specialist banks focus on offering certain products and services to smaller businesses. These range from asset finance, commercial property finance and agricultural lending. Some specialist banks are less able to absorb increases in funding costs and pass on more of it to borrowers. Consequently, smaller businesses that are a safe bet usually find it cheaper to borrow from the major banks.

Some challenger and specialist banks struggled to raise capital

In 2022 two challenger and specialist banks, Bank North and Masthaven Bank, announced plans to withdraw from the UK market because they were unable to raise the capital required.

Bank North was a digital bank for regional smaller businesses. In 2021 the Prudential Regulation Authority (PRA) granted Bank North a UK bank licence that authorised it to operate with restrictions.[187] However, Bank North was unable to raise the £50bn of capital required for it to be granted a full bank licence.[188] The bank's loan book for smaller businesses was subsequently bought by LHV UK, part of an Estonian financial group.[189,190]

Masthaven Bank offered specialist property finance, mortgage lending and digital retail savings. The bank's plans for growth required a significant commitment of long-term capital and it was unable to secure the level of investment necessary.[191] Starling Bank, a digital bank, subsequently acquired the mortgage book of Masthaven Bank.[192]

According to the Bank's market intelligence, capital has become more difficult to access and the cost of it has risen. This reflects that rising interest rates, in the UK and globally, made investing in UK challenger and specialist banks less attractive. Also, investors became more cautious as the UK and global economic outlook deteriorated following Russia's invasion of Ukraine. Start-up banks are particularly vulnerable because they are heavily dependent on raising capital. However, there were exceptions. For example, Allica Bank, a digital bank for smaller businesses, successfully raised £100m in late 2022.[193]

Four start-up banks were granted UK banking licences in 2022, of which two lend to smaller businesses

In 2022 the PRA granted four banks with a licence to operate with restrictions. This was one fewer than in 2021 and the lowest number since 2015 (Figure B.57).

The four banks were Ashman Bank, StreamBank, Fiinu Bank and Perenna Bank.[194] Of these, Ashman Bank and Streambank serve customers including smaller businesses. This is the same number as in 2021.

Ashman Bank is a digital bank that is based in Birmingham and serves smaller businesses in commercial real estate. Streambank is a specialist bank that provides property professionals with bridging and development finance.

Market intelligence suggests the reduced number of bank licences granted in 2022 reflects that launching a start-up bank in the UK is expensive in terms of time and capital. A start-up bank requires around £20m-£30m of capital from beginning to launch. Also, it is becoming harder for start-up banks to do things differently from existing banks and identify a niche that will be profitable.

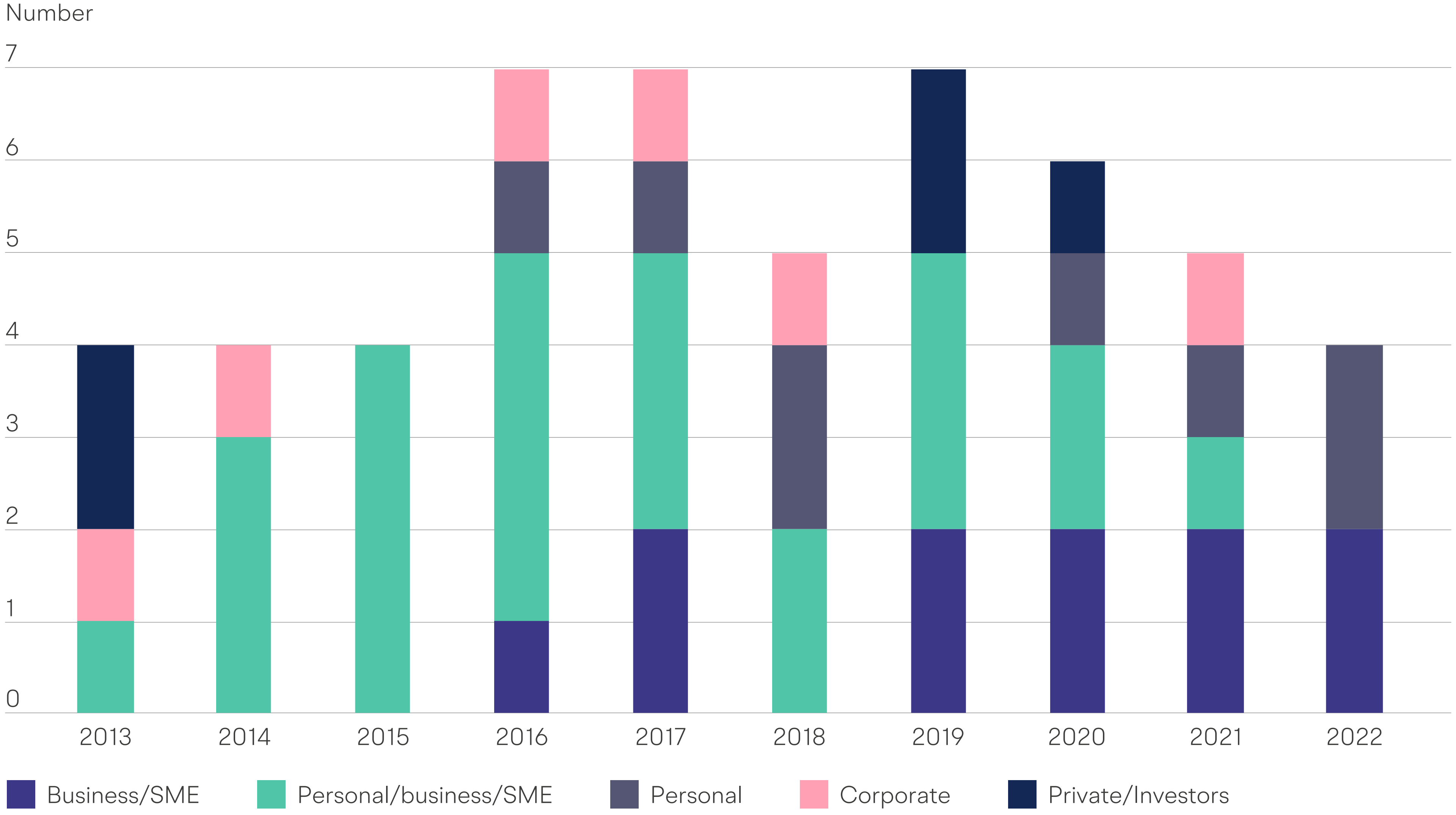
Despite the difficulties for start-up banks, publicly available information indicates there are a handful of applications pending. These include LHV UK, Griffin, Conister Bank and Revolut.[195,196,197,198]

The British Business Bank continues support challenger and specialist banks in making smaller business banking markets more diverse through its programmes including the ENABLE Build Guarantee and its subsidiary, British Business Investments.

Figure B.57

Number of banks authorised by the PRA, 2013–2022

Source: British Business Bank analysis of BoE data



2.9

Alternative finance

Alternative finance lending volumes are likely to have decreased in 2022

Buy now pay later has attracted interest as SMEs seek cash flow finance

Multiple funding challenges arose throughout the year

2023 is likely to be a year of transition and slow growth

This section covers the role alternative finance providers play in UK smaller business finance markets. Most alternative finance providers, with a few notable exceptions, do not compete with the traditional banks but complement their offerings. As such they have not only increased the options available to SMEs but have also increased the accessibility and appropriateness of finance available.

The SME lending landscape has changed substantially since the Global Financial Crisis (GFC), significantly reducing the biggest four lenders' share of SME lending which had stood at around 90% at the end of the crisis. Post-GFC, alternative finance providers, defined here as non-bank providers of products such as asset finance, invoice finance, term loans, cashflow loans, venture debt and private debt greatly increased their share of SME finance markets. This has been achieved not only by attracting businesses traditionally served by high street banks but also by being able to offer services to viable SMEs that were previously unable to access funding at all.

For the purposes of this section, the alternative lenders we discuss include marketplace, non-bank balance sheet and platform lenders but it does not cover asset finance providers or the more traditional invoice finance providers which are discussed in other chapters.

Alternative finance lending volumes are likely to have decreased in 2022

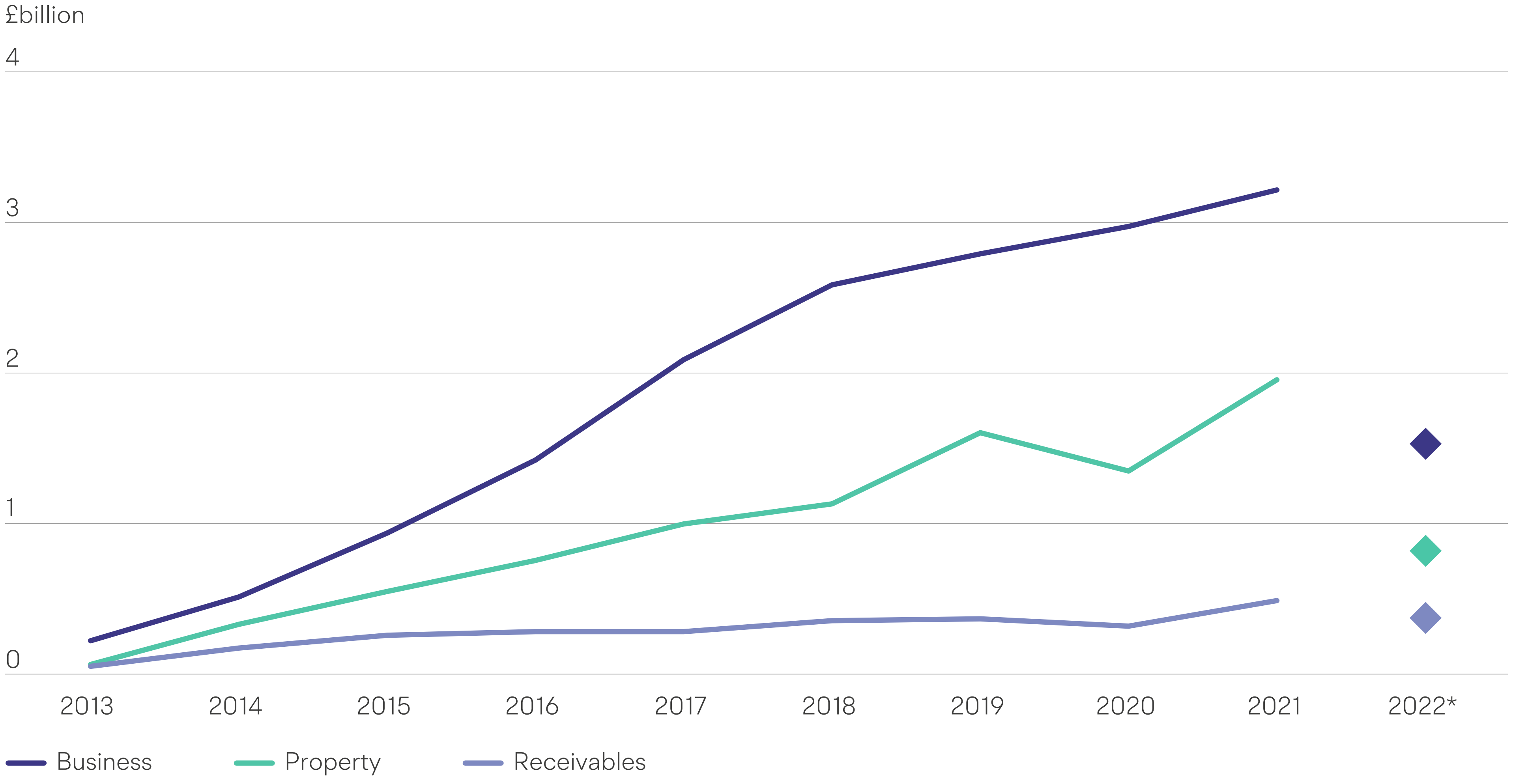
So far, around £2.3bn of SME business and property lending via alternative finance providers has been reported. This compares to £5.1bn lent by the alternative lenders we have data for in 2021 (Figure B.58). However, full year results for many alternative lenders, including some of the largest business and property lenders, are yet to be published. As such it is difficult to get the full picture of how the various alternative finance markets have performed during what has again been a very difficult year. Demand and supply have both seen headwinds, driven by uncertainty, inflation, interest rate increases and a considerable dip in sentiment amongst many SMEs.

Figure B.58

Gross SME business, commercial property and receivables lending via alternative finance providers, split by type

Source: British Business Bank analysis of finance provider submissions and public filings

*Note: 2022 data is only partial, several finance providers are yet to publish 2022 full year data



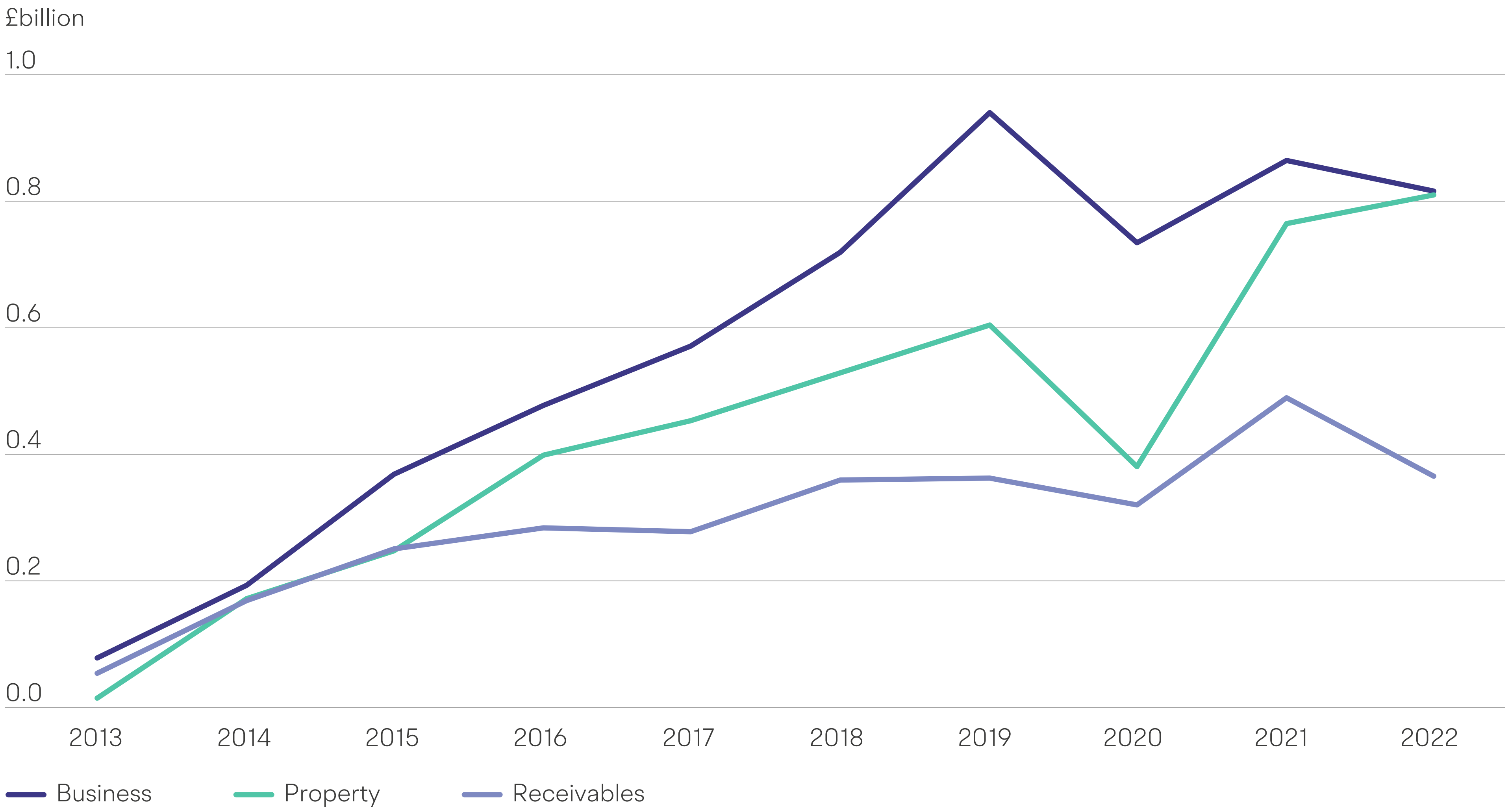
For those business and property lenders that have published 2022 full year origination, the aggregate numbers are very similar to 2021 (Figure B.59). So far, SME business lending is down 5% on last year while SME property lending is up 6%. When compared to pre-pandemic levels the picture is a bit more divergent with business lending still 13% down on 2019 levels while property lending is up 33% and at a record high for this subset of lenders. Marketplace receivables lending has fallen by around a quarter in 2022 but is still 1% up on 2019.

As the largest marketplace lender, Funding Circle's full year figures will be eagerly awaited but these will be published after this report is finalised. They have however published their 2022 H1 figures.[199] These show UK loan originations dropped by around 54% to £641m in 2022 H1 compared with £1.38bn for the same period last year. The much higher 2021 H1 predominately reflected lending via the government-guaranteed covid loan schemes which closed in early 2021. Origination in 2022 H1 also remains below the equivalent pre-Covid period, down around 20% on 2019 H1. However, the 2022 H1 figure was 8% higher than that recorded in 2021 H2 (£591m).

Figure B.59

SME business, property and receivables lending via alternative finance providers who have produced 2022 full year origination data

Source: British Business Bank analysis of finance provider submissions and public filings



Buy now pay later has attracted interest as SMEs seek cash flow finance

A set of relatively new products in the alternative finance space that received a lot of attention in 2022 were the buy now pay later (BNPL) style business-to-business products. While BNPL has been long used in the business-to-consumer space, with the classic example being the purchase of sofas, finance providers have realised the increasing demand for working capital and the recent increase in costs of some traditional lending has created a market for business-to-business BNPL style products.

These business-to-business BNPL products work much like invoice finance but can be utilised for much smaller transactions and by businesses with limited credit history. For the vendor it gives them the opportunity to offer longer payment terms while for a buyer it can help them spread payments over time thus smoothing their cash flow and often without incurring interest or additional fees. Instead of the customer paying at the point of purchase, payments, minus a fee, to the vendor come from the BNPL provider. Several finance providers have reported strong growth throughout the last year. The iwocaPay buy now, pay later platform for example saw average month on month transaction growth of 15% in 2022.[200]

BNPL does not come without risks though and some market commentators have approached the sector with caution. For the buyer, there is the risk of taking on too much debt that they can't pay off in time. This can result in them having to pay interest, additional fees or even defaulting and can negatively impact the business's credit rating. For the lender there is the risk of default without security. BNPL lenders use soft credit checks on businesses rather than more in depth credit checks and are typically willing to deal with businesses who traditionally struggle to raise funds from elsewhere due to lower credit scores or limited track record.

Multiple funding challenges arose throughout the year

The funding landscape for alternative finance providers became increasingly difficult throughout 2022. That was true whether a fintech was seeking equity investment, a lender was seeking institutional funders or a marketplace lender was trying to attract retail funds.

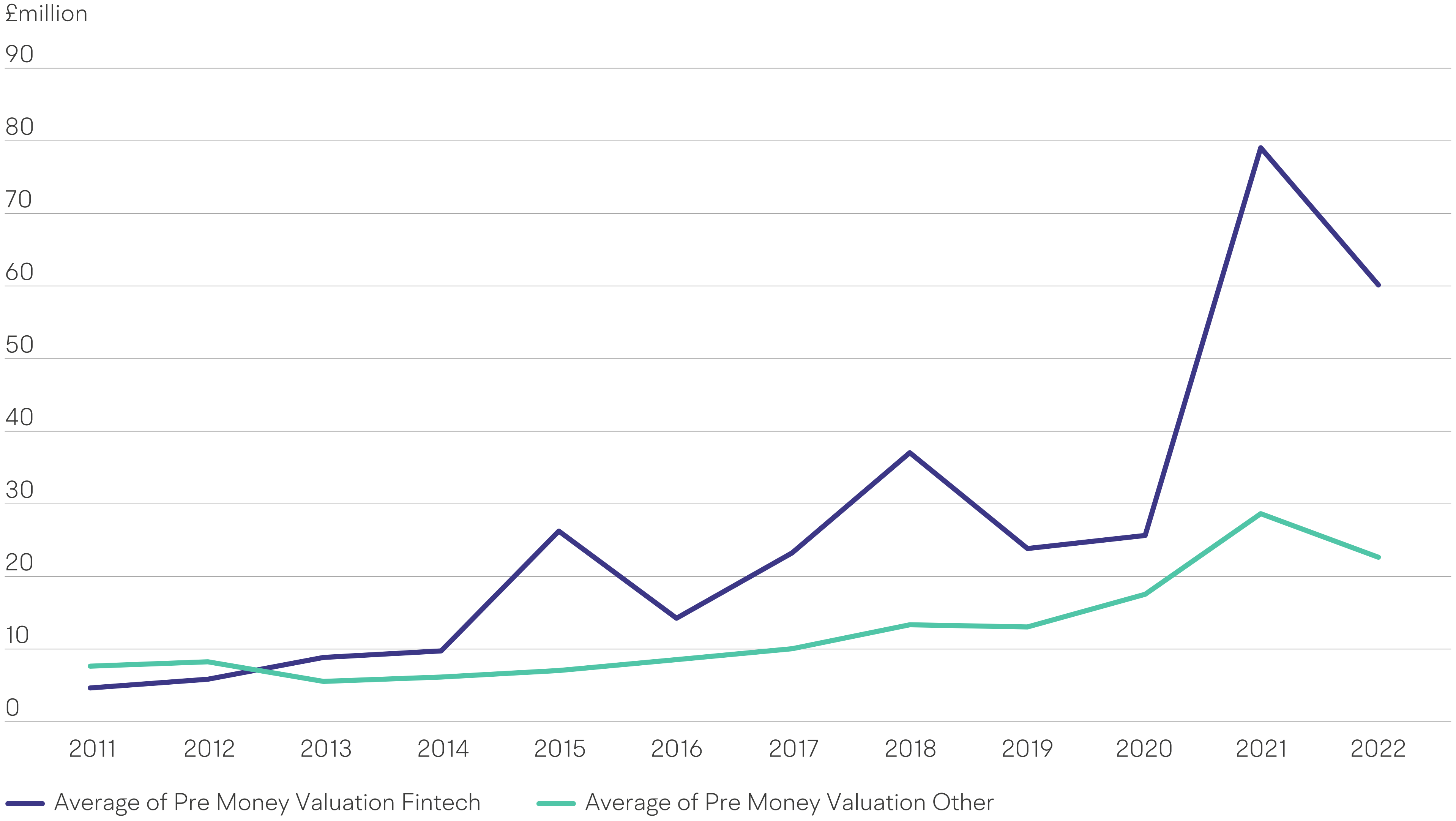
Data from the fintech industry body Innovate Finance showed that UK fintech start-ups raised $12.5bn in 2022, a figure 8% lower than the previous year.[201] However, this data is often updated as the year goes on and as such the final picture could potentially be different. This fall is less than the fall seen globally which the same report suggested was down by nearly a third compared with 2021's record-setting year. Furthermore, they noted "... the UK is still receiving more investment in fintech than all of the next ten European countries combined and remains second in the world only to the US."

2022 Q3 also saw valuations fall. 2021 was a record year in terms of investment, average deal sizes, and equity backed company valuations. Average pre-money valuations for fintech deals in 2021 reached £78.9m, substantially higher than for deals in other sectors which reached £28.6m. This trend for higher company valuations continued into the first half of 2022 but started experiencing a pullback in Q3 2022 as the impact of the wider shift in macroeconomic, conditions including higher inflation, rising interest rates, lower public market valuations and the war in Ukraine was felt. Data for the first three quarters of 2022 (latest available data) shows average pre-money valuations for fintech deals fell by 24% which is broadly in line with other sectors which also fell 20% compared to the previous year (Figure B.60). Depressed valuations and ongoing challenging fundraising conditions in 2023 could well see increased partnerships with or purchases by financial institutions developing as a theme for fintechs.

Figure B.60

Average company pre-money valuation of fintech and other sectors

Source: British Business Bank analysis of Beauhurst data



Wholesale funding costs have also increased for smaller banks and non-bank lenders. Since February, increased interest rates, primarily in SONIA swap rates, which factor in Bank of England Bank Rate expectations, have meant the cost of wholesale funding for marketplace lenders, asset finance providers and Community Development Financial Institutions (CDFIs) has increased by around 50%. SONIA 2 year yields increased 3.47% to 4.47% by the end of 2022, peaking at 5.87% in late September (Figure B.61).

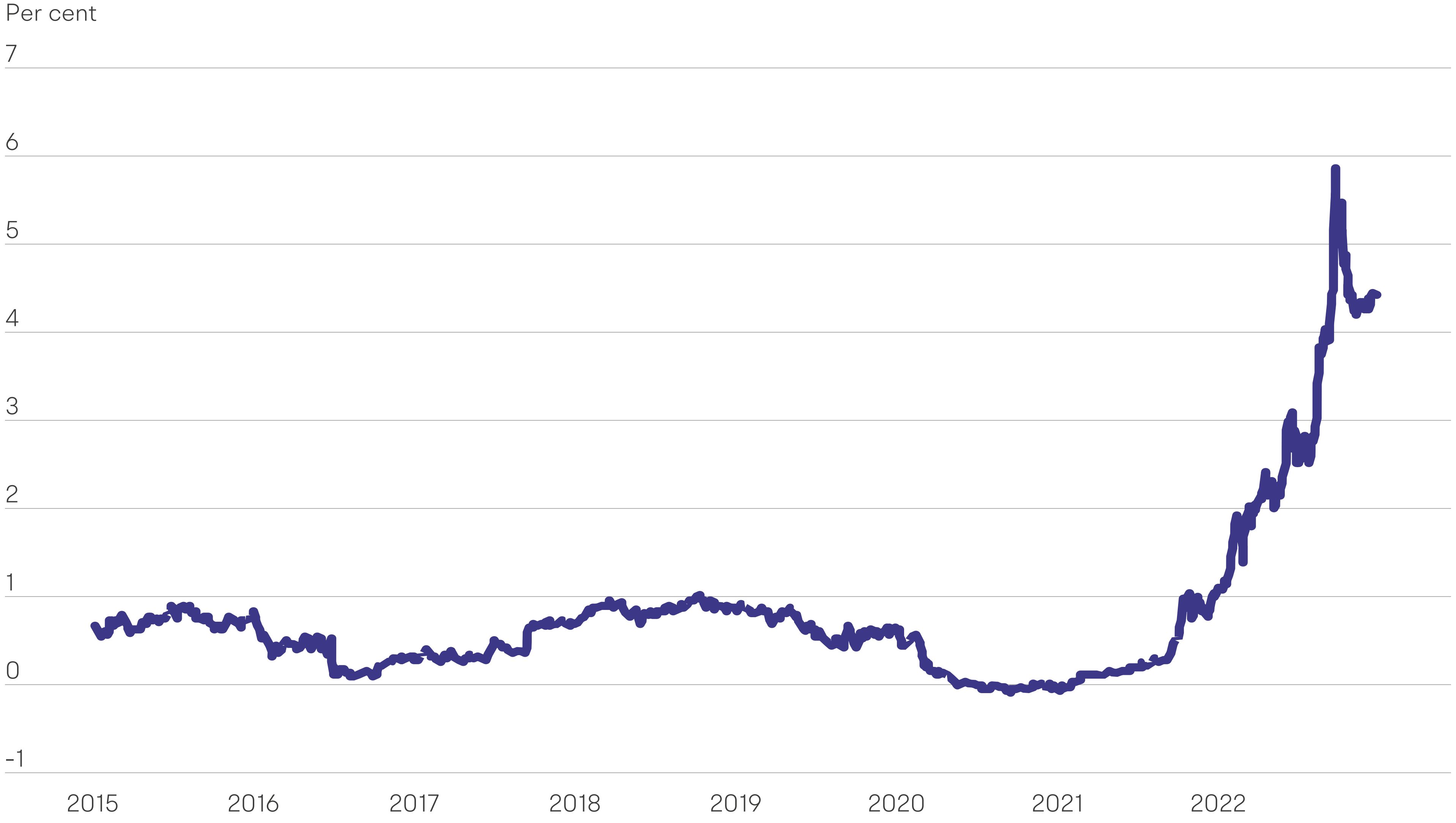
Finally, the switch away from retail funding also continued in 2022. There has been a long-term trend towards institutional funding as business models mature, the FCA tighten regulation and as a result of some of the lenders developing greater relationships with institutions via partnerships and the Covid loan schemes. 2022 has potentially sped up this process but this time due to market conditions.

Assetz Capital is amongst the latest to announce a switch away from retail funds. It stated their decision to no longer seek retail funds was as a result of "once-in-a-generation inflation, war in Ukraine and turmoil caused by 2022's political and economic policy events, interest rates have moved upwards on what now looks like a semi-permanent basis, negatively impacting the retail

Figure B.61

2 year SONIA swap rate

Source: Bloomberg



investment proposition”.[202] Furthermore, they said: “Given market conditions, retail investors now have more choice over bank savings products than at any time in the last decade and this has reduced their investment appetite as a result.”

This latter point is probably the most significant. Initially, a large amount of the appetite from retail investors was driven by the ‘search for yield’ in the low interest rate environment that most the world was experiencing since the Global Financial Crisis. The search for yield is no longer such a difficult task for investors and that is likely to remain the case for a medium term. This suggests that even as economic and lending conditions improve retail investor are still likely to be presented with attractive alternative investment options. In 2023 we will see how much borrower pricing increases, given across-the-board increases in all types of funding costs, and whether marketplace lenders can recapture retail investors with more competitive rate offerings.

2023 is likely to be a year of transition and slow growth

The trends seen in 2022 are unlikely to fade in 2023, at least in the early part of the year. Both funding costs and lending conditions are likely to remain challenging for alternative finance providers. As such, market contacts report that many in the industry expect lending volumes to be subdued in 2023. These challenges, alongside their expectations that the FCA will further tighten regulations, also led Ablrate to exit the marketplace lending space.[203] 2023 could see further lenders either leaving the market or being acquired.

The changing interest rate and regulatory environment also raises a question around where the next alternative finance providers will come from. Since the Global Finance Crisis, the UK has seen a flood of innovation and new lenders in the SME lending space. Several of the more heralded lenders were born in the P2P industry with retail funds allowing these lenders to grow quickly despite limited track record. Without the funds, higher wholesale funding costs and potentially lower equity valuations it could result in less new lenders and business models coming to the market.

Big Tech has long been discussed as potential source of new lending volumes in the SME lending space.[204] However, while many Big Tech firms have entered the market their volumes are yet to take off reports suggest they have faced underwriting challenges due to their reliance on proprietary data over credit rating data. Furthermore, the FCA has launched an inquiry “asking Big Tech companies, their partners and potential rivals for their views on Silicon Valley’s expansion into payments, deposits, credit and insurance.”[205] While this is focusing on their role in retail lending it is possible it could also impact their plans in the SME lending space.

As the sector adapts to the challenges it currently faces and spearheads innovation within SME lending markets the British Business Bank will continue to support alternative finance providers via products such as ENABLE Funding and the Investment Programme to further enrich the options available to UK smaller businesses.

2.10

Asset finance

Asset finance new business to SMEs reached a new high in 2022

Supply chain issues continue to impact some asset classes

Costs and interest rates have increased driven by macroeconomic conditions

Direct sales volumes increased significantly in 2022

This section provides an update on developments in the asset finance (primarily leasing and hire purchase) market in 2022, highlighting the continued rebound in the level of annual new business as the economy reopened following the Covid-19 lockdowns. Asset finance continues to be the alternative finance instrument used by the largest proportion of smaller businesses. Following the unprecedented uptake of government guaranteed loans, it dropped from third to the fourth most used external finance type behind term loans, bank overdrafts and credit cards.

The asset finance market, through the provision of leasing and hire purchase, helps businesses invest in vehicles, equipment and plant and machinery. Leasing allows businesses to obtain new equipment by renting it for a contracted period without owning it. If a business wants to own the equipment at the end of the contract period, then hire purchase is the appropriate finance option. In both cases, businesses avoid paying the full cost of the equipment upfront, easing pressures on cash flow.

Asset finance new business to SMEs reached a new high in 2022

The SME asset finance market reported a nominal increase in new business of 11% in 2022 to £22.5bn following an increase of 24% in 2021 to £20.3bn (Figure B.62). Annual asset finance new business provided to SMEs in 2022 was 9% higher in nominal terms than the pre-pandemic total in 2019. This compares to total asset finance new business which has seen growth of 6% in 2022 but remained 5% lower than the 2019 level.

Growth has been uneven during 2022. Q1 saw SME asset finance new business grow by 10% compared with the same quarter in 2021 and reach a record monthly total of £2.3bn in March of that quarter. The asset finance market as a whole reported its strongest performance for three years in March.

Q2 saw SME new business up by only 2% compared to the same period in 2021 as the economic environment deteriorated, uncertainty increased and confidence measures decreased. Despite this, taking the first half of 2022 as a whole, SME new lending increased by 6% compared with the same period in 2021.

Q3 saw something of a resurgence with SME new business growing 18% compared with the same period in 2021. All three months showed strong growth peaking in September at 21%. Q4 saw a further strong performance with SME new business growing by 15% compared with the same period in 2021.

Sentiment looking ahead to 2023 has decreased significantly. The FLA's Q4 2022 Industry Outlook Survey showed mixed expectations for growth over the next year among asset finance providers. Only 47% reported they expected some increase in new business compared to 62% in Q3, while 39% expected some decrease in new business.

Supply chain issues continue to impact some asset classes

Supply chain issues have continued to impact the availability of assets. This has reduced businesses' ability to invest and in turn, finance providers ability to lend. This has resulted in a pipeline of deals agreed but waiting to be fulfilled and surges of new business being completed as and when assets become available.

A significant proportion of the volatility in Q2 lending was attributed to disruption to the supply of assets to finance. The FLA noted transport equipment investment has been particularly impacted. This has especially been the case in the new car finance market. The IT equipment finance sector has also faced challenges.

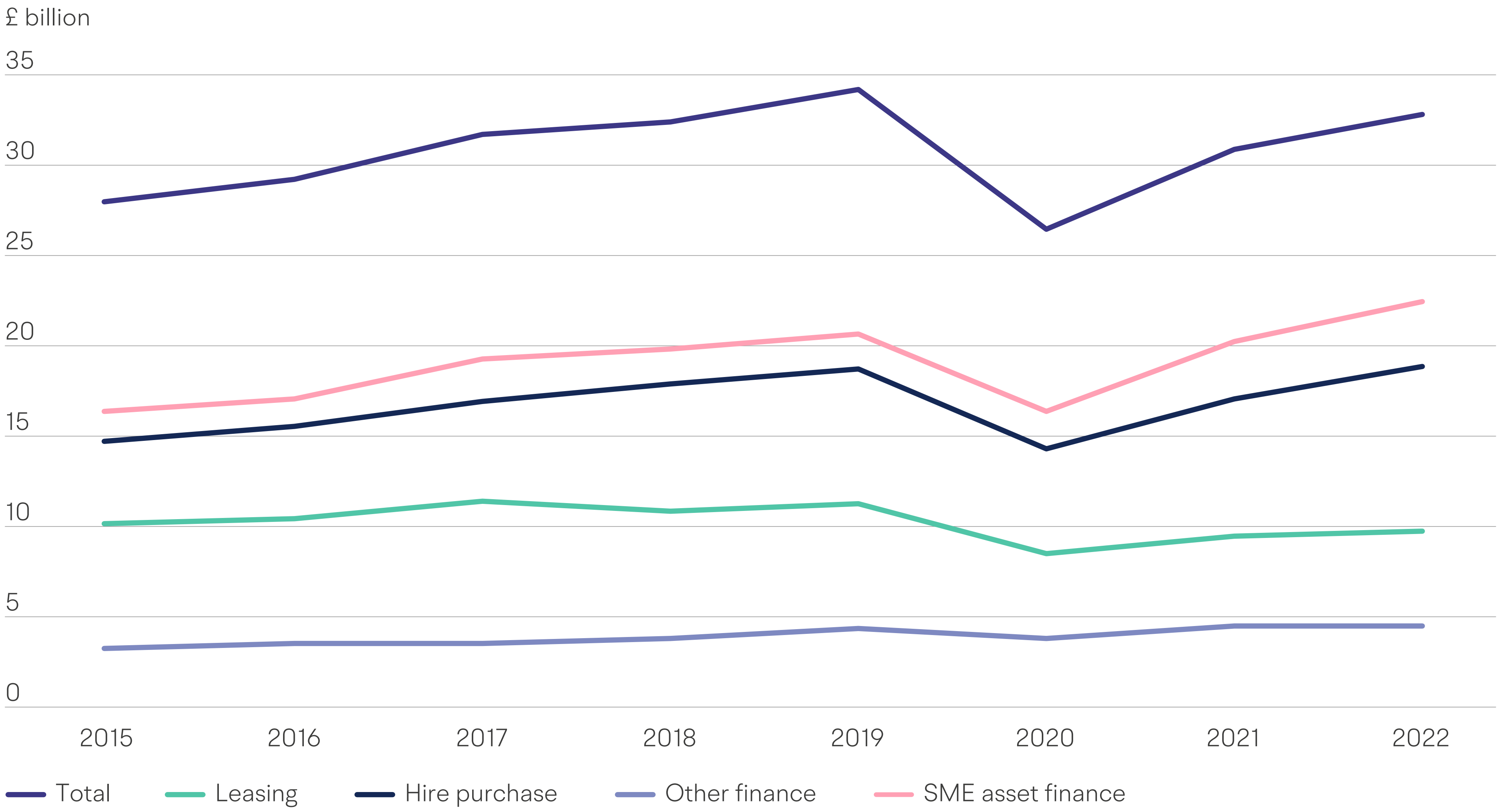
Given that there remains pent-up demand from businesses to invest in new or replace old assets, the gradual easing of supply chain shortages is expected to support new business volumes. How quickly these issues are resolved is likely to have a significant impact on asset finance flows and ramifications for UK growth.

Figure B.62

Size of UK asset finance market for businesses, new business[a]

Source: Finance & Leasing Association (FLA)

a. Asset finance new business for deals of up to £20 million



Costs and interest rates have increased driven by macroeconomic conditions

As well as supply chain issues, 2022 saw the economy hit by a range of macroeconomic headwinds. The war in Ukraine led to a steep rise in the price of many commodities which accelerated the rise in inflation which had gathered momentum in late 2021. Furthermore, the mini-Budget put forward in September 2022 led to an adverse reaction in financial markets and increases in the cost of government borrowing.

As a result of these challenges to their inflation and financial stability targets, the Bank of England raised Bank rate throughout the second half of the year. For many, especially smaller and non-bank asset finance providers, this led to some difficulties in securing funding and often a need to pass on the increased cost of funding to existing or new borrowers.

The surge seen in new business since September 2022 was in part borrowers looking to secure asset finance before these increases were passed on but, even for those who had already agreed finance in some cases there has been some renegotiation or activation of clauses to allow at least some of the increased costs to be passed on.

Box 3: Commercial Finance Brokers

- Broker activity grew in 2022
- Brokers play a key role in supporting often underserved smaller businesses
- Brokers are a key to many lender acquisition models and support market diversity

Brokers are an important intermediary in smaller business finance markets, with commercial property and asset finance making up two of their highest uses. Through their knowledge and expertise, they try to match a borrower's requirements with the most appropriate lender operating in the market. Smaller businesses who have either been unsuccessful in finding the funding they want when approaching a lender direct or who do not have the time or financial confidence can instead tap into the expertise of the broker.

The data in this section comes from the National Association of Commercial Finance Brokers (NACFB) and their 2022 broker survey.[206] The NACFB is the UK representative body with 1,033 member firms employing 2,030 brokers which they estimate represents around 75% of the market.

Broker activity grew in 2022

Finance facilitated by brokers increased strongly again in 2022 reaching £45bn, up from £41bn in 2021, an increase of 10%. Just under half (48%) of respondents said the value of business they had successfully introduced to lenders had increased in 2022. Just 17% said their value was lower whilst 35% of members said it was broadly the same.

As well as an overall increase in the value of lending via brokers the number of transactions also appear to have increased. 37% of NACFB Members said their total transaction volume was more in 2022 than in 2021. Just 14% said the total number of transactions was less, whilst 49% said it had remained broadly the same.

The average transaction size of £563,000 represents a 23% increase on 2021's total. The biggest value increases were in the property-led sectors where short-term and bridging finance brokers oversaw an average of 132%, whilst the average commercial mortgage transaction rose by 43%. The high average transaction size is a result of property lending, for example the average commercial mortgage was £814,000 in 2022. At the other end of the scale the average asset finance loan was £81,000 while the average unsecured loan was £130,000.

As with 2021, the largest amounts of finance were mostly facilitated in sectors linked to property. Commercial mortgages, buy-to-let and development finance accounted for 69% of the total 2022 figure, up from 60% in 2021. The two non-property linked sectors in the top five were leasing and asset finance, which was the second largest sector, and unsecured finance. Combined, these two sectors accounted for 28% of total finance, down from 31% in 2021.

Brokers play a key role in supporting often underserved smaller businesses

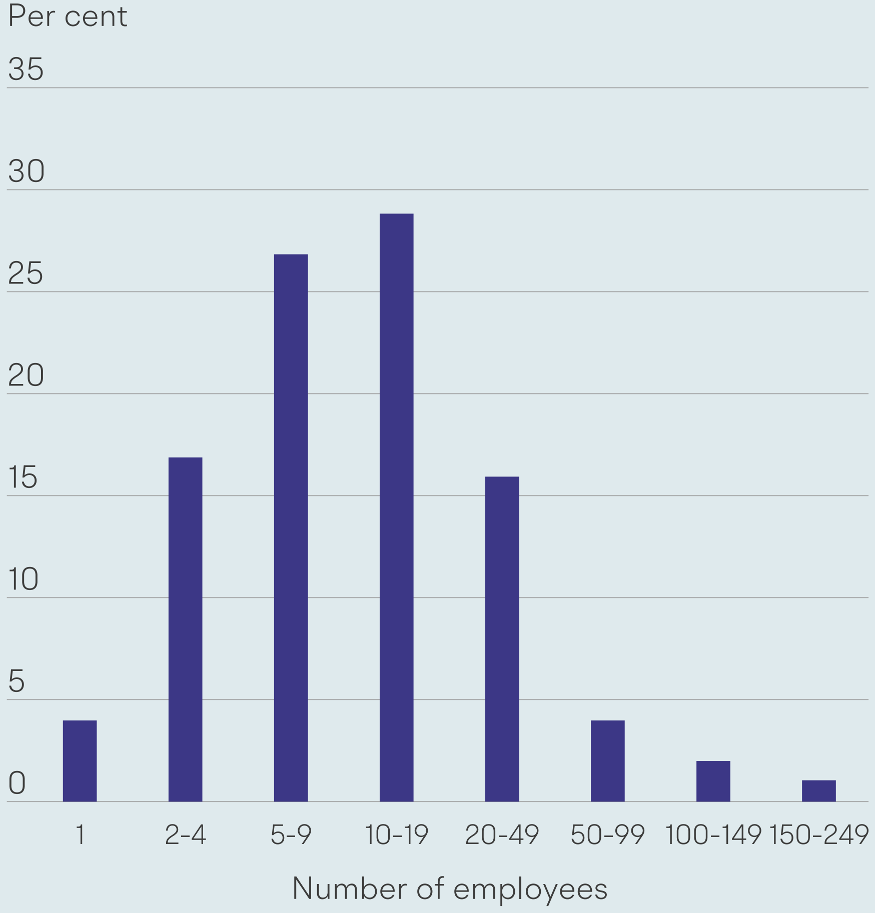
Just under half (48%) of respondent brokers said the average headcount of the clients they serve was no bigger than nine people (Figure B.63). This is particularly important given many smaller businesses do not have the time, resources or financial knowledge to weigh up the range of finance options that are available to them.

Unsurprisingly, the larger the borrower the less likely they are to use as broker. This is likely a combination of having inhouse resource and expertise and greater appetite from finance providers to service them directly. The latter is often due to existing relationships or the fact that larger companies often have a longer credit history, collateral or are seeking a larger amount of finance all which make the due diligence required for the finance easier and more financially worthwhile for the lender.

Figure B.63

Average headcount of client smaller businesses

Source: NACFB 2022 survey



Perhaps the most illustrative statistic of how brokers support underserved smaller businesses is that 29% of successfully funded new clients had been turned away for funding elsewhere. These are businesses that may not otherwise have received finance had they not engaged the help of a broker. Furthermore, 28% of broker-led transactions resulted in a client selecting a different solution to the one they had initially enquired about, suggesting that not only did brokers help smaller businesses get finance they may otherwise had not received but also potentially more appropriate finance.

Brokers are a key to many lender acquisition models and support market diversity

This year the NACFB have also surveyed their lender patrons. While some of these lenders have a direct to SME lending route in conjunction with the intermediary route, others rely entirely on brokers and introducers for their business. In 2022, of those who used a mixed model, 70% of their total lending to UK SMEs was through the commercial intermediary channel showing the reliance many lenders have on brokers.

The is a large range of lenders than utilise the broker route. As shown in the Challenger and Specialist bank section (2.2) and previous editions of the Small Business Finance Markets report, UK smaller businesses are no longer as reliant on the largest banks as they once were. Data from the latest NACFB survey suggests that brokers have played a role in helping this transition to a more diverse smaller business finance ecosystem.

In 2022, 49% of brokers surveyed said the most common type of lenders through which they successfully placed business were challenger banks. While high street banks were second (24%) this was only just ahead of specialist banks (21%). Furthermore, some brokers, albeit a relatively small number, also most commonly placed business with P2P lenders (3%), Community Development Financial Institutions (1%) and some even funded lending via their own books (2%).

Direct sales volumes increased significantly in 2022

SME direct sales volumes increased 19% to £7.7bn in 2022, making it the fastest growing channel for new asset finance business (Figure B.64). Broker-introduced finance grew 13% in 2022, while sales finance increased only 3%. Prior to the Covid pandemic direct sales had been the most used channel but during 2020 it fell 27%, the most of the three channels, and sales finance overtook it for the first time in the series providing £0.5bn more in new business.

Despite this strong growth, the direct sales channel is still 1% below its pre-Covid level. This compares to broker-introduced finance which is now at a record £6.5bn, 16% higher than its pre-Covid peak and sales finance which now stands at £8.3bn, 15% higher than its previous record year. Furthermore, the sales finance channel has retained the position as the most used channel for SME new business.

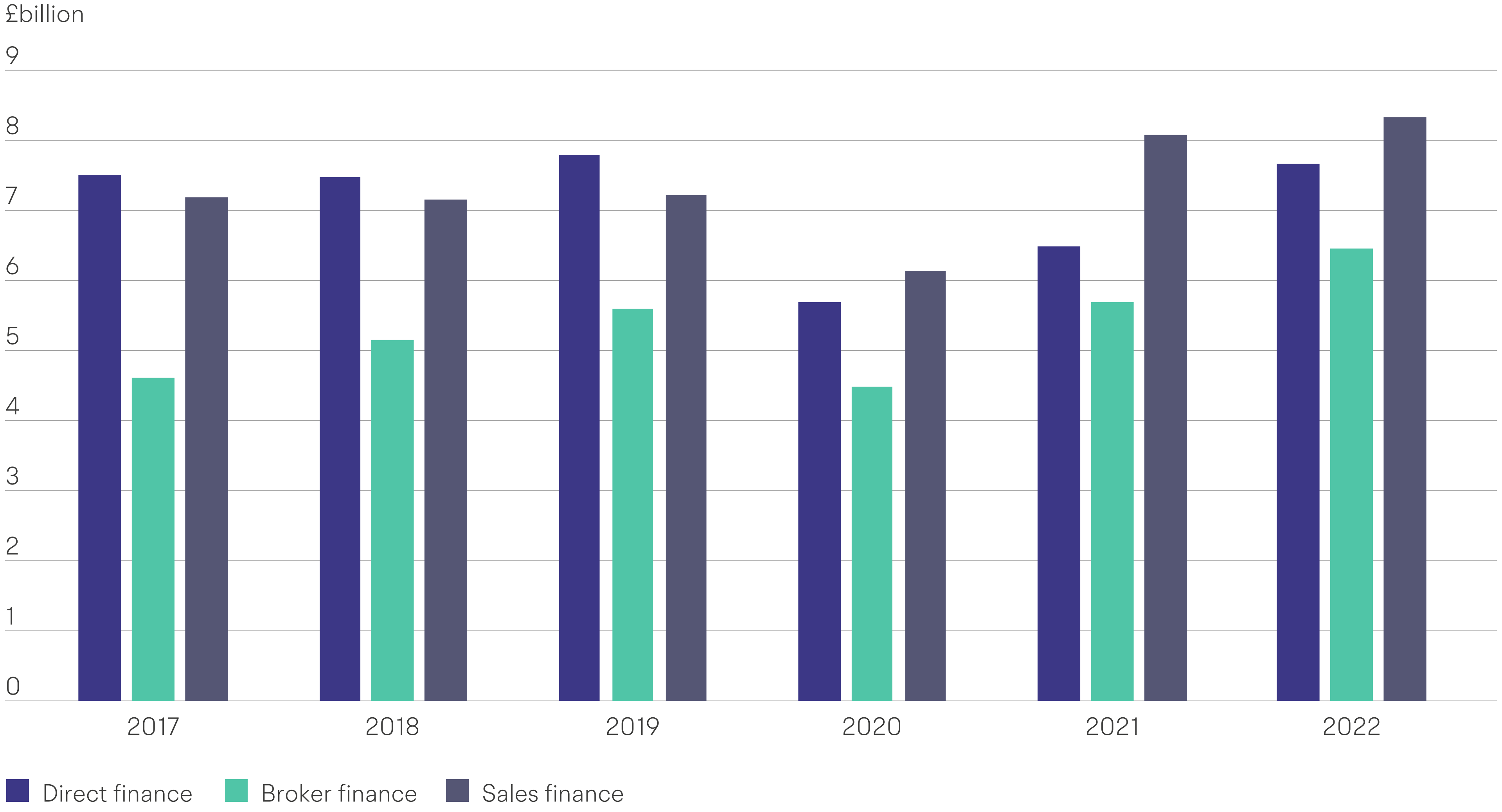
Asset finance plays a significant role in helping smaller businesses invest and grow. Business investment is yet to recover to pre-pandemic levels and the availability of asset finance will be crucial over the coming years for both the recovery of UK business investment and achieving net zero targets. As such the British Business Bank will continue to support asset finance providers via products such as ENABLE Funding and the Investment Programme.

Figure B.64

SME asset finance new business by channel[a]

Source: Finance & Leasing Association (FLA)

a. Asset finance new business for deals of up to £20 million



2.11

Invoice and asset-based lending

The value of advances to SMEs continued to recover in 2022 and is nearing pre-covid levels

Average advances have not only recovered but reached a new high in Q3

The number of SMEs using invoice finance & asset-based lending was broadly flat throughout the year

Despite challenging economic conditions, IF/ABL providers expect to see continued appetite for their products

Invoice finance & asset-based lending (IF/ABL) is a term used to describe funding against a range of business assets including accounts receivables (the debts owed to a business by its business customers, often represented by its invoices), stock and inventory, plant and machinery, real estate and even (sometimes) intellectual property and brands. In various forms, the principles underpinning invoice finance and asset-based lending have enabled funding to British businesses for centuries.

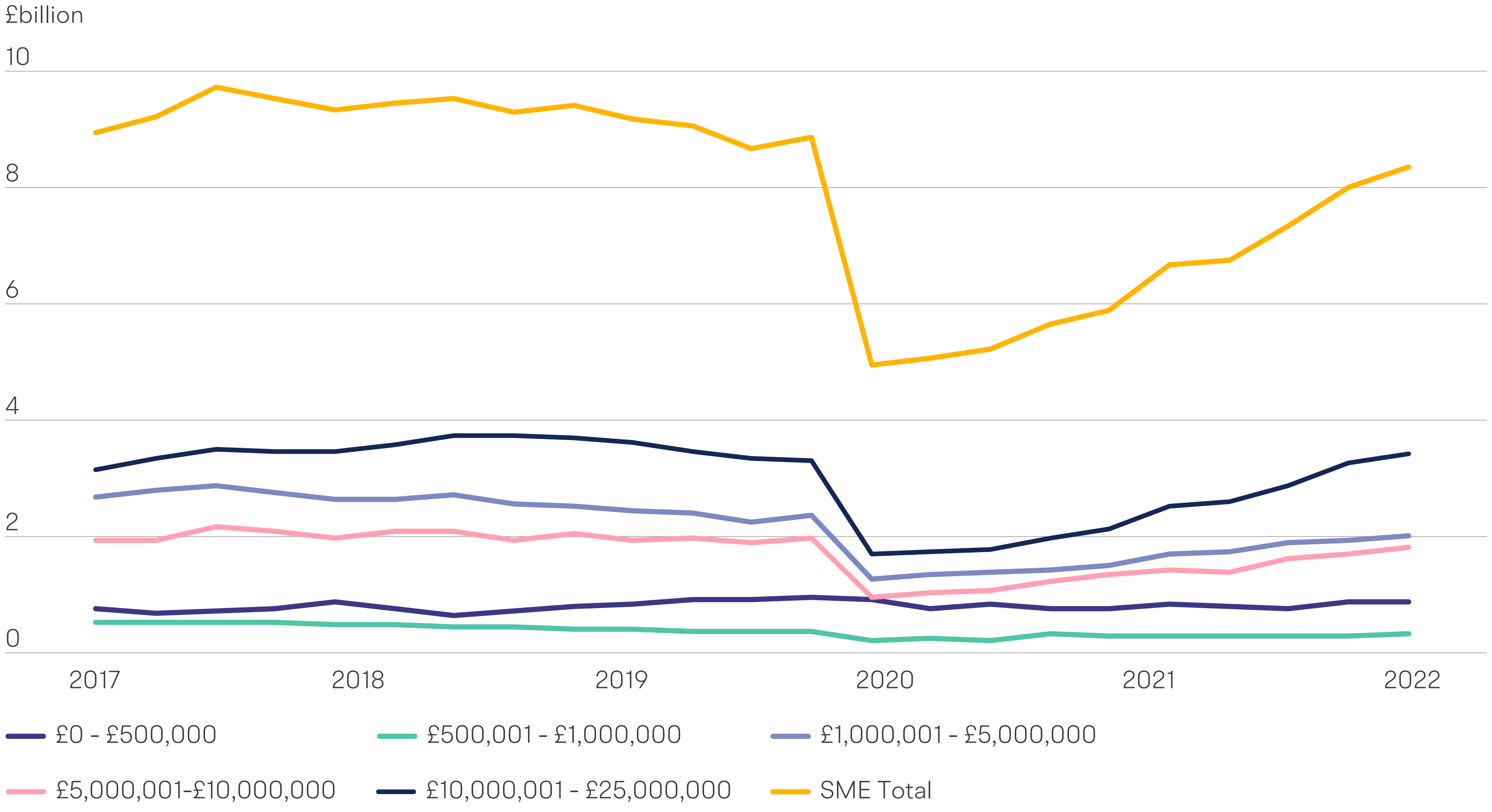
The value of advances to SMEs continued to recover in 2022 and is nearing pre-covid levels

Total SME advances increased in each of the first three quarters of 2022 (Figure B.65). By Q3, the latest datapoint at the time of writing, advances were up 24% from the end of 2021. Advances are now 69% above Q2 2020 levels, the pandemic and lockdown impacted low for

Figure B.65

Quarterly advances of invoice and asset-based lending, by SME turnover size cohort

Source: British Business Bank analysis of UK Finance data
Note: 2022 is up to Q3



the series, and only 6% down on Q1 2020, the last pre-pandemic quarter. UK Finance estimates however that advances may retract by up to 4.5% in Q4, mainly due to lower client sales reported in December and partly due to improvements in average debtor payment days reported in the last two months of the year.

Advances began to recover in 2021 as the economy recovered. Despite the challenges for the economic recovery in 2022 (see Macroeconomic developments chapter), SMEs have continued to turn to IF/ABL and this likely reflects a combination of the need for working capital during challenging economic times and to some degree the increased uncertainty with regards creditor solvency and customer demand.

The increase has been seen across all SME sizes but has been greater the larger the business. The smallest SMEs (turnover of £0–500k) have seen an increase of 11% since the end of last year while at the other end of the scale the £10–25m cohort have seen an increase of 32%. This may well reflect, at least in part, the fact that smallest SMEs saw the smallest drop in advances after the onset of the pandemic. However, the second (£500k-1m) and third (£1m-5m) smallest cohorts have also grown slower than the two largest cohorts in 2022 despite falling similar levels to them in 2020.

Average advances have not only recovered but reached a new high in Q3

While total advances have nearly recovered to pre-pandemic levels, average advances have not only recovered but are now at a new high for SMEs as a whole (Figure B.66). SME average advances rose to £256k in Q3, 23% higher than at the end of last year. The previous record for the series was in Q3 2017 (£255k). The last pre-pandemic value was £243k (Q1 2020) before falling to £138k in Q2 2020.

This record figure was despite no individual SME cohort reaching a high for their series. Only the smallest SMEs were near the cohort series high at 4% lower while the others ranged from 17% to 35% lower. The new high for SME average advances, despite the far from record high for most SME size cohorts, is due to the two largest SME cohorts making up a greater proportion of SMEs using IF/ABL in Q3 2022 (21%) compared to Q3 2017 (18%).

The number of SMEs using invoice finance & asset-based lending was broadly flat throughout the year

The number of SMEs using IF/ABL increased 1% in Q3 2022 compared to Q4 2021, after three years of reductions (Figure B.67). Despite this, numbers remain 11% below pre-pandemic levels.

The picture is more mixed when broken down by size cohort. The increase was predominantly driven by the largest SME cohort (£10m-25m). This cohort increased by 15% which equated to 443 more users. This was the highest it had been since the end of 2019, one of highest in the series since it began in 2009 and only 3% below the record reported in Q4 2018. The smallest cohort and the second largest also grew, 2% and 3% respectively.

However, the other two cohorts (£500k-£1m and £1m-£5m) both saw declining numbers, -6% and -2% respectively. For the £500k-£1m cohort, it looks likely this will be the fifth consecutive year of declines and continues a long-term trend since the data series began in Q1 2009 (-43%). For the £1m-£5m it would be the fourth year in a row of declines.

Interestingly our SME Finance Survey shows that SME awareness of IF/ABL significantly increased in 2022 (Figure B.68). Of the debt-based alternative finance options the survey asked SMEs about, IF/ABL showed the greatest increase and now stands 10 percentage points above its pre-crisis figure. This likely reflects the increased need SMEs have had for working capital and the fact it can be used alongside other debt products.

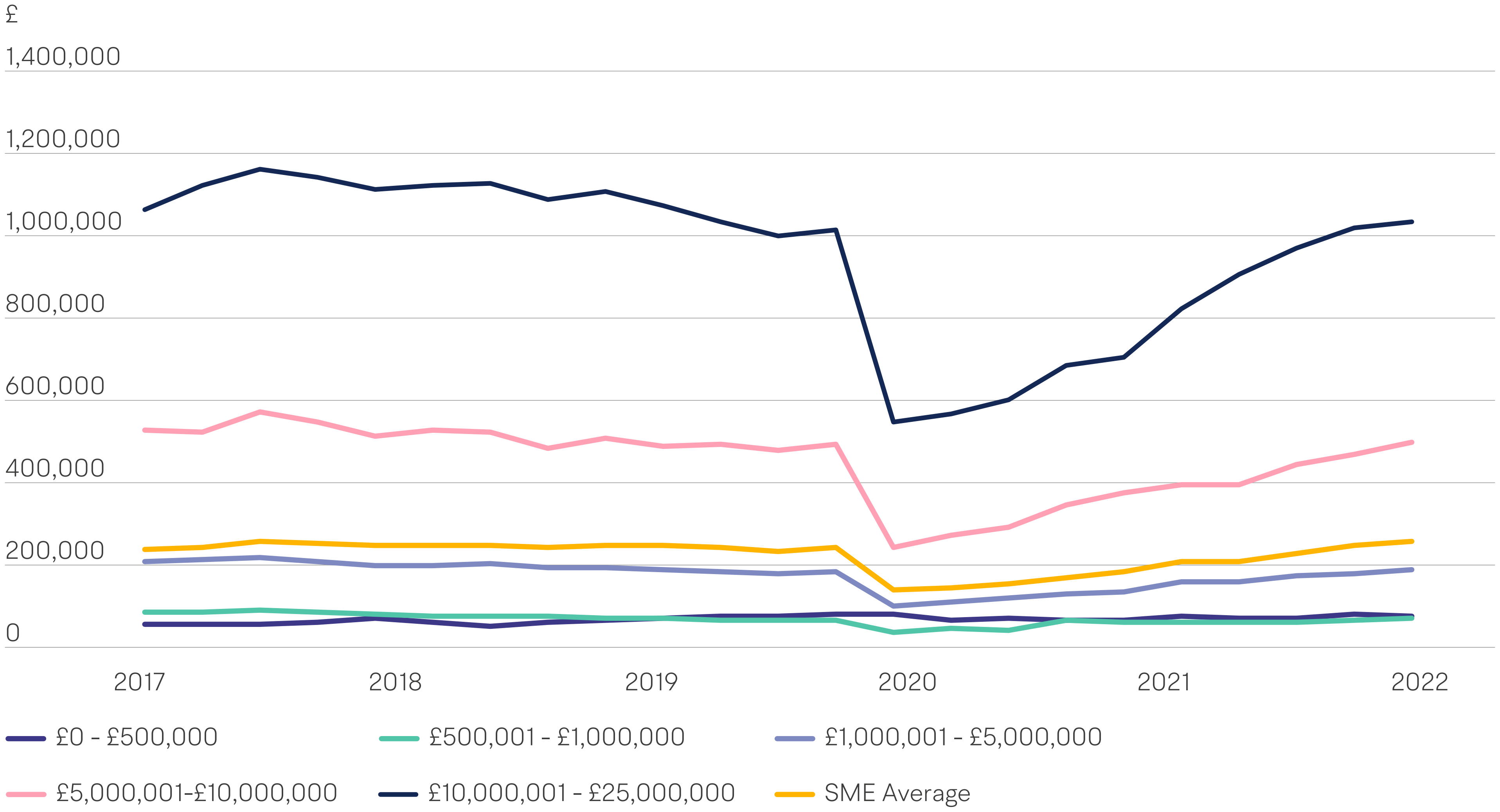
Two other notable trends appear in the UK Finance IF/ABL data, albeit via statistics that can't be broken down by borrower size and will thus include non-SMEs. Firstly, total client turnover was a record in Q3 2022, totalling almost £80 billion and up 10% on the final quarter of 2021 despite the economic conditions. The one exception was those clients using export and import factoring which fell to a series low and was down 32%. UK Finance estimates suggest that total client turnover (for client businesses of all sizes) in 2022 will reach around £310 billion, the highest ever annual total (previously in 2018 at £287 billion) and 12% higher than 2021.

Figure B.66

Quarterly average advances of invoice and asset-based lending, by SME turnover size cohort

Source: British Business Bank analysis of UK Finance data

Note: 2022 is up to Q3



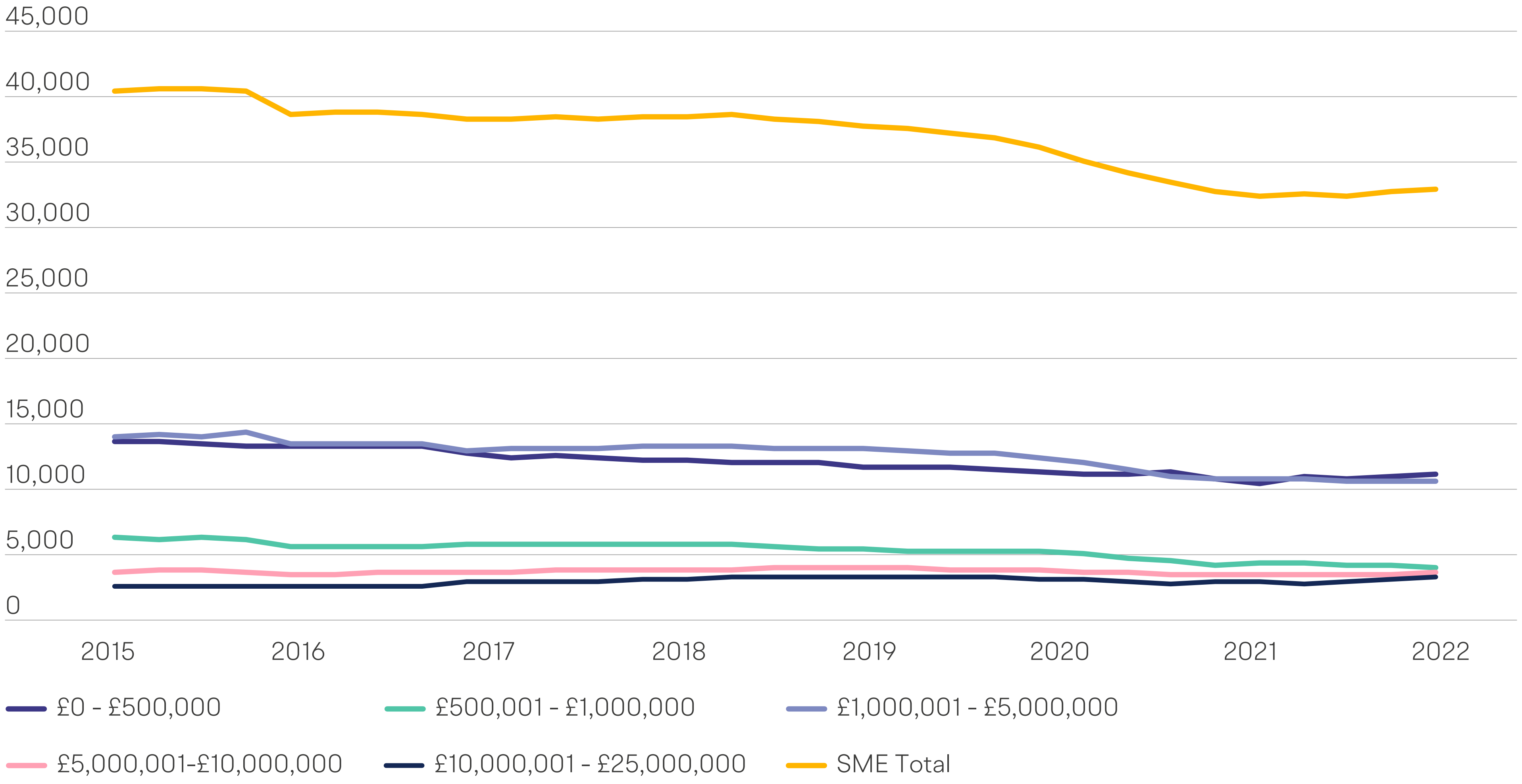
Secondly, analysis of client numbers by client industry shows little change for all industries except retail. IF/ABL users from the retail sector increased 44% in Q3 compared to the end of 2021. Indeed, both Q2 and Q3 2022 were the two highest numbers recorded in the series. For the other industries, growth in IF/ABL users ranged from a decrease of 3% for the distribution sector to an increase of 3% for the construction industry. While the sectoral data cannot be split by SME/non-SME the numbers involved mean it is likely that these new retail users will have been predominantly SMEs.

Figure B.67

Quarterly number of clients, by SME turnover size cohort

Source: British Business Bank analysis of UK Finance data

Note: 2022 is up to Q3



Despite challenging economic conditions, IF/ABL providers expect to see continued appetite for their products

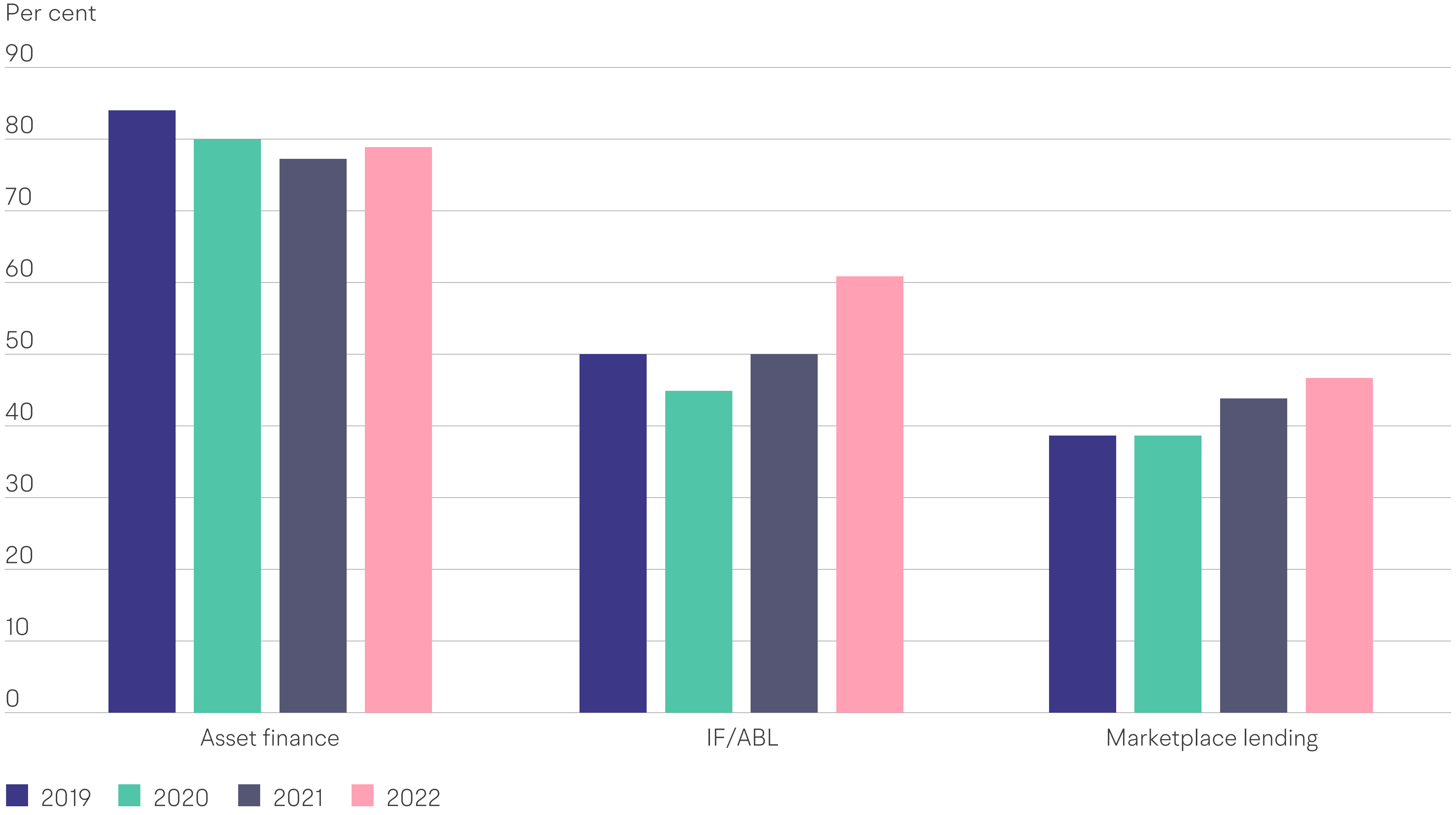
Market contacts have reported increasing cash pressures within client businesses as supply chain inflation and interest rate increases impact cashflow. They have also noted some increase in insolvencies and fraud amongst the client base but so far these remain limited. Despite this, many IF/ABL providers expect to see continued appetite for their products as banks tighten credit conditions on other products, economic challenges continue, and in the case of ABL providers, some SMEs within the retail sector continue to carry more stock than usual.

The British Business Bank continues to support IF/ABL lenders via both the Recovery Loan Scheme and British Business Investment programmes.

Figure B.68

Awareness of alternative debt products, percentage of SMEs

Source: British Business Bank Business Finance Survey – Ipsos MORI



Endnotes

1. The UK economic recovery from the pandemic began in mid-2020 but stalled in Q1 2021 amid the third national Covid-19 lockdown before resuming in the following quarter.
2. The first estimate of real GDP in Q4 2021 showed the level was 0.4% below Q4 2019. However, this was subsequently revised down to 1.2% below Q4 2019.
3. From 1 April 2021 until 31 March 2023, companies investing in qualifying new plant and machinery assets will be able to claim: a 130% super-deduction capital allowance on qualifying plant and machinery investments; a 50% first-year allowance for qualifying special rate assets.
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19. OECD/Eurostat (2018), Oslo Manual.
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21. World Intellectual Property Organization (WIPO) (2022), Global Innovation Index 2022: What is the future of innovation-driven growth?
22. Innovation surveys underpinning cross country comparisons may naturally exhibit some differences in design and implementation methodology. Results can, therefore, be influenced by national idiosyncratic choices such as the line of questioning, statistical techniques, and data availability.
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25. Note that this diagram includes simplifications to aid understanding. In practice these groups are not always mutually exclusive and there will be feedback loops and crossovers.
26. The Bank takes an active role supporting these early-stage businesses through its range of debt and equity programmes as detailed later in this section.
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28. BEIS (2021), Evidence for the UK Innovation Strategy.
29. OECD (2015), OECF Innovation Strategy 2015: An agenda for policy action.
30. Permanent non-borrowers are SMEs firmly disinclined to borrow either because they are not currently using external finance or they have not used finance in the previous 5 years, with no desire to borrow in the next 3 months. Full definition can be found in the BVA BDRC SME Finance Monitor annual reports published online.
31. Finance-comfortable are all SMEs that are not Permanent Non-borrowers.
32. BEIS, Longitudinal Small Business Survey 2021.
33. NTM in this context combines respondents to the BEIS Longitudinal Small Business Survey that introduced new or significantly improved goods or services innovations or process innovations that answered at least some innovations were new to the market or new to the industry, n=744.
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38. The rest either didn't know or refused to state.
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65. BEIS, Business population estimates (2022).
66. ONS, Business demography (2021).
67. BEIS, Business population estimates (2022).
68. All individuals starting up or ceasing trading have to notify HMRC, for example to meet mandatory requirements for paying tax via self-assessment, but there is no obligation to formally register the firm on start up or closure at Companies House.
69. Registered firms have formally notified relevant authorities to comply with their legal obligations for payment of VAT and/or PAYE (national insurance and income tax for themselves and employees). Zero employee registered firms can voluntarily opt to charge and pay VAT, as beneficial to their business model, or on nearing the registration threshold for mandatory registration of £85,000 gross turnover per annum.
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77. The Bank's research on entrepreneurship has resulted in the formation of public-private intermediary working groups at a local level, showcasing the Bank's expertise. Through its UK Network, these working groups collaborate on ways to enhance diversity and inclusion within their local communities, acknowledging the impact of location on underrepresented entrepreneurs.

78. External finance covers overdrafts, credit cards, bank loans, commercial mortgages, leasing or hire purchase, loans or equity from family and friends or directors, invoice finance, grants, loans from other third parties, export or import finance, crowd funding, asset-based lending, or any other loan or overdraft facility and government or local authority finance.

79. SMEs that seem firmly disinclined to borrow because they meet all of the following conditions: are not currently using external finance, have not used external finance in the past 5 years, have had no borrowing events in the past 12 months, have not applied for any other forms of finance in the last 12 months, said that they had had no desire to borrow in the past 12 months and reported no inclination to borrow in the next 3 months.

80. Chart doesn't add to 100 because PNB describes SMEs who follow a set of conditions in the survey cohort.

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103. UK Finance/BVA BDRC, SME Finance Monitor, 4 quarters to Q2 2022, n=261.

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109. BEIS, Longitudinal Small Business Survey, 2021, nb. Low base, n=4,567 of which n=41 were female-led, Ethnic Minority-led businesses.

110. BEIS, Longitudinal Small Business Survey, 2021, n=232 of which n=43 Ethnic Minority-led.

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171. Bank of England Bankstats tables.

172. Market-based lending refers to bank lending that is not guaranteed by the government.

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181. Financial provider refers to banks and non-banks.

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