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# FOREWORD

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The British Business Bank, established in 2014, improves finance markets so they more effectively serve the needs of smaller UK businesses.

Our fifth Small Business Finance Markets report provides a timely, comprehensive and impartial assessment of finance markets for smaller businesses at a moment of great significance for the UK and its economy. Combined with our experience as an active market participant, the evidence, research and insights in this and other reports enables us to monitor and respond to the finance needs of smaller UK businesses, develop and refine our programmes, and to support the goals of the Government's modern Industrial Strategy.

The British Business Bank's interventions to improve finance markets for smaller businesses are based on strong research, evidence and analysis. We continue to implement measures stemming from 2017's Patient Capital Review, including a new £500m Managed Funds Programme and our £2.5bn British Patient Capital initiative, and will be following up actions from our recently-published report which identified many issues around the relative underfunding of female-led businesses by the Venture Capital industry.

Two broad themes provide the background to this year's report. First, there is evidence that small businesses, due to the current period of uncertainty, are either using external finance to put in place contingency plans or reducing their finance requirements as they delay longer term investment and expansion decisions. An increasing number of smaller businesses - 29%, up from 22% in 2017 - expect the UK leaving the European Union to have a negative effect on their business. A similar proportion (34%) expect it to be more difficult to access finance post-departure, with only 3% expecting it to be easier. Despite this, just over half of those smaller businesses surveyed in Q4 2018 expect to grow over the next 12 months.

The second theme is declining demand for finance. As the latest data in this report shows, the stock of bank lending - which forms the largest part of the market - has continued to decline in real terms although, encouragingly, alternatives to bank lending have continued to grow, albeit at a slower rate than previously. Equity deals - at least by value - continue to rise, which is positive for businesses with ambitious growth plans, despite the near absence of the European Investment Fund from the UK market.

Demand for external finance continues its long-term decline, with just 36% of smaller businesses now using external finance compared to 44% in 2012. Data also suggests applications for new loans and overdrafts are continuing to fall. Of most concern for the economic outlook, over 7 in 10 firms say they would rather forgo growth than take on external finance.

There are many possible contributing factors to this drop in demand but we believe that providing better information to smaller businesses, aimed at building their awareness of and confidence in finance options, is an essential first step in encouraging them to seek the finance best suited to their needs. The Business Bank has introduced 2 initiatives to address this gap:

- The Business Finance Guide, co-published with the ICAEW, which helps to build understanding of and confidence in the full range of finance options available through traditional and newer providers of finance.
- The Finance Hub, a new online resource which provides independent and impartial information on the debt and equity finance options available to high growth and high growth potential smaller businesses.

It is therefore encouraging that awareness of alternatives to traditional finance has continued to grow in the past year, with 52% of small businesses aware of peer to peer lending, 70% aware of crowdfunding platforms and 69% aware of Venture Capital (up from 47%, 60% and 62% respectively in the previous year). This increased awareness of options will be important in ensuring smaller businesses are better placed to make the right finance choices as uncertainty diminishes and confidence returns.

Beyond those 2 themes, this report examines the awareness and use of both equity and debt finance in unprecedented depth, for the first time using local rather than regional level data. For policy makers, the variations revealed confirm well-documented and stubborn issues around the distribution of equity finance: almost half of equity deals are in London despite it accounting for only around 20% of high growth firms.

At the British Business Bank, our view is that such imbalances hamper the ability of businesses to fulfil their growth ambitions and as a result contribute to disparities in productivity and growth between UK regions. The government's Industrial Strategy makes a similar case in reference to its 'Places' foundation.

A variety of factors drive these disparities and will require a range of policy levers and co-ordinated action to address the underlying issues. In terms of the Bank's work to support that goal, our approach has not been simply to divert funding away from London. Instead, our focus has been on building local finance ecosystems and existing clusters of activity outside of London so that, over the long-term, private sector activity becomes self-sustaining without public intervention. As well as a programme of engagement with stakeholders in the English regions - including the LEP network - and in the devolved nations, we have recently introduced a number of initiatives to help deliver that goal:

- **The UK Network:** a new team of dedicated managers, covering all areas of the country, which will enhance collaboration and coordination between key actors within areas, share best practice and provide insight into local and regional finance markets
- **Regional funds:** our 3 funds - the Northern Powerhouse Investment Fund, the Midlands Engine Investment Fund and the Cornwall & Isles of Scilly Investment Fund continue to provide both debt and equity finance to businesses at a local level
- **Regional Angels Programme:** a new £100m initiative specifically designed to develop clusters of angel activity to support much-needed early-stage equity to businesses across the country, and particularly in areas of the UK that are currently underrepresented.

The increased depth of analysis we have undertaken in compiling this year's Small Business Finance Market report reflects an increasing need to examine carefully, and in detail, markets at the national, regional and local level. In doing so, we can more effectively design solutions to meet the needs of businesses across the country. We know that previous editions have proved to be a valuable source of information for policy makers and others with an interest in ensuring the success of our smaller businesses, and I hope you find this year's report informative and useful.

# EXECUTIVE SUMMARY

The fifth edition of our Small Business Finance Markets report comes at an important time for the UK economy. Improving productivity is central to driving long-term growth in the UK economy, and SME finance has a significant role to play in supporting that growth. With a relatively weak macroeconomic outlook influenced by Brexit and other factors, ensuring availability of finance to viable small businesses is critical.

Furthermore, the Government's Industrial Strategy highlights the need for the UK economy to respond well to several long-term economic challenges and opportunities facing all advanced economies. Tailoring the approach for delivering economic growth to meet the needs of all the nations and regions of the UK is also a key priority. Small businesses have a key role to play in this agenda and ensuring that finance markets work well is vital to their success.

## FLOWS OF FINANCE TO SMEs REMAIN STRONG DESPITE UNCERTAINTY ABOUT THE ECONOMIC ENVIRONMENT

2018 saw flows of finance to SMEs match or exceed those in 2017, continuing the progress over the last 5 years. Gross bank lending remained stable in nominal terms, with the gross lending closely matching repayments over 2018. Other forms of finance continued to advance, albeit more slowly than in 2017. Notably, equity finance, asset finance and market-based lending have grown by 4%, 3% and 18% respectively.

There remains a significant number of businesses that expect to grow in 2019, but the economic environment is challenging, with many business surveys showing a decline in confidence during the second half of 2018. In addition, the impact of Brexit on small business finance may be unclear for some time, so it is important that the finance market developments are carefully monitored. The British Business Bank remains ready to respond to economic developments in 2019 and beyond.

## MANY SMALLER BUSINESSES REMAIN RELUCTANT TO USE FINANCE

There is increasing evidence that SMEs' continued reluctance to use finance is, in significant part, driven by attitudes towards finance rather than circumstances. Most SMEs are willing to forgo some growth in order to avoid finance, and even those that already use external finance have often not thought about using more.

The outcome of this reluctance to use finance is that the number of SMEs seeking new finance has weakened further, with applications at a record low level according to the latest SME Finance Monitor data.

To encourage more SMEs to use finance, several hurdles need to be overcome. First, greater understanding of the potential benefits of using finance is required, combined with more awareness of the increasingly diverse range of products and providers that exist in the small business finance market.

Second, encouraging more smaller businesses to seek advice, and to actively consider using a wider range of finance products and providers, will help them access the most appropriate finance for their needs from this more diverse market. High quality, trusted advice will help increase their confidence in assessing the finance offered to them.

Finally, smaller businesses tend to be overly pessimistic about their likelihood of success when applying for finance. Fear of rejection discourages some from applying, however unjustified. This fear must be overcome for attitudes towards, and use of, finance to improve.

The British Business Bank has considerably expanded its demand side activity with the creation of a Demand Development Unit. The Finance Hub includes independent and impartial information on the debt and equity finance options available to high growth and high growth potential smaller businesses.

Those SMEs who are unable to get finance from their bank are offered a referral to platforms where other providers may be able to offer them finance. As of the end of June 2018, nearly 19,000 SMEs had been referred.

#### MANY HIGH GROWTH POTENTIAL FIRMS NEED ACCESS TO APPROPRIATE EQUITY FINANCE

Ensuring that those businesses that have growth potential and aspiration can access the finance they need is important for long-term UK productivity and competitiveness. The evidence suggests that smaller businesses with growth aspirations are more likely to achieve those growth plans if they make use of external finance.

Many small businesses that have undergone a period of high growth in recent years have achieved that growth without using equity finance. However, the faster the rate of growth achieved, the more likely it is that they made use of equity finance. Equity finance is particularly suited to highly innovative, but also high risk, businesses who are delivering new technologies.

Evidence presented in this report shows that equity finance has helped create many highly successful technologically based businesses. A handful of the most successful (commonly referred to as unicorns) have achieved company valuations of over \$1 bn, with 12 current unicorns in the UK accounting for nearly half the unicorns in Europe.

More widely, there have been other signs of improvement in the UK's equity ecosystem, with substantial increases in the flows of equity finance to smaller businesses, often in successful equity clusters in technology driven sectors. In early stage finance, there is evidence of an increased funding of university spinouts. In addition, equity finance has flowed to businesses seeking to respond to many of the challenges facing the UK economy, including the Grand Challenges identified in the Government's Industrial Strategy.

But, as identified in the Government's 2017 Patient Capital Review, there is still room for considerable improvement in the finance of businesses with high growth potential. Despite the increase in equity finance as a proportion of GDP in recent years, the UK remains well behind the US. Our research has also identified that there are several specific sections of the market that could function more effectively.

First, a low proportion of VC continues to be invested in female founded businesses. Second, first time fund managers are finding it increasingly difficult to raise funds from institutional investors. Third, the market for VC secondaries is not yet fully realised. Finally, in debt markets, innovative businesses with intangible assets have problems in accessing debt finance due to the difficulties in the valuation of intellectual property.

British Patient Capital, which launched in June 2018, is responsible for investing an additional £2.5bn of funding over 10 years for UK venture and growth capital. In addition, the £500m Managed Funds programme will invest in large-scale funds of funds, run by experienced managers, to boost the amount of patient capital available to the UK's high growth potential businesses.

#### NEED TO HELP VIABLE FIRMS ACROSS THE UK HAVE ACCESS TO THE FINANCE THEY NEED

The UK wide picture on small business finance markets masks examples of notable success in some local areas, but also considerable challenges in many parts of the UK.

On the debt side, bank lending volumes broadly match the regional distribution of the small business population. However, local level data demonstrates greater variation in lending. Furthermore, evidence on the extent to which alternative providers and products reach across all parts of the UK is limited.

On the equity side, the evidence continues to suggest that high growth firms are spread across the nations and regions of the UK. However, awareness of equity finance is less common outside London and the South East and there is much resistance to using equity in many parts of the UK, even amongst those looking to grow.

In addition, the clustering of angel and venture capital finance in a relatively small number of cities, suggests there is more to be done to increase the reach of early stage equity finance, to support business with growth potential in many parts of the UK.

The British Business Bank has now rolled out regional funds providing debt and equity finance covering the Northern Powerhouse region, the Midlands Engine region, Cornwall & the Isles of Scilly and Northern Ireland. In response to the challenge, identified in our research with the UKBAA, of developing a greater number of clusters of business angel activity, the Bank has launched a £100 million Regional Angel Programme.

The Bank has also established a UK Network of regional managers to help enhance business finance ecosystems across the UK, so smaller business, wherever they are, can grow and prosper. The Network will also help the Bank develop a deeper understanding of small business finance markets in all parts of the UK, so that, ultimately, the Bank can improve its support to smaller businesses everywhere.

# INTRODUCTION

This is the fifth annual British Business Bank Small Business Finance Markets report, setting out the latest evidence on the ways in which finance markets support smaller business and help them contribute to improving productivity and growth in the UK economy.

Our understanding of smaller business finance markets, both in terms of the latest available data on SMEs and their financing needs, and the intelligence obtained as an active participant in the finance markets, is central to delivering on our new objective to be the centre of expertise on smaller business finance markets in the UK, providing advice and support to Government. It is also used to shape our business plan and the design of our programmes and products.

The challenges facing the economy as we move into 2019 reinforce the need to ensure that small businesses have the finance required from them to make a strong contribution to economic growth.

## NEW EVIDENCE AND ANALYSIS

The British Business Bank has continued to develop evidence and analysis to deepen our understanding of smaller business finance markets. In particular:

- Our small business finance survey has been run again to give up to date insight into smaller businesses awareness and use of the finance options available to them

- We use SME market segmentation analysis to show how different types of SMEs use and access finance
- We carry out more detailed analysis of UK equity markets to inform our implementation of the Patient Capital Review
- Building on the work of newly established UK Network we are drilling down to the local level to understand how SME finance markets vary across the UK

This report also references a wide range of evidence drawn from government, market and academic research.

## STRUCTURE OF THE REPORT

The report begins with an overall assessment of the aggregate flows of finance and macroeconomic developments and the implications for small business finance needs.

Part A provides a thematic overview looking in turn at SME demand for finance, the latest issues equity finance for high growth potential firms and the local variations in SME finance across the UK.

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



# AGGREGATE FLOW AND STOCK OF FINANCE TO SMALLER BUSINESSES

- Net flow of bank lending products remained positive in 2018, but only just
- Equity finance values continue to increase whilst asset and invoice & asset-based lending and marketplace lending continue to grow, albeit slower than in recent years
- Small business demand for finance continues to decline despite conditions remaining broadly favourable

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. 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.

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

FIG 1

## ESTIMATES OF THE FLOW & STOCK OF EXTERNAL FINANCE FOR UK SMEs (£ BILLION) (a)

		2013	2014	2015	2016	2017	2018	
<b>Bank lending stock</b>	Outstanding Amount (b)	166	167	164	166	165	<b>166</b>	to end Dec 18
<i>Source: Bank of England</i>								
<b>Bank lending flows</b>	Net flows (c)	-2.4	-1.7	2.2	3.3	0.7	<b>0.5</b>	to end Dec 18
<i>Source: Bank of England</i>								
	Gross flows (d)	43	53	58	59	57	<b>58</b>	to end Dec 18
Other gross flows of SME finance								
<b>Private external equity investments</b>		1.57	2.48	3.70	3.11	5.89	<b>4.65</b>	to end Sep 18
<i>Source: Beauhurst (e)</i>								
	Number of reported deals	989	1364	1498	1405	1487	<b>1079</b>	to end Sep 18
<b>Asset finance flows</b>		12.9	14.4	15.9	16.7	18.3	<b>18.9</b>	to end Dec 18
<i>Source: FLA (f)</i>								
<b>Peer-to-peer business lending flows</b>		0.20	0.41	0.73	1.38	1.97	<b>2.33</b>	to end Dec 18
<i>Source: Brismo and British Business Bank calculations (g)</i>								

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

(b) Data includes overdrafts and loans. Movements in amounts outstanding can reflect breaks in data series as well as underlying flows.

(c) Net flows do 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) 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.

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

(f) The Finance & Leasing Association (FLA) whose members make up 90-95% of the market. Data obtained from FLA Asset Finance Confidence Survey. SME asset finance is assumed to represent 60% of total asset finance in 2011.

(g) Figures do not represent the entire market. Data obtained from Brismo.

### NET FLOW OF BANK LENDING PRODUCTS REMAINED POSITIVE IN 2018, BUT ONLY JUST

The annual net flows of bank loans (new loans, excluding overdrafts) to smaller businesses was broadly unchanged on 2017. Quarterly gross bank lending to smaller businesses averaged £14.4bn in 2018, in line with 2017. However, this was largely offset by repayments which averaged £14.3bn per quarter.

The value of deposits held by SMEs rose to a record high in the Q3 2018 and are up 66% since the data series started in 2011. At the same time there has been a continued reduction in the usage of overdrafts.

### EQUITY FINANCE VALUES CONTINUE TO INCREASE WHILST ASSET AND INVOICE & ASSET-BASED LENDING AND MARKETPLACE LENDING CONTINUE TO GROW, ALBEIT SLOWER THAN IN RECENT YEARS

The value of new equity deals to UK SMEs looks set to reach a record high in 2018. £4.6bn of equity was invested in UK SMEs in the first 3 quarters of 2018, up 4% compared to the same quarters in 2017. However, there was also a 6% decline in the number of deals completed in the same quarters driven by a reduction in the number of seed stage deals (16%).

Data from the Finance and Leasing Association suggests that new asset finance volumes to smaller businesses was around £18.9bn by the end of 2018, an increase of 3% on 2017. This is a significantly slower rate of growth than witnessed in recent years and the 10% growth seen last year. Total invoice & asset-based lending advances to smaller businesses continue to rise and across but we have seen the first reductions for some size cohorts.

Gross flows of lending to businesses via market place lending continue to grow reaching £2.3bn in 2018, an increase of 18%. This is significantly lower than previous growth rates, but this is unsurprising as the industry matures. One category bucking this trend was marketplace invoice finance which grew by 105% in 2018 to £1.1bn. Part B provides a detailed discussion of the trends in volumes for different types of finance.

### SMALL BUSINESS DEMAND FOR FINANCE CONTINUES TO DECLINE DESPITE CONDITIONS REMAINING BROADLY FAVOURABLE

Demand for external finance by UK smaller businesses has continued to decline. Around a third (36%) of smaller businesses currently use external finance, slightly down from 38% in 2017 and significantly below the 44% in 2012. The recent dip in use of external finance was driven by micro and small businesses (those with 0-49 employees), while use of finance has increased among medium-sized businesses (50-249 employees).

Credit conditions remain broadly favourable despite some signs of tightening. The FSB's Voice of Small Business survey for Q4 2018 reported that the credit availability index rose for the first time in a year to its highest level since it was introduced in 2012. BoE data also indicates that credit is still affordable by historical standards, but interest rates on a range of SME loans have increased slightly since the start of the year.

The latest SME Finance survey asked whether SMEs thought Brexit would have an impact on their ability to access finance. Just over a third thought that it would be a lot or a little more difficult to access debt and equity finance, whilst only 3% thought it would be a lot or a little easier. However, there is increasing evidence that SMEs' continued reluctance to use finance is, in significant part, driven by attitudes towards finance rather than circumstances.

## MACROECONOMIC DEVELOPMENTS

- The UK economy experienced uneven growth driven by a range of factors
- OBR revised its growth forecast down for 2018, but up for subsequent years
- SME confidence surveys downbeat
- Increasing signs of a negative Brexit impact, albeit for a minority of SMEs
- Credit conditions have remained accommodative overall, though there are signs of tightening

### THE UK ECONOMY EXPERIENCED UNEVEN GROWTH IN 2018 DRIVEN BY A RANGE OF FACTORS

Following a slow start the UK economy bounced back over the middle part of the year. The Beast from the East suppressed activity in Q1, with GDP growth of just 0.1%. The hot summer and a successful World Cup for the England football team encouraged spending in Q2 and Q3, with growth reaching 0.4% and 0.6% respectively. The latter was the highest quarterly growth figure since Q4 2016, driven by a buoyant July. Despite this improvement, the UK still sat near the bottom of G7 growth rates with only Italy below.

Early indicators of economic activity for Q4 look more subdued. Q4 GDP will not be known until early 2019, but in November, retail sales excluding food was flat and in shop sales was down. According to the ONS, manufacturing saw no growth at all in the latest 3 months (to October). The services sector, which makes up 80% of the economy, grew by 0.3% on the 3-month rolling measure - the lowest growth since the 3 months to April 2018. Construction continued its recent solid performance with growth in housebuilding and infrastructure but slowed slightly. The Purchasing Managers' Index, a leading indicator of business activity, recorded its worst reading in the services sector since the month after the EU referendum.

Despite slow GDP growth, the employment rate reached new highs during 2018 and unemployment remains low at 4.1%, down 0.2% in comparison with last year. The growth has been in full-time jobs. The number of people in part-time jobs and in self-employment has gradually fallen but has been more than offset by the rise in full-time work. This is perhaps reflected in the decrease in the number of zero-employee firms and the growth in the number of employee firms as reported by the BEIS Business population estimates, 2018 (see section 2.1, SME Business Population).

Sterling has remained volatile but mostly weak in 2018 hitting an 18-month low in December following news of a delayed Brexit agreement vote. The falls in the pound since the EU referendum, combined with recent increases in oil prices, have kept Consumer Price Inflation above the Bank of England's 2.0% target but, at 2.3% in November, it has fallen from its late 2017 peak of 3.1%.

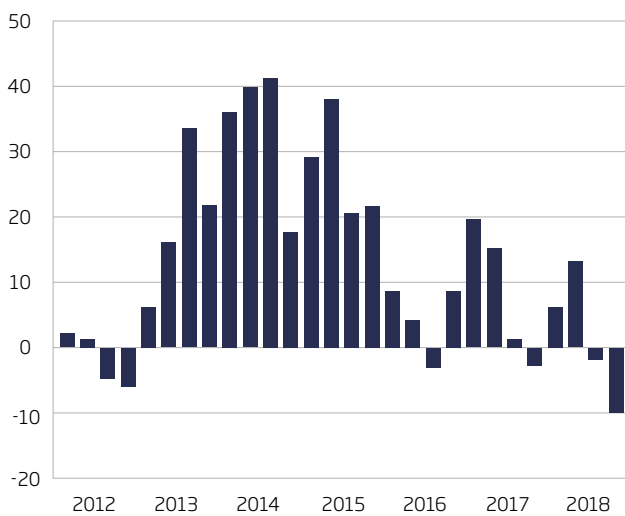
When combined with the recent increased wage growth rates (3.3% excluding bonuses), households' real incomes have increased slightly after several years of falling. This increase in real wage growth and the improved GDP outcomes of the summer months led the Bank of England to increase Bank Rate by 0.25% in August 2018 to 0.75%, only the second increase in a decade and the highest rate since March 2009.

### OBR REVISED ITS GROWTH FORECAST DOWN FOR 2018, BUT UP FOR SUBSEQUENT YEARS

The OBR has downgraded its growth forecasts for 2018, saying the UK economy would grow by just 1.3%, down from the 1.5% forecast in March. The OBR then expects it to pick up to 1.6% in 2019 (previously 1.3%) and 1.4% in 2020 and 2021. A key driver of the change in the OBR's view since the March forecast was 2018 business investment, which declined by 1.1%.

The OBR forecast assumes "a relatively smooth" Brexit during 2019. The OBR highlight that a disorderly Brexit could have "severe short-term implications" that are difficult to predict. The downside risks relating to such a Brexit are not possible to quantify without specifying exactly what a disorderly Brexit might look like.

FIG 2  
**SMALL BUSINESS CONFIDENCE INDEX**  
 Source: FSB Voice of Small Business Index Q4 2018



Although much of the negative discussion of the macroeconomic environment has been dominated by Brexit and wider political uncertainty, it is not the only factor influencing macroeconomic projections. Other factors include rising trade protection from the USA and China, Eurozone problems with Italy and France, and risks of residential or commercial real estate price corrections have also caused concern.

#### SME CONFIDENCE SURVEYS DOWNBEAT

The impact of the current macroeconomic situation on SMEs' confidence and growth expectations are explored in several surveys. The Federation of Small Businesses' survey focuses on SMEs and finds that small business confidence dipped into negative territory in Q3 2018 and reached its lowest point since the financial crisis in Q4 at -9.9 (Figure 2).

Several industries registered large falls in confidence from Q3 to Q4. Confidence amongst small businesses in the UK's information and communication industry, construction and manufacturing sectors all fell into negative territory from strong, positive positions in Q3. Manufacturing businesses reported a significant decline (-47.5) which led to small manufacturing businesses seeing their confidence index dip below zero for the first time since Q3 2016, in the immediate aftermath of the referendum result. Despite the depreciation of sterling since the referendum result, a net balance of only 0.2% expect to grow exports in Q1 2019, a record low.

There had been significant variation in regional/national confidence up to Q3 with most regions in positive territory but with significant falls in confidence across several regions and Wales between Q3 and Q4 there is now closer alignment. The East Midlands is the most confident (+3.7) and Scotland the least confident (-32.7) in Q4. The only other regions to register positive confidence scores were the West Midlands (+3.6) and Wales (+2.9).

Q3 saw growth aspirations weaken to 47.7%, the fourth consecutive quarter that it had been below 50% and a record for the index. Despite the falls in confidence reported above, growth aspirations rebounded slightly in Q4. Just over a half (50.4%) of small firms reported expecting to grow over the next 12 months. More than half (58%) of smaller businesses reported that the domestic economy is a barrier to growth.

#### INCREASING SIGNS OF A NEGATIVE BREXIT IMPACT, ALBEIT FOR A MINORITY OF SMEs

The British Business Bank's SME Finance Survey, conducted during September and October 2018, gives insight into the expected direct impact of Brexit on smaller businesses. Most SMEs have not seen, and do not expect to see, a direct impact of Brexit on their business, but the results show an increasing number who do see an impact, and more of these see a negative, rather than a positive, impact.

Looking at the impact on turnover growth, 56% of SMEs do not expect the UK leaving the EU to impact on the growth of their firm. But the number expecting to have a negative impact has risen to 29% from 22% in 2017, compared to only 5% in each year who expect to grow more because of Brexit.

Almost 1 in 5 (17%) of SMEs have already made a change in their business because of Brexit.<sup>1</sup> More businesses expect to make a change, but this is still limited to just under 1 in 4 (24%) of SMEs. The majority of those who have made or anticipate changes do so in terms of price adjustment of goods or services sold (18%). When it comes to investment plans, 5% have made and 6% expect to make a change. Of those that have made or plan to make a change, two-thirds have or expect to decrease investment, whilst only 15% have or 16% expect to increase investment.

The overall message from these results is of an SME population in which the majority are not worried about Brexit, but where there is nevertheless an increasing share who do see a negative impact. This latter group are starting to take more measures, such as reducing investment, in an attempt to shield themselves from perceived Brexit impacts. These findings are consistent with the Bank of England's Q3 Agents Summary findings.

#### CREDIT CONDITIONS HAVE REMAINED ACCOMMODATIVE OVERALL, THOUGH THERE ARE SIGNS OF TIGHTENING

There have been conflicting reports about credit conditions though overall, they have remained accommodative. The Bank of England Credit Conditions survey reported that according to lenders, the credit availability to small businesses was little changed in Q4 following large net increases in both Q2 and Q3 2018.

In Q4 the FSB's Voice of Small Business survey struck a very positive note and registered a record high for the proportion of firms rating the availability of credit as good or very good. However, this was after the credit availability score had fallen for 3 quarters in a row to the lowest level in more than 2 years in Q3. The Bank of England's Q4 Agents Summary also reported that the availability of all forms of credit, including trade credit insurance, had tightened for construction, consumer-facing and agricultural firms in recent months.

Looking ahead, the SME Finance survey asked whether SMEs thought Brexit would have an impact on their ability to access finance. Just over a third thought that it would be a lot or a little more difficult to access debt and equity finance, whilst only 3% thought it would be a lot or a little easier, ie more than 10 times as many expect it to be more difficult to get finance than expect it to get easier.

## PART A THEMES

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1.1

ATTITUDES TO USING FINANCE

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1.2

EQUITY FUNDING ENVIRONMENT FOR  
INNOVATIVE AND HIGH GROWTH FIRMS

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1.3

SME FINANCE AT THE LOCAL LEVEL

## 1.1

## ATTITUDES TO USING FINANCE

- Most small businesses prefer to self-fund and half are being more cautious due to political and economic uncertainty
- Small businesses have become entrenched with their reluctance to use finance
- Barriers suppress use of equity, including a lack of awareness and a reluctance to give up control
- Businesses typically still approach their main bank first

Demand for external finance (excluding trade credit) has fallen since 2012.<sup>2</sup> Most smaller businesses do not use external finance, potentially resulting in lower economic growth. The decline in usage of external finance is covered in more detail in section 2.2 Use of external finance.

The British Business Bank has undertaken SME segmentation analysis to identify the highest potential and most receptive businesses. SMEs were clustered based on attitudes towards finance using SME Finance Monitor data. The segmentation, introduced in the 2017/18 Small Business Finance Markets report, looked at need for and use of different types of finance. It also overlaid an SME's openness to external information about finance and how to secure it.

This attitudinally based approach suggests that UK SMEs can be usefully divided into 4 distinct groups that currently use external finance or are open towards using finance (Figure A.1), in addition to a large group which neither currently uses nor intends to use any form of finance. This latter group of 'Permanent non-borrowers' (PNB) is very large and currently makes up approximately half (47%) of all UK SMEs.<sup>3</sup>

FIG A.1

## BRITISH BUSINESS BANK SEGMENTS AND SHARE OF BUSINESSES

Source: British Business Bank Analysis of SME Finance Monitor, Q2 2018. Data is in the 10 quarters to the end of the period stated, (10 quarters have been pooled together to increase sample size).

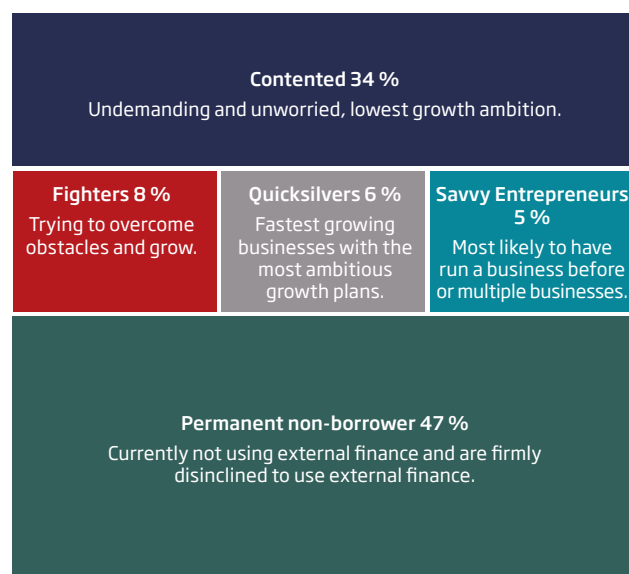
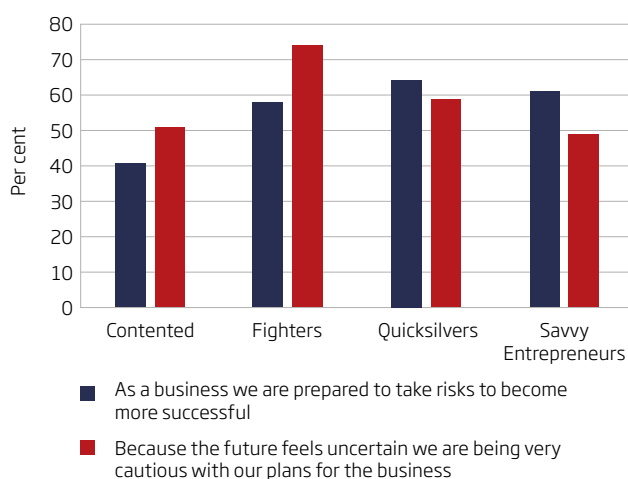


FIG A.2

### ATTITUDES TOWARDS RISK AND BUSINESS PLANNING, BY SME SEGMENTATION

Source: British Business Bank analysis of SME Finance Monitor 4 quarter dataset ending Q2 2018 [risks] and 2 quarter dataset ending Q2 2018 [plans for business]



Factors like risk tolerance, self-funding ability or preference and growth ambition can affect small businesses' use of external finance. This chapter will focus on developments in SME attitudes towards using external finance and explore differences across the SME segments. For the purposes of analysing attitudes to finance across segments, the PNB group has been excluded, as they are not currently using finance, have not used finance in the past 5 years, have not applied for finance in the past 12 months, and have no plans to apply in the next 3 months.

### MOST SMALL BUSINESSES PREFER TO SELF-FUND AND HALF ARE BEING MORE CAUTIOUS DUE TO POLITICAL AND ECONOMIC UNCERTAINTY

Some smaller businesses may be able to self-fund expansion and many prefer to do so. Pecking order theory suggests smaller businesses will fund growth internally before using debt and then external equity.<sup>4</sup> Given these preferences, the type of finance sought may indicate the businesses' need for finance.

Ambition to grow also influences SME demand for external finance, for example whether small businesses are seeking to enter new markets, expand or develop product lines. In the first half of 2018, just a third of businesses said they were happy to use external finance to help the business grow, falling to 29% in Q4 2018.<sup>5</sup> Almost three-quarters (73%) of businesses were willing to grow more slowly than borrow to grow more quickly.<sup>6</sup>

Uncertainty around the political and economic climate appears to be suppressing investment intentions and demand for finance.<sup>7</sup> In H1 2018, half of SMEs (51%) agreed that they were being more cautious because the future felt uncertain and by Q4 almost a quarter (24%) of smaller businesses had more than £10k in reserve, up from 16% in 2012.<sup>8</sup>

Utilising our segmentation analysis, risk tolerance is highest amongst Quicksilvers and Savvy Entrepreneurs, with over 60% of those businesses prepared to take risks to become more successful (Figure A.2). However, Quicksilvers and also Fighters demonstrate a higher level of caution when it comes to future uncertainty, with 74% and 59% indicating they are cautious with their business plans.



### SMALL BUSINESSES HAVE BECOME ENTRENCHED WITH THEIR RELUCTANCE TO USE FINANCE

Most businesses (80%) base their business plans on current levels of external finance or what they can afford, with little variation across our segments. Almost half (48%) of all small businesses say they never think about whether they could or should use more external finance with Savvy Entrepreneurs and Contented slightly lower at 43% and 42% respectively (Figure A.3).

Across the segments, businesses are becoming increasingly reluctant to consider using external finance. For the 4 quarters ending Q2 2018, over half of Fighters (54%) agreed that they never think about whether they could or should use more finance. This is likely to reflect an increasing aversion to using finance in recent surveys.

Just a third of small businesses say they are happy to use external finance to help them grow and the share has been falling over time (Figure A.4). Between 2014 to Q4 2018, the proportion willing to use external finance fell from 42% down to 29%.

Although most smaller businesses are willing to accept a slower growth rate than borrow to grow faster, Quicksilvers are the most open to using external finance to grow, while fewer of the Contented group are happy to use external finance (Figure A.5). The Fighters are the most likely to forgo a faster growth rate (71%).

More recently, the share of the Contented groups and the Fighter groups happy to use external finance has decreased. For the 4 quarters ending Q2 2018, the share of Contented businesses agreeing with that statement fell by 6 percentage points, as did the share of Fighters. However, the share of Savvy Entrepreneurs and Quicksilvers happy to use finance increased by 3 percentage points and 1 percentage point respectively. This suggests while political and economic uncertainty over the past year could be affecting businesses' willingness to use finance, it is not uniform across all our segments.

FIG A.3  
CONSIDERATION OF EXTERNAL FINANCE, BY SME SEGMENTATION

Source: British Business Bank analysis of SME Finance Monitor 10 quarter dataset ending Q2 2018

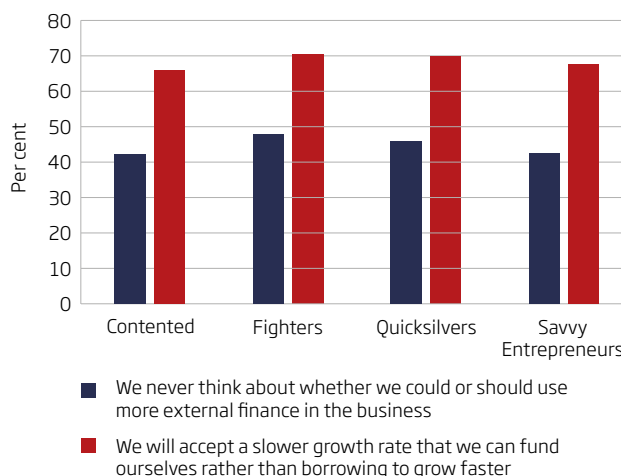


FIG A.4  
SHARE OF SMEs HAPPY TO USE EXTERNAL FINANCE TO HELP GROW AND DEVELOP THE BUSINESS

Source: British Business Bank analysis of SME Finance Monitor

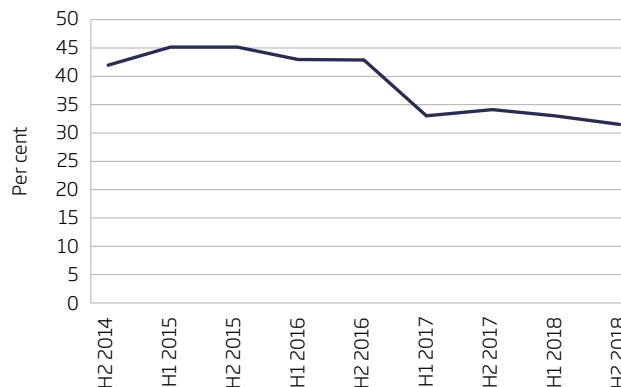


FIG A.5  
ATTITUDES TOWARDS GROWING A BUSINESS AND USE OF EXTERNAL FINANCE, BY SME SEGMENTATION

Source: British Business Bank analysis of SME Finance Monitor 10 quarter dataset ending Q2 2018

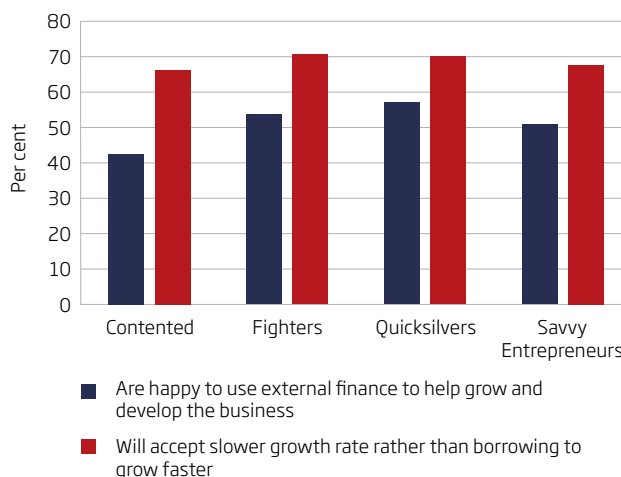
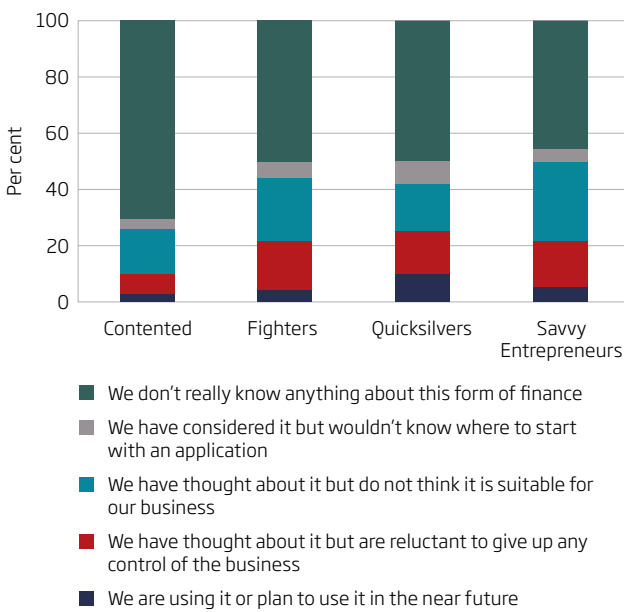


FIG A.6  
**ATTITUDES TOWARDS EQUITY, BY SME SEGMENTATION**

Source: British Business Bank analysis of SME Finance Monitor 4 quarter dataset ending Q2 2018, companies only



**BARRIERS SUPPRESS USE OF EQUITY, INCLUDING A LACK OF AWARENESS AND A RELUCTANCE TO GIVE UP CONTROL**

Few SMEs use or plan to use equity in the near future. Reasons range from a reluctance to give up control, not knowing where to start with an application and judging it to be unsuitable for them.

Over half of smaller businesses said they did not know anything about equity finance, suggesting there is still an information gap (Figure A.6). Savvy Entrepreneurs, Fighters and Quicksilvers have the highest level of awareness of equity finance. Quicksilvers are the most open to using equity finance with 9% either using it or planning to use it in the near future.

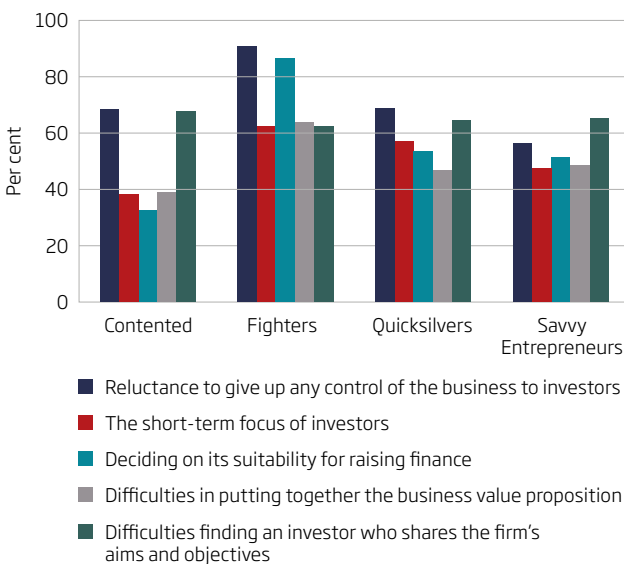
Almost half of Savvy Entrepreneurs and Fighters have thought about using equity (48% and 45% respectively), but do not think it is suitable for their business, are reluctant to give up control or wouldn't know where to start (in that order of significance).

Even for those who have applied or are considering applying for equity, a reluctance to give up control was either the most or second most frequently cited barrier across segments (Figure A.7). Contented and Savvy Entrepreneurs most frequently identified difficulties in finding investors who share the firm's aims and objectives.

Many smaller businesses may also be unaware of the different types of equity finance available. Equity awareness is measured by being aware of venture capital (VC), equity crowd funding and business angels to demonstrate a broad knowledge of equity options (mezzanine finance has not been included as its overall awareness is very small). Almost a quarter (23%) of smaller businesses have considered using equity but are not aware of these 3 types of equity finance (Figure A.8). This analysis suggests an 'equity information gap' amongst SMEs who are potentially receptive to receiving information.

FIG A.7  
**BARRIERS TO CONSIDERING EQUITY FINANCE, BY SME SEGMENTATION**

Source: British Business Bank 2018 Business Finance Survey - Ipsos MORI  
 Base = all who sought finance in the last 3 years (n=344)



**BUSINESSES TYPICALLY STILL APPROACH THEIR MAIN BANK FIRST**

When businesses first identify a need for finance, the most common first port of call is their main bank. The second most common response is to look for information online. Just under 1 in 5 (19%) of Quicksilvers research finance types and products on the internet, the highest share across segments, followed by Savvy Entrepreneurs (15%) (Figure A.9). Small businesses also spoke to their supplier or manufacturer about available finance options, with 11% of businesses citing this option. Only 7% of SMEs tend to seek professional advice from accountants or financial advisers but this is still more than go to finance providers other than their main bank (5%).

Around half of small businesses tend to consider just 1 provider when seeking finance. The share is lowest for Savvy Entrepreneurs (49%) and highest for Contented businesses (59%). More businesses consider 3 providers rather than 2 (except for the Contented group), indicating that Fighters, Savvy Entrepreneurs and Quicksilvers are willing to shop around. Businesses who sought advice from an accountant or finance advisor were more likely to shop around, with 58% of these businesses considering more than 1 provider.<sup>9</sup>

Information from banks, particularly the SME's existing bank or provider, was the most cited main influence on the Contented, Fighter and Savvy Entrepreneurs' decision on which type of finance to apply for (Figure A.10). The main influence on Quicksilvers was their own experience, fairly evenly split between their previous experience/relationship with provider (13%), their own knowledge (13%), or previous experience from within the business (or its staff) (10%). Fighters were the most likely to be influenced by information on the internet with over a quarter (26%) highlighting this as the main driver of their decision to apply. Government advisory services were cited by 7%, with Fighters the most likely to mention them.

The most commonly cited reason for choosing a finance provider by smaller businesses is a pre-existing relationship (Figure A.11). Over half of Fighters (57%) cite this as their main reason for choosing their provider, while Savvy Entrepreneurs (30%) are least likely to cite this reason.

Cost was the second most cited across 3 of the 4 segments, with Contented most likely to cite price competitiveness over the short to medium term as a main reason (16%). Fighters were the least likely (7%) and 9% cited ease of application which was also an important factor for Quicksilvers, with over 1 in 10 (11%) citing this as their main reason.

FIG A.8

**AWARENESS OF EQUITY AND CONSIDERED USING EQUITY**

Source: British Business Bank analysis of SME Finance Monitor, 4 quarters ending Q2 2018. 'Have considered equity' includes businesses who are using or planning to use equity or have thought about or considered using it.

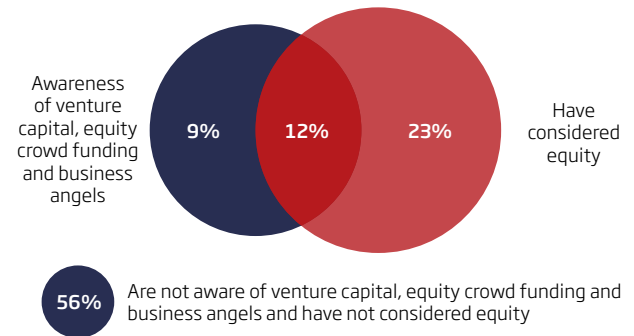


FIG A.9

**THE FIRST THING BUSINESSES DID WHEN THEY REALISED THEY HAD A FINANCING NEED, BY SME SEGMENTATION**

Source: British Business Bank 2018 Business Finance Survey - Ipsos MORI.

Base = all who sought finance in the last 3 years (n=718)

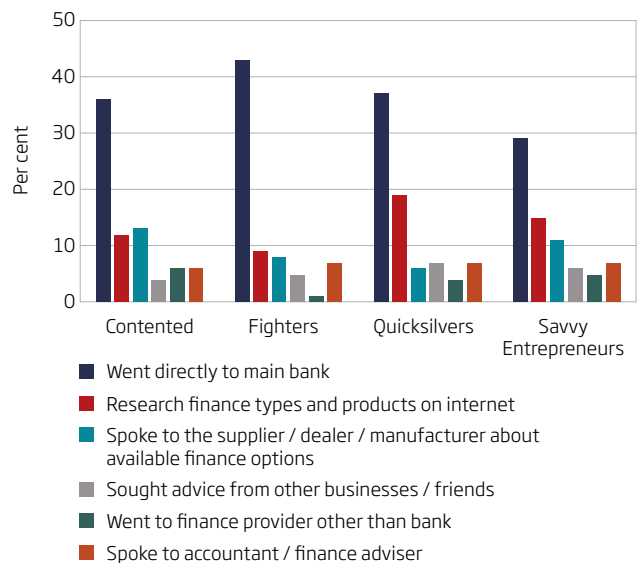


FIG A.10

**THE MAIN INFLUENCE ON SMEs' DECISIONS ON WHICH TYPE OF FINANCE TO APPLY FOR, BY SME SEGMENTATION**

Source: British Business Bank 2018 Business Finance Survey - Ipsos MORI

Base = all who sought finance in the last 3 years (n=104)

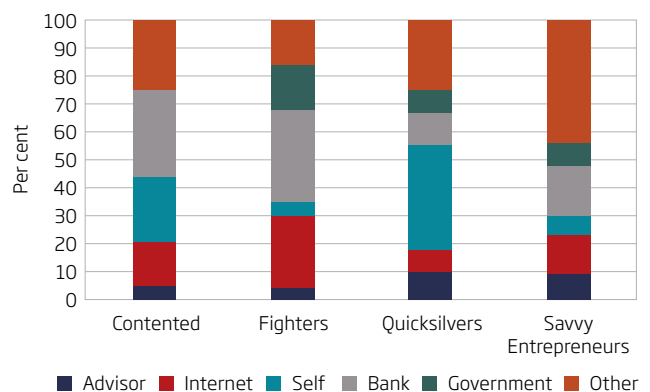
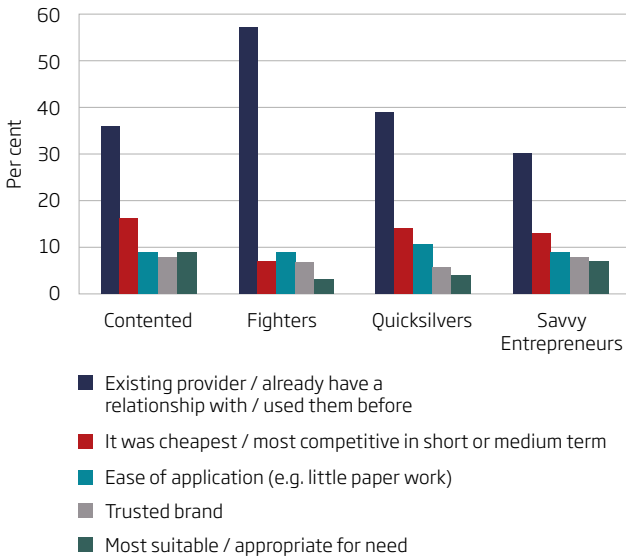


FIG A.11  
**MAIN REASONS FOR CHOOSING FINANCE PROVIDER (CITED BY OVER 5%), BY SME SEGMENTATION**

Source: British Business Bank 2018 Business Finance Survey - Ipsos MORI  
 Base = all who sought finance in the last 3 years (n=718)



Smaller businesses reported feeling more confident in assessing the advantages and disadvantages of finance products offered by their own bank than those offered by other finance providers (Figure A.12). This could explain why such a high proportion of small businesses go straight to their main bank with a financing need, and why so many cite their existing relationship with their provider as a key reason for choosing them.

Perhaps reinforcing this is the fact that Fighters are the only group that; have an equal number of businesses that feel confident and unconfident in assessing products from multiple providers, that have a negative net balance of confidence in applying for products from multiple providers and have a majority reporting an existing relationship as the main reason for choosing a provider.

Fittingly, from a naming convention at least, Savvy Entrepreneurs have the highest confidence scores for both assessing and applying for finance products offered by multiple providers and the Contented show much more confidence in assessing finance products from their own bank compared to other finance providers than any other group.

**THE BRITISH BUSINESS BANK HAS ESTABLISHED AN INFORMATION STRATEGY AS PART OF ITS DEMAND-SIDE STIMULUS, TO ENABLE BUSINESSES TO MAKE THE RIGHT FINANCE CHOICE FOR THEM**

The Bank has established a Demand Development Unit (DDU) to help businesses understand the types of finance available and access the finance best suited to them. SMEs may have insufficient information on the types of finance available, possible providers and the benefits to using external finance. This lack of information or awareness may affect SMEs' willingness to apply for finance that could otherwise enable them to grow. These information gaps can lead to an inefficient allocation of capital, constraining business development and potentially resulting in forgone growth across the UK economy.

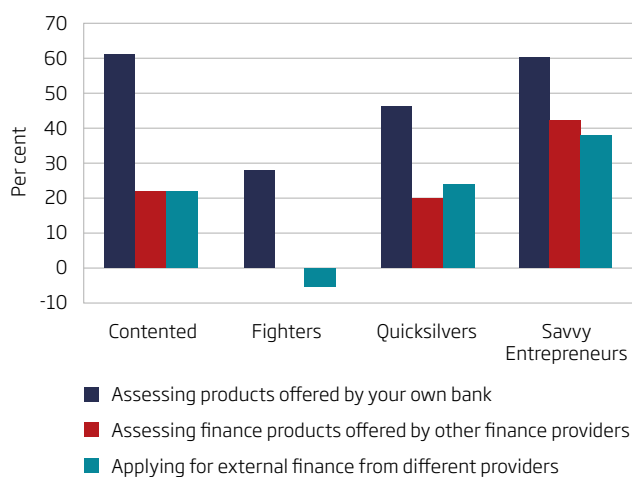
The DDU is focused on raising awareness of the different finance options available to UK SMEs, encouraging and enabling SMEs to seek the finance best suited to their needs and identifying and helping to reduce regional imbalances in access to finance for smaller businesses across the UK.

Activities of the DDU include provision of independent and impartial information on different finance options for scale-up, high growth and potential high growth businesses. Through the development and launch of its Finance Hub, the Bank is actively engaging with growth-orientated small businesses seeking information on external finance.

The Business Finance Guide provides information on finance options for all SMEs. The Bank has appointed a Chief Marketing Officer to lead the DDU, to build on its work so far and forge stronger relationships with smaller businesses and SME intermediaries. A new UK Network has been established to reduce regional imbalances in access to finance, covered in more detail in section 1.3, SME finance at a local level.

**FIG A.12**  
**NET BALANCE OF CONFIDENCE IN ASSESSING DIFFERENT TYPES OF FINANCE PRODUCTS AND APPLYING FOR EXTERNAL FINANCE**

Source: British Business Bank 2018 Business Finance Survey - Ipsos MORI  
Base = all SMEs (n=2,000)



## 1.2

## EQUITY FINANCE ENVIRONMENT FOR INNOVATIVE AND HIGH GROWTH FIRMS

- Equity finance is an important source of funding for innovative and High Growth Firms, but only a small proportion of businesses use equity finance
- Equity finance is supporting the development of the technology sectors of tomorrow, which are vital for the future industrial success of the UK
- The UK equity ecosystem has developed over the last decade and is now better able to support businesses at all stages of their development, from start-up to unicorn<sup>10</sup>
- British Business Bank analysis has confirmed the importance of several factors identified in the Patient Capital Review that impede the effectiveness of the Patient Capital ecosystem in supporting High Growth Firms

Equity finance for growing smaller businesses can come from a variety of different types of equity investor including business angels, venture capitalists, crowdfunding platforms, private investors and Government backed funds.<sup>11</sup> This chapter explores the equity finance environment for High Growth Firms (HGFs) in the UK, identifying several areas where the ecosystem has improved over the last few years.<sup>12</sup> The chapter also highlights potential areas of concern where the market is not working as effectively as it could be, restricting the availability of finance to high growth potential businesses. In part B of the report, recent trends in UK and international equity finance are covered, including the latest financial performance of VC compared to public markets.

**EQUITY FINANCE IS AN IMPORTANT SOURCE OF FUNDING FOR INNOVATIVE AND HIGH GROWTH FIRMS, BUT ONLY A SMALL PROPORTION OF BUSINESSES USE EQUITY FINANCE**

Equity finance is an important source of funding for businesses that have the potential for rapid growth. It is suitable for early stage businesses that are unable to secure debt finance due to their risk profile, lack of collateral or unstable cash flows. Equity finance is also suitable for established businesses looking to scale up by expanding or entering new markets, which may not be able to obtain debt finance due to their existing leverage or risk profile. An outside equity investor brings financial capital and can also bring additional benefits and added value through their experience, scale-up expertise and access to networks. This can be especially useful for early stage businesses that have not yet developed these resources or capabilities. Equity investors are only compensated when they sell their equity stake, so their interests are aligned with growing the business to create value.

Whilst equity finance is not suitable for every business, only a small proportion of smaller businesses overall are currently using equity finance (2%).<sup>13</sup> Survey evidence shows HGFs are more likely to use equity finance than non-HGFs, but debt finance remains the most frequently used source of funding for both high growth and non-HGFs.<sup>14</sup>

A recent Beauhurst and Scaleup Institute report shows the use of equity finance is correlated with higher turnover and employment growth rates amongst scale up businesses.<sup>15,16</sup> Figure A.13 shows 42% of scale up businesses growing their annual turnover by more than 100% used equity finance, compared with 17% amongst businesses that grew their annual turnover by 20 to 40%. The more equity finance a scale up company raises, the more likely it is to increase its annual turnover by over 100% a year. Business owners are unlikely to give up equity in their company unless they feel there are likely benefits from doing so. This demonstrates equity finance can have a positive contribution to growth.

#### EQUITY FINANCE IS SUPPORTING THE DEVELOPMENT OF THE TECHNOLOGY SECTORS OF TOMORROW, WHICH ARE VITAL FOR THE FUTURE INDUSTRIAL SUCCESS OF THE UK

The Industrial Strategy sets out several Grand Challenges to put the UK at the forefront of the industries of the future, ensuring that the UK takes advantage of major global changes to improve peoples' lives and the country's productivity.<sup>17</sup> The first 4 Grand Challenges include artificial intelligence and data, ageing society, clean growth and future of mobility. External finance can enable the development of an emerging sector, allowing businesses to start up, fund R&D and scale up into globally competitive businesses.

The British Business Bank has used Beauhurst data to measure equity investment going to companies within each of the 4 Grand Challenge sectors, showing the extent to which they are being supported by the current equity ecosystem. Businesses were selected using a mixture of Beauhurst sectors and matching key words in the company description. This provides an estimate of the total number of equity deals going to businesses in each of the Grand Challenge sectors between 2011 and Q3 2018, as shown in Figure A.14. Comparisons are also made over time up to 2017 (the last full year of data).

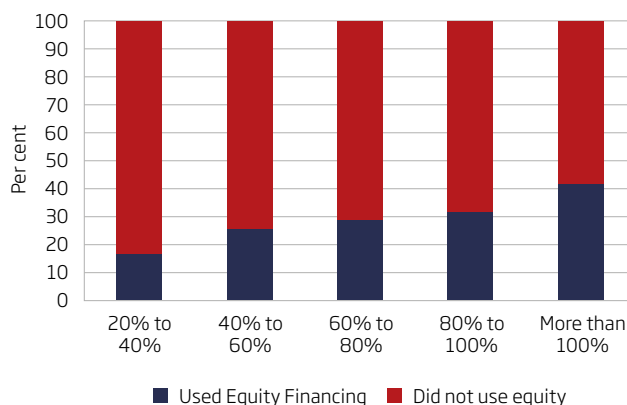
The largest sector by both number of deals and investment value is clean growth, with 470 equity deals and a total investment value of £1.2bn between 2011 and Q3 2018. This reflects clean growth being established in the market and the larger capital requirements of companies in this Grand Challenge. The number of equity deals going to clean growth companies has been relatively stable since 2011, with around 60 deals per year.

FIG A.13

#### PROPORTION OF SCALE UP BUSINESSES USING EQUITY FINANCE, BY ANNUAL TURNOVER GROWTH

Source: Beauhurst/ Scale up Institute 'The Scale up Index 2018'

Note: As measured by scale up business accounts.



The next largest sector by number of deals is artificial intelligence and data with 125 equity deals and a total investment value of £403m between 2011 and Q3 2018. This sector has grown rapidly over the last few years, with the number of equity deals going from zero in 2011 to 42 in 2017 (and forming around 3% of UK equity deals in 2017). Investment value has also increased, from zero in 2011 to £188m in 2017, and this growth looks set to continue.

The future of mobility sector is also growing rapidly, albeit at a slower rate than artificial intelligence and data. Between 2011 and Q3 2018 there were 71 equity deals with a total investment value of £147m in this sector. The number of deals increased from 3 in 2011 to 18 in 2017, growing from 0.6% of UK equity deals in 2011 to 1.2% in 2017. Investment amounts have grown at a similar rate, from £8m in 2011 to £32m in 2017.

Ageing society is the Grand Challenge that has raised the least amount of equity finance, with 32 equity deals between 2011 and Q3 2018 (£16m by value). The number of deals going to companies involved in the ageing society sector has remained low at around 5 deals per year since 2012.

The British Business Bank has an important role in supporting the Grand Challenges, by ensuring access to finance is available to these innovative and high growth potential businesses. To date, VC funds supported by the Bank's equity programmes have invested £350m into 249 businesses falling into 1 of the Grand Challenge sectors.<sup>18</sup> This looks to increase further in the future as the Bank's programmes continue to make investments in UK VC funds. For instance, British Patient Capital has recently invested in the Dementia Discovery Fund, which will increase the amount of finance available to businesses in the ageing society Grand Challenge.<sup>19, 20</sup>

FIG A.14

## EQUITY DEALS AND INVESTMENT IN THE GRAND CHALLENGES

Source: British Business Bank analysis of Beauhurst

Grand Challenge	Total number of deals (2011- Q3 2018)	Total number of unique companies (2011- Q3 2018)	Total investment (2011- Q3 2018)	Proportion of UK SME equity deals (2016- Q3 2018)	Proportion of UK SME equity investment (2016-Q3 2018)
Artificial Intelligence and Data	125	78	£403m	2.6%	2.9%
Ageing Society	32	24	£16m	0.3%	0.02%
Clean Growth	470	298	£1.2bn	4.2%	3.3%
Future of Mobility	71	40	£147m	1.0%	0.7%



## THE UK EQUITY ECOSYSTEM HAS DEVELOPED OVER THE LAST DECADE AND IS NOW BETTER ABLE TO SUPPORT COMPANIES AT ALL STAGES OF THEIR DEVELOPMENT, FROM START-UP TO UNICORN

The UK and European technology and equity funding ecosystem continues to mature as demonstrated by the latest Atomico 'State of European Tech' report.<sup>21</sup> The report identifies \$23bn of equity finance was invested into the European technology ecosystem in 2018, a large increase from the \$5bn invested in 2013, and that 2018 was 'another record year for investment into the European tech ecosystem'.<sup>22</sup> The number of people employed in European technology sectors is also increasing. For instance, Europe's professional (software) developer workforce grew to 5.7m people in 2018, up from 5.5m in 2017. Europe has a higher number of people employed as professional developers than the US (4.4m people). Within Europe, the UK has the second highest number of people employed as professional developers (830,500), slightly behind Germany (851,000), but well ahead of France (491,800).

### UK BUSINESSES HAVE ATTRACTED HIGH VOLUMES OF EQUITY FINANCE IN RECENT YEARS, WITH SEVERAL SUCCESSFUL CLUSTERS DEVELOPING

Equity finance into smaller businesses has increased rapidly over the last few years. The number of deals trebled between 2011 and 2017, and total UK equity investment value in 2017 was over 4 times larger than it was in 2011.

Equity finance is increasingly grouped around geographic clusters, both in a global context and within countries. Six cities around the world (San Francisco, Beijing, New York, San Jose, Boston, and Shanghai) attract more than half of all global venture capital investment, despite accounting for just 1% of the global population.<sup>23</sup> Clusters develop where innovative companies, skilled labour and equity investors locate closely together which can lead to increased benefits for all parties. This includes minimised search and transaction costs, and positive spill over effects from increased sharing of information. This is explored further in section 1.3 SME finance at a local level. In 2011, the 25 UK Local Authority Districts with the highest number of deals accounted for 56% of the total number of deals, rising to 64% in 2017, suggesting clusters are becoming an increasingly important feature of the UK equity ecosystem.

## THE UK HAS RECENTLY CLOSED SOME OF THE GAP WITH THE US

The 2017/18 Small Business Finance Markets report identified equity finance was twice as large in the US compared to the UK once the size of the UK and US economies are taken into account, but the UK performed relatively well compared to other European countries. Figure A.15 shows the gap between the value of UK and US equity finance investment as a proportion of GDP has fallen, with the US equity market being twice as large as the UK market in 2015, but by 2017 had fallen to 1.5 times larger.

The US had an equity investment to GDP ratio of 0.45% in 2015, but this fell slightly to 0.42% in 2017. The UK equity to GDP ratio increased from 0.22% in 2015 to 0.29% in 2017. The large increases in UK equity deal sizes seen in 2017 (See Equity Tracker 2018) was a key contributor to the overall increase in equity investment. The value of UK equity investment grew 40% between 2015 and 2017, compared to 21% over the same period in the US, partly explaining why the gap as measured by the ratio of GDP has closed.

The UK's equity to GDP ratio was substantially higher than most other European countries over the 3-year period, apart from Sweden, which has increased rapidly in 2016. The Swedish VC market has grown in recent years, creating several successful global companies including Spotify and iZettle.<sup>24</sup> The UK remains Europe's largest equity market, with 35% of European equity deals and 41% of European equity investment value going into UK headquartered companies in 2017.<sup>25</sup> Over the last few years there has been strong growth in Venture Capital financing in Asia, and especially China, suggesting the VC ecosystem is becoming firmly established in Asia. Whilst Government-backed funds and state-corporate collaborations make up a large part of the Chinese VC market, recent reports suggest the Chinese VC market is a similar size to the US VC market or even larger.<sup>26, 27, 28</sup>

The HMT Patient Capital Review identified 'the main difference between the UK and the US is in the amount of investment per firm rather than the number of firms that receive investment'.<sup>29</sup> This continues to be the case, as the UK had a higher number of completed equity deals as a proportion of GDP than the US in 2016 and 2017. The UK has therefore made good progress in establishing and developing its ecosystem over the last few years, with the total number of equity deals in the UK now largely in line with US markets.

FIG A.15

## EQUITY FINANCE AS A PROPORTION OF GDP

Source: British Business Bank calculations, PitchBook and World Bank

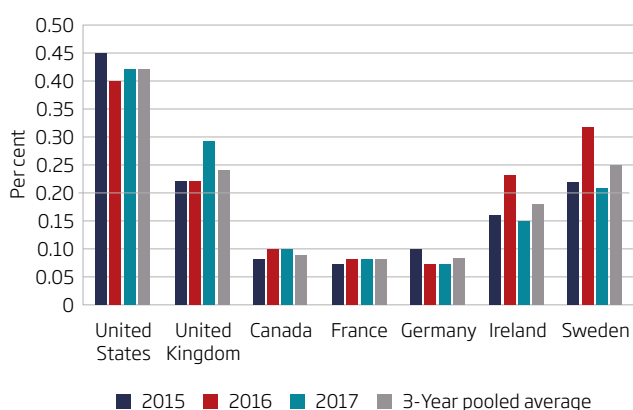


FIG A.16

## INTERNATIONAL COMPARISONS OF EQUITY FINANCE

Source: British Business Bank analysis of PitchBook (19th November 2018)

Investment value (£m)	2015	2016	2017
United States	52,753	54,394	63,706
United Kingdom	4,163	4,338	5,817
Canada	1,253	1,587	1,656
France	1,154	1,414	1,543
Germany	2,105	1,793	2,091
Ireland	299	518	386
Sweden	693	1,198	902

Number of equity deals	2015	2016	2017
United States	10,746	9,137	9,356
United Kingdom	1,692	1,470	1,458
Canada	568	488	438
France	517	543	489
Germany	475	475	434
Ireland	176	146	123
Sweden	253	365	267

## THERE HAS BEEN INCREASED FUNDING OF UNIVERSITY SPINOUTS OVER TIME, BUT LARGE DIFFERENCES EXIST ACROSS DIFFERENT ACADEMIC INSTITUTIONS

A university spinout is a company that has been developed from a university's research, with the management team typically consisting of former or current university researchers. The university, through its commercialisation office or one of its associated venture capital funds, will often provide the company with its initial finance and guidance to help develop the idea into a commercial proposition. The company may continue to have access to the academic institution's workspace facilities.<sup>30</sup> University spinouts are important for transforming academic research into commercial propositions in order to extract the economic value from the research. Commercialisation of a university's Intellectual Property (IP) generates wider impacts with spillover benefits impacting on other businesses and the local economy, helping to generate economic growth.<sup>31</sup>

The Patient Capital Review highlighted that university spinout companies sometimes struggle to access finance at the earliest stages of their development.<sup>32</sup> While early stage investment conditions have generally improved in the UK over the last decade, the Review identified a continuing gap for early proof of concept investment in university spinouts. Many responses to the Review highlighted that technology rich and knowledge intensive businesses are most acutely affected by difficulties in raising funding. British Business Bank analysis of Beauhurst data confirms the number of UK equity deals involving university spinout companies has increased from 61 in 2011 to 121 in 2017, with investment value more than doubling from £420m to £977m over the same time period (Figure A.17). Whilst this is positive, university spinouts now make up a smaller proportion of overall equity deals in 2017 compared to 2011, suggesting funding has not kept pace with wider market growth. University spinouts formed 13% of all equity deals in 2011, but this had declined to 8% by 2017.

The UK has some of the highest ranked universities globally in terms of the quality of their research. For instance, the latest 2019 Times Higher Education World University Rankings ranks Oxford and Cambridge in first and second places respectively, with Imperial College London (ICL) and University College London (UCL) ranked in the top 20 for their research.<sup>33</sup> There is a widespread perception that British universities have historically struggled to capitalise on this strong research capability and have tended to sell their ideas to outside companies at an early stage, missing out on the profits further down the line.<sup>34</sup> This perception is likely to be dated to some extent as 3 of the UK's 12 current unicorn status businesses were spun out of a UK university:

- Oxford Nanopore (University of Oxford)
- Improbable (University of Cambridge)
- Darktrace (University of Cambridge)

However, Beauhurst research does show university spinout companies are more likely to exit at an earlier stage than non-spinout companies at the venture stage, compared to non-spinouts which exit at the growth stage.<sup>35, 36</sup>

UK Higher Education Institutions differ markedly in the success of their commercialisation activities. Figure A.18 shows there is a wide variation in the number of active spinout companies created between the 2 highest institutions (Oxford and Cambridge) which have 104 and 78 active spinout companies and the long tail of institutions with no active spinout companies. The HESA data suggests 77 out of the 163 institutions have no reported active spinout companies. Some of the difference may be explained by differences in research focus, but the level and quality of commercialisation support available could also be an explanatory factor.

There are also variations in the amount of funding going to university spinout companies by institution. In 2016, University of Oxford spinout companies received £245m, followed by University of Cambridge (£145m), ICL (£75m) and UCL (£40m).<sup>37</sup> Spinout companies from Oxford University raised more equity investment than the spinouts from the fourth to fifteenth ranked universities combined. Some of this difference is explained by funding at the later growth stage. Spinouts from the University of Oxford, the University of Cambridge and Imperial College London raised £236m at the growth stage in 2016, but other universities have not raised any growth stage investment at all.

FIG A.17

#### NUMBER AND VALUE OF EQUITY DEALS INVOLVING UNIVERSITY SPINOUTS

Source: British Business Bank analysis of Beauhurst

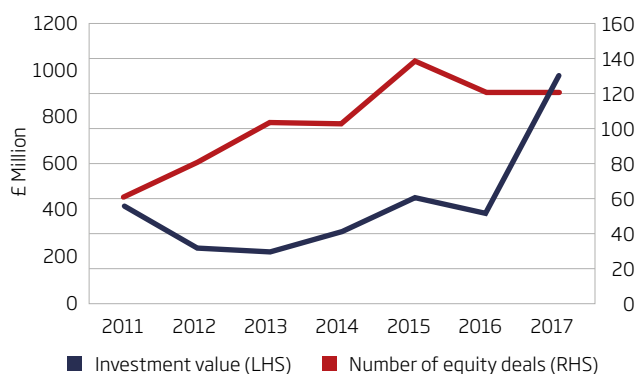
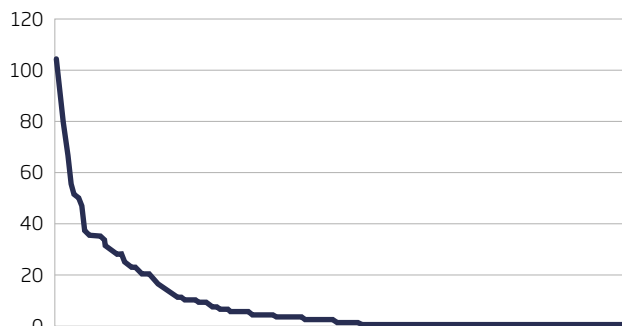


FIG A.18

#### DISTRIBUTION OF ACTIVE SPINOUTS CREATED BY HIGHER EDUCATION INSTITUTIONS IN 2016/17

Source: HESA



The fundraising of spinouts from the top 3 universities is helped by dedicated funds that have been established in collaboration with the university. Oxford Sciences Innovation (OSI) was involved in 13 of the 25 investments into Oxford spinouts announced in 2016. Cambridge Innovation Capital was involved in 4 of the 20 investments into Cambridge spinouts in the same period. Touchstone Innovations were involved in 3 of the 9 investments into spinouts from Imperial College London.

It is promising that 3 university spinout companies have developed into current unicorn status businesses, but there are big differences in spinout activity and funding between different universities with many universities having no active spinouts at all. It can take many years for university research to develop into a commercial application, and the British Business Bank through BPC is working collaboratively with UK Research and Innovation (UKRI) and Higher Education Institutions to increase the amount of patient capital available to these early stage businesses.

#### THE UK CONTRIBUTES A HIGH PROPORTION OF EUROPE'S UNICORN COMPANIES

The term 'unicorn' was first introduced by Venture Capitalist Aileen Lee in a 2013 TechCrunch article to refer to the then near mythical status of building a company worth over \$1bn.<sup>38</sup> Lee's definition included any technology startup company less than 10 years old that reached a \$1 billion valuation, whether on private or public markets. Today, more companies are reaching unicorn status and there is a strong media and industry interest in companies gaining high valuations and reaching this coveted status. There are several different data sources counting and tracking unicorn businesses, and differences in terms of the definition used and their measurement.<sup>39</sup>

For the purposes of this report, the British Business Bank has adopted the following definition of a unicorn: a privately held, venture capital backed company valued at more than \$1 billion.<sup>40</sup> When a unicorn investment is exited, the company no longer retains unicorn status but can still be considered a successful scale-up business.<sup>41</sup> This definition concentrates on high growth firms supported by venture capital, which is the focus of the Bank, and therefore excludes private equity backed companies or older companies that might be valued over \$1 billion. The decision to exclude acquired businesses from the unicorn definition was taken to avoid capturing companies that are no longer separate entities and may no longer be operating in the UK or Europe.<sup>42</sup> Whilst Initial Public Offerings (IPOs) are often regarded as a successful exit outcome for venture capitalists, public company valuations can be volatile. The British Business Bank definition of unicorn can therefore be used to indicate the pipeline of successful venture capital backed companies that are likely to exit shortly.

The UK contributes nearly half of Europe's total number of unicorn businesses. As of 15th January 2019, the UK had 12 unicorn status businesses out of 25 in Europe as a whole.<sup>43,44</sup> This evidence establishes that the UK is now able to support companies from start up to become leading, globally competitive businesses.

Reaching unicorn status helps companies recruit employees, attract publicity, increase their profile and raise further funding, but recent research has highlighted questions over whether the focus on unicorns is healthy, especially if companies are overvalued.<sup>45</sup> The equity shares issued and the rights they give investors vary substantially between different private companies and also between different funding rounds in the same company. Many later stage investors negotiate preferential rights to their shares giving them greater protection or a guarantee of returns compared to early stage investors. This attracts a price premium compared to ordinary shares. Many venture capital funds use the most recent round's price as a fair value to determine the value of their unrealised investments, which could inflate the unrealised return value. This could explain why some unicorns are suffering disappointing post-IPO performances as the capital structure simplifies and equity shares become equally valued.<sup>46</sup>

Evidence also suggests unicorn status companies are staying private for longer.<sup>47</sup> Many companies that would have undertaken an IPO in the past are now raising late stage VC rounds instead, in part due to greater amounts of later stage funding available.<sup>48</sup> Companies may delay going public to avoid the listing process and ongoing scrutiny inherent with being a publicly listed company. The latter is especially important for a growth stage company still developing its strategy. Eventually, VC-backed companies will need to exit in order to allow their investors to realise financial returns. A recent PitchBook blog highlights the dangers of investors and policy makers exclusively focusing on unicorn businesses: 'A private company being valued at \$1 billion in Europe is cause for celebration to be sure. However, reaching that number is the means, not the end—and in the vast majority of cases, shouldn't be the means in the first place.'<sup>49</sup>

Movement towards companies raising larger, later stage rounds and subsequently staying private for longer can explain the decline seen in the number of VC-backed companies successfully exiting, but an increase in the exit value. PitchBook data shows 74 UK VC-backed companies exited in 2018, which is 44% lower than the number of exits in 2017.<sup>50,51</sup> The exit value in 2018 is high at £3.8bn, which increased 77% compared to the exit value seen in 2017. High exit values combined with a slowdown in number of exits is a trend that can be seen across wider European VC markets, and indicates that the average exit size increased substantially in 2018.<sup>52</sup>

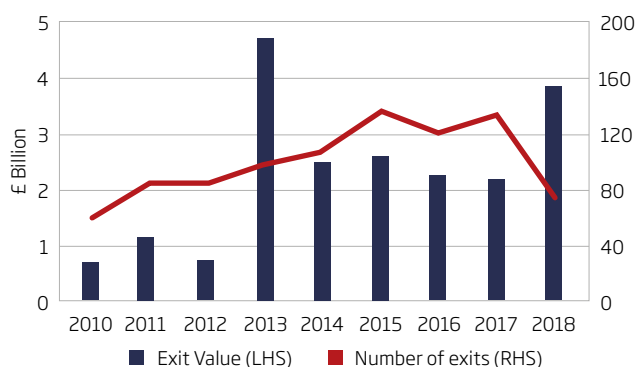
Trade sales continue to be most frequent exit route for UK VC-backed companies, although the proportion has fallen over the last few years from 85% of all exits in 2010 to 62% in 2018. Higher company valuations in global VC markets may be contributing to this, making company acquisitions a less attractive strategy for large corporates.<sup>53</sup> Buyouts formed the second largest proportion of exits in 2018, with IPO's forming the minority (14%) of UK exits. There were 10 VC-backed company IPOs in 2018 (1 more than 2017) worth £1.7bn with successful companies valued over \$1bn like Funding Circle and Farfetch contributing to the increased value of exits seen in 2018.

The UK equity ecosystem has shown its ability to support companies from start-up to become globally competitive companies, and it is a positive sign that the UK contributes nearly half of Europe's unicorn businesses. Some of these UK unicorn businesses have been supported by the Bank's venture capital programmes. British Patient Capital (BPC) will increase the amount of later stage VC finance available to help growth potential businesses to scale up.

FIG A.19

## NUMBER AND VALUE OF UK VC-BACKED COMPANY EXITS

Source: British Business Bank analysis of PitchBook (Data accessed 14/01/2019)



BRITISH BUSINESS BANK ANALYSIS HAS CONFIRMED THE IMPORTANCE OF SEVERAL FACTORS IDENTIFIED IN THE PATIENT CAPITAL REVIEW THAT IMPEDE THE EFFECTIVENESS OF THE PATIENT CAPITAL ECOSYSTEM IN SUPPORTING HIGH GROWTH FIRMS

The second part of this section explores areas of the UK ecosystem that are not functioning as well as they could be. This includes:

- Innovative businesses with a predominance of intangible assets can have difficulties securing debt finance
- Women are significantly underrepresented in UK VC deals and investment pipeline
- First-time fund managers are finding it increasingly difficult to raise new funds, despite UK VC fundraising being at historically high levels
- A secondary market in venture capital has not yet fully developed in the UK

INNOVATIVE BUSINESSES WITH A PREDOMINANCE OF INTANGIBLE ASSETS CAN HAVE DIFFICULTIES SECURING DEBT FINANCE

Innovation is an important driver of economic growth in the long term.<sup>54</sup> However, some cutting-edge companies rich in Intellectual Property (IP) can struggle to obtain finance relative to companies with physical assets. The British Business Bank has recently published new research in collaboration with the Intellectual Property Office exploring the role of IP as collateral for debt finance.<sup>55</sup> This section provides a short overview of the research.

Due to imperfect information between lenders and businesses, lenders often require businesses to provide collateral to act as security for the loan. Intangible assets such as IP, know-how, brand and creative output have become increasingly important in recent years, but finance institutions ability to value IP cost effectively have not yet fully caught up. IP and other intangible assets can be difficult to value, especially if they are innovative and therefore untested in the market. Moreover, the value of such assets is often context-specific in that they may only be valuable within the firm that developed it.

There is no single approach or agreed methodology for valuing IP. This uncertainty makes it more difficult for a lender to know how much they could recover in the event of default and, as a result, lenders impose a significant discount on the valuation to take into account this uncertainty. Smaller businesses with intangible assets find it harder to access finance, which can hold back their growth.

Private debt funds supported by the Bank's Investment Programme provide finance to growth businesses that fall outside of the existing lending criteria of banks. Fund managers are better able to assess the viability of the company and review the value of the IP, which can then be used as security or in lieu of physical assets.

## WOMEN ARE SIGNIFICANTLY UNDERREPRESENTED IN UK VC DEALS AND INVESTMENT PIPELINE

The British Business Bank has recently published research looking into the extent female founders receive VC finance.<sup>56</sup> The vast majority of UK VC deals go to businesses with no women in the founding team. Analysis of PitchBook data shows that all-female teams received 4% of UK VC deals in 2017 and less than 1% by value. Mixed gender teams received 12% of deals and 10% by value. Taken together, this means only 17% of all UK VC deals in 2017 (11% by value) went to businesses with at least 1 female founder.

The proportion of VC deals and investment going to female founded companies in the UK has remained low over the last decade, with the rate of improvement being very slow. This is not a problem unique to the UK, as the US also shows a similar percentage of fundraising going to female-founded companies.<sup>57</sup>

Businesses with at least 1 female founder are less likely than all-male founded businesses to receive follow-on funding. Of businesses receiving Seed/ Series A funding between 2010 and 2012, 61% of businesses with all-male founders received a second funding round compared to 53% of businesses with at least 1 female founder. The effect persists in subsequent funding rounds.

Some of the differences in overall female participation and follow-on funding rounds could be due to sectoral differences. Software is the sector that receives the greatest number of UK VC deals, but it is also the sector where all-female founder teams are most under-represented. Software accounts for 36% of deals for all-male teams, and 34% for teams with at least 1 female founder. For all-female teams the figure is only 26%. In contrast, female founders are more likely to be in the Consumer Goods and Recreation sector. The sector accounts for 17% of all-female teams' deals, and 11% for teams with at least 1 female founder, but just 4% for all-male teams.

Previous research has identified there is 'little solid UK evidence on female entrepreneurs and their experiences of accessing venture capital'.<sup>58</sup> In light of the ongoing evidence gap, the British Business Bank collaborated with Diversity VC and the BVCA by undertaking new research. The Bank undertook a survey of UK fund managers to explore the proportion of female founded businesses progressing through each stage of the investment pipeline. Fund managers provided new data to the British Business Bank on the gender composition of the teams that had contacted them, those deals that progressed to Investment Committee (IC) stage and those that received funding.

FIG A.20

### 2017 UK VC DEAL NUMBER AND VALUE BY FOUNDER TEAM GENDER

Source: PitchBook

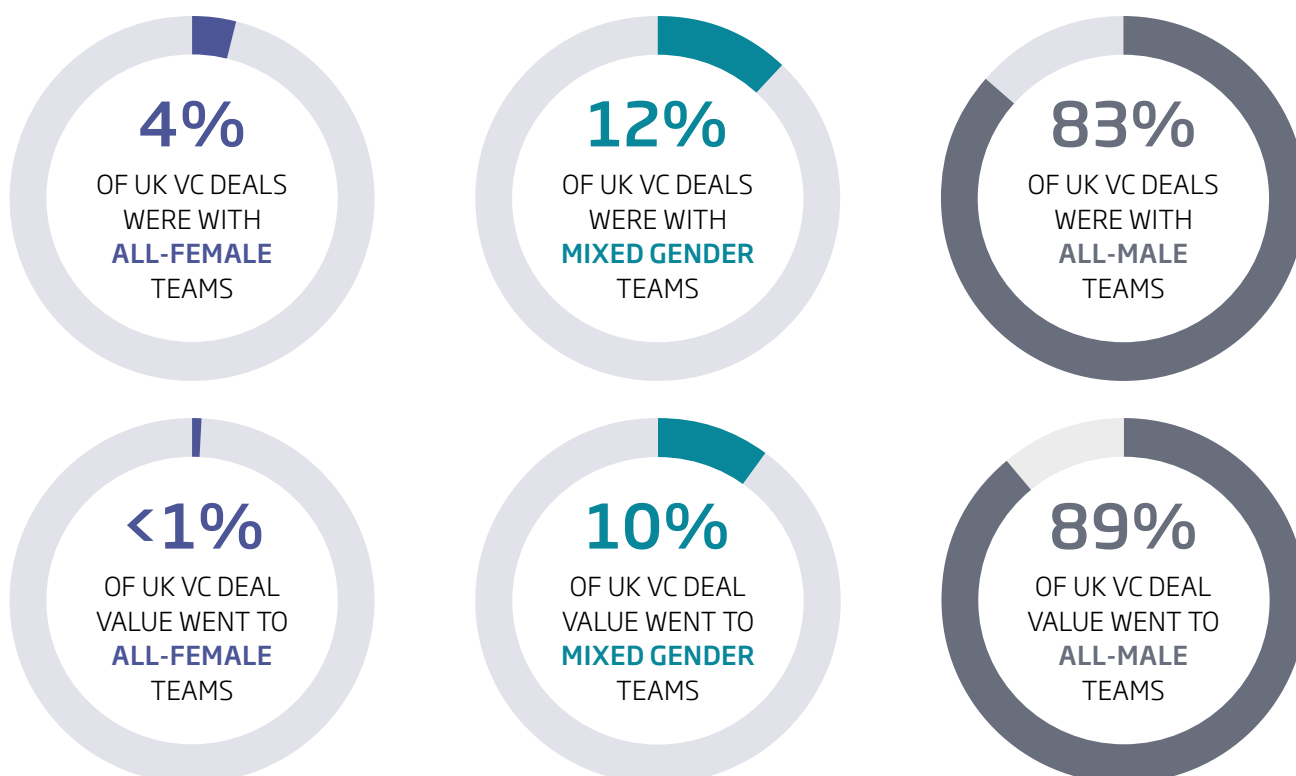
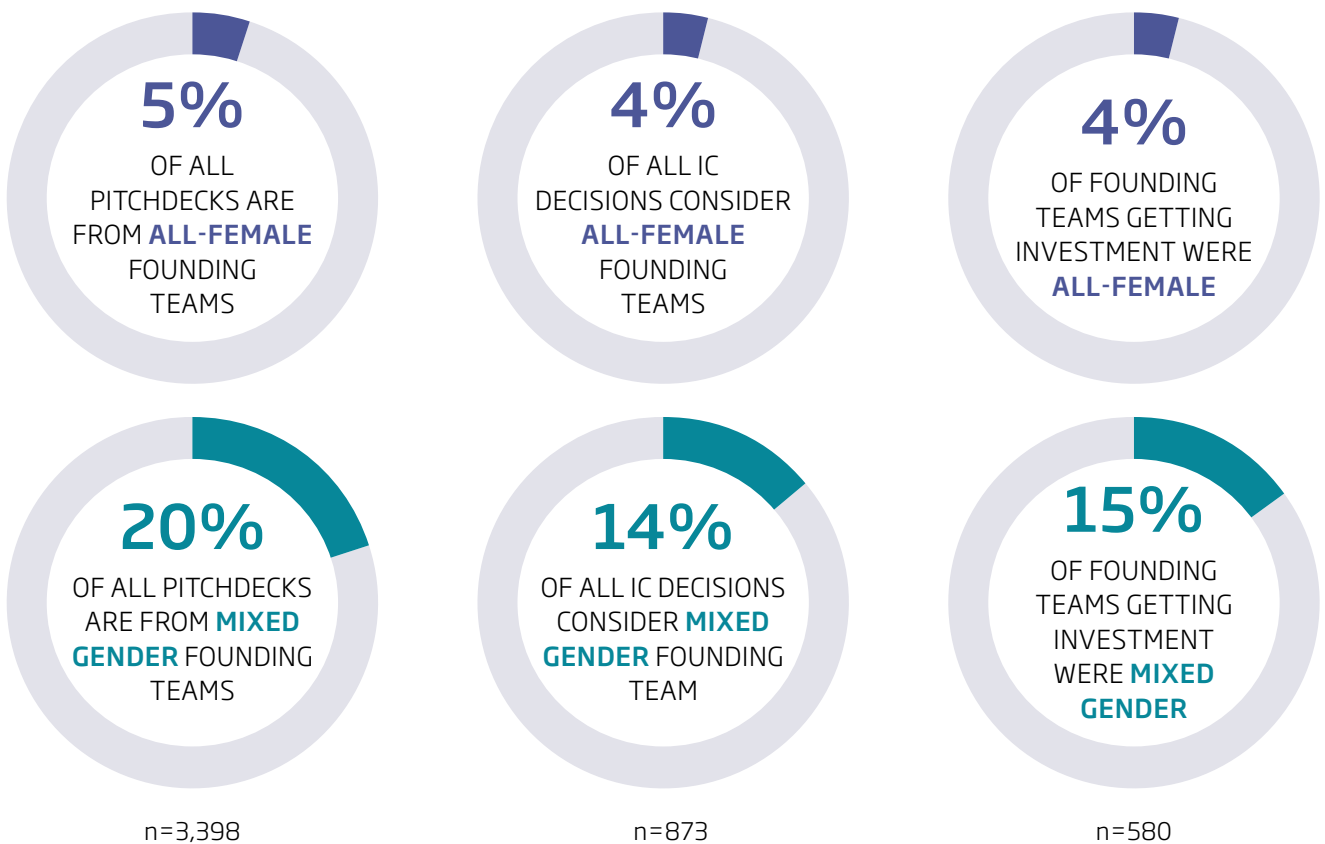


FIG A.21  
**VC INVESTMENT PIPELINE**  
 Source: British Business Bank research



The research showed that women are significantly underrepresented at all stages of UK VC investment pipelines. 75% of all pitchdecks received by VC fund managers came from businesses with no women in the founding team. At IC, these all-male teams account for 81% of deals funded.

All-female founding teams make up 5% of all approaches to VCs. This proportion is approximately maintained through to funding, with 4% of all female founding teams receiving funding. In contrast, mixed gender teams make up 20% of all approaches the industry receives, but their proportion declines at subsequent stages, with only 14% making it to the IC stage and 15% obtaining funding.

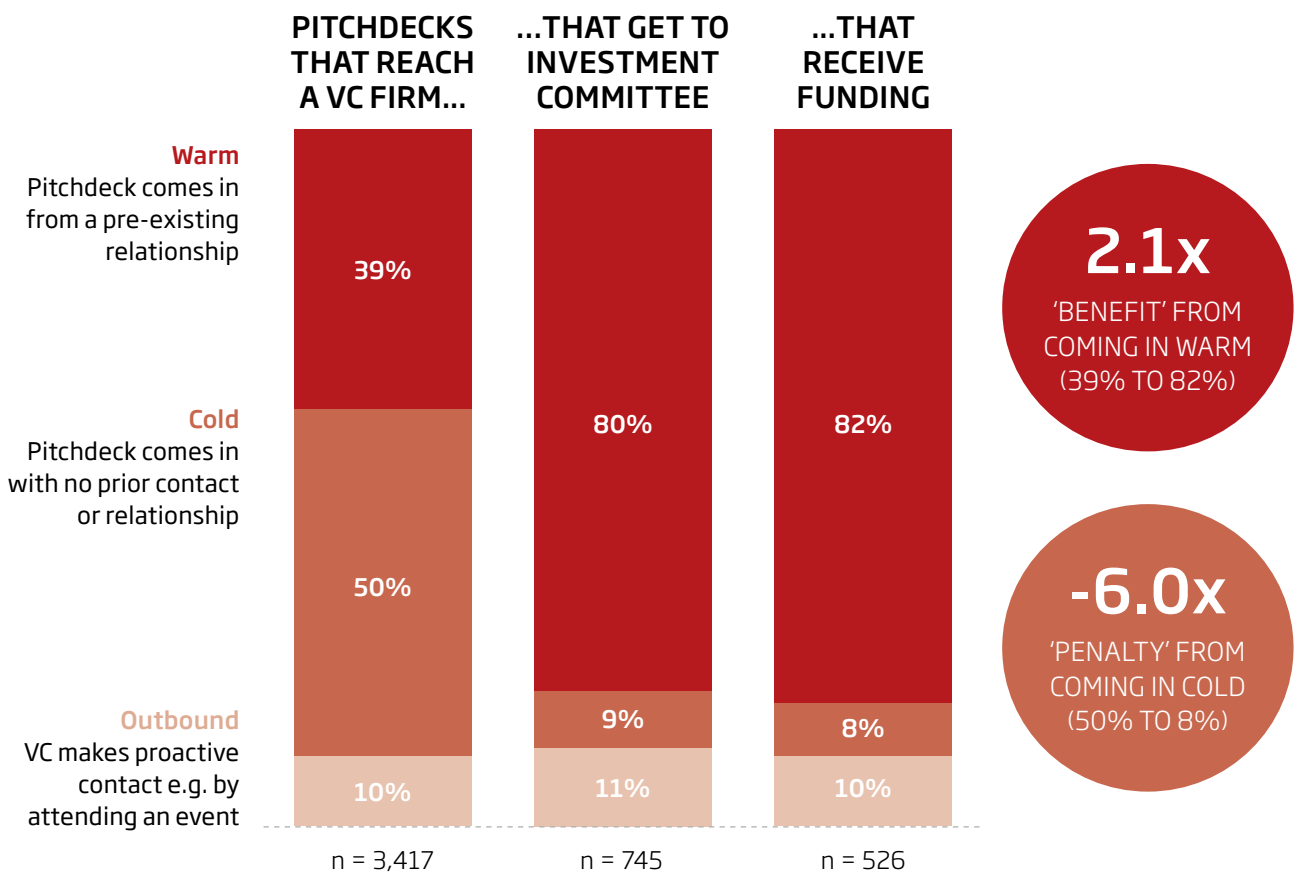
Networks are an important part of the venture capital ecosystem and are linked to better fund performance.<sup>59</sup> Investors, bankers, angels, accountants and other entrepreneurs are major sources of introductions for potential deals to VC investors. The new research showed warm introductions (where a pitchdeck comes in via a pre-existing relationship) formed 82% of equity deals, despite forming only 39% of the pitchdecks VCs receive.



FIG A.22

**BREAKDOWN OF PITCHDECKS RECEIVED BY TYPE OF SOURCE, AND PROGRESSION THROUGH STAGES OF THE PIPELINE**

Source: British Business Bank research

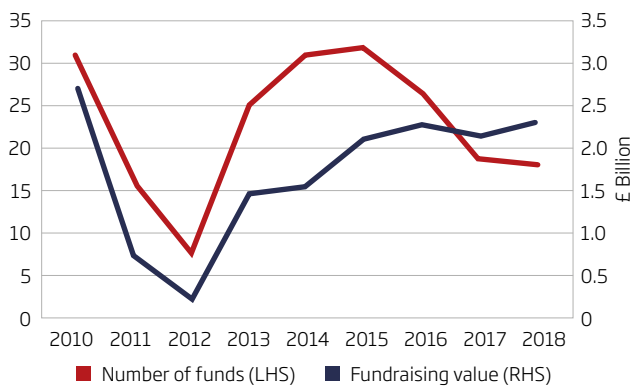


Given the importance of networks, if female founders are not well connected to networks or are unable to engage with them successfully, then fewer will be able to reach a VC. The findings confirm that female founders are less likely to have a warm introduction compared to male founded businesses. 42% of all-male teams had a warm introduction, compared to 40% of mixed gender teams and 36% of all-female teams. Warm introductions are more likely to result in the deal going to IC and ultimately end up with funding. Furthermore, all-female and mixed gender teams appear to get less benefit from a warm introduction than all-male teams.

This research shows that women are significantly under-represented in the pipelines and investments of UK VCs. Issues of diversity and inclusion are complex, interdependent and important. For these reasons, lack of diversity cannot be 'addressed' quickly or easily. The British Business Bank has put forward several actions to encourage UK VC investors to commit themselves to addressing the issue; developing better diversity and inclusion data; connecting with other fund managers to share best practices; and taking action within their own firms. British Patient Capital will become a 'catalyst and champion' within the UK VC market, leading on diversity and inclusion and other market-wide issues.

FIG A.23  
**NUMBER AND VALUE OF UK VC FUNDS REACHING FINAL CLOSE, BY YEAR**

Source: British Business Bank analysis of PitchBook (Data accessed 14/01/2019)



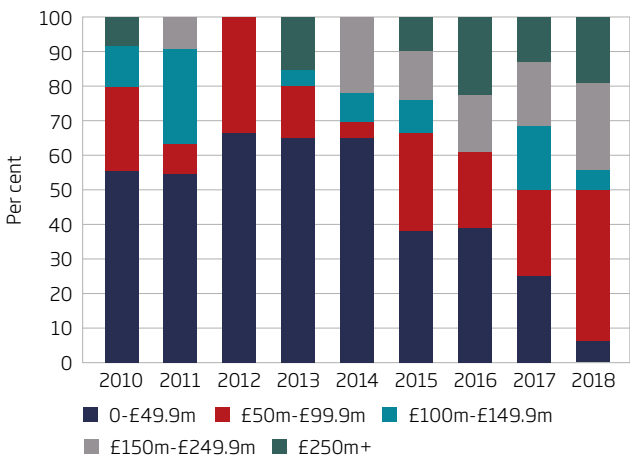
**FIRST-TIME FUND MANAGERS ARE FINDING IT INCREASINGLY DIFFICULT TO RAISE NEW FUNDS, DESPITE UK VC FUNDRAISING BEING AT HISTORICALLY HIGH LEVELS**

UK-based VC funds raised £2.3bn in 2018, an 8% increase relative to 2017. Fundraising values have been increasing since 2012, but the number of funds closing has decreased every year since 2015.<sup>60</sup> 32 funds closed in 2015 before falling to 19 in 2017, and to 18 in 2018. The UK VC market has largely followed wider global trends towards fewer, larger VC funds being raised. The average size of a VC fund in the UK increased from £37m in 2012 to £145m in 2018.

The trend towards larger fund sizes is noticeable when considering how the distribution of UK VC fund sizes has changed. In 2010, 56% of the UK VC funds reaching final close were under £50m in size, whereas in 2018 only 1 fund under £50m closed. Although smaller funds may have a longer time delay in reporting fund closures compared to larger funds, it does indicate a significant change in the UK VC fundraising environment.

FIG A.24  
**DISTRIBUTION OF UK VC FUND SIZE, BY YEAR**

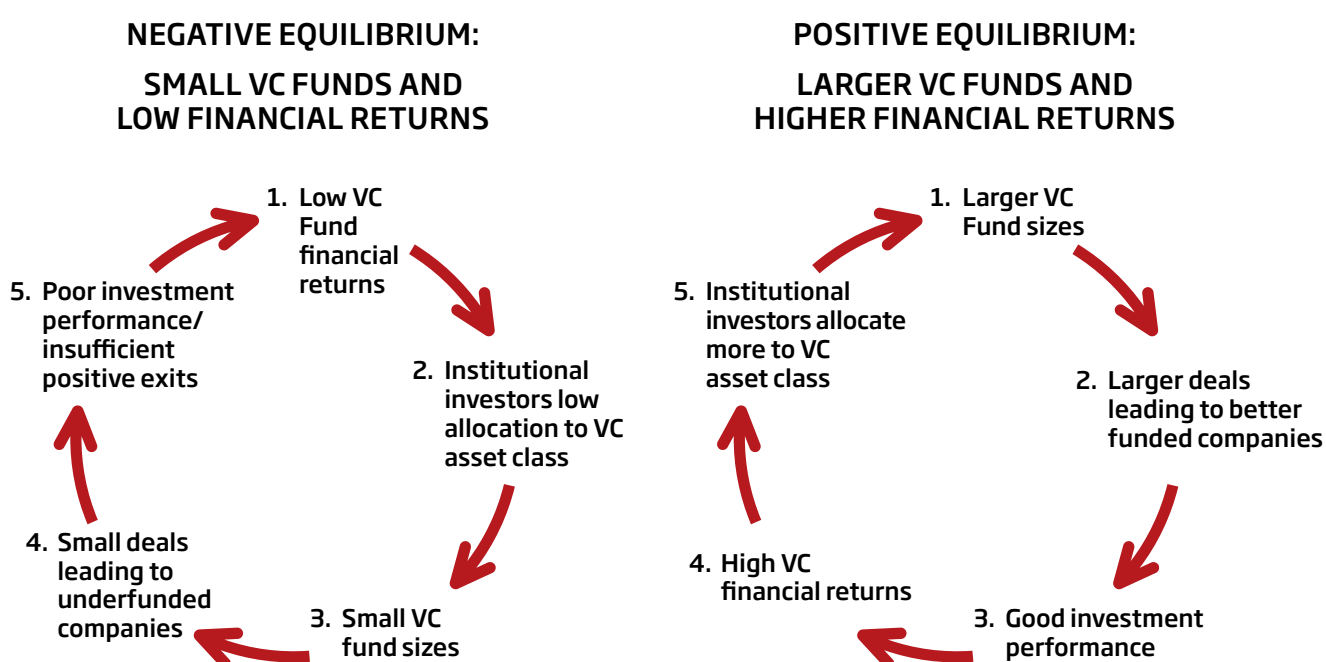
Source: British Business Bank analysis of PitchBook (Data accessed 14/01/2019)



Larger VC funds closing is a positive market development for the UK, as it helps break the negative equilibrium cycle of small VC funds and underfunded companies as identified in the Patient Capital Review and Small Business Finance Markets report 2016/17 (Figure A.25). Larger fund sizes will help turn the cycle into a virtuous one by enabling better capitalised companies that are more likely to be able to successfully exit, leading to higher financial returns. A track record of high financial returns from investing in VC will attract greater institutional funding into the VC asset class. British Patient Capital will play an important role in helping to demonstrate to the wider market that attractive financial returns are possible from investing in UK VC.

FIG A.25

## TURNING A NEGATIVE EQUILIBRIUM CYCLE INTO A POSITIVE CYCLE



Movement away from smaller fund sizes has made it more difficult for new fund managers to enter the market. Of the VC funds reaching a final close in 2012, 38% were raised by first-time fund managers, but by 2017 this had dropped to 16%.<sup>61</sup> New fund manager teams are important for the long-term success of the VC ecosystem by encouraging greater dynamic efficiency and increasing VC industry diversity, for instance by enabling female led fund manager teams to become established.

New fund manager teams are also important for ensuring the structural equity gap does not worsen, as smaller funds tend to undertake smaller deals.<sup>62</sup> As fund managers gain more experience and demonstrate a successful track record they tend to raise larger amounts of capital and thus move towards larger deals with lower risk. They therefore may leave the 'equity gap' space, and without new fund managers entering the market this gap may be left unfilled.

The British Business Bank continues to invest in first-time and emerging fund managers through the Enterprise Capital Funds (ECF) programme. The ECF programme allows new fund manager teams to raise funds from institutional investors, with an attractive returns structure that rewards good performance, allowing new fund managers to develop a track record. The ECF programme is designed to encourage equity investment into small HGFs affected by the equity gap.

## A SECONDARY MARKET IN VENTURE CAPITAL HAS NOT YET FULLY DEVELOPED IN THE UK

Venture capital is largely an illiquid asset class. Once investors have committed to investing in a company or a VC fund, they will not easily be able to exit from the investment without incurring significant costs. This occurs at both the VC deal level where the average time to exit a company is around 6.4 years, but also at the VC fund level which are typically structured as 10-year Limited Partnerships (LP) with the option to extend for a further 2 years.<sup>63</sup> Secondary market transactions are a way to provide liquidity to the VC ecosystem and fall into 2 main types:

- **'Direct' secondary:** A VC fund purchases another VC fund's equity stake in an individual portfolio company directly.
- **'Indirect' secondary:** A buyer purchases a position in a VC fund from an existing Limited Partner in that fund. In this case the buyer will indirectly be purchasing equity stakes in the fund's underlying portfolio companies, usually taking over the remaining capital commitments of the seller in the process.<sup>64</sup>

It is important to make the distinction between secondary equity sales from primary equity sales. A primary sale involves a company issuing new shares to investors, the proceeds of which go directly into the business as fresh capital, for instance to support growth of that business. Pure secondary sales involve the transfer of equity stakes in companies or funds from one organisation to another without any additional capital being made available to the business itself. In practice, many secondary sales are not entirely pure and can involve fresh capital.

There are wider benefits for the venture capital ecosystem of a well-functioning secondary market. Secondary sales provide early investors (e.g. angels and seed investors) with an earlier opportunity to liquidate their capital that is currently held in their investments, so they don't have to look for a trade sale or IPO listing too early in the company's life cycle. This capital can then be redeployed in other early-stage companies looking to raise equity finance. The British Business Bank Angel survey found 89% of angels reinvest some or all gains from successful exits into further investments.<sup>65</sup>

Secondary sales are also important as a liquidity tool for the company's founders and ex-employees who may want to access some of their wealth. This again avoids having to undertake a full exit event at a too early stage, which could have potential negative consequences for the growth prospects of the company and its future value creation. Secondary sales allow founders and early stage investors to liquidate part of their holding in the company without the need for the company to undertake a full exit event. 'Taking some money off the table' can have a positive effect on founders by making them more risk tolerant and increase their appetite for building scale up companies, rather than selling their company early on.<sup>66</sup>

A recent example of secondary sale was Draper Esprit acquiring the 2 opening funds of early-stage investor Seedcamp for €20 million in 2017. Within Seedcamp's portfolio was fintech unicorn status business TransferWise. TransferWise sought additional investment from large later stage VC funds such as Index Ventures, Andreessen Horowitz and Baillie Gifford and these funds are likely to have longer investment horizons than an early stage seed investor like Seedcamp can tolerate.<sup>67</sup>

Secondary sales at the fund level are useful for institutional investors like pension funds that want to rebalance their portfolio and reduce their overall allocation to VC or to exit from a specific manager relationship. From a purchaser's perspective, secondary sales can be an attractive option as they allow managers access to deals and funds at a later stage when more information about the quality of the assets is known.

Due to a lack of competition in the secondary market, secondary sales often offer discount on market value that can produce sizable returns. Funds with investment strategies focusing on secondary sales have consistently produced positive net cashflows over the years, and often avoid many of the J-curve effects associated with early stage investing.<sup>68</sup> Secondary sales play an essential role within a patient ecosystem by enabling equity investors to 'pass the baton' on to other equity investors that are better able to take the company forward.

Secondary buyouts of portfolio companies have been a feature of the private equity industry for decades, but it is only in recent years that venture firms are making secondary investments. For instance, early Uber investors achieved partial liquidity in January 2018 due to a secondary deal led by SoftBank Group.<sup>69</sup>

Figure A.26 shows there were only 23 global secondary deals in VC backed companies in 2008 but this had increased to 129 deals in 2017. Figure A.27 shows there were 12 secondary deals in VC backed companies in 'Rest of Europe' in 2008 increasing to 44 deals by 2017. By comparison the UK market only grew to 9 deals over the same period. Therefore, despite the UK contributing around a third of all VC deals in Europe overall, the UK has a smaller share of deals in the secondary VC market (20%), suggesting this part of the UK market is not as developed as it could be.

This could be about to change with UK-based Balderton Capital recently raising a \$145 million fund (Balderton Liquidity 1) with a focus solely on targeted secondary transactions in European scale up companies. Balderton have identified a market opportunity as 'Up to now in Europe, while there are ad-hoc transfers of shares (secondary transactions) between 2 parties, there is no go-to professional venture investor that a company can turn to'.<sup>70</sup>

Globally, the increase in secondary deals both as an exit route and as a fund investment strategy is a result of wider changes in the VC ecosystem. High historic VC fundraising means there are large amounts of capital ready to deploy (known as dry powder). Preqin estimates that global VC fund dry powder levels are at \$230bn as of December 2018, up from \$207bn a year ago.<sup>71</sup> The abundance of capital available has led to investment timelines extending for unicorn status businesses, with these later stage companies able to stay private for longer. Early investors in these companies are therefore under increased pressure from their LP's to achieve liquidity, making secondary sales an attractive exit route.

The lack of secondary transactions in the UK could suggest the market is not working effectively. This is acknowledged by the Scale up report which states: 'At present, the market for secondary shares is a highly fragmented, opaque, and inefficient segment of the entrepreneurial ecosystem'.<sup>72</sup> The British Business Bank's BPC programme has the flexibility to be able to make secondary transactions and could therefore have an important role in helping to facilitate the development of the secondary market in the UK.

FIG A.26  
**NUMBER AND VALUE OF GLOBAL VC-BACKED SECONDARY DEALS**  
 Source: British Business Bank analysis of PitchBook

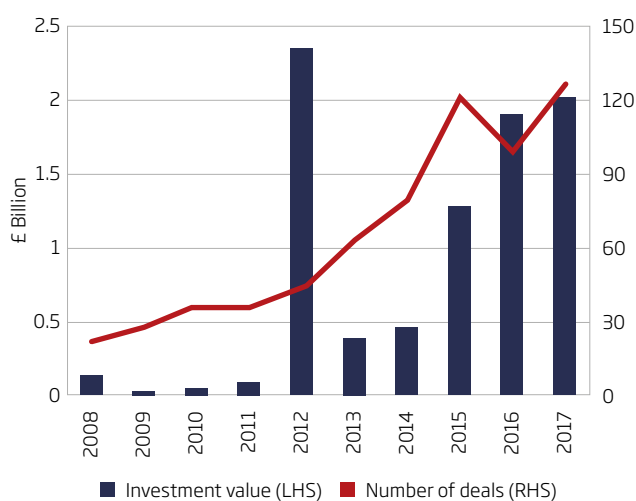
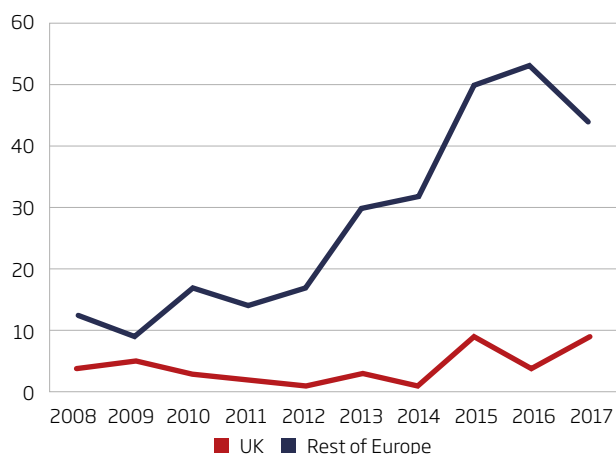


FIG A.27  
**NUMBER OF VC-BACKED SECONDARY DEALS, UK COMPARED TO REST OF EUROPE**  
 Source: British Business Bank analysis of PitchBook



## 1.3

## SME FINANCE AT THE LOCAL LEVEL

- Core bank lending remains broadly in line with SME populations around the regions and devolved nations of the UK
- Data on alternative debt finance is limited but access to finance products and providers varies considerably at the local level
- Equity deals continue to be concentrated in London, but considerable differences in access to equity finance can be seen at the Local Authority District level
- Business angel activity is also concentrated in London
- Equity finance often supports the development of clusters of economic activity focused on specific sectors or technologies
- Supporting the growth of clusters across the UK is an important element of the Industrial Strategy

This section analyses the latest data from a range of sources highlighting the variations in SME finance markets at the regional and sub-regional level. Local data covering the 38 Local Enterprise Partnerships (LEPs) in England and the 391 Local Authority Districts (LADs) across the UK helps to paint a more nuanced picture of the debt and equity markets at a local level.

The second part of this section covers the importance of clusters to economic development in the UK and the role that finance plays in the development of those clusters. The section concludes with the implications of this analysis for British Business Bank activity.

#### CORE BANK LENDING REMAINS BROADLY IN LINE WITH SME POPULATIONS AROUND THE REGIONS AND DEVOLVED NATIONS OF THE UK

The regional distribution of bank lending to SMEs is broadly in line with the distribution of the SME population (Figure A.28). There are regions which receive a lower share of SME lending versus their share of the SME population, such as the North West, Yorkshire & Humber, the East Midlands and London.

The lower share of bank lending in London does not necessarily mean that businesses in London are struggling to access bank lending. Firstly, SMEs in London may have greater knowledge of, and access to, other types of finance such as venture capital. This would mean that SMEs in London are less reliant on bank lending.

A further reason why these figures don't necessarily imply problems with access to bank lending in London is due to headquarter effect.<sup>73</sup> It is likely the number of SMEs reported as being in London significantly overstates how many are carrying out day-to-day operations there. This suggests that London's SME population may be lower than 19% as outlined in the 2017/18 Small Business Finance Markets report.

At a postcode level, bank lending is broadly in line with the population of the area with the largest percentage difference between population and bank lending at just 2% (Figure A.29). Ideally, we would want to compare lending against SME distribution by postcode but this data is not readily available.

The Bank has also completed some analysis to look at the impact of local area deprivation on bank lending. When controlling for other factors, the Bank found that deprivation is not a good indicator of whether an SME will use finance. What this analysis did, however, was highlight that the data can be cut in different ways to get a clearer picture of the financial markets around the UK.

It is important to look at the available data at a local level where possible because it highlights differences that aren't apparent at a regional level. At a sub-regional level, differences between parts of London become apparent for example, as West London receives a larger share of bank lending in comparison to its population, whereas, for South East London the opposite is true.

FIG A.28

VOLUME OF BANK LENDING TO SMEs AND SME POPULATION, BY REGION AND DEVOLVED NATION

Source: UK Finance, SME Update Q2 2018 and BEIS, Business Population Estimates 2018

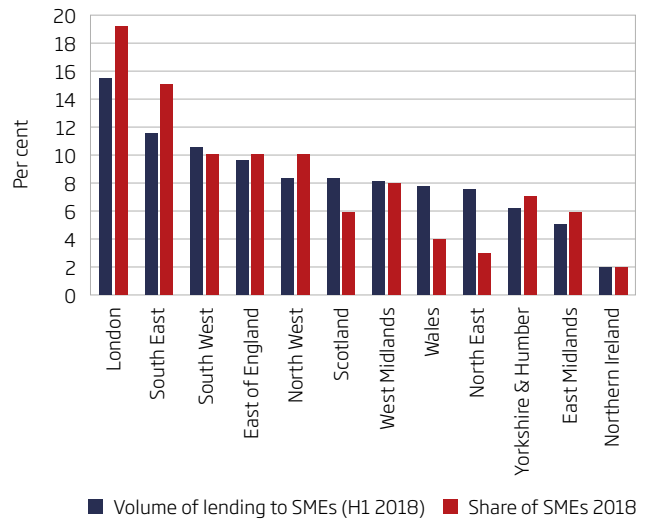
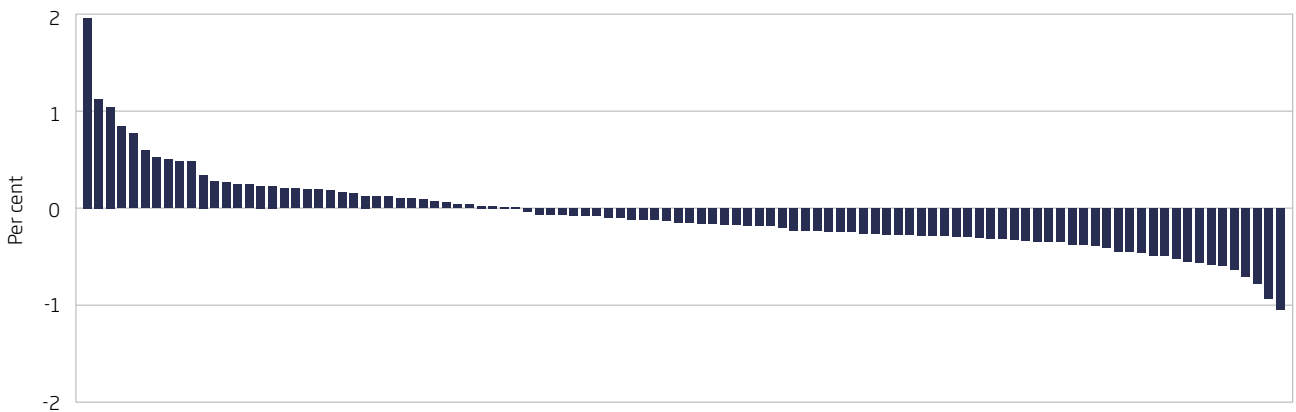


FIG A.29

GAP BETWEEN VALUE OF BANK LENDING TO SMEs AND POPULATION BY POSTCODE AREA IN Q1 2018

Source: UK Finance, Postcode lending



## DATA ON ALTERNATIVE DEBT FINANCE IS LIMITED BUT ACCESS TO FINANCE PRODUCTS AND PROVIDERS VARIES CONSIDERABLY AT THE LOCAL LEVEL

There are many types of debt finance and providers that form part of a diverse finance market for smaller businesses, both nationally and within regions. These can include providers of asset finance, debt funds, invoice and asset-based lenders and marketplace finance providers, which may have different distributions across the regions and devolved nations.

Diversity of finance can increase access to finance for a wider range of smaller businesses throughout the credit cycle and can improve smaller business financial market stability. Diversity of finance can also improve the terms and ease of use of finance available to smaller businesses and the appropriateness of the finance, including for those who already have access to at least 1 finance product or provider.

The Bank's Benefits of Diverse Smaller Business Finance Markets report sets out the framework we use when thinking about the impacts diversity has on who, where, when, what and how SMEs access finance.<sup>74</sup> It highlights access to finance products and providers is not consistent across the UK with uneven regional distribution. For seemingly near identical companies where they are based has a significant impact on the type of finance and the finance providers they access.

Data sources for the regional and local distribution of alternative finance are limited. Other than UK Finance data on bank lending and the equity data we use for the second part of this chapter there is only limited survey data. For example, the Cambridge Centre for Alternative Finance produces a survey of funders and borrowers on marketplace lending platforms in the UK. This found both are concentrated in London and the South East suggesting that businesses outside of these 2 locations may not be getting access to even the most theoretically footloose of finance options.<sup>75</sup>

The Bank's new UK Network will give us access to further information on local financing conditions from across the UK. In addition, we are currently working with several industry bodies and finance providers in the hope of enriching the regional data available and would welcome any suggestions on additional or new data sources.

## EQUITY DEALS CONTINUE TO BE CONCENTRATED IN LONDON, BUT CONSIDERABLE DIFFERENCES IN ACCESS TO EQUITY FINANCE CAN BE SEEN AT THE LOCAL AUTHORITY DISTRICT LEVEL

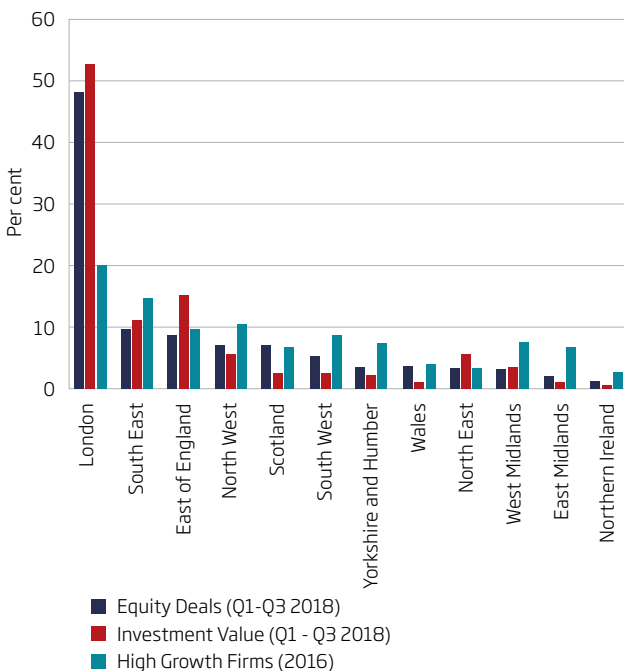
Data on the location of firms receiving private external equity finance is available. Equity finance is focused on firms with potential to scale-up rapidly. This is also in part why equity finance tends to be concentrated in technology sectors, which are more likely to be able to be scaled up quickly.

HGFs are found in all parts of the UK.<sup>76</sup> Unsurprisingly though, at both a regional and LEP level, there are significant differences in the share of HGFs. At a regional level, London has 20% of HGFs in comparison to the North West's 10% (Figure A.30).<sup>77</sup> Regional level data can hide further uneven distribution. Within the Yorkshire and the Humber region 18% of businesses in the Leeds LAD are HGFs, in comparison to 5% in York LAD.<sup>78</sup>

FIG A.30

### SHARE OF EQUITY DEALS, INVESTMENT AND HIGH GROWTH FIRMS, BY REGION AND DEVOLVED NATIONS

Source: British Business Bank analysis of Beauhurst data and ONS, High Growth Enterprises 2013 to 2016





Only a small proportion of HGFs will use equity finance, but for some potential HGFs, it may be the only method that would allow them to fully deliver on their growth potential. It is therefore important that equity finance is available to those firms with high growth potential, but Figure A.31 suggests this is currently not the case.

The 2018 deal figures are broadly comparable with the previous 2 years. 50% of deals in 2016 and 51% in 2017 were in London, compared with 48% in 2018.

A slight decline in the combined share of London and the South East reflects greater volumes of equity finance in the rest of the UK. The North West, East of England, Scotland, the South West and Wales have seen growth in share of equity deals from 2016, whilst Yorkshire and Humber, the North East, Northern Ireland and the East and West Midlands have remained flat over this period. If NPIF funding was removed, Yorkshire and Humber would have had a lower share of equity deals in 2017 and the North West would have had a lower share of equity deals in 2018. The North East's share would remain flat, however, with NPIF being a young product and the volatility of the equity markets, this could change going forward.

The East of England, Scotland and the North East received a share of equity deals proportionate to their share of HGF in 2018. 9% of deals were in the East of England, 7% in Scotland and 3% in the North East.

The most common sectors for equity deals in 2018 were technology, business and professional services, industrials, leisure and entertainment and personal services. Of these, 3 of them have over 50% of their deals in London, which explains in-part why equity deals are so skewed towards London (Figure A.32). Sector distribution, on its own, only partly explains why equity investment is so heavily skewed towards London. A further contributing factor is the maturity of the financial markets within the area. London has had a strong financial services sector for many years including a mature and varied equity ecosystem.

Within the Technology sector, there are certain sub-sectors which are concentrated heavily in London. Between 2016 and 2018 there were 984 software deals. Of those, 594 (60%) were in London. This is similar to the 61% of software deals in London between 2014 and 2016.<sup>79</sup>

Regional level data can hide more localised variations. Differences in equity deal numbers are even greater at the local level. This is particularly stark at the local authority level. Figure A.33 shows the long-tail of LADs that had little or no equity activity in 2018. Almost half (45%) of LADs did not have any equity deals completed in their area in 2018 and a further 24% of LADs only had 1 deal.

FIG A.31  
**SHARE OF EQUITY DEALS AND HIGH GROWTH FIRMS, BY REGION AND DEVOLVED NATIONS FROM 2016**  
 Source: British Business Bank analysis of Beahurst data and ONS, High Growth Enterprises 2013 to 2016

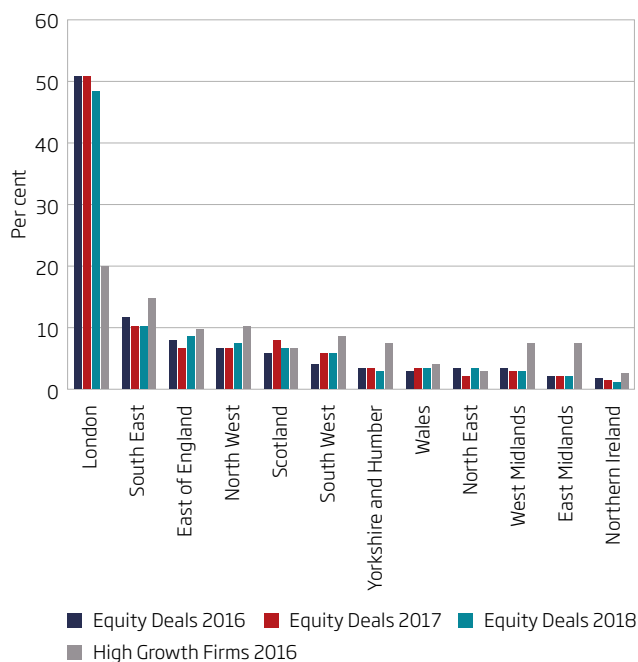
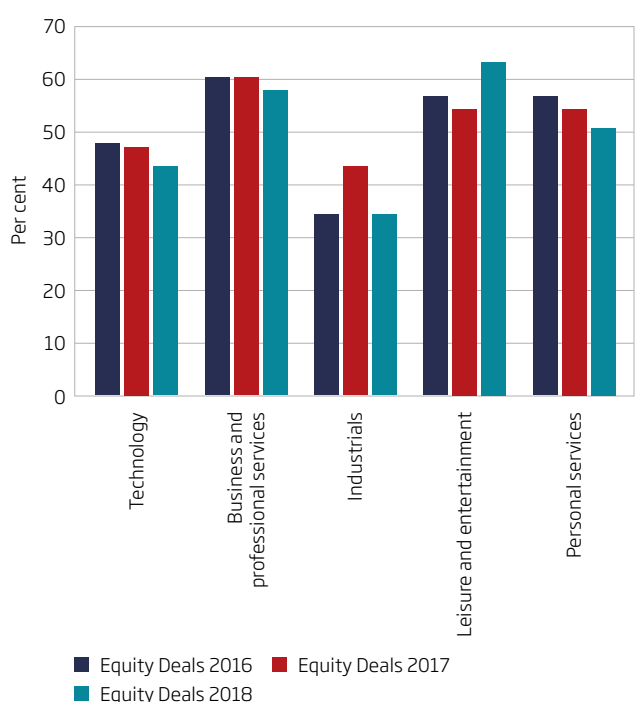


FIG A.32  
**SHARE OF EQUITY DEALS OF TOP 5 BEAUHURST SECTORS IN LONDON**  
 Source: British Business Bank analysis of Beahurst data



Even within London, equity deals are focussed in a relatively small number of London Boroughs. Eight of the top 10 LADs for equity deals in 2018 were in London. The other 2 are Cambridge City Council, which had 37 deals, and Edinburgh City Council, which had 26 deals (Figure A.34). In both Edinburgh and Cambridge, software had a large role to play for their equity deals. In Cambridge, life sciences and medical technology was also an important part of equity activity, as each sector had 9 deals.

The variation between London Boroughs is demonstrated by the range from Westminster City Council with 77 deals to Waltham Forest with only 1 deal.

Regions other than London see similar distributions with equity deals concentrated in certain localities within a region. Figure A.35 highlights the concentration of equity deals in the top 5 LADs for equity activity in 2018.

This highlights the extent to which clusters of activity within a region can dominate the total flow of equity finance to the region. Whilst clusters have an important role to play (see later part of this section), it is important to encourage both viable demand and effective supply across the region.

### BUSINESS ANGEL ACTIVITY IS ALSO CONCENTRATED IN LONDON

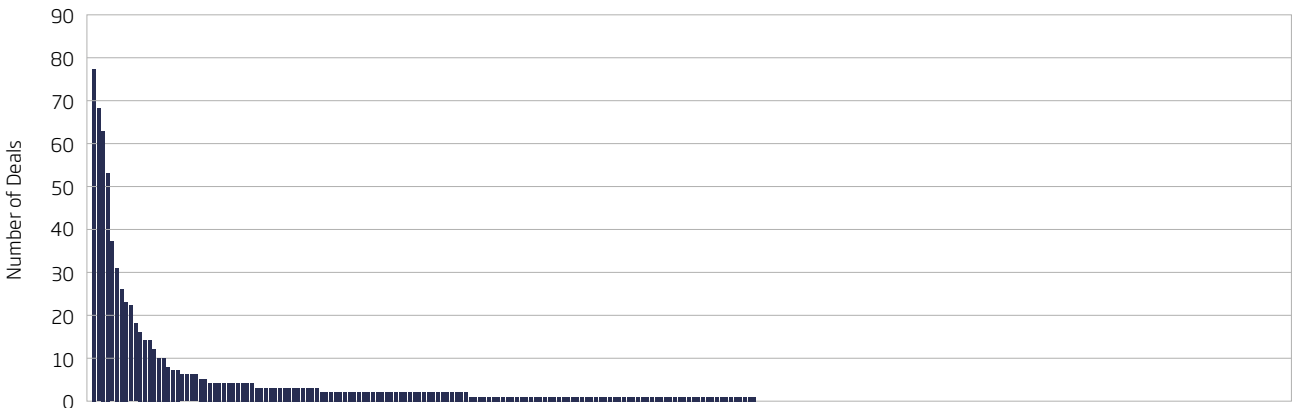
Business angels are High Net Worth Individuals (HNWI) that invest their own money through an equity stake in small growing businesses. Business angels are an important source of finance for SMEs. Quantifying the number of deals involving business angels is difficult as business angels are less likely to seek publicity on completing investments, and so are largely missing from investment numbers in data sources based on public announcements. A detailed review of angel activity is provided in The UK Business Angel Market report produced by the British Business Bank and the UK Business Angel Association.<sup>80</sup>

Many business angels use Enterprise Investment Scheme (EIS) tax relief within their investments, which can provide an estimate for the total amount of business angel activity in the UK. The UK Business Angel Market report confirms that 87% of angels who invested in 2016 used EIS or SEIS.

FIG A.33

### DISTRIBUTION OF EQUITY DEALS ACROSS LOCAL AUTHORITY DISTRICTS BETWEEN Q1 AND Q3 2018

Source: British Business Bank analysis of Beahurst data



HMRC data shows that 3,470 companies raised a total of £1.8bn of funding in 2016-17 under the EIS scheme. An additional 2,260 companies also received investment through the Seed Enterprise Investment Scheme (SEIS) in 2016-17 raising £175m of funding. This exceeds the number of companies funded by VC funds and shows the importance of angel funding to UK companies.

EIS and SEIS deals are highly concentrated in London and the South East with 47% of all deals located in these regions in 2016/17 (Figure A.36). This is despite London accounting for only 24% of start-ups and 20% of HGFs. This suggests the supply of equity finance from business angels is under-represented in areas outside of London. This is corroborated by The UK Business Angel Market report which found that over half (57%) of angels are located in London and the South East.

**EQUITY FINANCE OFTEN SUPPORTS THE DEVELOPMENT OF CLUSTERS OF ECONOMIC ACTIVITY FOCUSED ON SPECIFIC SECTORS OR TECHNOLOGIES**

Cluster theory suggests, that once a cluster has developed it becomes self-sustaining. This is because businesses tend to locate where the resources, for example labour or natural resources, are. Once efficient businesses have established themselves, it is likely that some equity finance will come to an area. This will in-turn promote more business start-ups or spin-outs and the individuals that manage to sell successful businesses may go on to become angel investors, as has happened in the Bristol-Bath cluster.<sup>81</sup>

Silicon Valley experienced significant growth in equity finance as more high-technology businesses moved there. Venture capital assets in California, Massachusetts and New York accounted for 83.6% of total U.S. assets under management in 2017.<sup>82</sup> All of these areas have a strong cluster that has been built upon over time as the business network has grown.

Cluster theory has built on the “industrial district” that Marshall conceptualised in 1920.<sup>83</sup> The reason for the increased focusing on the formation of business clusters is due to policy makers using it as a tool to improve economic performance at a micro and macro level.

A cluster is defined as a geographic concentration of interconnected companies, specialised suppliers and providers and firms in related industries.<sup>84</sup> An example of a well-developed cluster is Leeds’ financial services sector.<sup>85</sup> Leeds hosts a significant number of debt finance providers, professional services and universities with a strong business focus. This has led to larger businesses often using Leeds as a regional hub to cover the entire Yorkshire region.

FIG A.34  
TOP 10 LOCAL AUTHORITY DISTRICTS FOR EQUITY DEALS BETWEEN Q1 AND Q3 2018

Source: British Business Bank analysis of Beauhurst data

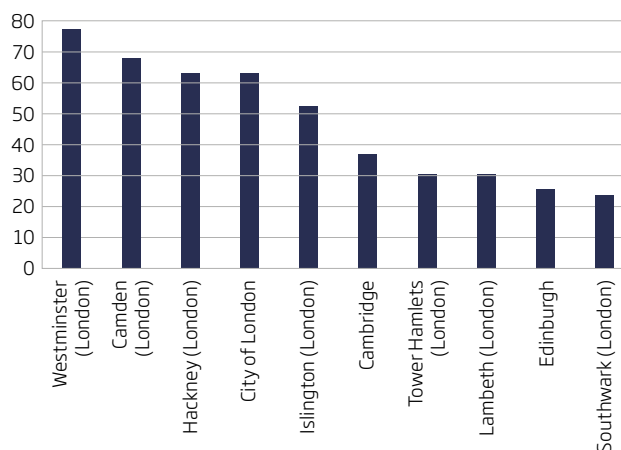


FIG A.35  
SHARE OF EQUITY DEALS CONCENTRATED WITHIN 5 LOCAL AUTHORITY DISTRICTS

Source: British Business Bank analysis of Beauhurst data, Q1 to Q3 2018

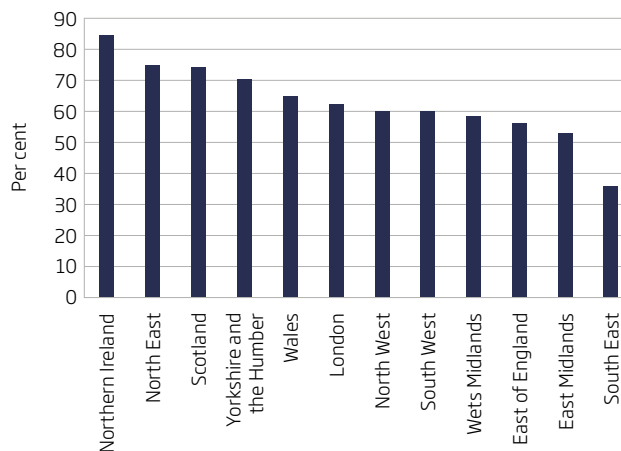


FIG A.36  
NUMBER OF EIS AND SEIS DEALS, HIGH GROWTH FIRMS AND START-UPS, BY UK REGION AND DEVOLVED NATION

Source: HMRC, ONS and British Business Bank calculations

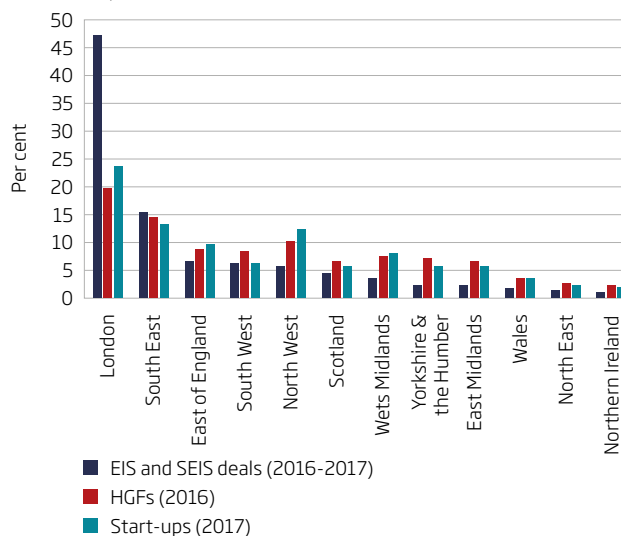


FIG A.37

**REASONS WHY SMEs WANTED FUNDING, H1 2018**

Source: BVA BDRC SME Finance Monitor Q2 2018

	Percentage
To fund expansion in the UK	29%
Working capital	28%
Invest in new plant or machinery	22%
A new business opportunity	19%
To cover a short-term funding gap	14%
To help through trading difficulties	12%
To take on staff	6%
To fund new premises	6%
To fund expansion overseas	1%

Businesses can benefit from efficiency gains if they're located in a cluster. This promotes growth and innovation due to the increased competition and industry knowledge being more readily available. Businesses benefit from lower transaction costs relating to distances between buyers and sellers, including transport and search fees due to the proximity of the input-output links within a cluster.

Businesses can also benefit from labour specialisation. The cost of finding employees will be reduced for businesses located in the cluster as people move, or are willing to commute, to the area. The Cambridge IT sector has benefited significantly from this, as has the London FinTech sector around Old Street.<sup>86</sup> This allows businesses to benefit from knowledge spill-overs as employees move between companies within the cluster.<sup>87</sup>

The macroeconomy also benefits from strong clusters forming. Analysis of the UK technology industry shows that the GVA of a digital tech worker is more than twice that of a non-digital tech worker, so areas such as the Silicon Roundabout are seeing large economic benefits.<sup>88</sup> With strong employment growth in this sector outside of London, in places such as Dundee, Sunderland and Truro, the UK economy is set to benefit.

Cluster development is reliant on several factors, of which access to finance is one. Access to finance is important due to helping businesses to grow and encouraging new start-ups to locate in the area. Access to external finance can help a cluster to develop and grow, however, as the data demonstrates not every area has the same level of access to finance as others. HGFs often use a combination of different types of finance to grow, so it is important that varied and appropriate finance is available.

As well as enabling businesses to grow, improved access to finance can lead to more start-ups in the area from people spinning out and setting up their own venture, and from those that want to enter the industry. This is in part due to the sociological effects of being close to the resources that are required to grow a business, and the ability to reap rewards of knowledge spill over.

Close to a third of SMEs who wanted funding wanted it to fund expansion, so it is important that barriers to accessing finance are removed (Figure A.37).

The Small Business Equity Tracker identified demand side and supply side factors that lead to a disproportionate amount of equity investment going to London, as opposed to elsewhere. SME awareness of external finance from VC and business angels varies across areas. If a business isn't aware of possible finance options, they won't apply for them and it leads to finance getting concentrated in certain places. The British Business Bank Finance Survey found that 74% of SMEs in London were aware of venture capitalists, whilst areas such as the North or Midlands had awareness rates of 67% and 66% respectively. 47% of SMEs in London are aware of business angels as a form of raising external finance, whilst only 39% of SMEs in the North and 35% of SMEs in the Midlands were aware.

A lack of equity fund manager presence in areas outside of London could explain some of the lower availability. Investors often prefer to invest locally to minimise their time and travel costs.<sup>89</sup> British Business Bank analysis of PitchBook in January 2018 shows of the 626 active investors with VC listed as one of their investment strategies, 75% have their head office listed with a London address.<sup>90,91</sup> Outside of London, equity investor presence drops significantly, which leads to problems when SMEs want to access finance. This matters because it has knock on effects to the professional services sector, which may offer fewer services if access to finance is constrained.

This isn't limited to equity though. There are also demand and supply side barriers that exist which prevent some HGFs from accessing the debt finance that they need to grow. SME awareness of alternative lending products such as peer-to-peer lending has risen rapidly in recent years but is still around 50%. In London and the rest of the UK only 55% and 52%, respectively, were aware of peer-to-peer lending according to the British Business Bank Finance Survey.

## OTHER BARRIERS

There are other barriers that prevent the development of clusters in certain areas other than access to finance.

Clusters often develop in cities as opposed to towns. Historically, businesses will have located close to natural resources, however, as the economy has become more service sector orientated, businesses have moved towards cities as this is where the resources are. In turn, professional services have migrated towards cities as well. Both businesses and professional service providers want to reduce transaction costs, so it is beneficial to be located close to each other. Without easy access to professional services, it makes growing a business harder, so clusters will form elsewhere.

Another barrier which slows cluster development down is transport infrastructure. The Bristol-Bath cluster is experiencing growing pains because of increased demand on transport infrastructure. This is not uncommon, as both Oxford and Cambridge suffered similar difficulties as that cluster was developing. Congestion on local roads/ issues linked to parking was cited as the issue most frequently identified as a major concern in the Bristol-Bath area with high speed trains being infrequent and slower trains leading to a much longer commute.<sup>92</sup>

With clustering playing an important role in the Industrial Strategy, it is important that policy makers recognise why clustering is possible in some areas but struggles elsewhere.

FIG A.38

## TOP 10 CLUSTERS IDENTIFIED ACROSS DIGITAL-HEALTH, FINANCIAL SERVICES AND PROCESSING IN SIZE ORDER

Source: BEIS

Digital-Health	Financial Services	Processing
London	London	Aberdeen
Birmingham	Birmingham	London
Leeds	Bristol	Manchester
Manchester	Manchester	Bristol
Cambridge	Leeds	Bournemouth
Liverpool	Bournemouth	Cambridge
Coventry	Cardiff	Cardiff
Edinburgh	Nottingham	Newcastle
Glasgow	Newcastle	Hull
Nottingham	Edinburgh	Edinburgh

## SUPPORTING THE GROWTH OF CLUSTERS ACROSS THE UK IS AN IMPORTANT ELEMENT OF THE INDUSTRIAL STRATEGY

The Industrial Strategy highlights the important role that developing innovative clusters around the UK will have on economic growth.<sup>93</sup> The aim of these clusters is to bring together universities, research organisations and businesses in a way that creates jobs and attracts inward investment. Analysis by BEIS has identified clusters within 3 sectors: Digital-Health, Financial Services and Processing.<sup>94</sup> The 10 clusters within these sectors can be seen in Figure A.38.

The Industrial Strategy has outlined the important role that universities will play in attracting investment and further analysis of equity hotspots around the UK adds to this. The continued expansion of equity outside of London will help to address the equity finance imbalance that is currently present and will help these regions to grow. Each region has its own equity cluster, which tend to be where some of the strongest UK universities are (Figure A.39).

FIG A.39

## MAIN EQUITY CLUSTERS BY REGION AND DEVOLVED NATION BASED ON DEAL ACTIVITY BETWEEN 2016 AND 2018

Source: British Business Bank analysis of Beahurst data

Region	Cluster	Share of deals in the region
North East	Newcastle - Durham	61%
North West	Manchester	29%
Yorkshire and Humber	Leeds - Sheffield	53%
East Midlands	Nottingham - Leicester	36%
West Midlands	Birmingham - Coventry	43%
East of England	Cambridge - South Cambridgeshire	51%
London	Westminster - Hackney - Camden	41%
South East	Oxford - South Oxfordshire	19%
South West	Bristol - Bath	42%
Wales	Cardiff	44%
Scotland	Edinburgh - Glasgow	57%
Northern Ireland	Belfast	70%

### WHAT IS THE BANK DOING TO HELP IMPROVE ACCESS TO FINANCE ACROSS THE REGIONS?

The Industrial Strategy identified the Bank as a support mechanism for developing clusters outside of London. The Regional Angels Programme will help to develop these innovative clusters around the UK. The programme aims to raise the profile and professionalism of angel investment activity and to attract further third-party capital alongside business angels while generating a market rate of return.

This £100m programme will work by committing funds alongside business angels and other early stage equity investors. Business angels tend to be high net worth individuals (HNWI) who invest their own money in an area that they have previous expertise in. The HNWI population is much more regionally diverse, in comparison to equity fund managers, which means that there is a greater opportunity to increase funding outside of London.<sup>95</sup>

To improve the supply of finance across the regions, the Bank has also set up regional investment funds. To help clusters grow within regions, the Bank has set up regional investment funds. These are the Northern Powerhouse Investment Fund, the Midlands Engine Investment Fund and the Cornwall & Isles of Scilly Investment Fund. These funds provide both debt and equity finance to businesses in these areas to deal with supply side constraints that prevent businesses accessing the finance that they need.

Furthermore, the Bank works closely with the relevant bodies in the devolved nations such as the Scottish Investment Bank, the Development Bank of Wales and Invest Northern Ireland. Some of our recent activity has included a £10m growth finance commitment in Northern Ireland, £51m ENABLE Funding for Henry Howard Finance and investing over £80m in the 3 largest VC funds in Scotland.

With a focus on demand side imbalances, the Bank has also established a new UK Network. This team is spread across every region and nation of the UK and is engaging with business finance stakeholders in each of the English regions and devolved nations, in order to increase small businesses' awareness and understanding of the finance options best suited to their needs. It will develop a deep understanding of the business finance ecosystems in all parts of the UK, so that, ultimately, the British Business Bank can improve its support to SMEs across the entire UK. It will add value to the business finance ecosystems across the UK, by enhancing collaboration and co-ordination within and across each English region and devolved nation.

## PART B

# MARKET DEVELOPMENTS

### SMALL BUSINESSES

2.1

SME BUSINESS  
POPULATION

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2.2

USE OF EXTERNAL  
FINANCE

### FINANCE PRODUCTS

2.3

BANK LENDING AND  
CHALLENGER BANKS

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2.4

EQUITY FINANCE

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2.5

DEBT FUNDS

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2.6

ASSET FINANCE AND  
INVOICE & ASSET-  
BASED LENDING

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2.7

MARKETPLACE  
LENDING



## 2.1

## SME BUSINESS POPULATION

- Small decline in the number of private sector businesses as the growth of zero employee firms stalls
- New business birth rates have slowed and business death rates have increased
- Scale-ups and high-growth firms remain the exception rather than the rule
- SMEs' share of employment and turnover varies by size of firm, sector and location across the UK

SMEs comprise 99% of employers, 60% of private sector employment and around half (52%) of private sector turnover - with some sectoral and spatial variation across the UK. This section reviews the most recent numbers for the UK SME business population, including changes since last year and sectoral and spatial variations. The data is provided by BEIS business population estimates, ONS business demography, and ONS business structure database.

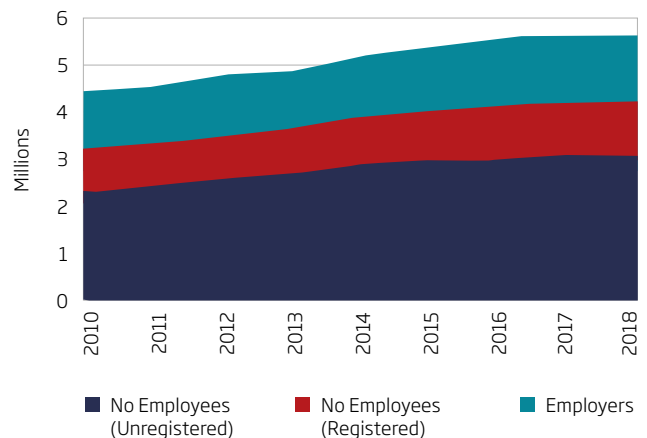
#### SMALL DECLINE IN THE NUMBER OF PRIVATE SECTOR BUSINESSES AS THE GROWTH OF ZERO EMPLOYEE FIRMS STALLS

There were 5.7 million UK private sector businesses at the beginning of 2018, a 0.5% reduction in the number of firms overall in 2017. This first annual reduction in the business population since the data series commenced in 2000, was driven by a 1% reduction in zero employee firms (Figure B.1).

FIG B.1

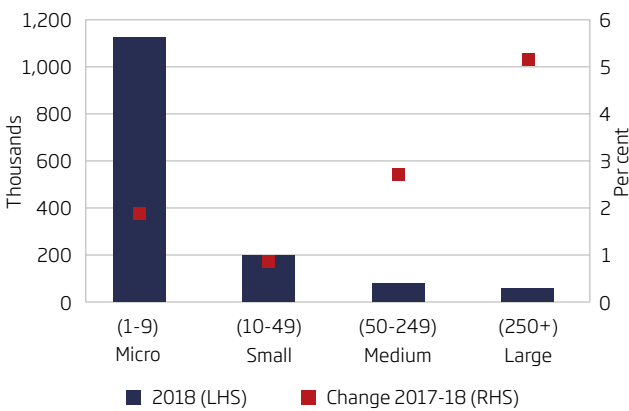
#### UK BUSINESS POPULATION

Source: BEIS, Business population estimates, 2018



**FIG B.2**  
**OVERALL NUMBER OF AND CHANGE IN UK SMALLER EMPLOYERS, BY SIZE OF FIRM (NUMBER OF EMPLOYEES)**

Source: BEIS, Business population estimates, 2018



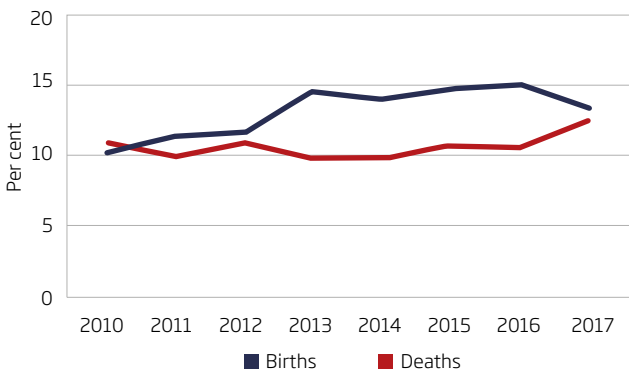
This decrease in zero employee firms was partially offset by a 1.6% increase in the number of smaller employers (1-249 employees), continuing the positive trend started in 2013. Whilst over the medium term, the increase in these smaller employers has been driven by the more numerous micro firms (1-9 employees), the growth rate in 2017-18 was higher amongst medium sized SMEs (50-249 employees) and large employers (Figure B.2).

Some of the decline in zero employee firms is likely due to changes in employment practices set out within the Finance Act 2017 resulting in an increase in direct employment within the public sector and the de-registration of intermediary companies.

**NEW BUSINESS BIRTH RATES HAVE SLOWED AND BUSINESS DEATH RATES HAVE INCREASED**

**FIG B.3**  
**NEW FIRM STARTS (BIRTHS) AND CLOSURES (DEATHS) AS A PERCENTAGE OF EXISTING ENTERPRISES**

Source: ONS, Business demography, UK: 2017



A further contributory factor to the reduction in total firms in 2017 is the first slowdown in the number of UK registered business births since 2010. The ONS reported a falling UK birth rate of 13.1% in 2017, down from 14.5% in 2016 and an increasing death rate of 12.2%, up from 10.2%, the narrowest margin since 2012 (Figure B.3).

This slowdown in business births was broad based across England, with only the North West region registering an increase in the number of new businesses in 2017 (12.9%) whilst the South West had the greatest slowdown (20.6%). The UK as a whole averaged 7.7% fewer new businesses registered in 2017 than in 2016 but both Northern Ireland (15.5%) and Wales (16.5%) showed continued growth (Figure B.4).

There was also a substantial pick up in the number of registered business deaths recorded in 2017. Across the UK, the ONS recorded an increase of 24% in the number of registered SMEs ceasing trading in 2017 on 2016. In England there was an increase of 25.8% with the regions ranging from 12.5% in the South East to 39.2% in the East of England. Each of the devolved administrations also saw an increase with Scotland the lowest (7.7%) followed by Wales (12%) and Northern Ireland (15.6%) (Figure B.5).

Alongside the previously mentioned regulatory change, the ONS suggests a possible further factor impacting new business formation could be ongoing uncertainty surrounding the UK's relationship with the EU, whilst high employment and low unemployment rates are also likely to have had an impact.

**SCALE-UPS AND HIGH-GROWTH FIRMS REMAIN THE EXCEPTION RATHER THAN THE RULE**

As noted in last year's Small Business Finance Markets report there was an improvement in the share of high-growth firms in the UK between 2012 and 2014, with the number returning to the long-term average range of 10-12 thousand per year. The Enterprise Research Centre's (ERC) "UK Local Growth Dashboard" published in June 2018 looks at the growth of start-ups, existing businesses and high-growth firms across the UK.

For all 3 of these groups, the ERC looks at their performance over a 3-year period. Under the ERC definition, for start-ups (with revenue of below £0.5m), to achieve 'scale' they must first survive and then grow to over £1m in revenues after 3 years. The latest data used is from the end of 2017 tracking the performance of companies that were started in 2014. Of these, 54.7% survive the first 3 years, in line with data going back to 1998. When the second condition is taken into account only 1.9% of UK start-ups achieved this level of scale.

For existing businesses "stepping up" the ERC looks at firms that have increased their turnover from £1-2m to at least £3m over a 3-year period. Overall, 7.2% of existing firms achieved this level of scale in 2017, up from 7% in 2016 which itself was a 6% increase on 2015.

Conversely the number of firms that achieved the traditional OECD employment-based measure of a high-growth firm fell in 2017 to 10,718 (6.3%), down from 11,855 in 2015 (7.5%), but still within in the long-term average range.<sup>96</sup>

Scale-ups, step-ups, as defined as by the ERC, and high growth firms, as defined by the OECD, are spread across the UK economy, with some variation within and between English regions and the devolved nations. Northern Ireland exhibits the highest rate for scale-ups and London for step-ups and high-growth firms (Figure B.6).

Within the devolved nations Northern Ireland stands out. It has the highest proportion of start-ups reaching scale yet the lowest level of start-ups in the UK (2.7%). Whilst overall, the 3 devolved nations have a lower than average incidence of existing firms stepping up or achieving high growth, firms in outer Belfast and the border areas of Northern Ireland, respectively, exhibit a higher incidence of scale on these 2 measures.

FIG B.4  
NEW FIRM STARTS (BIRTHS), BY REGION AND DEVOLVED NATION

Source: ONS, Business demography, 2017

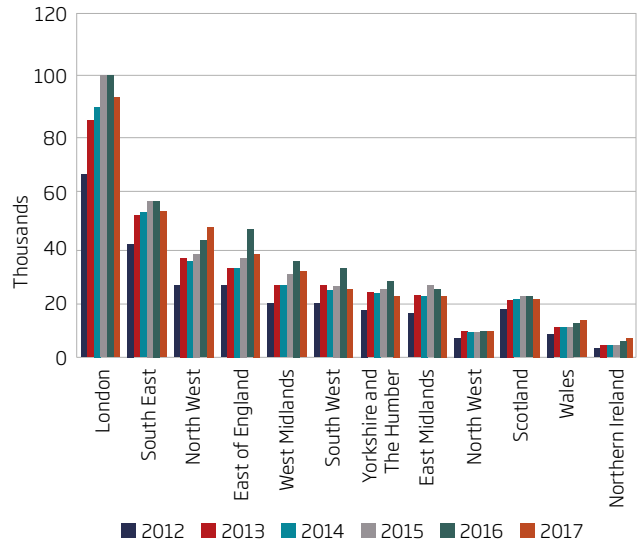


FIG B.5  
FIRM CLOSURES (DEATHS), BY REGION AND DEVOLVED NATION

Source: ONS, Business demography, 2017

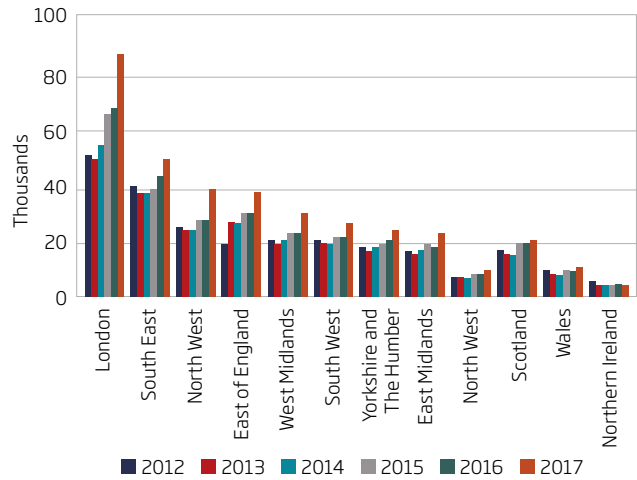
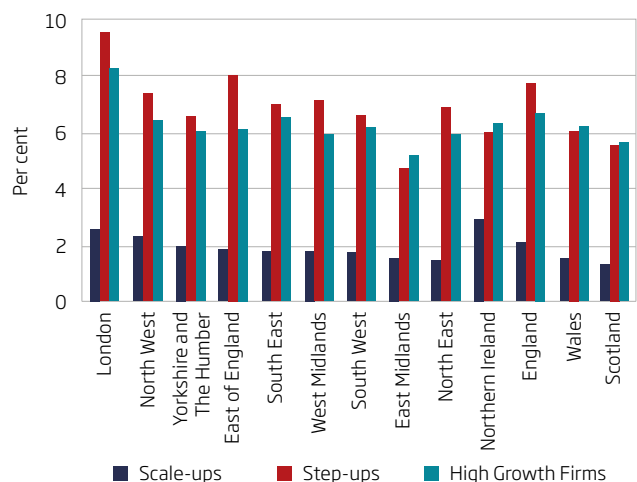


FIG B.6  
ENTERPRISES ACHIEVING SCALE-UP, STEP-UP AND HIGH GROWTH, BY REGION AND DEVOLVED ADMINISTRATION (2014-2017 PERIOD) (a) (b) (c)

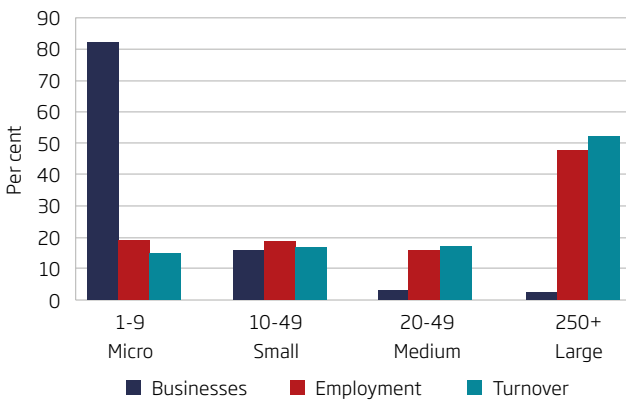
Source: ERC, ONS, Business Structure Database

- (a) Scale-up ERC definition
- (b) Step-up ERC definition
- (c) High Growth OECD definition



**FIG B.7**  
**EMPLOYERS: SHARE OF BUSINESSES, EMPLOYMENT AND TURNOVER, BY SIZE OF FIRM (NUMBER OF EMPLOYEES)**

Source: BEIS, Business population estimates, 2018



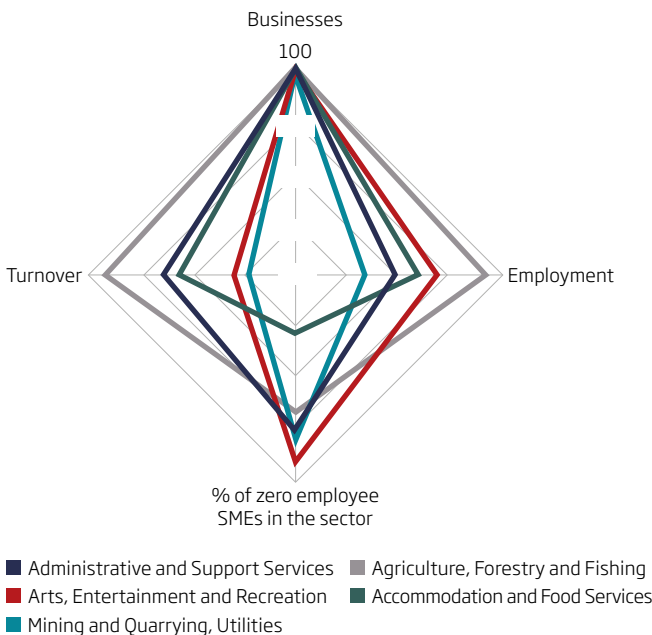
The British Business Bank continues to help provide appropriate finance for businesses ranging from start-ups to HGFs and across the UK. In addition to finance, the Bank offers support such as mentoring from Start-up Loans or the Finance Hub for those looking to grow.

**SMEs' SHARE OF EMPLOYMENT AND TURNOVER VARIES BY SIZE OF FIRM, SECTOR AND LOCATION ACROSS THE UK**

The role of HGFs in generating new jobs and productivity gains is often highlighted, but SMEs, high growth or not, are significant contributors to every sector and every region of the UK. As discussed in 1.3 SME Finance at a local level, not all regions have the same access to debt or equity products and the same can be said for different sectors too due to a range of issues such as differing business models or even levels of eligible collateral availability. This final section illustrates the role SMEs play in various sectors and regions and shows it is therefore vital that all types of viable SMEs have access to appropriate finance be it for growth plans or working capital.

**FIG B.8**  
**SME SHARE OF BUSINESSES, EMPLOYMENT AND TURNOVER, BY SECTOR**

Source: BEIS, Business population estimates, 2018



Businesses with no employees represent almost 76% of all businesses and contribute 7% of total private sector turnover in the UK overall. Micro firms (1-9 employees) make up the vast majority of employer private sector firms at 82%, but account for less than a fifth of all SME employment (19%) and turnover (15%). Conversely, the share of employment and turnover in medium-sized firms (50-249 employees), at 15% and 17% respectively, is over 5 times their 3% share of firms (Figure B.7).

SMEs account for 99% of businesses in all sectors but their shares of employment and turnover within those sectors can vary considerably. At one end of the scale, in Agriculture, Forestry and Fishing, SMEs are responsible for 92% of employment and 90% of turnover. However, in Mining and Quarrying, Utilities, SMEs only employ 34% of the sector workforce and produce 22% of the sector turnover (Figure B.8).

Other sectors have more varied employment to turnover ratios when comparing SMEs to larger businesses. SMEs within Administrative and Support Services employ just under half the sector’s workforce (49%) but account for 62% of turnover. At the opposite end of the scale, Arts, Entertainment and Recreation SMEs employ 68% of the sector’s workforce but only produce 28% of its revenue.

SMEs also account for 99% of businesses in all regions and devolved administrations, but again there are variations in the shares of employment and turnover. In the South West, SMEs account for the highest share of employment (73%) and turnover (58%), well above the total UK figures of 60% and 52%, respectively, and the highest in England.

The South East has an above average SME share of employment (62%) but the lowest SME share of turnover (45%) resulting in the lowest SME employment to turnover ratio, not just in England, but the UK. London is the only region where the share of SME turnover (56%) exceeds its share of employment (53%). This latter figure also means London has the lowest within region SME share of employment in the UK (Figure B.9).

While all the devolved administrations have an above average SME share of employment, Wales and Northern Ireland stand out with both having 75% of their workforce being employed by SMEs. Both these countries have a higher SME shares of turnover than any English region, but Northern Ireland is particularly striking at 71% (Figure B.10).

The important role all types, ages and sizes of SMEs play in every sector, region and devolved nation of the UK economy demonstrates why it is important the British Business Bank supports a range of finance solutions from debt to equity and across the sectors, regions and devolved nations of the UK economy.

FIG B.9  
SME SHARE OF BUSINESSES, EMPLOYMENT AND TURNOVER, BY REGION

Source: BEIS, Business population estimates, 2018



FIG B.10  
SME SHARE OF BUSINESSES, EMPLOYMENT AND TURNOVER, BY NATION

Source: BEIS, Business population estimates, 2018



## 2.2

## USE OF EXTERNAL FINANCE

- Current use of external finance by smaller businesses fell to 34% in H1 2018 before recovering
- The share of SMEs using of 'core' debt products (bank overdrafts, loans, mortgages and credit cards) remains at low levels
- Record low number of applications reported for new overdrafts and loans in H1 2018
- Over a third (36%) of SMEs currently use trade credit, reducing the need for external finance of some businesses

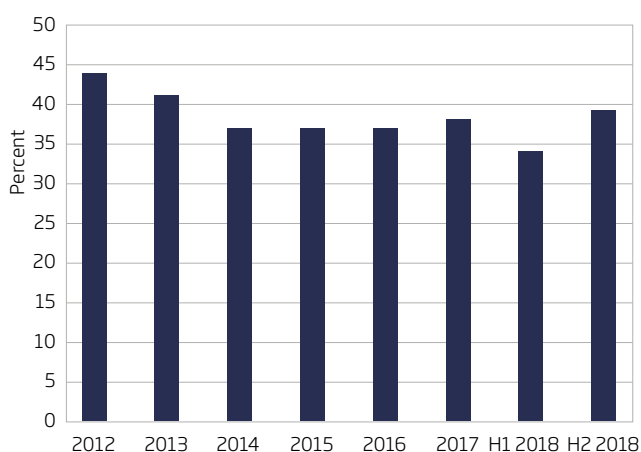
This section highlights current usage of external finance and trends in debt applications, drawing on data from BVA BDRC's SME Finance Monitor and the British Business Bank's Business Finance Survey. External finance includes overdrafts, credit cards, bank loans, commercial mortgages, leasing or hire 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. This definition excludes trade credit, which is discussed separately at the end of the chapter.

Almost half (47%) of smaller businesses are 'Permanent non-borrowers' (PNB).<sup>97,98</sup> Between 2012 and 2015, the share of PNBs increased from 34% to 47% and has been relatively stable since then. PNBs are discussed in more detail in section 1.1 Attitudes to finance.

FIG B.11

## SMEs CURRENTLY USING EXTERNAL FINANCE

Source: BVA BDRC SME Finance Monitor, 3 months to December 2018.



### CURRENT USE OF EXTERNAL FINANCE BY SMALLER BUSINESSES FELL TO 34% IN H1 2018 BEFORE RECOVERING

Around a third (34%) of smaller businesses used external finance in the first half of 2018, slightly down from 38% in 2017 (Figure B.11). The dip in use of external finance was driven by micro and small businesses (those with 0-49 employees), while use of finance has increased among medium-sized businesses (50-249 employees), and is 10 percentage points below the 44% recorded when the series started in 2011. The second half of 2018 saw this number recover to 39%.

Evidence on the share of small businesses seeking and applying for external finance is mixed. According to BEIS' Small Business Survey, the share of smaller businesses with employees seeking external finance has halved since 2010. In 2017, 13% per cent of SME employers had sought external finance in the last year, down from a peak of 26% in 2010.<sup>99</sup> According to the British Business Bank's 2018 Business Finance Survey, 41% of SMEs have sought or applied for finance in the past 3 years, consistent with 2017.<sup>100</sup> This suggests that businesses are continuing to seek or apply for finance, but barriers to use remain.

### THE SHARE OF SMEs USING OF 'CORE' DEBT PRODUCTS (BANK OVERDRAFTS, LOANS, MORTGAGES AND CREDIT CARDS) REMAINS AT LOW LEVELS

The downward trend in use of external finance has been driven by a decline in the use of 'core' finance products since 2012, as reported by the SME Finance Monitor. Figure B.12 shows 17% of smaller businesses currently use an overdraft, 13% use a credit card, and 8% use a bank loan or commercial mortgage.

The use of core finance products has declined over time as the use of self-funding options including credit balances, non-bank sources and personal funds has grown. The share of SMEs with credit balances above £10,000 has increased to 24% in the Q4 2018, from 16% in 2012. As covered in section 2.4 Bank lending, this could be reducing their need for external finance.

For businesses currently using some form of external finance, the proportion using non-bank sources as opposed to bank sources is almost double (56% and 31% respectively).<sup>101</sup> Of businesses that have applied or sought finance in the past 3 years, a third (33%) approached non-bank providers, compared with 18% that approached banks.<sup>102</sup> This is particularly true for leasing or hire purchase and specialist credit (loans from other individuals or organisations), where 88% and 66% of businesses sought finance from non-bank sources respectively.<sup>103</sup>

The share of smaller businesses drawing on personal funds has slightly increased, from 24% in Q4 2017 to 27% in Q4 2018.<sup>104</sup> Personal savings are the most frequently used means of establishing a new business, used by 86% of businesses. The next most cited means was credit card, at 14%.<sup>105</sup> The Wesleyan Bank survey of over 500 SMEs also found that the use of personal financing options like savings, inheritance, donations from relatives, house re-mortgaging and selling precious possessions had increased, with savings alone being used by over two-thirds of smaller businesses in 2018.<sup>106</sup>

Taken together, this suggests smaller businesses have an aversion to using external finance to grow. This is explored in more depth in section 1.1 Attitudes to using finance.

### RECORD LOW NUMBER OF APPLICATIONS FOR NEW OVERDRAFTS AND LOANS IN 2018 IN H1 2018

Rates of application for new overdrafts and new loans have also fallen since 2012 (Figure B.13), reflecting the decreased demand for external finance and use of core debt products. Since 2012, the application rate for overdrafts has fallen by half, to 2.0% in Q4 2017, down from 4.0% in 2012. Similarly, the rate of application for loans has fallen to 1.5% in Q4 2017, down from 2.9% in 2012.

FIG B.12  
SMEs USING OF CORE FINANCE PRODUCTS OVER TIME

Source: BVA BDRC SME Finance Monitor Q2 2018

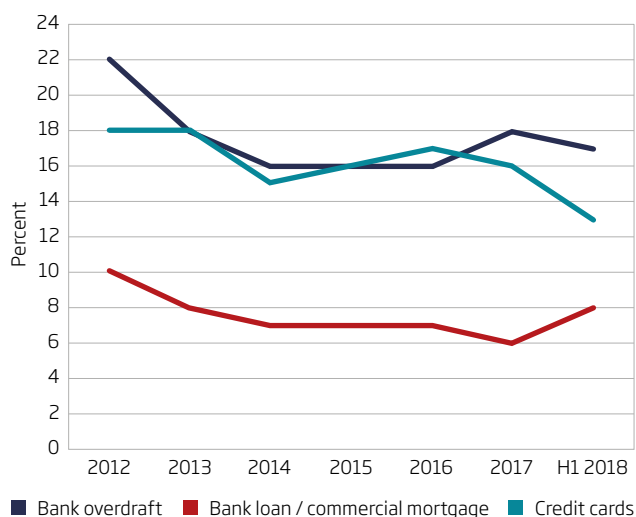


FIG B.13

**NEW DEBT APPLICATION RATES**

Source: British Business Bank Analysis, SME Finance Monitor. Data is presented over all applications reported in the 10 quarters to the end of the period stated.

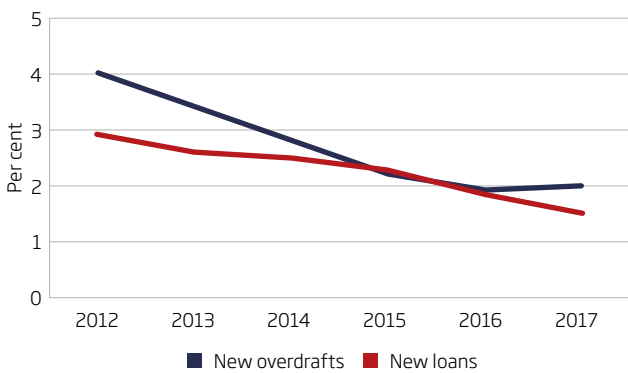
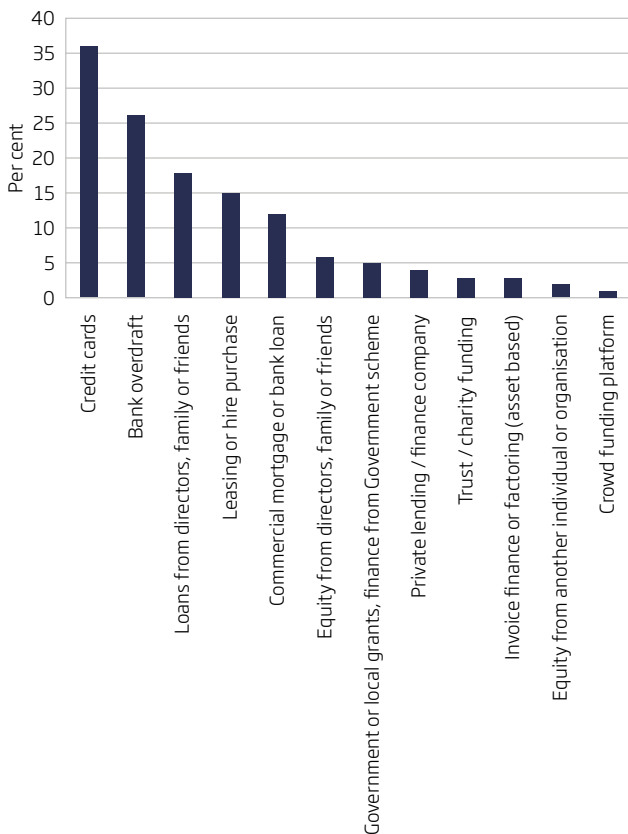


FIG B.14

**SMEs CURRENTLY USING SELECTED EXTERNAL FINANCE PRODUCTS**

Source: British Business Bank 2018 Business Finance Survey - Ipsos MORI. Base = all businesses (n=2000)



From Q1 2018 the SME Finance Monitor has collected data on a wider range of finance applications than just loans and overdrafts, and the nature of the questions asked about these applications has also changed. This means rolling data over time on loan and overdraft applications and success rates is not currently available but work is underway to link the latest 2018 data with previous years'. Data for the 10 quarters to Q2 2018 suggests that the rate of new applications for overdrafts and loans have fallen to 1.5% and 1.1% respectively. Other indicators are consistent with the downward trend, with loan and overdraft application volumes remaining below pre-recession levels across all providers according to UK Finance.<sup>107</sup> However, as the SME Finance Monitor Q2 2018 data points are not directly comparable, due to changes in the data collection method, this may be an underestimation of new application rates.

Use of core debt products remains higher than alternative forms of finance, with the exception of leasing or hire purchase, used by 15% of smaller businesses (Figure B.14). Loans and equity from directors, family and/or friends are used by 18% and 6% respectively.

**OVER A THIRD (36%) OF SMEs CURRENTLY USE TRADE CREDIT, REDUCING THE NEED FOR EXTERNAL FINANCE OF SOME BUSINESSES**

The definition of external finance used by the SME Finance Monitor excludes trade credit. Trade credit is an agreement between a buyer and seller, whereby the buyer of the goods or service does not need to pay for those goods or services immediately but can delay the payment for an agreed period of time. This can help the buyer to manage their cashflow.

An increasing proportion of smaller businesses use trade credit, which reduces the demand for external finance of some. Of the 36% of smaller businesses who currently use trade credit, over two-thirds (69%) said it reduced their need for external finance (Figure B.15). An increasing proportion of smaller businesses use trade credit, with the share rising from 31% in 2014.



Trade credit can act as either a substitute or complement for external finance. Of businesses who receive trade credit, just under half use no external finance, which is equal to 17% of all SMEs (Figure B.16). While trade credit may reduce the need of some SMEs for external finance, just over half (51%) of smaller businesses using trade credit also use external finance.

Small businesses offer trade credit to their customers, as well as receiving it. The share of businesses who receive trade credit (34%) is roughly equal to those who offer it (34%).<sup>108</sup> However, at least 2 in 5 SMEs report an average delay in payment of at least 1 month for invoices and trade credit.<sup>109</sup> This can lead to cash flow issues and time spent chasing payments for SMEs.

Given its importance to SMEs both in receiving and offering trade credit, the British Business Bank is currently undertaking further research on the use of trade credit by SMEs.

The Bank has worked with its delivery partners, including all the major high street lenders, to increase access to finance for SMEs who may not be able to meet a provider's normal security requirements. Following Carillion's collapse in January 2018, the Bank made up to £100 million of additional lending available to SMEs through lenders accredited under its Enterprise Finance Guarantee programme.

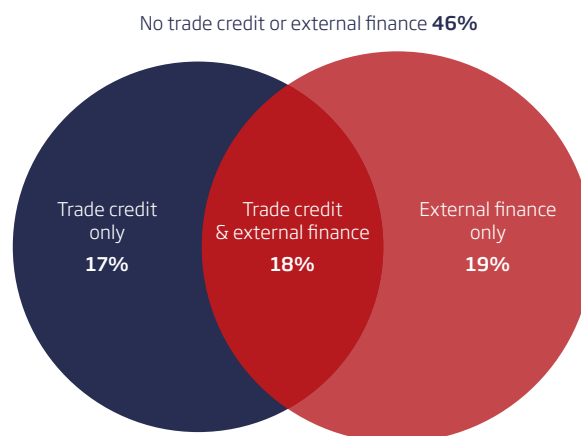
FIG B.15  
**IMPACT OF RECEIVING TRADE CREDIT, PERCENTAGE OF SMEs**

Source: BVA BDRC SME Finance Monitor YE Q2 2018.

Receive trade credit	35%
Have less of a need for external finance	24%
Do not have less of a need for external finance	9%
Not sure	2%
Do not receive trade credit	65%
% of those with trade credit where it reduces need	69%

FIG B.16  
**SMEs RECEIVING TRADE CREDIT OR USING EXTERNAL FINANCE**

Source: BVA BDRC SME Finance Monitor YE Q2 2018, calculations by British Business Bank, n=c.50,000



## 2.3

## BANK LENDING AND CHALLENGER BANKS

- Gross bank lending remains stable while repayments reached a record high in 2018, leading to limited net lending
- Overdraft usage remains on a downward trend, deposits have risen further
- Credit conditions are broadly favourable but there are some signs of tightening
- The UK story is consistent with its international counterparts

This chapter begins by looking at trends in bank lending to smaller businesses over the past year. It examines developments in the supply of bank lending, looking at changes in aggregate measures such as gross lending and repayments. The chapter then covers recent developments in competition in SME finance markets. It explores the role of challenger banks that provide products and services to smaller businesses. Finally, the awareness amongst SMEs of Opening Banking regulations, which aim to promote competition, is examined.

**GROSS BANK LENDING REMAINS STABLE WHILE REPAYMENTS REACHED A RECORD HIGH IN 2018, LEADING TO LIMITED NET LENDING**

The value of new bank lending in 2018 was broadly unchanged in nominal terms from the previous year. The gross flow of new loans (excluding overdrafts) to SMEs was £57.7bn in 2018, according to the Bank of England (BoE).<sup>110</sup> This is marginally higher than the £57.3bn in 2017.

Although gross lending in 2018 matched that of previous years (Figure B.17), the recent weakness of business investment data suggests that the new lending is likely to be precautionary or needs-based for short-term finance to help manage cash flow.

At the same time, the repayment of loans increased slightly in 2018 to reach £57.2bn, its highest recorded value. This is up from £56.6bn in 2017. It is possible that recent economic and political uncertainty in the UK has led SMEs to pay down debt in order to get their finances in the best position possible ahead of potential challenges.

FIG B.17

## GROSS LENDING TO, AND REPAYMENTS BY, SMEs

Source: Bank of England

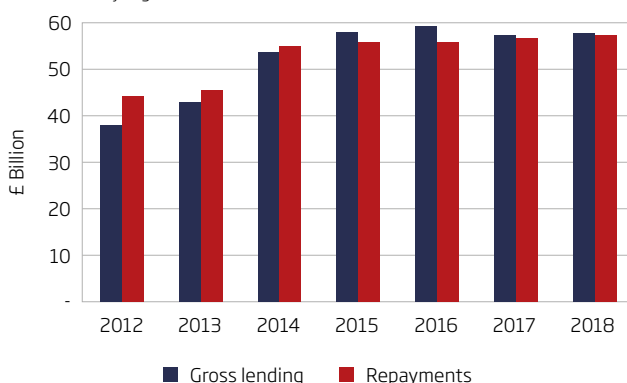


FIG B.18  
BOE QUARTERLY GROSS AND NET FLOWS OF BANK LOANS TO SMES

Source: Bank of England

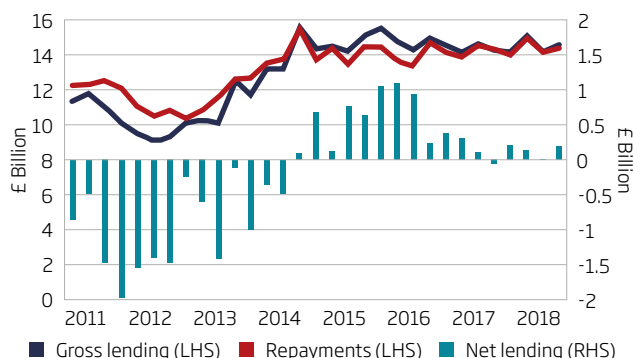


FIG B.19  
UK FINANCE QUARTERLY GROSS AND NET FLOWS OF BANK LOANS TO SMES

Source: UK Finance

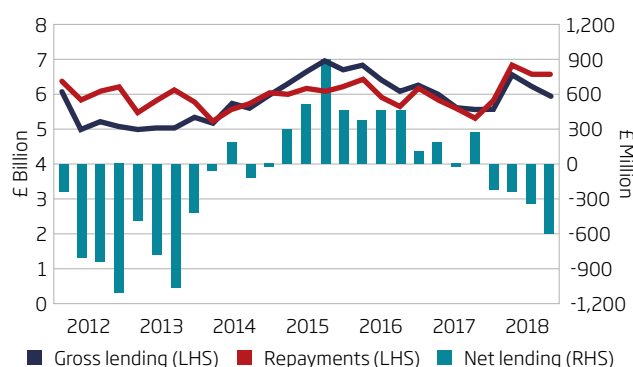
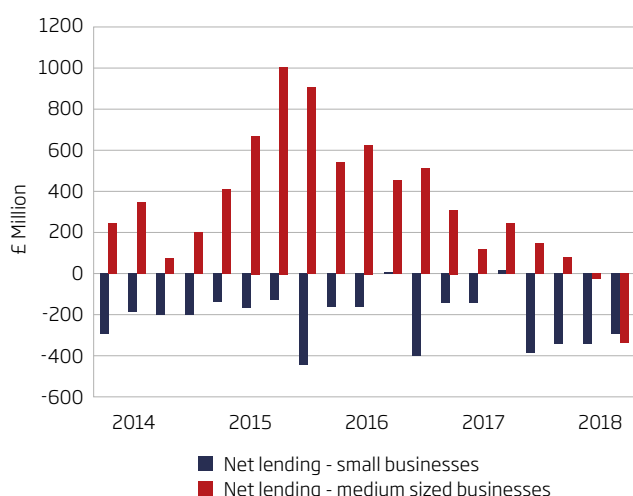


FIG B.20  
NET LENDING, SMALL AND MEDIUM-SIZED BUSINESSES

Source: UK Finance



These 2 trends have resulted in net lending being broadly flat in 2018, as the gap between repayments and gross lending narrowed (Figure B.18). In 2018, net lending totalled only £0.5bn. Net lending was positive in 2017 (£0.7bn), 2016 (£3.3bn) and 2015 (£2.2bn) following negative years following the financial crisis.

The alternative UK Finance measure, based on SME overdraft and term loan provision from 7 high street banks, paints a similar picture.<sup>111</sup> Net lending in Q3 2018 was a negative £0.6bn, and a negative £1.2bn for the first 3 quarters of 2018 in aggregate (Figure B.19). This compares to positive net lending of £0.4bn in the corresponding period of 2017. Like the BoE measure, net lending was positive in 2017 (£0.2bn), 2016 (£1.4bn) and 2015 (£2.1bn) following several years of negative outturns post the financial crisis.

UK Finance splits the SME data into small businesses and medium-sized businesses. This shows that net lending to small businesses in Q3 2018 was slightly negative (-£0.3bn) (Figure B.20)<sup>112</sup>. Net lending to small businesses has been negative in most quarters since the data series began in 2011. Similarly, in Q3 2018 net lending to medium-sized businesses was slightly negative. This compares to positive net lending to medium-sized businesses in every quarter in the 4 years to Q1 2018.

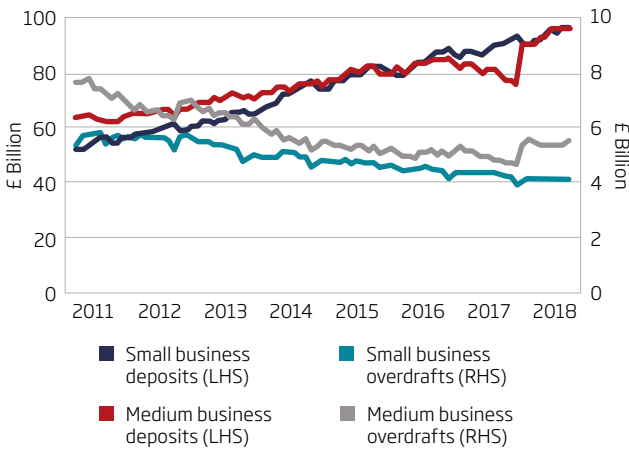
**OVERDRAFT USAGE REMAINS ON A DOWNWARD TREND, DEPOSITS HAVE RISEN FURTHER**

The value of outstanding overdrafts for both small and medium-sized businesses has trended downward since 2011 (Figure B.21). UK Finance data shows that overdrafts outstanding in Q3 2018 was a little higher than in the same period of the previous year. However, it has fallen by 30% since the data series began in 2011.

**FIG B.21**  
**STOCK OF OVERDRAFTS AND VALUE OF DEPOSITS, SMALL AND MEDIUM-SIZED BUSINESSES**

Source: UK Finance

Note: The large jump in the deposits and overdrafts of medium-sized businesses in early 2018 was due to a change in the reporting by one of the high street banks that provides data to UK Finance.



In contrast, the value of deposits held by SMEs have been on an upward trend since 2011. Deposits rose to a record high in the Q3 2018 and are up 66% since the data series started in 2011. The value of deposits held by small businesses rose above that of their medium-sized counterparts in mid-2016 and remained so for 2 years before falling back below in Q3 of 2018 (Figure B.21).

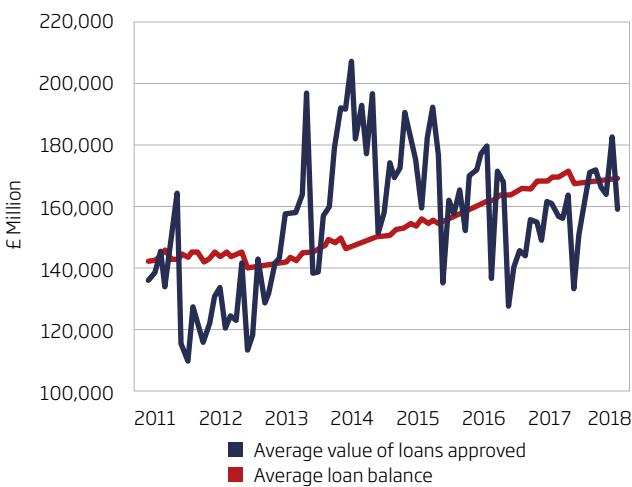
According to the latest SME Finance Monitor (Q2 2018), nearly all (96%) smaller businesses held some credit balances in the first half of 2018.<sup>113</sup> In Q4 2018, the share of SMEs holding large credit balances, ie £10,000 or more, was 24%.<sup>114</sup> This is slightly lower than in 2017 (25%), but well up from 16% in 2012. There is evidence of a link between holding large credit balances and demand for external finance. Most (ie 8 in 10) of the SMEs holding £10,000 or more said it reduced their need for external finance.<sup>115</sup>

Indicators signal that business demand for finance is generally low. The use of external finance chapter highlighted a continuing decrease in the demand for finance (section 2.2). Mirroring this, the BoE Agents' summary of business conditions for Q4 2018 reported that the credit demand of companies (which includes SMEs) continued to soften, reflecting subdued investment intentions, and a slowdown in refinancing. It also reported a general reluctance to increase borrowing, due to uncertainty about the economic outlook. Similarly, the BoE Credit Conditions Survey for Q4 2018 reported a fall in the demand of small businesses for corporate lending for the second consecutive quarter.<sup>116</sup>

The low demand for finance, combined with gross lending being little changed from 2017, suggests that the average size of loans has risen. UK Finance data shows that the average value of SME loans approved has increased over time, from approximately £137,000 in July 2011 (when data series began) to around £160,000 in September 2018 (the latest available) (Figure B.22). Similarly, the average SME loan balance has risen over the same period, from about £142,000 to roughly £168,000.

**FIG B.22**  
**AVERAGE LOAN SIZE APPROVED AND LOAN BALANCE, SMES**

Source: UK Finance



### CREDIT CONDITIONS ARE BROADLY FAVOURABLE BUT THERE ARE SOME SIGNS OF TIGHTENING

Lenders reported that the availability of credit to small businesses was little changed in Q4 2018, according to the BoE Credit Conditions Survey. The net percentage balance of respondents that reported a decrease in credit availability was only slightly larger than those reporting an increase (Figure B.23). In the previous 2 quarters, lenders reported modest net increases in the availability of credit to small businesses.

A different pattern was reported by the FSB's Voice of Small Business survey. In Q4 2018, the FSB reported that its credit availability index rose for the first time in a year to the highest level since it was introduced in 2012.<sup>117</sup> This was after it had fallen in Q3 for the third quarter in a row to the lowest level in more than 2 years.

There also appears to be a sectoral story emerging. The BoE Agents' summary of business conditions for Q4 2018 reported that the availability of credit continued to tighten for companies (which include SMEs) in sectors more vulnerable to an economic slowdown such as construction, procurement and consumer-facing businesses.<sup>118</sup> This, taken with the BoE Credit Conditions survey, suggests the overall availability of credit has been fairly stable. However, credit may be more dispersed than previously, based on whether the businesses are in sectors perceived by banks to be of greater or lesser credit quality.

Separate BoE data indicates that credit is still affordable by historical standards. Interest rates on a range of SME loans have increased slightly since the start of the year. The effective interest rate on all SME loans has risen from 3.18% in November 2017 to 3.68% in the same month of 2018 (Figure B.24). The effective floating-rate, which broadly tracks the BoE's Bank Rate, is a little lower than that for all loans while the effective fixed-rate is somewhat higher.<sup>119</sup>

The BoE's Monetary Policy Committee (MPC) increased the Bank Rate in August 2018 by 25 basis points to 0.75%, the first increase since November 2017 and only the second in a decade. MPC members reiterated that any future increases in the Bank Rate are likely to be at a gradual pace and to a limited extent, whilst also keeping the option of a reduction depending on the final Brexit outcome.

The FSB's survey also suggests that credit remains relatively affordable for small businesses. Credit affordability rose in Q4 2018 to a 1-year high but was still slightly below the level of Q3 2016, the highest since the index was introduced in 2012.

FIG B.23

### NET CHANGE IN THE AVAILABILITY OF CREDIT, SMALL BUSINESSES AND CORPORATE SECTOR

Source: Bank of England

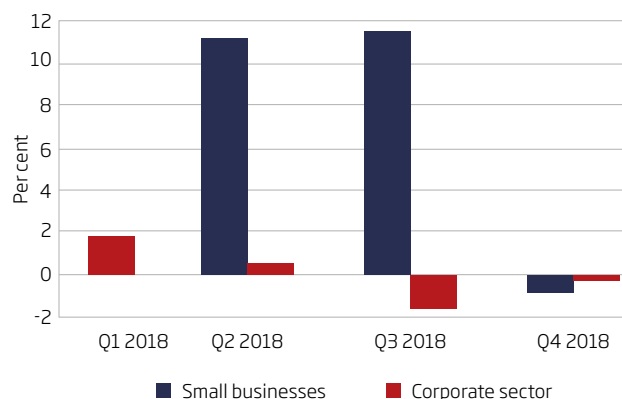
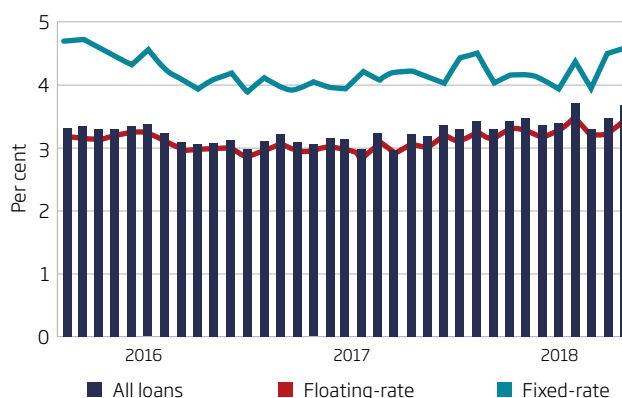


FIG B.24

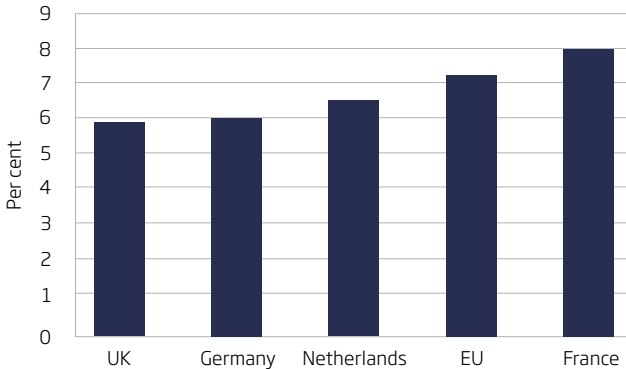
### EFFECTIVE INTEREST RATES (NEW BUSINESS) FOR SMEs

Source: Bank of England



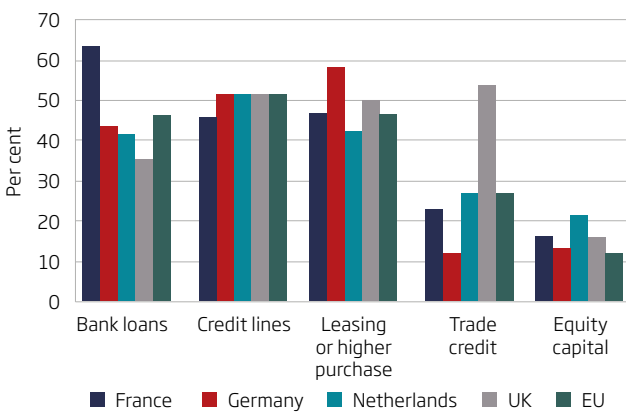
**FIG B.25**  
**SMEs REPORTING ACCESS TO FINANCE AS THE MOST IMPORTANT PROBLEM FACING THE BUSINESS**

Source: Survey on access to finance to enterprises (SAFE), 2018



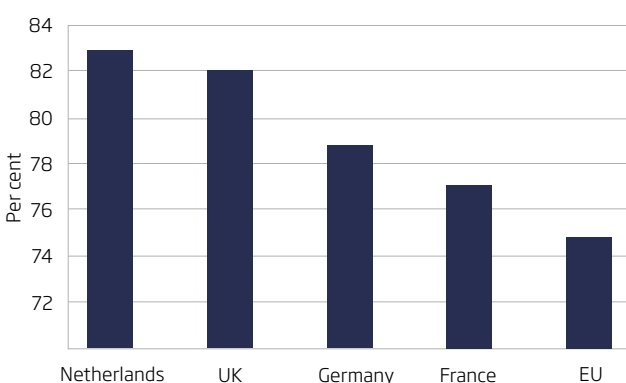
**FIG B.26**  
**SMEs REPORTING FINANCE PRODUCTS AS RELEVANT TO THE BUSINESS**

Source: Survey on access to finance to enterprises (SAFE), 2018



**FIG B.27**  
**SMEs REPORTING BANK LOANS ARE NOT RELEVANT BECAUSE THEY DON'T NEED THAT TYPE OF FINANCE**

Source: Survey on access to finance to enterprises (SAFE), 2018



**THE UK STORY IS CONSISTENT WITH ITS INTERNATIONAL COUNTERPARTS**

The experience of UK SMEs in obtaining finance resembles those in other major economies. The best source of evidence for comparisons within the European Union is the Survey on the Access to Finance of Enterprises (SAFE), which is produced by the European Commission and European Central Bank. The latest wave of the SAFE took place from April to September 2018. The sample of firms interviewed in this survey includes some large businesses as well as SMEs, but it is still the best data source for comparisons within the EU.

The survey reports on smaller businesses that currently see access to finance as the most important issue they face. The share of UK SMEs that view access to finance as the top issue was around 6% (Figure B.25). This was broadly in line with Germany and the Netherlands, which are among the UK's top trading partners, but slightly lower than the average across the EU (7%) and that of France (8%).

The survey also provides guidance on which groups of financial products are relevant to SMEs. In this survey, relevance is defined as the business having used the products in the past or were considering in the future. The UK is close to the EU average for credit lines (which includes bank or credit card overdrafts) and leasing or hire purchase (Figure B.26). In contrast, UK SMEs appear to be less reliant on bank loans and utilise trade credit much more than the EU average.

SMEs are also asked about the relevance of bank loans to their business. Of those that said bank loans were not relevant, the share of UK businesses indicating they did not need bank loans was 82% (Figure B.27). This was higher than in Germany (79%) and the EU average (75%) but broadly in line with the Netherlands (83%). Other reasons given were a lack of collateral, the interest rate or price was too high, lack of availability, reduced control over the enterprise, and too much paperwork. Each of these other reasons were cited by only a small share of SMEs, ie 4% or less.

Access to finance remains high on the policy agenda throughout the world. The UK Government and those of most other OECD member countries provide guarantees to support lending in SME finance markets. The Australian Government is the latest to announce plans for smaller business loan guarantees.

The size of SME lending guarantees relative to GDP varies widely among OECD members. The latest available data at the time of publication is for 2016.<sup>120</sup> Among the countries for which data is available, the largest scheme was in Japan, where the outstanding volume of the guarantees as a share of GDP was more than 4% (Figure B.28). This compares to slightly less than 4% in South Korea and just over 2% in Thailand.

In most OECD countries, SME loan guarantees represent less than 1% of GDP. The UK's guarantees (as a share of GDP) for lending to smaller businesses are modest compared to most OECD countries (Figure B.29).

Market failures such as information asymmetry provide a rationale for support through loan guarantee schemes. The British Business Bank has expanded its long-running Enterprise Finance Guarantee (EFG) product to address market failures in SME finance markets.

FIG B.28  
GOVERNMENT LOAN GUARANTEES FOR SMES IN 2016, PERCENTAGE OF GDP, LARGEST 8

Source: OECD

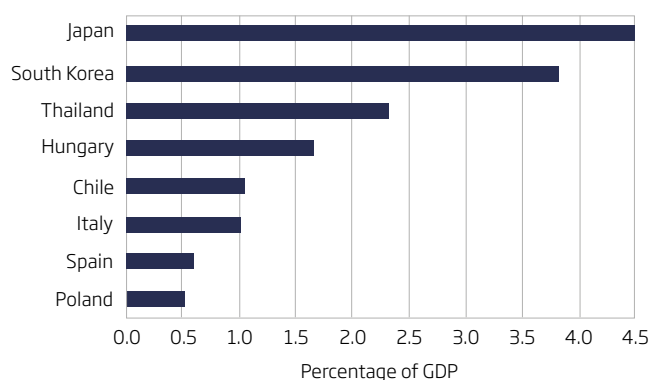
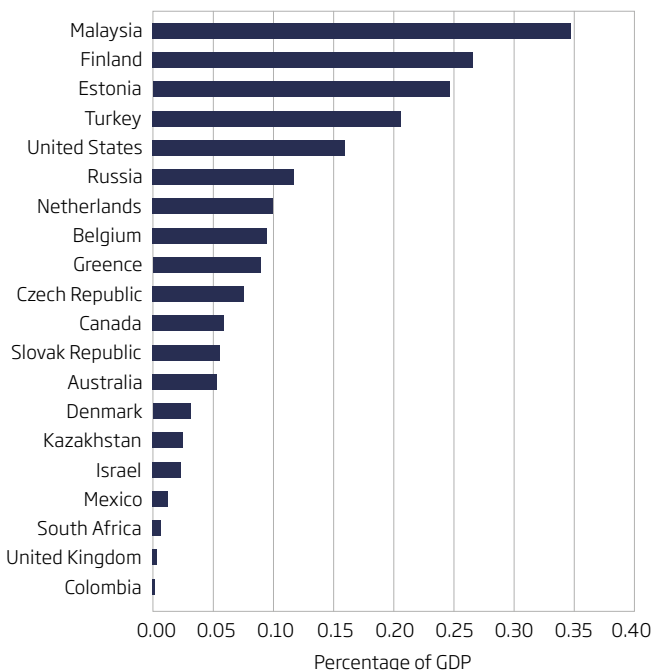


FIG B.29  
GOVERNMENT LOAN GUARANTEES FOR SMES IN 2016, PERCENTAGE OF GDP, CONTINUED

Source: OECD



## CHALLENGER BANKS

- UK challenger banks are growing in size and number and have been successfully raising capital
- Challenger banks and marketplace lenders appear to be influencing the wider banking sector
- SMEs' awareness of Open Banking is limited, but it's still early days

'Challenger banks' is a broad term that refers to financial institutions outside of the UK's 5 largest high street banks that offer banking products and services.<sup>121</sup> However, this definition does not capture that there are different types of challenger banks.

A useful classification is from KPMG, which identified 3 main types of challenger banks: classic, contemporary, and nouveau. Classic challengers feature elements of traditional banking, eg physical branches, accepting deposits and offering loans. However, they are flexible enough to exploit new technology and business models for innovative customer-focused services.<sup>122</sup>

In contrast, contemporary challengers operate largely or solely online or via a mobile application ('app') and partner with, or consider themselves to be, financial technology (FinTech) companies.<sup>123</sup> Nouveau challengers tailor their services to customers in underserved markets, around cutting-edge technologies or with services outside the boundaries of traditional banking.<sup>124</sup>

Some but not all challenger banks operate in SME finance markets. Several cater exclusively for smaller businesses, while others also offer products and services to personal customers. The types of products offered by challenger banks to SMEs include loans, overdrafts, asset finance, invoice finance, and current and saving accounts.

### UK CHALLENGER BANKS ARE GROWING IN SIZE AND NUMBER AND HAVE BEEN SUCCESSFULLY RAISING CAPITAL

Comparable information on lending by challenger banks is hard to come by because their lending activities are not reported separately from the big banks. However, a sense can be gained by looking at their balance sheets. The latest annual reports of 7 challenger banks that operate in SME finance markets show that the deposits, loan books and assets of most (6 out of 7) grew compared to the previous year.<sup>125</sup>

Four new banks were granted a UK banking licence in 2018.<sup>126</sup> Of these, 1 offers products and services to smaller businesses. This compares to 12 institutions being granted banking licenses in 2017, some due to ring-fencing, of which around half operate in SME markets.<sup>127</sup>

In addition, several challenger banks have diversified and now offer products and services to smaller businesses. For example, Starling Bank launched current accounts for micro businesses and sole traders.<sup>128</sup> Furthermore, some existing challenger banks in SME markets expanded the products and services they offer, eg OakNorth introduced a fixed-rate bond business savings account.<sup>129</sup>

There has also been some consolidation among those challenger banks that offer products and services to SMEs. CYBG Group became the sixth largest UK bank by assets after it acquired Virgin Money in 2018.<sup>130</sup> In addition, Aldermore was acquired by First Rand Group (a financial services provider in South Africa).<sup>131</sup>

Many challenger banks, particularly contemporary challengers, are funded by capital raised from investors. Contemporary challengers attract investors in the expectation that the new digital technology used will disrupt the financial sector. In addition, contemporary challengers have become more attractive to investors because the popularity of them among their users has started to translate into profits. For example, OakNorth made a pre-tax operating profit in the year to November 2017 for the first time since it was founded in 2015.<sup>132</sup>



Globally, challenger banks raised a record amount of capital in Q1 2018, according to FinTech Global.<sup>133</sup> In Q1 2018, the capital raised by challenger banks was equal to around two-thirds of that raised by challenger banks throughout 2017 (Figure B.30).

Contemporary challengers that raised capital in 2018 and operate in SME markets include Starling Bank, Atom Bank and OakNorth. Those that did so and offer products and services to individuals include Monzo and Zopa.

Four of the largest 10 capital raisings by challenger banks between 2014 and Q1 2018 have been by those based in the UK (Figure B.31). Two of the 4 were by Atom Bank, with the others by OakNorth and Tandem. However, we know from our market contacts that this is not the full picture and more capital has been raised by these and other challenger banks.

A further potential source of funding for challenger banks is the Royal Bank of Scotland (RBS) funded Alternative Remedies Package (the Package).<sup>134</sup> The Package is made up of 2 RBS funded measures; a £425m Capability and Innovation Fund (CIF); comprised of 15 grants that eligible challenger banks and other financial service providers can compete for to increase their business banking capabilities; and a £350m Incentivised Switching Scheme (ISS) facilitating the switching of SME business current accounts and related loans from RBS to challenger banks.

The Package was agreed with the European Commission as a resolution to RBS' final state aid commitment to divest the business formerly known as Williams & Glyn. It is designed to boost competition in the business banking market and was agreed on the basis that it is capable of having an equivalent positive impact on competition as the Williams & Glyn divestment.

Banking Competition Remedies Ltd (BCR) is the independent body established with responsibility for delivery of the Package. BCR intend to launch the ISS and make the first CIF awards in February 2019, having already announced the first 11 banks that will be eligible for the ISS.<sup>135</sup>

The Prudential Regulation Authority (PRA) has approved the use of CYBG's own internal risk model to weight the risk on its SME and corporate loan book.<sup>136</sup> This is viewed as a significant milestone for the sector as they became the first UK challenger bank to receive such approval since the financial crisis. Previously, CYBG and many other challenger banks have been required to use a standardised risk rating model. The move should allow CYBG to hold less capital against its lending, enabling them to lend more to its customers, which include SMEs, and may also reduce the pricing of its SME products and services.

FIG B.30  
GLOBAL INVESTMENT IN CHALLENGER BANKS

Source: FinTech Global

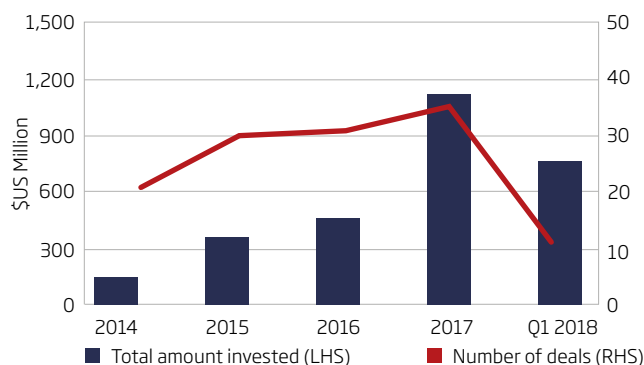


FIG B.31  
TOP 10 INVESTMENTS IN CHALLENGER BANKS

Source: FinTech Global

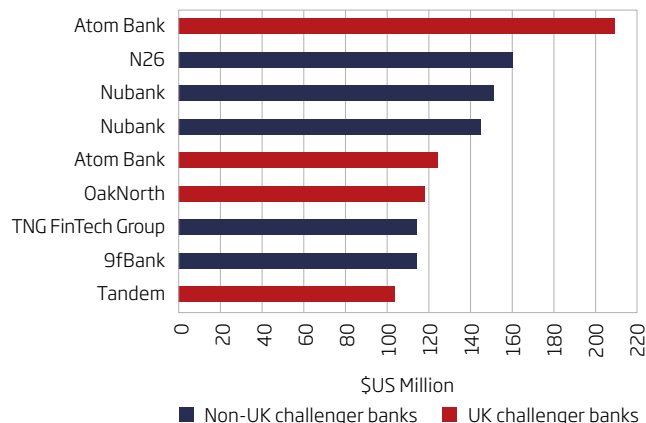
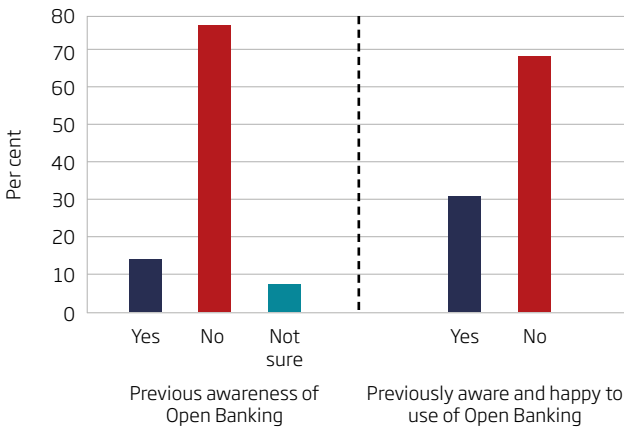


FIG B.32  
**AWARENESS OF, AND HAPPINESS TO USE, OPEN BANKING**  
 Source: SME Finance Monitor Q2 2018



Several other challenger banks are currently in the process of seeking approval. TSB, due to being spun out of Lloyds Bank, and the Co-operative Bank, which received approval in 2008, already have approval to use their own models.

One important development for the sector is the closure of the BoE’s Term Funding Scheme (TFS) in early 2018. The TFS provided funding to banks and building societies at interest rates close to the Bank Rate. As a result, those banks that lack a large base of customer deposits, and had previously benefitted from the TFS, may have seen their average funding cost increase quicker than those with large deposit bases. This is likely to have affected challenger banks more than the big 5. This is something we will look to explore in the coming year.

**CHALLENGER BANKS AND MARKETPLACE LENDERS APPEAR TO BE INFLUENCING THE WIDER BANKING SECTOR**

Perhaps in response to the challenger banks and alternative finance providers, several of the UK’s largest banks have boosted their investment in technology, or partnered with FinTech companies, to enhance the customer experience and drive efficiency. An example is Lloyds, which announced a strategic partnership with the FinTech company Thought Machine to accelerate the digital transformation of the bank’s business.<sup>137</sup>

The existing systems and organisational structures of the large banks have made them less agile than some challenger banks. For example, the large banks can create new mobile apps but are not always able to link them to their back-office system. To become more agile, and to get around the issue of unwieldy legacy systems, some of the largest banks have launched their own standalone unit digital banks. One example is the RBS which unveiled Mettle, a digital-only banking service with a current account aimed at SMEs.<sup>138</sup>

**SMEs’ AWARENESS OF OPEN BANKING IS LIMITED BUT IT’S STILL EARLY DAYS**

A key measure in the Competition and Markets Authority’s (CMA) final report on the retail banking market investigation in 2016 was to implement open data standards for banking.<sup>139</sup> The CMA required the 9 largest UK providers of current accounts to release personal and business account data by mid-January 2018. This involved each provider having to develop and maintain standard Application Programming Interfaces (APIs), ie software intermediaries that allow 2 apps to talk to each other. Doing so was optional for other banks and building societies.

Open Banking aims to promote competition and innovation in the retail banking industry to benefit both consumers and smaller businesses. It involves an individual or SME customer explicitly consenting to; their banking data being shared securely with other providers, and paying companies for goods and services directly from their bank account and not through a third party such as Visa or Mastercard. Open Banking is only available to customers using online or mobile banking.

There is potential for Open Banking to deliver significant benefits, but its success is too early to call. Open Banking is an ongoing process and its benefits will take time to materialise. By September 2019, a wider range of financial institutions are required to release Open Banking APIs. This will enable Open Banking to be extended to other payment accounts such as credit card accounts and e-wallets, giving customers a comprehensive view of their finances.

The SME Finance Monitor report for Q2 2018 provides some early evidence of smaller businesses' awareness of, and happiness to use, Open Banking (Figure B.32). However, the data should be treated with caution because Open Banking is still in its early days. We expect that smaller businesses' awareness of, and happiness to use, Open Banking will increase over time as it becomes more established.

The report indicates that SMEs' awareness of Open Banking is currently limited. Only 15% of respondents had heard of Open Banking before they took part in the survey.<sup>140</sup> In contrast, 78% had not previously heard of it.<sup>141</sup>

The results are broadly comparable to a YouGov survey, which found that less than 28% of UK adults had heard of Open Banking and 72% had not.<sup>142</sup> It's not clear if the variation among the surveys can be attributed to a difference in the precise questions asked because those of YouGov are not publicly available.

The SME Finance Monitor also reported that the appetite for Open Banking is modest. Of those smaller businesses that were aware of Open Banking prior to participating in the survey, 31% said they would be happy to use it.<sup>143</sup> This is equal to just 5% of all SMEs.

Among those that were not previously aware of Open Banking, only 12% indicated they would be happy to use it. However, this should be treated with caution because people typically take time to come to a judgement as to whether they would be happy or not to use a product or service.

The low appetite of smaller businesses for Open Banking could be due to a lack of understanding of its benefits or concerns about data sharing with third party providers. The YouGov survey reported that only 18% of adults understood the ways they could use Open Banking, while 45% did not. It also found that 77% of participants would be concerned about sharing their financial data with companies other than their main bank, whilst just 16% would not be.

The potential benefits of Open Banking include integrating SMEs with Cloud accounting software to improve their customer experience and capability. This will give customers an opportunity to gain more control over how they manage their finances. Those holding accounts with multiple providers can use a single digital app to smooth cash flow, anticipate cash flow needs based on previous trends (which could help avoid overdraft charges), assess whether they may need finance, and receive more personalised offers on products. Also, those customers seeking credit can show the details of their finances to potential lenders online. While existing services do this, Open Banking is more secure.

In addition, Open Banking simplifies customer payments to third parties such as retailers. Customers can give retailers permission to initiate payments directly from their current account. This compares to the existing complicated system, where customers make payments to retailers via intermediaries. Furthermore, Open Banking has the potential to encourage SMEs and other customers to switch from their current bank to another. This could benefit challenger banks, particularly contemporary challengers.

#### IMPLICATIONS FOR THE BRITISH BUSINESS BANK

The British Business Bank's Enterprise Finance Guarantee (EFG) supports SMEs' access to finance. The use of EFG varies over the economic cycle because it responds to market conditions. Historically, EFG volumes have been higher during economic downturns. If market conditions require it, the British Business Bank could increase its activity via EFG.

The amount of regulated capital that banks are required to hold can constrain some from lending to the markets they serve such as SMEs. The results of the BoE's bank stress tests for 2018 suggest that the capital buffers of 7 major UK banks and building societies that lend to households and businesses are reasonably high.<sup>144</sup> The British Business Bank's ENABLE Guarantee scheme aims to improve the efficiency of capital in SME finance markets. They effectively reduce the amount of capital that a bank must hold, ie lower the regulated cost of capital. The ENABLE Guarantee product has helped several challenger banks. British Business Investments, a subsidiary of the British Business Bank, has also provided help to some challenger banks including Secure Trust Bank.<sup>145</sup>

The support from the British Business Bank's programs for several challenger banks has increased diversity in SME finance markets. However, there's more to do as most smaller businesses still approach their main bank first.

## 2.4 EQUITY FINANCE

- The value of equity investment in UK SMEs is set to reach a record level in 2018, due to increasing deal sizes
- The overall number of equity deals has declined, driven by fewer seed stage deals and a shift towards later stage deals
- Global venture capital finance markets have also seen a decline in the number of equity deals in 2018
- The 10-year financial returns from investing in venture capital continue to improve, with the financial performance of recent vintage venture capital funds now higher than public equity markets

Part A of the report highlights that only a small proportion of businesses use equity finance, but equity finance is an important funding source for early stage innovative and high growth firms. This section provides an overview of recent trends in UK (private) equity finance over the last 7 years, using data from Beauhurst.

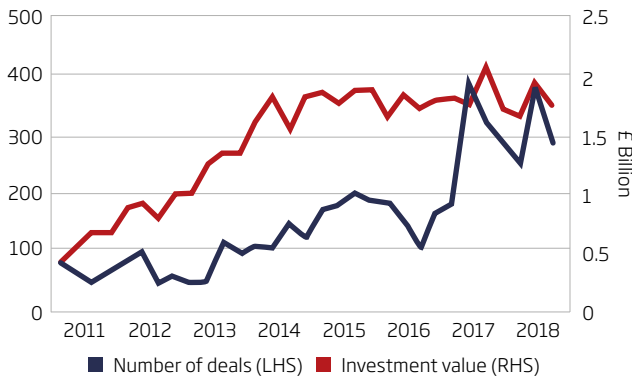
The British Business Bank 2018 Equity Tracker report identified a bounce back in the number and value of equity deals in 2017, following a weaker 2016.<sup>146</sup> The picture for the first 3 quarters of 2018 is now more mixed, with investment values at record levels but a decline in the overall number of equity deals (Figure B.33).

The British Business Bank continues to use Beauhurst for UK equity deal data as it covers the full range of equity investors including, business angels, crowdfunding platforms, corporate investors, government funds and other investors. Comparisons are also made to international VC markets using PitchBook data. The recent financial performance of UK venture capital (VC) funds is then analysed using British Venture Capital Association (BVCA) financial returns data with comparisons made to wider private equity and public equity markets.

The Beauhurst data in this report covers up to Q3 2018 for announced equity deals, with numbers differing to the numbers published by Beauhurst due to the application of an SME filter. Figures for the full 2018 year will be published in the forthcoming Equity Tracker report, which provides a more detailed assessment of market conditions than the higher-level summary contained in this wider market report.

FIG B.33  
NUMBER OF EQUITY DEALS AND VALUE OF INVESTMENT, PER QUARTER

Source: British Business Bank analysis of Beauhurst



**THE VALUE OF EQUITY INVESTMENT IN UK SMEs IS SET TO REACH A RECORD LEVEL IN 2018, DUE TO INCREASING DEAL SIZES**

Equity investment substantially increased in 2017 relative to historical levels, and 2018 looks set to continue this trend. Over the first 3 quarters of 2018 £4.6bn of equity was invested in UK SMEs, up 4% compared to the same quarters in 2017 (Figure B.33). Quarterly investment values have remained over £1bn for 6 consecutive quarters, with Q2 2018 figures being closer to £2bn. Investment values can be volatile due to the impact of a small number of very large deals.

Trends in investment value vary between the 3 Beahurst business stages. Beahurst classifies deals into 3 distinct stages; seed, venture and growth. These stages reflect the company's underlying position in terms of product development, commercialisation, sales and profitability.<sup>147</sup>

The increase in overall investment value relative to 2017 has been driven by large increases at the venture stage. Investment value at the venture stage increased to £1.8bn over the first 3 quarters of 2018, from £1.3bn over the same quarters in 2017, a 35% increase. Investment value across the seed and growth stages has fallen by 11% and 9% respectively compared to 2017. Quarterly investment value is volatile, especially at the growth stage where one or two very large deals can cause large variation in reported investment numbers, as seen in Q2 2017.

The key driving force behind the contraction in growth stage investment value in Q1 to Q3 2018 was a reduction in the size of the largest equity deals. In Q1 to Q3 2017, £1.2bn was invested in deals above £100m in size, contributing 27% of total investment value. In Q1 to Q3 2018, this had fallen to £646m or 14% of total equity investment (Figure B.35). This reduction was not due to lack of £100m deals, as there were 5 in Q1 to Q3 2018 relative to 6 over the same period last year, but rather a reduction in the size of the largest deals. Between Q1 and Q3 2017, the average size of deals above £100m was £204m, whereas in the same quarters of 2018 it had fallen 37% to £129m.

To date 2018 has lacked the 'blockbuster' £300m plus sized deals seen in 2017. The largest deal over Q1 to Q3 2017 was the £397m investment in Farfetch, whereas the largest deal in 2018 was £180m in Revolut.

FIG B.34  
VALUE OF EQUITY DEALS BY STAGE, PER QUARTER

Source: British Business Bank analysis of Beahurst

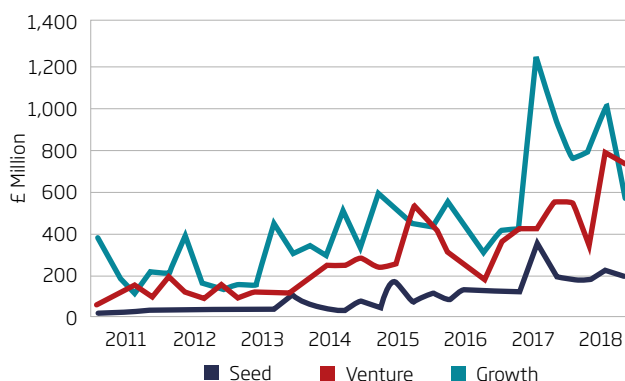


FIG B.35  
PROPORTION OF INVESTMENT VALUE GOING TO EQUITY DEALS ABOVE £100M

Source: British Business Bank analysis of Beahurst

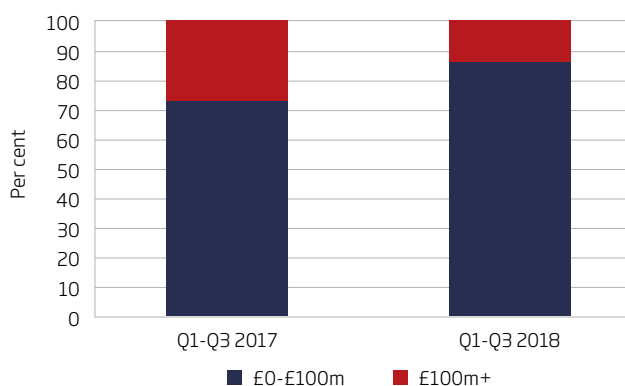
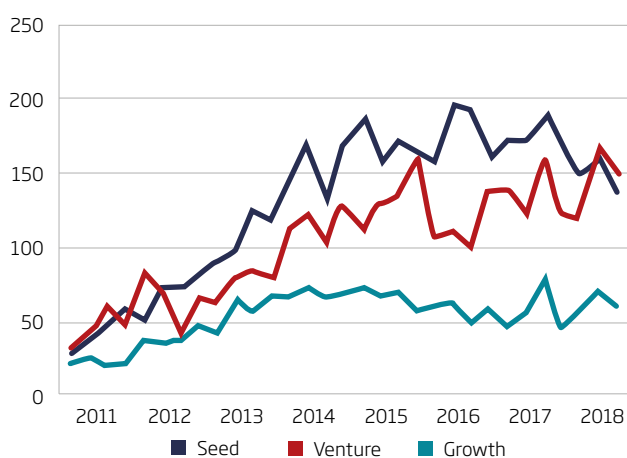


FIG B.36  
NUMBER OF EQUITY DEALS, BY STAGE

Source: British Business Bank analysis of Beauhurst



### THE OVERALL NUMBER OF EQUITY DEALS HAS DECLINED, DRIVEN BY FEWER SEED STAGE DEALS AND A SHIFT TOWARDS LATER STAGE DEALS

Over the first 3 quarters of 2018, 1,079 equity deals in UK SMEs were completed, a 6% decline compared to the same quarters in 2017. The decline in overall deal numbers has been driven by fewer seed stage deals, with an increase in the number of deals in companies at later stages of development.

There were only 449 seed stage equity deals completed between Q1 and Q3 2018, a 16% reduction compared to the same quarters in 2017. Conversely, deal numbers have increased at both the venture and growth stages this year, by 3% and 4% respectively. However, these increases are not high enough to offset the seed stage decline.

The quarterly number of seed stage deals fell below the number of venture stage deals in Q2 and Q3 2018, the first time it has done so since 2012 (Figure B.36). Beauhurst's Q3 2018 report noted 'We think investors are looking for safer bets in the current climate.'<sup>148</sup> This signals a continued need in the market for the Bank's Enterprise Capital Fund (ECF) programme, Angel CoFund and Regional Angel Programme, which all focus on supporting smaller and early stage deals.

Private Equity/ Venture Capital (PE/VC) funds continue to be the most prominent equity investor in UK SMEs overall (Figure B.37), involved in 422 equity deals so far this year (39% of all deals). The number of deals involving PE/VC investors has fallen by 11% compared to 2017, but their share of the market has remained stable over the last 3 years.

The 2018 Equity Tracker report identified that the number of crowdfunding deals recovered in 2017 following the decline seen in 2016. There were 287 crowdfunding deals completed in Q1 to Q3 2018, a 17% increase relative to the same quarters in 2017. Assuming the current trend continues, the number of crowdfunding deals is set to reach its highest level in 2018.

There were 142 equity deals involving Private Investment Vehicles (PIVs) in Q1 to Q3 2018, 37% fewer than the same quarters in 2017. Only 13 PIV deals were completed in Q3 2018, the lowest number in any quarter on Beauhurst's records and down from 66 in the previous quarter. This may reflect quarterly volatility or an unusual lag in the reporting of PIV deals for this latest quarter. The British Business Bank will continue to monitor these market developments.

The decrease in the number of seed stage deals compared to 2017 is seen across the 2 main types of equity investor (PE/VC funds and PIV). The number of seed stage deals involving VC/PE funds has fallen 38% in Q1 to Q3 2018 compared to the same quarters in 2017. Deals involving PIVs have fallen by nearly half (47%). Only crowdfunding platforms have shown an increase in the number of seed stage deals, increasing by 9% compared to a year ago.

Historically, crowdfunding platforms have focussed on funding seed stage companies with over 80% of their deals in companies at the seed stage in 2013, but the proportion of crowdfunding deals at the seed stage has shown a long-term decline (Figure B.38). Whilst most crowdfunding deals are still in seed stage companies, with 57% of deals at the seed stage in Q1 to Q3 2018, crowdfunding platforms are now increasingly being used to fund larger deals in more developed companies. This wider spread of deals across businesses at different stages is a result of crowdfunding maturing as an industry. Crowdfunding platforms continue to be an important source of funding for early stage companies and were involved in 36% of all seed stage deals in Q1 to Q3 2018.

The wider shift away from seed stage deals is also apparent when considering the size distribution of equity deals, with a movement away from the very smallest deal sizes into deals in the middle size categories (Figure B.39). Deals less than £0.5m in size form the largest single proportion of deals, but this proportion has fallen from 35% in 2014 to 24% this year. The number of deals in this bracket fell 17% in absolute terms compared to Q1 to Q3 2017, continuing the trend identified in the 2018 Equity Tracker Report.

The proportion of equity deals in the middle and upper deal size categories has steadily increased since 2013. The number of deals across all 3 of the largest deal size categories (above £2m) significantly increased in 2018, with a 19% increase compared to 2017.

FIG B.37  
NUMBER OF EQUITY DEALS, BY INVESTOR TYPE

Source: British Business Bank Analysis of Beauhurst

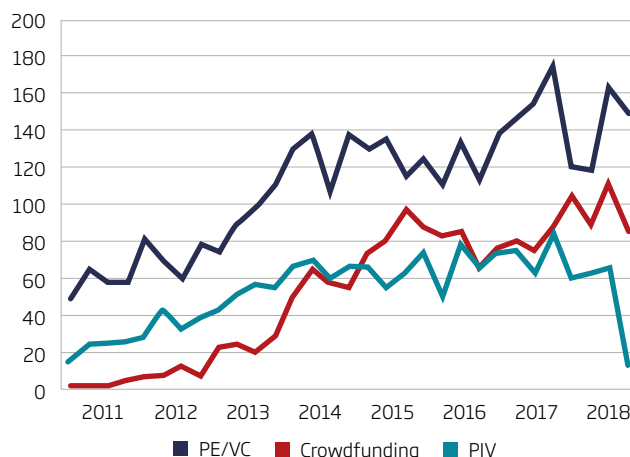


FIG B.38  
PROPORTION OF DEALS GOING TO SEED STAGE COMPANIES, BY INVESTOR TYPE

Source: British Business Bank analysis of Beauhurst

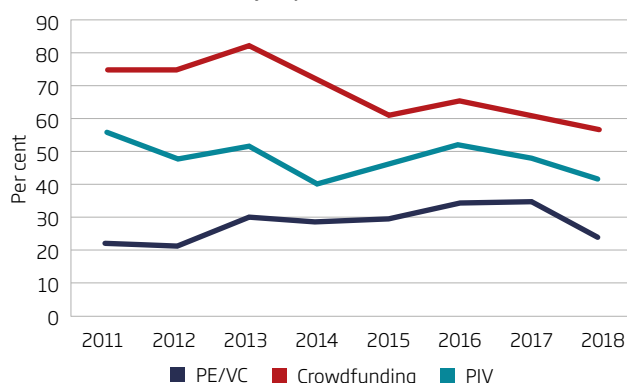


FIG B.39

**EQUITY DEALS, BY DEAL SIZE**

Source: British Business Bank analysis of Beauhurst

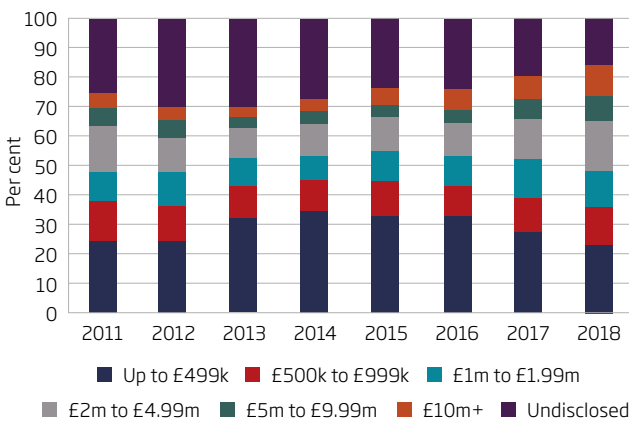


FIG B.40

**MEAN AVERAGE EQUITY DEAL SIZE, BY STAGE**

Source: British Business Bank analysis of Beauhurst

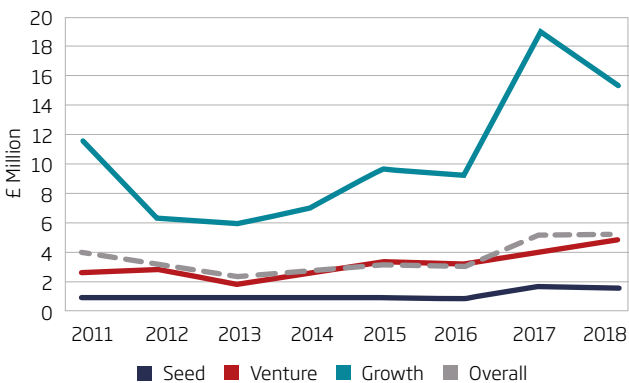
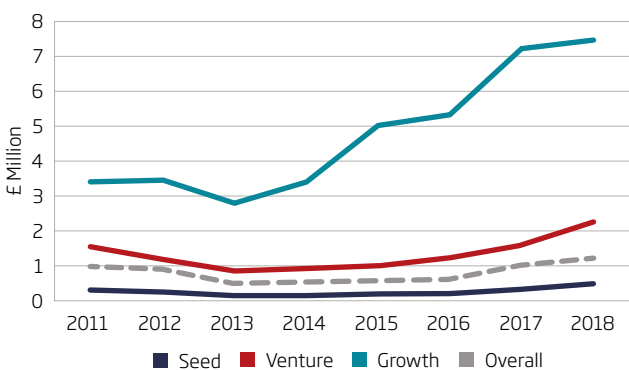


FIG B.41

**MEDIAN AVERAGE EQUITY DEAL SIZE, BY STAGE**

Source: British Business Bank analysis of Beauhurst



The share of deals without a disclosed value has also trended downwards since 2012, falling from 20% of all deals in Q1 to Q3 2017, to 15% over the same period in 2018. This is likely to be the result of improvements of Beauhurst methodology for capturing investment deal size.

The slowdown in deal numbers identified earlier combined with higher investment value implies an increase in average deal sizes (Figure B.40). The average equity deal size increased by 4%, from £4.9m in Q1 to Q3 2017, to £5.1m in over the same period in 2018.<sup>149</sup> The median deal size also increased by 20%, from £1m to £1.2m in 2018, showing an overall increase in deal sizes across a range of deals. Median deal sizes have increased across all 3 investment stages (Figure B.41), which is due to a decline in the number of the very smallest deals.

The average growth stage deal size declined from £19m to £15m (Figure B.41), reflecting the lack of very large (£300m and above) deals seen in 2018 compared to 2017. In contrast, deal sizes at the venture stage increased by 21% to £4.7m between 2017 and 2018. Seed stage deals remain at around £1.5m.

**GLOBAL VENTURE CAPITAL FINANCE MARKETS HAVE ALSO SEEN A DECLINE IN THE NUMBER OF EQUITY DEALS IN 2018**

The decline in the number of equity deals in 2018 is not unique to the UK. The US and Europe have also seen a fall in deal numbers, but with investment values remaining strong. Figure B.42 shows the decline in the number of equity deals in the UK, Europe and US using data from PitchBook.<sup>150</sup> The number of UK deals in the first 3 quarters of 2018 has fallen at a similar rate to Europe overall, but the US decline is much smaller.

Investment values are significantly up across all 3 geographies. Larger investment amounts across fewer equity deals appears to be a consistent feature of global venture capital markets in 2018. PitchBook has commented, 'the trend of high concentration of capital into fewer, larger investments has solidified into the status quo for the US VC ecosystem'.<sup>151</sup> Similarly, PitchBook describe the 2018 outlook for the European venture capital market as, 'at the current pace, we expect to see 2018 (European) deal value match or top 2017 in terms of capital invested, albeit likely across fewer deals'.<sup>152</sup> Movement away from the seed stage is a European wide trend, possibly signalling a reduction in the risk appetite of equity investors faced with increased global uncertainty or larger fund sizes being raised.<sup>153</sup>



## THE 10-YEAR FINANCIAL RETURNS FROM INVESTING IN VENTURE CAPITAL CONTINUE TO IMPROVE, WITH THE FINANCIAL PERFORMANCE OF RECENT VINTAGE VENTURE CAPITAL FUNDS NOW HIGHER THAN PUBLIC EQUITY MARKETS

Portfolio company exits are an important way for equity investors to realise their financial returns. Successful exits can occur via IPOs, trade sales or management buyouts. Investing in VC is high risk with most portfolio companies being unsuccessful (i.e. returning less capital than was invested), but the financial returns generated from the top performing VC investments can be very high.

Analysis by Top Tier, a US VC, of their portfolio confirmed financial returns are concentrated in a small proportion of their portfolio companies. Around 18 to 22% of VC investments create 80% of the total returns value of a fund, regardless of whether it is a top performing or a poorly performing fund overall.<sup>154</sup> Over half of the value of the total returns often comes from just 1 or 2 large exits. For instance, Scottish Equity Partners reportedly made 50 times return from its £9m investment in Skyscanner.<sup>155</sup> Being able to identify these 'star' investments with the most potential is important for the overall success of a VC fund.

Long-run financial returns from investing in VC continued to show improvement. The latest BVCA Performance Measurement Survey reports the 10-year horizon VC Internal Rate of Return (IRR) as 6.6% up to December 2017, up from 6.2% reported in the previous year.<sup>156</sup> Despite this improvement the gap between VC returns and public market returns remains, with the difference being 0.3%. This reflects an improvement in performance of the 10-year FTSE All Share Index, which increased from 5.6% to 6.3%. The 0.3%-point IRR premium from investing in venture capital compared to public markets is likely to not be enough to offset the increased risk and lack of liquidity involved in VC investment.

The 10-year horizon IRR for post-2002 venture funds is 8.8%, markedly above public market returns, and is the more accurate measure of current UK VC fund performance as it excludes the impact of the Dot Com bubble bursting in 2001. Post 2002 vintage VC funds have a 2.5%-point IRR premium over public markets, which is likely to be more attractive to investors.

Short-term VC returns have declined this year, with 3-year returns for VC funds established since 2002 falling from 12.7% to 8%. Short term returns, especially IRRs, are more volatile than the longer-term horizon IRRs and should therefore be interpreted with caution.

Venture returns continue to lag the returns from wider private equity, with the 10-year horizon IRR for PE at 11%. This difference is more pronounced when assessing shorter term IRRs. The 3 and 5-year PE IRR's are 21.2% and 17.9% respectively, compared to 8% and 13.3% for post-2002 VC funds, driven by the performance of buyout funds. Buyout deals are generally lower risk than VC deals due to investment in larger later stage companies and with shorter deal time horizons.

The next Equity Tracker Report, due to be published in Spring 2019, will explore VC market developments in more detail.

FIG B.42

### GROWTH IN THE NUMBER AND VALUE OF VC DEALS

Source: British Business Bank analysis of PitchBook (Data accessed 08/11/2018)

Q1 to Q3 2017 to Q1 to Q3 2018	Percentage change in number of deals	Percentage change in investment value
UK	-15%	+14%
Europe overall	-18%	+23%
US	-3%	+34%

FIG B.43

### LONG-TERM RATES OF RETURN, BY INVESTMENT CATEGORY AND SELECTED MARKET COMPARATORS (1996 ONWARDS)

Source: BVCA (2018) Performance Measurement Survey 2017

IRR (% P.A)	3-Year	5-Year	10-Year
Private Equity Overall (includes VC)	21.2	17.9	11.0
Venture Capital	7.1	13.6	6.6
Venture Capital pre-2002 vintage funds	2.6	14.9	1.3
Venture Capital 2002 vintage funds onwards	8.0	13.3	8.8
Small MBO	21.9	17.9	15.3
Medium MBO	17.3	16.8	10.3
Large MBO	23.7	18.4	11.4
<b>Selected comparators</b>			
FTSE All Share	10.1	10.3	6.3

## 2.5 DEBT FUNDS

- Private debt funds continue to have an important role in lending markets, with increases in the number of deals made to smaller businesses in the UK
- The number of venture debt deals is increasing, although the UK venture debt market is less developed than the US with fewer providers

### PRIVATE DEBT FUNDS CONTINUE TO HAVE AN IMPORTANT ROLE IN LENDING MARKETS, WITH INCREASES IN THE NUMBER OF DEALS MADE TO SMALLER BUSINESSES IN THE UK

Private debt funds make up a relatively small part of the overall lending market to businesses, but the businesses funded are likely to be aiming for high growth, and so make an important contribution to the UK economy. The UK private debt market has grown over the last few years, since its emergence in 2010, in response to tighter bank lending conditions for businesses and a low interest rate environment for investors.

Private debt funds provide bespoke debt finance offering businesses an alternative source of funding to banks. Private debt funds tend to accommodate greater levels of risk and lend at higher interest rates than banks. However, private debt funds also offer greater speed in their lending, greater flexibility in deal structure and greater leverage, which offers growing businesses an alternative source of funding.

OECD note that the private debt market originally formed in conjunction with the private equity market but is now a standalone form of financing; 'Until recently, virtually all of the private debt market was "sponsored", meaning that it was the leverage component of a private equity operation containing both equity and debt.<sup>157</sup> However, in the past 2 years the sponsor-less share of total transactions has been rising.'

There is less market data on private debt deals compared to private equity deals, in part due to private debt being a relatively young asset class in European markets. Existing private debt data providers like Deloitte, through the Alternative Lending Tracker, and Preqin, through the Private Debt Module, largely capture deals involving mid-market companies only.<sup>158,159</sup> These datasets do not yet capture deals involving smaller businesses which is the focus of British Business Bank activity. The British Business Bank welcomes suggestions for improving data on private debt deals to smaller businesses and is currently exploring this further.

The British Business Bank has played a catalytic role in supporting the development and growth of SME focused private debt funds in the UK through the Small Cap Business Finance Partnership and the Investment Programme. As at 31st December 2018, the Bank had committed £475m to 14 SME private debt funds and is involved in a significant proportion of UK private debt funds focused on lending to smaller businesses.

British Business Bank monitoring information covering the Small-Cap Business Finance Partnership and Investment Programme shows an increase in the activity of private debt funds focused on lending to smaller businesses from 2013 onwards. British Business Bank supported debt funds targeting smaller businesses lent £72m to 22 businesses in 2014, but by 2016 this had increased to £388m to 69 businesses. The number of companies funded increased in 2017 to 106 but the investment amount declined to £316m. Strong performance is seen in the first half of 2018 with 65 companies funded, suggesting continued growth in the number of deals over time (Figure B.44).

Figure B.45 shows UK mid-market private debt deals have also increased over time as shown by Deloitte and Preqin data. Both datasets have relatively similar coverage of UK mid-market deals. Deloitte shows there was 137 deals in 2017 compared to 127 for Preqin, but Deloitte identify fewer deals in 2016 (100 compared to 116 for Preqin).

**THE NUMBER OF VENTURE DEBT DEALS IS INCREASING, ALTHOUGH THE UK VENTURE DEBT MARKET IS LESS DEVELOPED THAN THE US WITH FEWER PROVIDERS**

Venture debt covers loans to early stage VC-backed companies. In return for the loan, venture lenders receive principal and interest payments together with warrants and sometimes, depending upon the contract, the right to invest in a future round. Venture debt lenders differ to traditional lenders in that they look at the current and expected performance of a business, rather than historical balance sheets to assess if a venture loan is appropriate.

Venture debt loans look to have similar characteristics to other private debt loans, but the main distinction is the involvement of the venture capitalist investor in the company. Venture debt providers are largely trading off the due diligence undertaken by venture capitalists.

Venture debt allows companies to unlock greater finance than they would otherwise have done so. Venture debt leverages further capital to increase valuations between equity rounds, reducing dilution for all current stakeholders and so enhance investor return. Venture loans can generally be arranged much more quickly than equity rounds, saving management time or meeting unforeseen financing needs. Venture debt needs to be structured correctly to avoid constraining a company's growth or becoming an obstacle to future equity rounds.

FIG B.44  
NUMBER OF COMPANIES AND VALUE OF PRIVATE DEBT DEALS FROM FUNDS SUPPORTED BY THE BRITISH BUSINESS BANK

Source: British Business Bank MI Data

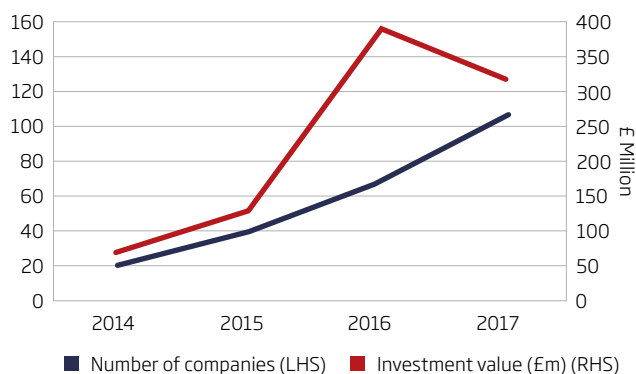


FIG B.45  
NUMBER OF MID-MARKET PRIVATE DEBT DEALS, BY DATA SOURCE

Source: British Business Bank analysis of Preqin (05/12/2018) and Deloitte Alternative Lending Autumn 2018

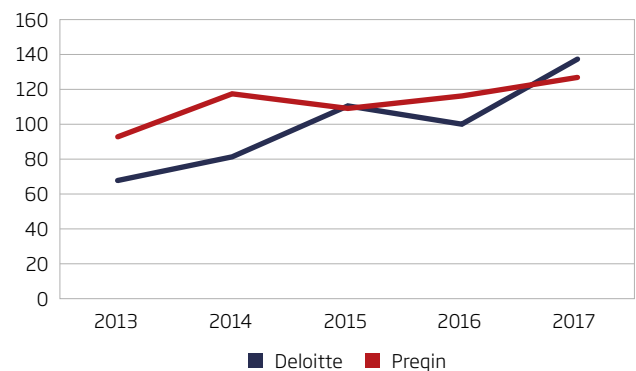
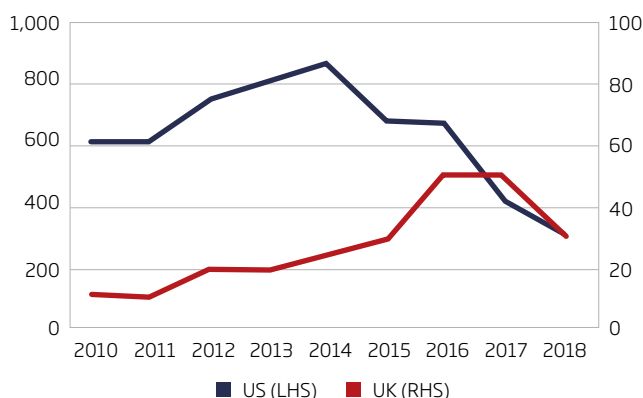


FIG B.46

**NUMBER OF VENTURE DEBT DEALS, PER YEAR**

Source: British Business Bank analysis of Preqin (15/01/2019)



Venture debt has been established in the US since the 1980s and the venture debt market in Europe has grown at an extremely rapid pace since its beginnings in the late 1990s. The number of venture debt deals in the UK has increased from 11 in 2011 to 49 in both 2016 and 2017, showing the market is expanding significantly albeit from a low starting position (Figure B.46). In contrast, the number of venture debt deals in the US market peaked in 2014 with 863 deals, before declining to 419 deals in 2017. This may reflect the wider slowdown in VC company exits (IPOs and trade sales) seen in the US market since 2014.<sup>160</sup> Lower VC exits can affect the attractiveness of using venture debt. In comparison, the number of UK VC-backed companies exiting has remained strong over the last few years. The number of venture debt deals appears to have declined in 2018, but this may be due to a time lag in deals being disclosed to Preqin and may not be a real decline.

The UK venture debt market is markedly less developed than the US with fewer providers. For instance, Preqin shows the UK has 16 active venture debt fund managers compared to 109 in the US.<sup>161</sup> As a result, venture debt use is more prevalent in the US compared to the UK.

**THE BRITISH BUSINESS BANK'S INVESTMENT PROGRAMME IS DESIGNED TO INCREASE THE SUPPLY OF FLEXIBLE DEBT TO SMALLER BUSINESSES**

Whilst private debt funding conditions remain strong for mid-market companies, structural issues remain for funds targeting smaller businesses which report ongoing difficulties in raising new funds. The British Business Bank's Investment Programme, along with its predecessor programme the Business Finance Partnership Small Cap Tranche, promotes diversity of lending supply through supporting a variety of potential finance. As of 31st December 2018, the British Business Bank has committed £475m to 14 private debt funds focusing on smaller businesses. These include funds managed by Beechbrook, BMS Finance, Boost&Co, Praesidian, Muzinich, European Capital, Harbert, Shard Credit Partners, Cordet Capital Partners, Tosca Debt Capital and Growth Capital Partners. These funds provide a range of different types of debt and will help the smaller business private debt market to build up a track record with investors.

## 2.6

ASSET FINANCE AND INVOICE  
& ASSET-BASED LENDING

- Asset finance overall has continued to grow, albeit at a slower rate compared to recent years
- Brokers continue to grow in influence
- The UK is the world's largest invoice finance market
- The number of SMEs using invoice finance has held steady, but the value of finance advanced continues to grow
- Invoice finance is still the most commonly used product, but diversity is growing in terms of the products used and the sources of them.
- New legislation enabling greater access to invoice finance is likely to benefit SMEs.

This section provides an update on developments in the asset finance (leasing and hire purchase) markets in 2018, highlighting the continued increase, albeit it at a slower rate, in new business. Asset finance continues to be the alternative finance instrument used by the largest proportion of smaller businesses surveyed in the SME FM (Q2 2018 numbers) with only bank overdrafts and credit cards more frequently used.

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 OVERALL HAS CONTINUED TO GROW, ALBEIT AT A SLOWER RATE COMPARED TO RECENT YEARS

The latest Finance & Leasing Association (FLA) figures show growth of 3% in the total value of asset finance new business in 2018, with the amount provided to SMEs also increasing by 3% (Figure B.47).<sup>162</sup> While this is significantly below the 10% growth reported in 2017 for SME asset finance new business, revised down from 12%. This likely reflects the fact UK business investment was estimated to have fallen by 1.1% to £46.9 billion between Quarter 2 2018 and Quarter 3 2018; the third consecutive quarter-on-quarter fall in business investment and the first time this has happened since the economic downturn of 2008 to 2009.<sup>163</sup>

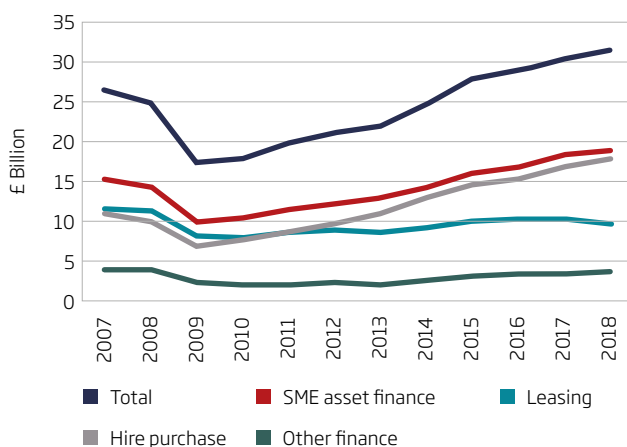
FLA also breaks down the data by asset financed. The IT equipment finance sector has seen the fastest growth (15%) while most other major SME categories experienced single figure growth. Business new car finance was the one exception, decreasing by 8% in 2018.

FIG B.47

#### SIZE OF UK ASSET FINANCE MARKET FOR BUSINESSES 2007-2018 - NEW BUSINESS

Source: Finance & Leasing Association (FLA)

Asset finance new business for deals of up to £20 million. Full year 2018 figures are provisional.



In the 2018 budget the Chancellor announced a temporary increase in the Annual Investment Allowance (AIA) from £200,000 to £1,000,000 for plant and machinery investment. This measure is designed to stimulate business investment in the economy by providing an increased incentive for businesses to invest in plant or machinery. With the measure being announced in late October and kicking on January 1st 2019, there is a possibility some SMEs may have postponed planned Q4 investment until the new year.

However, FLA provisional figures for the final quarter of 2018 showed strong growth in new business reported by the plant and machinery finance sector (17%). Market contacts have reported one possible explanation is that businesses brought forward investment as a result of the perceived increased likelihood of a disorderly Brexit.

## BROKERS CONTINUE TO GROW IN INFLUENCE

Strong competition and increasing diversity have been recurring themes in the asset finance industry in recent years, be it driven by new money and new entrants to the industry, or evolving business models such as the rise of digitalisation. In the 2017/18 Small Business Finance Markets report we discussed the decreasing share for the largest banks and the growth in captives' and non-bank books.

While the FLA data does not report data by ultimate funder type it does report data by channel. Broker-introduced finance, the fastest growing channel in 2017 (8%) continued to grow in 2018 (11%), while the direct channel grew by 3%, the same rate as in 2017 and the sales finance channel decreased by 1%. The broker channel is growing strongly, but it still has some distance to go to catch up with these other channels.

Despite this growth in the broker channel a United Trust Bank (UTB) Broker Sentiment Poll reported only 20% of asset finance brokers say they are experiencing most competition from other brokers, joint third with customer's self-sourcing funding,<sup>164</sup> 27% of asset finance brokers said they were experiencing more competition from their customers' own banks than anyone else. Direct approaches from finance providers and vendor sales teams was second (24%).

## INVOICE FINANCE & ASSET-BASED LENDING

Invoice finance & asset-based lending is a term used to describe funding against a range of business assets including accounts receivable (the debts owed to a business by its business customers, often represented by its invoices), 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 UK IS THE WORLD'S LARGEST INVOICE FINANCE MARKET

The UK is the largest invoice finance market in the world, slightly bigger than the fast-growing Chinese market and around double the size of the well-established US market (Figure B.48). The UK data is provided by UK Finance. It is estimated that UK Finance members involved in the provision of invoice finance and asset-based lending account for around 95% of the UK market (by client turnover).

Depending on how the products are defined, UK Finance estimates there are around 60 active invoice finance and asset-based lending providers of any size. The 5 largest UK commercial banks are responsible for writing around three-quarters of advances by value and supporting around 65% of the UK businesses that use invoice finance and asset-based lending. UK Finance's data includes the end of quarter stock of advances to smaller business and the number of smaller businesses utilising invoice finance and asset-based lending at the end of a quarter.

### THE NUMBER OF SMEs USING INVOICE FINANCE HELD STEADY, BUT THE VALUE OF FUNDING PROVIDED CONTINUES TO GROW

The Q3 2018 figures show that the year-to-date quarterly average number of smaller businesses utilising invoice finance and asset-based lending was little changed at 38,357 compared to 38,160 for the 2017 year-end quarterly average (Figure B.49). The number of very small businesses (turnover < £500,000) using invoice finance and asset-based lending has fallen marginally, offset by growth amongst larger SMEs, a story that continued into mid-cap and larger corporates.

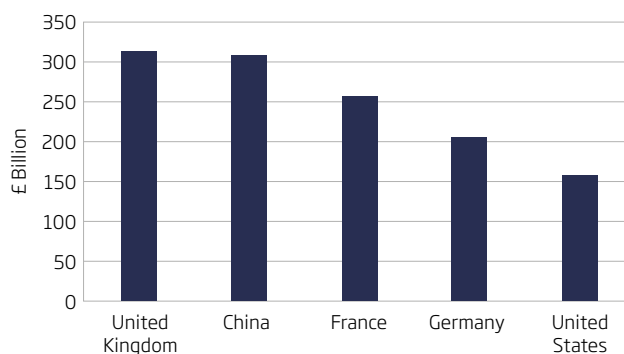
FIG B.48

### THE 5 LARGEST INVOICE FINANCE MARKETS, TOTAL FACTORING VOLUMES IN 2017 (a) (b)

Source: BCR, World Factoring Yearbook 2018

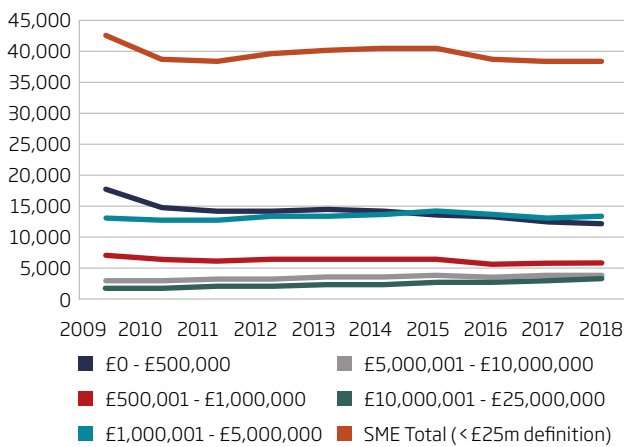
(a) This is based on "Total factoring Volumes", this is not our preferred metric but the only one reported across all the countries in the World Factoring Yearbook. Even then the definitions are likely to be non-uniform.

(b) In the UK at least, this excludes marketplace lenders and is thought to cover around 95% of the traditional receivables industry.



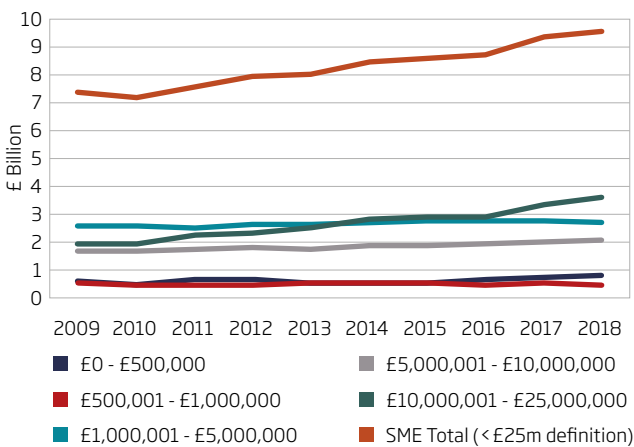
**FIG B.49**  
**NUMBER OF BUSINESSES USING INVOICE AND ASSET-BASED FINANCE, BY SIZE COHORT**

Source: UK Finance, Bank of England and British Business Bank calculations



**FIG B.50**  
**LEVELS OF QUARTERLY AVERAGE STOCK OF ADVANCES, BY SIZE COHORT**

Source: UK Finance, Bank of England and British Business Bank calculations



Despite the fall in the number of very small business using asset finance, the value of finance to them has increased (Figure B.50). This is also true for the largest SMEs. The average advance for the smallest SMEs has increased at an average of 14% a year since 2015, averaging £62,269 in 2018, up from £57,105 in 2017. The largest SMEs also recorded a small increase in the average advance whilst the rest of the size brackets experienced decreases for the first time since figures were restated in 2015. Despite this, growth remains positive when SMEs are aggregated.

**INVOICE FINANCE IS STILL THE MOST COMMONLY USED PRODUCT, BUT DIVERSITY IS GROWING IN TERMS OF THE PRODUCTS USED AND THE SOURCES OF THEM**

The most widely known types are factoring and invoice discounting (collectively referred to as invoice finance). Together they account for approximately 79% of the finance facilitated across all sizes of businesses. With many SMEs lacking the collateral traditionally required to gain access to finance, invoice finance products can be particularly important as they do not always rely on the SME owning any physical assets to act as security. Perhaps reflecting this, SMEs account for 95% of all firms using invoice and asset-based lending, according to UK Finance data.

In addition, for those smaller or less experienced SMEs, invoice finance products can bring other benefits such as shortened and more predictable payment cycles. They may also come with optional add-ons such as bad debt protection, back-end payroll support and expertise on doing business in particular industries. These can free up time and offer some protection from late payment, other poor payment practices or default risk. The most recent data shows just over 10% of the invoice finance provided in the UK is on a 'non-recourse' basis, where the financier effectively takes on the credit risk and will not recourse the debts back to the client business if they are not paid.

The remaining 21% of finance advanced mostly falls under the category of asset-based lending. Within this category, advances against stock (£867m) and advances against plant and machinery (£442m) have continued to grow, up around 50% and 70% respectively since the start of 2015. Advances against property (£102m), the third largest sub-category, has mostly trended down in recent quarters and is currently 40% down on the peak recorded in Q3 2016 and 20% down on Q1 2015.



### NEW LEGISLATION ENABLING GREATER ACCESS TO INVOICE FINANCE IS LIKELY TO BENEFIT SMEs

Previously many firms supplying goods and services to other firms were contractually restricted or even prevented from using invoice finance by their customer businesses through the imposition of so-called 'ban on assignment' clauses. These contractual clauses prevented suppliers from assigning the debts owed to them by their customer businesses (their trade receivables). The practical effect of these clauses prevented or restricted the business seeking finance from using those debts to unlock working capital from third-party financiers. These bans, through custom and practice, were relatively common in contracts, often as a by-product of wider bans on subcontracting.

They were not always actively sought or enforced by customers (the debtors) in practice. Nonetheless, those customers - who tended to be larger businesses - had little incentive to change the arrangements of their own volition, and disparities in negotiating power often made smaller suppliers reluctant to raise the issue.

The recent government intervention, the Business Contract Terms (Assignment of Receivables) Regulations 2018, to nullify the effect of such terms should now give firms greater freedom and flexibility to access invoice finance if they wish to. This measure is likely to particularly benefit smaller businesses which tended to have disproportionately suffered from the imposition of such practices. The measure only nullifies bans in contracts commencing after the legislation date so is not retrospective, but it removes a contractual barrier to invoice financing and therefore improves the ability of firms to access the full range of finance options.

Previously, invoice financiers restricted funding when there was ban on assignment. In some cases, depending on the overall composition of the sales ledger, financiers were unable to provide finance at all, or imposed extra collateral requirements or used other risk mitigation. This restricted finance or increased the costs of provision.

With nullification the expectation is demand will rise from SMEs that do not currently apply for invoice finance, along with the invoice finance sector being able to provide more finance to more businesses. In addition to increased funding, with less due diligence required, a BEIS impact assessment also found the policy could result in a lower cost of finance should these savings be passed on by the finance provider.

## 2.7 MARKETPLACE LENDING

- Marketplace lending continues to grow
- Regulatory environment a strength for the industry in the UK
- Innovative Finance ISA helping to boost retail funding
- MarketInvoice partnership with Barclays and Funding Circle IPO signs of a maturing market

Marketplace lending is a term used to describe the market mechanisms, usually online, that link lenders and borrowers. This section reviews developments in this market, with a focus on business lending, using information from Brismo. Brismo, formerly AltFi Data, covers Peer-to-Peer (P2P) consumer, P2P business, P2P property and invoice financing. This section focusses on P2P business lending and invoice financing, which is predominantly to SMEs, whilst equity crowdfunding is covered in section 2.5 Equity finance.

### MARKETPLACE LENDING CONTINUES TO GROW

Marketplace lending values continue to grow. According to Brismo, total lending in 2018 exceeded £6.2bn, an increase of 21% on 2017.<sup>165</sup> This brings the total originated to £20bn since Brismo started recording data in 2011 (Figure B.51). Of the £6.2bn, business lending is the largest sub-category and accounted for nearly £2.3bn, significantly above the £1.8bn of consumer marketplace lending in 2018, and an increase of 18% on 2017 (Figure B.52). Whilst the percentage increases for both total marketplace lending and business lending are well below previous years this partly reflects the fact the industry is no longer in its infancy.

Marketplace facilitated lending against invoices (receivables) recorded the most significant growth in 2018. This was up 105% on the previous year and contributed an additional £1.1bn of finance to SMEs (Figure B.53).

Much of the increase in invoice finance has been provided by MarketInvoice. This has in part been driven by the introduction of confidential invoice discounting and business loans products last year. Confidential invoice discounting is a whole ledger invoice discounting facility more commonly offered by traditional invoice finance providers.

FIG B.51  
GROSS UK MARKETPLACE LENDING  
Source: Brismo and British Business Bank calculations

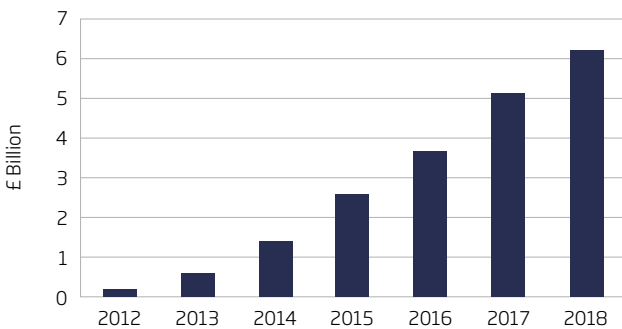
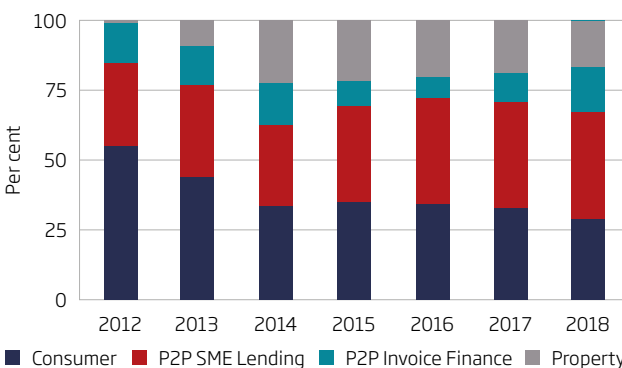


FIG B.52  
GROSS UK MARKETPLACE LENDING, SPLIT BY TYPE  
Source: British Business Bank analysis of Brismo data



Awareness of P2P lending and crowdfunding platforms continues to grow. In 2018, 52% and 70% of respondents respectively said they were aware of these platforms, up from 47% and 60% and much higher than when the Business Finance Survey started in 2012 (Figure B.54).

**REGULATORY ENVIRONMENT A STRENGTH FOR THE INDUSTRY IN THE UK**

According to the latest data reported by the Cambridge Centre for Alternative Finance (CCAF), the UK is the third largest marketplace lending market in the world behind China and the US (Figure B.55). Despite starting out at roughly the same time, these 3 markets are all at very different stages and this is predominately driven by regulation or lack thereof.

The UK accounts for around 77% of EU volumes. In general, the UK legal and regulatory frameworks are considered a key strength for the UK finance sector. Whilst there has been increased regulation for marketplace lenders in recent years, and there are further changes in the pipeline, it has been mostly considered positive. The regulatory environment and leadership from industry bodies such as the Peer2Peer Finance Association (P2PFA) has allowed for multiple business models whilst avoiding the issues seen in countries such as China.

China’s alternative financing volume equated to over 99% of the total Asia-Pacific alternative finance market’s size in 2017 and is estimated to equate to around 86% of the total global market. Despite a number of widely reported issues with the marketplace lending industry in China, including fraud and investor protests in the streets, the industry has continued to grow rapidly.

In China, regulators were slow to address marketplace lending when it first emerged, leading to plenty of opportunities for fraud which both lenders and borrowers have exploited. WDJ.com, which provides daily data on various Chinese P2P companies, suggests there are around 1,500 operating in China currently, but a much-delayed licensing framework looks set to slash this number. Market commentators and surveys alike have suggested as few as around 50 may survive once new regulations are fully introduced.

The US is the second largest market currently and represents around 98% of the total Americas alternative finance market. The fintech sector is largely regulated by individual states with the industry attempting to self-regulate transparency, disclosure and standards.

Within the US, newly incorporated marketplace lenders peaked in 2013. CCAF reports regulatory agencies have since tightened their policies and increased the number of requirements for new alternative finance companies entering the market. Newer entrants have struggled to pass regulatory hurdles both at federal and state levels while raising capital for growth and expansion and US lenders have long relied on institutional funding.

FIG B.53  
Y-O-Y GROWTH IN TYPES OF P2P LENDING

Source: British Business Bank analysis of Brismo data

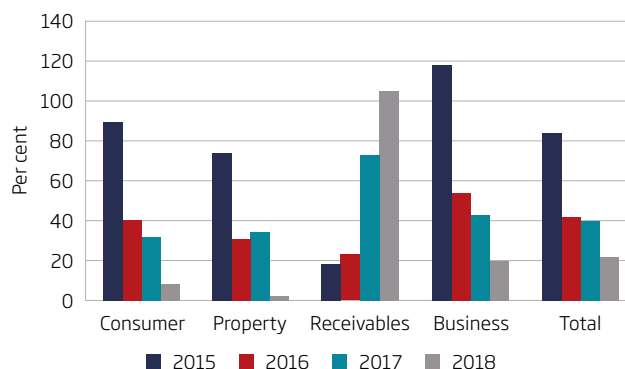


FIG B.54  
SME AWARENESS OF ALTERNATIVE FORMS OF EXTERNAL FINANCE

Source: BDRC Continental SME Finance Monitor

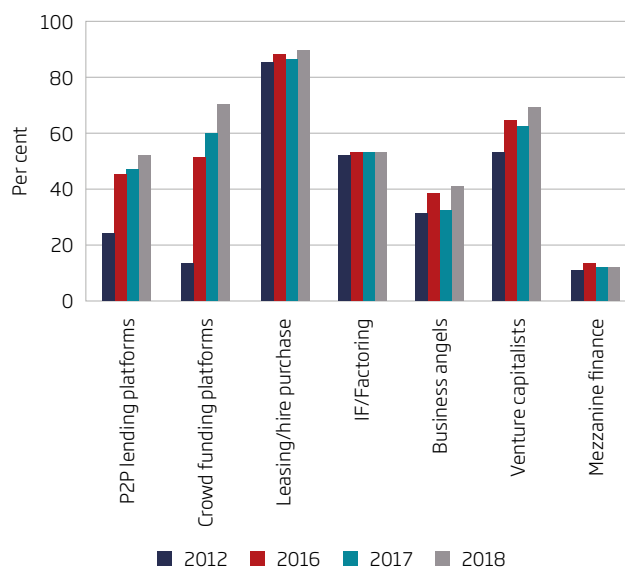


FIG B.55  
VOLUMES OF DEBT-BASED MARKETPLACE BUSINESS LENDING

Source: Cambridge Centre for Alternative Finance

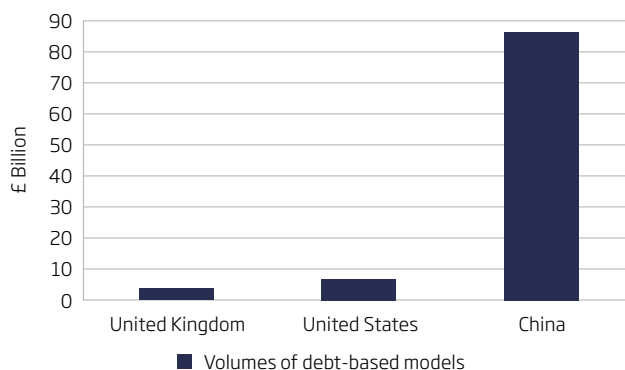
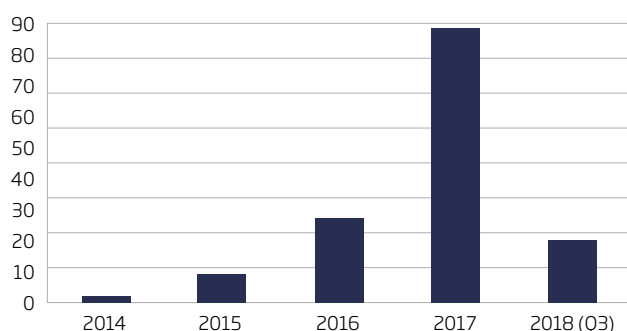


FIG B.56  
MARKETPLACE LENDERS, NEW AUTHORISATIONS

Source: FCA



### INNOVATIVE FINANCE ISA HELPING TO BOOST RETAIL FUNDING

An innovative finance ISA - sometimes called an IF ISA - is an ISA that contains marketplace loans instead of cash or stocks and shares and typically sits between these 2 ISAs in terms of risk and return profile. Launched in April 2016 there were initially limited offerings from the major marketplace lenders, partly because providers require authorisation from the Financial Conduct Authority (FCA) before they can launch an ISA, but they are now much more widely offered.

When the IF ISA was launched there were only 8 FCA authorised marketplace lenders. Since then, a further 57 have received authorisation. New authorisations peaked in 2017 when there were 39 granted, but this appears to have now slowed down with 9 new authorisations in 2018 up to the end of Q3 (Figure B.56).

According to HMRC figures, only 2,000 IF ISA accounts were opened in the 2016/17 tax year, attracting £17m but this has since picked up. In July 2018 the P2PFA reported that 28,000 IF ISA accounts have now been opened by customers of 6 of their member platforms, with more than £300 million already under management. This could yet prove a drop in the ocean as some large marketplace lenders are reportedly targeting £500m in a single year.

As marketplace lenders have become more reliant on institutional money this has opened a potentially significant source of retail funding, but it does come with some challenges. Some marketplace lenders have either started waiting lists or closed IF ISAs to new customers as they attempt to balance demand from investors with borrowers.

## MARKETINVOICE PARTNERSHIP WITH BARCLAYS AND FUNDING CIRCLE IPO SIGNS OF A MATURING MARKET

As the marketplace lending market in the UK continues to mature, 2 significant events occurred in 2018. In August, MarketInvoice and Barclays announced a tie up, the first of its kind in the UK. Barclays Bank have taken a minority equity stake in the marketplace invoice financing platform and are rolling out the service to its large SME client base.

The proposition was initially introduced to Barclays' SME clients in areas across the UK, including the East Midlands, West Midlands, Hertfordshire and North West London, with a full roll-out set to commence nationwide in 2019. Barclays also plans to fund invoices via the platform in the future, growing its asset base in the small business segment further.

The second milestone was the Funding Circle IPO in October making it the UK's first marketplace lender to go public and valuing the company at £1.5bn. This is yet another first for the Funding Circle having been the first in the UK to securitise its business loans in 2016.

# GLOSSARY

## ASSET FINANCE

The use of credit or leasing facilities provided by a leasing provider to finance the acquisition of assets. The asset finance provider will normally require security to be taken on the asset itself and the cost of the asset finance arrangements is spread over the life of the asset.

## ASSET-BASED FINANCE

Funding against a range of business assets including accounts receivable, inventory, plant and machinery, real property and even intellectual property and brands. The most common types of asset based finance include factoring and invoice discounting (collectively referred to as invoice finance) and asset-based lending.

## BANK CAPITAL REQUIREMENTS

Standardised requirements for banks, whereby they must hold liquid assets for a certain level of total assets. These are enforced by regulatory authorities.

## BUSINESS ANGELS

A high net worth individual who provides financing to small businesses in exchange for an equity stake in the business. Business angels are often thought of as a bridge between loans from family and friends and venture capital. Business angels may also provide expertise in helping to run the business.

## BUSINESS CHURN

The rate at which new businesses start-up and existing business close over a period of time. In a competitive economy, business churn can help to facilitate economic growth as inefficient businesses close down and are replaced by efficient ones.

## CAPITAL MARKETS

The market where debt and equity instruments, such as stocks and bonds, are issued, bought and sold. Institutions and some businesses can use primary capital markets to raise funds by issuing bonds and equity.

## CHALLENGER BANKS

Banks outside of the 4 largest UK banks (or 5 if Santander is included), which provide competition to these existing banks. Challenger banks include new entrants to the market, spin-offs or dis-investments from large banks and existing smaller banks seeking to grow. Some are regionally based, whilst others provide only personal or small business banking rather than the wide range of services provided by the larger banks.

## COLLATERAL

Assets pledged by the business as security for a loan, so that in the event that the borrower defaults, the collateral may be sold, with the proceeds used to satisfy any remaining debt obligations.

## CORE BANK LENDING PRODUCTS

Traditional forms of external finance which include: Bank loans, overdrafts and credit cards.

## CROWDFUNDING

Equity Fundraising for businesses where relatively small amounts of money are lent or invested by large numbers of individuals, typically facilitated by an online platform.

## DEBT FUNDS

A limited liability partnership which invests in businesses using debt instruments. Debt funds often provide businesses with bespoke debt finance that is used by 'event driven' growth orientated companies.

## DISCOURAGEMENT

Businesses which would like to borrow but which do not apply for bank finance because they either feel they would be turned down ('indirectly discouraged'), or they've made informal enquiries but not proceeded with their application because the bank seemed reluctant to lend ('directly discouraged').

**ENTERPRISE INVESTMENT SCHEME (EIS)**

This is a tax relief scheme designed to increase the amount of equity finance available to high growth potential businesses by offering investors tax relief.

**EQUITY GAP**

An estimated range of equity deal sizes which receive relatively little investment from private investors, due to structural issues which make it commercially unviable to undertake smaller deal sizes due to the fixed costs of undertaking due diligence.

**EXTERNAL FINANCE**

Money obtained from lenders or investors outside of the business and its directors with an expectation of a financial return for making the funding available.

**FINTECH**

Finance providers or financial service providers which use technology and /or innovative delivery and assessment models.

**FLOWS OF FINANCE**

The Gross flow of finance is the movement of money from lenders or investors to businesses or individuals (businesses only in this report) over a period of time. The net flow refers to the gross flow, net of repayments over the same time period. For instance the gross flows of bank loans refers to the value of new loans issued over a certain period, whereas the net flow of bank loans is the value of new loans minus the value of repayments over the same period. In theory, the net flow of bank lending over a certain period should equal the change in the stock over the same period, excluding any other adjustments.

**FUND MANAGER**

A fund manager is responsible for implementing the fund's investment strategy and managing its portfolio.

**GROWTH CAPITAL**

Equity investment used for more developed, profitable companies looking to expand or enter new markets.

**HIGH GROWTH FIRM**

There is no single definition of a 'high growth' firm. The ONS define high growth firms as 'All enterprises with average annualised growth greater than 20% per annum, over a 3-year period. Growth can be measured by the number of employees or by turnover.'

**HIGH NET WORTH INDIVIDUAL**

High net worth individuals are people that have high income and/ or high net assets. These people are often entrepreneurs who become angel investors.

**HIRE PURCHASE (HP)**

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

**INDUSTRIAL STRATEGY**

The aim of the Government's Industrial Strategy is to boost productivity, create jobs and increase wages across the UK with investment in skills, industries and infrastructure.

**INITIAL PUBLIC OFFERING (IPO)**

The first time a private owned company sells its shares publicly on a listed stock exchange.

**INSTITUTIONAL INVESTMENT**

These are typically large organisations that make investments in debt or equity funds as part of a wider portfolio of investments across different asset classes. For example, investment banks, insurers, pension funds and hedge funds.

**INTANGIBLE ASSETS**

Intangible assets are assets which are not physical in nature and encompass Intellectual Property, research and development, reputation and software amongst others.

**INTELLECTUAL PROPERTY**

Intangible and non-physical goods, which can include names, ideas and computerised information. Ownership of intellectual property can be asserted using Intellectual Property Rights.

**INVESTMENT PIPELINE**

Investment pipeline in this context refers to the different stages in the process undertaken by VC firms to evaluate prospective investment opportunities.

### INVESTMENT COMMITTEE

Investment committee is a formalised stage in the VC investment process where the committee members make a final decision, subject to legal agreements, whether to progress with a prospective investment

### INVOICE FINANCE

When a third party agrees to buy a business's unpaid invoices for a fee. There are 2 types of invoice financing; Factoring and Discounting. Factors - factoring finance providers - purchase a businesses' unpaid invoices and advance most of the value of the invoices, with the balance less any charges paid when the invoices are paid by the end customer. Factors also manage the sales ledger and collect payment from the end customer. Discounting is like factoring except the client business retains control over managing the sales ledger.

### LEASE FINANCING

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

### LOCAL AUTHORITY DISTRICT (LAD)

These are sub-regional authorities that make up local government.

### LOCAL ENTERPRISE PARTNERSHIP (LEP)

These are partnerships between local authorities and businesses across England. There are currently 38 LEPs operating across England whose responsibility it is to generate growth in the area.

### MANAGEMENT BUYOUT (MBO)

The senior management of a company buying a large part of the company's shares. The management of the company will not usually have sufficient money to buy the company outright themselves, but will use Private Equity funding to support the purchase.

### MARKET FAILURE

A situation whereby the market does not allocate resources efficiently. Failures result in a loss of economic welfare which could be captured if the market was working effectively.

### MARKETPLACE LENDING

Marketplace lenders are online platforms that enable investors to lend to retail and commercial borrowers. Unlike banks Marketplace lenders do not take deposits or lend themselves; as such they do not take any risk onto their balance sheets. They make money from fees and commissions received from borrowers and lenders.

### MEZZANINE FINANCE

A form of debt-finance finance that combines features of both debt and equity in a single instrument. Whilst there is no single model, mezzanine debt usually contains 3 distinct features: cash coupon; payment-in-kind or PIK, which is only paid at the maturity of the loan; and, warrants or a share in the profits or growth of the company.

### MID-CAP BUSINESS

Mid-cap businesses are larger than SMEs and cover businesses with an annual turnover of between £25m-£500m, but have not yet reached the size of the largest businesses. The UK Government defines SMEs according to the number of employees (249 employees or less), and so there is some possible overlap between the 2 definitions for some businesses.

### NON-AMORTISING

Payments which only the interest on a loan or the minimum payments are met, meaning the value of the original amount (capital) does not decrease until the loan matures.

### PATIENT CAPITAL

Provision of funding to businesses that are capital intensive with long product lead times, typically but not exclusively in life sciences, clean technologies and advanced manufacturing sectors. Patient capital funding follows on from proof of concept and early stage R&D grant funding, and covers both debt and equity finance.



### PEER-TO-PEER LENDING (P2P)

Peer-to-peer lending involves the use of internet-based platforms to match online lenders with borrowers. This can be broken down into business lending, property lending and consumer lending. Peer-to-peer lending platforms make money from fees charged to the borrower and/or from commission on the interest received by the investors.

### PRIVATE EQUITY (PE)

Equity ownership in a business that is not publicly-traded. Private equity involves fund managers investing in privately held companies using institutional money. Venture Capital is a type of Private Equity finance.

### PUBLICLY LISTED COMPANY (PLC)

A company with shares that are traded on the open market, through a stock exchange. Individual and institutional shareholders constitute the owners of a publicly listed company, in proportion to the amount of shares they own as a percentage of all outstanding shares.

### SECURITISATION

A financial technology which pools individual illiquid assets into liquid financial securities that can be sold on. It is used by lenders to raise funds and manage their risk exposure.

### SEED CAPITAL

Equity investment generally used for R&D, and initial concept or product development. Usually businesses receiving the investment are pre-revenue.

### SEED ENTERPRISE INVESTMENT SCHEME (SEIS)

This is a tax relief launched in 2012 to encourage investors to finance early stage start-ups. The company must be under 2 years old and it must have fewer than 25 employees.

### SME/SMALLER BUSINESSES

These terms are used interchangeably in this report. This typically refers to businesses which have less than 250 employees. An alternative definition is businesses which have an annual turnover of less than £25m.

### START-UP, SCALE-UP AND STAY-AHEAD

This relates to the British Business Bank segmentation of SMEs, based on broad financing requirements. Start-up solutions focus on enabling business set-up, scale-up on business growth and stay-ahead schemes are generally aimed at businesses aiming to retain or enhance their position. When considering in the context of analysing available survey data, start-ups are classified as trading for no more than 5 years, scale-up and stay ahead businesses are defined as those trading for more than 5 years, with scale-ups reporting an ambition to grow.

### STOCK OF LENDING

The total value of outstanding debt at a given point in time.

### TRADE CREDIT

An agreement between a buyer and seller, whereby the buyer of the goods or service does not need to pay for those goods or services immediately but can delay the payment for an agreed period of time. This can help alleviate the cashflow of the buyer.

### VENTURE CAPITAL (VC)

The provision of funding to a start-up or young business with high growth potential. Venture capital differs to business angels in that venture capitalists other people's money (mainly institutions).

### WORKING CAPITAL

Money used for the day to day cash flow operations of a company.

## ENDNOTES

1. Changes include prices, investment, staffing, exporting or other changes.
2. External finance includes overdrafts, credit cards, bank loans, commercial mortgage, 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.
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11. Equity finance is also provided through public markets, but this is not the focus of this report.
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34. For examples of articles discussing this: <https://moneyweek.com/464099/billions-from-boffins-how-to-profit-from-university-spin-out-companies/>, <https://www.theguardian.com/education/2004/aug/18/highereducation.uk1>
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120. Financing SMEs and entrepreneurs 2018: An OECD Scoreboard, 2018, <http://www.oecd.org/cfe/smes/financing-smes-and-entrepreneurs-23065265.htm>
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127. The banks granted a UK banking licence in 2017 were Redwood Bank, Barclays UK and Europe, Civilised Bank, The Royal Bank of Scotland International (London branch), HSBC UK Ring Fenced Bank (RFB), Lloyds Bank Corporate Markets, State Bank of India, Sumitomo Mitsui Corporation London Branch, Agricultural Bank of China London Branch, Baroda (UK) Operations, Shanghai Pudong Development Bank and Chetwood Bank.
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# NOTES

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