

RESEARCH REPORT

Analysis of the UK Smaller Business Growth Loans Market

March 2015

www.british-business-bank.co.uk

Contents

Executive Summary	3
Chapter 1: Economic Context	12
Chapter 2: Findings from UK research.....	20
Chapter 3: Overseas Institutions Delivering Growth Loans.....	47
Chapter 4: Conclusions	53
References	55
Glossary of Terms	58
Acknowledgments.....	58
Legal notice	60

Executive Summary

Introduction

Smaller businesses are important to the success of the UK economy, contributing to new job creation and innovation through new and improved products and services. Ensuring growth potential smaller businesses have access to appropriate sources of external finance is vital if these businesses are to realise their full growth potential. This is particularly important as the UK economic recovery continues, and businesses look for new market opportunities and undertake significant new investment.

Senior debt from a bank or peer to peer lending platform meets the financing needs of the majority of businesses seeking external finance for working capital and investment. However, senior debt providers typically require collateral and high growth businesses can soon exhaust their available collateral. In addition, interest payments on senior debt can constrain the cash flow of growth orientated businesses in the early stages of growth.

In these circumstances, venture capitalists or business angels may provide funding to viable high growth companies but in return, will require an equity stake in the business. For some smaller businesses, giving up a significant equity share is a disincentive and the owners would rather sacrifice their growth.

Growth loans offer an alternative to senior debt and equity finance. It offers a possible funding solution to growth orientated companies that are too risky for senior debt or lack collateral but are not able to generate sufficiently high returns to attract equity finance or where the business owner wants to avoid or minimise their equity dilution.

The purpose of this paper is to examine the finance market for growth loans to UK smaller businesses.

Research objectives

The Government's concern over the supply of growth loans to support growing smaller businesses is not a recent phenomenon. The 2009 Rowlands Review¹ identified a funding gap in the supply of growth capital for funding amounts of between £2m and £10m and suggested mezzanine finance may offer a solution to the gap. In response to the Rowlands Review findings, the Government worked with some of the UK's largest banks to establish the Business Growth Fund (BGF). BGF invests using a minority equity stake and has helped increase the supply of growth capital for deal sizes of £2m to £10m for businesses with turnover of between £5m and £100m. However, many of the issues raised by the Rowlands Review appear to be relevant today, especially for smaller growth loans of below £2m.

¹ BIS (2009) "The Provision of Growth Capital to UK SMEs"

The purpose of this research paper is to assess the market for growth loans to UK smaller businesses to answer the following questions:

- What are growth loans and what type of businesses are most suitable for this type of finance?
- How many smaller businesses have characteristics that make them suitable for growth loans? Is there actual demand for this type of finance or is demand latent?
- What is the current supply of growth loans to smaller business? What is the structure of the market?
- Does the British Business Bank need to intervene in this market?

There is currently limited research and statistics available on the growth loans market, especially for smaller businesses. In order to understand the market, and to inform the design of any future British Business Bank funding solution, the need for new primary research was identified. In-depth qualitative interviews were undertaken with finance providers in spring 2014 including banks, private debt funds focusing on mid-market and smaller businesses, smaller businesses themselves, and other organisations with an interest in small business financing to provide an overview of the issues. The research was updated in spring 2015 with a number of additional interviews with new and previous interview participants to assess if the market had changed since 2014 and this was also supplemented by additional secondary data analysis.

Research Findings

What are growth loans?

Growth loans are bespoke debt-based finance that goes beyond senior debt in terms of its risk appetite and higher pricing and is used to support business growth and development. Growth loans include a variety of debt funding solutions including unitranche, mezzanine, subordinated debt, junior debt and second lien.² Growth loans are typically unsecured or the security is subordinated behind senior lenders, or is based on intangible assets like patents and other intellectual property.

Mezzanine finance is a type of growth loan structured as debt finance, but shares some of the characteristics of equity finance as a certain proportion of the financial return is variable and depends on the future success of the business and its ability to expand. Whilst there is no single model, mezzanine debt usually contains three distinct features:

- Cash interest (similar to interest paid on a conventional loan)

² See the glossary at the back of the report for definitions.

- Payment-In-Kind (PIK) interest, which is interest paid at the loan maturity or when refinanced
- Variable share of the business upside taken through either an equity warrant or a levy on the profits or growth of the company.

Mezzanine finance is a flexible product that can be tailored to the risk and repayment profile of the business to avoid over burdening the business with interest payments in the early stages of growth.

The expected financial returns from investing in growth loans lie between senior debt and equity. Whilst equity investors are looking for an Internal Rate of Return (IRR) in excess of 20-30%, and debt interest rates are currently in the region of 4-5%, growth loan investors are aiming for overall returns in the region of 8-20% comprised of interest and possible performance related payments.

The mid-market definition of mezzanine focuses on the mezzanine tranche used in Private Equity sponsored buyouts to bridge the funding gap between senior debt and equity. However, mezzanine instruments can also be used as growth capital to fund growing owner managed businesses that have exhausted the availability of security to take on additional senior debt, but have sufficient cash flows to service additional debt. The focus of this research paper is on the latter use of mezzanine loans to support growing businesses rather than supporting changes in business ownership.

What types of smaller business is it suitable for?

Whilst senior debt from a bank or a peer to peer lending platform meets the funding needs of the majority of businesses seeking external finance, growth loans are a niche funding solution that are only suitable for a small proportion of businesses. The providers consulted suggest growth loans are most suitable for:

- Established businesses with a strong balance sheet that are generating cash revenues.
- Businesses looking to significantly expand in order to pay the deferred interest and increased value of equity stakes (for mezzanine finance).
- Businesses that have exhausted their tangible collateral or have no physical collateral to offer.

Growth loans are also used by businesses that are not willing to give up equity or a majority equity stake, such as family owned businesses, either in isolation, or alongside private equity providers in order to reduce dilution of their equity shares. Alternatively, it may be too costly or time consuming to raise small amounts of equity finance.

What is the existing level of demand?

Smaller businesses awareness of growth loans is currently very low, especially compared to other types of external finance. Interviewees consulted as part of this research suggest that businesses do not specifically seek mezzanine products and will only approach specialist debt providers if they cannot get finance from a bank. Fund managers report the main referral route is often through commercial finance brokers or Private Equity funds as part of a sponsored deal. Fund managers report businesses perceive mezzanine finance to be “expensive debt rather than cheaper equity finance”.

British Business Bank analysis suggests there are around 16,000 companies in the UK that have characteristics that make them potentially suitable for growth loans. However, not all of these businesses are likely to be requiring funding at any one time. The majority of these businesses are also likely to be served by existing finance providers such as banks or peer to peer lending platforms. Further analysis suggests around 500 businesses per year might require growth loans, as they are currently not being funded by existing finance providers or are being sub-optimally funded/ having difficulties obtaining senior debt funding, or are discouraged from applying for finance.

Whilst the number is relatively small out of the total population of smaller business, it is important to remember that these businesses are established growth orientated businesses that are very important to the success of the UK economy. The funding gap is likely to change over time, as current demand for external finance is low, but business demand is likely to increase in the future as confidence to invest increases.

What is the supply of growth loans?

The current use of mezzanine finance by smaller businesses is very low, with less than 0.5% of all smaller businesses having used mezzanine finance in the last 3 years.³

The growth loan market can be segmented into four main types of providers:

- Mid-market focused private debt funds.
- Private sector smaller business focused debt funds.
- Publicly backed smaller business focused debt funds.
- Other growth lenders comprising of private lenders and Venture Capital Trusts (VCTs).

The British Business Bank estimate that in 2014 the total supply of growth loans to smaller business to be in the region of £60m for deals sizes of less £2m but higher in scale for deals between £2m and £5m.

³ British Business Bank (2014) “2014 SME Journey towards raising finance”

Mid-market focused private debt funds

Mid-market funds tend to operate as “debt solution providers” providing a range of flexible debt products. These funds attract large scale investment from institutional investors like pension and insurance companies and are typically several billion pounds in size. The minimum investment size of these funds is at least £10m, although they tend to do larger deals in the region of £20m-£30m in practice to corporate businesses that are larger than smaller businesses.

There has been significant new entry in the private debt market in Europe in the last few years from new funds, in response to the decline in bank lending to corporate businesses. This means funding conditions in the European mid-market are now a lot more competitive than previously, with a range of different finance providers. There does not appear to be a strong case for the British Business Bank to increase growth loan activity at the mid-market at this time beyond finance provided through the Mid-cap Business Finance Partnership.

Private sector smaller business focused debt funds

Below the mid-market level there is a smaller number of private sector debt funds focused on providing growth loans for deal sizes below £10m to smaller businesses. The minimum size of investment that these funds are willing to undertake is generally around £5m, although a few funds do go lower.

There has been some new entry by private sector funds in this segment of the market, but funds targeted at smaller businesses report greater difficulties in raising funding from institutional investors than larger funds targeting mid-market deals. The Small-Cap Business Finance Partnership and Investment Programme operate at this end of the market to increase diversity in supply. The Business Growth Fund also provides between £2m and £10m of growth capital.

Publicly backed debt funds

There are a number of existing publicly backed funds including the Scottish Loan Fund, Northern Ireland Growth loan funds and a number of JEREMIE loan funds currently providing growth loans to smaller businesses seeking between £250,000 to £5m. The majority of these funds have been established since 2009 in direct response to the recession and credit crunch, and are limited to funding businesses that meet the EU definition of a small business due to State Aid restrictions.

Many of these funds have economic development objectives alongside their commercial objectives. Fund managers of publicly backed funds report these funds have an important role in the market, as there are no other funds providing growth loans and these growing companies would otherwise go unfunded. However, the financial performance of these funds is not yet known as they are still relatively young, and are operating in a difficult part of the market to make high financial returns.

Other

There are other sources of private debt funding for growth loans below £2m made up of individuals investing their own money, who act in a similar way to business angels, but structure their deals as debt rather than equity. It is difficult to estimate the number of these individuals as they tend to be “under the radar” and “will only invest if the right deal comes along”.

Several fund managers commented that the lower end of the growth loan market is also covered by Venture Capital Trust (VCT) schemes, where tax relief and downside protection to investing makes it attractive to investors to invest in smaller companies. VCTs address the growth capital funding gap predominantly through an equity instrument, but are able to structure a significant proportion (up to 30%) of their deals as debt or mezzanine.⁴

Is there a market gap?

A number of respondents reported that banks previously provided growth loans directly and indirectly through senior debt funding higher risk businesses, which then restricted the development of alternative debt suppliers. Changes in banks’ collateral requirements, maximum lending multiples and margins over time may provide an indication of this change in risk appetite but it is not possible to empirically prove this.

However, the consulted fund managers and business representative organisations suggest that since 2007 banks have tightened up their lending criteria and credit assessment criteria compared to the early part of the decade. Despite funding conditions for mid-market businesses and medium sized businesses beginning to improve in 2014, stakeholders acknowledge that external factors like tighter regulatory capital requirements have led banks to be more risk adverse, creating space in the market for new growth loan providers. Fund managers suggest the recent improvement in the availability of debt finance seen in 2014 has not yet filtered down to smaller businesses.

Whilst banks report that they fund all viable businesses based on their assessment of the business ability to repay with availability of collateral being a secondary consideration, both banks themselves and other providers report there is space in the market for additional specialist lenders to target businesses that fall outside of banks’ existing lending criteria. Fund managers report that there are incidences of viable growth businesses not being able to get senior debt finance and this provides evidence of a “funding gap”. Fund managers also suggest that the observed demand from smaller businesses for higher priced growth loans proves there is a funding gap that senior debt providers are currently unable to meet.

Since the recession, there has been limited entry to date by new growth loan providers targeting smaller business, especially for smaller deals. In particular,

⁴ <http://www.hmrc.gov.uk/guidance/vct.htm>

market commentators suggest there is gap in provision of growth loans at the sub £5m level but the size of the gap is difficult to quantify with any precision.

British Business Bank analysis that subtracts current market supply in 2014 from potential market demand suggests the potential funding gap for growth loans up to £2m is in the range of £170m to £870m per year depending on the average deal size. The gap could be considerable larger when deals in the range £2m to £5m are considered. Whilst the size of the gap is relatively small in relation to the total amount of capital in the economy, it is important to acknowledge that the businesses affected by this funding gap are established growth orientated businesses that are important to the UK economy. The scale of the gap is also likely to increase in the future as business demand for finance increases from its current low levels.

Is there a market failure?

There may be good commercial reasons for a lack of growth loans to smaller businesses. For instance, it is widely acknowledged by fund managers that smaller growth loans are higher risk than senior debt deals in larger businesses due to their higher probability of default and lower recovery of assets should things go wrong. Fund managers also report smaller deals require additional resources for building up an extensive referral network, which makes it less attractive than undertaking a smaller number of larger deals.

However, fund managers report there is the potential for generating good finance returns from mezzanine finance, especially for the level of risk taken compared to other investment strategies. Consultation with stakeholders has revealed the existence of a number of structural market failures that lead to a sub-optimal supply and demand of growth loans to smaller businesses. The issues can be grouped into three main types:

- **Information Failures:** Information is needed for markets to work effectively.
- **Co-ordination Failures:** Limitations within the economic system prevent agents from coordinating their plans.
- **Impact of Regulations:** Financial regulations make unsecured lending to higher risk businesses more costly in terms of their treatment of capital.

Information Failures

Imperfect information leads to fund managers incurring costs in obtaining information about businesses investment prospects. This issue particularly affects smaller businesses as relatively more information is freely available or at least readily attainable on the viability and potential returns of larger businesses. Whilst theory suggests the fixed costs of undertaking due diligence does not vary by the size of the loan, in practice, fund managers report that they do adjust the level of due diligence to reflect the size of the deal they are assessing. Nevertheless, due diligence costs form a sizeable proportion of the total investment size of smaller growth loans which makes them less commercially viable.

Smaller business growth loans have a limited track record as an asset class.

Lack of a track record is likely to make institutional investors more risk adverse when investing in this asset class, and as a result demand a higher level of financial returns as compensation. If investors have incorrect expectations, this will result in a sub-optimal allocation of capital. Several fund managers commented that they have had little contact with institutional investors to date⁵, but that the situation is now changing with institutional investors becoming aware of private debt.

Smaller businesses lack information on how mezzanine finance works and where to obtain such finance. Although this is also now changing, many smaller businesses may have the perception that senior debt finance is the only form of finance suitable for their business. Whilst growth loans can solve the issue of business aversion to equity finance, mezzanine finance involving deferred interest and equity warrants can be very complex for businesses to understand. Lack of investment readiness leads to small businesses lacking the ability to present themselves as investable opportunities, for instance due to poorly specified business plans or inadequate management skills. This will constrain the ability of these businesses to obtain investment.

Co-ordination Failures

There are co-ordination failures between institutional investors like pension funds and insurance companies and private debt funds making growth loans to smaller businesses. Fund managers report institutional investors generally make investments in at least £100m to £200m tranches, but don't want to be more than 10% of any one fund to reduce their risk. This means they only invest in large private debt funds of £1bn, which in turn only undertake larger deals.

Co-ordination failures also occur between senior debt and growth loan providers in establishing inter-creditor agreements. Some fund managers report negotiating a satisfactory inter-creditor arrangement between senior debt providers and growth loan providers can be time consuming and complex to negotiate at the start of a deal. An inability to negotiate inter-creditor agreement leads to growth loan fund managers being in a weak position, leading them to prefer not to participate in smaller growth loan transactions.

Impact of Regulation

The impact of banking regulations make capital for smaller business lending relatively expensive, which makes it unlikely that banks will return to higher risk and less secured growth loan lending in the future.

⁵ From Spring 2014 interviews

Conclusions

This research has found evidence to suggest that the small business growth loan market is currently not working as effectively as it could with impediments affecting both the supply and the demand-side. Despite a number of new government funded growth funds established since 2009 and entry by new private debt funds at the mid-market level, the British Business Bank has identified a possible growth loan funding gap in the range of £170m to £870m per year depending on average deal size, but the gap could be considerable larger when deals in the range £2m to £5m are considered.

Supply

There has been limited entry into the market by new private debt funds focused on smaller businesses, so that there are only a small number of providers currently making growth loans to smaller businesses. As private sector debt funds start to invest at deal sizes £5m and above, any future British Business Bank programme should prioritise smaller deal sizes of less than £5m, especially for deal sizes of less than £2m where the gap is most acute. However, due diligence and other arrangement costs for smaller deals are more difficult for providers to undertake commercially, and so incentive mechanisms may be required to offset the higher due diligence costs.

Demand

It is important to recognise that the demand side is as equally important as the supply side. The evidence points towards low current demand for growth loans as smaller businesses are largely not aware of mezzanine finance and are not aware of specific providers. Awareness campaigns involving stakeholder organisations and advisors to raise the profile of growth loans and funders may help stimulate demand.

There are no quick fixes, and it is likely that UK small business growth loan market will take time to become established, but the British Business Bank can play an important role in helping to catalyse the market.

Chapter 1: Economic Context

Trends in debt finance over time⁶

Ensuring that smaller businesses have access to appropriate sources of external finance is crucial for their survival and growth opportunities, which in turn is important for the long-term economic growth prospects of the economy as a whole. Senior debt⁷ through a bank or more recently through a peer to peer lending platform meets the financing needs of the majority of businesses requiring finance for cash flow or to support investment and growth. For instance, around 7 out of 10 of all loan and overdraft applications from a bank result in a finance facility.⁸

Whilst the stock of bank lending to small businesses has declined significantly since 2008, and continues to decline during 2014, albeit at a lesser rate (see figure 1 below), British Banking Association (BBA) data has shown the gross flow of term lending has increased in 2014 by 11% compared to 2013.⁹ Bank of England data¹⁰ which includes more banks and bank asset finance has also shown a 24% increase in 2014 compared to 2013, also confirming a recent improvement in market conditions. However, the BBA data shows this improvement is mainly concentrated in larger SMEs with a 2% increase in volume and almost 20% by value compared to 2013. The volume and value of lending to smaller businesses with less than £1m turnover has continued to decline in 2014 compared to 2013. The decline in the stock of lending has occurred in part due to higher level of debt repayments from businesses benefiting from the low interest rate environment that currently prevails.

⁶ See British Business Bank (2014) "Small Business Finance Markets 2014" for a more detailed examination of trends in small business finance markets.

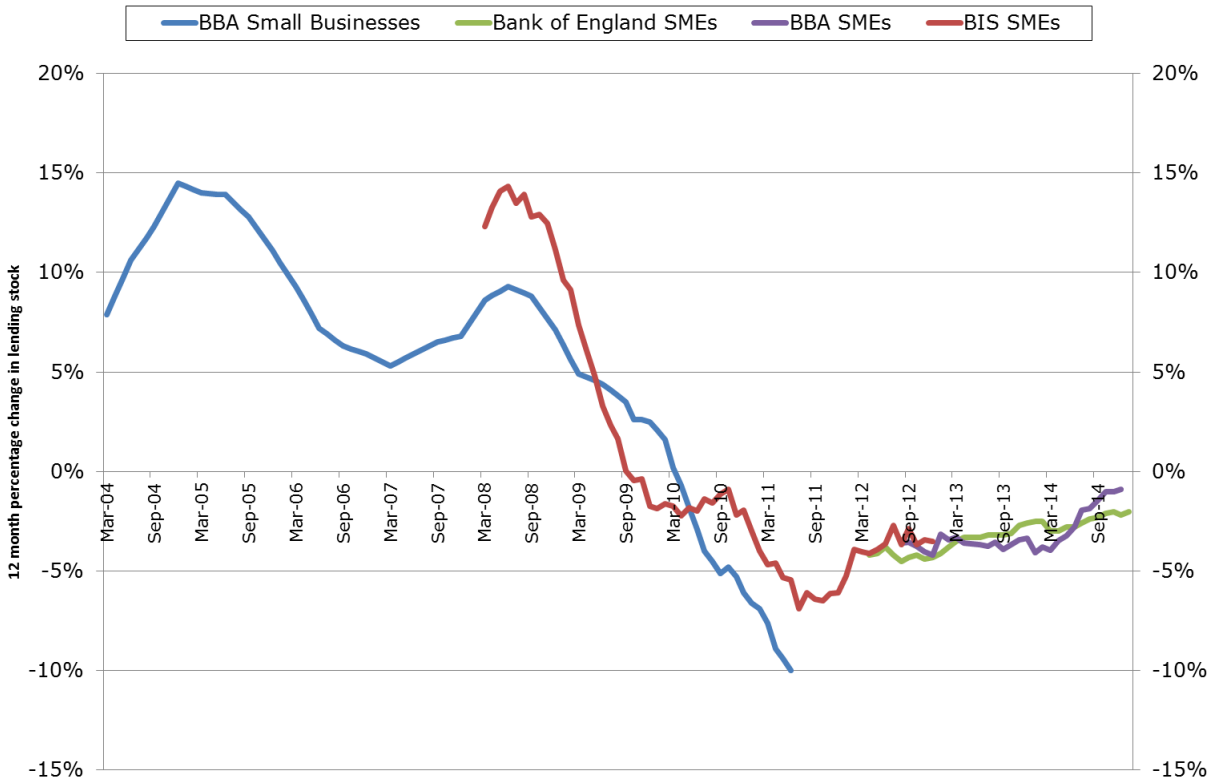
⁷ Including loans, overdrafts and credit cards.

⁸ BDRG Continental (2014) "SME Finance Monitor"

⁹ <https://www.bba.org.uk/news/statistics/sme-statistics/bank-support-for-smes-4th-quarter-2014/>

¹⁰ <http://www.bankofengland.co.uk/statistics/Pages/bankstats/current/default.aspx>

Figure 1: Lending to UK Businesses (12 month percentage change in lending stock)¹¹



Source: Bank of England, British Bankers Association (Updated by British Business Bank)

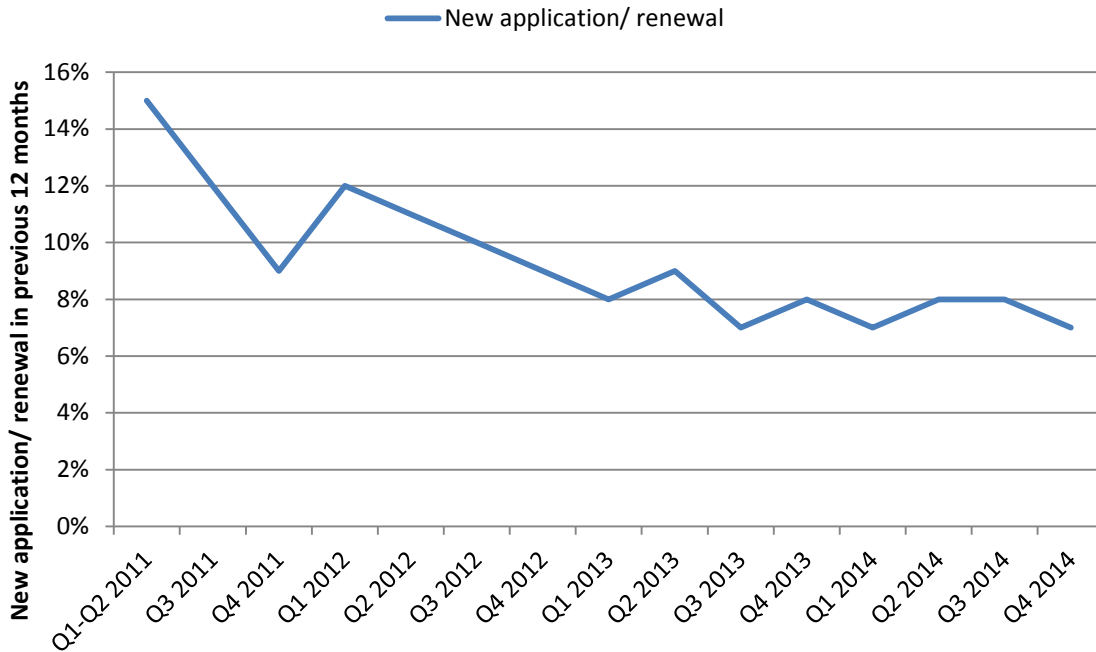
Whilst the supply of loans has shown some recent improvement, business demand for external debt finance continues to worsen. Figure 2 shows 7% of smaller businesses had a new finance application or renewal in the previous 12 months in Q4 2014 compared to 15% in Q1-Q2 2011.¹² During the recession, businesses have become more cautious about expansion and taking on additional debt in uncertain economic conditions. Some businesses may have also become discouraged from applying for additional finance because they think they will be rejected. For instance, the SME Finance Monitor survey¹³ shows 1% of all smaller businesses reported having felt discouraged from applying for an overdraft, and the same percentage felt discouraged from applying for a loan.

¹¹ There is no single continuous data source covering SME Lending before, during and after the recession.

¹² BDRG Continental (2014) "SME Finance Monitor Q4 2014"

¹³ BDRG Continental (2014) "SME Finance Monitor Q4 2014"

Figure 2: Small Business finance applications and renewals in previous 12 months



Source: SME Finance Monitor

Finance for growth

The UK economy has experienced the worst and most prolonged recession in recent history, but is now in a sustained economic recovery with eight continuous quarters of positive economic growth.¹⁴ The UK economy grew robustly in 2014 with a yearly growth rate of 2.6%, currently the fastest rate amongst the G7 economies. This is likely to lead to a change in the value and types of external finance being sought by businesses compared to a few years ago, as businesses are now looking to invest and grow to take advantage of new market opportunities.

Survey evidence shows the composition of demand for external finance has already changed from 2012 with a switch away from working capital to funding fixed assets as the main reason for seeking finance.¹⁵ For instance, 45% of businesses were seeking finance for working capital purposes in 2012, but this has declined to 33% in 2014. The proportion of businesses seeking finance to purchase fixed assets has increased from 33% in 2012 to 43% in 2014. Businesses seeking finance for expansion has also increased from 6% in 2012 to 11% in 2014. This is also confirmed by other surveys

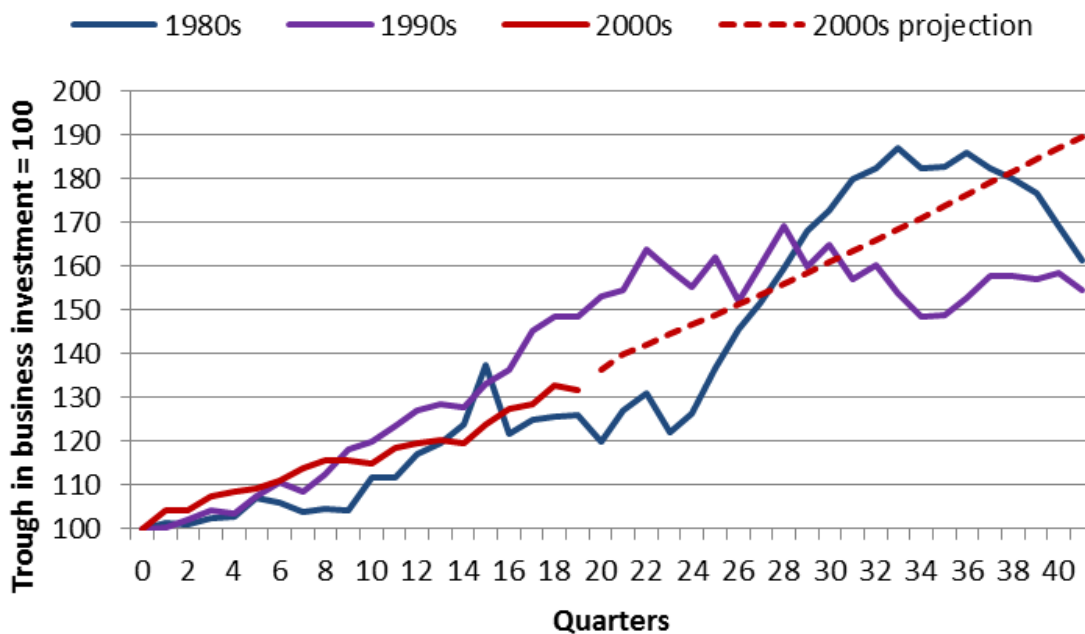
¹⁴ ONS (2015) "Gross Domestic Product Preliminary Estimate, Q4 2014"

¹⁵ British Business Bank (2014) "SME Journey towards raising finance"

including the BIS Small Business Survey 2014.¹⁶ The report’s authors state “The reasons for applying for finance in 2014 were very different from those given in 2010 and 2012, and were much more similar to those in 2007/08 seemingly indicative of a better economic position than in the recession years”.

Business investment declined by 20% between Q2 2008 and Q4 2009. It is widely recognised that business uncertainty over future demand has been a major factor influencing the lack of business investment, combined with funding constraints that particularly affected smaller businesses.¹⁷ Business investment usually recovers after a recession (Figure 3), and this economic recovery is unlikely to be any different. For instance, Office of Budget Responsibility (OBR) forecast business investment to grow 6.7% per year between 2015 and 2019.¹⁸

Figure 3: Real business investment following the last three recessions



Source: OBR

A key factor driving business investment intentions is the increase in business confidence about the economy and future trading conditions. A wide range of small business focused surveys, including ICAEW/ Grant Thornton, CBI SME Trends, Lloyds Bank and FSB, all show business confidence deteriorated during the recession but began to recover from 2012 onwards as economic conditions stabilised, and from 2013 onwards, business confidence measures have been positive. A recent FSB

¹⁶ BIS (2015) “Small Business Survey 2014: businesses with employees”

¹⁷ Bank of England (2014) “Inflation Report August 2014”

¹⁸ OBR (2014) “Economic and Fiscal Outlook”

survey¹⁹ confirms a net balance of 28% of smaller businesses expect to increase their investment over the next 12 months, significantly higher than the levels seen in 2012. Business investment may increase, as the amount of spare capacity in small businesses has been on a gradual downward trend since Q1 2013.

Other surveys also show a higher proportion of small businesses are now aiming to grow than previously. For instance, nearly half (46%) of smaller business intend to grow their turnover over the next year with 17% of these expecting to fully or part fund this expansion with external finance.²⁰

Government involvement in growth loans

The concern over the supply of growth loans to support growing smaller businesses is not a recent phenomenon, and there have been a number of Government Reviews and interventions within the small business growth loan area over the last decade.²¹

The DTI Enterprise Strategy in 2008 announced that “the Government is building on the range of initiatives already in place to help businesses finance their ambitions to grow, with a particular focus on early stage venture capital and mezzanine finance”. The strategy mentioned working with the banks and fund managers to seek to stimulate the delivery of mezzanine products and led to the establishment of the Capital for Enterprise Fund (CfEF), which was announced in January 2009.²²

In November 2009 the Rowlands Review was published by BIS.²³ The review was tasked with assessing the evidence of market failure in the supply of growth capital for growing smaller businesses to examine whether there was a case for Government intervention. The review defined growth capital as being a very broad term used to describe funding that enables established businesses to expand. In particular, the review stated:

¹⁹ FSB (2014) “Voice of Small Business Index, Q4 2014”

²⁰ British Business Bank (2014) “2014 SME Journey towards raising external finance”

²¹ One of the first mezzanine interventions was the Finance South East Accelerator Fund, which was part of the Early Growth Fund programme. The fund was established in 2004 and is a £10m mezzanine loan fund providing up to £200,000 of debt finance for growth companies in the South East region.

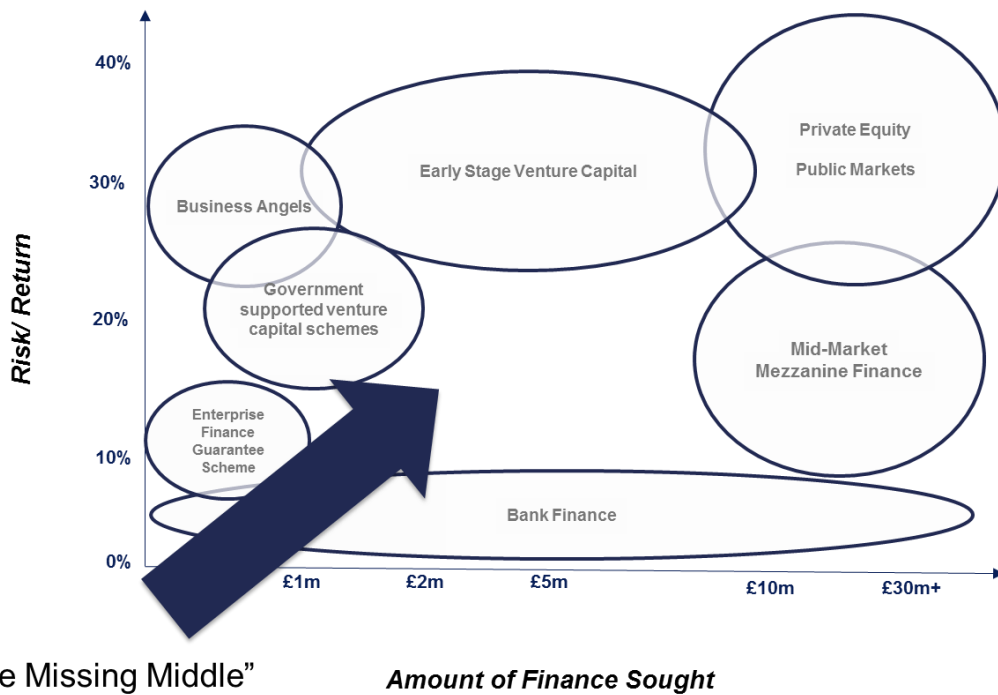
²² The CfEF was targeted at viable businesses with growth potential in need of equity or mezzanine funding to grow and/or deal with over-gearing.

²³ BIS (2009) “Provision of Growth Capital to UK SMEs”

“What differentiates growth capital from other types of investment is the level of risk. It is positioned between the two extremes of high risk-high return pure equity investment and lower risk, usually fully secured, bank lending. Growth capital involves moderate risk with some security and, as a result, providers expect a moderate return. It is for this reason that demand for growth capital may be met through mezzanine finance products.”

The review’s main conclusions was that a funding gap exists in the supply of growth capital for funding amounts of between £2m and £10m with neither bank lending nor equity investors are likely to fill this gap in the foreseeable future. The review conceptualised the gap in the following diagram which shows the risk/ return profile of different types of funding against the size of investment. This space in the middle shows the missing gap in the provision of growth capital.

Figure 4: “The Missing Middle”



Source: BIS (2009) “The Provision of Growth Capital to UK SMEs”

“The review concludes that this market gap is permanent, not just short term and cyclical, and escalated by recession. The easy availability of bank lending in recent years served to obscure an underlying lack of capital provision.”

Chris Rowlands (Chair)

The review put forward that a mezzanine product would be best suited to fill this gap and that there was a need for a new Government backed intervention. In response to the Rowlands Review findings, the Government worked with some of the UK’s largest banks to establish the Business Growth Fund (BGF). BGF invests using a minority equity stake and has helped to significantly increase the supply of growth capital for deal sizes of between £2m to £10m for businesses with an annual turnover of £5m to £100m. Whilst the economic recovery has only begun in the last two years, many of

the issues raised by the Rowlands Review are still relevant today, especially for smaller growth loans.

In 2012, the Breedon Review²⁴ was tasked with looking at increasing the non-bank funding options available to businesses. Although growth loans were not the specific focus of the report, the report stated:

“It is the view of the Taskforce that there is potential to grow the mezzanine finance market further in the UK. This will require greater interest from investors and fund managers to raise their familiarity; and increasing the size of individual funds to attract institutional investors. The Taskforce believes that the Government, through its Business Finance Partnership, could play a crucial role in driving the development of this market.”

The Business Finance Partnership (and later the Investment Programme), was launched in April 2013 with the aim to promote diversity of lending supply through supporting a variety of potential finance providers including private debt funds making growth loans. Alongside a mid-cap tranche²⁵, a number of commercial debt funds focusing on providing growth loans to small businesses have been funded by the British Business Bank through the small-cap tranche including Beechbrook, BMS Finance, Boost, Praesidian and European Capital.

Research objectives

Given the current stage in the economic recovery, it is timely to review the evidence on the supply of growth loans to support the growth of smaller businesses, and to assess the potential role of this type of finance in the wider market. The aim of this research paper is to specifically assess the following questions:

1. What are growth loans and how does mezzanine finance fit in it?
2. What types of smaller business are most suitable for growth loans and how many businesses have these characteristics that make them suitable?
3. What is the current demand for growth loans by smaller businesses? This will include an assessment of how aware small businesses are about growth loans and alternative lending providers.
4. What is the current supply of growth loans? This includes assessing what products are delivered in the market and segmenting the market by types of providers.

²⁴ BIS (2012) “Boosting Finance Options for Business” (Breedon Review)

²⁵ The mid-cap tranche consists of 6 private debt funds (Alcentra, Ares, Hayfin, ICG, M&G and Pricoa). British Business Bank funding is matched with at least an equal amount from private sector investors and is invested on fully commercial terms.

5. Is there a funding gap in terms of the level of supply and demand, and does a growth loans help fill the gap?
6. Is this gap a result of cyclical factors or structural market failures, which are unlikely to correct themselves?
7. Finally, the research will conclude whether the British Business Bank needs to intervene in the UK growth loans market.

Chapter 2: Findings from UK research

Methodology

This research was undertaken by members of the British Business Bank Market Analysis Team and uses a mixed methodology approach combining both new primary qualitative research with market participants and secondary data analysis to provide an insight into the UK private debt market.

It is notable that there is currently limited data on the number and value of growth loans to smaller businesses, which makes analysis of the market and assessment of a funding gap very difficult.²⁶ Data only exists for mid-market deals in larger corporate businesses, which is not the focus of this research, which is looking at the provision of growth loans to smaller businesses.

In-depth qualitative interviews were undertaken with finance providers including banks, small business and mid-market focused debt funds, smaller businesses themselves, and other organisations with an interest in small business financing or investment in alternative assets in spring 2014. A focus group was also organised by NACFB²⁷ comprising of 11 commercial finance brokers to assess their views of the market.

Type of organisation	Number of interviews (2014)
Banks	5
Mid-Market focused debt Funds	5
Small business focused debt funds	10
Small businesses	6
Academic researchers	2
Other organisations including business representative orgs, accountancy bodies, finance associations and institutional investor organisations.	7
Total interviews	34

²⁶ This is a view shared by the OECD (2013). "There is a dearth of reliable statistical data on the size of the markets in commercial mezzanine finance particularly on the use of commercial mezzanine finance by SMEs."

²⁷ National Association of Commercial Finance Brokers.

Interviews were undertaken by the authors between December 2013 and February 2014 using standardised interview template. Around 80% of the interviews were held face to face to maximise the quality of the research. Interviewees were sent a preview of higher level questions and topics the research interview would cover to give them time to prepare and think through the market issues. The research findings were updated in spring 2015 with at least 5 new interviews with finance providers that were interviewed in 2014 and additional data analysis was also undertaken.²⁸

What are growth loans?

Growth loans are bespoke debt-based finance that goes beyond senior debt in terms of its risk appetite and higher pricing. They are used to support business growth and development. Growth loans include a variety of debt funding solutions including unitranche, mezzanine, subordinated debt, junior debt and second lien.²⁹ Growth loans are known as a variety of different names including growth capital, development capital, flexible debt, on-lending, stretched debt, cash-flow lending, long term patient capital, venture debt, subordinated finance, synthetic equity, hybrid instruments, etc. Growth loans are typically unsecured or the security is subordinated behind senior lenders, or is based on intangible assets like patents and other intellectual property. Growth loans offer a funding solution to businesses looking to expand that cannot obtain (any more) senior debt finance due to the level of risk or lack of collateral.

Mezzanine finance is a type of growth loan structured as debt finance, but shares some of the characteristics of equity finance as a certain proportion of the financial returns are variable and depends on the future success of the business and its ability to expand. Whilst there is no single model³⁰, mezzanine debt usually contains three distinct features:

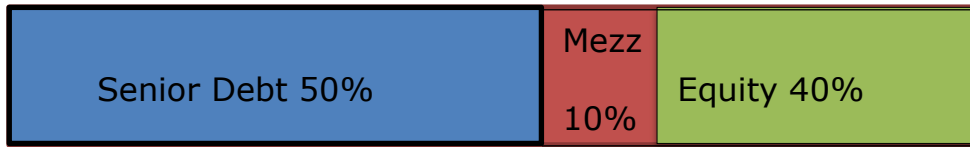
- Cash interest (similar to interest paid on a conventional loan)
- Payment-In-Kind (PIK) interest, which is interest paid at the loan maturity or when refinanced
- Variable share of the upside returns taken through either an equity warrant or a levy on the profits or turnover growth of the company.

Mezzanine finance is a hybrid type of finance that also fits in the middle of the risk-reward profile between senior debt and equity. Mezzanine finance is widely used in Private Equity sponsored buyouts to bridge the funding gap from senior debt to equity, and as such market participants often defined it as the “bit in the middle”. This can be shown graphically in Figure 5.

²⁸ The market gap figures were also updated to include the latest available 2014 data.

²⁹ See glossary at the end of this report for definition of terms.

³⁰ “There is no universally accepted definition of the term (mezzanine finance)” (OECD, 2013)

Figure 5: Representative Finance structure in buyouts

However, mezzanine finance is also used as growth finance. Growth loans encompass funding which allows businesses to significantly expand their operations, by developing new products and processes or moving into new markets over and above their existing activities and markets. Growth loans involves intermediate levels of risk with investors accepting lower levels of return than in the case of high risk venture capital, but a higher return is required compared to secured senior debt finance.³¹

Finance providers consulted as part of this review report the following features make up a mezzanine loan:

Variable returns component based on business success. This is usually taken as an equity warrant, but sometimes a profit share is used or a turnover levy. Given the higher failure rate and also the lower asset recovery rate, a “share of the upside” for successful investments is important to pay for the investments that fail. Whilst senior debt providers primary look at the business ability to repay when making a loan, a mezzanine investor will also be assessing the growth potential and value of the upside.³²

Sometimes (but not always) **security is subordinated behind senior debt or is unsecured**. Alternatively security is taken on intangible assets which some senior debt providers sometimes find difficult to value. Subordinated security usually requires an inter-creditor agreement with the providers of senior debt (e.g. banks), who have first right to the recovered assets in the event of a loan default event or breaking of loan covenants.

Some but not all mezzanine loans have **flexible repayment period**, including some element of rolled up interest. Whilst this can provide benefits for the company as it does drain cash flow in the short term whilst the company is reinvesting its cash flow to sustain growth, payment holidays can increase the overall cost of finance as the

³¹ OECD (2013) “Alternative Financing Instruments for SMEs and Entrepreneurs: the Case of Mezzanine Finance”

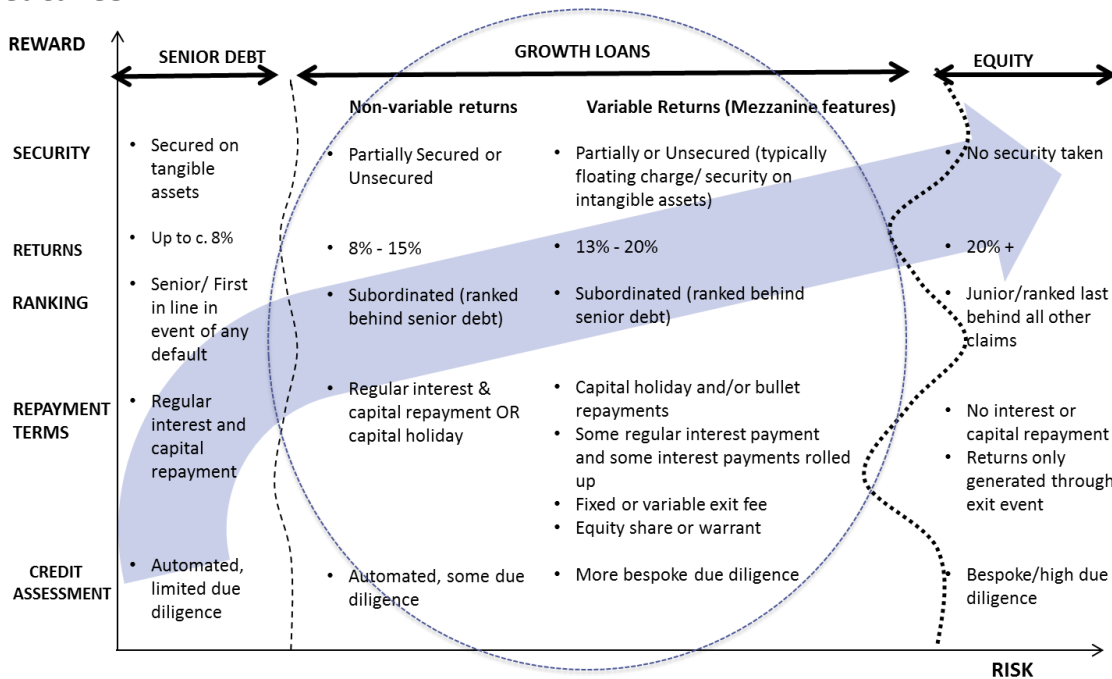
³² Some mezzanine providers may look to invest in companies that represent opportunities for an Initial Public Offering (IPO) or trade sale, but more commonly, mezzanine providers are usually bought out by the initial owner through a recapitalisation with less expensive senior debt or through the accumulated profits generated by the business.

interest builds up.³³ Some mezzanine finance deals involve a bullet payment at the end, which resembles equity and which often requires refinancing to occur so that the mezzanine loan can be paid off.

Respondents report mezzanine loans are generally priced at 10-15% interest rates, plus minority equity warrants/ performance payment, giving an expected return in the region of 13% to 20% IRR over a 5 year period (1.5 to 1.7 times money back). As such mezzanine investments are significantly more expensive than senior debt to reflect the greater risk and also the bespoke nature of the finance. Growth loans without mezzanine features are targeted at slightly lower risk businesses than mezzanine finance and are generally priced between 8 and 15%.

The following diagram illustrates where growth loans fits between debt and equity and some of the key product features:

Figure 6: Growth loans within the risk-reward continuum: Key product features



As the diagram shows, the lines between senior debt and growth loans, and equity and mezzanine are blurred, depending on how the finance is structured. Growth loans therefore covers a wide range of funding solutions from riskier senior debt (sometimes called “stretched debt”) to near equity (loan notes) to reflect the specific financing needs of the business and requirements of the finance provider to generate returns. Mezzanine is a subset of growth loans and is “Flexible debt” with a “myriad of options” due to the numerous ways it can be structured.

³³ Repayment holidays also increase the risk for the growth loan investor, and some investors are cautious about structuring their deals in this way as they prefer to get the company used to making interest payments.

“Mezzanine is a funding solution with different shades of grey”

Small business focused debt fund manager

“Mezzanine is not a product, but a way of structuring a deal to make it work”

Mid-market focused debt fund manager

What types of smaller business is it suitable for?

“Senior debt meets the needs of most businesses... Structured finance fits a tricky role, only suitable for niche businesses going through a significant life cycle event. It is not for commodity businesses.”

Bank providing structured finance

All finance providers reported that growth loans are a niche funding solution, only suitable for a small proportion of businesses with specific funding needs and is not a mainstream finance solution. Fund managers report that they look out for businesses with the following characteristics when making growth loans.

- **Established businesses with a strong balance sheet generating cash.** This is in order to service the loan, as businesses that are not yet generating cash or not forecast to generate cash in the short term are equity risk businesses that are not suitable for growth loans. Providers generally report, businesses tend to be at least 3 years old with minimum turnover of £1m.
- **Businesses looking to significantly expand and have demonstrated strong existing growth.** Sustained growth is required in order to pay the rolled interest and for mezzanine finance to increase the value of the equity stake. Whilst fund managers have different views on the level of growth required these tend to be in the broad range of at least 5 to 20% per annum sustained over a sustained period, e.g. 3 year period. This level of growth is lower than what typical venture capitalist would typically seek, but should be lower risk as the company is established. Some private debt funds also target turnaround businesses, although finance providers report these can be more risky than funding growth companies.
- **Businesses that have exhausted their tangible collateral or have no collateral** to offer. If the business has access to physical assets to use as collateral on secured lending, it is likely to be cheaper for the business to use senior debt rather than growth loans or mezzanine finance. Some growth loan providers take security on remaining intangible assets that were not used by senior debt providers for collateral.
- **Businesses with strong management teams.** Fund managers are in agreement that strong management teams are crucial to the success of their investment. Mezzanine loan providers do not want to take equity level risks and do not want to be running a company themselves as they hold minority equity stakes in the investee company.

“We are not looking for businesses with exponential growth, but businesses that have good potential for sustainable growth over a number of years”

Mid-market focused debt fund manager

Growth loans are suitable for viable growth orientated businesses that fall outside of banks’ lending criteria and are not able to obtain senior debt finance due to their level of risk or lack of security. Growing the business by developing new products, processes and services or moving into new product or geographic markets has a greater risk than the business focusing on growing its existing core activity and market. However, these businesses may not be able to generate the high returns required by equity investors.

Providers report that growth loans may be suitable for traditional businesses e.g. manufacturing as well as businesses based on intangibles that lack physical assets e.g. software businesses. As growth loan fund managers undertake greater level of due diligence than senior debt providers in understanding all aspects of the business, they are more able to assess the quality and value of intangible assets. Therefore growth loan providers are able to make investments in businesses that fall outside banks’ lending criteria or require more in depth due diligence to assess the viability of the business than senior debt providers are able to do, albeit at a higher cost.³⁴

“Banks have difficulties in lending against intangible assets”

Small business focused debt fund manager

Mezzanine finance is often used by businesses that are not willing to give up equity or majority equity stakes, e.g. family businesses, either in isolation, or alongside private equity providers in order to reduce business dilution.³⁵

It is very difficult to make an assessment of minimum deal size for growth loans as this varies by provider. The design of the financial instrument including its security position and mechanism for capturing potential upside influences the minimum investment size. Providers that specialise in undertaking smaller investments tend to use standardised loan terms and legal agreements, are less likely to take security charges and generally don’t take equity warrants. This all helps to lower the costs of making growth loans. Mezzanine investments tend to be undertaken for larger investments due to the greater costs in structuring the deal. However, all finance

³⁴ Recent IPO research (2014) found that IP rich businesses have difficulty using their IP as collateral to secure debt finance. “The main obstacle is that IP is generally regarded as being too complex an asset class to finance within the constraints of normal lending margins, mainly due to the difficulties in understanding what it is, how it relates to cash, and where its value can be realised independently of a business.” Therefore, businesses are less likely to be able to raise the full amount of senior debt finance than if intangible assets were included as collateral.

³⁵ The extent to which deals are sponsored by a Private Equity House varies by different fund, and depends on the specific investment strategy of the mezzanine fund. However, sponsored deals are seen as being less risky than unsponsored deals due to the involvement of Private Equity investor, which includes their additional due diligence and equity being ranked behind mezzanine in its security position.

providers agree smaller deals are significantly harder to do commercially than larger deals because:

- Risks are higher in smaller investments. A number of reasons were put forward by respondents for the greater risk including:
 - Businesses are more susceptible to changes in market conditions. E.g. main customer cancelling order.
 - Management are less capable of dealing with shocks as they are less likely to have dealt with the issue before
 - Collateral is more specific to the business and so resale is harder compared to the assets of a larger company.
- Growth loans require more due diligence than senior debt to understand the workings of the business and the markets in which it operates. These costs are often passed onto the business through arrangement fees.³⁶ Fund managers report due diligence is more important for smaller deals, especially unsponsored growth capital investments.

“Things go wrong more quickly in a smaller company”

Mid-market private debt fund manager

Funders report the need to avoid funding equity risk proposals using debt products (with limited up-side returns), and to avoid mandatory debt repayments constraining the business’s growth ability. As such, growth loans and mezzanine finance is not suitable for start-ups or businesses without a track record.³⁷

Growth loan providers undertake extensive due diligence of deals assessing cash flow predictions, and often spending time in the company to understand the business and the market environment the business operates it. This is generally more comprehensive than senior debt providers, but is required due to the lower ranking of security the growth loan provider has compared to senior debt providers, and the potential for upside returns in mezzanine loans.

What is the existing level of demand?

It is difficult to measure the demand for growth loans, as the market is very fragmented. Small businesses use of mezzanine finance is very low with survey evidence suggesting less than 0.5% of all SMEs have used mezzanine in the last 3

³⁶ The typical costs of undertaking due diligence is explored in the market failures section.

³⁷ Mezzanine instruments are used in venture debt but in this instance, mezzanine providers are trading off the due diligence undertaken by venture capitalists. Security is usually taken on intangible assets like Intellectual Property rights.

years.³⁸ Use of mezzanine finance is related to size of business, with larger businesses significantly more likely to be using mezzanine finance compared to businesses with no employees.

In addition, only around 1% of mid-sized businesses³⁹ have used mezzanine finance in 2013.⁴⁰ Use of mezzanine finance is highly correlated with size of business with companies with a turnover of £100m to £500m were most likely to use mezzanine finance (4%).

Use of Mezzanine finance in last 12 months by turnover band

	All	£10m to less than £25m	£25m to less than £50m	£50m to less than £100m	£100m to £500m
Mezzanine finance	1%	1%	*% ⁴¹	1%	4%

Source: British Business Bank (2014) "Access to Finance of Mid-sized Businesses"

"There is a 'Chicken and egg' situation going on in the supply of mezzanine... Basically there is no demand because supply is limited, but supply won't increase because of lack of business demand"

Small Business focused debt fund manager

The low use of growth loans by smaller businesses may be explained by businesses lack of awareness of mezzanine finance, especially compared to other sources of external finance. Only 15% of smaller businesses were aware of mezzanine finance, but a lower proportion (only 5%) was aware of a specific supplier of mezzanine finance.⁴² This is significantly lower than other types of finance, including crowd sourcing and export/ import finance. As with use of mezzanine finance, awareness significantly increases with the size of business, so that 38% of medium sized businesses were aware of mezzanine finance and 19% were aware of a specific supplier. This implies low awareness of mezzanine finance is a wider issue that is not just related to smaller businesses.

³⁸ British Business Bank (2014) "2014 SME Journey towards raising finance"

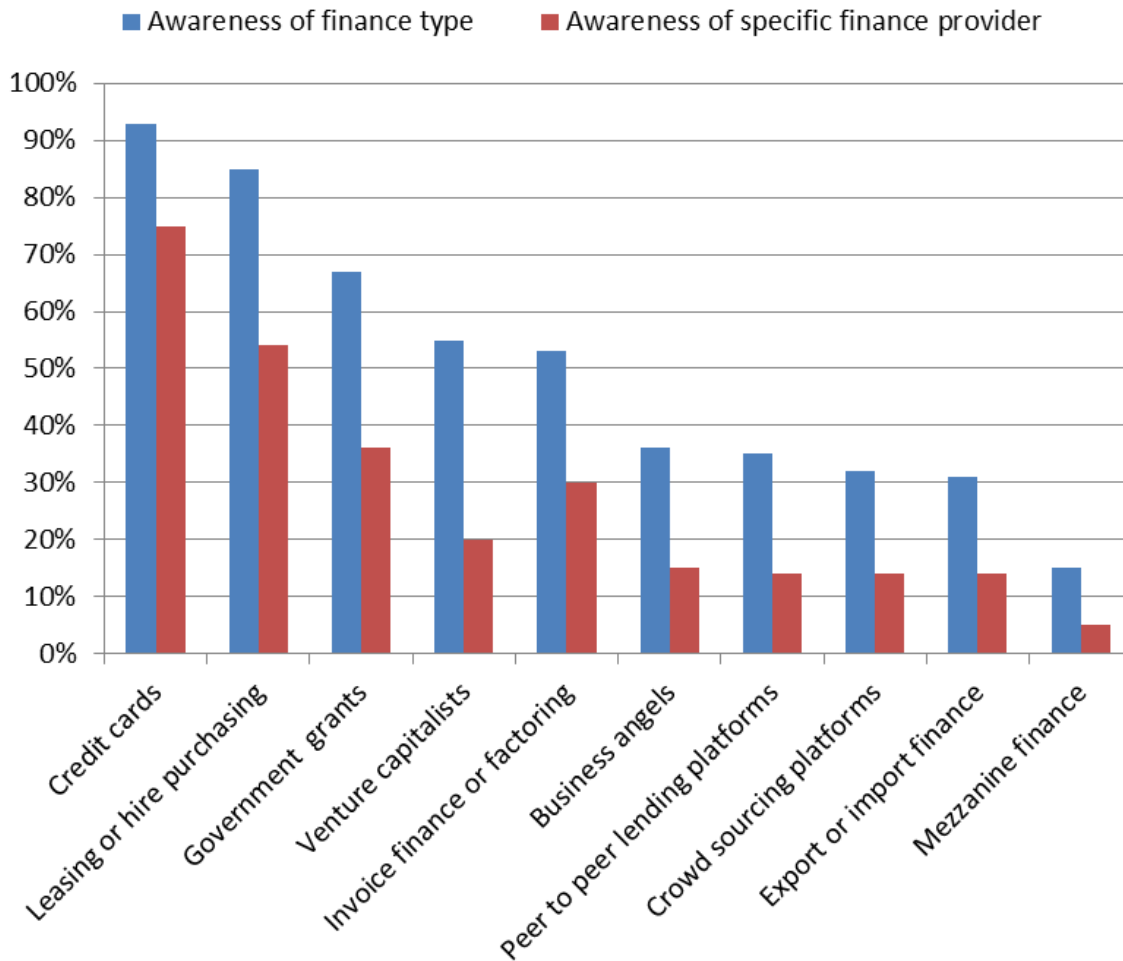
³⁹ defined as having turnover of between £10m to £500m turnover

⁴⁰ British Business Bank (2014) "Access to Finance of Mid-sized Businesses"

⁴¹ An asterisk (*) denotes any value less than half a per cent but greater than zero.

⁴² British Business Bank (2014) "2014 SME Journey towards raising finance"

Figure 7: Awareness of different types of finance and providers of that finance type



Source: British Business Bank (2014) "2014 SME Journey towards raising finance"

Interviews with businesses and finance providers also confirm businesses do not specifically seek mezzanine finance products. Businesses have low awareness of growth loans and mezzanine providers and generally only approach specialist debt providers if they cannot get finance from a bank. The referral route for growth loans is often through commercial finance brokers, accountants or Private Equity funds. Fund managers delivering growth loans to smaller businesses report that they put a significant amount of effort into maintaining a network of local contacts with intermediaries and also small business themselves in order to identify high quality deals.

Finance providers and interviews with smaller businesses themselves identify that businesses often perceive growth loans to be expensive debt rather than cheaper equity finance, but for those businesses that use growth loans; they conclude that growth loans are a vital source of funding for businesses that cannot obtain finance elsewhere.

Fund managers reported that small business owners need more information about the differences between senior debt and growth loans, as the higher cost of growth loans reflects the greater level of risk taken by the investor and bespoke deal structuring. Whilst mezzanine finance is seen as “flexible debt” with a “myriad of options”, this can also make it difficult for business owners to assess the costs and benefits of using mezzanine finance due to the added complexity of structuring a mezzanine deal. Fund managers mentioned a number of specific deals that did not proceed as the business owners were not willing to pay the higher interest rates on a growth loan, and which possibly had an adverse effect on the business, or resulted in a lost opportunity for growth. Some fund managers undertaking smaller deals did not take equity warrants or other performance returns, in order to keep investments simpler and lower cost to organise, although they report it does limit the type of investments they are able to undertake.

“As with anything, flexible bespoke solutions costs more than standardised off the shelf products”.

Mid-market focused debt fund manager

“We have lost half a dozen proposals from businesses that were not willing to pay our higher interest rates (compared to secured senior debt offered by a bank) and would rather grow at a much slower rate”.

Publicly backed debt fund manager

Not only are there structural factors affecting businesses demand for growth loans, but there are cyclical factors affecting businesses demand for finance. Growth loan providers report that demand for growth loans has been low to date because business have been cautious about expanding and have instead been “sweating their assets”. However, finance providers report confidence is now beginning to return to the market as the economy recovers and are beginning to see demand for growth loans increasing over 2014 with the trend expected to continue.

What is the potential demand for growth loans?

It is difficult to estimate with precision the number of businesses that may be suitable for growth loans as the market is not yet sufficiently developed. Any demand for growth loans is likely to be latent demand, where the business is not aware that growth loans and mezzanine finance are most suitable for its needs.

The British Business Bank has undertaken analysis of Companies House data⁴³ to estimate the number of businesses that may be suitable for growth loans. The analysis suggests around 16,000 companies are currently in eligible population for growth loans based on meeting the following combined criteria:

- **At least 3 years old** (in order to have an established track record).
- **Turnover of £1m or greater** (Company is of sufficient size for a growth loan).

⁴³ Via FAME <https://fame.bvdfinfo.com/>

- **3 year average turnover growth of between 5-20%** (Company has demonstrated strong growth and is potentially viable).⁴⁴

Not all of these businesses are likely to be seeking external finance at any one time, and the majority of these businesses are likely to be served by existing senior debt providers. British Business Bank analysis of the SME Finance Monitor dataset for businesses with similar characteristics suggests around 6% of businesses have sought a term loan in the last 12 months in 2014. Of these, around 60% of businesses obtained funding, whilst the remaining 40% were either refused finance, took other funding or obtained the funding but only after a number of difficulties were experienced. In addition around 5% of businesses with the outlined characteristics were discouraged from seeking finance. The British Business Bank assumes up to 10% of these may be willing to seek growth loans instead if awareness of this type of finance was increased.

This therefore suggests around 500 businesses per year might be suitable for growth loans. This is a best estimate of likely demand. Whilst the number is relatively small out of the total number of businesses in the UK (5.2 million), it is important to remember that these businesses are established growth orientated businesses that are important to the success of the UK economy.

In practice there is likely to be a higher number of businesses as demand for finance is currently very low, with limited signs of recovery to date. If demand for finance increases, the number of businesses suitable for growth loans could increase assuming senior debt providers' credit assessment criteria does not change from current levels.

"Optimism is beginning to return to the economy, with small businesses wanting to borrow. Businesses are seeing their competitors investing and growing and don't want to be left behind."

Small business focused debt fund manager (2015)

"There was not a big funding gap for growth capital during the recession, but funding gap is likely to grow as business demand for finance increases."

Small business focused debt fund manager

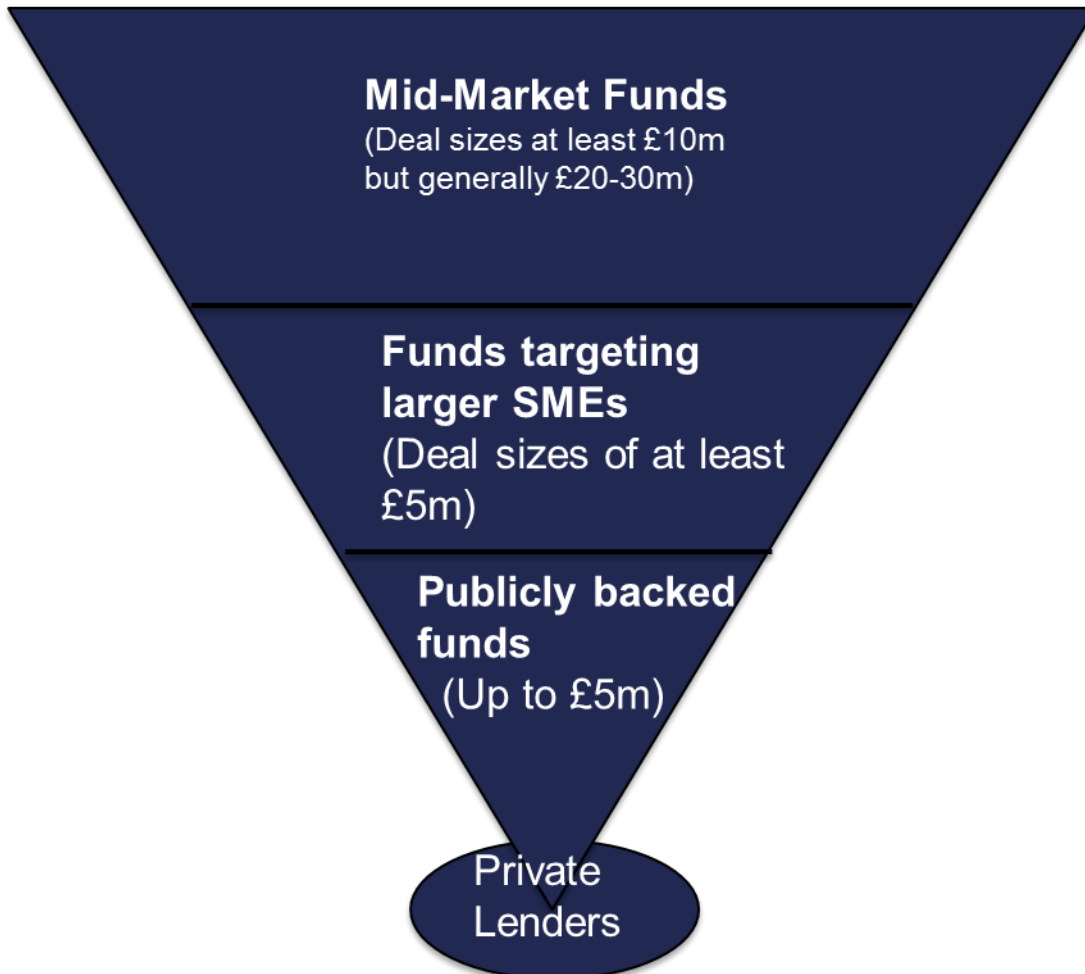
Notwithstanding the above estimates, it is apparent from the research undertaken that smaller business debt funds currently operating in the UK market appear to have relatively slow deal flow, but has increased substantially in 2014. Whilst demand may only just be picking up, it is important to recognise that demand for growth loans may therefore be latent, with significant resistance by smaller businesses to the terms and conditions and higher pricing of growth loans compared to senior debt, as well as the lack of awareness of the product or suppliers.

⁴⁴ Businesses with an annual average growth rate in excess of 20% are defined as high growth businesses by the OECD, and are assumed to be more suitable for equity finance.

What is the supply of growth loans?

Figure 8 illustrates how the growth loan market is structured into four main segments. Many private debt providers provide a range of debt finance solutions including senior debt, growth loans and mezzanine finance.

Figure 8: Growth loans market segmentation



Mid-market focused debt funds

The British Business Bank is aware of at least 17 “mid-market” private debt funds operating in the UK.⁴⁵ Over the last few years there has been a lot of new entry in Europe from private debt funds including Hayfin, Bluebay, Babson, and Alcentra, so

⁴⁵ As part of this research representatives from 5 mid-market focused private debt funds were interviewed. Prequin also confirms there are 17 private debt fund managers with the headquarters located in the UK. This compares to 134 in the US, also giving evidence of the UK market being relatively under developed.

that there are at least 35 fund managers operating at the mid-market in Europe.⁴⁶ These funds tend to operate as bespoke debt funding solution providers offering a range of debt finance options for companies going through a significant 'growth event'. The majority of transactions (79%) are structured as senior or unitranche debt, but 21% are subordinated structures including mezzanine finance. These funds attract large scale investment from institutional investors like pension and insurance companies, and are typically several billion pounds in size.

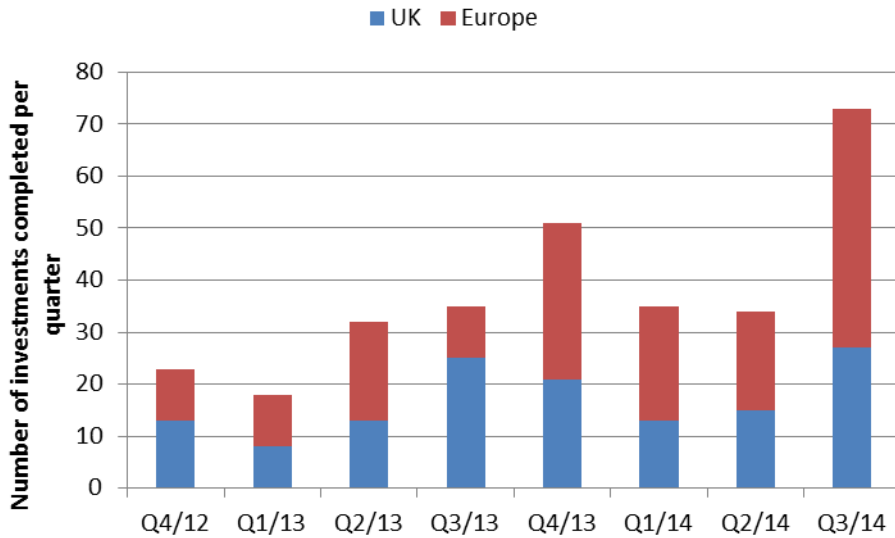
Research consultees reported that the minimum investment size of these funds is at least £10m, although they tend to do larger deals in practice in the region of £20m-£30m, with mid-sized businesses with turnover above £25m per year. To a large extent, deal flow comes from Private Equity houses through sponsored deals where mezzanine is used in leveraged buyouts to fill gaps between the financing needs of the borrower and maximum thresholds (measured by various leverage metrics) of senior lenders.⁴⁷ Mezzanine loans have higher arrangement fees and interest compared to senior debt loans, but mezzanine finance reduces the amount of equity diluted, which is welcomed by the owners of the business as well as the Private Equity fund.

The Deloitte Alternative lender tracker shows the number of European transactions (including the UK) has increased by 217% from Q4 2012 to Q3 2014, showing private debt funds have become an important source of finance for mid-market businesses. New entry by private debt funds into the European mid-market, suggests the market is now more competitive than previously, which fund managers have indicated has lowered yields. Whilst bank lending declined during the recession, mid-market fund managers' report there is currently competition from banks in providing finance to companies at this level, albeit through lower margins for less risky businesses.

⁴⁶ Deloitte (2014) "Deloitte Alternative Lending Tracker (December 2014)"

⁴⁷ Only 22% of transactions did not involve a Private Equity sponsor.

Figure 9: Number of mid-market private debt fund investments



Source: Deloitte Alternative Lending Tracker

Whilst private debt is seen as an ‘alternative asset’ providers report good quality funds can generally raise funding from institutional investors who like risk-reward profile and ongoing yield of private debt. There appears to be no need for the British Business Bank to increase growth loan activity at the mid-market beyond its current involvement through the Mid-cap Business Finance Partnership.

Private sector small business focused debt funds

Below the mid-market there is a smaller number of private sector debt funds focused on providing growth loans for deal sizes below £10m to smaller businesses. The minimum size of investment that these funds are willing to undertake is generally around £5m, although a few funds go lower. All fund managers agree that funding small businesses is more risky than larger businesses as small businesses are more susceptible to changes in market conditions, whilst larger companies are more resilient.

“At the lower SME level it is difficult to differentiate risk, and if you are not careful you end up subsidising equity level risk”.

Small business focused debt fund manager

Funds report it can be more difficult to make smaller growth investments work commercially, and so some small business focused funds provide a full funding solution that includes senior debt and/ or equity to make the investment work commercially. This is following larger mid-market funds that are using unitranche solutions, which combines both senior debt and mezzanine into one loan document. Fund managers report unitranche is an alternative to stand alone mezzanine finance and the number of unitranche deals is increasing at the expense of mezzanine deals, as the solution is simpler and less expensive for the business.

The British Business Bank's Small-Cap Business Finance Partnership and Investment Programme, which aims to diversify sources of debt finance available to businesses, has funded a number of commercial debt funds operating in this space including Boost, Beechbrook, BMS Finance, Praesidian and European Capital.⁴⁸ The Business Growth Fund, established in 2011 is a relatively new entrant into the market, but is currently one of the most active providers of growth capital to businesses with an annual turnover of between £5m and £100m. BGF provides growth capital for deals between £2m and £10m predominantly structured through an equity instrument, although some deals include elements of debt.

Publicly backed small business focused debt funds

There are at least 11 publicly backed funds currently providing growth loans to smaller businesses within the £250,000 to £5m space. These include Santander Growth Fund⁴⁹, the Scottish Loan Fund, the Manchester loan fund, the North West JEREMIE Mezzanine fund, Yorkshire JEREMIE Equity Linked investment Fund, North East JEREMIE Loan Fund and Northern Ireland Growth Loan Fund. The majority of these funds have been established since 2009 in direct response to the recession and credit crunch, and are limited to funding businesses that meet the EU definition of an SME due to State Aid restrictions.⁵⁰ The majority of these funds have restrictions on geographic areas they are able to invest and are generally limited to smaller deal sizes of £2m.

Many of these funds have development objectives alongside their commercial objectives. Financial returns are not yet known for these funds as these are still relatively young. However, some private sector debt fund managers are critical of the role of publicly backed loan funds in this area, and feel they distort the market because they are using debt products that are not sufficiently priced or structured to reflect the high-risks of the investments being made. Some banks raised concerns about overleveraging businesses with additional debt, and suggested an injection of equity would improve the balance sheet position of these companies and make them more resistant to future economic and market shocks.

⁴⁸ British Business Bank has invested on a pari passu basis alongside institutional investors and is aiming for a commercial return on its investment in line with the level of risk taken.

⁴⁹ Which has received Government funding through the Regional Growth Fund.

⁵⁰ A Small or Medium-sized Enterprise (SME) is a business employing less than 250 employees, with an annual turnover of less than 50m Euros or balance sheet net assets of less than 43m Euros. The business cannot be part of a larger group employing more than 250 employees where the group owns at least a 25% share of the business. In addition, funds cannot invest in re-financing existing commercial borrowings or failing businesses.

“There is a lot of soft money operating in the mezzanine space where deals are structured as debt, but are taking an equity risk. These funds are not large enough to provide follow on funding or have a limited investment period to provide follow on funding, so end up in a blocking position for semi-successful companies, preventing them from taking on any additional equity.”

Private sector small business focused debt fund manager

However, fund managers of publicly backed funds report these funds have an important, albeit small role in meeting demand in the market, as there are no other providers operating in the smaller growth loan space. Fund managers report the funding they provide is complementary to the senior debt provided by banks, as they are putting additional cash into growing companies and are not usually impacting on security position. Furthermore, fund managers of regional funds report private debt funds do not operate in their locality. They suggest this is because delivering growth loans to this group of businesses is not sufficiently profitable for a private sector fund maximising its financial returns, or that it is “too much effort” for private sector fund managers to establish local offices outside of their main office.

Funds focusing on small deals in smaller businesses typically struggle to attract private or institutional capital due to a lack of track record for the asset class and small fund size.

Other

There are other sources of private debt funding made up of individuals investing their own money, who act in a similar way to business angels, but who structure their deals as debt rather than equity. It is difficult to estimate the number of these individuals as they tend to be “under the radar” and “will only invest if the right deal comes along”. Commercial finance brokers are the usual way companies looking for finance find out, and are put in contact with, these private investors.

Several debt fund managers commented that the lower end of the mezzanine market is crowded out by VCT schemes, where tax relief and downside protection to investing makes it attractive to investors to invest in smaller companies. Whilst VCTs address the growth capital funding gap predominantly through an equity instrument, they are also able to make debt and mezzanine investments of up to £5m.⁵¹ However no data is available on the proportion of VCT investments that are structured as mezzanine or debt. In 2013/14 there were 97 VCTs in existence, having raised £440 million in 2013/14, which does suggest VCTs have a large coverage of the market for smaller investments.⁵² AIC research⁵³ shows the average size of VCT investment is £2.8m

⁵¹ VCTs also able to provide up to £5m (previous £2m) and have to invest 70% of their investment value in equity, but the remaining investments can be structured as debt or mezzanine. The previous requirement was for only 30% of investments to be equity investments. This restriction applies to fund activity as a whole, rather than deal by deal basis.

⁵² HMRC Statistics on VCTs: <http://www.hmrc.gov.uk/statistics/vct.htm>

⁵³ AIC (2013) “Investing for the future”

and the average size of company at time of investment is £10m turnover and 87 employees, which is broadly in line with the size of growth loan investments.

Summary of UK growth loan market

- Existing publicly backed growth loan funds tend to target deal sizes of between £250,000 up to £2m, although a few go up to £5m.
- Small-cap Business Finance Partnership and Investment Programme backed funds target larger deal sizes than other publicly backed fund, and operate like other commercial SME funds in the market, undertaking deal sizes in excess of £2m.
- Private Sector debt funds tend to target larger deals, with commercial smaller business funds undertaking deal sizes in excess of £5m and mid-market funds undertaking deal sizes in excess of £10m.

The British Business Bank has requested investment data from a number of Growth loan providers making growth loans to smaller businesses. The Bank has aggregated the total value of growth loans provided to smaller businesses in 2014, based on funds that we are aware of to estimate the total level of supply of this type of finance. Fund managers advised that a large amount of VCT funding is currently going into sub-£5m growth loan space through debt and mezzanine. VCTs raised £440m funding in 2013/14. On basis that 70% of VCT funding is to be used on equity (or equity-like transactions) under the current scheme rules, the British Business Bank assumes that the remaining 30% may be used to fund smaller growth loans through debt and mezzanine instruments. This would imply an additional £130m per year of funding entering the sub £5m growth loan market through debt and mezzanine finance.

Therefore the British Business Bank estimate the total supply of growth loans to small business in 2014 to be in the region of £60m for investment sizes of less than £2m and £260m for investments of less than £5m in size. This is a very small amount of finance in terms of the overall funding that goes to smaller businesses, clearly showing the market is not yet developed in scale.

Is there a market gap?

This question is separated into two parts:

- Is there a debt funding gap, and what role do growth loans have in filling it?
- Is there a gap in the supply of growth loans?

Is there a debt funding gap, and what role do growth loans have in filling it?

The economic context section of this report provided an overview of trends in bank lending over time. The fund managers consulted as part of the research report during the recession banks tightened up their lending criteria, assessment of business ability to repay and the required level of security cover compared to before 2007. Fund managers acknowledge that this is a result of external factors like tighter regulatory capital requirements and that market conditions were not sustainable prior to 2007. However, several fund managers reported there are recent signs of more competition between the banks in 2014, especially competing on price for relatively low risk businesses with high security coverage, and larger businesses. Market participants suggested senior debt providers are unlikely to go back to where they were in terms of their lending practices leading up to the credit crunch.

"There is clear evidence of funding gap left by banks as we are able to operate a model based on secured lending at mezzanine prices."

Small business focused debt fund manager

"There are good companies out there that cannot get finance from their bank."

Commercial finance broker

"Bank lending is largely a standardised product, whilst mezzanine is more bespoke. Banks are currently not comfortable with taking excessive risk and look for security to minimise the risk."

Bank

The research participants reported growth loans are a possible solution to the debt funding gap, but are not a panacea as they are only suitable for a small proportion of growth businesses. Whilst banks have standardised products and assessment criteria for undertaking term lending, growth lenders undertake greater due diligence in to the company to overcome information asymmetries. For instance, they often spend several days visiting the business in situ to fully understand the business and to see how it operates. Fund managers making growth loans reported that they undertake cash flow lending with less emphasis on physical assets as collateral.

"We typically invest in businesses with intangible assets as these are the businesses that banks find difficult to lend against."

Small business focused debt fund manager

"Many businesses will have blemishes on their credit history coming out of the recession, and will find their choice of funding sources limited as banks and peer to peer lenders will effectively be closed."

Commercial Finance Broker

Private Debt providers and banks both report there is room in the debt market for specialist lenders as they are not in direct competition with each other. Funds suggest growth loans do not compete with senior debt as growth funds target businesses with greater risks and where businesses have credit risks that are difficult to assess or

whose profile lie outside of bank's lending criteria. Growth loans are charged at a higher interest rate than for senior debt loans, so business will always go for cheapest option if it can. Fund managers gave specific examples of deals they have lost to banks, especially in recent times (2014) as funding conditions improve. Some growth loan fund managers also reported the increased availability of senior debt lending in 2014 is also having a positive impact on their business model, as businesses are undertaking greater investment, with growth loans being used to fund any funding shortfall that senior debt cannot stretch to.

Is there a gap in the supply of growth loans?

It is widely recognised that European businesses are more reliant on banks for their funding compared to the US, where bank finance forms the minority of long term funding.⁵⁴ This also points to the UK private debt market being less developed than the US. Many respondents mentioned banks previously provided growth loans directly and indirectly through senior debt as banks were competing for deals through low margins, but respondents suggest banks are unlikely to return as the capital costs from unsecured lending and mezzanine loans are too heavy and there is political and reputational risks of charging interest rates beyond normal senior debt loans on a product that is not widely understood.

"The mezzanine market is more competitive the larger you go, especially at the mid-market, but there is limited competition for mezzanine deals at smaller business level as there are only a handful of people in this space."

Small Business focused debt fund manager

Whilst there has been new entry by private debt funds that provide bespoke debt finance into the European market, these funds appear to be making loans in excess of £10m-15m to larger corporate businesses. The large number of Private Debt funds operating in Europe and the increasing number of investments suggests this part of the market is working relatively well.

"There has been recent entry by new mezzanine funds but this has been at the mid-market and not at the lower SME level."

Small business focused debt fund manager

There appears to have been limited entry by private sector debt funds specifically targeting small businesses with deal sizes of less £10m. The research interviews with fund managers specifically asked providers who their main competitors were. In many cases, fund managers of small business focused debt funds said they did not experience much competition from other suppliers as there are very few funds providing this type of finance. As such, nearly all small business debt funds say there is room in market for more growth loan providers making investments below £10m.

"If we had more capital we could Hoover up the market."

Small Business debt fund manager

⁵⁴ Financial Stability Board (2011) 'Shadow Banking: Strengthening Oversight and Regulation' www.financialstabilityboard.org/publications/r_111027a.pdf

However, fund managers' report it can be difficult to make smaller growth loans work commercially with a £5m lower limit being mentioned by several private sector small business focused fund managers. If not careful, fund managers report debt funds can end up taking equity risks through a debt instrument that has less potential for capturing upside gains, and the arrangement and due diligence costs can be a large proportion of smaller investments.

"Although there is a funding gap, it is difficult to address in a cost effective way."

Small Business debt fund manger

The primary research with market stakeholders suggests there is a funding gap in the supply of growth loans of less than £10m but particularly for smaller loans of up to £2m to £5m. Respondents state that it is difficult to quantify the size of the funding gap with any accuracy. The British Business Bank has attempted to provide an empirical estimate of the gap by assessing possible latent demand against the current supply of growth loans in 2014. This analysis is subject to a number of caveats and can only provide an indicative view of the market.

Estimating the size of the growth loan gap in 2014:

Demand: From the earlier analysis it was identified that there are currently around 500 viable smaller businesses per year that would benefit from growth loans based on their characteristics and difficulties in obtaining senior debt.⁵⁵ Assuming the average loan size for smaller businesses seeking mezzanine is between £500,000 and £5m; this suggests a possible latent demand of between £250m-£2.5bn per annum.

Supply: From the earlier analysis, it is estimated that publicly backed growth funds and VCTs provide around £60m funding in 2014 for deal sizes up to £2m (£260m for deal sizes up to £5m).

Potential Gap: Subtracting the potential supply from the potential demand suggests the potential funding gap for growth loans up to £2m is in the range of £170m to £870m per year depending on the average deal size. The gap could be considerable larger when deals in the range £2m to £5m are included (£2.1bn).

These figures are indicative and the methodology is subject to the following number of points:

- Business demand for finance is currently very low, but is likely to increase in the near future suggesting the size of the gap will increase.
- This approach assumes there is no change in small business likelihood to obtain senior debt funding.

⁵⁵ Greater than 3 years old, greater than £1m turnover and have a 3 year average growth rate of between 5 to 20%

- Businesses may not be willing to use growth loans due to the terms and conditions, and so these figures do not provide an indication of actual deal flow.

Estimates of market gap in 2014 under different growth loan size scenarios⁵⁶

Likely growth loan deal size	Estimated demand-number of businesses per annum	Estimated demand per annum	Current supply of growth loans in 2014	Potential market gap per annum
£500,000	500	£230m	£60m	£170M
£1m	500	£460m	£60m	£400m
£2m	500	£930m	£60m	£870m
£5m	500	£2.3bn	£260m	£2.1bn

Source: British Business Bank Analysis

Is there a market failure?

The lack of supply in growth loans to small businesses is not a market failure per se if it is because there is not enough economic value for the level of risk taken by the investor. If this is the case the market is working efficiently at allocating resources to higher productive uses.

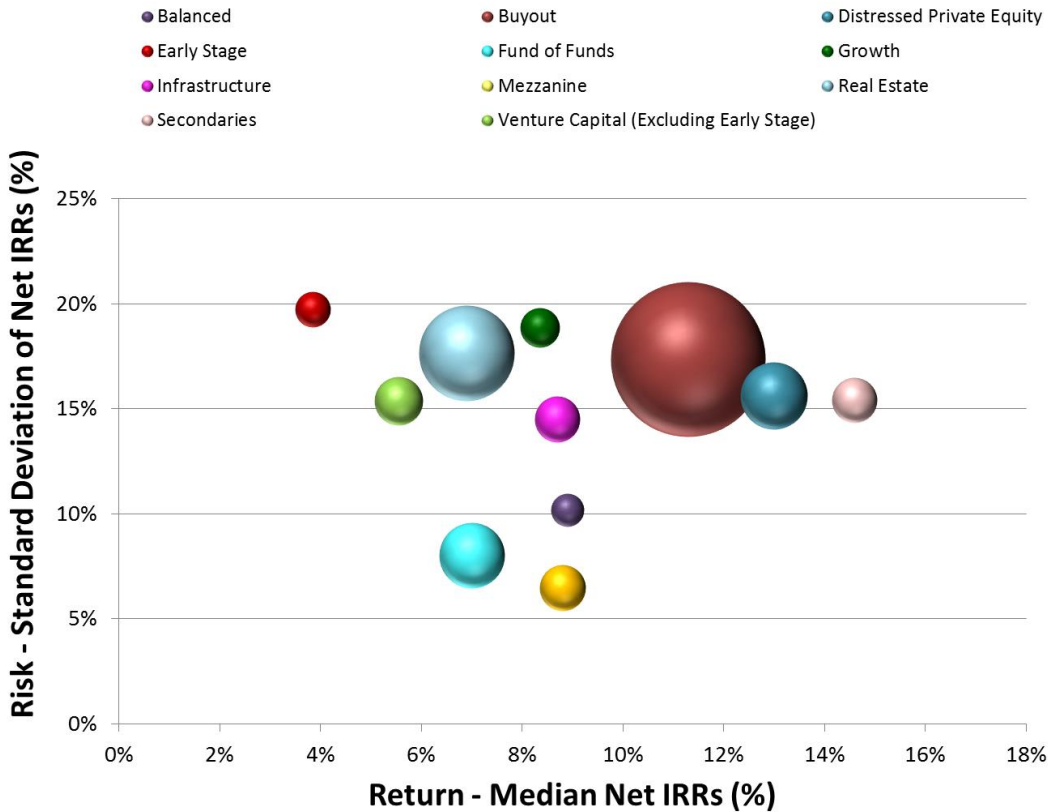
Interviews with fund managers reveal that providing growth loans commercially is more difficult than providing senior debt.⁵⁷ However, fund managers, particular mid-market funds report good finance returns from investing in mezzanine with an achieved track record of between 8-14% IRR, which compares favourably with other asset classes. Preqin⁵⁸ confirms mezzanine funds operating mainly at the mid-market level offer an attractive risk reward profile compared to other assets, especially equity finance. The median net IRR of 9% for mezzanine is achieved with a standard deviation of 6%.

⁵⁶ Numbers are rounded.

⁵⁷ Without care and attention, it is possible for mezzanine providers to end up with the transaction costs and risks comparable to an equity provider, but with a return only slightly higher than a provider of senior debt. For instance, Durteste (2013) highlights "Clearly mezzanine is a great asset class, but it has to be done well. Done poorly it's just under-priced equity without the rights".

⁵⁸ Preqin (2014) "2015 Preqin Global Private Equity and Venture Capital Report"

Figure 10: Risk and Return profile of different fund strategies



Source: Preqin

The research has revealed specific examples of small business focused debt funds that are operating with an attractive level of financial returns after fees and defaults in the same broad range, showing it is possible to make money from smaller deals if the fund is carefully designed and managed.

Whilst fund managers reported that smaller growth deals are harder to do due to the increased risks of things go wrong, which impacts on overall fund return, they also confirmed evidence of a number of structural market failures. These market failures reduce the supply of growth loans below what is economically optimal, so that some potentially viable businesses with growth potential are unable to obtain finance.

Consultation with market stakeholders has revealed a number of structural market issues affecting the supply and demand of growth loans:

- **Information Failures:** Information is needed for markets to work effectively.
- **Co-ordination Failures:** Limitations within the economic system prevent agents from coordinating their plans.
- **Impact of Regulations:** Financial regulations make unsecured lending to higher risk businesses more costly in terms of their treatment of capital.

Information Failures

Imperfect information leads to fund managers incurring costs in obtaining information about businesses investment prospects. This issue particularly affects smaller businesses as relatively more information is freely available or at least readily attainable on the viability and potential returns of larger businesses. Whilst economic theory suggests the costs of undertaking due diligence is fixed and do not vary by the size of investment deal, in practice, fund managers report that they do adjust the level of due diligence to reflect the size of the deal they are assessing, for instance by doing more in-house research to lower the costs. However, fund managers state due diligence is more important for smaller companies due to the greater level of risk.

“Due diligence is proportional to the amount of cash the company is seeking”
Smaller business focused debt fund manager

Due diligence for growth loans generally takes around 3-6 weeks in practice, and typical cost around £50k to £100k for loan sizes of around £5m, but can be larger if the fund commission’s specialist research from third party providers including leading accountants or specialist technical research.

“It is also inefficient in terms of the amount of due diligence and advisory fees to undertake smaller deals.”

Bank providing structured corporate finance

Fund managers report due diligence costs form a sizeable proportion of the total investment size of smaller investments and can makes smaller investments less commercially viable. There is some disagreement on what the minimum deal size would be. Whilst mid-market growth loan funds tend not to invest less than £10m, Private sector small business debt funds tend have a lower investment level of around £5m. Funds or finance providers with a volume driven model suggested it was possible to go as low as £250,000 to £500,000 only by using standardised loan documents and undertaking internal due diligence to keep the costs down.⁵⁹

Small business growth loans have a limited track record as an asset class.

Lack of a track record of generating financial returns is likely to make investors more risk adverse when investing in this asset class, and as a result demand a higher level of returns as compensation. If investors have incorrect expectations, this will result in a sub-optimal allocation of capital. Previously the availability of senior debt in the 1990’s and early 2000’s has restricted the supply of private debt and growth loans to smaller businesses from emerging. Therefore, small business growth loans have not developed a sufficient track record as an asset class, as there is only a small number of existing small business focused growth providers.⁶⁰ Several fund managers

⁵⁹ Fund managers also report to keeping legal fees low by not taking equity stakes or a charge over security. Therefore, structuring the finance as a growth loan may be more applicable to smaller investments, whilst mezzanine loans are used for larger investments.

⁶⁰ OECD (2013) reports mezzanine funds first began in the United States in the 1980s with the main investors being insurance companies and savings and loan associations. This has allowed

commented⁶¹ that investors have had very little face time with fund managers to date, but that the situation is now changing with institutional investors becoming aware of private debt.

The primary research revealed that institutional investors are becoming more aware of growth loans and mezzanine finance as asset class as it is perceived to be safer than equity funds and offers the potential for ongoing yield. However, a lack of a 15 year track record restricts the amount of funding they are able to allocate to this "alternative" investment.

"Private debt is beginning to become an asset class"

Institutional investment advisor

Respondents who had detailed knowledge of the investment environment commented that the outlook for private debt was fairly positive, but market changes take time.

"Fund managers are currently in the process of raising their second or third fund, after developing some (limited) track record from their first fund. Investment will pick up as long as positive financial returns materialise."

Institutional investment advisor

Small businesses lack information on how mezzanine finance works and where to obtain such finance. Whilst around 15% of smaller businesses are aware of mezzanine finance, only 5% of smaller businesses are aware of a specific supplier of mezzanine finance.⁶² Many businesses do not understand the positioning of mezzanine finance over secured debt, instead seeing it as 'expensive debt'.⁶³ Although this is also now changing, many smaller businesses may have the perception that senior debt finance from a bank is the only form of finance suitable for their business. Whilst growth loans can solve the issue of business aversion to equity finance, mezzanine loans can be very complex for businesses to understand. Businesses have to consider carefully whether it is cost effective using a mezzanine loan to facilitate additional growth, or whether other sources of finance like senior debt or equity is most appropriate for their specific needs.

"Entrepreneurs never see the risk, and do not understand cost of finance for riskier investments"

Smaller business focused debt fund manager

a sufficient track record to be built up, so that at present, the investor base has widened to include investors such as high net worth individuals, family offices, pension funds, hedge funds, leveraged public funds, as well as banks.

⁶¹ 2014 interviews

⁶² British Business Bank (2014) "SME journey towards external finance"

⁶³ This point was raised by recipients of the Finance South East Accelerator Fund, a fund providing mezzanine loans to smaller businesses. See BIS (2010) "Early Assessment of Impact of BIS Equity Fund Initiatives"

Market participants felt businesses needed educating on the relationship between risk and cost of finance, and also the implications of subordinated security to the growth loan lender.

“Mezzanine is more expensive than a senior debt loan, and the business must pay for flexibility and bespoke financing package.”

Small business focused debt fund manager

Lack of investment readiness leads to small businesses lacking the ability to present themselves as investable opportunities, for instance due to poorly specified business plans or inadequate management skills.⁶⁴ This will constrain the ability of these businesses to obtain investment. This is particularly important for growth loans which has a greater level of due diligence than senior debt, where growth loan providers look at all aspects of the company and its management.

“If the company does not have management accounts, we walk away.”

Small Business focused debt fund manager

There is thought to be an insufficient number of skilled fund managers able to assess small business growth investments and structure appropriate deals, with those that are skilled operating in other higher return parts of the market e.g. Private Equity funding Management Buy Outs (MBO) deals.

“It is too much effort to lend £2-£5m, when we can make investments of £50m.”

Mid-market focused debt fund manager

Fund managers report there are significant barriers to new fund managers from entering the market, as investors will tend to use reputation and track record as a proxy for likely future performance as gathering information on the quality of fund management teams is costly. Successful debt funds need a balanced team comprising of people with credit assessment skills, financial structuring skills and Merger and Acquisition skills including corporate restructuring for when things go wrong.

However, it is worth noting that the market is not static, so that even if there is new entry at the lower end of the growth loan market by new fund teams, fund success leads to providers moving upstream to larger deals. Larger funds do not lead to a greater number of deals but to greater deal sizes, as it is widely acknowledged that there are an optimal number of investments per fund.⁶⁵ Several of the fund managers of established private debt providers consulted as part of this research provided specific examples of how each subsequent fund they raised was larger than the previous one and in turn focused on larger deal sizes in later stage companies.

⁶⁴ To a certain extent smaller businesses face fixed costs in developing their financial capability, e.g. in terms of employing a qualified finance director.

⁶⁵ OECD (2013) suggests this to be in the region of 20-30 companies being the average before the fund becomes too administratively challenging to monitor and manage.

Co-ordination Failures

There are co-ordination failures between institutional investors like pension funds and insurance companies and debt funds making growth loans into smaller businesses. Fund managers report institutional investors generally make investments in at least £100m to £200m tranches, but don't want to be more than 10% of any one fund to reduce their risk. This means they only invest in large private debt funds of £1bn, which in turn only undertake larger deals. Small business focused debt funds are therefore excluded from obtaining funding from institutional investors and instead must obtain their capital from other sources.

Co-ordination failures also occur between senior debt and growth loan providers in establishing inter-creditor agreements. In the event of a borrower defaulting, fund managers report a misalignment of incentives between senior debt lenders and growth lenders, with senior lenders focussing upon quickly realising their security position, whereas growth lenders want a standstill period to get the company back on track. A satisfactory inter-creditor arrangement between senior debt provider and growth provider can be time consuming and complex to negotiate at the start of a deal. An inability to negotiate an arrangement leads to growth fund managers being in a weak position, leading them to prefer not to participate in smaller growth loan transactions in the first place. Fund managers had mixed views on the extent inter-creditor agreements was an issue, although most acknowledged that it does add some additional costs to smaller deals.

Impact of Regulation

Regulatory developments such as Basel III impact on how capital is allocated to different types of lending and asset classes. Whilst Basel III affects the overall supply of bank lending to businesses, it is likely discourage growth lending by banks due its riskier and less secured nature. Market participants⁶⁶ reported a number of UK banks had previously provided growth loans to businesses; mainly at the corporate level but the banking regulations and changes to economic conditions have stopped banks from directly offering mezzanine or venture debt. Several banks commented that the current tighter capital adequacy rules would make unsecured lending and smaller mezzanine deals disproportionately expensive in terms of capital, and as such it would not be commercially viable.

“The current regulatory environment would make it difficult it implement a mezzanine product today”

Bank

The Solvency II Directive is an EU Directive that focuses on the amount of capital EU insurance companies must hold to ensure that they have enough capital set aside to cover all insurance claims that they are likely to receive.⁶⁷ Some market participants

⁶⁶ Including banks themselves

⁶⁷ For more information see: <https://www.abi.org.uk/Insurance-and-savings/Topics-and-issues/Solvency-II>

felt that Solvency II's capital treatment does not fully reflect the true level of risk of the underlying asset as larger asset classes have better capital treatment, but smaller asset classes like private debt use a standardised model which is more capital intensive.

Chapter 3: Overseas Institutions Delivering Growth Loans

Primary research was also undertaken by the British Business Bank Market Analysis team with three overseas development banks delivering growth loans. The organisations consulted included:

- BPI France
- KfW in Germany
- Business Development Bank of Canada

The specific focus of this research was to collect information on programme design, performance and market impact. Assessment of publicly available information on design and performance across a wider range of countries schemes was also undertaken to identify clear lessons learned and common design features.

This section draws heavily on evidence collected by the OECD⁶⁸ on its member countries small business mezzanine finance schemes, as well as new evidence collection from publicly available information and direct contact with representatives of these overseas finance institutions.

Main Findings

Overseas development banks are actively involved in growth loan markets for smaller businesses, although the extent of involvement varies by country. There is widespread use of growth loans amongst international economic development banks, with support from the OECD welcoming development of mezzanine instruments and specifically acknowledging mezzanine finance as part of the solution to the current cyclical problems in the supply of bank finance:

“In countries where SMEs could obtain adequate growth capital from banks in the past, but where banks are seeking to contract their balance sheets, it will be important to broaden the range of financing options for SMEs”

OECD (2013) p60

Country specific factors e.g. laws, institutions, culture and policies have tended to influence the delivery mechanisms of Government initiated mezzanine finance schemes within each country. For instance, the use of loan guarantees for banks providing mezzanine products by KfW in Germany is partly due to German small businesses having a very close relationship with only one bank, which might have made direct origination by KfW less effective.

⁶⁸ OECD (2013) “Alternative Financing Instruments for SMEs and Entrepreneurs: the Case of Mezzanine Finance”

Many state development banks have been providing growth loans for at least 10 years, but particularly since 2009 in response to worldwide economic downturn. However, the experience in delivering growth loans suggests it can take a while for small business demand to become established.

Most public growth loan programmes avoid equity-like instruments such as equity warrants and instead favour “success fees” under which the finance agency receives a share of the profit or turnover of the company but does not acquire an active equity stake in the company. For instance, BPI France receives some compensation in the form of a share in the firm’s turnover above a specified level. This is likely to lead to lower costs in structuring the investments and legal costs. The Business Development Bank of Canada (BCD) is one exception as it does take equity positions in its mezzanine investments.

The majority of mezzanine finance schemes operate under the principle that the public sector finance agency or development bank mitigates or shares the risk with private suppliers of capital, whilst sharing in the rewards if the company attains above average growth. Public finance organisations are sometimes willing to accept riskier subordinate tranches, whilst the private sector bank provides the senior tranche of the finance. Most mezzanine guarantee schemes guarantee between 50-80% of the loan in the event of a default, the exception being KfW which guarantees 100% of the mezzanine tranche. However, KfW does require the bank to provide a senior debt component equivalent in size to the mezzanine tranche, so the bank also has some alignment of interest in ensuring the lending proposition is viable. These programmes usually stipulate conditions that the SME must meet in order to receive funding and set the terms of the contract, including the term length of the facility and the interest rate.

A number of organisations directly make loans available to businesses. Businesses can apply directly for mezzanine finance from BDC, KredEx, the Czech-Moravian Guarantee and Development Bank and from BPI France. However, most schemes are more passive (apart from mezzanine funds), with the public sector finance agency partnering with other finance organisations such as banks to deliver the growth loan product.

Overseas schemes are able to target smaller businesses up to £50m turnover. Although smaller deals of sub £500,000 are eligible, activity appears to be focused upon larger deal sizes. A detailed examination of four schemes is undertaken below to identify key design features.

France: BPI-France: The Contrat de Développement Participatif (CDP)

BPI-France is the French Business Bank tasked with improving access to finance for French businesses. The Bank has a number of regional offices and maintains close contact with businesses through its relationships with commercial partners (e.g. banks) which make the programmes available to businesses. BPI France has a range of mezzanine type finance products, but the main product is the Development Contract or DC (Contrat de Développement Participatif). This was introduced in October 2009 in response to the increasing difficulties of French businesses in obtaining finance as a result of the economic downturn. The aim of this programme is to provide financial support to growing businesses experiencing a funding gap.

Finance can be used for business expansion, real estate investment, acquisition of equipment, or assets, including intangible assets and working capital.

The DC is structured as a 7 year subordinated loan that has a two year capital repayment holiday. The interest rate varies depending on the risk rating assigned to the business by the Banque de France. No business or personal collateral is taken in the DC part of the loan but may be taken within the senior debt part. The investee business also provides an additional 5% deposit, which is returned to the business once the loan is repaid back. BPI France risk is also limited by a public guarantee fund from another part of BPI France which covers 80% of the risk.

The scheme is available for businesses that are at least three years old with less than 5,000 employees. Although businesses with up to 5,000 employees have taken advantage of the programme, some 76% of DCs have been to businesses with 249 or fewer employees. DCs of EUR1 million or less account for about 70% of the total, measured by the amount of the Contract.⁶⁹

The DC loan provides finance in the range of EUR 300,000 to EUR 3 million, although the median value invested was €680,000.⁷⁰ However, the amount that BPI France will contribute is usually limited by the size of additional funding raised. The business must obtain bank funding that is at least twice as large as the BPI France contribution or an increase in equity from existing or new shareholders of an amount at least equal to the BPI France contribution. In practice, the loan leverages between 4 and 5 times the sum lent by BPI France.⁷¹ In 2013, BPI lent €791m, a 9% increase from the previous year.⁷²

Germany: KfW: Entrepreneur Loan

In 2004, KfW launched "Unternehmerkapital" (Entrepreneur Capital) programme, which was designed to provide finance to growing businesses, and which adapted mezzanine products previously used by larger businesses to meet the needs of smaller growing businesses.

The loan offered under KfW Entrepreneur Loan subordinated capital scheme consists of two loan tranches of equal size, provided through a commercial bank. One part of the finance comprises of a traditional senior debt, in which the risk is carried by the bank and the growth loan tranche comprises of a subordinated loan that is 100% guaranteed by KfW. The small business applies for this finance via their main bank who can then offer the KfW product. KfW's credit risk management department conducts a second assessment based on its own and independent risk assessment

⁶⁹ OECD (2013) "Alternative Financing Instruments for SMEs and Entrepreneurs: the Case of Mezzanine Finance"

⁷⁰ CSES (2012) "Evaluation of Member State Policies to Facilitate Access to Finance for SMEs"

⁷¹ CSES (2012) "Evaluation of Member State Policies to Facilitate Access to Finance for SMEs"

⁷² BPI France (2014) "Annual Report 2013"

reviewing the information and the credit proposal issued by the originating bank. No collateral is required for the subordinated loan.

Businesses must be at least 3 years old and have a maximum annual turnover of €500 million.⁷³ Interest rates are fixed for up to 10 years, at favourable rates compared to the wider market and there is a long repayment holiday of up to 7 years. It is important to recognise that the German financing model is characterised by a general preference of smaller businesses for long-term debt over equity and the extensive network of bank offices.

At the end of April 2013, KfW closed this programme “due to low demand”. Possible reasons put forward by KfW for the low demand include the economic slowdown reducing business demand for finance, increased use of equity finance by German businesses and the scheme being subsumed into wider programme so becoming less visible. Nevertheless there are other mezzanine finance schemes operating in Germany.

Canada: Business Development Bank of Canada (BDC)⁷⁴

BDC is a financial institution owned by the Government of Canada, with its own branch network. BDC also delivers financial and consulting services to small and medium-sized businesses in Canada and BDC has been active in providing mezzanine finance for over 10 years. The mezzanine finance represents a relatively small share of total BDC activity, but is important for supporting growing companies. BDC can provide all of the financing on its own, but often partners with private financiers, including banks.

The subordinated finance can be used for acquisition, to fund business growth or working capital. The BDC does not generally provide mezzanine finance to early stage companies, but to established companies with a strong market position. The amount of subordinated finance available ranges from 250,000 CAD to 20 million CAD.

BDC mezzanine offering contains a subordinated loan which ranks behind secured lenders, as well as other features that provide additional income linked to the performance of the company. For instance, additional income can take the form of royalties on sales, interest based on enhanced value of the company, equity warrants. The maturity of the subordinated loan can be from three to seven years.

The number of mezzanine deals contracted at the beginning of the crisis in 2007 and remained flat throughout 2009, but then rebounded in 2010-2011. BDC Subordinate Financing lent a total of \$186.6 million financing in 2014, compared to \$189.8 million in 2013.⁷⁵

⁷³ CSES (2012) “Evaluation of Member State Policies to Facilitate Access to Finance for SMEs”

⁷⁴ http://www.bdc.ca/EN/solutions/subordinate_financing/Pages/default.aspx

⁷⁵ BDC “Annual Report 2014”

United States: The SBIC programme

The Small Business Investment Company (SBIC) programme is administered by the Small Business Administration (SBA) and was created in 1958 to address funding gaps affecting small businesses. SBICs are privately owned and managed investment funds that are licensed and regulated by SBA, that use their own capital combined with funds borrowed from the SBA to make investments in small businesses. SBICs have funded a number of well-known businesses including Apple, FedEx and Intel, and have a major impact on the financing of American small businesses. For instance, SBA report⁷⁶ that since inception, SBICs have provided around 64% of the total amount of private capital to American small businesses.⁷⁷

SBICs provided \$5.5bn in financing to over 1,000 small businesses in 2014 financial year. SBICs can invest in venture capital, but the majority of their investments are through debt instruments including mezzanine financing. For instance, 82% of SBIC investments by value in 2014 went to debt or debt with equity features.⁷⁸

SBICs are required to invest in small businesses, but depending on sector, a small business can have up to 5,000 employees which are considerably larger than the UK definition which includes businesses with up to 250 employees. At least 25% of an SBIC's funds must be invested in smaller businesses that have total net worth of less than USD 6 million and average taxable net income of less than USD 2 million for the two last fiscal years. Investment in financial institutions, real estate projects, single purpose projects, and foreign owned businesses are prohibited under the SBIC rules.

The SBIC programme is funded by a combination of both public and private capital, with the SBA being the senior creditor to the individual SBIC fund. SBA receives a prioritised interest regardless of the performance of the underlying portfolio companies, and so there is an incentive for the fund to maximise its returns to benefit from the leverage provided by the SBIC.⁷⁹ The cost of borrowing from the SBA is attractive as it is based upon the 10-year US Treasury rate plus a spread, usually of about 60-80 points, which is lower than other sources of funding. In 2012, the

⁷⁶ SBA (2014) "Office of Investment and Innovation Office Overview"

⁷⁷ SBA (2014) "Small Business Investment Company (SBIC) Program Overview (As of December 31 2014)"

⁷⁸ SBA (2014) Small Business Investment Company (SBIC) Program Overview (As of December 31 2014)

⁷⁹ Relative to the private equity industry as a whole, SBICs that perform in the first and second quartile of private equity on an unleveraged basis benefit significantly from access to SBA-guaranteed leverage. For third quartile SBICs, the leverage has a slightly negative effect, but for SBICs that perform in the bottom quartile there is a large negative impact from the use of SBA leverage.

interest rate charged to SBICs was 2.25%, and the programme is cost neutral to the US taxpayer.⁸⁰

SBICs are considered as a distinct asset class by investors and are attractive to a range of institutional investors, pension funds and multinational corporations. SBA analysis suggests "SBIC performance compares favourably on a pooled basis to the rest of the industry in terms of multiples, IRRs and distributions". Mezzanine SBIC funds appear to have performed strongly with 19% falling into the top quartile of the wider PE industry with a median IRR of 22.9% and 41% are second quartile with a median net IRR of 10.9%.⁸¹ This suggests the SBIC structure is attractive to private sector investors, especially when considered on a risk adjusted basis compared to equity finance.

⁸⁰ SBA (2012) "The Small Business Investment Company (SBIC) Program Annual Report FY 2012"

⁸¹ SBA (2012) "The Small Business Investment Company (SBIC) Program Annual Report FY 2012"

Chapter 4: Conclusions

The British Business Bank has the objective to create more effective finance markets for smaller businesses in the UK. This research has found evidence to suggest that the smaller business growth loans market is currently not working as effectively as it could with impediments affecting both the supply and the demand-side. Despite a number of new Government funded growth and mezzanine loan funds established since 2009, the British Business Bank has identified a possible growth loan funding gap in the range of £170m to £870m per year for deal sizes of up to £2m. The gap could be considerable larger when deals in the range £2m to £5m are considered. The scale of the gap is also likely to increase in the future as business demand for finance increases from its current low levels.

Whilst the British Business Bank already operates in the growth loan market through the Small-Cap Business Finance Partnership and Investment Programme, these funds are targeted at larger loans in larger SMEs. This research therefore identifies a funding gap that exists for smaller businesses seeking investment in the range of £0.5-£5m, but particularly for deal sizes up to £2m.

Market participants consulted as part of this research provide evidence of a funding gap as there are instances of viable growing businesses that currently cannot obtain funding from senior debt providers due to their risk or lack of physical security. Respondents identified growth loans may suit the funding needs of some of these businesses to facilitate additional business growth, but there has been limited entry by new growth loan providers targeting smaller businesses. The research has identified specific market failures restricting the supply of growth deals to smaller businesses, and also restrictions on growth loans as an asset class overall.

On the demand side there is clear evidence that businesses lack information on where to obtain finance if they are not suitable for senior debt, and there is some resistance from smaller businesses to the higher costs of using growth loans compared to senior debt. Addressing issues on the demand side is as equally as important as addressing supply side constraints as the smaller business growth loan market is currently a 'missing market' with very few suppliers and businesses specifically seeking this type of finance. Whilst the UK small business growth loan market is currently under developed, there is some historical precedence from 3i⁸² and experience of overseas growth loan schemes that demonstrate mezzanine instruments can work in the overall funding environment.

⁸² See Coopey et al. (1995) for a fuller description. The organisation was formed in 1945 as the Industrial and Commercial Finance Corporation (ICFC), by the Bank of England and major British banks to provide long term investment funding for smaller businesses to address concerns raised by the Macmillan Committee. ICFC expanded in the 1950's and 1960's to become the largest provider of growth capital for UK companies predominantly using a mezzanine instrument. In the 1980s, the organisation became a leading provider of finance for management buyouts, and expanded internationally, but by the time 3i floated in the early 1990's, 3i no longer provided growth loans to smaller companies.

It is important to acknowledge that small business demand for external finance has not yet substantially increased from its low levels, but is widely expected to do so as business wish to undertake investment beyond internal sources of funding. Many businesses will also have experienced adverse trading factors in the recession, which will have blemished their credit ratings, and so the establishment of specialist finance providers better able to assess the viability of non-standard businesses should be encouraged. The current supply of growth loans is unlikely to meet the additional demand for finance from growing business. The experience of overseas growth loan programmes suggests that there are no quick fixes, and it is likely that UK small business growth loan market will take time to become established, but the British Business Bank can play an important role in helping to catalyse the market.

References

- AIC (2013) "Investing for the future"
<http://www.theaic.co.uk/sites/default/files/hidden-files/AICVCTInvestingfortheFutureMay13.pdf>
- Bank of England, 2014 "Inflation Report August 2014"
<http://www.bankofengland.co.uk/publications/Documents/inflationreport/2014/ir14aug.pdf>
- BBA (2014) "Bank support for SMEs – 4th Quarter 2014"
<https://www.bba.org.uk/news/statistics/sme-statistics/bank-support-for-smes-4th-quarter-2014/>
- BDC "Annual Report 2014"
http://www.bdc.ca/EN/Documents/annualreport/BDC_AnnualReport_2014.pdf
- BDRC (2015) "SME Finance Monitor Q4 2014" <http://bdrc-continental.com/products/sme-finance-monitor/>
- BIS (2009) "The provision of Growth Capital to UK SMEs" (Rowlands Review)
<http://www.bis.gov.uk/files/file53698.pdf>
- BIS (2010) "Early Assessment of impact of BIS equity Fund initiatives"
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32234/10-1037-early-assessment-bis-equity-fund-initiatives.pdf
- BIS (2012) "Boosting Finance Options for Business" (Breedon Review)
<http://www.bis.gov.uk/assets/biscore/enterprise/docs/b/12-668-boosting-finance-options-for-business.pdf>
- BIS (2012) "MSB Demographics"
<https://www.gov.uk/government/publications/msb-demographics>
- BIS (2014) "Business population estimates for the UK and Regions 2014"
www.gov.uk/government/uploads/system/uploads/attachment_data/file/377934/bpe_2014_statistical_release.pdf
- BIS (2015) "Small Business Survey 2014: businesses with employees"
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/408498/bis-15-151-small-business-survey-2014-sme-employers.pdf
- BPI France (2014) "EPIC BPI-Groupe Annual Report 2013"
<http://www.bpifrance.fr/content/download/5556/61879/version/1/file/Annual%20Report%202013%20EPIC%20BPI-Groupe.pdf>
- British Business Bank (2013) "SME Journey towards raising finance"
<http://british-business-bank.co.uk/wp-content/uploads/2013/10/SME-Journey-Towards-Raising-Finance.pdf>

- British Business Bank (2014) "Access to Finance of Mid-sized Businesses: Lessons for tomorrow's medium-sized businesses" <http://british-business-bank.co.uk/wp-content/uploads/2014/05/13-035831-01-Access-to-Finance-report-130514-Final-pdf.pdf>
- British Business Bank (2014) "SME Journey towards raising finance" <http://british-business-bank.co.uk/wp-content/uploads/2014/12/Final-BMG-SME-Journey-Research-Report.pdf>
- British Business Bank (2014) "Small business finance markets 2014" http://british-business-bank.co.uk/wp-content/uploads/2014/12/BBB_Small-Business-Finance-Markets-2014_Online_Interactive.pdf
- Coopey and Clarke (1995) "3i: Fifty years investing in industry"
- CSES (2012) "Evaluation of Member State Policies to Facilitate Access to Finance for SMEs" http://ec.europa.eu/enterprise/policies/finance/guide-to-funding/indirect-funding/files/evaluation-of-national-financing-programmes-2012_en.pdf
- Deloitte (2014) "Deloitte Alternative Lender Deal Tracker (December 2014)" <http://www2.deloitte.com/content/dam/Deloitte/uk/Documents/corporate-finance/deloitte-uk-alternative-lender-deal-tracker-q3-public-for-distribution.pdf>
- Durteste (2013) "Flexibility and Scale" <http://www.icgplc.com/SiteCollectionDocuments/private-debt-investor-benoit-durteste-article-oct13.pdf>
- European Commission (2011) "Impact Assessment Accompanying the document Regulation of the European Parliament and the Council on prudential requirements for the credit institutions and investment firms" http://ec.europa.eu/internal_market/bank/docs/regcapital/CRD4_reform/IA_regulation_en.pdf
- Evain (2013) "European Direct Lending – an Attractive Risk/Return Opportunity for Investors?" <http://www.icgplc.com/SiteCollectionDocuments/2013-Preqin-Investor-Network-Global-Alternatives-Report.pdf>
- Financial Stability Board (2011) "Shadow Banking: Strengthening Oversight and Regulation" www.financialstabilityboard.org/publications/r_111027a.pdf
- FSB (2014) "Voice of Small Business Index, Q4 2014" <http://www.fsb.org.uk/policy/assets/fsb-index-q4-2014-final.pdf>
- HMRC (2014) "Venture Capital Trusts: number of trusts and amount of funds raised (September 2014)" https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/358214/140812_IRS_Sep2014.pdf

- Independent Lending Review (2013) "RBS Independent Lending Review"
http://www.independentlendingreview.co.uk/RBS_ILR_Full_Report.pdf
- IPO (2014) "Banking on IP? The role of intellectual property and intangible assets in facilitating business finance: Final report"
<http://www.ipso.gov.uk/ipresearch-bankingip.pdf>
- NESTA (2011) "Barriers to growth"
<http://www.nesta.org.uk/publications/barriers-growth>
- OBR (2014) "Economic and Fiscal Outlook"- December 2014
http://budgetresponsibility.org.uk/pubs/December_2014_EFO-web513.pdf
- OECD (2013) "Alternative Financing Instruments for SMEs and Entrepreneurs: the Case of Mezzanine Finance"
[http://search.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=CFE/SME\(2012\)9/FINAL&docLanguage=En](http://search.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=CFE/SME(2012)9/FINAL&docLanguage=En)
- ONS (2015) "Gross Domestic Product Preliminary Estimate, Q4 2014"
http://www.ons.gov.uk/ons/dcp171778_392909.pdf
- Preqin (2014) "2015 Preqin Global Private Equity and Venture Capital Report"
<https://www.preqin.com/docs/newsletters/pe/Preqin-Private-Equity-Spotlight-December-2014.pdf>
- SBA (2012) "The Small Business Investment Company (SBIC) Program Annual Report FY 2012"
<http://www.sba.gov/sites/default/files/files/SBIC%20Program%20FY%202012%20Annual%20Report.pdf>
- SBA (2014) "Office of Investment and Innovation Office Overview"
[https://www.sba.gov/sites/default/files/lender/2014-06-11%20\(OII%20Overview\).pdf](https://www.sba.gov/sites/default/files/lender/2014-06-11%20(OII%20Overview).pdf)
- SBA (2014) "Small Business Investment Company (SBIC) Program Overview (As of December 31 2014)"
https://www.sba.gov/sites/default/files/articles/WebSBICProgramOverview_December2014_0.pdf

Glossary of Terms

- **Buyout**- A financial transaction by which the ownership of a company, or a majority share of the ownership of a company is acquired by another party.
- **Collateral**- Assets that are pledged as security for repayment of a loan and which are forfeited in the event of the loan defaulting.
- **Covenant**- Clauses placed in a loan agreement that require the borrower to fulfil certain conditions or which forbid the borrower from undertaking certain actions. If the borrower violates a covenant this may result in a default on the loan being declared, so that penalties are applied by the lender, or the loan is recalled requiring full repayment.
- **Default**- A borrower has not paid a debt that they were required to pay.
- **Equity Finance**- Finance provided through an equity stake in a company, with the anticipation of a financial return through a capital gain as the value of the equity stake rises with the growth of the company or from dividend.
- **Equity Warrant**- Offers the lender the right to buy an agreed share in the company at a known price for a certain period of time. Equity warrants are used by mezzanine lenders to capture a share of the upside should the company perform well.
- **Inter-creditor Agreement**- An agreement between one or more lenders that have a shared interest in a particular borrower specifying aspects of their relationship. For instance, what happens in a default position or if loan covenants are broken by the borrowing business.
- **Intellectual property (IP)** – A narrow definition of IP consists of intangible assets that can formally be registered (e.g. patents, trademarks and registered designs), and also copyright activities, which have some value. A wider definition includes assets that are embedded within what a business sells, such as trade secrets and contractual agreements.
- **Initial Public Offering (IPO)** - The process by which a privately owned company transforms into a public company, where its shares are traded on a public stock market. It allows venture capitalists to exit their investments and realise their capital.
- **IRR (Internal Rate of Return)** - The IRR is the annualized effective compounded rate of return on an investment.
- **Management Buy Outs (MBO)** - A form of acquisition where a company's existing managers acquire a large part or all of the company from either the parent company or from private owners. This is largely financed using Private Equity funding.

- **Mezzanine finance**- A debt instrument that shares some of the characteristics of equity finance by having a variable returns component within it.
- **Mid-cap**- Mid-cap businesses are larger than SMEs and are defined as having an annual turnover of between £25m to £500m.
- **Mid-market debt fund**- Private Debt fund making loans in excess of £10-£15m to larger businesses.
- **Pari passu**- A Latin phrase that means "on equal footing". Investing on a pari passu basis means all investors invest on equal terms.
- **Private debt funds**- A limited liability fund structure which uses debt instruments to invest in businesses. Debt funds provide flexible finance for 'event driven' growth orientated companies.
- **Second Lien**- A type of subordinated loan where the collateral pledged for the second lien loan is ranked behind the secured senior debt. In the event of liquidation, the assets used by the borrower as security would first be provided to the secured lenders first, with any assets left over after repayment only then going to the second lien lender.
- **Senior debt**- Lending that a borrower must repay ahead of all other borrowing if the company is liquidated.
- **Small and Medium sized Enterprise (SME)** - There is no standard definition of an SME, but generally SMEs are defined as having less than 250 employees or annual turnover of less than £25m.
- **Sponsored deals**- Growth loan deals involving a Private Equity House, where growth loans are used to minimise the equity dilution of the Private Equity House and business owner. The Private Equity house brings the deal to the growth loan provider, and it is largely used in buy out transactions.
- **Subordinated debt**- Debt that ranks behind senior debt in the event of the loan defaulting.
- **Venture Capital**- Finance provided through an equity stake to early-stage, high growth potential companies by Limited Liability Partnership equity funds.
- **Unitranche**- A type of debt that combines senior and subordinated debt into one loan agreement.
- **Un-sponsored deals**- Growth loan not involving a Private Equity sponsor, predominantly used to grow the business. The growth loan provider is responsible for sourcing the investment and undertaking all due diligence.

Acknowledgments

This paper was developed by Dan van der Schans in the British Business Bank Market Analysis Team with contributions from Matt Adey, Judith Ozcan, Mark Hambly and Scott O'Brien.

We would like to thank everyone that gave their time and discussed their views of the growth loan market. In particular, we would like to thank the following people:

- Sumon Bhaumik (University of Sheffield) for his useful comments on an earlier draft of the paper.
- Adam Tyler (NACFB) for facilitating contact with their broker members.

Legal notice

British Business Bank plc is a public limited company registered in England and Wales registration number 08616013, registered office at Foundry House, 3 Millsands, Sheffield, S3 8NH. As the holding company of the group operating under the trading name of British Business Bank, it is a development bank wholly owned by HM Government and is not authorised or regulated by the Prudential Regulation Authority (PRA) or the Financial Conduct Authority (FCA). British Business Bank operates under its own trading name through a number of subsidiaries, one of which is authorised and regulated by the FCA. British Business Finance Ltd (registration number 09091928), British Business Bank Investments Ltd (registration number 09091930) and British Business Financial Services Ltd (registration number 09174621) are wholly owned subsidiaries of British Business Bank plc. These companies are all registered in England and Wales, with their registered office at Foundry House, 3 Millsands, Sheffield, S3 8NH. They are not authorised or regulated by the PRA or FCA. Capital for Enterprise Fund Managers Limited is a wholly owned subsidiary of British Business Bank plc, registered in England and Wales, registration number 06826072, registered office at Foundry House, 3 Millsands, Sheffield, S3 8NH. It is authorised and regulated by the FCA (FRN: 496977). British Business Bank plc and its subsidiary entities are not banking institutions and **do not** operate as such. A complete legal structure chart for British Business Bank plc and its subsidiaries can be found at www.british-business-bank.co.uk.

© British Business Bank plc (March 2015)

This publication is available from british-business-bank.co.uk.

Any enquiries regarding this publication should be sent to:

British Business Bank plc

Foundry House

3 Millsands

Sheffield S3 8NH

