BRITISH BUSINESS BANK

Small Business Finance Markets

2019/20

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FOREWORD

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The British Business Bank, established in 2014, improves finance markets for smaller businesses - wherever they are in the UK and wherever they are on their finance journey – enabling them to prosper and grow.

Our sixth Small Business Finance Markets report provides a timely, comprehensive and impartial assessment of finance markets for smaller businesses. Its insights and analysis, combined with our market intelligence and experience as an active market participant, enable the Bank to act as a centre of expertise on finance for smaller UK businesses and advise the Government on their finance needs.

Since the Bank's creation in 2014, there has been significant long-term growth in finance flows outside of traditional bank lending products, with equity finance more than doubling, marketplace lending exceeding £2bn in 2018 and asset finance growing by an average of 7% per year since 2014. This is in contrast to bank lending, where flows have been flat in real terms, driven by weakness in demand for new loans and overdrafts and a reluctance to take on external finance.

The past five years have seen increased competition and innovation in the supply of SME finance. The increased diversity in the range of providers, products and platforms, together with increasing volumes in these markets, means that smaller businesses have more finance options to choose from than ever before. When it comes to the demand for finance smaller businesses are also prepared to consider more options, with over half of those businesses that sought finance in 2019 contacting finance providers outside the five main UK banks.

Looking forward, smaller businesses' confidence is showing signs of recovery following the economic and political uncertainty of 2019. The Bank has worked with other market participants and Government through the Business Finance Council to ensure smaller businesses can continue to access the finance they need to grow. We will continue to monitor markets closely to help smaller businesses respond effectively to the economic opportunities and challenges in 2020.

Recognising the importance of smaller businesses being able to access finance wherever they're based, a key theme of this year's report is how entrepreneurial ecosystems vary across the regions and localities of the UK. The availability and ease of accessing finance for smaller businesses depends greatly on locality, with disparities particularly apparent in awareness and availability of alternative finance options, particularly those that finance growth. In this report, we examine the characteristics of successful local ecosystems, and how public and private sector intermediaries can best collaborate to enhance the development of local finance markets.

This year, we've included more market intelligence from our own programmes alongside the results of our expanded Small Business Finance Survey to get a more complete picture of smaller businesses' use of and attitudes towards finance across the UK. There are signs of improvement in particular hubs – Manchester, Edinburgh and Cambridge sit alongside 7 London boroughs in the top 10 of local authority districts for number of equity deals in the first three quarters of 2019.

However, the Bank recognises there is more to be done in addressing regional gaps on both the demand and supply side. There are several ways the Bank looks to tackle local disparities in finance markets, supporting the Government's aim of 'levelling up' the regions:

- With a Government commitment to expand our Start Up Loans programme, we can continue to support entrepreneurial activity, by providing loans and mentoring, across the UK.
- We continue to support investment and high-skilled employment through specific funds operating in the Northern Powerhouse, Midlands Engine and Cornwall & Isles of Scilly regions.
- The Bank's UK Network works with intermediaries to improve connectivity within local and regional ecosystems.
- The Bank's Finance Hub enables smaller businesses to explore the finance options that would work best for their business and signposts to relevant finance experts and associations, to ensure that wherever businesses are based they can access reliable, independent information on their finance options.

The Bank continues to develop a strong evidence base to underpin its interventions and proactively address information gaps, such as collaborating with European development banks on research to understand the challenges UK businesses face when investing in digitalisation and working with stakeholders to collect data on the UK's private debt market and business angel investment.

We continue to expand the network of organisations we work with in a bid to deepen our knowledge and understanding of the ways in which finance markets support smaller businesses. We know that previous editions of our Small Business Finance Markets report have proved to be a valuable source of information for policy makers and others with an interest in ensuring the success of the sector.

I hope you find this year's report informative and useful.

EXECUTIVE SUMMARY

Small business finance markets have always had a key role to play in supporting small businesses, whether that be helping start and grow new businesses or supporting the activities of established SMEs. Business finance will be particularly important as the UK economy adapts to leaving the EU and responds to the opportunities and challenges ranging from the generation and adoption of new technologies to increased trade protectionism and decarbonisation.

This report combines a look at developments in Small Business Finance Markets in the five years since the Bank was launched, with a more detailed look at the developments in 2019 and prospects for 2020. Four key findings stand out.

SIGNIFICANT GROWTH IN SME FINANCE MARKETS OUTSIDE OF TRADITIONAL BANK LENDING PRODUCTS SINCE 2014

First, there has been significant growth in the volume of finance supplied to smaller businesses outside of traditional bank lending products. Notably the value of equity finance has more than doubled, driven by an increase in large later stage deals. On the debt side asset finance volumes have grown at a compound annual rate of 7% and marketplace business lending exceeded £2bn in 2018. This growth in volumes reflected a significant increase in SMEs' awareness of the products available to them and has provided support to a wide range of start-ups and smaller businesses looking to invest and grow.

However, many smaller businesses are reluctant to use finance, with falling demand for core bank products from 2014 to 2018. While use of external finance did increase in 2019, the long-term decline in applications for term loans has not reversed. This has been reflected in relatively flat levels of bank lending.

The decline in applications reflects smaller businesses' continued desire to avoid debt finance in recent years with more than 70% of SMEs saying that they would forego some growth in order to avoid taking on more debt. In addition, smaller businesses underestimate their chances of success when applying for finance. Improving the demand side of the small business finance market therefore remains a key objective of the British Business Bank.

INCREASED RANGE OF PROVIDERS IN BANKING AND OTHER SME FINANCE PRODUCTS

The increase in volume of SME finance has been matched by an increase in the range of providers of products, many of them offering new ways of delivering finance. Between 2013 and 2019 over 40 new bank licences were granted, around half of which went to challenger or specialist banks that provide services to businesses. These range from online only banks to more traditional branch-based delivery models.

Emerging providers of SME finance have also gained an increased share of other debt product markets, for example the share of asset finance provided by independent challenger and specialist banks has increased steadily in recent years.

In equity finance there is a greater range of fund managers in the market with 26 funds closing in 2019, many of them new or emerging fund managers, resulting in an increase in available capital.

This significant entry of new providers and products has been supported by the British Business Bank which has made an important contribution to growing supply capacity and helping increase competition in SME finance markets.

ECONOMIC UNCERTAINTY LED TO INCREASED DEMAND FOR SHORT-TERM FINANCE IN EARLY 2019

Turning to more recent developments, 2019 saw a weak and uncertain economic environment, driven by EU exit uncertainty and wider economic concerns such as increased trade protectionism. This resulted in lower business confidence and a decline in investment intentions amongst SMEs.

In the run up to the initial EU exit date of 31st March 2019, there was an increase in the use of external finance peaking at 46% of SMEs using at least one external finance product in H1 2019. The increase in use was concentrated in short-term debt products, such as credit cards and overdrafts, and asset finance products. Use of finance has fallen back slightly to 43% in Q4.

British Business Bank survey work undertaken in the Autumn of 2019 suggested that the majority of smaller businesses did not expect leaving the EU to impact, either positively or negatively, on their growth prospects. However, the majority of those expecting an impact reported that it would have a negative impact.

Since the Withdrawal Agreement was reached, there have been some signs of a recovery in business sentiment, with monthly bank lending data improving in November and December and some forecasters suggesting improved business investment and economic growth in 2020. The Bank will continue to monitor SME finance markets closely in 2020.

IMPROVING REGIONAL & LOCAL ENTREPRENEURIAL ECOSYSTEMS WILL HELP REDUCE LOCAL ECONOMIC DISPARITIES

Previous Small Business Finance Market Reports have reviewed the regional distribution of SME finance. This year the report looks in more depth into the characteristics of successful entrepreneurial ecosystems. This is particularly important in the context of some signs of weakness in entrepreneurial activity in 2019, and slower growth of early stage equity finance compared to late stage growth.

Understanding local ecosystems highlights not just the links between suppliers and users of finance, but how they interact with other intermediaries. This is the case, both for private intermediaries such as financial advisers, accountants and other business services, but also the public sector bodies such as growth hubs and Local Enterprise Partnerships.

THE BRITISH BUSINESS BANK CONTINUES TO DEVELOP ITS ACTIVITIES IN SME FINANCE MARKETS

The British Business Bank strategy has evolved to both reflect, and shape, the market developments highlighted above. The increase in equity activity following the creation of the Bank's dedicated equity finance business, British Patient Capital, and the establishment of regional funds such as the Northern Powerhouse and Midlands Engine Investment Funds, has helped shape developments.

And the increase in our demand side activity, for example with the creation of the Finance Hub and the UK Network, which works with small business finance intermediaries to enhance business finance ecosystems, will help develop a better functioning market for smaller business finance.

INTRODUCTION

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

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

NEW EVIDENCE AND ANALYSIS

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

- Our annual Small Business Finance Survey has been expanded to 4,000 interviews to give greater insight into variation in SME finance across the UK.
- We have added extra sections to Part B of the report to give more insight into developments in challenger bank activities and invoice and asset-based lending.
- We draw on our own Management Information (MI) and experience as a market participant to gain insights into use of Bank-supported programmes across the UK.

The report draws on data available through to the end of January 2020.

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

STRUCTURE OF THE REPORT

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

Part A provides a thematic overview looking in turn at SME finance markets over the last five years, the impact of the macroeconomy on SMEs' use of finance and a review of the role of finance in entrepreneurial ecosystems.

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

1.1 FIVE YEARS ON – WHAT HAS CHANGED IN SMALL BUSINESS FINANCE MARKETS

- Significant growth in finance volumes since 2014, except for core bank lending products
- Small businesses remain reluctant to use finance, with lack of demand the main driver in the decline in the use of core bank lending products
- Increased diversity in many of the dimensions of small business finance markets with significant entry of new providers and new product developments
- The recent increase in later stage equity finance should help improve scale-up performance of UK smaller businesses over time
- Significant regional and local variation, particularly in smaller businesses' use of equity finance
- The British Business Bank strategy has evolved to both reflect, and shape, market developments

It is just over five years since the launch of the British Business Bank and the first Small Business Finance Markets report. That publication identified three themes. First, that more smaller businesses would seek finance for growth following the recovery from the financial crisis. Second, that a more diverse and vibrant supply of finance was needed. Third, that awareness and understanding of the range of finance options was patchy with some small businesses discouraged from applying.

These themes link to three of the Bank's four original objectives, namely to increase the supply of finance available to smaller businesses in areas where markets do not work well, to create a more diverse finance market for smaller businesses and to help ensure better provision of information in the market, connecting smaller businesses and finance providers.

This chapter reviews developments in the small business finance markets over the subsequent five years, identifying how those markets have evolved and concluding by summarising the evolution of the British Business Bank's activities to reflect that changing market.

SIGNIFICANT GROWTH IN FINANCE VOLUMES SINCE 2014, EXCEPT FOR CORE BANK LENDING PRODUCTS

Each edition of the Small Business Finance Markets report has included a core table tracking the volume of several of the key finance products used by smaller businesses. The annual volume of activity for each product from 2014 onwards is included, as well as the latest available data for 2019 (figure A.1).

Bank lending, measured both by stock and gross flows was close to flat in nominal terms between 2015 and 2018. This followed a rise in gross bank lending of £4.4bn from 2014 to 2015. In 2019 gross flows fell by 1.7% to £56.7bn, the lowest figure for five years. This represents a significant real fall in the gross flow since 2015. Real bank lending flows increased by 1.2% from 2014 to 2018, but the real decline from 2015 to 2018 is 6.0%.[1]

Following the financial crisis there was a focus on both gross and net lending. Gross bank lending was on an upward trend from 2012 to 2014 as levels recovered from the financial crisis, however repayments were on a similar upward trend. As a result, net lending did not turn positive until the final quarter of 2014. Since then net lending has been positive but only just so in 2017 and 2018. UK Finance data gives a similar picture for term loans and overdrafts, see section 2.4 for a more detailed discussion.

Other products have all shown considerable nominal growth between 2014 and 2018. Asset finance, already a significant source of funding for smaller businesses, grew at a compound annual growth rate (CAGR) of 7% from 2014 to 2018, and showed continued growth in 2019.

FIG A.1

VOLUMES OF MAIN SME EXTERNAL FINANCE PRODUCTS (£BILLION) (a)

Source: As in table

		2014	2015	2016	2017	2018	**2019**
Bank lending stock *Source: Bank of England*	Outstanding Amount	167	164	166	165	166	**168**
Bank lending flows *Source: Bank of England*	Gross flows (b)	53.4	57.9	59.2	57.3	57.7	**56.7**
Other gross flows of SME Finance							
Private external equity investments *Source: Beauhurst*		2.9	4.2	3.9	6.4	6.7	**5.5** (Sep)
	No. of reported deals	1406	1562	1524	1710	1602	**1241** (Sep)
Asset finance flows *Source: FLA (c)*		14.7	16.3	17.0	19.0	19.4	**20.1**
Marketplace lending business lending flows *Source: Brismo & British Business Bank calculations (d)*		0.50	0.90	1.39	1.99	2.37	**1.90** (Sep)

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

(b) Data exclude overdrafts and covers loans in both sterling and foreign currency, expressed in sterling.

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

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

FIG A.2

SMEs USING EXTERNAL FINANCE AND PERMANENT NON-BORROWERS

Source: BVA BDRC SME Finance Monitor, 3 months to December 2019. 2011 data not shown consistent with BVA BDRC reporting. Dotted line denotes start of quarterly data.

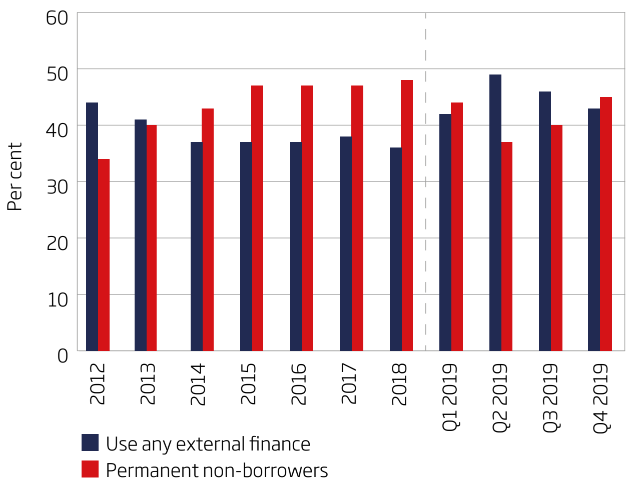
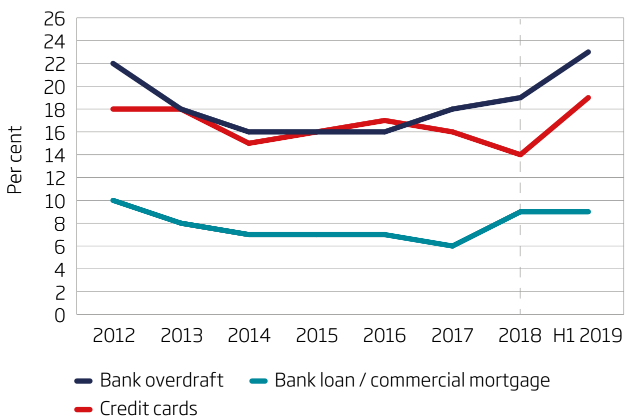


FIG A.3

SME's USING CORE FINANCE PRODUCTS OVER TIME

Source: BVA BDRC SME Finance Monitor Q2 2019



Marketplace business lending, formerly referred to as peer to peer lending, was still in its infancy in 2014 and demonstrated a remarkable CAGR of 48% from 2014 to 2018, becoming a significant source of finance to smaller businesses. Growth has fallen back in 2019, and the sector is facing some challenges. These are discussed in more detail in section 2.10: Marketplace lending.

Outside of debt finance, the value of external equity finance provided to smaller businesses increased markedly between 2014 and 2018 with a 23% CAGR leading to a doubling of equity investment. However, it should be noted that the growth in deal numbers, whilst still significant, is lower at 3%, resulting in a rise in the average deal size, see section 2.6: Equity finance for a discussion of more recent developments.

The rapid growth of equity finance and marketplace lending, combined with the consistently significant growth of asset finance, demonstrate the increased diversity in the volume of finance products used by smaller businesses.

SMALL BUSINESSES REMAIN RELUCTANT TO USE FINANCE, WITH LACK OF DEMAND THE MAIN DRIVER IN THE DECLINE IN THE USE OF CORE BANK LENDING PRODUCTS

Despite the relatively healthy performance of the aggregate flows of the main SME finance products, the share of small businesses using external finance did not increase from 2014 to 2018 (figure A.2). The number of SMEs using external finance had been on a downward trend following the financial crisis, whilst this stabilised from 2014 to 2018 it is only in 2019 that the series showed a significant increase.

Unsurprisingly, the trend in permanent non-borrowers, those who are not using external finance, have not done so in recent years and are not planning to do so, rose significantly through to 2015 and has only begun to fall in 2019, the reasons for which are explored in section 2.2: Use of external finance.

These trends have been driven by a decline in the use of core debt finance products traditionally supplied by banks. Through to 2018, use of credit cards remained weak, with bank loans also low relative to 2012. Use of bank overdrafts showed a significant decline, but with a partial recovery in 2017 and 2018. Since 2018, credit card and overdraft use rose to their highest levels, at 23% and 19% respectively in H1 2019 (figure A.3).

This lower usage of core bank lending products has reflected reduced applications for new loans and overdrafts (figure A.4). Changes to the question for 2018 made direct comparison difficult but the number of applications for new loans is likely to have continued to decline, with latest data suggesting the application rate was 1.3% in the 6 quarters to Q2 2019. In contrast, the number of overdraft facilities granted increased in the run up to the March 2019 EU withdrawal date according to UK Finance data.

The supply of bank lending to SMEs, as measured by credit conditions, has been relatively strong in recent years. The net balance of credit conditions as reported by bank lending officers has been neutral or positive from 2015 through to early 2019, with a marginal decline in second half of 2019 for medium-sized businesses.

Further evidence for relatively benign lending conditions is provided in the cost of lending. Bank of England data suggests that the effective interest rate has remained below 4% in recent years. This suggests that the fall in demand was not caused by a tightening of lending conditions.

The decline in demand for core bank lending products supplied by the main bank may in part be explained by the rise in the awareness of alternative finance products such as equity products and marketplace lending (figure A.5) supplied by other providers. However, the increase in the number of users of these products has not been sufficient to account for the total fall in demand for bank products. Furthermore, the decline in overall use of external finance points to a net fall in demand for finance since the financial crisis.

The most likely explanation for the weak levels of demand is the growing unwillingness of SMEs to use finance to grow and develop their businesses. The share of SME willing to use finance to grow and develop fell sharply from 45% to less than 30% in 2019 (figure A.6).

The growing evidence on the weak demand for external finance has driven the development of increased British Business Bank demand side activity to help smaller businesses understand and identify suitable finance options to help the business grow.

FIG A.4

NEW DEBT APPLICATION RATES

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

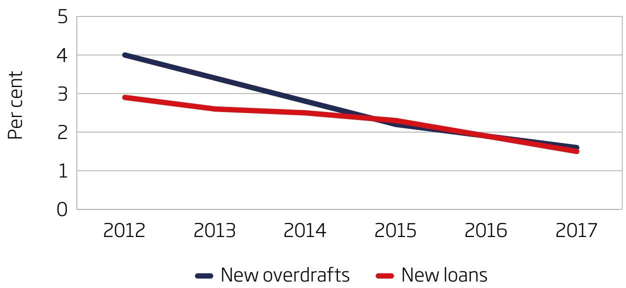


FIG A.5

AWARENESS OF ALTERNATIVE FINANCE PRODUCTS

Source: British Business Bank Business Finance Survey 2014-19

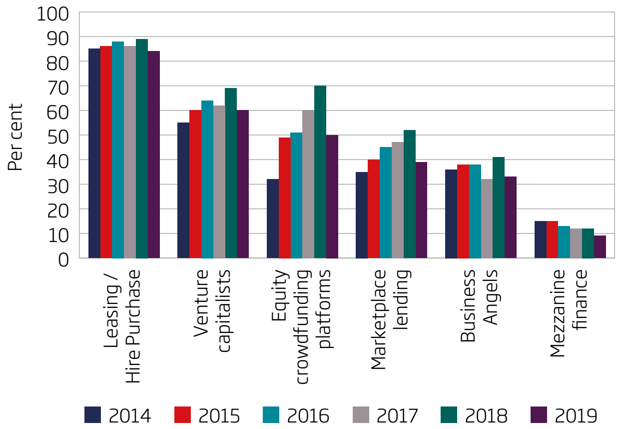
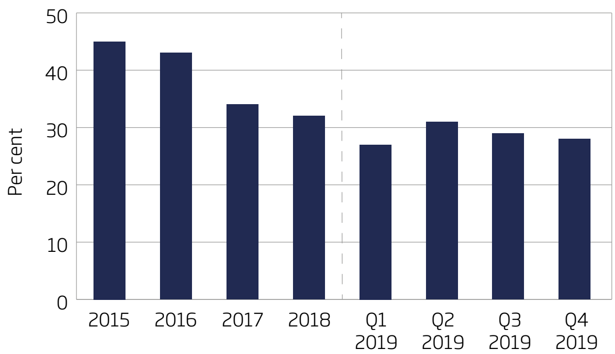


FIG A.6

SHARE OF SMES WILLING TO USE FINANCE TO GROW AND DEVELOP

Source: BVA BDRC SME Finance Monitor, 3 months to December2019. Dotted line denotes start of quarterly data.



INCREASED DIVERSITY IN MANY OF THE DIMENSIONS OF SMALL BUSINESS FINANCE MARKETS WITH SIGNIFICANT ENTRY OF NEW PROVIDERS AND NEW PRODUCT DEVELOPMENTS

Diversity in finance markets can help improve the outcome for smaller businesses seeking finance. Increasing diversity of SME finance was an original objective of the British Business Bank, with the Bank seeking to support both new products and new providers entering the market.

A typology has been used to capture the potential benefits arising from diversity, these include who has access, where finance can be accessed, what terms, when access can be arranged and how access is delivered (figure A.7)

This typology enables us to consider the different aspects of diversity in turn, briefly summarising the trend over the last five years. Taking WHO first, this refers to the characteristics of the SME such as the size, age and sector of the SME.

Historically, the larger the SME, the more likely it was that they would use external finance, with a distinct gap between zero employee businesses, where only 43% use finance, compared to medium-sized businesses with 77% using external finance (figure A.8).

This result is consistent with other surveys including the Bank's Business Finance Survey 2019 which found that only 38% of zero employee businesses had sought finance in the last three years compared to 83% of medium sized businesses. This is not surprising as larger businesses are more likely to have collateral to provide as security and have significant finance experience within the business increasing their ability to access a wide range of finance products.

FIG A.7

TYPOLOGY OF DIVERSITY OF FINANCE

Source: British Business Bank, The Benefits of Diverse Finance Smaller Business Finance Markets

Who has access (turnover)	• Finance reaches subsets of SMEs that cannot access mainstream finance and/or for whom mainstream products are not suitable or relevant • Can be driven by different risk appetite or different qualifying requirements	New Product New Provider
Where can finance be accessed (turnover)	• New provider supplies a type of finance to SMEs in a region where that type is otherwise rare/unavailable • Can be driven by a different approach to decision-making, e.g. decentralisation	New Provider
What terms is finance accessed on (terms)	• Increased competition improves terms (including duration and repayment) for some finance • Can be driven by better suitability of a form of finance to the needs of subsets of SMEs	New Product New Provider
When access can be arranged (benefits)	• SMEs can access finance faster, or more conveniently than they could otherwise • Can be driven by differentiated business models or product features	New Product New Provider
How access is delivered (benefits)	• SMEs access finance that comes with ancillary business benefits that are not otherwise available • Can be driven by indirect impact on finance economics	New Product New Provider

However, figure A.8 suggests that the gap has decreased with micro-enterprises (1-9 employees) use of external finance (51% in H1 2019) closer to zero employee businesses (43% in H1 2019) in the last two years.

Turning to sector, it is not surprising that some make greater use of external finance than other sectors, given their distinct characteristics. But there have been some changes in the relative use of external finance between sectors. Notably, use of external finance by SMEs in the health sector increased rapidly from 2016, with use by property and business services SMEs declining (figure A.9).

WHO can also refer to the ownership of smaller businesses as well as the business itself. Over the last five years increasing attention has been given to different dimensions of diversity and whether this is reflected in differences in use of finance. For example, evidence has shown the very limited use of venture capital by female founded smaller businesses. Research undertaken by the British Business Bank in partnership with Diversity VC and the BVCA found that for every £1 of venture capital (VC) investment in the UK, all-female founder teams get less than 1p, all-male founder teams get 89p and mixed-gender teams 10p.[2]

The British Business Bank is planning further research to gain better understanding of the drivers of entrepreneurship and SME ownership patterns across this and other dimensions of diversity.

Turning to WHERE, there are distinct patterns of SME finance use, in particular in equity finance, at the regional level and much greater variation still at the local level. This is in part driven by the sectoral composition of the economy at the regional and local level, but is also impacted by the depth of the finance ecosystem in those regions. Regional developments over the last five years are considered later in this chapter and in more detail in the section 1.3 and 2.3 on Finance in Entrepreneurial Ecosystems and SME Finance at a local level respectively.

On WHAT terms is a key question for many smaller businesses. Increased competition has the potential to improve terms for SMEs, for example when new entrants join the market or SMEs are able to more easily switch supplier. An important development was the Competition and Markets Authority Retail banking market investigation which introduced recommendations in areas such as Open Banking.[3]

FIG A.8

USE OF EXTERNAL FINANCE BY SMEs BY FIRM SIZE

Source: BVA BDRC SME Finance Monitor, Q2 2019

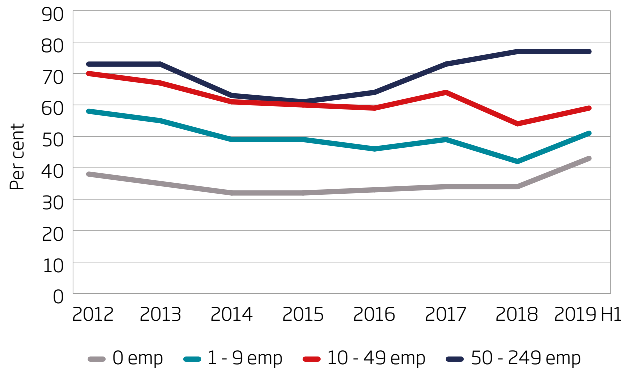


FIG A.9

USE OF EXTERNAL FINANCE BY SMEs BY SECTOR

Source: BVA BDRC SME Finance Monitor, Q2 2019

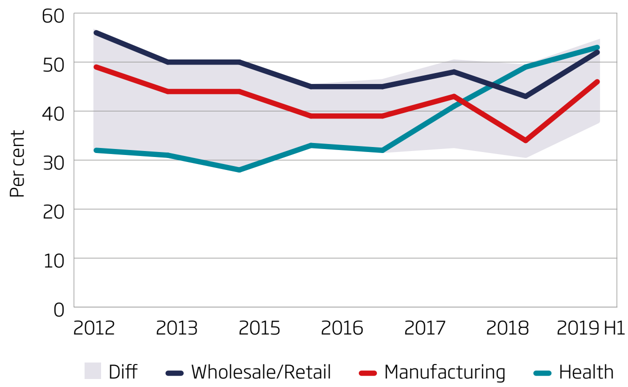
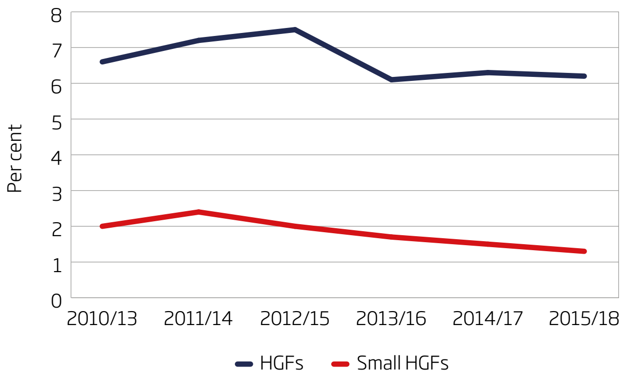


FIG A.10

INCIDENCE OF HIGH GROWTH FIRMS OVER TIME

Source: Enterprise Research Centre, Local Growth Dashboard 2019



Furthermore, the increased range of providers and products has increased the variety of terms and conditions on offer, increasing the likelihood of SMEs being able to find a suitable form of finance to meet their needs. This has increased the demand for information about the finance options available, with the British Business Bank playing a role in this through its Finance Hub and Business Finance Guide.[4]

WHEN and HOW SMEs access external finance has continued to evolve rapidly in the last five years. For the first time, more than half of SMEs that sought finance in 2019 contacted finance providers outside of the five main UK banks. Technological improvements have increased the variety of ways in which finance providers can engage with customers. This has occurred through new entrants to banking and other markets, who focus on new approaches, such as online only banks. Established providers have also greatly broadened the range of ways that SMEs can access their products. The discussion on challenger banks in section 2.5 explores many of these developments in more detail.

In conclusion, there have been significant positive developments across many dimensions of diversity, although there is still room for improvement. The extent to which the increased diversity of finance markets has had a positive effect on finance markets will only be fully tested in the event of an economic downturn.

THE RECENT INCREASE IN LATER STAGE EQUITY FINANCE SHOULD HELP IMPROVE THE SCALE-UP PERFORMANCE OF UK SMALLER BUSINESSES OVER TIME

High growth firms have long been identified as important to economic growth.[5] High growth firm data has tended to focus on definitions related to the OECD definition which focuses on employment growth of 20% per annum for three years. Estimates of the number of high growth firms in the UK are available from a number of sources.

The ERC looks at a wider range of metrics designed to capture different stages of scale-up that smaller businesses may go through. These include the standard OECD high growth firm definition and also a small high growth firm definition based on SMEs adding at least 8 employees over 5 years (figure A.10).

The incidence of high growth firms fell from 2012/15 to 2013/16 but has remained stable since then. The incidence of small high growth firms, defined as small businesses adding at least 8 employees over a three-year period has declined from 2011/14 to 2015/18.

The Scaleup Institute also looks at a broad range of high growth measures including those businesses that have increased either employment or turnover by 20% a year over a three-year period, and those that have increased both turnover and employment by 20%.

This suggests that the number of high growth firms based on turnover growth has been markedly better than based on employment growth (figure A.11). Overall the evidence on the number and share of high growth firms has been stable or increasing slightly depending on the metric chosen.

Given the need for significant growth over a three-year period, and the potential for external finance to take some time to impact on firm growth, it is still too early to demonstrate the impact of finance delivered in the last three years on the performance of the UK economy in generating high growth firms.

But there is strong evidence that equity finance is more likely to have been used where the growth performance has been greatest (figure A.12). Firms looking to scale-up use a wide variety of finance to support and deliver their growth plans. Where the risk is highest, equity finance is particularly useful.

FIG A.11

NUMBER OF HIGH GROWTH BUSINESSES BY MEASURE OF GROWTH OVER TIME

Source: ScaleUp Institute (2019) 'The Scaleup Review 2019'

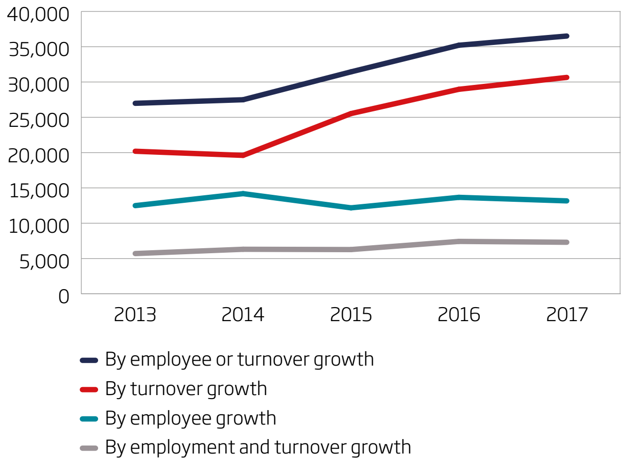


FIG A.12

PROPORTION OF HIGH GROWTH FIRMS USING EQUITY FINANCE

Source: ScaleUp Institute and Beauhurst (2019) 'The Scaleup Index 2019'

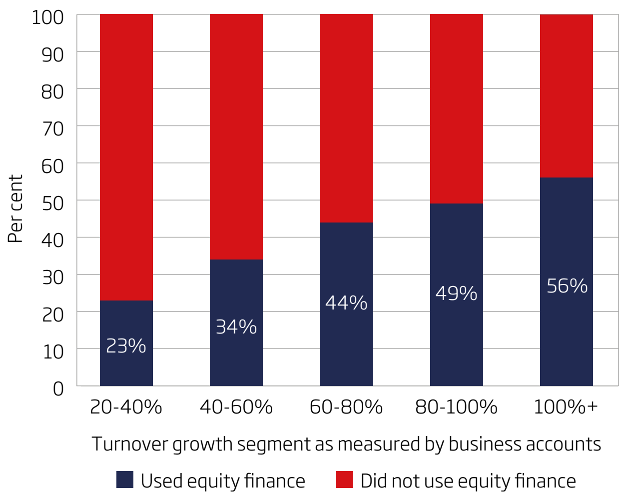


FIG A.13

COHORT ANALYSIS OF COMPANIES RECEIVING INITIAL VC FUNDING IN 2011-2012
COMPANIES WITH SUBSEQUENT FUNDING ROUNDS

Source: British Business Bank analysis of PitchBook

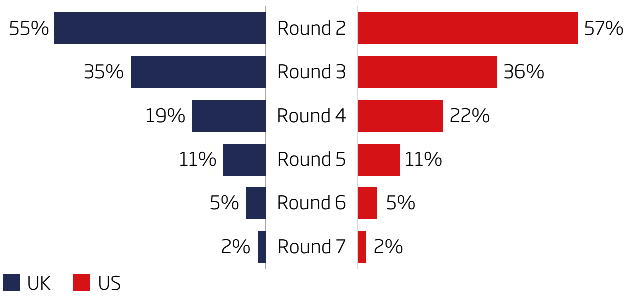
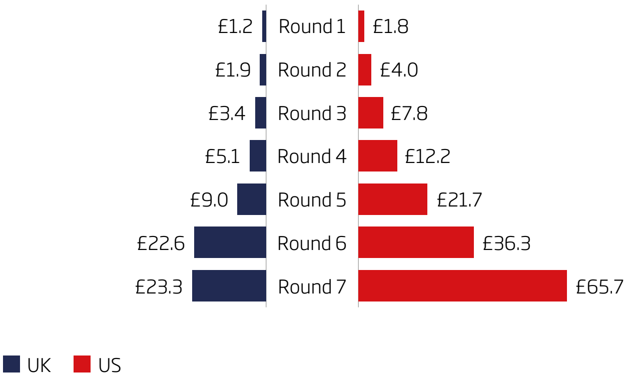


FIG A.14

COHORT ANALYSIS OF COMPANIES RECEIVING INITIAL VC FUNDING IN 2011-2012
AVERAGE DEAL SIZE BY FUNDING ROUND (£ MILLION)

Source: British Business Bank analysis of PitchBook



During the government Patient Capital Review, evidence from the British Business Bank was used to demonstrate UK SMEs' use of follow on equity finance. UK start-ups receiving early stage equity finance, commonly called seed or Series A funding, between 2008 and 2010 were less likely than their US counterparts to receive follow on funding.[6] In addition, the value of finance received in each round was markedly lower for UK firms seeking later stage funding than for those in the US.

A particularly welcome development is the increased likelihood of receiving later stage equity finance. UK firms receiving initial VC funding in 2011-12 are now able to receive subsequent funding rounds with a frequency that closely matches the US (figure A.13).

However, there remains a significant gap in terms of the size of the average deal (figure A.14). Although this can be partly explained by smaller product market size for companies targeting domestic markets relative to US VC backed companies, it does make it more difficult for UK firms to expand rapidly in global markets.

The greater number of later stage equity deals received by scale-ups in the previous five years will not yet have fully impacted on the high growth firm data series and other scale-up metrics. First, it may take some time for finance to impact on firm growth, and second, with most scale-up metrics measuring growth over a three-year period, the growth impact of finance received will not be captured in scale-up data.

It will therefore take time to fully access the growth impact of finance on scale-up firms. Where that finance has been facilitated by the British Business Bank, the growth impact will be assessed by the rolling programme of evaluations of the Bank's finance products.[7]

SIGNIFICANT REGIONAL AND LOCAL VARIATION, PARTICULARLY IN SMALLER BUSINESSES' USE OF EQUITY FINANCE

Regional patterns of SME finance have been a regular feature of the Small Business Finance Markets publication since the 2015/16 report. Discussion has focused on the concentration of equity finance in London, Oxford and Cambridge, sometimes referred to as the Golden Triangle.

Although there has been some variation from year to year, the volume of external equity finance received by smaller businesses in London (figure A.15) considerably exceeds the region's share of SMEs and High Growth Firms.

Greater attention is now being given to within region variation. The British Business Bank Equity Tracker publication has, since 2016, included an analysis of the local authorities with the most equity deals. This has demonstrated the extent to which equity activity is clustered in a relatively small number of cities. Even within London, equity deals are concentrated in certain boroughs with Westminster, City of London, Islington, Hackney, Camden and Southwark taking the top six positions in terms of deals by local authority district in first three quarters 2019.[8]

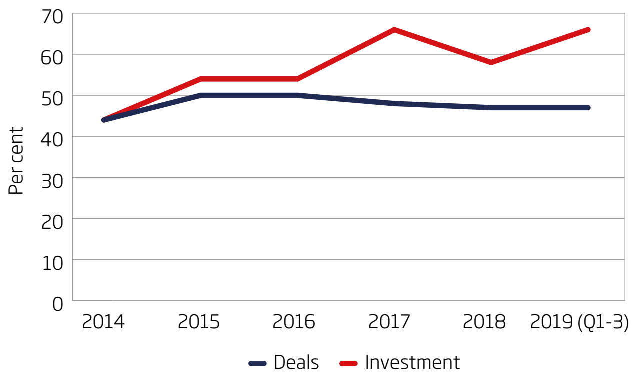
Analysis in the British Business Bank Equity Tracker 2019 publication looked at various measures of equity deal concentration in the UK which suggested that concentration peaked in 2015/16 with some decline since then. Possible suggestions for this slight increase in diversification is that there has been an increase in VC funds with offices outside London.

On the debt side, the distribution of core bank lending activity has always been more closely aligned to the regional share of the business population. Indeed, London has frequently looked underweight on bank lending compared to the share of the UK SME business population based in London.

FIG A.15

PROPORTION OF UK EQUITY DEALS AND INVESTMENT GOING TO COMPANIES IN LONDON

Source: British Business Bank analysis of Beauhurst data



This 'lack' of lending in London, may in part reflect the relatively high number of businesses registered in London, for example, where a headquarters, or registered office is listed in London, but relatively little economic activity takes place. Furthermore, London based SMEs have consistently been found to be aware of a wider range of finance options, hence lack of bank lending may reflect greater use of a wider range of debt products.

Unfortunately, neither regional nor more local level data is available for many debt finance products. The British Business Bank is looking to work more closely with representative bodies and data providers to increase the availability of disaggregated data for more debt finance products.

British Business Bank activities have expanded since 2014 to include the funds covering regions such as the Northern Powerhouse, the Midlands Engine and Cornwall & the Isles of Scilly.

THE BRITISH BUSINESS BANK STRATEGY HAS EVOLVED TO BOTH REFLECT, AND SHAPE, MARKET DEVELOPMENTS

Following the financial crisis, SME finance markets have been monitored more closely, with significant additional data sources becoming available. British Business Bank activity has evolved, based on our analysis and understanding of evolving problems in the markets and significant government policy developments, most notably the Industrial Strategy and the Patient Capital Review.

Three examples are particularly important

- First, the creation of the Bank's British Patient Capital subsidiary responded to an identified market gap for equity finance to support the continued growth of scale-up businesses.
- Second, the creation of a series of regionally focused funds to help correct regional imbalances via the Northern Powerhouse Investment Fund, the Midlands Engine Investment Fund and the Cornwall & Isles of Scilly Fund. These funds are key components in delivering the Bank's regional objective.
- Third, the Bank has increased its demand side activity to provide information on the finance options available to smaller businesses.

The Bank will continue to develop its strategy in the light of market developments and emerging government priorities.

Finally, the Bank has a rolling programme of evaluation to measure the effectiveness of our products in improving access to finance. Recent examples include an early assessment of the Northern Powerhouse Investment Fund[9] and an evaluation of the UK Innovation Investment Fund.[10] These demonstrate the positive impact that the Bank's policies have on smaller businesses.

1.2 IMPACTS OF MACROECONOMIC DEVELOPMENTS ON SME FINANCE MARKETS

- The UK economy experienced uneven growth in 2019
- Surveys showed business confidence was at multi-year lows
- Investment levels and intentions remained low in 2019
- The impact of macroeconomic developments and political uncertainty were reflected in SMEs' use of short-term finance
- The majority of SMEs expected Brexit to have no impact on their growth or sales but those who did were mostly pessimistic
- There has been a recent decline in concern about political uncertainty, improving business confidence
- The Bank will continue to monitor economic and market developments

THE UK ECONOMY EXPERIENCED UNEVEN GROWTH IN 2019

UK economic growth was volatile and slowed materially during 2019. The latest Bank of England assessment of UK economic developments attributed this slowdown to weakening global growth as well as Brexit related uncertainties.[11]

The first half of the year was one of contrasts. UK growth in Q1 2019 got off to a strong start at 0.6% (figure A.16). However, the ONS reported this growth was inflated by firms stockpiling inventories ahead of the original date the UK was expected to leave the EU. The economy then shrank by 0.2% in Q2 driven by firms trying to wind-down the inventories they had built up earlier in the year and the deteriorating global economy (figure A.17). This was the first time the UK had experienced negative quarterly growth since 2012 and led to concern the economy may enter a technical recession.

FIG A.16

UK QUARTER ON QUARTER GDP GROWTH

Source: ONS GDP quarterly national accounts to Q3 2019

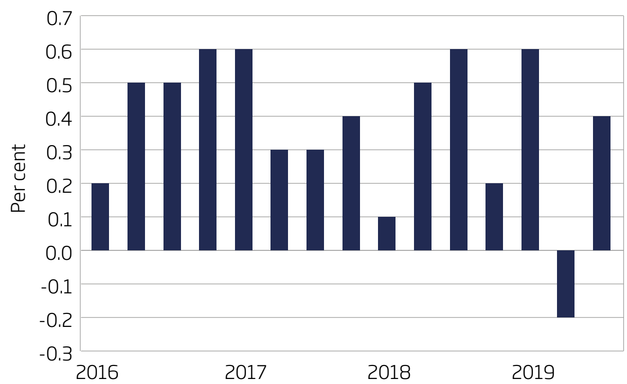


FIG A.17

UK, EURO AREA AND G7 ANNUAL GDP GROWTH

Source: IMF Datamapper

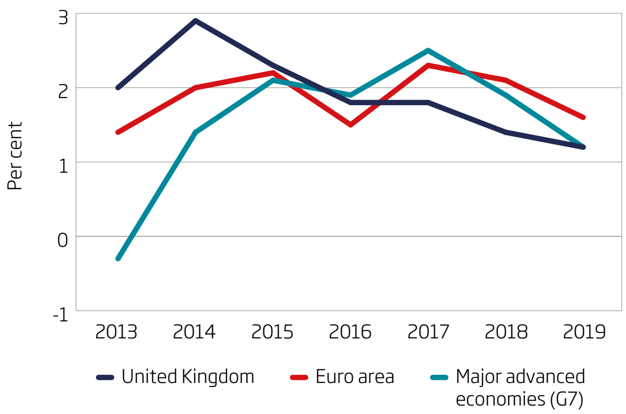


FIG A.18

BANK OF ENGLAND ECONOMIC FORECAST

Source: Bank of England - January Monetary Policy Report

	2019	2020	2021	2022
GDP	1.25	0.75	1.50	1.75
CPI inflation	1.50	1.50	2.00	2.25
LFS unemployment rate	3.75	4.00	3.75	3.50

The UK economy grew 0.4% in Q3. Services made the strongest contribution while both construction and production also contributed positively. This growth eased concerns of the UK entering a recession but when compared with the same quarter a year ago, UK GDP increased by 1.1% in Q3 2019; this is the joint slowest rate of quarter-on-year growth since Q1 2010. Early estimates suggest GDP growth in Q4 is broadly flat.

Sterling has been similarly volatile in 2019 creating uncertainty for SMEs who trade internationally, either as exporters or importers. For example, sterling fell in Q3 2019, predominantly due to a very weak August which saw the average value of sterling against the Euro fall to around €1.10 before recovering in Q4 2019 to reach €1.20 following the election.

The labour market has remained strong, in the three months to November UK employment was estimated at a record high of 76.3%, 0.6 percentage points higher than a year earlier and 0.5 percentage points up on the previous quarter. Employment growth in the UK over the last year has been due to an increase in full-time jobs, up 349,000 on the year to a record high of 24.36 million, an increase in self-employment and an increase in women entering the workforce. The unemployment rate also fell by 0.2 percentage points on a year earlier to 3.8% and the UK economic inactivity rate was estimated at a record low of 20.6%, 0.4 percentage points lower than the previous year.

Inflation has been on a downward trend since Q4 2017 when inflation hit 2.8%. It fell to its lowest rate for more than three years in December at 1.3%. Combined with a tight labour market this has led to both nominal and real pay increases. Estimated average weekly earnings growth for employees in Great Britain was 3.2% for total pay (including bonuses), a real terms increase of 1.6%.

Looking forward, some forecasters suggest that economic growth will pick up from 2020 onwards. For example the Bank of England January Monetary Policy Report forecasts GDP growth of 0.75% for 2020 rising to 1.75% in 2022 (figure A.18). This is conditioned on a transition to a deep free trade agreement with the EU and the Government fiscal measures announced in the September 2019 Spending Round. The forecasted pick up is in significant part driven by a reduction in near-term uncertainties following the Withdrawal Agreement.

SURVEYS SHOWED BUSINESS CONFIDENCE WAS AT MULTI-YEAR LOWS

The impact of the macroeconomic situation on SMEs' confidence and growth expectations throughout 2019 was explored in several surveys. The Federation of Small Business' (FSB) Voice of Small Business Index continued to show weak confidence amongst SMEs throughout 2019. Confidence amongst SMEs was -21.6 in Q4 2019 (carried out just before the general election), down from -8.1 in the previous quarter and the lowest in eight years (figure A.19).[12]

There was some variation in confidence levels across the country though no regions were positive about the coming three months. London had the lowest confidence in the UK at -36, jointly followed by Scotland and Wales at -27. The North West had the highest confidence at -1. The next highest was the South West at -15.

Further analysis of FSB data shows variation within sectors of the economy too. The construction industry was the only sector for which confidence was positive in Q4, at +7. The next highest were the professional, scientific and technical services, along with the information and communication, sectors jointly at -10. Manufacturing confidence fell to -17 whilst the lowest confidence was in the accommodation and food services at -65. Confidence in the wholesale and retail trade sector was a little higher at -47.

The decline in manufacturer confidence has also been shown by CBI data. According to the CBI, business sentiment amongst SME manufacturers deteriorated in the three months to October, falling from -28% to -32%.[13] This was the sharpest fall in optimism since July 2016.

FIG A.19

FSB CONFIDENCE INDEX

Source: FSB Voice of Small Business survey

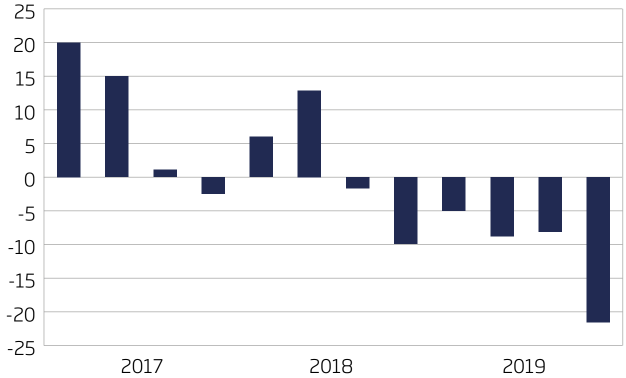


FIG A.20

UK QUARTER ON QUARTER BUSINESS INVESTMENT

Source: Office of National Statistics to Q3 2019

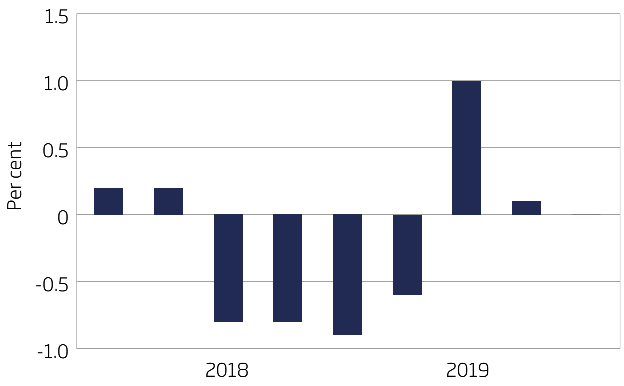


FIG A.21

BUSINESS INVESTMENT GROWTH, YEAR ON YEAR CHANGE, ACTUAL AND BoE FORECAST

Source: Bank of England January Monetary Policy Report, ONS GAN8

This decline in confidence came against flat output growth for SME manufacturers. Q3 domestic and export orders fell by 12% and 6% respectively leading to an overall decline in new orders of 6% with output predicted to fall in Q4.

Other surveys also show that confidence in the economy was low. The Recruitment and Employment Confederation (REC) suggested that employers' hiring activity was subdued in 2019 compared to recent years, though there was a small pickup in the latest release to December.[14] Furthermore, the Association of Independent Professionals and the Self-Employed (IPSE) survey of freelancers (zero employee businesses) also reported confidence in the UK economy at an all-time low.[15]

INVESTMENT LEVELS AND INTENTIONS REMAINED LOW IN 2019

Business investment has been a key driver of OBR downward growth revisions in recent forecasts. Given the low business confidence levels it is unsurprising the ONS business investment numbers for the first three quarters of 2019 have remained subdued. Business investment growth, in volume terms, was flat in Q3 following an increase of 0.1% in Q2 (figure A.20). When compared with the same quarter a year ago, business investment grew by 0.5% in Q3 2019.

Looking forwards, whilst the Bank of England's forecast has a central projection that growth in business investment will begin to pick up in 2020, reaching 3.5% by 2022 (figure A.21), its latest Agents' Summary of business conditions reported that investment intentions remained depressed.

Both the CBI and FSB surveys also ask about future investment. The CBI survey showed the fragility of investment intentions amongst SME manufacturers. Across four metrics, intentions remained beneath their long-run averages. These were training and retraining, plant and machinery, product and process innovation and builds. This is unsurprising given how volatile business investment is when the macroeconomic situation becomes less certain.

As with the CBI survey, the low confidence found in the FSB survey is impacting SMEs' investment plans with the share of businesses intending to expand their capital investment at its lowest level since 2012. According to the FSB, in Q3 74% of SMEs did not intend on upping their capital investment. Of this, 14% were actively planning on reducing capital investment and 60% were planning on maintaining their levels.

The British Chambers of Commerce (BCC) has forecast business investment is set to decline 1% in 2019 and 0.7% in 2020. When added to the 2018 0.4% decline this would be the longest period of annual declines in business investment since the dotcom bubble burst. The BCC put this down to Brexit uncertainty and the upfront costs associated with doing business in the UK.

THE IMPACT OF MACROECONOMIC DEVELOPMENTS AND POLITICAL UNCERTAINTY WERE REFLECTED IN SMEs' USE OF SHORT-TERM FINANCE

The British Business Bank's market contacts continue to report subdued demand for medium and long-term borrowing among SMEs. This is in line with the Q4 BoE Agents' summary. The soft demand for new loans is consistent with the recent weakness of business investment, as the current environment has reduced the appetite among SMEs to invest for growth. SME Finance Monitor data showed the willingness of firms to use finance to grow and develop their business fell to 28% in Q4 2019, from 32% in the 2018 calendar year.

At the same time the data has shown an increase in the use of short-term finance. The Q2 2019 SME Finance Monitor showed the use of overdrafts and credit cards rose in the first half of 2019 to 23% and 19% respectively, the highest since 2012. This appears to have carried on into the latter half of the year with the Q3 BoE Agents' summary noting a pickup in demand for working capital in the form of unsecured borrowing and overdrafts to support cash flow.

Separate UK Finance data showed that the value of overdraft facilities approved or increased declined in Q3 2019 for second consecutive quarter (figure A.22). However, it remained higher than in 2016 and 2017. Previously, the value of overdraft facilities approved or increased surged from late 2017 through 2018 to a seven-year high. One probable explanation for the values in Q2 and Q3 2019 being lower than in Q1 2019 and 2018 is that many SMEs had already acted to get overdraft facilities in place.

FIG A.22

VALUE OF OVERDRAFT FACILITIES APPROVED OR INCREASED FOR SMEs

Source: UK Finance

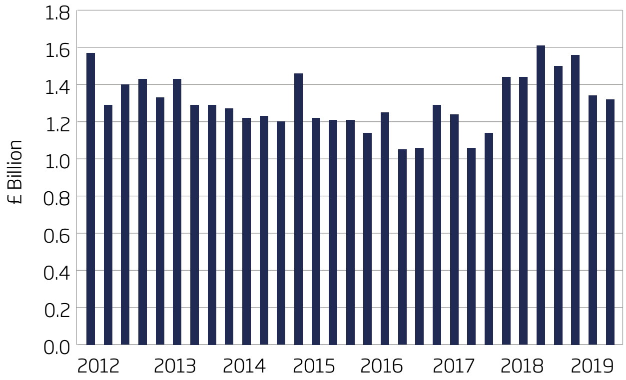
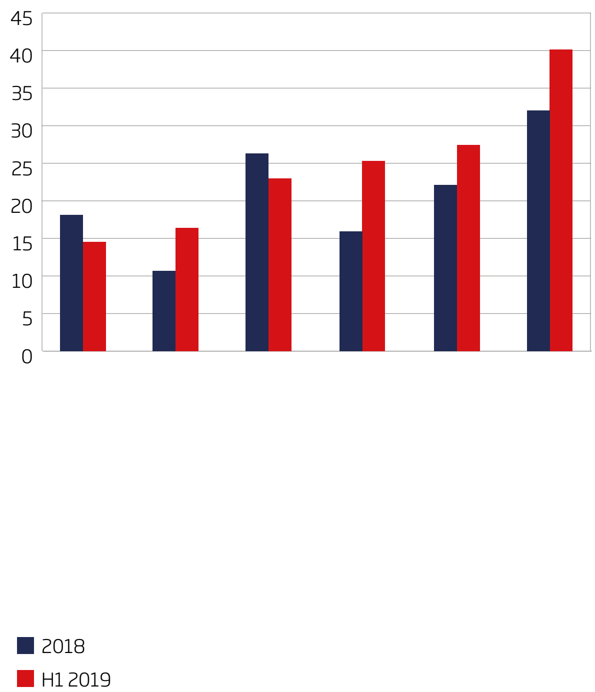


FIG A.23

REASONS FOR NEED FOR FUNDING OF SMEs WHO HAD A FUNDING NEED

Source: BVA BDRC SME Finance Monitor Q2 2019, n=807 (2018) and n=377 (H1 2019)



There are also signs that the demand for credit card lending has held up. The Q3 2019 BoE Credit Conditions survey reported that lenders saw an increase in the demand for credit card lending by small businesses for the third consecutive quarter, whilst Q4 was flat.

The value of invoice finance advanced to the smallest businesses has also increased. Whilst a slightly lower number of these companies are using invoice finance, the amount they are drawing down has increased. This again is consistent with an increased demand for short-term finance among some businesses. Possible reasons for the pickup in invoice finance usage is that late payments have increased and that some SMEs are finding the current conditions difficult, both suggesting maintaining cash flow is proving challenging.

The SME Finance Monitor reported businesses are increasingly citing cash flow issues as their reason for requiring funding, while business development related reasons have remained stable or declined. In the first half of 2019, there were increased mentions of needing funding for working capital to help with cashflow, to cover a short-term funding gap or to help through trading difficulties.

Of those SMEs identifying a need for funding in H1 2019 (4%), cashflow support was the most frequently cited reason for needing funding, mentioned by 40% of SMEs, up from 32% in 2018 (figure A.23). This was followed by investing in new plant or machinery, cited by 27%, up from 22% in 2018, which has been to some degree linked to stockpiling activities. Over the same period, there were fewer mentions of funding expansion in the UK, taking advantage of new business opportunities or taking on staff.

Bibby Financial Services' Q3 Confidence Tracker, which surveys 1,000 SMEs each quarter, also found nearly half of UK SMEs (45%) suffered from some form of cashflow problem during the quarter, up from 44% in Q2. In Q2 it reported almost a third (29%) of SMEs were actively using funding, up from 23% in Q1. This was in line with the SME Finance Monitor which showed a rise from 42% to 49% in Q2.

Half of UK SMEs surveyed thought there would be a recession in 2019 and were looking to address cashflow issues, with 26% turning to credit cards, bank overdrafts and borrowing from family and friends. Bibby cited increasing competition, rising material costs and the broader economy as reasons businesses appear to be sourcing finance to cope with these challenging conditions rather than investing for growth.

THE MAJORITY OF SMEs EXPECTED BREXIT TO HAVE NO IMPACT ON THEIR GROWTH OR SALES BUT THOSE WHO DID WERE MOSTLY PESSIMISTIC

The British Business Bank's Business Finance survey, which was carried out between the end of August and November 2019, asked a range of Brexit specific questions. Though a narrow majority of SMEs continued to say it would not affect their growth (56%), those who did were mostly pessimistic. The percentage of SMEs that felt they would grow more (6%) or grow less (29%) as a result of leaving the EU remained unchanged in 2019 from our 2018 survey (figure A.24).

Similarly, the majority of SMEs expected Brexit would have no effect on sales (62%), though among those that did the outlook was again mostly negative with 28% expecting sales to decrease and only 5% expecting them to increase.

The survey also asked SMEs whether they expected to make changes to their pricing, staff numbers, investment and exports. Of those SMEs expecting to make changes, 74% expected these to be negative. The biggest changes were expected within pricing where 58% expected to increase their prices (figure A.25).

Finally, our survey asked about access to finance. Here only 39% and 35% of respondents felt that there would be no impact on access to debt and equity respectively though a significant percentage did not know or refused to say (figure A.26). 37% felt debt would be more difficult to obtain whilst 33% expected equity to be more difficult to obtain than before Brexit. Businesses under 10 years old were the most pessimistic with 45% and 44% expecting debt and equity respectively to be more difficult to obtain post Brexit.

Several other surveys have asked questions on the impact of Brexit and Brexit uncertainty. A survey by Close Brothers Asset Finance found that most SMEs (63%) felt that the uncertainty caused by Brexit was continuing to impact businesses' ability to trade. The remaining 37% had felt no difference, stating they were trading as they were before the vote. The survey concluded that many firms had been stockpiling while pausing their spending and growth plans until an element of certainty returned.

FIG A.24

PERCENTAGE OF SMEs THAT EXPECTED TO GROW MORE OR LESS AS A RESULT OF LEAVING EU

Source: Business Finance Survey

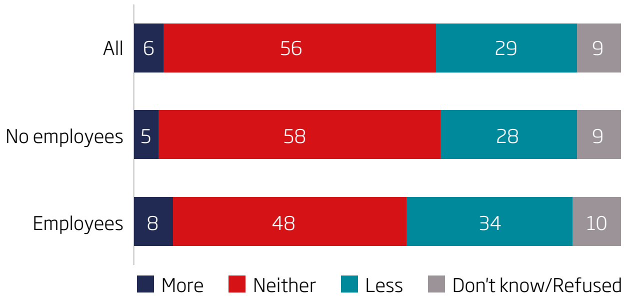


FIG A.25

SMEs THAT HAVE MADE OR EXPECTED TO MAKE CHANGES AS A RESULT OF THE UK LEAVING THE EU

Source: Business Finance Survey, base: all SMEs that have made or expected to make changes as a result of the UKleaving the EU

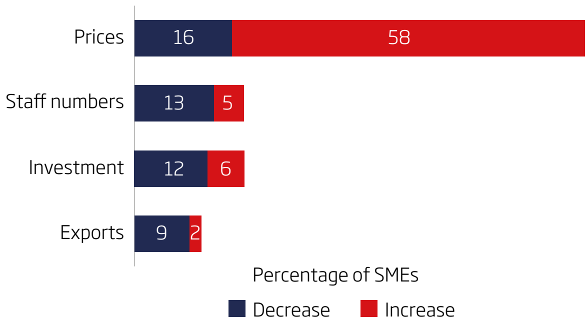
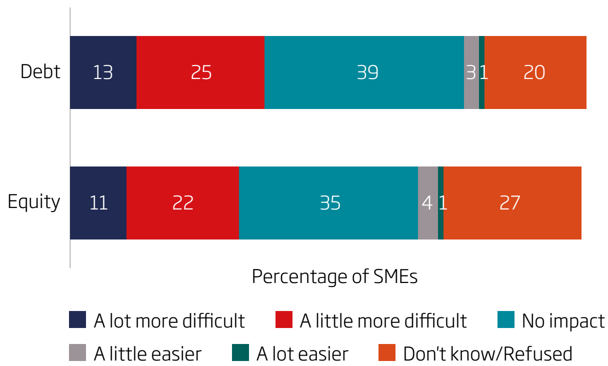


FIG A.26

EXPECTED IMPACT OF LEAVING EU ON DEBT AND EQUITY AVAILABILITY

Source: Business Finance Survey



The sectors found to be most affected were manufacturing and engineering, with 75% stating their trading capability had been impacted by Brexit. The survey went on to say those with the most exposure to Europe were the most unsettled because they weren't clear about how Brexit would impact their customers, import tariffs, supply chain and inputs. Small businesses were the least impacted, with 60% having felt little to no difference.

Bibby Financial Services' SME Confidence Tracker, asked how prepared SMEs were for Brexit. Perhaps unsurprisingly, given a similar percentage of SMEs thought Brexit won't impact them, it found that over half of SMEs (54%) had done nothing to prepare for Brexit. The SMEs that had prepared had mostly done so defensively via building cash reserves and stockpiling goods.

The survey also noted for those operating in supply chains had looked to manage their costs by renegotiating with suppliers (15%) and by exploring options to manage their exposure to currency volatility (14%). According to the Bibby Tracker, a further 10% had applied for Authorised Economic Operator (AEO) status. AEO status is an internationally recognised quality mark and can give quicker access to some simplified customs procedures and, in some cases, the right to 'fast-track' your shipments through some customs and safety and security procedures.

THERE HAS BEEN A RECENT DECLINE IN CONCERN ABOUT POLITICAL UNCERTAINTY, IMPROVING BUSINESS CONFIDENCE

According to the SME Finance Monitor, concerns about political uncertainty increased steadily during 2018 (19% for 2018 as a whole), as did concerns about the economic climate (17% for the year as a whole) and cash flow/ late payment (13%). Only political uncertainty increased significantly during 2019 (28% for the 3 months to October and November) but this has reduced somewhat in December (24%). This improvement in sentiment has also been seen in several other recent data releases.

Amid widespread reports that the reduced political uncertainty following the general election had a positive impact on business and consumer spending decisions, the seasonally adjusted IHS Markit / CIPS Flash UK Composite Output Index rose in January (52.4), up from 49.3 in December. As a result, the headline index reached expansion territory (above 50.0) for the first time since August 2019. The latest reading was the highest for almost one-and-a-half years and signalled a moderate expansion of business activity across the UK private sector economy.

The business optimism measure within the CBI's Industrial Trends survey in Q4 also improved and at the strongest pace since 2014. Business optimism improved significantly in the three months to January (+23% from -44% in October), the largest swing in sentiment (67% points) in a single quarter on record (since 1958). Manufacturers expect total new orders to grow next quarter (+9%), with domestic orders broadly flat (-2%) and export orders growing slightly (+5%).

This was despite poor trading conditions over the past quarter, with output and orders still declining. 19% of businesses said that the volume of output rose in the three months to January, while 33% said it was down. In addition, total new orders dropped in the quarter to January (-21%) at the fastest pace since the financial crisis, with 24% of firms reporting an increase and 45% reporting a decrease. The fall in new orders was reflected in the quickest drop in domestic orders (-21%) since the financial crisis. While export orders also fell, it was at a slower pace than the previous quarter (-10% from -24% in October).

Finally, the latest survey of UK Chief Financial Officers shows an unprecedented rise in business sentiment. The fourth quarter survey took place in the wake of the UK general election, between 13th December and 6th January. Confidence has seen the largest increase in the 11-year history of the survey taking it to its highest ever level. CFO perceptions of external uncertainty have fallen from one of the highest ever readings to near-average levels. Deloitte reported that "the bounce in CFO spirits extends beyond political factors, with concerns about US protectionism, weakness in the euro area and financial bubbles easing."

THE BANK WILL CONTINUE TO MONITOR ECONOMIC AND MARKET DEVELOPMENTS

The British Business Bank stepped up monitoring of SME finance markets in the run up to Brexit. Whilst the UK has now exited the EU and has entered the transition period, close market monitoring will be continued, and the Bank stands ready to respond should it be required.

1.3 FINANCE IN ENTREPRENEURIAL ECOSYSTEMS

- External finance is a key part of entrepreneurial ecosystems
- A number of indicators are pointing to a slowdown in entrepreneurial activity
- Early stage finance flows also appear to be slowing
- The slowdown in entrepreneurial activity is apparent across much of the UK
- Strengthening regional ecosystems will help address SME finance market imbalances
- The Bank is working with partners to understand and further strengthen ecosystems across the whole of the UK

The way that researchers, policy makers and business leaders seek to understand entrepreneurial activity has gone through significant change in the past twenty years. In the early 2000s many viewed entrepreneurship either as an individual process of discovery, where pre-existing entrepreneurial opportunities were found, or of creation, where opportunities didn't exist until able entrepreneurs invented them.[16]

In recent years, a more realistic, middle ground has emerged, acknowledging that aspects of both creation and discovery are part of entrepreneurship.[17] This modern view of entrepreneurship explicitly places entrepreneurs in their wider context, most notably through the concept of entrepreneurial ecosystems.[18]

EXTERNAL FINANCE IS A KEY PART OF ENTREPRENEURIAL ECOSYSTEMS

Entrepreneurial ecosystems include a variety of entities connected through relationships and processes that influence entrepreneurial outcomes. Figure A.27 presents a stylised example of the kinds of actors and linkages that make up an ecosystem.

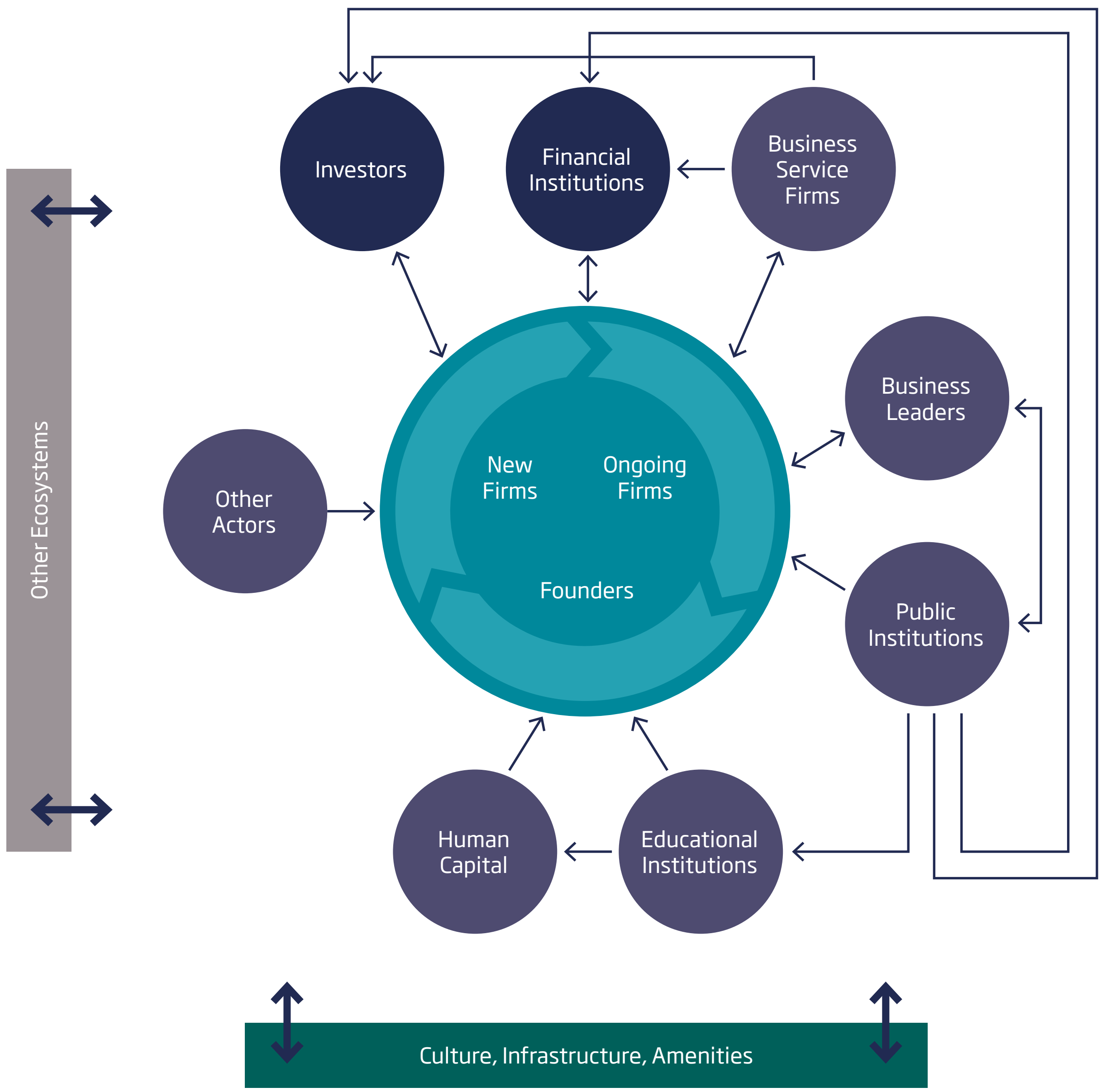
At the very centre is the business population which is going through a continual process of churn from births, deaths, expansions and contractions. Businesses interact with each other through rivalries or customer-supplier relationships but are also linked with the wider ecosystem. External finance is a key part of this.

At the most basic level, the formation and growth of new firms creates demand for finance. Simultaneously the supply of finance facilitates firm formation and growth. Such dependencies are common in entrepreneurial ecosystems and mean that changes in outcomes can ripple though the system.

FIG A.27

ENTREPRENEURIAL ECOSYSTEM SCHEMATIC

Source: British Business Bank drawing on multiple sources[19]



A NUMBER OF INDICATORS ARE POINTING TO A SLOWDOWN IN ENTREPRENURIAL ACTIVITY

Since the Bank's formation in 2014, UK early stage entrepreneurial activity has been healthy and finance markets have been improving. There are, however, emerging signs of a slowdown in the early stage activity that is central to entrepreneurial ecosystems. This slowdown is likely to be partly associated with the prolonged period of uncertainty UK entrepreneurs have been facing and is apparent in multiple indicators.

The first example is the UK's total entrepreneurial activity (TEA) rate. This has declined for a second consecutive year in 2018 according to the Global Entrepreneurship Monitor (figure A.28). The TEA rate is the share of the population currently founding a business or running a business that has existed for less than 42 months. Both components dropped slightly in 2018, meaning total entrepreneurial activity is more than two percentage points down from the peak in 2012. This trend is not mirrored in France or Germany, where the TEA rate has remained relatively stable since 2012, nor in the United States where activity has increased by nearly three percentage points since 2012. These recent trends mean the UK TEA rate now lags that of the United States by almost eight percentage points but remains above the levels seen in France and Germany.

The Global Entrepreneurship Monitor also tracks the share of early stage entrepreneurs that expect their venture to have employment growth of at least 50% over five years. This too has declined in recent years with only 16% of early stage entrepreneurs having such high expectations, down from over 20% in the early 2000s.[20]

ONS data on registered firm birth rates also show a decline in 2018 (figure A.29). The 12.9% UK birth rate is the lowest since 2012. The biggest absolute reductions in firm births were in administrative and support service activities (3,300 fewer births in 2018), construction (3,000 fewer births) and professional, scientific and technical activities (2,600 fewer births).

The recent strength of UK labour markets could be a factor in this trend and given that the Global Entrepreneurship Monitor suggests business set-up activity has declined in 2018, birth rates could drop further in 2019.

Hidden within the population of new firms are a small number of university spinouts.[21] The number formed in 2017/18, the latest year covered by data from the Higher Education Statistics Agency, is 2% down. Spinouts are innovative by definition and have historically been over-represented in equity deals, reflecting their high growth potential, so dropping spinout formation could add to potential concerns.

FIG A.28

TOTAL ENTREPRENEURIAL ACTIVITY RATE FOR THE UK

Source: British Business Bank analysis of the Global Entrepreneurship Monitor

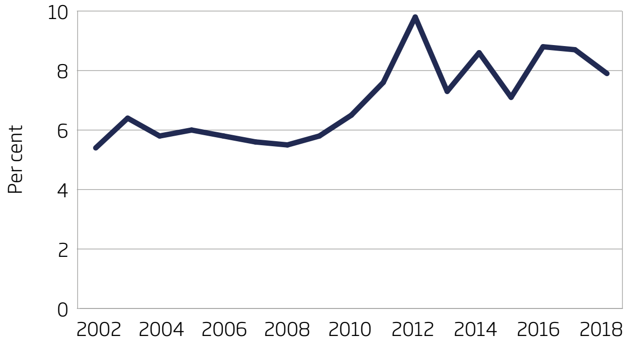


FIG A.29

ENTERPRISE BIRTH RATE

Source: British Business Bank analysis of ONS Business Demography

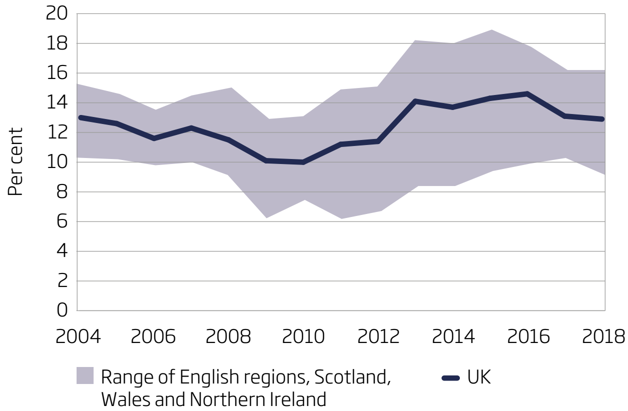


FIG A.30

MAIN REASONS FOR SEEKING FINANCE

Source: British Business Bank 2019 and 2018 Business Finance Surveys - Ipsos MORI.
Base = all businesses who sought finance in the last three years (n=755 and 913)
Note: 2019 Survey has slightly different wording for 'develop new product / service'.
Reasons shown were the 5 most popular in 2018

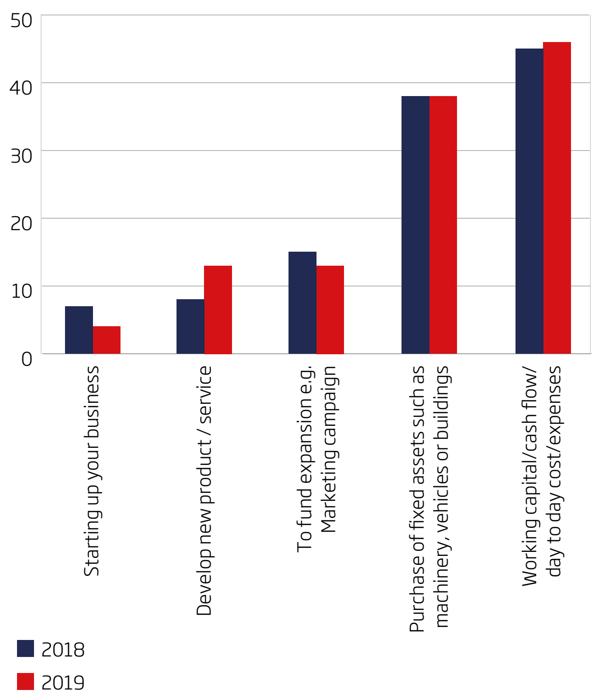
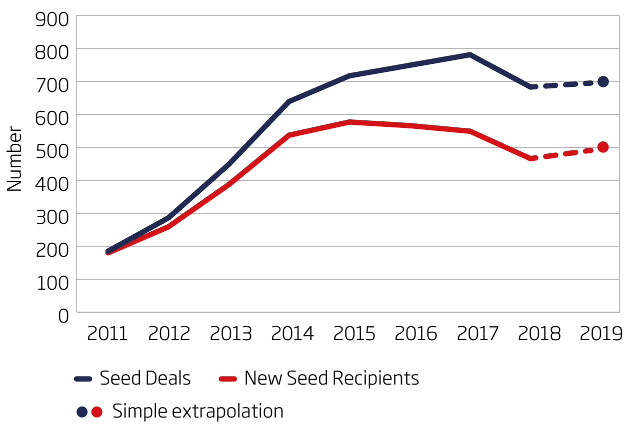


FIG A.31

SEED STAGE EQUITY ACTIVITY

Source: British Business Bank analysis of Beauhurst
Note: 2019 values extrapolated from three quarters of data



EARLY STAGE FINANCE FLOWS ALSO APPEAR TO BE SLOWING

Entrepreneurial ecosystems are characterised by complex dependencies and interactions. It is, therefore, unsurprising that this slowdown in entrepreneurial activity appears to be accompanied by declining flows of early stage finance.

In the bank lending market there is some evidence of muted flows of finance. Gross lending is down in 2019 on the previous year leaving flows significantly down in real terms relative to 2015 (see sections 1.1 and 2.4). We do not have data on loan purposes at the market-level, but data from the Bank's latest Finance Survey suggests the slowdown in early-stage activity is playing a part in the decline in lending.

In 2018 starting a business was one of the top five most commonly cited reasons for seeking finance. A smaller share of firms cited starting up as one of their motivations for seeking finance in the 2019 survey. This contrasts with the shares of firms mentioning working capital, asset purchases and product development as one of their reasons which all stayed stable or increased (figure A.30).

The 2019 Business Finance Survey provides further context on this, suggesting that 16% of businesses up to five years in age had wanted to apply for external finance but had been stopped by something. Only 5% of firms aged 10 years or more report the same experience, a significant difference. Reasons cited include fear of rejection, not wanting to take on risk and concerns about economic conditions.

The 16% figure is the highest since the question was introduced in 2017 and could provide some evidence that changing attitudes among young firms are contributing to the current slowdown in bank lending.

There are also signs of slowing in early stage equity finance. Full-year data for 2019 is not yet available, but extrapolation suggests both the number of seed deals and the number of new companies getting their first seed deal will remain below historic peaks in 2019 (figure A.31).

There is a similar slowdown in the number of companies submitting advance assurance requests (AARs) for the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) in 2018/19 (figure A.32). AARs are a discretionary part of the process for seeking EIS or SEIS investment so falling levels may feed through into reduced EIS and SEIS investments in subsequent years.

Some of the drop in AAR numbers is likely to be associated with the risk-to-capital condition added to the schemes following the Patient Capital review and with revised HMRC processes.[22] Though these factors may explain part of the decline, falling AAR volumes add to the pattern of slowing early stage entrepreneurial activity.

THE SLOWDOWN IN ENTREPRENEURIAL ACTIVITY IS APPARENT ACROSS MUCH OF THE UK

The indicators above are national figures but these trends appear to be fairly broad-based. For example, 2018 enterprise birth rates are between 1.5 and 3.5 percentage points down from peak levels in Scotland, Wales, Northern Ireland and the nine English regions (figure A.29).

These reductions equate to sizeable declines in the number of new firms formed in each part of the UK. Relative to peak birth rates, the slower rates of firm formation seen in 2018 equate to 1,000 fewer firm births in Northern Ireland, where the business population is lowest. This increases to 16,000 fewer births in London which has the largest stock of firms.

The decline in lending is also fairly consistent. UK Finance data suggest that numbers of loan and overdraft approvals are below historic averages in every part of the UK. Similarly, early stage equity activity looks muted across the board with Yorkshire and the Humber the only part of the UK that looks likely to see a record number of new companies raising seed equity funds in 2019.[23]

FIG A.32

COMPANIES SEEKING ADVANCED ASSURANCE FOR EIS AND SEIS INVESTMENT

Source: British Business Bank analysis of HMRC EIS and SEIS Data

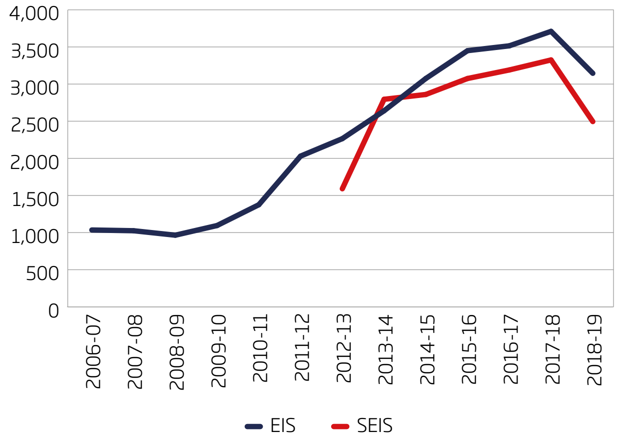
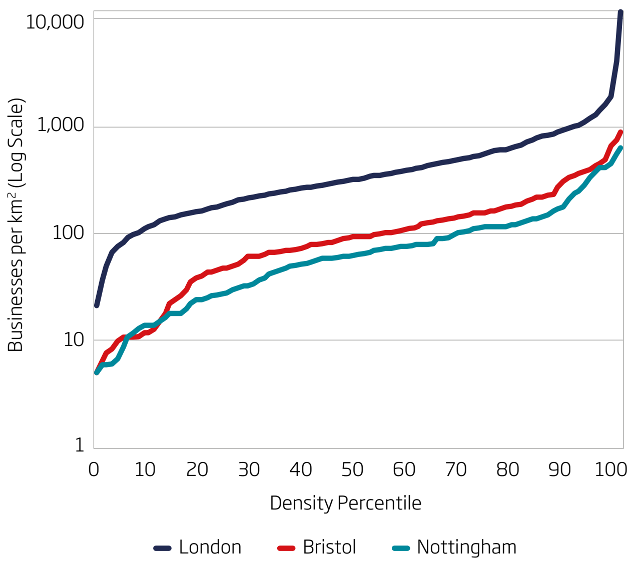


FIG A.33

BUSINESS DENSITY OF SELECTED AREAS

Source: British Business Bank analysis of ONS UK Business Counts in 2019
Note: Chart plots business density of Middle Layer Super Output Areas in Greater London, Bristol plus bordering local authorities and Nottingham plus bordering local authorities[25]



STRENGTHENING REGIONAL ECOSYSTEMS WILL HELP ADDRESS SME FINANCE MARKET IMBALANCES

The slowing in early stage entrepreneurial activity and related finance flows could have important implications for entrepreneurial ecosystems in the UK. Mature ecosystems that are packed with diverse participants linked through strong connections are likely to be more resilient to adversity than emerging ecosystems with lower densities and weaker ties.[24] Any differences in resilience could mean leading and lagging ecosystems diverging further.

The UK hosts multiple overlapping entrepreneurial ecosystems ranging from small, emerging ecosystems to huge, globally-significant ecosystems. The following passages illustrate how ecosystem characteristics may interact with the slowdown in early stage entrepreneurial activity by using three example ecosystems; London, Bristol and Nottingham. These examples could never cover the diversity of all the ecosystems in the UK but analysing these examples should help show how ecosystem characteristics vary and explain the potential impacts of this variation.

London is consistently viewed as the UK's strongest entrepreneurial ecosystem so its inclusion illustrates the characteristics of a globally-leading ecosystem. Bristol and Nottingham are both successful ecosystems with thriving business populations too, but at smaller scales than London. They both have different strengths and are based in different regions of the UK so their inclusion should help point to some of the challenges and opportunities in non-London ecosystems.

Starting at the centre of the ecosystem by looking at firms, we can see that the UK has huge variations in business density. London's business density is greater than Bristol and Nottingham's at every point in the distribution and some parts of central London host upwards of 10,000 businesses per square kilometre (figure A.33). This business density fosters connections between firms that can buy, sell and learn from each other and is unrivalled in other parts of the UK.

Even with business birth rates slowing, the sheer scale of the London ecosystem means there were still 97,000 new businesses registered in London in 2018 which will help maintain demand for business service firms that cater for start-ups.

In a smaller, less dense ecosystem, a persistent slowing in firm birth rates could shrink the market for start-up services below a viable absolute size. Ecosystems where this happens could become less attractive for future start-ups. This could create a reinforcing effect that may only dissipate over time as commercial rents fall enough to offset these disadvantages.

Business service firms, whether focused on serving start-ups or more established business, are vital for ecosystem health and development.[26] These firms act as connectors in an ecosystem. For example, our 2019 Business Finance Survey demonstrates that accountants were the most popular source of external advice for firms applying for finance. Firms report that accountancy advice didn't just influence their choice of finance type but of specific provider too, highlighting their connecting role.

As with the general business population, London also has far greater density of business support firms such as management consultancy, accountancy firms and legal firms than our comparator ecosystems (figure A.34).

Having a greater density of business service firms should allow them to specialise in serving certain businesses in different sectors or with different needs. This specialisation is likely to improve the services they can offer creating benefits for client businesses.[27]

Business service firms aren't the only important connectors within entrepreneurial ecosystems. Equity investors, business incubators and business accelerators are also key connectors.

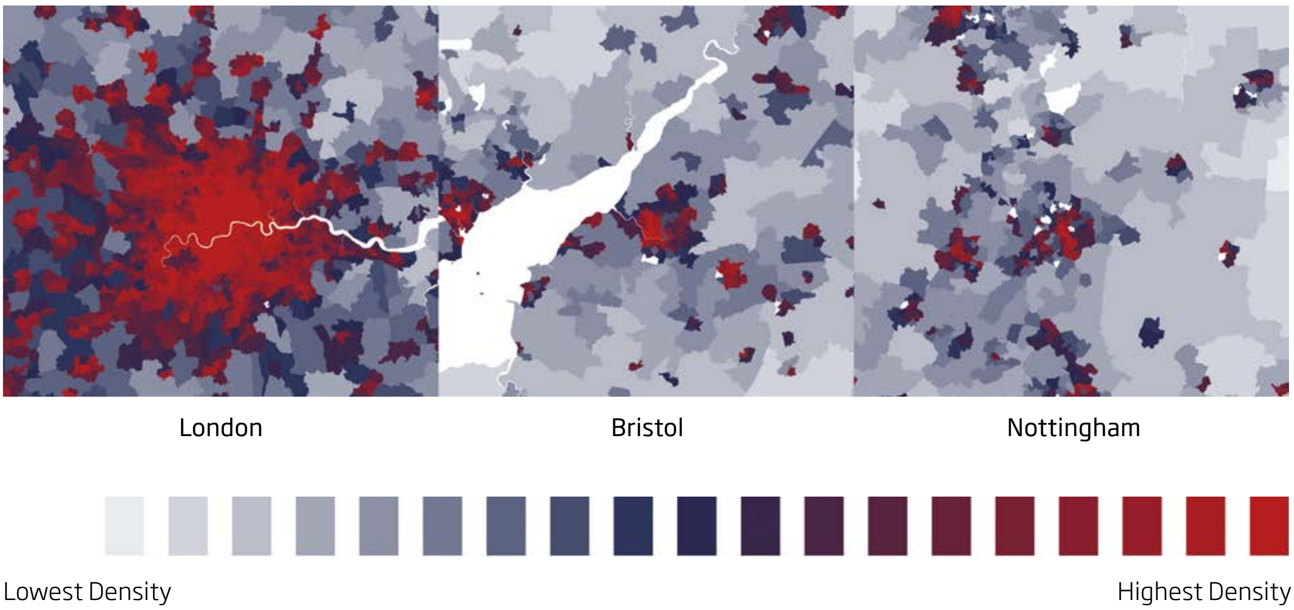
Equity investors provide funds but also help connect firms with talent, whether at staff or board level, and with potential corporate customers. This linking effect of equity investors is apparent in many of the Bank's equity programmes. For example the Northern Powerhouse Investment Fund early assessment report sets out a case study where a fund manager found a technical expert to act as a Non-Executive Director for their investee firm.[29]

In addition to equity investors linking their portfolio firms to others, links from prospective portfolio firms to investors are important. Around two fifths of pitchdecks that reach VC firms come from a pre-existing relationship but these warm leads eventually account for over four fifths of investments.[30] One specific inward link that appears important is having a director with previous experience of raising equity finance. Firms in this position are significantly more likely to obtain equity finance than their peers.[31]

FIG A.34

BUSINESS DENSITY OF SELECTED AREAS - BUSINESS SERVICE FIRMS

Source: British Business Bank analysis of ONS UK Business Counts in 2019[28]



Equity investors plan for eventual exits from their investments through initial public offerings, trade sales and secondary sales. Exits are a key process in entrepreneurial ecosystems as they drive investor returns and provide liquidity to limited partners, freeing up capital for future investments. Exits also create wealth for company founders, enabling them to found new ventures, invest in other firms or share their expertise.

This process is often called entrepreneurial recycling[32] and will play a role in the substantial variation in the presence of equity investors we see in the UK.[33] Again London is significantly better stocked than the rest of the UK including our comparator ecosystems (figure A.35). This strong presence of VC investors in London appears to filter down to firms considering raising equity as just 27% of London firms in this position view a lack of suitable investors in their local area as a barrier.

This is comfortably below the 40% of firms in the UK overall that have considered raising equity but view the lack of investor presence as a barrier according to the latest Business Finance Survey.

There is a similar pattern for the locations of incubators and accelerators. Incubators and accelerators both aim to support businesses through their earliest stages of growth. They use a range of approaches such as providing physical space, mentoring, training and funding. Incubators tend to be open-ended with looser selection criteria and rent-based funding. Accelerators are generally time-limited programmes and often take equity stakes in attendee firms as part of their funding arrangements.[34]

FIG A.35

VENTURE CAPITAL INVESTOR LOCATIONS

Source: British Business Bank analysis of PitchBook Investor Information as of mid-2019

As of the last comprehensive data gathering exercise in 2017, London hosted over 180 incubators and accelerators. This was 30% of the UK total, a notably higher share than the 19% of UK businesses in the capital. Bristol and Nottingham hosted 10 and seven incubators and accelerators, respectively, fewer than seven individual London boroughs[35] (figure A.36).

Incubators and accelerators are particularly revered ecosystem connectors. Most participant firms view the contribution of the incubator or accelerator they attended as significant or vital to their success. Programme features that appear to be strongly related to positive outcomes include access to investors and peers, help with team formation, direct funding, and mentoring by a business angel, venture capitalist or industry expert. Non-attendee firms also appear to benefit as there is evidence of spillover benefits in the form of increases in the number and value of equity investments for non-attendee firms.[36]

Major banks and other large corporates increasingly sponsor their own incubators and accelerators. This arrangement can have benefits for both parties. Attendee firms can potentially access their sponsor's networks alongside the network of peers formed through the programme. Sponsors gain awareness of innovations that attendees develop, and they may even take small equity stakes too.[37]

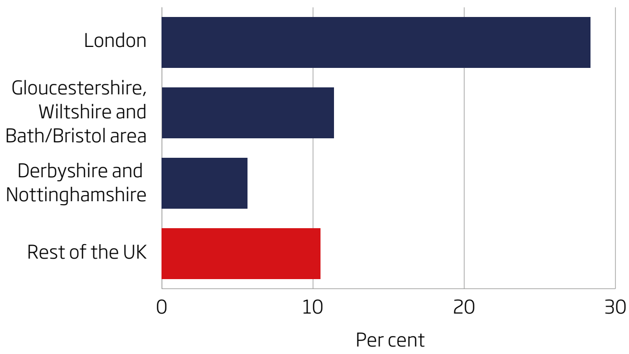
These forms of sponsorship have some similarity to the concept of anchor tenants in entrepreneurial ecosystems. Anchor tenants are large firms that undertake significant research and development of their own but also absorb innovations from other entities. Anchor tenants were originally viewed as helping the absorption and use of university-derived innovation. Through sponsoring incubators and accelerators this absorption can expand to innovative firms without university links. This is particularly true where the sponsor select participants working on innovations relevant to their own business model.

FIG A.36
INCUBATOR AND ACCELERATOR LOCATIONS
Source: British Business Bank analysis of BEIS Incubator and Accelerator Directory, 2017

FIG A.37

SERVICE EXPORTS AS A PROPORTION OF GROSS VALUE ADDED

Source: British Business Bank analysis of ONS Service Exports, 2016
Note: Chart plots data for NUTS2 regions [40]



Universities are another prevalent sponsor of incubators and accelerators. University involvement can create a direct route for spinouts to participate in accelerators or incubators and may be part of overarching technology transfer strategies.

In addition to connections within ecosystems like incubators and accelerators, connections to other ecosystems also support ecosystem strength and resilience. Equity investors are a good illustration of this too as VC firms often invest in companies outside their home ecosystem. For London firms, over 20% of deals since 2011 have been confirmed as involving overseas investors while the share is much lower at around 10% for Bristol, Nottingham and the rest of the UK.

Some evidence suggests that companies backed by cross-border VC investors experience stronger long-term growth even when compared to other VC-backed firms where the backers are all domestic. Part of this is likely to be associated with the linking effects that can help portfolio businesses to internationalise.[38]

External connections to customers are also an important link to other ecosystems and again London has notable strength. Service exports make up a far higher share of gross value added in London than the rest of the UK and our two comparator ecosystems (figure A.37). London is particularly strong in exports of financial and information and communication services, accounting for more than 50% of the UK total in both.

Exporting doesn't just provide firms with new markets, it can also boost productivity. Recent evidence based on UK firms identifies a clear learning-by-prior-exporting effect on productivity that further highlights how external links can benefit an ecosystem.[39]

Given London's position as the leading UK ecosystem it is not surprising it has unparalleled internal connectivity from its incredible business density, its huge stock of incubators and accelerators and its population of investors. London also has strong external connections with high levels of equity investments involving overseas funds and significant volumes of service exports.

London's characteristics are so strong that the 2019 Global Startup Ecosystem report placed London as one of only four global ecosystems in what they call the integration phase.[41] The authors describe ecosystems in the integration phase as having a self-sustaining degree of global connectedness that keeps firms at the forefront of technological and business model innovation.

Alongside London in the integration phase are Silicon Valley, Boston and New York. Silicon Valley is ranked at the top of all the ecosystem pillars used in the report, but London matches the Valley, outranking Boston and New York, on market reach and connectedness.[42] These world-leading strengths mean the London ecosystem is well-placed to withstand the current slowdown in early stage activity though we cannot be complacent.

Ecosystems in the rest of the UK have their own strengths too as our comparators have demonstrated. Nottingham and Bristol have many desirable features that the preceding text has covered such as the presence of multiple incubators, accelerators and VC investors nearby. These ecosystems also have strengths not covered in this report that create resilience. Examples include the presence of leading universities and major international firms. It is also true that London's global position benefits other UK ecosystems with links into the capital, including our comparator ecosystems.

THE BANK IS WORKING WITH PARTNERS TO UNDERSTAND AND FURTHER STRENGTHEN ECOSYSTEMS ACROSS THE WHOLE OF THE UK

While never taking London's global position for granted, the Bank is working with partners to understand and further strengthen ecosystems across the whole of the UK. We have a range of existing activities and are using our regional intelligence to set a long-term strategy.

In the past year the Bank's UK Network have had over 1,000 meetings with stakeholders across the breadth of the UK. Our contacts range from accountancy firms to Local Enterprise Partnerships (LEPs) to trade associations and beyond. What links them all is the connecting role they play in their respective ecosystems, something we are aiming to strengthen by connecting the connectors. For example, in the last year we have brought together access to finance experts working in neighbouring LEPs to share knowledge. In the coming year we will launch our Regional Partner programme through which we will recruit organisations to help boost connectivity in their ecosystems through improving coordination and collaboration.

The Bank is also involved in an ongoing pilot aiming to enhance ecosystems in the Metro Mayoral Authorities of Greater Manchester, the West of England and the West Midlands. This DCMS-led project, focusing on scaling businesses in the creative industries (CI), is taking an innovative 'dual' demand and supply approach, which is locally developed and driven. This provides both intensive business support to CI businesses to enhance investment readiness (demand) and investor network and capacity building (supply), with the ultimate goal of unlocking growth finance for CI businesses. The Bank will take 'what works' findings forward from this work, across the range of programme elements being tested, such as stimulating the process of entrepreneurial recycling, by encouraging successful entrepreneurs to become angel investors. This local involvement in design and delivery is part of the Bank's regional funds too and helps align activity with ecosystem characteristics.

Allied to our efforts to improve connectivity, we are also bringing new players and additional funds to entrepreneurial ecosystems. Our regional funds, the Northern Powerhouse Investment Fund, the Midlands Engine Investment Fund and Cornwall and Isles of Scilly Investment Fund, have brought established fund managers into new regions, providing their value-adding expertise to the ecosystem as well as channelling additional funds, including from private sector sources, toward exciting companies.

At a national level, the Bank is exploring what can be done to support early stage entrepreneurial activity, including the types of innovative concept-building research that can create spinouts. At present potential entrepreneurs at the very earliest stages of developing new technologies or products are primarily dependent on grants for research and development. When this funding is no longer suitable the high cost of due diligence, relative to the small investment sizes and high risk, is often prohibitive preventing equity investors from stepping in.

This is just one example of a potential blockage affecting early-stage entrepreneurial activity. Our plans for 2020 also include undertaking new primary research on the entrepreneurial development process, specifically aiming to understand the blockages that may face female or ethnic minority entrepreneurs. This research will report later in the year and will support the Bank's continued commitment to enabling entrepreneurship for everyone in the UK.

2.1 SME BUSINESS POPULATION

- UK business population increased to 5.9 million at the start of 2019
- Growth in unregistered firms exceeded growth in registered firms
- Early indicators suggest the number of new businesses registering for VAT throughout 2019 has been stable
- The incidence and growth of smaller firms varies by location and sector across the UK

This section reviews the most recent changes in the UK SME business population together with spatial and sectoral variations, using the latest BEIS business population estimates and ONS business demography data. The section also draws on new data published as part of the ONS 'Faster indicators of UK economic activity' initiative, launched in April 2019. These indicators include the number of new VAT reporters, providing a proxy for firm births (at the threshold level of £85,000 taxable turnover).[43]

UK BUSINESS POPULATION INCREASED TO 5.9 MILLION AT THE START OF 2019

There were 5.9 million private sector firms in the UK at the start of 2019, an increase of 3.5% from 2018 (figure B.1). These firms are comprised of 5.82 million small businesses (0-49 employees), 35,600 medium-sized businesses (50-249 employees) and 7,700 large businesses with 250 or more employees. Taken together, smaller businesses (0-249 employees), which comprise 99% of firms, contribute £2.2 trillion in turnover to the UK economy and account for 52% of private sector turnover. They also employ 16.6 million employees, comprised of 12.2 million workers and 4.4 million working proprietors - 61% of the private sector workforce and 48% of the total workforce (which includes central and local government and non-profit organisations).[44]

BEIS business population estimates provide numbers for private sector businesses at the start of the year, by combining estimated counts for unregistered businesses (those that are not VAT and/or PAYE registered) with data on registered businesses derived from the ONS Inter Departmental Business Register. The estimates are published 10 months after the reference point and reflect business activity in the preceding year (employment) or earlier (turnover data is based on VAT returns for the 12-month period ending December 2017 or January/ February 2018).[45] This section compares the latest business counts from January 2019 with counts from January 2018.

GROWTH IN UNREGISTERED FIRMS EXCEEDED GROWTH IN REGISTERED FIRMS

Growth, in both absolute and percentage terms, was highest amongst unregistered firms with no employees rising by 4.9% to 3.25 million, reversing the 1.2% decline at the start of 2018 (figure B.2).

The number of zero employee registered firms also grew (2.4%) to 1.21 million in 2019, reversing the 1% reduction in numbers reported in 2018. The number of registered employers grew by 1.5% to 1.41 million in 2019, slightly below the 1.6% growth rate recorded in the previous year.

FIG B.1

UK BUSINESS POPULATION

Source: BEIS, Business population estimates

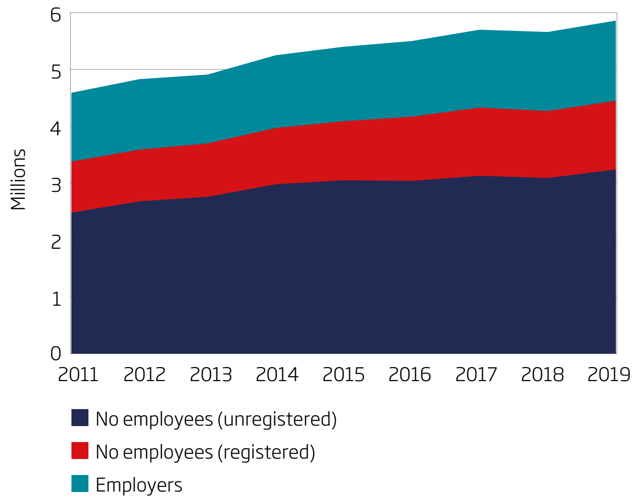


FIG B.2

UK BUSINESS POPULATION, NUMBER OF BUSINESSES AND GROWTH

Source: BEIS, Business population estimates

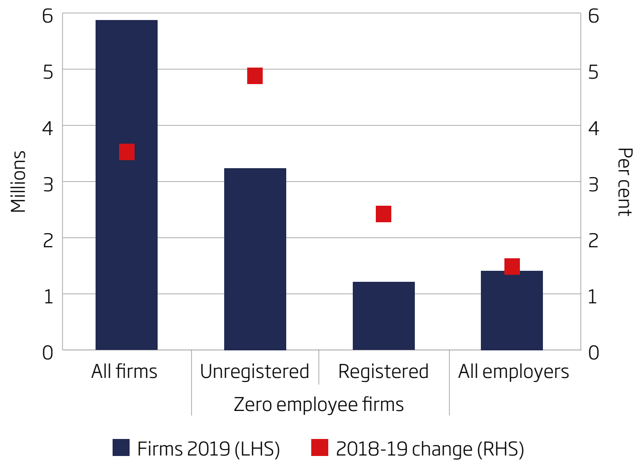


FIG B.3
UK NEW FIRM STARTS (BIRTHS) AND CLOSURES (DEATHS)
** births and deaths as % of active businesses in each year*
Source: ONS, Business Demography

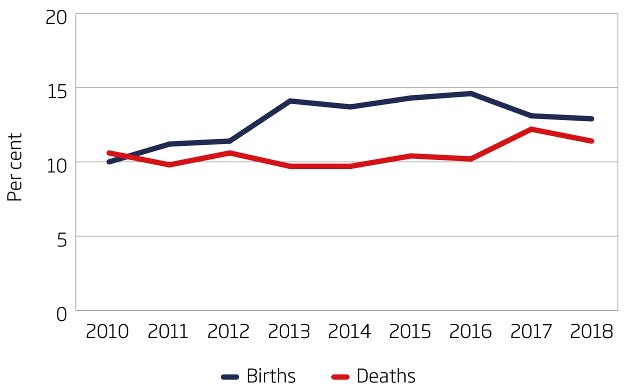
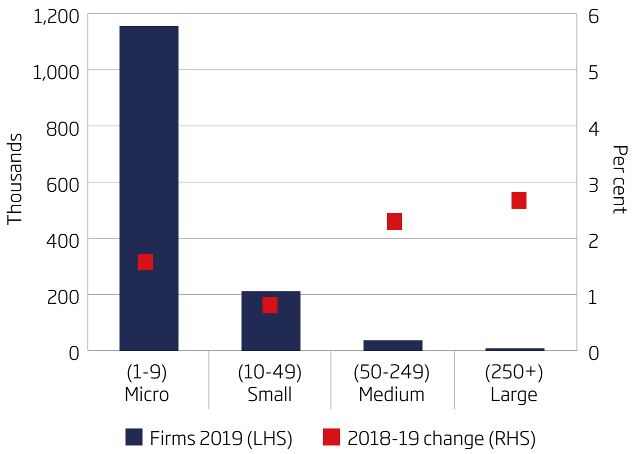


FIG B.4
UK EMPLOYERS, NUMBER OF BUSINESSES AND GROWTH
Source: BEIS, Business population estimates



The rate of registered business formation, as measured by the ONS, has exceeded that for business closures in every year since 2011. The business birth rate (number of new business registrations for VAT or PAYE as a share of the business population) peaked at 14.6% in 2016. However, the 12.9% birth rate in 2018 (the latest available data) was the lowest reported in six years and is slightly down on 2017 (13.1%). The number and rate of business closures (as a share of the business population) also decreased to 11.4% in 2018, from 12.2% in 2017 (figure B.3).[46] The result of these changes is a widening gap between firm births and deaths and a net increase in the stock of registered businesses.

Despite this, growth in the number of new registered businesses over 2018 (both zero employee registered firms and employers) remained somewhat subdued when compared to that of non-registered firms. There are several possible reasons for this including the expansion of Intermediaries Legislation (IR35), which introduced rules aimed at making sure workers providing services through intermediaries pay the same tax and NICs as employees would. This was initially applied to public sector intermediaries and as of April 2020 will also be applied to private sector intermediaries. The ONS highlighted that a decline in new firm registration in the education and health sector in 2018 coincided with the introduction of IR35 (introduced in April 2017). Further potential reasons for the decline in new firm registrations are discussed in section 1.3: Finance in entrepreneurial ecosystems.

BEIS data also breaks SMEs with employees into headcount cohorts. As at 2019, there were almost 1.16 million micro (1-9 employee) firms (82% of all private sector employers). The number of micro firms grew by 1.6% to 2019, slightly below the growth rate of 1.7% recorded to 2018, whilst the growth rate of small firms (10 to 49 employees) has remained below 1% in both periods. Medium and large employers recorded growth rates of 2.3% and 2.7%, respectively, to 2019, somewhat below the 2.7% and 4.2% growth rates recorded in the previous year (figure B.4).[47]

EARLY INDICATORS SUGGEST THE NUMBER OF NEW BUSINESSES REGISTERING FOR VAT THROUGHOUT 2019 HAS BEEN STABLE

The ONS has recently introduced a range of faster indicators of UK economic activity, including the publication of the number of new businesses that have registered for VAT in the period. These "first reports" from firms that have attained the mandatory threshold in turnover to make a VAT return, or that have voluntarily registered, provide a proxy birth rate for registered enterprises and "relate to the overall creation and increase of business activity in the economy."[48] The average of 61,000 new reports per quarter recorded in 2019 was below the peak of 65,000 in 2016 (figure B.5). While there has been relative stability in this timely measure since the middle of 2017, new VAT reports measure just one aspect of entrepreneurial activity and indicators of potential entrepreneurial slowdown are explored further in section 1.3: Finance in entrepreneurial ecosystems.

THE INCIDENCE AND GROWTH OF SMALLER FIRMS VARIES BY LOCATION AND SECTOR ACROSS THE UK

Growth rates in the number of firms to 2019 for UK regions and devolved nations were generally higher than those recorded in the previous year, with a few exceptions (figure B.6). The North East had the highest growth in business numbers to 2018 (14%), but the highest decline in numbers to 2019 (-6.9%). The East Midlands saw a decline in both 2018 and 2019 (-0.8% and -3.1% respectively). Northern Ireland also saw a decline to 2019 (-6.5%) after growth of 0.8% to 2018. London recorded a marginal reduction to 2019 (-0.4%).

FIG B.5

UK QUARTERLY NEW VAT REPORTS (PROXY BIRTH RATE)

Source: ONS, Data Science Campus

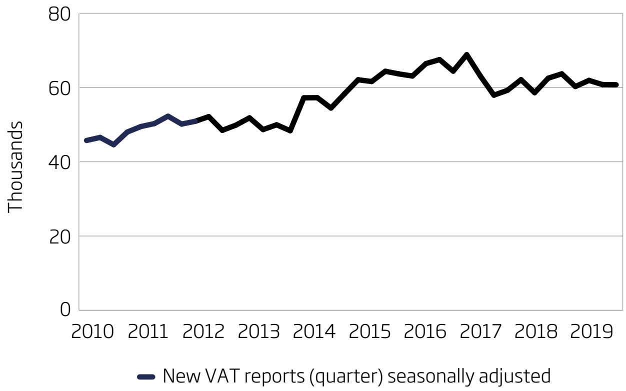
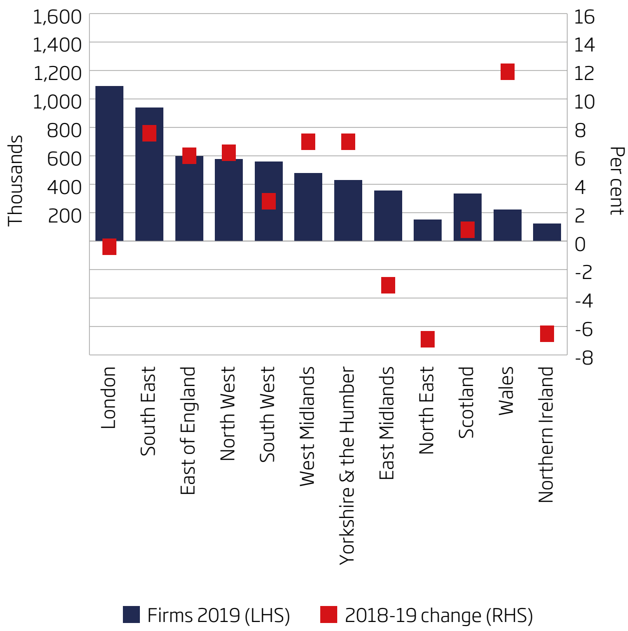


FIG B.6

UK SMALLER FIRMS AND CHANGE, BY ENGLISH REGION AND DEVOLVED NATION

Source: BEIS, Business population



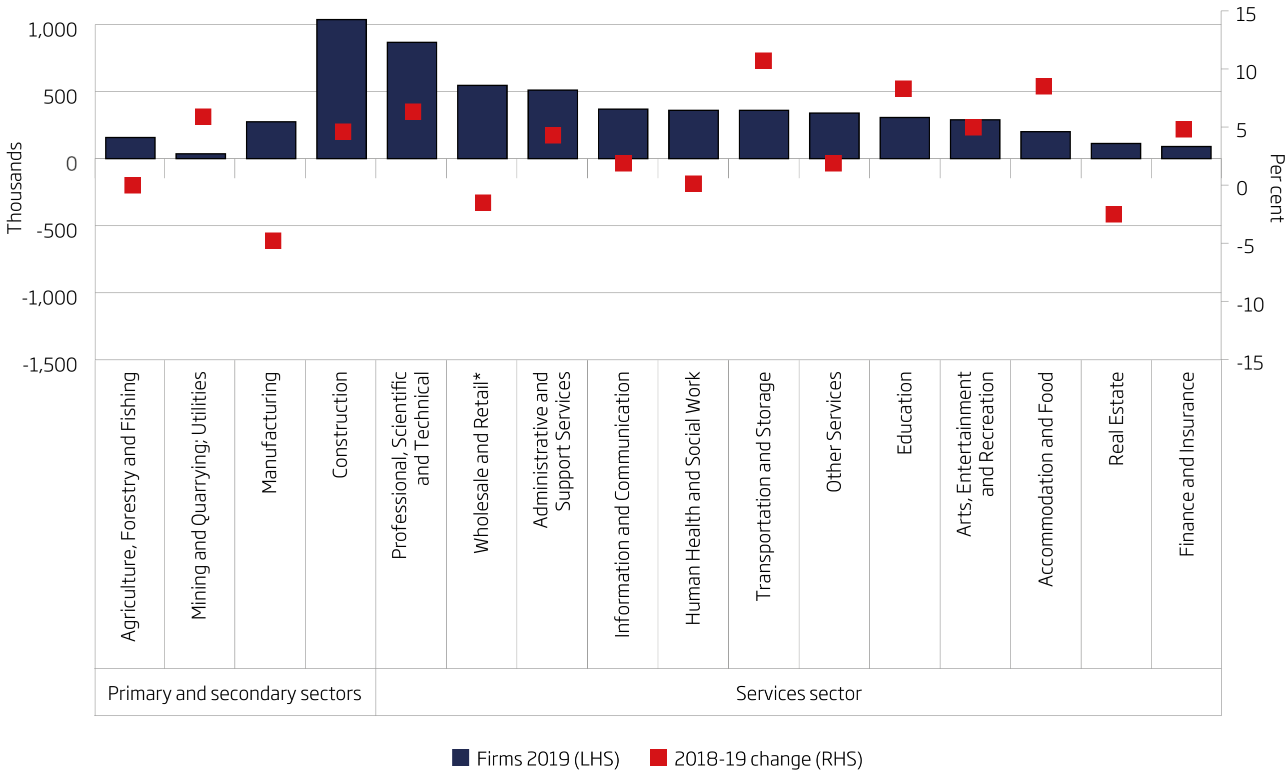
Services continue to comprise both a greater share of the stock of firms and contribution to the net annual growth rate of the private sector business population than the primary and secondary sectors (figure B.7).[49, 50] The highest growth rates to 2019 were recorded in Transportation and Storage, Accommodation and Food Services, Education, Professional, Scientific and Technical, and Financial Services. Whilst Manufacturing, Real Estate and Wholesale and Retail recorded a net reduction to 2019, these sectors had all recorded growth in the number of firms in the previous year.

The contribution smaller businesses make to the UK economy and employment, wherever they're based and whichever sector they're in, demonstrates the importance of the British Business Bank's focus on making finance markets working better for them. Reflecting the diversity of the smaller business population in terms of size, age, sector and location, the Bank supports a range of finance solutions from debt to equity across the UK, enabling smaller businesses to find the right type of finance for them.

FIG B.7

UK SMALLER FIRMS AND CHANGE, BY SECTOR

** Motor vehicle repair included in wholesale and retail*
Source: BEIS, Business population



2.2 USE OF EXTERNAL FINANCE

- Use of finance reached its highest level since 2012, driven by short-term finance types and working capital needs
- Reluctance to use long-term finance continued and application rates remained historically low, meaning businesses could be forgoing growth
- Barriers to using some types of finance persisted, including a lack of awareness and reluctance to give up control
- Many smaller businesses still rely on their own experience when considering finance options
- Over a third (36%) of SMEs use trade credit, reducing the need for external finance but highlighting vulnerability to late payments

This section highlights current usage of external finance, attitudes to finance and trends in debt applications, drawing on the latest available data from BVA BDRC's SME Finance Monitor, the British Business Bank's Business Finance Survey and BEIS' Longitudinal Small Business Survey.[51] The definition of external finance used excludes trade credit, which is discussed separately at the end of the chapter.

USE OF FINANCE REACHED ITS HIGHEST LEVEL SINCE 2012, DRIVEN BY SHORT-TERM FINANCE TYPES AND WORKING CAPITAL NEEDS

The share of businesses using external finance peaked at around half (49%) in Q2 2019, a significant increase from 36% in 2018. The share of finance users outnumbered 'Permanent non-borrowers' (PNBs), for the first time since 2014 and by 12 percentage points (figure B.8).[52] However, use of finance declined to 43% at the end of 2019, with the share of PNBs (45%) now slightly higher than finance users according to the latest available data (Q4 2019).[53]

FIG B.8

SMEs USING EXTERNAL FINANCE AND PERMANENT NON-BORROWERS

Source: BVA BDRC SME Finance Monitor, 3 months to December2019. 2011 data not shown consistent with BVA BDRC reporting. Dotted line denotes start of quarterly data.

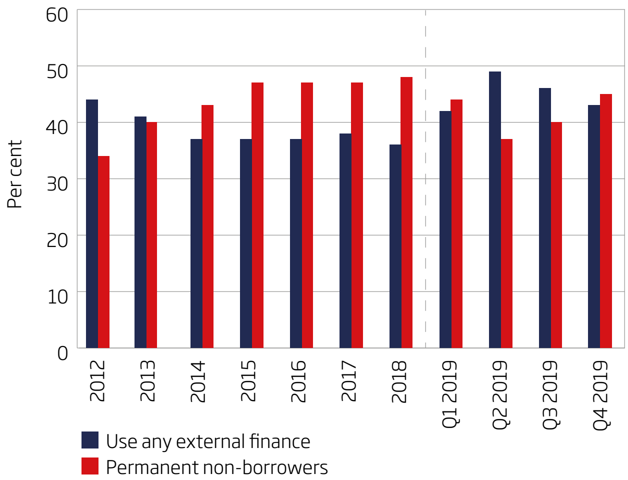
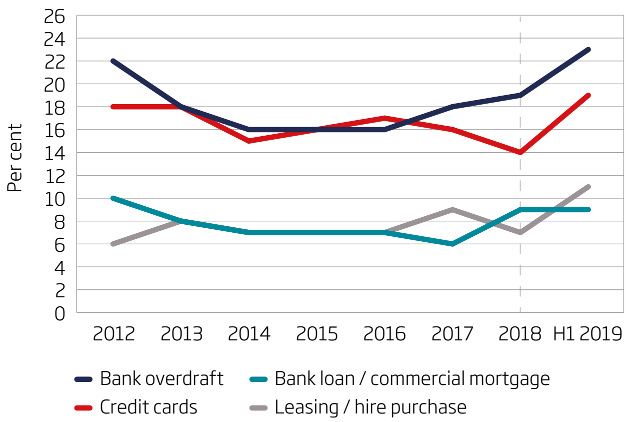


FIG B.9

SMES USING CORE FINANCE PRODUCTS AND LEASING/HIRE PURCHASE OVER TIME

Source: BVA BDRC SME Finance Monitor, Q2 2019. 2011 data not shown consistent with BVA BDRC reporting. Dotted line denotes end of annual data.



The increase in use of finance over the first half of 2019 was driven by smaller businesses (those with fewer than 10 employees). The share of 0 employee businesses and those with 1-9 employees using finance peaked at 46% and 57% respectively in Q2 2019, from 34% and 42% in 2018. These smaller businesses are significantly more likely to require funding for short-term cashflow related reasons (of the 4% who identified a need for funding, 51% of 0 employee businesses' funding need was cashflow related, compared to 34% of 50-249 employee businesses).[54]

Use of 'core' forms of finance increased significantly in the first half of 2019, with 39% of SMEs using any type of core product, up from 32% in 2018.[55] The increase was driven by types of finance often associated with short-term use. Credit card and overdraft use rose to their highest levels since 2012, at 23% and 19% respectively in H1 2019 (figure B.9) (discussed further in section 2.4: Bank lending).

Demand for bank loans and commercial mortgages and fixed assets or vehicles, typically associated with longer-term growth, remained stable.[56] Lenders reported increased demand for unsecured lending, particularly credit cards, over the first three quarters of 2019. In Q4 there were signs of demand for unsecured lending contracting, consistent with the lower use of finance reported by the SME Finance Monitor.[57]

The British Business Bank's Business Finance Survey did not record a similar pick up in use of credit cards and overdrafts from 2018 to 2019, remaining stable at 25-26% and 36% respectively.[58] However, the Bank's survey was in the field from the end of August to the end of November whereas the pickup recorded in these finance types by the SME Finance Monitor has occurred over the first half of 2019 so timing effects may account for these differences.

Alternative finance use has also increased to 19% in H1 2019, from 12% in 2018, driven by leasing and hire purchase, which overtook bank loans/commercial mortgages as the third most used type of finance. This was consistent with the Bank's Business Finance Survey (figure B.10), where leasing and hire purchase was the third most commonly used finance product.

Working capital and cashflow have typically been the most often cited reasons for seeking finance, but in the first half of 2019, there were more mentions of needing funding for working capital, to cover a short-term funding gap or to help through trading difficulties.[59] Of those identifying a need for funding (4% of SMEs), 40% said cashflow support was the reason for requiring funding in H1 2019, up from 32% in 2018 (also see figure A.23 in section 1.2: Impacts of macroeconomic developments on SME finance markets). This was followed by investing in new plant or machinery, cited by 27%, up from 22% in 2018, possibly reflecting the increased take up of leasing and hire purchase. Over the same period, there were fewer mentions of funding expansion in the UK, taking advantage of new business opportunities and taking on staff.

Taken together, this indicates the increased demand for finance is predominantly for short-term purposes rather than funding long-term growth ambitions or expansion. The Bank is exploring updating the Business Finance Guide, which sets out different sources of finance available to businesses, with more information relevant to smaller businesses looking for finance for short-term purposes. This would help businesses find finance to address their working capital and cash flow needs and manage any potential uncertainty associated with EU exit.

RELUCTANCE TO USE LONG-TERM FINANCE CONTINUED AND APPLICATION RATES REMAINED HISTORICALLY LOW, MEANING BUSINESSES COULDBE FORGOING GROWTH

Demand for longer-term credit has remained weak throughout 2019,[60] consistent with suppressed investment intentions as reported by a range of business surveys.[61] While more smaller businesses are using finance than ever before, the majority remain averse to using finance to grow and develop their business over the long-term. Current use of finance was previously a key predictor of positive attitudes towards, and future use of, finance.[62] However, the share of those using finance that wouldn't be happy to use it to grow their business rose from 43% in 2015 to 62% in H1 2019 (figure B.11).

FIG B.10

SHARE OF SMES CURRENTLY USING SELECTED EXTERNAL FINANCE PRODUCTS

Source: British Business Bank 2019 Business Finance Survey – Ipsos MORI.

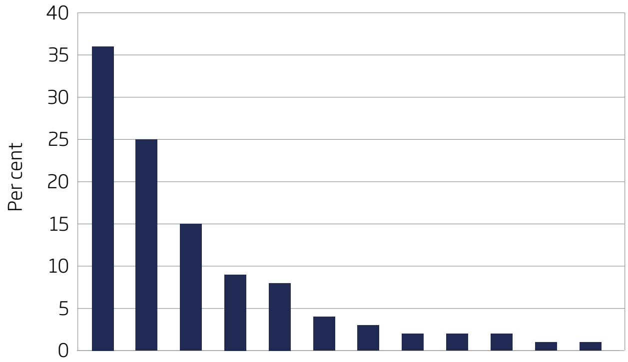
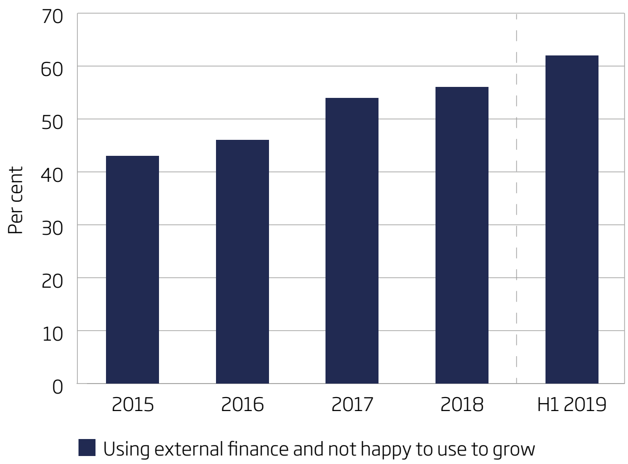


FIG B.11

PROPORTION OF USERS OF FINANCE NOT HAPPY TO USE IT TO GROW AND DEVELOP THEIR BUSINESS

Source: BVA BDRC SME Finance Monitor Q2 2019, dotted line denotes end of annual data.



ATTITUDES TO FINANCE BY BRITISH BUSINESS BANK SEGMENT

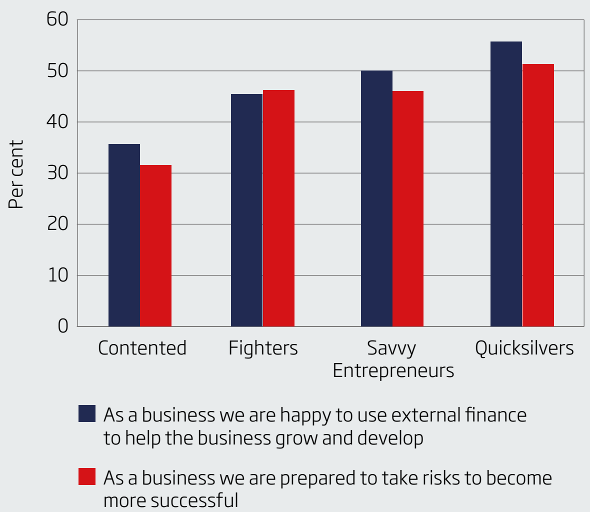
Attitudes to finance vary significantly across UK businesses. The British Business Bank has undertaken SME segmentation analysis based on attitudes to using finance to identify the highest potential and most receptive businesses. The segmentation approach is described in more detail in the 2018/19 Small Business Finance Markets report.

Quicksilvers, the fastest growing businesses with the most ambitious growth plans, are the most prepared to take risks to achieve success and the most open to using finance to help their business grow and develop (figure B.12). For Savvy Entrepreneurs (most likely to have run a business before or multiple businesses) and Fighters (trying to overcome obstacles), around half are willing to use finance and to take risks to become more successful. Fittingly, Contented businesses, with the lowest growth ambition, are the least open to using finance to grow and develop and the most risk-averse.

FIG B.12

WILLINGNESS TO TAKE RISKS AND TO USE FINANCE TO GROW AND DEVELOP THE BUSINESS

Source: BVA BDRC SME Finance Monitor, 10 quarters to Q2 2019



Reluctance to use finance for growth continued across most smaller businesses. As highlighted in section 1.1: Five years on, 28% agreed they would be happy to use finance in Q4 2019, down from 42% in 2014.[63] A steady three quarters of businesses (73%) would be willing to accept a slower growth rate rather than borrowing to grow faster and just over half (52%) said they never thought about using (more) finance in H1 2019.[64]

Significant variation in attitudes to finance exists across the UK's SME population, reflecting the diversity in smaller businesses. The box on 'Attitudes to finance by British Business Bank segment' explores this further.

The declining share of businesses seeking finance over the past decade reflects the downward trend in willingness to use finance. According to BEIS' Longitudinal Small Business Survey, just 12% of businesses with employees had sought finance over the past 12 months in 2018, the lowest recorded share so far[65] and less than half the share that sought finance in 2010. Factors related to uncertainty and risk remained the most important reason why businesses were not seeking finance in 2018.[66] The fear of rejection, the second most important factor, has become more prevalent as has the anticipated time and/or hassle involved in the process.[67]

More recently, uncertainty has continued to play a role in preventing some businesses from seeking finance towards the end of 2019, with uncertain economic conditions becoming the most common reason for wanting finance but not applying.[68]

Perceptions that it's difficult to get finance have risen amongst small businesses, from 38% in H1 2018 to 42% in H1 2019. This view is particularly prevalent amongst start-ups (businesses under 2 years old) (64%) who may lack the collateral, credit history and/or trading history to secure finance. The British Business Bank's Start Up Loans programme offers loans, alongside business support and mentoring, to new and early stage businesses.

Despite nearly half (46%) of businesses using finance in H1 2019, just 4% had applied for new or renewed finance in the 12 months prior to interview. This is consistent with 4% reporting the same in 2018 (with 36% using finance).[69] From Q1 2018 the SME Finance Monitor has collected data on a wider range of finance applications than loans and overdrafts only and applications to a wider range of finance providers. Applications for new loans declined from 2.9% in 2012 to 1.5% in 2017 and overdrafts from 4.0% to 1.6% over the same period (as referred to in section 1.1: Five years on).[70] While not directly comparable, the latest SME Finance Monitor data suggests the application rate for new loans was 1.3% in the 6 quarters to Q2 2019, with applications for new overdrafts at 0.9% over the same period.[71]

Increased use of finance combined with low application rates suggests that smaller businesses are likely to be renewing or drawing down on existing facilities (particularly overdrafts and credit cards) rather than applying for new facilities. The value of overdraft facilities to smaller businesses is discussed further in section 2.4: Bank lending.

Consistent with rising perceptions of difficulty securing finance, success rates for applications of all types of finance have decreased slightly since 2017, with the share of applicants not being offered a facility rising to 24% for all applications between Q3 2018 to Q4 2019 (from 16% from Q1 2017 to Q2 2018).[72] Trends in volume of approvals for debt products are discussed further in section 2.4:Bank lending.

Increased use of finance would usually suggest an increase in those considering applying for or renewing their finance in future.[73] Around half (40 to 50%) of Start Up Loans recipients surveyed over 2016 to 2018 planned to apply for external finance in the next twelve months.[74] However in the first half of 2019, just 9% of all SMEs were using finance and planned to apply for more, whereas 37% were using finance but with no plans to apply (figure B.13). This means that 80% of current finance users did not plan to use finance again in future (reflecting smaller businesses' aversion to using finance to grow and develop highlighted earlier in the section).

Just 12% of all smaller businesses had plans to apply or renew their finance over the next 3 months in H1 2019, a decline from 14% in 2012 and 2013. Of those planning to apply or renew their finance, 33% wanted more finance to help with cash flow, up from 26% in 2018. According to our Business Finance Survey, 17% of SMEs were planning to apply for finance in the next 3 months. Of those, 30% were planning to apply for an overdraft in the next 3 months (reported between August and November 2019), up from 22% in 2018.

From a supply perspective, lenders expected demand for lending to pick up in the near term. In Q4 2019, the Bank of England reported a positive balance in lender expectations for demand for small business lending over the next 3 months. This is driven by unsecured lending, with negative expectations for secured lending over the next 3 months.[75]

FIG B.13

USE OF FINANCE AND APPETITE FOR APPLYING (FOR MORE)

Source: BVA BDRC SME Finance Monitor Q2 2019, dotted line denotes end of annual data.

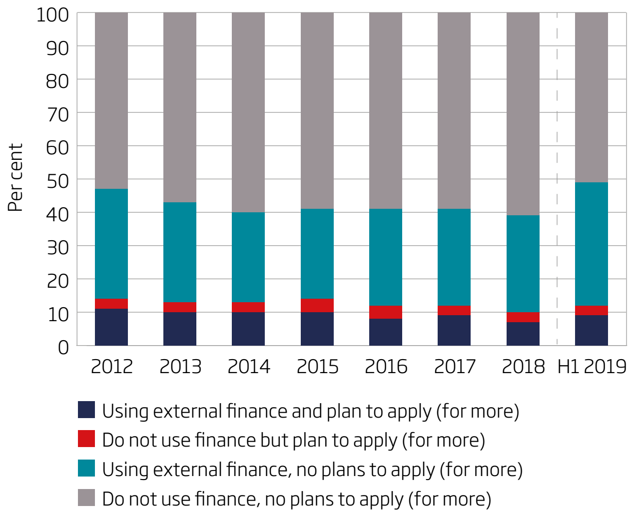
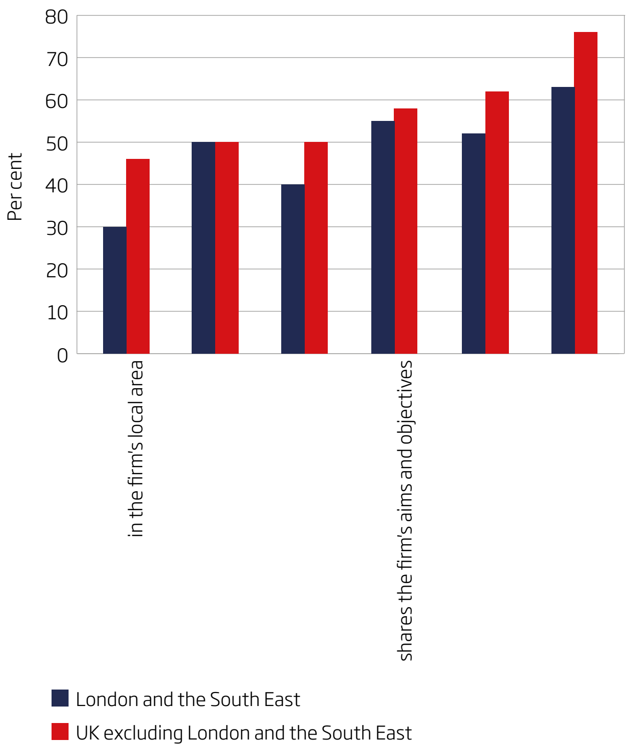


FIG B.14

BARRIERS TO APPLYING FOR EQUITY FINANCE IN LONDON AND THE SOUTH EAST AND THE REST OF THE UK

Source: British Business Bank 2019 Business Finance Survey – Ipsos MORI.
Base = all who have applied for or have considered raising equity finance (n=772)



BARRIERS TO USING SOME TYPES OF FINANCE PERSISTED, INCLUDING A LACK OF AWARENESS AND RELUCTANCE TO GIVE UP CONTROL

The increasing diversity of finance products, providers and platforms means that smaller businesses have a range of options when considering how to finance their growth. However, imperfect or inaccurate information may limit the efficiency by which capital is allocated to growing firms.

Almost all SMEs are aware of core debt products, but awareness of alternative forms of finance has decreased since 2018, including venture capital (down to 60% from 69% in 2018), business angels (down to 33% from 41% in 2018) and mezzanine finance (down to 9% from 12% in 2018).[76] More smaller businesses are aware of leasing/hire purchase than any alternative form of finance, but awareness has fallen to 84% from 89% in 2018, despite increased use over the same period. Awareness of equity crowdfunding platforms (50%) and marketplace lending (39%) has also decreased significantly in 2019 (falling by 20 percentage points and 13 percentage points respectively), although this may have been driven by questionnaire changes for these three forms of finance.[77]

Regional disparities in awareness of equity finance are also apparent. This is particularly true of venture capital and business angels, where the rate of awareness of both forms of finance was almost 10 percentage points higher in London and the South East than in the rest of the UK (66% compared to 57% for venture capital, 39% and 30% for business angels respectively).[78]

Although not suitable for all firms, equity finance can be an important source of funding for innovative and ambitious firms. High-growth businesses are more likely to be using equity finance.[79] However, over half of smaller businesses said they did not know anything about equity finance (62%)[80] and just 18% were aware of a specific provider to go to if they did want to apply for equity.[81] Despite the link between use of equity and growth, an equity information gap amongst scale-ups and other smaller businesses persists.

Fear of external ownership increasingly deterred businesses from using equity: 71% of those applying for or considering equity finance cited reluctance to give up control as a barrier (up from 62% in 2018). This reluctance was particularly prevalent outside London and the South East, with 76% of businesses agreeing this was a barrier, compared to 63% in London and the South East (figure B.14).

Regional disparities are also apparent in businesses' perceptions of other barriers to equity. Firms outside of London and the South East were more likely to highlight difficulties in putting together the business value proposition (50% compared to 40% in London and the South East) and a lack of suitable investors in their local area (46% compared to 30% in London and the South East). The perceived difficulty in raising equity finance outside of London and the South East could account for regional differences in equity use.

The Bank's programmes are designed to address different elements of these regional imbalances. The Bank's Finance Hub, which enables smaller businesses to explore which finance options would work best for their business, aims to increase awareness of different types of finance and help businesses get investor ready. The Bank's UK Network has been set up to help address regional imbalances in access to finance and works with intermediaries to improve connectivity within regional ecosystems and across the UK. In direct response to Bank analysis and UK Network insights into local disparities in access to finance, the Bank is developing its regional activities, including a regional events programme to help inform businesses of their finance options and next steps and a regional partner programme to increase engagement and coordination with key regional stakeholders.

MANY SMALLER BUSINESSES STILL RELY ON THEIR OWN EXPERIENCE WHEN CONSIDERING FINANCE OPTIONS

Smaller businesses are increasingly self-reliant when considering what type of finance to apply for and who to apply to. Over a third drew on their own knowledge, their staff's knowledge or previous experience (35% in 2019, up from 27% in 2018) when deciding what to apply for. Just under a third (31%, up from 25% in 2018) said their own sources of information were the main influence on what to apply for and 30% said this influenced their decision on which provider to approach (up from 24% in 2018).[82] This change has not been coupled with increased confidence from smaller businesses in their own ability to assess different finance options. Instead, it could reflect a reluctance to spend time considering a range of sources (consistent with the increased share of smaller businesses citing time or hassle as a key reason for not seeking finance).[83]

After their own knowledge or resources, SMEs were more likely to cite their existing bank or finance provider as an influence over their finance decision than any other information source: 1 in 5 (21%) cited their provider as an influence on what to apply for and 17% said their provider was the main influence. Fewer businesses cited their bank as an influence on which provider to approach, suggesting some may be exploring other options outside of their existing bank.[84]

When businesses first identified a need for finance, speaking to their main bank continued to be the most popular next step (29%), followed by researching finance types online (14%).[85] However fewer businesses were considering more than one finance provider (down to 34% from 40% in 2018) suggesting propensity to shop around could have declined. Smaller businesses increasingly lack confidence when it comes to applying for finance products from different providers, with a minority now saying they were confident in doing so (48%, down from 54% in 2018).

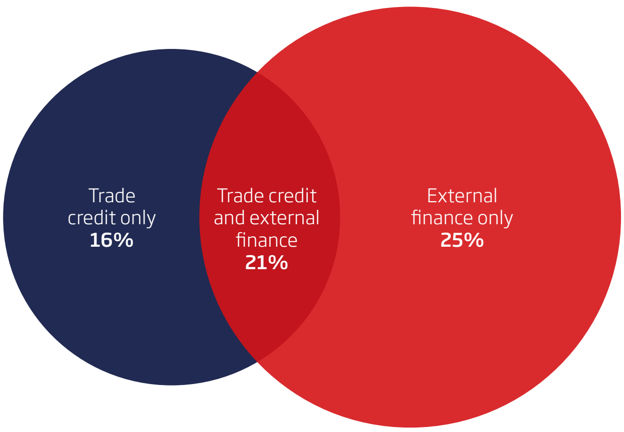
The most common reason for contacting just one provider was having an established relationship with that provider (45%), followed by price-related factors (cost/rates offered/best deal etc) (20%). The share of businesses that cited the hassle involved in contacting more than one provider has halved (6% compared to 12% in 2018), indicating that businesses may be cognitively more willing to shop around, but this is not necessarily being reflected in behaviour. Having an established relationship continued to be the most common reason overall for choosing a specific provider, with over a third (36%) citing this as their main reason and a large gap between that and the next most cited main reason (13% cited cost or rates offered).[86] This could indicate an inefficient allocation of resources where businesses are not choosing the type of finance or provider that represents the most competitive deal.

The British Business Bank's Finance Hub enables businesses to explore the finance types most suited to their current circumstances and future aspirations through its Finance Finder tool. The Hub provides independent information and insight into how to get finance ready and signposts to relevant finance experts and associations.

FIG B.15

RECEIVING OF TRADE CREDIT AND EXTERNAL FINANCE, % OF ALL SMEs

Source: SME Finance Monitor H1 2019, calculations by British Business Bank, n=c.9,000



OVER A THIRD (36%) OF SMEs USE TRADE CREDIT, REDUCING THE NEED FOR EXTERNAL FINANCE BUT HIGHLIGHTING VULNERABILITY TO LATE PAYMENTS

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

Use of trade credit has increased slightly to 36% in H1 2019, up from 34% in 2018, which could reduce the demand for external finance of some. Just over a quarter (26%) of all SMEs said trade credit reduced their need for finance. However, trade credit and external finance are increasingly being used as complements: over half (57%) of smaller businesses using trade credit use both (figure B.15).[87]

Small businesses offer trade credit to their customers, as well as receiving it. The share of businesses who receive trade credit (34%) is equal to those who offer it (34%).[88] However, at least two in five SMEs reported an average delay in payment of at least one month for invoices and trade credit.[89] This can lead to cash flow issues and time spent chasing payments for SMEs. The impact of late payments for businesses is discussed further in section 2.9: Invoice finance and asset-based lending.

Reflecting the scale of the challenge, the government is consulting on strengthening the powers of the Small Business Commissioner to hold late payers to account. Responsibility for the Prompt Payment Code will also move to the Small Business Commissioner, concentrating levers to tackle late payment into the same office.[90]

2.3 SME FINANCE AT A LOCAL LEVEL

- Firm characteristics play a key role in finance use in all locations
- Debt finance remains relatively evenly spread across the UK
- Equity finance continues to be concentrated in London
- We continue to expand our knowledge of the regional distribution of other forms of finance

This section analyses variations in SME finance markets across the UK. It builds on section 1.3: Finance in entrepreneurial ecosystems, by explaining the current imbalances in finance that ecosystem characteristics may affect over time. As with section 1.3, the analysis uses a range of spatial scales, dependent on data availability.

FIRM CHARACTERISTICS PLAY A KEY ROLE IN FINANCE USE IN ALL LOCATIONS

Entrepreneurial ecosystem characteristics can influence flows of finance in multiple ways. Alongside the influence of ecosystem characteristics, specific firms will make choices reflecting their own characteristics, as explained in section 2.2.

The latest Business Finance Survey highlights the importance of both factors. For example, 38% of firms without employees sought finance in the last three years compared to 83% of medium-sized firms with 50 to 249 employees. This 45-percentage point difference makes the importance of firm size in finance use very clear.

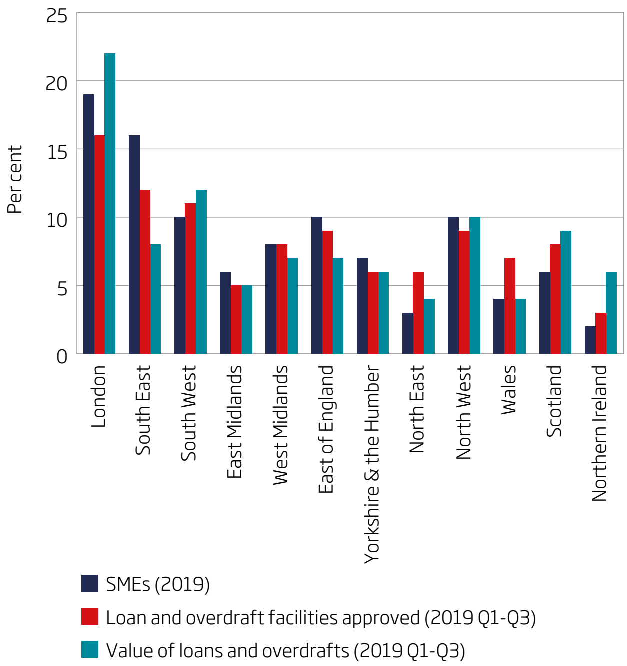
There are also differences across regions with between 40% and 57% of firms seeking finance in the last three years across the nine English regions, Scotland, Wales and Northern Ireland. This 17-percentage point gap makes the influence of ecosystem characteristics equally clear.

The relative importance of ecosystem and firm-level characteristics will vary depending on the outcome considered and the level of analysis. This is something that the remainder of this section will refer to when analysing the latest finance outcomes across the UK.

FIG B.16

BANK LENDING AND THE SME POPULATION IN 2019

Source: British Business Bank analysis of UK Finance, BEIS Business Population Estimates



DEBT FINANCE REMAINS RELATIVELY EVENLY SPREAD ACROSS THE UK

Debt finance continues to be relatively closely aligned with the business population. Data on loans and overdraft facilities granted by UK Finance members to SMEs demonstrate this relatively even spread has continued to 2019 (figure B.16).

Although the distribution is relatively even, there are variations. For example, the shares of finance facilities approved for SMEs in Northern Ireland, Wales and Scotland were comfortably above the shares of SMEs in those parts of the UK in 2019. Conversely, the shares of facilities granted by UK Finance members to SMEs in London and the South East were lower than the shares of SMEs in those regions.

These variations could be driven by a range of factors. For example, SMEs in London and the South East are likely to have access to a more diverse range of finance options than SMEs elsewhere. This could mean they are less reliant on UK Finance members so are under-represented in this data source.

Attitudinal factors could also play a role. For example, in Northern Ireland 83% of SMEs feel confident in their ability to apply for external finance from their own bank according to our 2019 Business Finance Survey. This is the highest in the UK and may help explain the relatively high use of debt finance in Northern Ireland.

Patterns of firms' use of debt finance do not just depend on their attitudes and the characteristics of their ecosystem but on their characteristics too. Even in thriving ecosystems, new firms lacking a track record, those being run by an entrepreneur with a weaker or shorter credit history or those lacking collateral may struggle to secure finance in the open market. Where there are market imperfections such as these, the Bank's programmes can play a role.

The Enterprise Finance Guarantee (EFG) is one such example. EFG is specifically designed to help facilitate finance for viable smaller businesses with sound borrowing proposals, but insufficient security to meet a lender's normal requirements.[91] Businesses that are faced with this problem can be found all over the UK. This is evidenced by the fact that EFG has been used by firms in at least 80% of the Local Authority Districts of the UK in every year of its existence. In some years over 95% of Local Authority Districts have had at least one firm benefitting.

Although EFG benefits firms all over the UK, there are some variations in usage. Examples of this include the West Midlands and Yorkshire and the Humber where 17% and 16% of EFG deals in 2019 have taken place, despite these regions only hosting 8% and 7% of UK SMEs, respectively. EFG usage is also relatively high in the North West, East Midlands and the North East (figure B.17). Usage appears to be relatively low in London and the South east which may again reflect the diversity of finance options available to firms in these locations.

The geographic pattern of EFG usage is clearly influenced by a complex range of factors but there is some evidence of a correlation with property prices. As figure B.18 shows, EFG usage is slightly higher in areas with lower property prices. Small business owners do often use their homes to secure finance for their business[92] but in reality this correlation may be driven by multiple factors including, for example, other components of wealth and attitudes to finance.

Debt is one of the more commonly used forms of finance in the UK with around 25% of SMEs using bank overdrafts and around 9% using bank loans according to the latest Business Finance Survey. Equity finance is less prevalent with around 1% of SMEs currently using this form of finance. Equity, however, is particularly suited to firms with potential to scale-up rapidly so its distribution is important despite its relative rarity.

FIG B.17

EFG DEALS AND THE SME POPULATION IN 2019

Source: British Business Bank analysis of EFG data and BEIS Business Population Estimates

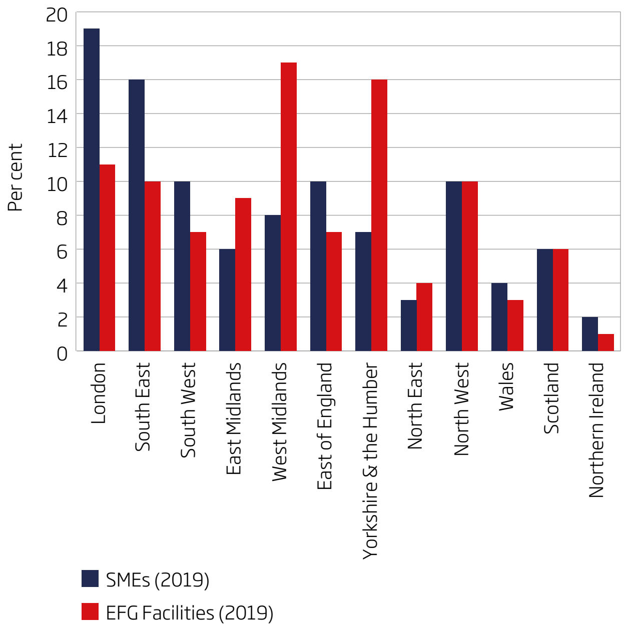


FIG B.18

EFG USAGE AND AVERAGE PROPERTY PRICES

Source: Business Bank analysis of EFG Data, BEIS Business Population Estimates and Land Registry House Prices

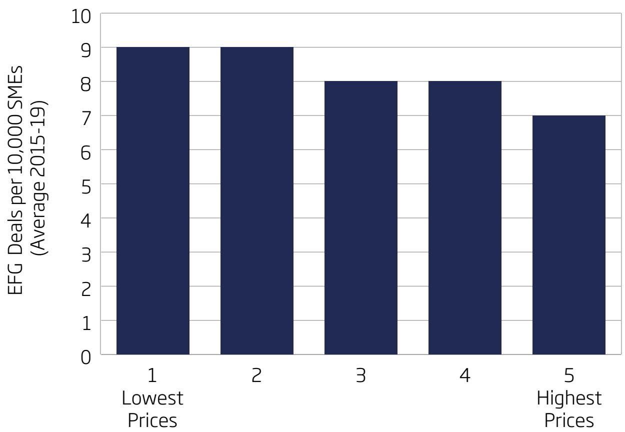


FIG B.19

EQUITY DEALS, INVESTMENT AND HIGH GROWTH BUSINESSES, 2019

Source: British Business Bank analysis of Beauhurst and ONS Business Demography

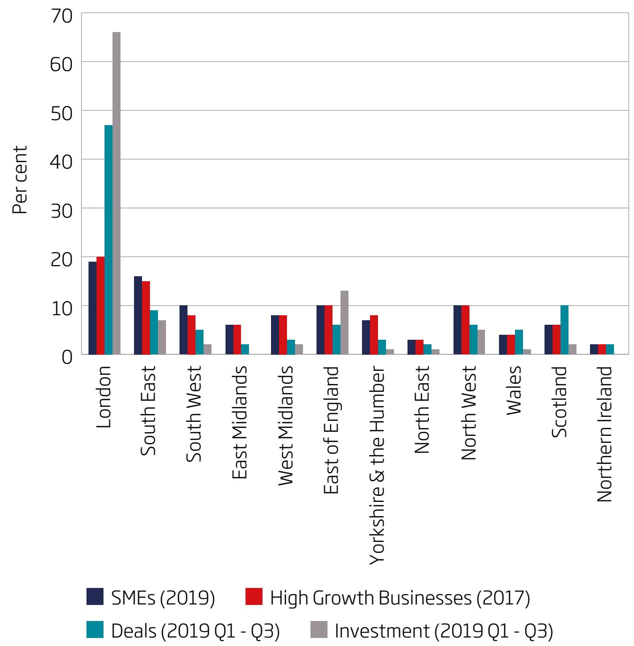


FIG B.20

TOP 10 LADS FOR EQUITY DEALS BETWEEN Q1 AND Q3 2019

Source: British Business Bank analysis of Beauhurst

Local Authority District	Deals
Westminster	93
City of London	84
Islington	83
Hackney	72
Camden	65
Southwark	46
City of Edinburgh	42
Tower Hamlets	38
Manchester	27
South Cambridgeshire	26

EQUITY FINANCE CONTINUES TO BE CONCENTRATED IN LONDON

London accounts for the largest share of equity activity of any part of the UK. In the year to Q3 2019, 47% of deals and 66% of investment in UK SMEs took place in London (figure B.19). This concentration in London is a fairly long-standing trend although recent years have seen the level of concentration decline a little.[93]

London's shares of deals and investment are well above its 19% share of SMEs and 20% share of high growth businesses.[94] The 47% share of deals in London in the first three quarters of 2019 matches London's deal share for 2018 exactly while London's 66% share of investment is higher than the 58% share for the whole of 2018. As with patterns of debt activity, both firm-level and ecosystem level factors will play a part in the distribution.

At the firm-level, awareness is likely to be part of the explanation as firms in London have the highest levels of awareness of venture capitalists of any part of the UK. The latest Business Finance Survey shows that 66% of London firms are aware of venture capitalists as a form of finance, a level matched only in the South East.

At the ecosystem level, factors including the high density of business support services such as advisory firms and the huge stock of venture capital investors mentioned in section 1.3 are important in explaining the distribution. The sectoral mix of companies in London will also be part of the driving force behind the high levels of equity activity. Technology companies are a key focus for equity investors and London's sectoral mix skews towards some technology sectors. For example, around 9% of London SMEs are involved in computer programming, consultancy and related activities, compared to only 5% of SMEs in the rest of the UK.

More granular data on deals at the Local Authority District level also show a pattern of concentration in London. Seven of the top 10 Local Authority Districts for deal volumes in the first three quarters of 2019 were in London (figure B.20).

Despite being in parts of the UK that received lower shares of investment in 2019 than their shares of SMEs, Manchester and Edinburgh also make it into the top ten. This highlights the fact that there are variations within regions as well as across them. South Cambridgeshire[95] completes the top ten which, taken together, account for 46% of deals in Q1 to Q3.

At the other end of the scale, around 45% of Local Authorities had no deals in the first three quarters of 2019 (figure B.21). This is largely in-keeping with previous years and can be partly explained by the volatility of equity activity when considered at low levels of geography.

Many business angels make equity investments using the Enterprise Investment (EIS)[96] and Seed Enterprise Investment Schemes (SEIS) so data on these schemes shed some additional light on the distribution of angel activity. As with the overall equity investment landscape, London is the most prominent region for EIS and SEIS activity with firms in the capital securing 47% of deals and 53% of investment in 2017/18 (figure B.22)[97].

In addition to having the largest shares of deals and investment, London also hosts the largest share of investors using the EIS and SEIS schemes. 31% of those whose location is known reside in the capital. Outside of London, most of the remaining English regions, along with Wales and Northern Ireland, have larger shares of EIS and SEIS investors than of EIS and SEIS deals. The exceptions are Scotland and the North West, some of which may be driven by the relative strength of Manchester and Edinburgh as highlighted above.

As with the overall equity market, awareness is likely to be a factor in London's leading share of EIS and SEIS activity. 41% of London SMEs are aware of business angels as a form of finance. This is the highest in the UK with firms in the South East close behind with 37% awareness. Section 2.2: Use of external finance, highlights regional disparities in awareness of types of equity finance.

FIG B.21

DISTRIBUTION OF EQUITY DEALS ACROSS LADs

Source: British Business Bank analysis of Beauhurst

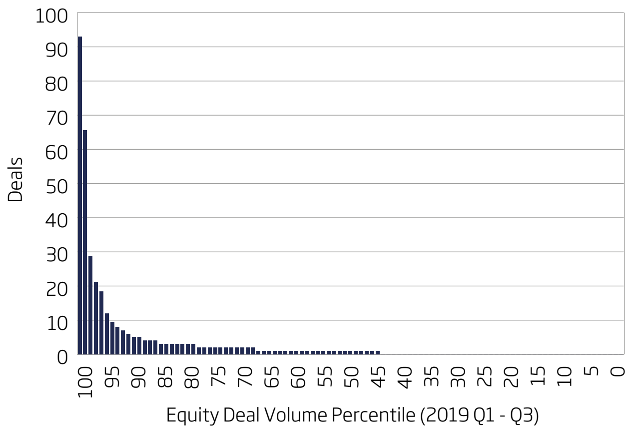


FIG B.22

SHARE OF EIS/SEIS DEALS, INVESTORS AND SMEs BY REGION AND DEVOLVED NATION FOR THE 2017/18 TAX YEAR

Source: British Business Bank analysis of HMRC EIS and SEIS data, and ONS Business Demography

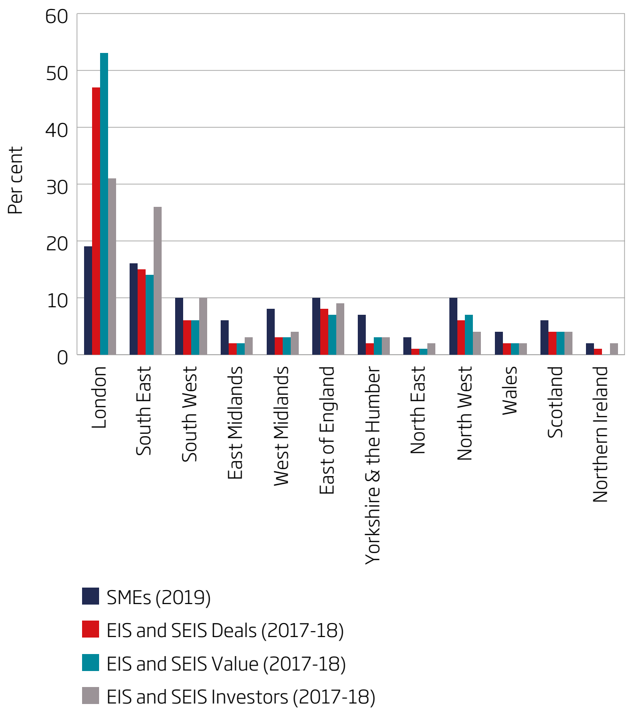
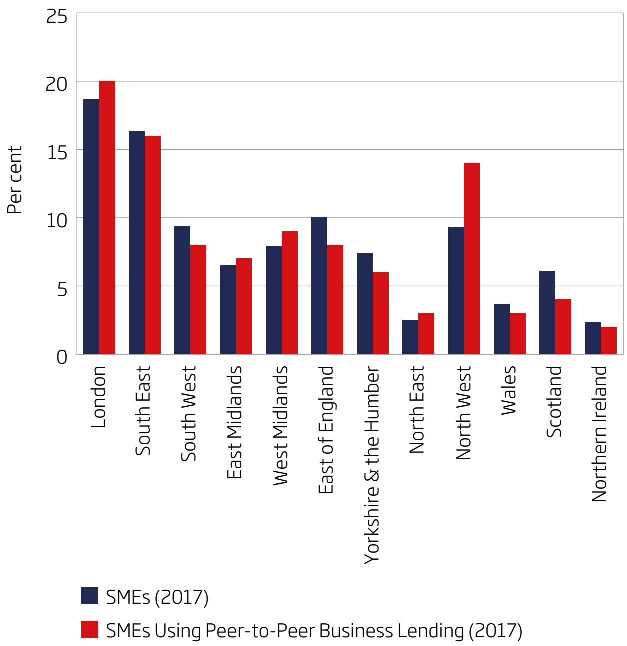


FIG B.23

PEER-TO-PEER BUSINESS LENDING

Source: British Business Bank analysis of data from the Cambridge Centre for alternative Finance and BEIS Business Population data
Note: CCAF collated transactions data from 15 peer-to-peer platforms so the figures in the chart do not reflect the entire market and may be skewed by the providers included.



WE CONTINUE TO EXPAND OUR KNOWLEDGE OF THE REGIONAL DISTRIBUTION OF OTHER FORMS OF FINANCE

Regional and sub-regional data on forms of finance other than bank lending and equity investment is relatively limited. There are, however, some useful sources and pieces of research available.

Monitoring data on the Bank's own programmes is one such example. While we would not automatically expect our activity to mirror the wider market given our focus on addressing market imperfections, the distribution of British Business Bank asset finance, and invoice and asset-based lending activity appears relatively in line with the SME population. This is explored further in section 2.8 and section 2.9.

Another source of insight on funding beyond equity and mainstream bank debt is Funding Circle's 2019 Impact Report.[98] This report shows a fairly close alignment between loans made by Funding Circle, one of the UK's major marketplace lenders, and the SME population. This is comparable to the pattern seen in the bank lending data from UK Finance and highlights how new online entrants can support finance availability across the UK.

Similar insights can be found in research by the Cambridge Centre for Alternative Finance.[99] The research suggests that peer-to-peer business lending is geographically diverse, particularly on the side of the businesses borrowing funds. Comparing the transaction data compiled for the study with the business population suggests, akin to the Funding Circle report, that the spread is relatively even (figure B.23). Given increased investment from institutional investors, the Bank now refers to this type of finance as marketplace lending, discussed further in section 2.10

Survey data offer another source of insight on the regional patterns of other forms of finance. For example, data from the SME Finance Monitor suggest that the proportion of firms using leasing, hire purchase or vehicle finance is relatively similar in most parts of the UK at around seven to 10% (figure B.24). The two exceptions are Scotland and Northern Ireland where 12% and 17% of SMEs have reported using leasing, hire purchase or vehicle finance between Q1 2017 and Q2 2019. This relatively even usage backs up the pattern seen in the Bank's asset finance programme data as analysed in section 2.8.

For less commonly used forms of finance, such as private debt, survey data is less able to identify regional differences. This is because even large surveys such as the SME Finance Monitor and our Business Finance survey are only likely to survey a handful SMEs using such uncommon finance forms across the national dataset, preventing meaningful regional comparisons.

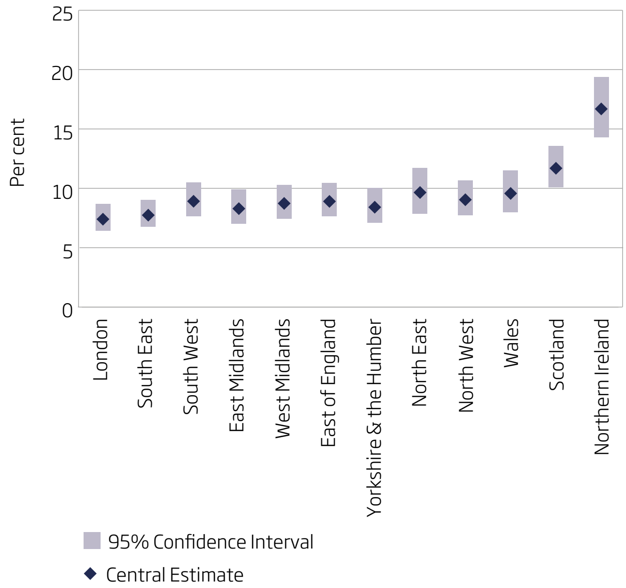
In order to improve our understanding of the imbalances in access to finance for smaller businesses across the UK the Bank intends to collect new primary data on private debt finance. As part of this project, also mentioned in section 2.7 on debt funds, we will work with lenders to anonymously compile data on transactions across the UK to better understand national and regional trends for this form of finance. This new data will complement the qualitative insights that our UK Network gather from their interactions with regional stakeholders across the UK.

Alongside our efforts to better understand regional finance markets, the Bank already has a range of programmes to help reduce imbalances. These include our regional funds which are bringing additional capital to the Northern Powerhouse, Midlands Engine and Cornwall and Isles of Scilly areas, and the Regional Angels Programme, which aims to help reduce regional imbalances in access to early stage equity finance for smaller businesses across the UK. On the demand side, the Bank's Demand Development Unit is raising the Bank's profile amongst smaller businesses across the UK so that they are encouraged and enabled by our demand-related activity to seek the finance best suited to their needs.

FIG B.24

PROPORTION OF SMEs USING LEASING, HIRE PURCHASE AND VEHICLE FINANCE

Source: British Business Bank analysis of the SME Finance Monitor Q1 2017 to Q2 2019



2.4 BANK LENDING

- Gross bank lending weakened in 2019 but repayments decreased by more
- The use of short-term finance picked up further in the first half of 2019 but there are signs demand and approvals have subsequently eased
- Deposits held by SMEs have risen to a fresh record high, largely driven by medium-sized businesses
- Credit conditions for small businesses are unchanged but have tightened for their medium-sized counterparts
- The experience of UK SMEs broadly mirrors those in other major economies

This section starts by covering trends in bank lending to SMEs over the past year, particularly changes in aggregate measures such as gross lending. It then looks at developments in short-term finance products including overdrafts and credit cards. This is followed by an examination of recent changes in the availability and affordability of credit. Next, the section covers developments in the deposits and credit balances held by SMEs. It concludes by comparing the experience of UK SMEs in obtaining finance to those in other major economies. The section draws on the latest data from sources including the Bank of England, UK Finance, BVA BDRC's SME Finance Monitor and the OECD.

GROSS BANK LENDING WEAKENED IN 2019 BUT REPAYMENTS DECREASED BY MORE

In nominal terms the value of new bank lending in 2019 was lower than in the same period of 2018. The gross flow of new loans to SMEs (excluding overdrafts) was £56.7bn in 2019, according to Bank of England (BoE) data (figure B.25).[100] This compares to £57.7bn in 2018, a fall of 1.7%.

The weaker gross lending is consistent with the softness of business investment last year. During 2019 the British Business Bank's market contacts reported subdued demand for medium and long-term borrowing among SMEs to invest for growth amid the economic uncertainty. The weaker gross lending also coincides with the recent strong growth of asset finance to smaller businesses (see section B2.8: Asset finance). It is possible that some SMEs have switched from using bank lending to asset finance. This could be because they are unable to access bank loans.

Similarly, the repayment of loans by SMEs in 2019 was £54.7bn, down by 4.3% from £57.2bn in the previous year. This follows repayments reaching a record high in 2018. A possible explanation for the lower repayments is that some SMEs paid down debt earlier (ie during 2018) to strengthen their balance sheets ahead of the original March 2019 Brexit date.

Another reason for the lower repayments could be that some SMEs have become more concerned about future cash flow and want to preserve their cash balances. The SME Finance Monitor for the three months to December 2019 showed that 24% of smaller businesses held large credit balances, ie of more than £10,000. This is up slightly from 23% in 2018 but much higher than in 2012 (16%), 2013 (17%) and 2014 (20%).[101] It's also possible the lower repayments reflect that some SMEs seek to preserve access to their loan facilities.

These two trends led net lending to be positive in 2019 (£2.0bn) (figure B.26). This was greater than the positive net lending of £0.5bn in 2018. Net lending was also positive in 2017 (£0.7bn), 2016 (£3.3bn) and 2015 (£2.2bn). Previously, net lending had several years of negative outturns following the financial crisis.

The alternative UK Finance measures of bank lending show broadly similar trends (figure B.27). However, the volumes are lower than for the BoE measures. This is because the UK Finance data is based on SME term loans and overdrafts provided by the seven largest banks in the UK, while the BoE measures represent the whole UK banking sector.

FIG B.25

GROSS LENDING TO, AND REPAYMENTS BY, SMEs

Source: Bank of England, Bankstats

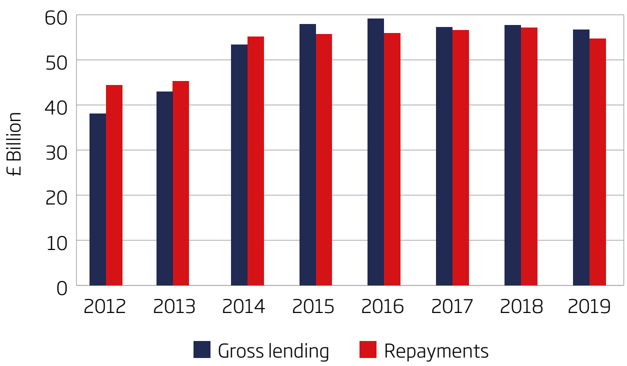


FIG B.26

BOE QUARTERLY GROSS AND NET FLOWS OF BANK LOANS TO SMEs

Source: Bank of England, Bankstats

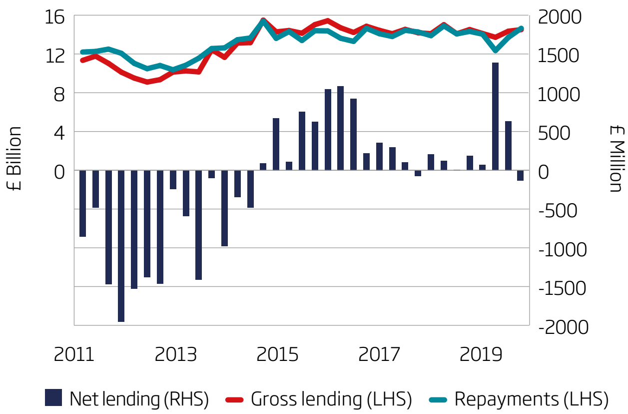


FIG B.27

UK FINANCE QUARTERLY GROSS AND NET FLOWS OF BANK LOANS TO SMEs

Source: UK Finance

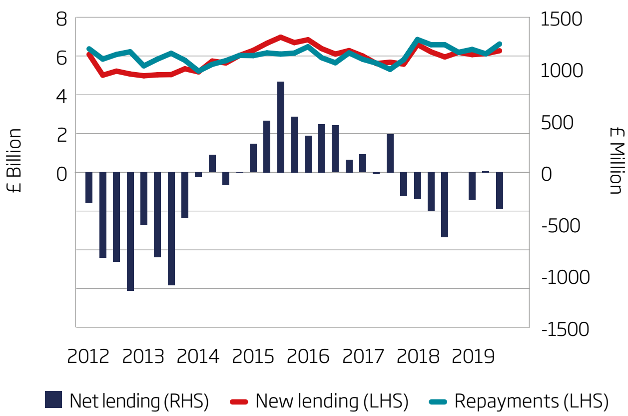


FIG B.28

UK FINANCE NEW LENDING, SMALL AND MEDIUM-SIZED BUSINESSES

Source: UK Finance

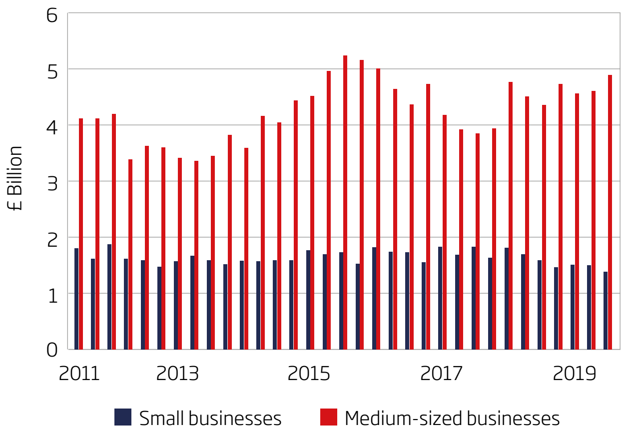
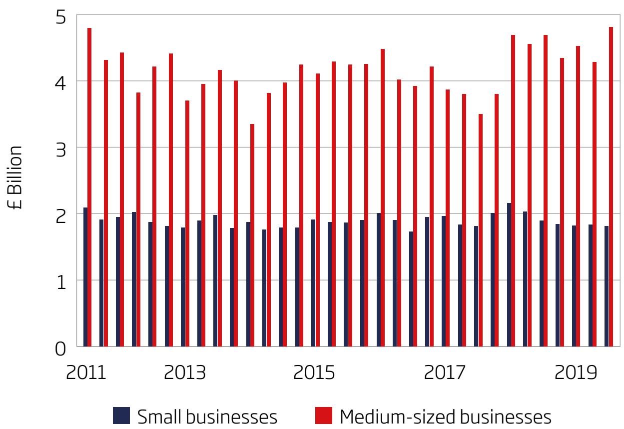


FIG B.29

UK FINANCE REPAYMENTS, SMALL AND MEDIUM-SIZED BUSINESSES

Source: UK Finance



The value of new lending to SMEs in the first three quarters of 2019 was £18.5bn. This was down by 2% from £18.8bn in the same period in 2018. Similarly, the repayment of loans by SMEs was £19.1bn in 2019-to-date, 5% lower than the £20bn in the equivalent period a year earlier.

Unlike the BoE measure, net lending was slightly negative in the first three quarters of 2019 (-£0.6bn). However, this is up from the negative net lending of £1.3bn in the corresponding period of 2018. Net lending was negative in 2018 (-£1.2bn) after being positive from 2015 to 2017.

UK Finance splits the SME data into small businesses and medium-sized businesses. This shows that new lending to small businesses in the first three quarters of 2019 was £4.4bn, down 14% from £5.1bn in the same period of 2018 (figure B.28). In contrast, new lending to medium-sized businesses rose in 2019-to-date to £14.1bn. This is up 3% from £13.6bn in the corresponding period of the previous year. Taken together, these indicate that the recent weakness of new lending to SMEs has been solely driven by small businesses.

The rise in new lending to medium-sized businesses is consistent with the British Business Bank 2019 Business Finance Survey. This showed that the share of medium-sized businesses currently using bank loans in 2019 (31%) was higher than in 2018 (23%).

The UK Finance split also shows that the value of repayments by small businesses in the first three quarters of 2019 combined was £5.5bn (figure B.29). This is down 10% from £6.1bn in the equivalent period of the previous year. Likewise, the value of repayments by medium-sized businesses in 2019-to-date was £13.6bn, 2% lower than in the same period of 2018. Overall, these similarly indicate that small businesses have recently been the main driver of SMEs' lower repayments.

THE USE OF SHORT-TERM FINANCE PICKED UP FURTHER IN THE FIRST HALF OF 2019 BUT THERE ARE SIGNS DEMAND AND APPROVALS HAVE SUBSEQUENTLY EASED

The use of bank overdrafts and credit cards rose in the first half of 2019, according to the SME Finance Monitor for Q2 2019 (the latest available for this particular data) (see figure B.9 in section B2.2 Use of external finance). The share of smaller businesses using bank overdrafts increased from 19% in 2018 to 23% in the first six months of 2019. This was the highest since the series began in 2012 and represents an acceleration of a trend that started in 2017. Similarly, the share using credit cards climbed to 19% in H1 2019, also a record high, from 14% in 2018.

The SME Finance Monitor data is consistent with the BoE Credit Conditions survey for Q2 2019, in which lenders reported a net increase in the demand for credit card lending by small businesses for the second consecutive quarter.[102] The British Business Bank's market contacts have reported a conscious strategic move by new and existing credit card providers toward serving businesses including SMEs. The providers now offer credit cards for business-to-business supplier payments with favourable terms, eg 45 days interest free credit. It's possible that this contributed to the pickup in the use of, and demand for, credit cards in the first half of 2019.

The SME Finance Monitor data is also in line with our market contacts noting a spike in overdraft usage in the period leading up to the original March 2019 Brexit date to cover the costs associated with mitigating potential disruption such as stock-building.

However, subsequent data on the demand for – and approvals of – overdrafts and credit cards suggest the use of short-term finance has eased. First, the BoE Credit Conditions Survey for Q4 2019 showed that lenders reported the demand for total unsecured lending from small businesses had fallen slightly (figure B.30).[103] This was the first quarterly decline in two years. The breakdown indicated that while the demand for credit card lending was unchanged, there was a net decline in other unsecured lending (which includes overdrafts). This is consistent with our market contacts not seeing a similar spike in overdraft usage in lead up to the October Brexit date.

FIG B.30

DEMAND FOR CREDIT CARDS AND OTHER UNSECURED LENDING, SMALL BUSINESSES

Source: Bank of England, Credit Conditions Survey

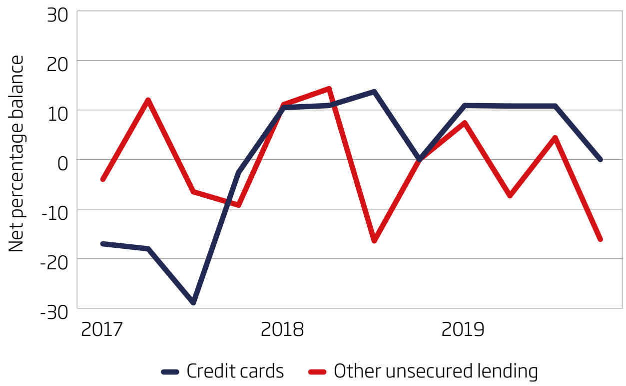
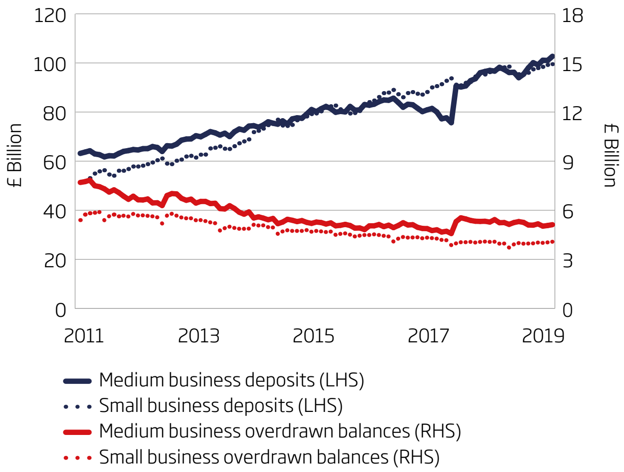


FIG B.31

OVERDRAWN BALANCES AND VALUE OF DEPOSITS, SMALL AND MEDIUM-SIZED BUSINESSES

Source: UK Finance
Note: The large increase in the deposits and overdrawn balances of medium-sized businesses in Q4 2018 was due to a change in the reporting by one of the high street banks that provides data to UK Finance



Second, separate UK Finance data showed the value of overdraft facilities approved or increased each month declined in Q3 2019 for the second consecutive quarter (see figure A.22 in section 1.2: Impact of macroeconomic developments on SME finance markets). However, it remained higher than in 2016 and 2017. Previously, the value of overdraft facilities approved/increased surged from late 2017 through 2018 to a seven-year high. A probable explanation for the lower values in Q2 and Q3 2019 is that many SMEs had already acted to get overdraft facilities in place, consistent with lower new overdraft application rates over 2018 and 2019 reported by the SME Finance Monitor (see section 2.2: Use of external finance).

Despite the rise in the use of credit cards and overdrafts in 2018 and the first half of 2019 reported by the SME Finance Monitor, data from UK Finance shows the value of SMEs' overdrawn balances remains much lower than when the series started in 2011 (figure B.31). In September 2019 the combined value of the overdrawn balances of small and medium-sized businesses was £9.2bn. This is down around 30% from £13.1bn in July 2011.

DEPOSITS HELD BY SMEs HAVE RISEN TO A FRESH RECORD HIGH, LARGELY DRIVEN BY MEDIUM-SIZED BUSINESSES

The value of deposits held by smaller businesses remained on an upward trend in 2019. The latest UK Finance data (September 2019) showed it rose to £202bn. This was a record high and up 76% from when the series started in July 2011.

By size, the main driver of the increase in the value of SMEs' deposits in the first nine months of 2019 was medium-sized businesses. This contrasts with the rises in 2017 and 2018, which were respectively solely and largely driven by small businesses. The recent pickup in the value of deposits held by medium-sized businesses led it to rise above that of their small counterparts in April 2019 and remain so thus far (figure B.31).

The SME Finance Monitor for Q2 2019 reported that most (96%) smaller businesses held some credit balances in the first half of 2019.[104] In the three months to December 2019 the share of SMEs holding credit balances of £10,000 or more was 24%.[105] As highlighted earlier in this section, this was one of the highest shares since the data series began in 2012. It was also much higher than in 2012 (16%). There is evidence of a link between holding large credit balances and demand for external finance. In Q2 2019 most (81%) of SMEs that held such sums said that it reduced their need for external finance, which is the equivalent of 10% of all SMEs.[106]

CREDIT CONDITIONS FOR SMALL BUSINESSES ARE UNCHANGED BUT HAVE TIGHTENED FOR THEIR MEDIUM-SIZED COUNTERPARTS

The BoE Agents' summary of business conditions (based on consultations with companies including SMEs) noted credit conditions tightening in some sectors throughout 2019. The summary for Q4 2019 indicated businesses in more sectors than previously had experienced tighter credit conditions to some extent.[107] It reported the appetite of banks to lend to sectors more vulnerable to an economic downturn (specifically retail, casual dining, construction and property) remained low. The summary also noted that banks tightened lending criteria modestly for other sectors (but did not specify which). This is consistent with our market contacts recently noting some banks tightening credit conditions.

However, the BoE Credit Conditions survey for Q4 2019 (based on consultations with lenders) reported a net decrease (-11.3%) in the availability of credit to medium-sized businesses only.[108] The net decrease was the third in a row and the largest since the data series began in 2009. In contrast, the availability of credit to small businesses was little changed. For the fifth consecutive quarter, the net percentage balance of respondents that reported a decrease in credit availability was broadly in line with those reporting an increase (figure B.32).

Separate BoE data indicates that credit remains affordable by historical standards. Interest rates on a range of SME loans have fallen modestly over the past year (figure B.33).[109] The effective interest rate on all SME loans has declined slightly from 3.35% in December 2018 to 3.29% in the same month of 2019.[110] The effective floating rate, which broadly tracks the BoE Bank Rate, remains slightly lower than that for all loans while the effective fixed rate is still somewhat higher. The BoE's Monetary Policy Committee Bank Rate was at 0.75% throughout 2019. This followed the Bank Rate rising by 25 basis points to 0.5% in November 2017 and by another 25 basis points in August 2018.

The Survey on the Access to Finance of Enterprises (SAFE) provides an insight into the interest rate charged for credit lines and overdrafts to SMEs in European Union countries. The latest wave of the survey (conducted from September to October 2019) showed the mean and median interest rates charged to UK SMEs for credit lines and overdrafts in 2019 were 5.6% and 3.5% respectively.[111] These were marginally lower than in 2018 (5.7% and 3.7%). However, the mean and median interest rates for the UK remained higher than the EU average of 3.2% and 2.5% respectively.

FIG B.32

NET CHANGE IN CREDIT AVAILABILITY, SMALL AND MEDIUM-SIZED BUSINESSES

Source: Bank of England, Credit Conditions Survey

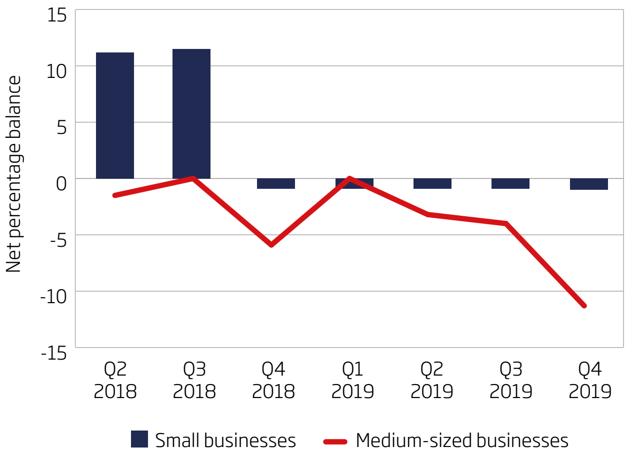


FIG B.33

EFFECTIVE INTEREST RATES (NEW BUSINESS) FOR SMEs

Source: Bank of England, Bankstats

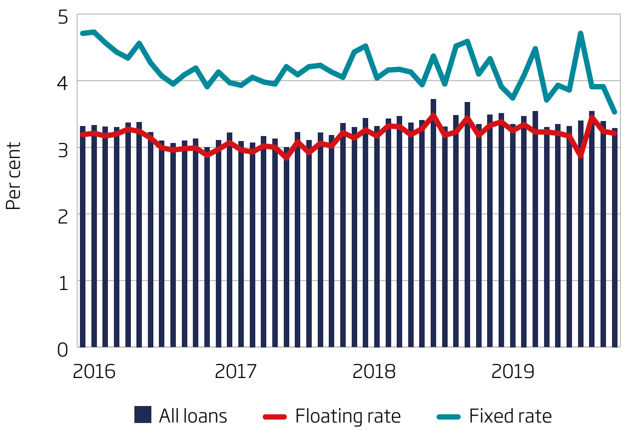


FIG B.34

SMEs REPORTING ACCESS TO FINANCE AS THE MOST IMPORTANT PROBLEM FACING THE BUSINESS

Source: European Commission and European Central Bank, European Survey on access to finance to enterprises (SAFE), 2019

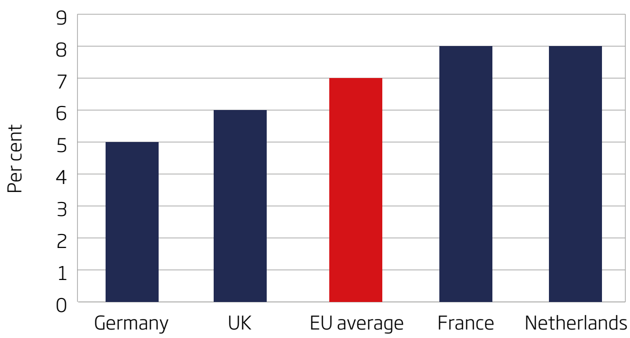


FIG B.35

SMEs REPORTING FINANCE PRODUCTS AS RELEVANT TO THE BUSINESS

Source: European Commission and European Central Bank, European Survey on access to finance to enterprises (SAFE), 2019

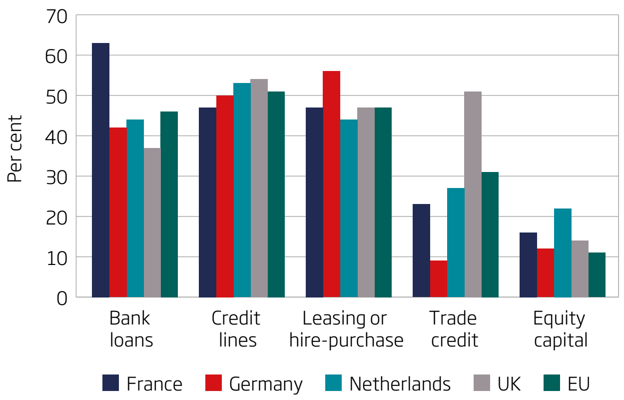
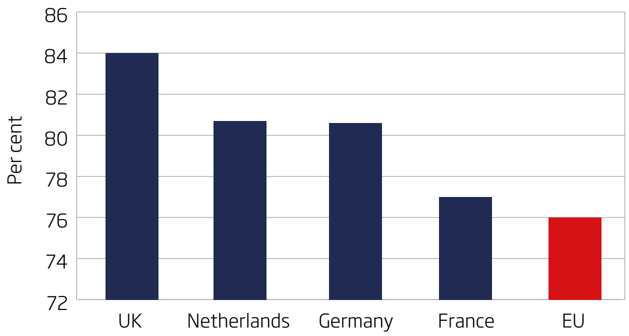


FIG B.36

SMEs REPORTING BANK LOANS AS NOT RELEVANT BECAUSE THEY DON'T NEED THAT TYPE OF FINANCE

Source: European Commission and European Central Bank, European Survey on access to finance to enterprises (SAFE), 2019



THE EXPERIENCE OF UK SMEs BROADLY MIRRORS THOSE IN OTHER MAJOR ECONOMIES

The story for smaller businesses in the UK obtaining finance resembles their international counterparts. When comparing the UK with the EU, the best source of evidence is the SAFE. It also reports on SMEs that currently see access to finance as the most important problem they face. The share in the UK that viewed access to finance as the top issue was 6% (figure B.34). This was slightly higher than Germany (5%) but a little lower than the average across the EU (7%). The UK's share was also below France and the Netherlands (both 8%). Germany, France and the Netherlands are among the UK's top trading partners.

The SAFE also provides insight into which groups of financial products are relevant to SMEs. It defines relevant as the enterprise having used the products in the past or were considering doing so in the future. The UK is in line with the EU average for leasing or hire-purchase (figure B.35). Similarly, the UK is close to the EU average for credit lines (which includes bank or credit card overdrafts) and equity capital. In contrast, UK SMEs appear less reliant on bank loans, and more on trade credit, than the EU average.

Among those SMEs that said bank loans were not relevant to their enterprise, the survey asked them the most important reason why this was the case. The top reason in all EU countries was they did not need bank loans. The share of UK SMEs citing this reason was 84% (figure B.36). This was higher than in Germany and the Netherlands (both 81%), France (77%) and the EU average (76%). Other reasons included insufficient collateral, the interest rate or price was too high, reduced control over the enterprise, too much paperwork, and no bank loans were available. In the UK each of these other reasons were cited by only a small share of SMEs, ie 3% or less.

Access to finance is still high on the policy agenda around the world. The governments of most OECD member countries including the UK provide guarantees to support lending in smaller business finance markets. The size of the SME loan guarantees relative to GDP varies widely among OECD countries. The latest available data at the time of publication is for 2017.[112] Among the countries for which data was available, the largest scheme was in Turkey, where the outstanding volume of the guarantees as a share of GDP was more than 7% (figure B.37). This compares to around 4% in Japan and South Korea.

In many OECD countries, SME loan guarantees represent less than 1% of GDP. The UK's SME lending guarantees as a share of GDP are modest compared to most OECD countries (figure B.38).

There remains a good rationale for the British Business Bank loan guarantee products that are designed to make lending markets work better for smaller businesses. The long running Enterprise Finance Guarantee (EFG) scheme facilitates lending to smaller businesses that are viable but unable to obtain finance due to having insufficient security to meet the lender's normal requirements. EFG has supported the provision of c.36,000 business facilities to a value of over £3.3bn.

FIG B.37

GOVERNMENT LOAN GUARANTEES FOR SMEs IN 2017, PERCENTAGE OF GDP, LARGEST 10

Source: OECD, Financing SMEs and Entrepreneurs, 2019

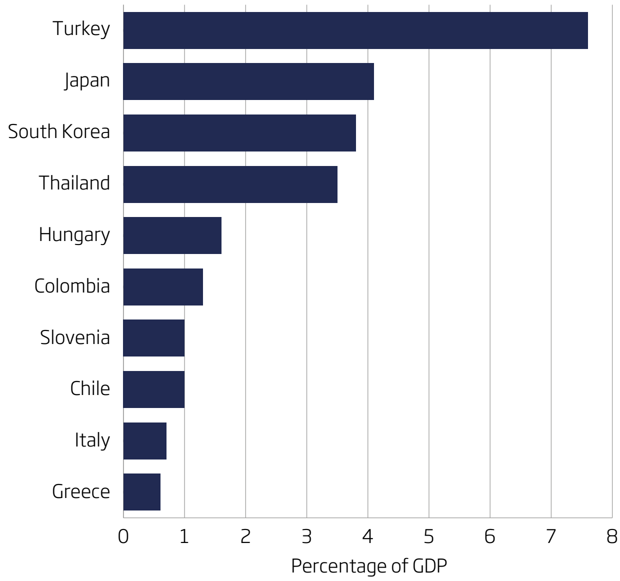
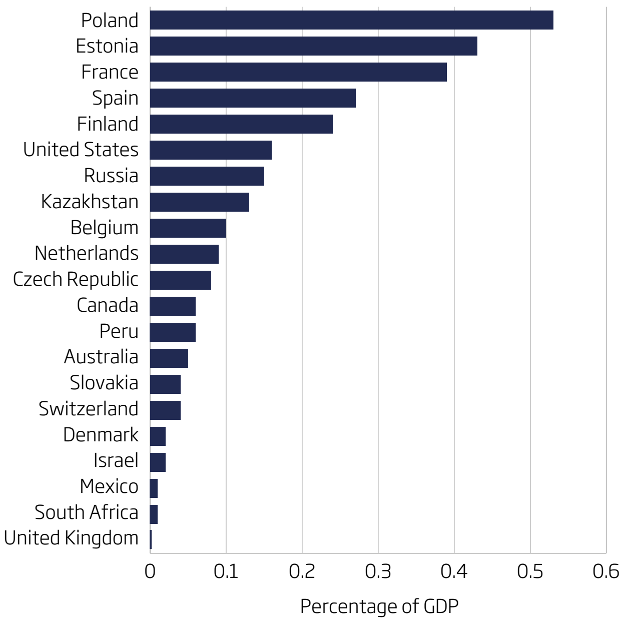


FIG B.38

GOVERNMENT LOAN GUARANTEES FOR SMES IN 2017, PERCENTAGE OF GDP, CONTINUED

Source: OECD, Financing SMEs and Entrepreneurs, 2019
Note: Data for Canada and Peru refers to 2016 and for Israel to 2015 instead of 2017. The UK data point is 0.002



2.5 CHALLENGER AND SPECIALIST BANKS

- The number of challenger and specialist banks has increased since 2013, most serve SMEs
- Challenger and specialist banks are improving the diversity of smaller business finance markets
- Challenger and specialist banks are adding capacity to the industry
- The range of products and services available to SMEs has been increased by challenger and specialist banks
- Larger UK banks are increasing their technology spend and creating new brands
- Challenges remain for the challenger and specialist banks
- Innovation and competition from challenger and specialist banks has improved the diversity of sme banking, the British Business Bank is committed to further supporting the sector

The term "challenger and specialist banks" covers all retail (as opposed to wholesale) financial institutions in the UK excluding the five largest.[113] This section focuses on challenger and specialist banks that provide products and services to businesses including SMEs. It draws on data from sources including PwC UK, UK Finance, the Bank of England (BoE), the Financial Conduct Authority (FCA) and the latest annual reports of challenger and specialist banks.

The section begins by outlining the different types of challenger and specialist banks. It then covers recent trends in the banking licences granted to challenger and specialist banks. Next, the section looks at a sample of challenger and specialist banks and provides an indication of the extent to which each lends to businesses. This is followed by a discussion of how challenger and specialist banks have added capacity to the industry. It then turns to the impact they have had on the behaviour of the largest banks. The section concludes with a look at the challenges faced by challenger and specialist banks.

Within the UK's challenger and specialist banks, there are different sub-groups. PwC UK have set out how they differentiate between them. Looking first at challenger banks, the relevant types identified by PwC UK are full-service and digital-only.[114]

Full-service banks are mid-sized and offer a broad range of relatively conventional products such as current accounts and loans to both personal and business customers including SMEs. They are committed to a physical presence as part of a model that is blended with a digital offering. The main examples are Virgin Money UK, Metro Bank, TSB Bank and the Co-operative Bank.[115]

Digital-only banks are mainly start-ups with a small but growing scale. Such banks typically have little or no physical presence and work solely through mobile phone applications. They serve personal or business customers, or both. Examples include Starling Bank and Atom Bank.

Turning to specialist banks, they are described by PwC UK as smaller than full-service banks and focused on offering a range of lending and saving products to customers that they believe are underserved in the market such as certain types of SMEs. Specialist banks tend to put more emphasis on call centres than a physical presence such as branches. They also have some regional offices and digital channels, and often use intermediaries such as brokers to acquire new business. Examples include Aldermore Bank, Shawbrook Bank, Secure Trust Bank, OneSavings Bank, Charter Court Financial Services, Close Brothers Group, Paragon Bank, Wyelands Bank and Wesleyan Bank.[116]

The British Business Bank considers a type of bank that has been identified by UK Finance – micro banks - to be a sub-group of specialist banks. UK Finance defines micro banks as deposit-taking institutions with assets of less than £5bn. Micro banks typically focus on offering products and services to businesses including SMEs.[117] Examples include OakNorth Bank, Cambridge & Counties Bank and United Trust Bank.

Challenger and specialist banks have been a great source of diversity within SME finance markets in recent years. The number of challenger and specialist banks in the UK has grown following the global financial crisis, developments in financial technology, and a regulatory change in 2013 that made it easier for firms to get a UK banking licence. Some of the new challenger and specialist banks have brought fresh business models to the sector.

The British Business Bank views diversity within SME finance markets from the point of view of a smaller business. Improving who can access finance, where it can be accessed, when and on what terms the access is arranged, and how it is delivered requires not only new providers but also new products and business models.[118] Consequently, the range of products and business models more than the sheer number of new banks has greatly enriched diversity in SME finance markets.

FIG B.39

NEW UK BANKS AUTHORISED BY THE PRUDENTIAL REGULATION AUTHORITY, 2013-2019

Sources: Bank of England, Financial Conduct Authority, British Business Bank calculations

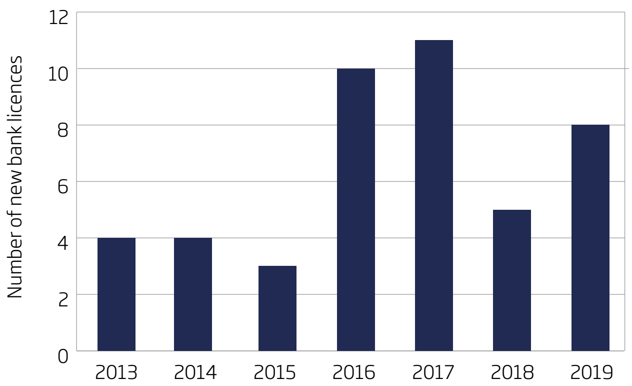
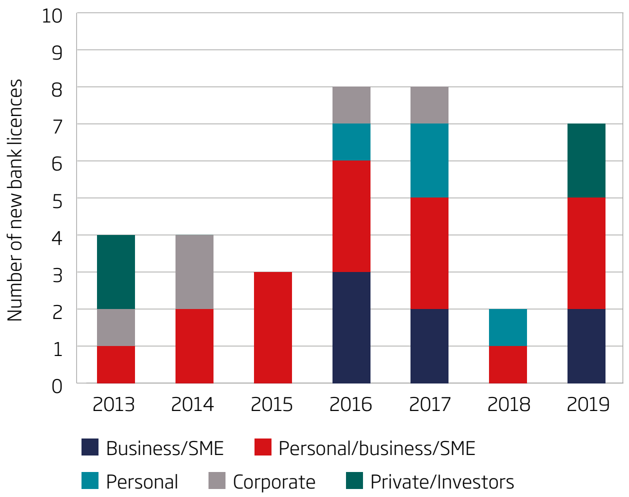


FIG B.40

CUSTOMERS SERVED BY NEW UK RETAIL BANKS AUTHORISED BY THE PRA

Sources: Bank of England, Financial Conduct Authority, British Business Bank calculations



THE NUMBER OF CHALLENGER AND SPECIALIST BANKS HAS INCREASED SINCE 2013, MOST SERVE SMEs

Between 2013 and 2019 more than 40 financial institutions were granted a full or restricted banking licence in the UK by the Prudential Regulation Authority (PRA) (figure B.39).[119] This followed the PRA and FCA introducing reforms in 2013 that lowered the barriers to entry.[120] In the three years to 2019 alone, over 20 new banking licences were issued. This was a little higher than in the three years to 2016.

Of those firms issued with a banking licence in the seven years to 2019, around half went to new overseas banks. Among the remainder, most were granted to new UK banks while a handful went to those that arose due to ring-fencing.[121]

Of the banking licences granted since 2013, around half have gone to those that provide retail products and services to businesses including SMEs. The other half went to wholesale banks and banks that offer retail products and services to personal, corporate and private/institutional customers (figure B.40).

Among the challenger and specialist banks that were issued a banking licence over this period, there was a mix of full-service, digital-only and specialist banks including micro banks. In recent years new digital-only and specialist banks including micro banks have been more common. Publicly available information indicates that there are a handful of applications for bank licences pending. These include B-North and Recognise,[122, 123] while DF Capital plans to apply.[124]

It is also possible to operate in the UK without a PRA banking licence. Under the European Economic Area “Passport” system, a firm licenced in one of the European Union member states to provide financial products and services can also offer these to other countries within the region without needing further authorisation. Examples include Revolut.[125] The FCA has indicated that, following the UK leaving the EU on 31 January 2020, passporting will continue until the transition period ends on 31 December 2020.[126]

An insight into the focus of challenger and specialist banks on commercial lending can be gained from their latest annual reports. The British Business Bank has looked at the commercial lending and loan books of nearly 20 challenger and specialist banks. Although the precise definitions of commercial lending vary among the banks in this sample, we have used the information to provide an indicative position. Consequently, the numbers are not directly comparable between the banks.

The annual reports indicate that commercial lending by full-service banks as a share of their loan book tends to be lower than that of micro banks. It is also generally a little lower than for most specialist banks. This is the case for full-service banks including Metro Bank, Clydesdale Bank and the Co-operative Bank (figure B.41).[127]

However, the loan books of full-service banks are typically larger than those of micro banks (eg Unity Trust Bank, Cambridge & Counties Bank and United Trust Bank) and specialist banks (eg Aldermore Bank, Secure Trust Bank and OneSavings Bank). Consequently, in value terms, commercial lending by full-service banks is greater than that by micro banks and their specialist counterparts.

The sole digital-only bank in our sample is Starling Bank. Commercial lending as a share of its loan book is lower than that of all full-service, specialist and micro banks. Similarly, Starling Bank's loan book is relatively small.

There is currently no publicly available data on the total value of lending to SMEs by UK challenger and specialist banks. The closest we have identified is research by BDO, which found that the total lending to personal and business customers by 19 UK challenger banks in the 12 months to September 2019 was £115bn.[128] This was up 3% from the same period a year earlier and a record high (the earliest data available is for the corresponding period to September 2010). It was also more than double that of five years' earlier.

A split of the data by personal and business customers is not available. However, BDO have indicated the data is very heavily weighted toward residential mortgages while the remainder – business lending – is largely comprised of commercial mortgages.

FIG B.41

COMMERCIAL LENDING AND LOAN BOOKS OF CHALLENGER AND SPECIALIST BANKS, LATEST ANNUAL REPORTS

Sources: Challenger and specialist banks' annual reports, British Business Investments
Note: Data is indicative only; data for Charter Court is from professional buy-to-let loans; OneSavings Bank acquired Charter Court in 2019; Clydesdale Bank is part of Virgin Money UK

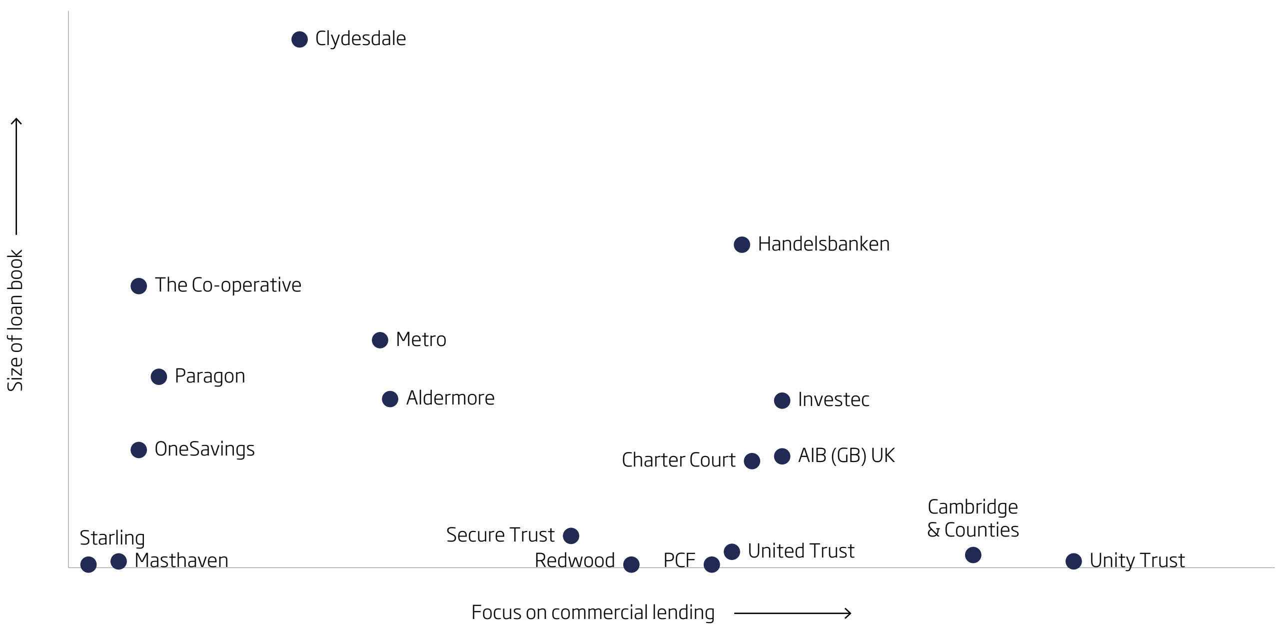
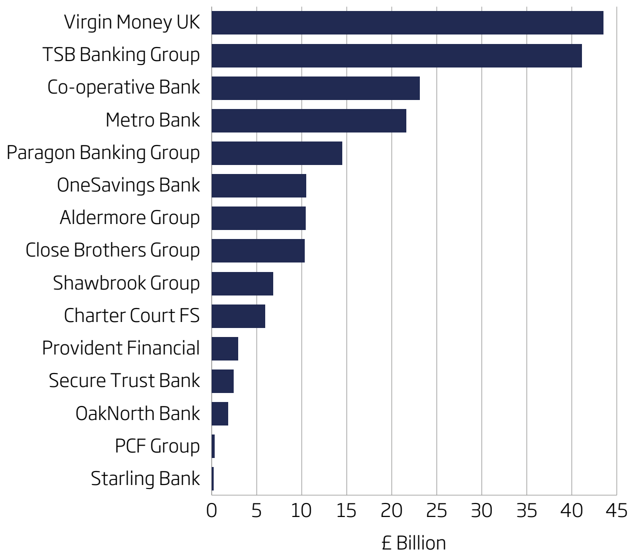


FIG B.42

TOTAL ASSETS OF CHALLENGER AND SPECIALIST BANKS, 2018 FINANCIAL YEAR

Source: Bloomberg
Notes: Aldermore Group & Charter Court are for the 2017 financial year; Virgin Money UK is comprised of CYBG and Virgin Money, OneSavings Bank acquired Charter Court in 2019



CHALLENGER AND SPECIALIST BANKS ARE IMPROVING THE DIVERSITY OF SMALLER BUSINESS FINANCE MARKETS

When trying to gauge the impact of challenger and specialist banks on smaller business finance markets, typically the starting point would be to look at their market share - but this is difficult to answer. One of the major reasons is there is no single market in which challenger and specialist banks compete, be it the customers they target, the regions they operate in or the products and services they offer.

Even if one pinpointed which market share to look at, the data currently isn't publicly available. Consequently, it is necessary to look at other indicators to see how challenger and specialist banks are improving the diversity of smaller business finance markets.

The remainder of this section looks at some of these indicators such as the capacity the challenger and specialist banks are adding to the industry, the products and services they offer, and their impact on the behaviour of the largest UK banks.

CHALLENGER AND SPECIALIST BANKS ARE ADDING CAPACITY TO THE INDUSTRY

In financial year 2018 the total assets of the five largest banking groups in the UK ranged from around £300bn (Santander UK) to more than £2 trillion (HSBC Bank). However, it is worth noting that HSBC Bank is a global bank with assets beyond the UK market.

The total assets of challenger and specialist banks, which typically focus on the UK market, are much smaller. Among the challenger and specialist banks for which 2018 financial year data is available, the largest total assets were held by full-service banks. Virgin Money UK ranked top (£43.5bn) and is the sixth largest UK bank by assets. The next largest was TSB Banking Group (£41.1bn), followed by the Co-operative Bank (£23.1bn) (figure B.42)

Digital-only banks had some of the smallest total assets. Starling Bank was lowest (£0.2bn). The disparity in the total assets of full-service banks and digital-only banks partly reflects that many digital-only banks are start-ups. It is also a function of the different business models that the two types of challenger and specialist banks utilise.

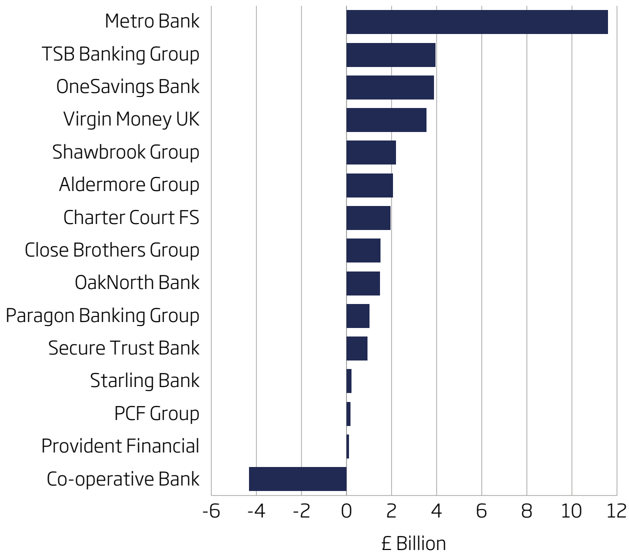
Between financial years 2016 and 2018, total assets of most of the five largest UK banking groups fell. The largest decline was experienced by the Royal Bank of Scotland Group (-13%), followed by Barclays (-7%), Santander UK (-6%) and Lloyds Banking Group (-2%). HSBC Bank was the only one that saw a rise in total assets (8%). However, some of the UK's largest banks increased their lending to SMEs, eg Lloyds Banking Group and Barclays.

In contrast, total assets of most challenger and specialist banks grew over the same period (figure B.43). Yet total assets of the long-established Co-operative Bank fell.

FIG B.43

CHANGE IN TOTAL ASSETS OF CHALLENGER AND SPECIALIST BANKS, FINANCIAL YEARS 2016 TO 2018

Source: Bloomberg
Notes: Aldermore Group and Charter Court are for the 2016 to 2017 financial years; OneSavings Bank acquired Charter Court in 2019



THE RANGE OF PRODUCTS AND SERVICES AVAILABLE TO SMEs HAS BEEN INCREASED BY CHALLENGER AND SPECIALIST BANKS

During and shortly after the financial crisis, many banks changed their focus and the extent of their activity in different markets. This process has slowed and, in some cases, reversed.

While Santander UK recently withdrew from the asset finance industry, it continues to be active in SME markets.[129] Many challenger and specialist banks have thrived in underserved markets such as asset finance. Asset finance is still well served by many of the largest banks (see B 2.8: Asset finance) but the range of assets they are prepared to lend against is often much less varied compared with some of the challenger and specialist banks.

Many of the challenger and specialist banks do not offer the full range of products and services that the largest UK banks provide, especially when they concentrate on exploiting perceived market gaps. However, to help their customers who need a wider range of products and services, some have partnered with financial technology companies (FinTechs) or other challenger and specialist banks that do offer some of these products and services. For example, several digital-only banks provide in-app "marketplaces" that offer products such as saving accounts, insurance or mortgage broking from third party providers. The largest UK banks had initially been apprehensive about such partnerships but are starting to explore them. For example, some of the largest banks that do not directly offer invoice finance to the smallest businesses refer such customers to relevant partners.[130]

LARGER UK BANKS ARE INCREASING THEIR TECHNOLOGY SPEND AND CREATING NEW BRANDS

Perhaps one of the most telling impacts that the newer challenger and specialist banks have had is they have changed the behaviour of the more established banks. Since these newer banks began to appear there was often talk of how to address both the ever-increasing customer expectations and the threat posed by the challenger and specialist banks themselves. Most of the largest UK banks have subsequently created in-house or out-sourced digital-only banks or are launching mobile applications to rival those of the challenger and specialist banks.

Lloyds Bank has committed to spend £3bn on its digital transformation. Similarly, the Royal Bank of Scotland Group (which includes NatWest) has created Esme , a digital-only bank which offers unsecured loans of up to £250,000 to businesses including SMEs. Barclays Bank has taken the slightly different approach of a partnership with MarketFinance, which gives Barclays both a new digital offering and an invoice finance product they did not offer SMEs previously. Such investment by the larger banks will increase the pressure on challenger and specialist banks to continue to innovate in order to stay ahead. If they don't, those that solely rely on having better technology to give them a competitive edge could find themselves losing ground.

One area in which challenger and specialist banks have sought to differentiate themselves is customer relationships. A recent survey of SME customers of the 14 largest business current account providers in Great Britain showed that some challenger and specialist banks scored highly in the rankings. For overall service quality, Handelsbanken UK and Metro Bank ranked first and second respectively.[131] Also, as Yorkshire Bank ranked fifth, three challenger and specialist banks were in the top five.

CHALLENGES REMAIN FOR THE CHALLENGER AND SPECIALIST BANKS

As with any new industry or market entrants, some challenger and specialist banks have experienced growing pains. The industry in total faces a few significant challenges as it matures.

Firstly, while share prices of challenger and specialist banks have mostly outperformed those of the largest banks, there are some notable exceptions. In January 2020 the share price of Metro Bank was around 90% lower than in the same month of the previous year. This followed an accounting error becoming public knowledge in early 2019. Some of the newer, digital-only banks, such as Revolut, have also come under scrutiny for their compliance processes. As the industry and challenger and specialist banks mature, it will be important they put in place suitable systems and processes. This will require investing time and money.

Secondly, challenger and specialist banks continue to raise the issue of their cost of funding. This includes the impact of a perceived lack of level playing field between banks using the internal ratings-based approach to model credit risk capital requirements (which is almost exclusively the largest five banks) and those that calculate it using the standardised approach. This is particularly important for those challenger and specialist banks that are competing against the larger banks for market share, and others that are stopped from writing more business by capital constraints.

Finally, particularly for the newer challenger and specialist banks, the expectation of them achieving scale and making a profit is being mentioned more and more. OakNorth Bank is notable in that it achieved "double unicorn" status, ie was valued at more than $2bn, in 2018 and was also profitable. In the initial years of the life of a business, many expect to, and do, make a loss as they look to establish themselves and build a customer base. Despite this, they can still attract very large investment and similarly vast valuations. For example, Revolut also achieved "unicorn" status in 2018 but remains loss making.[132] As these firms mature, investors will be increasingly looking for them to become profitable.

INNOVATION AND COMPETITION FROM CHALLENGER AND SPECIALIST BANKS HAS IMPROVED THE DIVERSITY OF SME BANKING, THE BRITISH BUSINESS BANK IS COMMITTED TO FURTHER SUPPORTING THE SECTOR

The increase in number of licences issued by the PRA has brought more banks and business models into the SME banking sector, which previously had changed very little in decades. The British Business Bank supports challenger and specialist banks through various programmes including the ENABLE Guarantee and Enterprise Finance Guarantee (EFG) and via our commercial arm British Business Investments.

2.6 EQUITY FINANCE

- UK equity investment is set to reach record levels in 2019 due to increased numbers of growth stage deals and larger deal sizes
- The UK remains Europe's largest venture capital market
- UK venture capital fundraising is at its highest ever level with a higher number of funds closing in 2019
- Long-run venture capital financial returns continue to improve but exit activity slowed in 2019
- The British Business Bank is increasing the availability of equity finance to UK SMEs

Equity finance for smaller businesses can come from a variety of different types of equity investor including business angels, venture capitalists, crowdfunding platforms, private investors and Government backed funds.[133] This section explores recent trends in UK equity finance up to Q3 2019 using data from Beauhurst. International comparisons of venture capital (VC) are also made using PitchBook data. This section also explores lower mid-market (LMM) private equity deals and recent trends in VC fundraising and financial performance.

Equity finance is an important source of funding for businesses with the potential for rapid growth. Equity finance can be used by early stage businesses that are unable to secure debt finance due to their risk profile, lack of collateral or unstable cash flows. Established businesses looking to expand into new markets or develop new products may also utilise equity finance. These businesses may not be able to obtain debt finance due to their existing leverage or risk profile.

Outside equity investors not only contribute financial capital but can also bring additional benefits and added value through their experience, scale-up expertise and access to networks.

Equity finance is not suitable for every business and only a small proportion of smaller businesses overall are currently using or have sought equity finance in the last three years (1%).[134] High growth firms are more likely to use equity finance than non-high growth firms, but debt finance remains the most frequently used source of funding for both high growth and non-high growth firms.[135]

FIG B.44

NUMBER OF EQUITY DEALS AND VALUE OF INVESTMENT, PER QUARTER

Source: British Business Bank analysis of Beauhurst

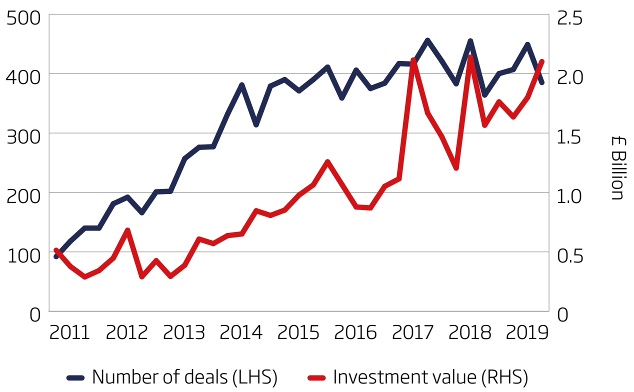
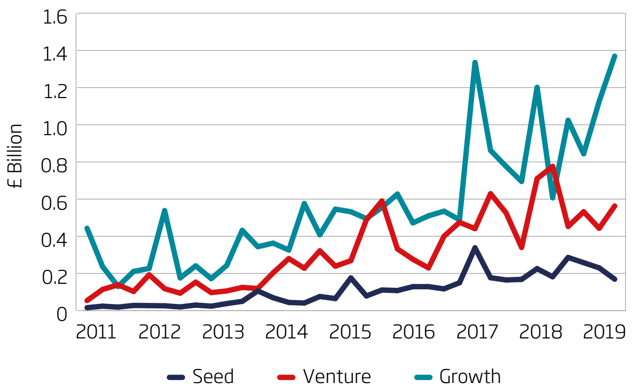


FIG B.45

VALUE OF EQUITY DEALS BY STAGE, PER QUARTER

Source: British Business Bank analysis of Beauhurst



UK EQUITY INVESTMENT IS SET TO REACH RECORD LEVELS IN 2019 DUE TO INCREASED NUMBERS OF GROWTH STAGE DEALS AND LARGER DEAL SIZES

Beauhurst data shows investment values were very strong over the first three quarters of 2019 and are set to reach record levels. £5.5bn of equity was invested into UK SMEs over Q1-3 2019, a 13% increase relative to the same period last year (figure B.44). This marks the third year in a row in which annual SME equity investment values have grown.

Beauhurst classifies equity deals into four distinct stages; seed, venture, growth and established, which reflect the recipient company's underlying position in terms of product development, commercialisation, sales and profitability. Investment value trends vary considerably between these stages. The British Business Bank has combined the Beauhurst growth and established stages together for simplicity, which we refer to as the 'growth' stage.

Figure B.45 shows equity investment value by business stage over time. The increase in overall investment value in 2019 was primarily driven by increases at the growth stage. £3.3bn of equity investment was made in growth stage SMEs over the first three quarters of 2019, a 33% increase compared to the same quarters in 2018. This was due to an increase in both the number and average size of growth stage deals.

Seed stage investment also increased in Q1-3 2019 compared to Q1-3 2018, by 14%, whilst investment into venture stage businesses was down 16% year-on-year.

Although the increase in investment value in 2019 was largely concentrated in growth stage SMEs, it was not purely due to a small number of very large deals in excess of £100m. There were six equity deals larger than £100m in Q1-3 2019, with a combined value of £891m, representing 16% of overall investment value. Although this is a higher proportion than 2018 when deals larger than £100m formed 14% of the market, it is much lower than 2017 (24%). Despite this, the overall proportion of investment coming from deals larger than £10m is at its highest level (69%).

This suggests there was capital available for UK scale-ups more broadly in 2019, not just for high profile 'unicorn' companies looking to raise equity rounds greater than £100m. Figure B.46 breaks down investment value by deal size category and shows that a record £1.2bn was invested in deal sizes between £25m and £50m, making this deal size category the largest contributor to total equity investment in Q1-3 2019.

Large increases in total UK SME equity investment were partly driven by increasing deal sizes. Figure B.47 shows that the overall mean average size of equity deals increased 9% to £4.8m in Q1-3 2019, a historically high level. Increasing overall average deal sizes in 2019 were driven by an 11% increase in the average deal size of growth deals, up from £14.7m to £16.4m. This is higher than the previous peak of £15.5m in 2017 despite fewer 'mega-deals' being completed, signalling an increase in growth stage deal sizes more widely. Average seed stage deal size also slightly increased from £1.3m to £1.4m, whilst there was an 11% decrease in the average size of venture stage deals.

Mean average deal sizes can be distorted by a few very large deals and so figure B.48 shows trends in the median deal size. The overall median equity deal size also increased in Q1-3 2019 compared to 2018, by 5% to £1.1m. This was driven by increases in the median size of seed and growth stage deals, increasing 4% and 9% respectively. Median deal sizes have been trending upwards across all stages since 2016, however the median size of venture stage deals reduced in Q1-3 2019 for the first time since 2013.

FIG B.46

EQUITY INVESTMENT VALUE BY DEAL SIZE, PER YEAR

Source: British Business Bank analysis of Beauhurst

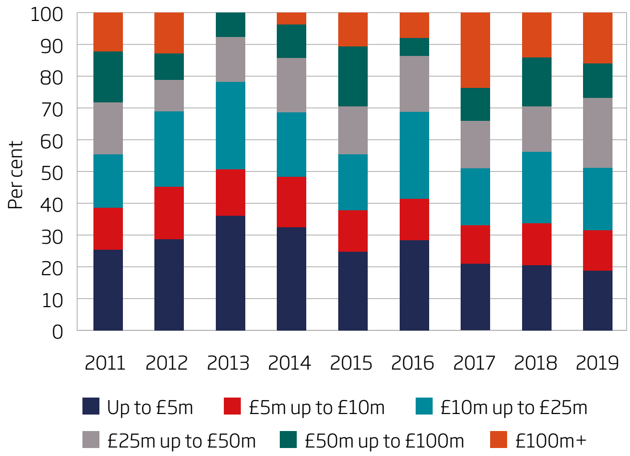


FIG B.47

MEAN AVERAGE EQUITY DEAL SIZE BY STAGE, PER YEAR

Source: British Business Bank analysis of Beauhurst

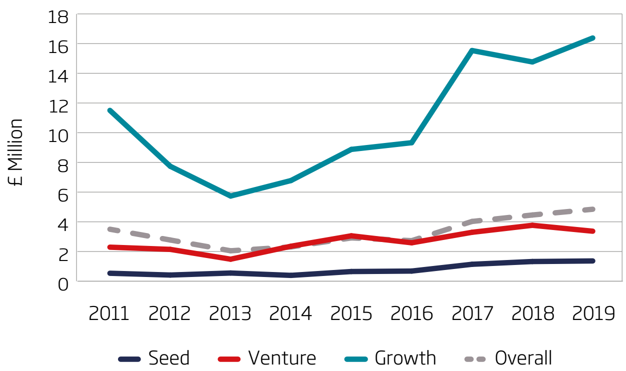


FIG B.48

MEDIAN AVERAGE EQUITY DEAL SIZE BY STAGE, PER YEAR

Source: British Business Bank analysis of Beauhurst

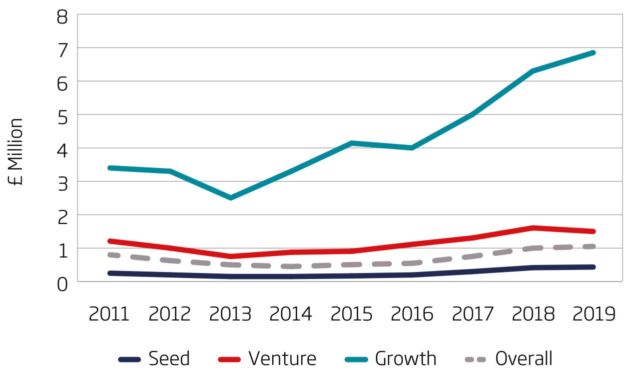


FIG B.49

NUMBER OF EQUITY DEALS BY STAGE, PER QUARTER

Source: British Business Bank analysis of Beauhurst

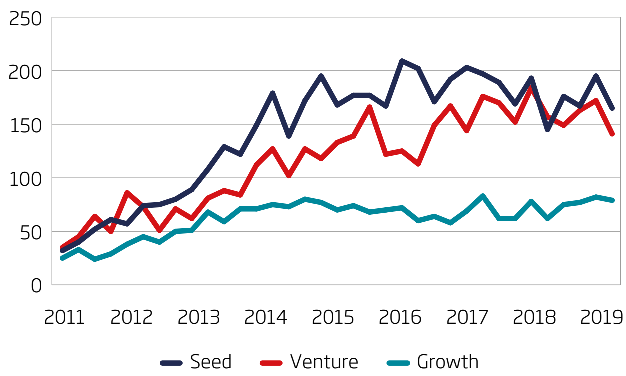


FIG B.50

NUMBER OF EQUITY DEALS BY INVESTOR TYPE, PER QUARTER

Source: British Business Bank analysis of Beauhurst

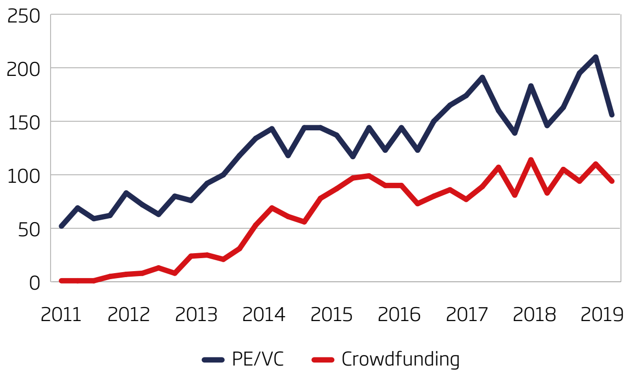


FIG B.51

EQUITY DEALS BY DEAL SIZE, PER YEAR

Source: British Business Bank analysis of Beauhurst

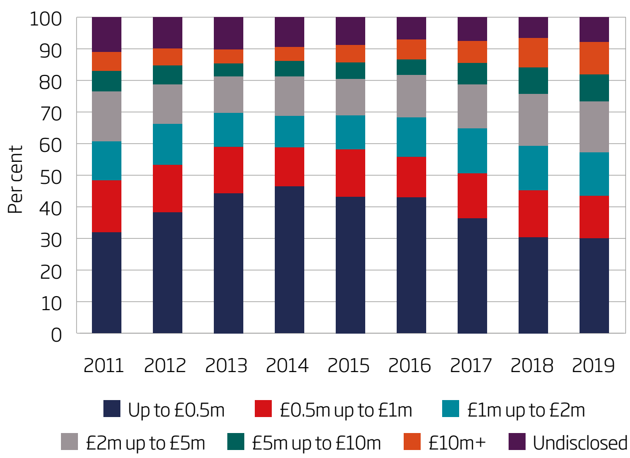


Figure B.44 shows that 1,241 equity deals were completed in UK SMEs over the first three quarters of 2019, a 3% increase relative to the same period last year. This was primarily due to an 18% increase in the number of growth stage deals, although seed stage deal numbers also slightly increased. Between Q1 and Q3 2019 there were 527 deals completed in seed stage UK SMEs, 4% more than Q1-3 2018 (figure B.49). Although this increase is a positive step for early-stage start-ups, seed stage deal numbers are still much lower than their peak in 2017. The number of venture stage deals declined slightly in Q1-3 2019 with 476 deals completed, 3% fewer than Q1-3 2018.

Private equity/venture capital (PE/VC) funds remained the most active type of equity investor in UK SMEs between Q1 and Q3 2019 with involvement in 561 deals (figure B.50). This is a 20% increase compared to the same period last year, driven by large increases in both seed and growth stage deals. Crowdfunding platforms had another strong year with involvement in 298 deals in Q1-3 2019, a 7% increase over Q1-3 2018.

Between 2014 and 2018 there was a noticeable change in the deal size demography of UK SME equity deals. Figure B.51 shows the proportion of deals below £0.5m saw a large decline between 2014 and 2018, with a greater proportion of deals falling into the larger deal size categories. This downward trend looks to have stopped in Q1-3 2019, with the proportion of overall deals smaller than £0.5m stabilising at 30%.

The number of completed deals above £10m increased by 15% in Q1-3 2019 compared to Q1-3 2018, growing as a proportion of overall deals. Deals between £500k and £5m in size declined as a proportion of overall deal numbers. In 2018 the large increases in the number of deals at the larger end came alongside a big decline in the smallest deals, potentially signalling a shift in investor risk appetite. It is therefore a positive sign in 2019 that increases in the number of larger deals did not come at the expense of earlier stage funding.

THE UK REMAINS EUROPE'S LARGEST VENTURE CAPITAL MARKET

PitchBook data shows £8.5bn of VC was invested into the UK in 2019, up from £6.7bn in 2018. The UK remains Europe's largest equity market, with 37% of European equity deals and 38% of equity investment going to UK-based companies in 2019.[136]

Yearly equity investment figures can be volatile and so the subsequent analysis examines the size of UK, European and US VC markets using three-year average figures covering 2016 to 2018.[137] There has also been strong growth in VC activity in Asia over the last few years, especially in China. Some reports suggest the Chinese VC market could be as large as the US, although there are concerns over the accuracy of the Chinese data. This report currently does not include China in the cross-country comparison.

The average amount of VC invested per year in the UK between 2016 and 2018 was £5.6bn, compared to £2.2bn in Germany and £2bn in France (figure B.52). Whilst differences in PitchBook's coverage of VC deals across countries could explain some of these differences, other data sources like Dealroom also show the UK market to be larger than Germany and France combined in 2019.[138] The proportion of VC funding going to seed stage deals is relatively similar across countries at around 5% of all VC funding, although the percentage is slightly higher in the UK (7%).

The UK has a higher average number of VC deals per year (1,390) than France and Germany, who averaged 561 and 450 deals respectively, over 2016 to 2018 (figure B.53). There are differences in the proportion of deals going to the seed stage with Ireland having the highest proportion of seed stage deals (35%), reflecting the early stage development of its VC market. On average 27% of UK equity deals were at the seed stage between 2016 and 2018, the same proportion as Germany but higher than Sweden (18%) and France (16%).

When making cross country comparisons of VC markets, it is useful to take the size of the economy into account. The following analysis expands on the analysis undertaken in the Bank's 2019 Equity Tracker report by examining VC investment as a proportion of GDP and the number of VC deals per trillion of GDP across different European countries. The US and Canada are also included in the charts to provide context.

FIG B.52

AVERAGE ANNUAL VC INVESTMENT BY STAGE, 2016 TO 2018

Source: British Business Bank analysis of PitchBook (data accessed 08/11/2019)

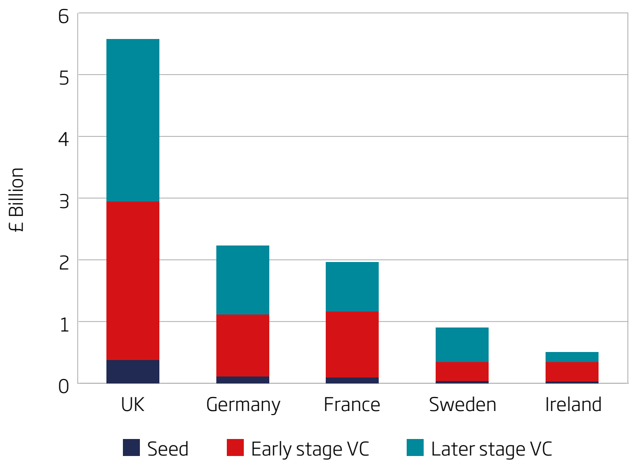


FIG B.53

NUMBER OF VC DEALS BY STAGE PER YEAR, 2016-2018 AVERAGE

Source: British Business Bank analysis of PitchBook (data accessed 08/11/2019)

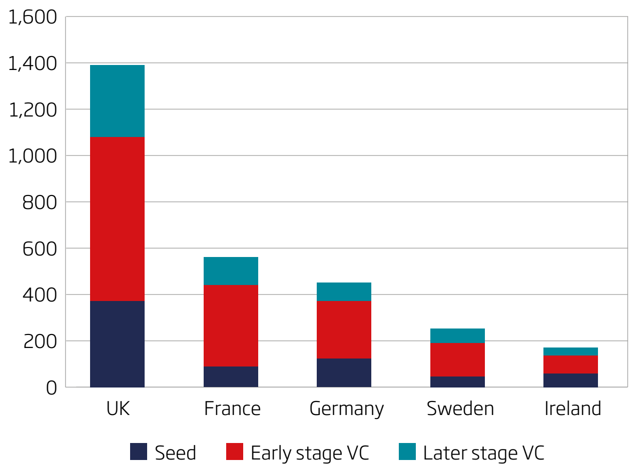


FIG B.54

VC INVESTMENT AS A PERCENTAGE OF GDP, 2016 TO 2018

Source: British Business Bank analysis of PitchBook and World Bank data (data accessed 08/11/2019)

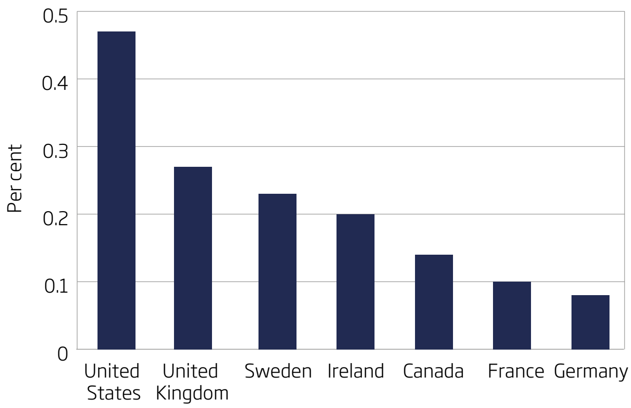
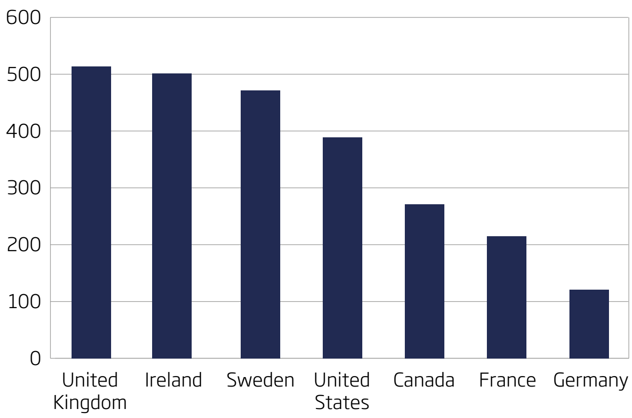


FIG B.55

NUMBER OF VC DEALS PER £TRN OF GDP, 2016-2018

Source: British Business Bank analysis of PitchBook and World Bank data (data accessed 08/11/2019)



Over the 2016-2018 period, the US VC market was 1.7 times larger than the UK VC market after accounting for differences in GDP (figure B.54). The UK VC market was around three times larger than France and Germany after accounting for differences in economy size. Sweden and Ireland also have reasonably high levels of VC relative to their GDP.

The UK has a higher number of VC deals relative to GDP compared to the US (514 and 389 deals per trillion of GDP respectively) (figure B.55). Ireland and Sweden also have a higher number of deals than the US after taking into account GDP. In comparison, the deal figures for France and Germany are much lower at 215 and 121 deals respectively.

An alternative approach is to compare the number of VC deals per capita. This shows the UK has 21 VC deals per million population over the 2016 to 2018 time period, slightly below the US at 23 deals per million population. The UK is ahead of France and Germany who have 8 and 5 deals per million population respectively, but Ireland and Sweden perform well on this measure with 35 and 25 deals per million population respectively.

The UK's VC market is highly developed and mature compared to most other European countries. This is also illustrated by the UK contributing 42% of Europe's current unicorn businesses.[139] The UK has 18 unicorns compared to 9 in Germany and 3 in France. The UK remains an important part of the European VC market going forward.

OVERVIEW OF LOWER MIDDLE MARKET PRIVATE EQUITY (PE)

The middle market sector comprises of companies sized between larger SMEs and companies that have access to wider capital markets. Mid-market companies play an important role in the UK, creating half a million jobs and generating one third of all private sector revenue.[140] The lower middle market (LMM) refers to the subset of companies at the smaller end of this segment in terms of revenue. LMM PE deals refer to equity investments into these firms.

Investment characteristics

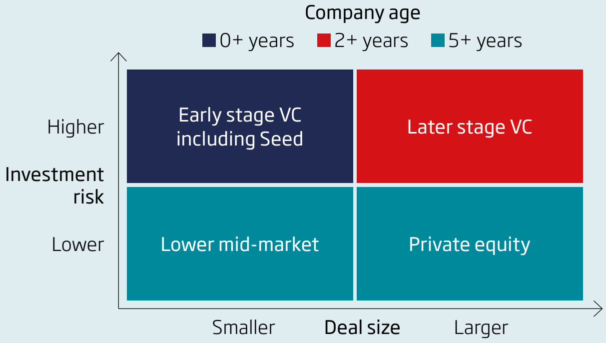
There are two main types of transaction falling under LMM deals – management buyouts (MBO) and growth capital. These deals often involve both primary capital issued, which is used for growth, as well as transferring ownership of existing shares from one owner to another. The key difference between MBO and growth capital deals is the size of the equity stake taken by the PE investor. MBOs involve large and majority stakes, whilst growth deals tend to be typically characterised by minority percentage shares. Despite this difference between deal types, all companies receiving LMM PE share similar characteristics. Target firms typically earn between £5m and £50m revenue per annum and are established businesses, having been in operation for at least eight years. They tend to be profitable, generating steady growth, albeit lower growth than the companies funded by VC.

Figure B.56 illustrates how LMM deals fits into the overall finance landscape compared to VC and wider PE with respect to company age, deal size and level of risk taken. LMM deals are focused on established firms with robust revenue streams and tend to cover companies operating in a broader range of sectors

FIG B.56

LMM CHARACTERISTICS VS PE/VC, STYLISED EXAMPLE

Source: British Business Bank analysis



than VC, which focuses on technology sectors. LMM deals differ from mainstream PE in that deal sizes are smaller - generally no larger than £20m. This is also reflected in funds which are also smaller – typically no bigger than £200m.

BENEFITS OF PE FUNDING TO COMPANY PERFORMANCE

LMM PE aims to create value through operational improvements rather than relying on leverage. Fund managers work with the company's management team devoting significant resources to help define and execute a business growth strategy. In doing so, LMM deals deliver benefits to the wider economy by enhancing productivity and creating sustainable growth. This is illustrated below with three examples of companies that have grown as a direct result of receiving LMM private equity:

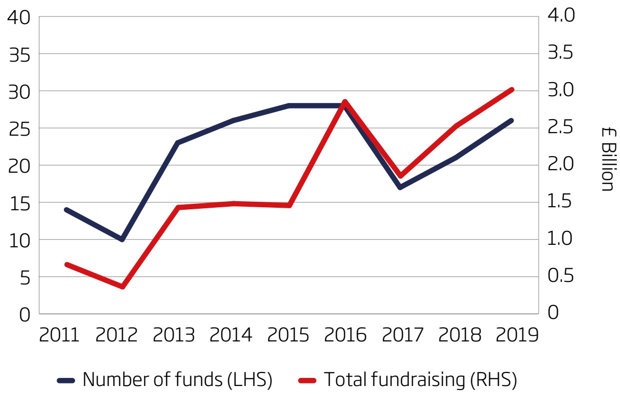
- Dorset Cereals, a small manufacturer of Muesli, was purchased through a management buy-in facilitated by Langholm Capital in 2005. Langholm helped rebrand the product and funded the building of a new packaging plant. Sales increased from around £4m in 2005 to around £30m in 2007 with head count doubling to more than 100.[141]
- President Engineering Group is a manufacturer and distributer of specialist engineering products. Yorkshire Fund Managers provided £6m for the management buyout of Cornflow and Bestobell Valves business from the parent company. Since 2010 turnover has doubled from £10m to £20m, with a greater focus on exports which now form 90% of business sales.[142] YFM have helped with access to sector, knowledgeable non-executive board members and facilitated strategic acquisitions.
- Entanet is a UK wholesale communications infrastructure provider, delivering a range of connectivity and telecommunication products and services to small businesses. Mobeus Equity Partners (MEP) backed the management team in an MBO 2014, committing £9.5m and introducing an experienced Chairman. Since the original investment, Entanet refined their business model and introduced new products and services. As a result, annual revenues grew from £27m to £36m in 2017.[143]

Over the past year British Patient Capital has invested in several LMM funds through a small pilot initiative as part of the VC Catalyst programme. The Bank will look to review the performance of these funds in due course.

FIG B.57

NUMBER AND VALUE OF UK VC FUNDS REACHING FINAL CLOSE, PER YEAR

Source: British Business Bank analysis of PitchBook (data accessed 14/01/2020)



UK VENTURE CAPITAL FUNDRAISING IS AT ITS HIGHEST EVER LEVEL WITH A HIGHER NUMBER OF FUNDS CLOSING IN 2019

The 2018/19 Small Business Finance Markets report identified that the number of UK-based VC funds reaching final close had been trending downwards since 2015.[144] PitchBook data shows this trend has now reversed, with the annual number of UK-based VC funds reaching final close increasing in two consecutive years (2018 and 2019). In total 26 UK-based VC funds reached final close in 2019 raising £3.0bn, the highest amount raised by UK VC funds in a single year (figure B.57).

Large VC funds (funds larger than £250m) raised the most capital, accounting for 58% of total VC fundraising in 2019. Global VC fundraising conditions have been strong in recent years, likely relating to the current low interest rate environment. Low interest rates increase the amount of capital available to invest in alternative asset markets as LPs increase their allocation to alternative strategies, including VC, seeking higher returns.[145]

Despite LPs focussing their capital in larger funds, 2019 was also a strong year for fund managers at the smaller end of the spectrum. There was a resurgence in the number of VC funds closing at under £50m, with seven funds in this size category reaching final close in 2019 compared to two in 2018 and three in 2017. This has led to a decline in the average size of UK VC funds reaching final close, with mean fund size falling 1.4% to £131m in 2019. Median fund size also dropped, for the first time since 2014, by 15.8% to £80m.

Improving conditions in 2019 for managers raising smaller funds is reflected in the increased number of first-time fund manager teams entering the market. Eight first-time fund managers raised VC funds in 2019, representing 31% of the funds reaching final close in the year. This trend was seen across European VC markets, with analysis by Atomico showing first-time fund managers closed more funds at much larger sizes than previously. The median size of funds raised by first-time managers increased threefold between 2014 and H1 2019, demonstrating the increased confidence LPs have in the latest generation of European fund managers.[146]

LONG-RUN VENTURE CAPITAL FINANCIAL RETURNS CONTINUE TO IMPROVE BUT EXIT ACTIVITY SLOWED IN 2019

Long-run financial returns from investing in VC continued to show improvement in 2019. The latest BVCA Performance Measurement Survey reports that the 10-year horizon Internal Rate of Return (IRR) for VC funds established since 1996 is 8.4% as of December 2018 (figure B.58). This is a 1.8 percentage point increase compared to the December 2017 position, likely reflecting strong exit activity in 2018 resulting in substantial capital distributions to LPs. Despite VC returns improving they still slightly lag public market returns, with the 10-year horizon IRR from the FTSE all-share index increasing by 1.8 percentage points to 9.1%. Investors generally expect a premium from investing in VC as it is a riskier and less liquid asset than a public market investment.

Limiting the VC fund sample to funds with a 2002 vintage onwards is more informative as it removes the cash flows of funds closed prior to the dot-com bubble bursting in 2001. These returns are therefore more representative of the returns an LP could expect from investing in UK VC. The IRR for this fund cohort is 10.3%, 1.2 percentage points higher than the equivalent FTSE all-share index return.

Venture returns still lag the returns achieved by management buy-out (MBO) funds. As of December 2018, the 10-year horizon IRR's for small, medium and large MBO funds are 13.7%, 10.8% and 15.1%. Buyout deals are generally lower risk than VC deals due to the investments having a shorter holding period and the recipient companies being more established and less likely to fail. Most limited partners therefore require a return premium to incentivise investment in a VC fund over a buyout fund.

It should be noted that most private equity MBO deals involve an element of leverage, so that fund managers partially fund the buyout of a company using debt. Global interest rates have remained at historically low levels in the decade since the global financial crisis, increasing the financial returns possible from buyout transactions utilising leverage.

FIG B.58

COMPARISON OF 10-YEAR HORIZON IRR's AND SELECTED MARKET COMPARATORS, BY YEAR

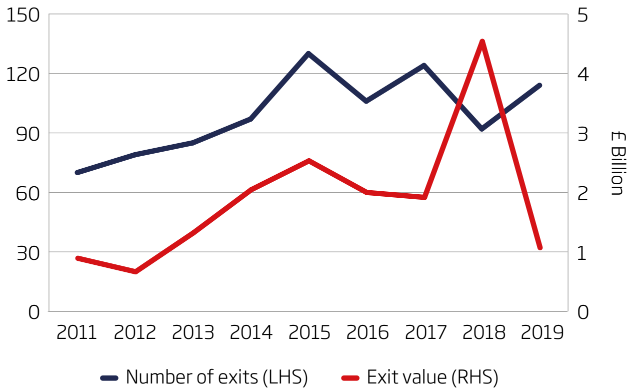
Source: BVCA Performance Measurement Survey 2017 and 2018

IRR (% P.A)	As at 31/12/2017	As at 31/12/2018
Private equity overall (including VC)	11.0	13.8
Venture capital	6.6	8.4
Venture capital (pre-2002 vintage funds)	1.3	1.1
Venture capital (2002 vintage funds onwards)	8.8	10.3
Small MBO	15.3	13.7
Medium MBO	10.3	10.8
Large MBO	11.4	15.1
Selected comparators		
FTSE all-share index	6.3	9.1

FIG B.59

NUMBER AND VALUE OF UK VC-BACKED COMPANY EXITS, PER YEAR

Source: British Business Bank analysis of PitchBook (data accessed 02/01/2020)



In the 'Future of Defined Contributions Pensions' report published in October 2019 the Bank committed to take specific action to increase transparency around VC returns for prospective LP investors.[147] We took the first steps towards this through our 'Analysis of UK VC financial returns' report which demonstrated that the pooled return of UK VC funds with a vintage year between 2002 and 2013 was higher than for the equivalent set of US funds.[148]

New data from Cambridge Associates also supports this, showing that as of Q2 2019 the 1-year and 3-year horizon IRR's for European VC funds are above US VC funds.[149] Global institutional investors are beginning to consider the opportunities available in European VC. Analysis from Atomico shows that in 2018 pension funds committed $1bn into European VC funds, which is much higher than the $395m they committed in 2017.[150]

Exit markets are an important component of the VC ecosystem as they ultimately generate financial returns and provide liquidity to LPs, freeing up capital for re-investment in other VC funds.[151] The 2019 Equity Tracker report identified that the value of VC-backed exits in the UK in 2018 was at record levels, whilst exit numbers had been trending downwards. This suggests larger exit valuations, which are likely contributing to improvements in reported UK VC IRRs in 2018.

Figure B.59 shows that this picture changed in 2019. The total number of VC-backed exits increased by 24% to 114 whilst exit value decreased by 76% to £1.1bn, meaning average exit size has reduced. 2018 can be considered an outlier year with several very large, high profile exits occurring including Farfetch and Funding Circle. Exit sizes in 2019 were more in line with historic levels.

UK VC-backed IPO (Initial Public Offering) activity has been particularly subdued in 2019, with only one relatively small IPO taking place. In contrast US IPO activity was very strong, with VC-backed 'unicorns' such as Uber and Lyft driving record exit values through their IPOs.[152] European IPO activity was also strong with more tech IPOs in Europe than in the US over the first six months of 2019, although the sizes of these European IPOs have been substantially smaller.[153]

Beauhurst research points towards a couple of factors contributing to the UK IPO market slowing in 2019. Firstly, large amounts of economic uncertainty combined with the current availability of later stage VC capital could mean some UK VC-backed companies are delaying their IPOs. In addition, the recent poor post-IPO performance of many global previously VC-backed companies has led to public investors paying closer attention to companies underlying financial metrics.[154] This may have also 'prompted strategic leaders of high-growth companies to err on the side of caution when it comes to braving the public market'.[155]

THE BRITISH BUSINESS BANK IS INCREASING THE AVAILABILITY OF EQUITY FINANCE TO UK SMEs

2019 was a positive year for UK SME equity finance overall with increases in both deal numbers and investment value. Despite increases in the amount of capital available to growth stage companies, the UK still lags behind the US in terms GDP-weighted VC investment. British Patient Capital continues to have an important role in providing later stage capital to UK scale-ups, ensuring they have enough funding to reach their full potential.

Fundraising conditions also improved in 2018 and 2019, especially for first-time fund manager teams. This highlights the success the Bank's equity programmes, particularly the Enterprise Capital Funds programme, have had in reducing barriers to entry and enabling new VC fund management teams to enter the market. For instance, in 2019 the British Business Bank invested in Ada Ventures' first VC fund.[156]

Multiple data sources are now showing that the performance of UK and European VC funds is competitive against the performance of US funds. The Bank is the largest UK-based investor in UK VC and has an important role in developing the market, including addressing information gaps. The Bank will therefore look to build on the VC financial returns report that was published in October 2019 by collecting new primary data on UK VC fund performance, to provide more robust data on the returns that are available from investing in UK venture.

Business angels are less likely than other investors to publicly disclose their equity deals. To help increase the amount of information available, the British Business Bank will shortly publish a new survey of UK business angels providing more information on their investment activities.

2.7 DEBT FUNDS

- The UK private debt market has developed since 2010 but growth in the number of mid-market deals has recently slowed
- The British Business Bank's Investment Programme has increased the supply of flexible debt to smaller businesses

THE UK PRIVATE DEBT MARKET HAS DEVELOPED SINCE 2010 BUT GROWTH IN THE NUMBER OF MID-MARKET DEALS HAS RECENTLY SLOWED

The UK private debt market has grown substantially since its emergence in 2010 in response to tighter bank lending conditions for businesses and a low interest rate environment for investors. The asset class provides a relatively attractive risk-adjusted return, diversification and low volatility for its investors.[157]

Private debt funds provide bespoke debt financing solutions, offering businesses an alternative source of funding to banks, accommodating a more flexible approach but typically with higher interest rates. Providers of private debt offer quicker decision making, more flexibility in deal structures and higher leverage than banks, making private debt a useful alternative option for growing businesses.

Although SME-focused private debt funds make up a relatively small part of the overall lending market to smaller businesses, the businesses in which these funds invest, are typically growth orientated and therefore make an important contribution to the UK economy.

There is less market data available on private debt deals compared to private equity deals, in part due to private debt being a less mature asset class in European markets. Existing private debt data providers include Deloitte through the Alternative Lending Tracker[158] and Preqin through the Private Debt Module.[159] These datasets mainly capture deals involving mid-market companies and do not yet capture sufficient numbers of deals involving smaller businesses.

Figure B.60 shows Preqin and Deloitte have relatively similar coverage of UK mid-market private debt deals over time. Both data sources show that the number of private debt deals going to mid-market companies in the UK has increased since 2013, demonstrating UK private debt markets have become more established. However, market conditions have changed in 2018 and 2019.

Preqin shows growth in private debt deal numbers slowed in 2018 with 135 deals completed, only one higher than in 2017. Initial deal numbers for 2019,[160] suggest a decline in the number of UK private deals in 2019 with 99 deals reported.

Whilst Deloitte shows there were 153 deals in 2018, up from 138 in 2017, 2019 data shows there were only 65 private debt deals in the first half of the year. Unless there is a particularly strong second half of the year, this also suggests the number of private debt deals in 2019 could be lower than 2018 levels. This may be due to cyclical factors, as well as the maturing of the mid-market private debt market.

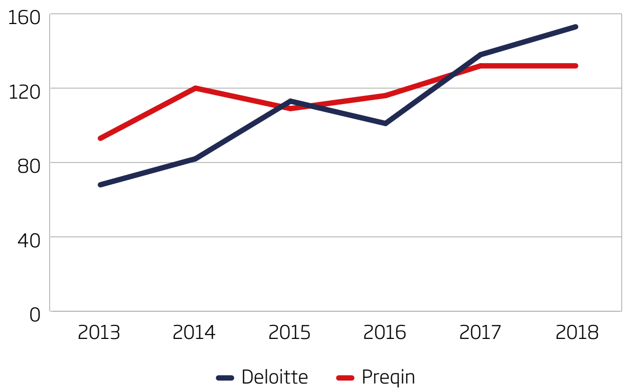
A similar picture is seen in Europe, with Preqin showing 449 private debt deals in 2018, a 1% increase compared to 2017. Preqin suggests 'with events like Brexit looming large, market uncertainty could present difficulties for fund managers in sourcing attractive deals on a risk-adjusted basis and effectively deploying capital'.[161] This raises the importance of private debt fund managers preserving their rigorous due diligence and underwriting processes, to ensure credit quality is maintained.[162]

Business demand for private debt finance is also likely to be influenced by wider market uncertainty. This is particularly the case in the UK, where the capital for 62% of UK private debt deals in the last 12 months was used for merger and acquisition (M&A) transactions. As such the majority (82%) of mid-market private debt deals in the UK are sponsored by private equity funds.[163] European merger and acquisition activity in 2018 was at its lowest level since 2010, with signs of further decline in 2019.[164] PitchBook notes 'volume has waned in the face of weak European economic indicators, growing protectionism and the uncertainty surrounding Brexit' and 'dealmakers are evidently cautious, opting for a wait and- see approach.'

FIG B.60

NUMBER OF UK MID-MARKET PRIVATE DEBT DEALS OVER TIME, BY DATA SOURCE

Source: British Business Bank analysis of Preqin (data accessed 27/11/2019) and Deloitte Alternative Lender Tracker Autumn 2019



Whilst mid-market private debt deal activity has slowed in the UK and Europe more generally in 2018 and 2019, Preqin shows investment values have risen with larger deals being undertaken in 2018.[165] $33.4bn (£25.4bn) of private debt funding went to UK companies in 2018, up from $9bn (£6.8bn) in 2017, leading to larger deal sizes. It should be noted that most of this capital has been used to provide leverage in M&A transactions, rather than going to SMEs in the form of growth capital.

UK mid-market private debt fundraising has been strong in recent years with $27.1bn (£21bn) raised in 2019, up 52% compared to 2018.[166] This fundraising has been mostly concentrated in the largest and most mature private debt fund managers in the market. For instance, Alcentra and BlueBay, two large, established private debt fund managers have both raised recently raised private debt funds larger than €5.5bn (£4.6bn) in 2018 and 2019.

Mid-market private debt funds in the UK have large amounts of capital available to deploy ($41bn or £31bn of dry powder)[167], which means fund managers are looking for larger deals. This increase in liquidity is not just seen in the private debt market but also the wider PE market, resulting in greater competition for deals and higher valuations. The liquidity at the mid-market level is unlikely to trickle down to smaller deals in smaller companies.

THE BRITISH BUSINESS BANK'S INVESTMENT PROGRAMME HAS INCREASED THE SUPPLY OF FLEXIBLE DEBT TO SMALLER BUSINESSES

Whilst fundraising conditions for mid-market funds remain strong with larger funds being raised, structural issues mean that fund managers targeting smaller businesses report ongoing difficulties in raising new funds.

The British Business Bank has played a catalytic role in supporting the development and growth of SME-focused private debt funds in the UK through the Small Cap Business Finance Partnership and the Investment Programme. As at 31st December 2019, the Bank had committed £624m into 18 SME private debt funds and is involved in a significant proportion of UK private debt funds focused on lending to smaller businesses. These funds provide a range of different types of debt and will help the smaller business private debt market to build a track record with investors.

The SME-focused funds supported by the British Business Bank form an important part of the market, not met by existing fund managers. The British Business Bank's Small Cap Business Finance Partnership and Investment programme has supported £2.1bn of funding into 201 businesses as at end of September 2019.

British Business Bank Management Information shows an increase in activity for the Small-Cap Business Finance Partnership and the Investment Programme from 2014 onwards. British Business Bank supported debt funds lent £72m in 2014, but this has continually increased year on year to £618m in 2018.

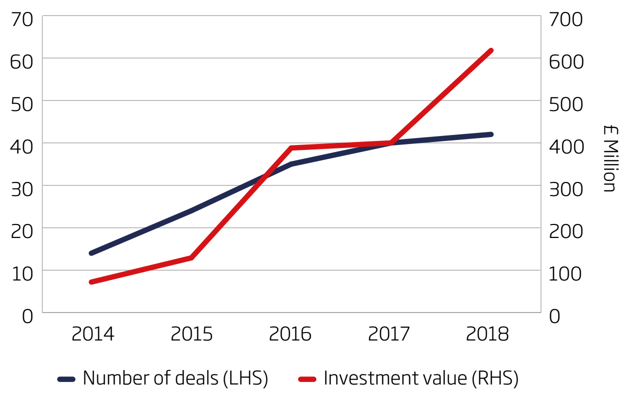
Figure B.61 shows the number of new companies funded per year has also increased over time, with 42 companies funded in 2018, up from 40 in 2017. Strong performance is also seen in the three quarters of 2019 with 40 companies funded, suggesting continued growth in the number of small company private debt deals in 2019. Smaller companies are more likely to be using private debt to fund growth, and so demand for this finance is likely to be less affected by cyclical factors affecting mergers and acquisitions.

Existing private debt data sources mainly capture deals involving mid-market companies and do not yet capture sufficient numbers of deals involving smaller businesses. To address this information gap, the British Business Bank is undertaking a new survey of private debt fund managers in the UK, with a particular focus on funds targeting smaller companies. This research will identify the number of private debt deals going to SMEs and the contribution these funded companies make to the wider economy.

FIG B.61

BRITISH BUSINESS BANK SUPPORTED PRIVATE DEBT FUNDS, NUMBER OF COMPANIES FUNDED AND INVESTMENT VALUE PER YEAR

Source: British Business Bank MI data



2.8 ASSET FINANCE

- Asset finance has continued to grow against a backdrop of low business investment
- Diversity of providers and business models in asset finance continues to grow
- Some asset finance providers are developing expertise in sustainable technologies
- Our asset finance partners support all regions and devolved nations

This section provides an update on developments in the asset finance (leasing and hire purchase) markets in 2019, highlighting the continued increase in new business. Asset finance continues to be the alternative finance instrument used by the largest proportion of smaller businesses surveyed in the Business Finance Survey (15% in 2019) with only bank overdrafts and credit cards more frequently used.

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

ASSET FINANCE HAS CONTINUED TO GROW AGAINST A BACKDROP OF LOW BUSINESS INVESTMENT

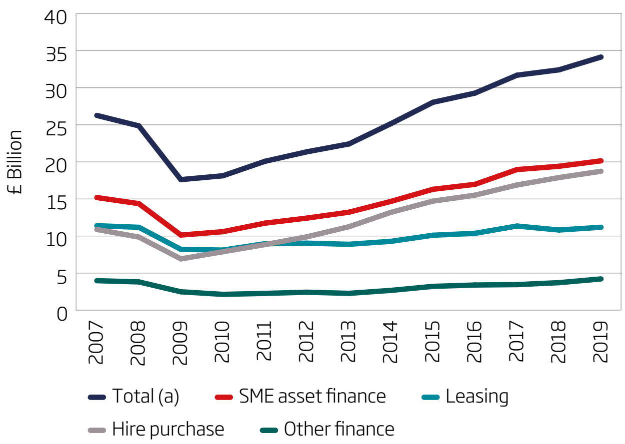
Asset finance growth has been resilient throughout the year. Total asset finance new business (primarily leasing and hire purchase) grew by 6% in 2019 whilst lending to SMEs grew 4% (figure B.62). This was despite weak business investment figures, driven by political and economic uncertainty, with one experienced market contact describing 2019 as "one of the most difficult years of trading in my career".

Whilst growth has been achieved, several contacts have noted it is more difficult in terms of revenue as there continues to be an increase in competition and pressure on rates. This has partly been driven by new money

FIG B.62

SIZE OF UK ASSET FINANCE MARKET FOR BUSINESSES - NEW BUSINESS

Source: Finance & Leasing Association (FLA)
Asset finance new business for deals of up to £20 million



entering the sector, in particular from private equity, a trend we first noted in the 2017/18 Small Business Finance Markets report.[168]

2019 has seen the unique dynamic of Brexit dates seemingly impacting the market. The FLA reported that "In September, the asset finance industry reported its strongest growth in new finance for plant and machinery since January 2019 as businesses stockpiled ahead of another Brexit deadline."

This may be a result of a combination of factors such as investment being brought forward ahead of a period of uncertainty or before credit conditions worsen, as suggested may be the case by the Q3 Bank of England Credit Conditions survey.

In addition, stockpiling is thought to have increased demand for plant and machinery finance to support some SMEs' increased inventories of raw materials and goods as reported by the ONS in Q1 2019 and by some market commentators in Q3. SME asset finance grew very strongly in Q1, up 11% compared to the equivalent period a year earlier.

The FLA breakdown shows the first three quarters of growth was primarily driven by plant and machinery finance and commercial vehicle finance. Some early market commentary suggested the strength in commercial vehicle finance could have been due to the impending introduction of the EU regulation that requires new commercial vehicles to have smart technographs from June. However, both commercial vehicle finance and the Society or Motor Manufacturers and Traders (SMMT) new light commercial vehicle (LCV) registrations data remained strong post the implementation. SMMT and the FLA have both reported this as being down to operators responding to regulatory changes and taking advantage of good deals on the latest models available.

The full-year 2019 figures showed that the commercial vehicle finance sector grew by 9% compared with 2018, while plant and machinery finance and IT equipment finance grew at the more modest rates of 5% and 3% respectively. Business equipment finance was the only asset category in negative territory (-2%) for the year.

The FLA are expecting further growth in 2020. Geraldine Kilkelly, Head of Research and Chief Economist at the FLA said in their December 2019 release: "Moving forward with the Brexit process should reduce some of the uncertainty that has weighed on business investment since the EU membership referendum. This will provide opportunities for further growth in the asset finance market in 2020."

DIVERSITY OF PROVIDERS AND BUSINESS MODELS IN ASSET FINANCE CONTINUES TO GROW

Strong competition and increasing diversity have been recurring themes in the asset finance industry in recent years, be it driven by new money and new entrants to the industry, or evolving business models such as the rise of digitalisation. This edition of the Small Business Finance Markets report utilises the AF50 UK data for the first time to analyse the composition of the asset finance industry. AF50 UK looks at the outstanding asset finance reported on the latest published balance sheets and is an annual publication by Asset Finance International in association with Asset Finance Policy.[169]

AF50 splits the data in a variety of ways including by the type of provider. For 2017/18 it reports 52% of outstanding asset finance was supplied by UK banks, 17% by overseas banks and 31% by non-banks suggesting a relatively unconcentrated market compared to many other financial markets.

Included within the 52% is a 17% share for independent challenger and specialist banks, a share that has been steadily increasing since the AF50 UK report began in 2016. Within this the AF50 UK top 50 list includes several challenger and specialist banks such as Aldermore and Close Brothers which both appear in the top 10 and Paragon and Metro Bank which only received their banking licences in the last decade. Similarly, several of the non-banks appearing in the latest report, such as White Oak and Simply, are new additions to the top 50, joining lenders like Haydock and Shire Leasing and evidencing the increasing diversity among independent providers.

The FLA does not report data by ultimate funder type, but it does report data by channel. Broker-introduced finance, the fastest growing channel in 2017 and 2018 has continued to set the pace and was up 9% in 2019, while the direct finance and sales finance channels grew by 5% and 2% respectively.

The continued growth in broker-introduced finance is despite some market contacts noting a number of brokers leaving the market due to recent regulatory changes including GDPR. Given both independent banks and non-bank finance providers typically rely on broker driven models more than the big banks the growth in broker-introduced business and the independents' balance sheets appear to be symbiotic.

Diversity isn't just about the number of providers though; the differing business models and service offerings available are also very important to customers. Whilst digitalisation and servitisation have been on the agenda for some time, 2019 saw several innovations from asset finance providers.

Lombard launched a new instant agreement tool and Aldermore launched an online portal to simplify transactions between small businesses and their funding providers. This latter tool lets brokers manage their portfolio in one place, calculate and deliver quotes, submit new business proposals, generate documentation and electronically sign agreement documents. Alongside the introduction of several asset finance provider apps, such as Propel's HowApp, this suggests the industry is starting to implement some of the trends we have more readily associated with FinTechs and digital banks.

SOME ASSET FINANCE PROVIDERS ARE DEVELOPING EXPERTISE IN SUSTAINABLE TECHNOLOGIES

Recently we have also seen a fair amount of discussion both within industry and government around the role finance providers can and need to play in helping the UK achieve decarbonisation goals. The legally binding target to reach net zero emissions by 2050 will require near complete decarbonisation of the UK's economy including power, buildings, surface transport, industry and waste, as well as the removal of residual emissions using greenhouse gas sequestration technologies.

On an individual basis an SMEs' environmental footprint is relatively low – and varies greatly within the set of SMEs because of diverse sectoral focuses, business models and sizes – but their aggregate impact is greater than that of large businesses. Studies that have sought to quantify industrial CO_2 emissions by enterprise size indicate that SMEs' contribution is as high as 60-70% in industrialised countries, though in the UK this number is considered to be closer to 50%.[170] As such, achieving carbon neutrality will require considerable changes to how SMEs operate.

Research typically suggests that barriers to SMEs adopting decarbonisation technology and practices are mostly not related to access to finance. Instead, SMEs appear to face challenges to decarbonisation because of the internal characteristics of firms. These included a lack of awareness of their impact on the environment and their obligations in this regard, but that doesn't mean there isn't a role for finance providers to help SMEs decarbonise.

In 2019 we have seen a growing focus on finance providers, and in particular asset finance providers, with expertise in sustainable or 'green' technologies and those who operate a circular economy model. Both of these finance options are potentially key to helping SMEs decarbonise. Specialist finance providers are important because many asset finance providers only lend against assets they understand and can price with a high degree of confidence. Some green solutions may well be difficult to value because either it is new or complex, or because there has not been a long existing secondary market leading to worries around residual values. Specialist finance providers may be better placed to mitigate some or all of these issues.

In addition, asset finance providers who follow a circular economy approach help their customers to decarbonise. Typically, this is through two approaches. One is to use business models adapted to maximise utilisation of products, eg through rental or sharing, thus reducing the number of products that are required to carry out the same amount of work and making sure resources are used to the fullest. The second is via collection and recycling. After use, products are taken through a differentiated value recovery system in which materials are specifically identified and sorted as a basis for high-quality recycling.

OUR ASSET FINANCE PARTNERS SUPPORT ALL REGIONS AND DEVOLVED NATIONS

Whilst the distribution of bank lending mostly matches that of SMEs (see section 2.3 SME finance at a local level) this is not the case for many other types of finance. For example, in 2018 the East Midlands was home to 6% of SMEs, received 5% of SME bank lending and less than 1% of equity finance. For the first time we can use the management information we receive from our delivery partners to proxy how asset finance is distributed.

Aggregating this data from across all our relevant programmes and delivery partners we can see the regional split of British Business Bank facilitated asset finance is broadly in line with SME distribution for many regions and devolved nations but with some interesting differences. London for example, received only 9% of the total asset finance we facilitated in H1 2019, well below London's SME share of 18.6% (figure B.63). The South East and South West also received three percentage points less than their SME share.

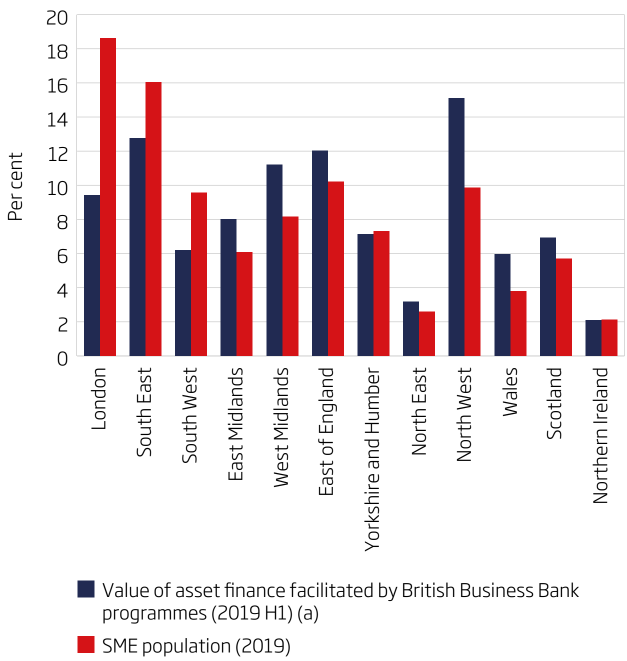
By contrast the remaining regions and devolved nations received a share in line with their SME share or above. The North West and the West Midlands topped the table with five percentage points and three percentage points above their SME shares respectively in 2019 H1. Whilst these are not yet full year numbers, 2018 full year numbers showed a very similar picture.

Unfortunately, there are no official published regional breakdown figures for the industry so it is difficult to verify how reflective of the wider industry our delivery partner numbers are. As a sense check we have spoken with several of our delivery partners and they have confirmed the finance they provide utilising our support is reflective of their wider book. In the future we hope to work with a wider number of asset providers to get a greater understanding of how much asset finance reaches both different regions and sectors.

FIG B.63

UK REGIONAL AND DEVOLVED NATION SHARES OF ASSET FINANCE FACILIATED BY BRITISH BUSINESS BANK PROGRAMMES AND THE SME POPULATION

Source: British Business Bank analysis of British Business Bank MI, BEIS Business Population Estimates
(a) Data excludes those where no location was recorded



2.9 INVOICE FINANCE & ASSET-BASED LENDING

- The value of outstanding advances to SMEs is down slightly following the 2018 peak
- The average advance to the smallest businesses has grown sharply
- Lending against stock has stalled, possibly due to the expected extension of the 'secondary preferential creditor status' legislation
- Asset-based lenders are joining the green revolution
- Our invoice and asset-based lending partners support all regions and devolved nations

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

THE VALUE OF OUTSTANDING ADVANCES TO SMEs IS DOWN SLIGHTLY FOLLOWING THE 2018 PEAK

SMEs outstanding advances averaged £9.3bn in IFABL finance during the first three quarters of 2019 according to the latest UK Finance numbers. This is down 2.1% on the full-year average for 2018 when the series peaked at £9.5bn and is likely to lead to the first full-year fall since 2015 (figure B.64).

All but one size band of SME experienced decreases in advances with the exception of the very smallest businesses (turnover below £500k). Year-to-date, the value of outstanding advances to the smallest businesses has averaged £838m, up from £737m in 2018, a new high for the series.

FIG B.64

NUMBER OF SMEs USING INVOICE AND ASSET-BASED FINANCE, BY TURNOVER COHORT

Source: UK Finance, Bank of England and British Business Bank calculations
(a) 2019 data up to and including Q3

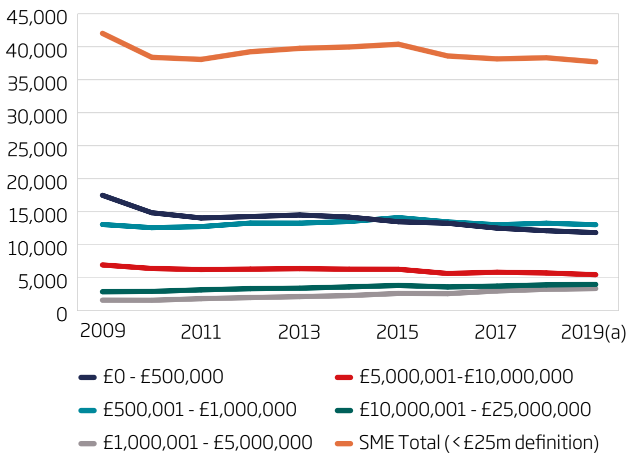
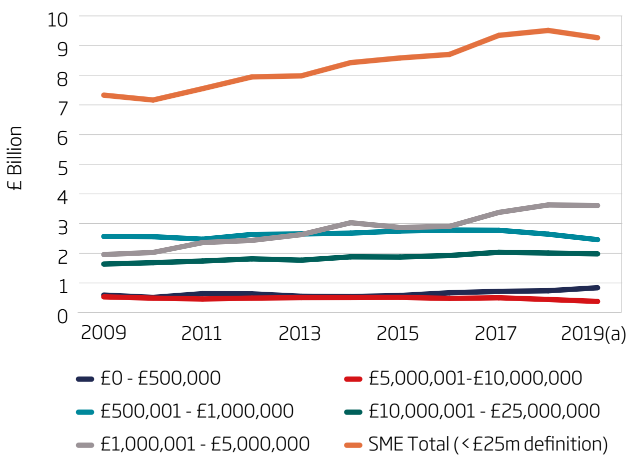


FIG B.65

LEVELS OF QUARTERLY AVERAGE STOCK OF ADVANCES, BY TURNOVER COHORT

Source: UK Finance, Bank of England and British Business Bank calculations
(a) 2019 data up to and including Q3



The number of SMEs utilising IFABL finance continued to fall in 2019 with the year-to-date quarterly average below 38,000 for the first time since the series began in 2009. In Q3 2019, the latest data point available, 37,465 smaller businesses used IFABL finance, again the lowest since the series began.

There is continued variation within size bands though. Fewer SMEs in the two smallest size bands used IFABL finance, a continuation of a trend seen more or less since the start of the series. However, the number of businesses with a turnover between £5m-£10m and £10m-£25m using IFABL finance have increased marginally and are currently both at series highs (figure B.65).

THE AVERAGE ADVANCE TO THE SMALLEST BUSINESSES HAS GROWN SHARPLY

The fall in the number of the very smallest businesses using IFABL finance and the sizeable increase in the value of finance advanced to them means the average advance per business has grown significantly in 2019 (13.7%). The 2019 year-to-date average is £70,836, up from £60,705 in 2018. Each quarter so far in 2019 has reported quarter-on-quarter growth at an average of just under £6,000 meaning the average advance in Q3 2019 is 30% higher than in Q4 2018.

This increase in the average amount advanced to the smallest businesses, when coupled with the usage of other short-term finance types highlighted in the bank lending chapter (2.4), suggests that some smaller businesses may have encountered cashflow issues in 2019. The smallest businesses are more likely to require funding for help with cashflow, covering a short-term funding gap or helping with trading difficulties than medium-sized businesses.[171] This may have been in part exacerbated by the increase in late payments highlighted by BEIS data and several surveys carried out in 2019.

According to the ICAEW Q2 Business Confidence Monitor, late payments from customers were a greater challenge than a year ago for one in five businesses (20%) and worse still (24%) if you are an SME. Previse, a payments fintech, released corroborating analysis of over 10 million invoices (representing more than £24bn of spending by some of the UK's largest buyers) in November. Their analysis suggested that, while late payments were common throughout the supply chain, the smallest suppliers were paid 30 days late while firms charging the biggest fees were paid, on average, less than a day late.

Suppliers invoicing for a value less than £10,000 p.a. and thus more likely to be smaller businesses, were on average processed by buyers 35 days after being received, meaning payment, usually due within 30 days, was late before the invoice had even been approved. Large suppliers, on the other hand, had their invoices prioritised, taking just three days to be processed on average, while also being paid faster after being approved.

LENDING AGAINST STOCK HAS STALLED, POSSIBLY DUE TO THE EXPECTED EXTENSION OF THE 'SECONDARY PREFERENTIAL CREDITOR STATUS' LEGISLATION

The most widely known types of asset-based finance are factoring and invoice discounting, collectively referred to as invoice finance, where the debtor book comprises the core 'security'. Together they account for approximately 79% of the finance facilitated across all sizes of businesses, by value of advances. However, in recent years, asset-based lending, where finance is advanced against business assets additional to the debtor book, has grown albeit from a relatively low base. This has been driven in large part by lending against stock which has grown at an average of nearly 50% for the three years up to 2018.

Given many smaller businesses have been stockpiling in 2019 one could have expected this emerging finance product to again grow strongly, however this has not been the case with lending against stock increasing only marginally in 2019 (1%). UK Finance, the industry body that represents IFABL finance providers, notes that this is likely to be in large part due to the proposed introduction of secondary preferential creditor status which will significantly degrade the value of floating charge assets – such as stock – for lending purposes.

ASSET-BASED LENDERS ARE JOINING THE GREEN REVOLUTION

Not to be outdone by asset finance providers, IFABL finance providers are also looking to provide solutions for those SMEs trying to decarbonise. One of the first examples is Wesleyan Bank and Alterinvest Capital who have launched a cash flow product for renewable heat technology.

The non-domestic Renewable Heat Incentive (RHI) is designed to help businesses, public sector and non-profit organisations meet the cost of installing renewable heat technologies. Payments are made quarterly over 20 years and are based on the heat output of the installed system. The cash flow solution offers an annual upfront payment against the RHI subsidy.

OUR INVOICE FINANCE AND ASSET-BASED LENDING PARTNERS SUPPORT ALL REGIONS AND DEVOLVED NATIONS

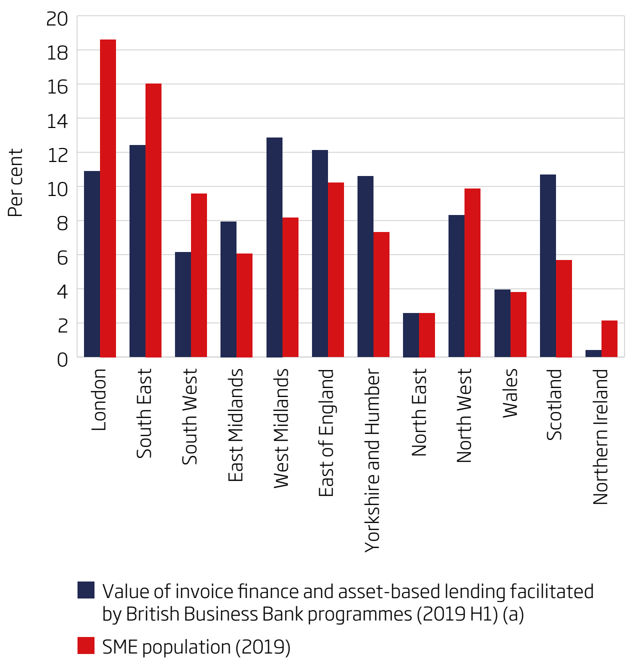
As with asset finance, there are no official regional breakdown figures for the industry published. Aggregating the data from across all our relevant programmes we can see the regional split of IFABL finance facilitated by our programmes is broadly in line with SME distribution for many regions and devolved nations but with some interesting differences. London for example, received only 11% of IFABL finance in the first half of 2019, well below London's SME share of 18.6% (figure B.66).

The South East and South West also received four percentage points and three percentage points less than their SME share respectively. By contrast Scotland and the West Midlands both received a significantly larger share of IFABL finance compared to their share or SMEs in 2019.

FIG B.66

UK REGIONAL AND DEVOLVED NATION SHARES OF INVOICE FINANCE AND ASSET-BASED LENDING FACILIATED BY BRITISH BUSINESS BANK PROGRAMMES AND THE SME POPULATION

Source: British Business Bank analysis of British Business Bank MI, BEIS Business Population Estimates
(a) Data excludes those where no location was recorded



2.10 MARKETPLACE LENDING

- Gross lending continues to grow but the sector has experienced its first real headwinds
- Returns have fallen across the industry, but net yield has remained steady
- FCA have strengthened the UK regulatory regime but respondents suggest more could be done
- Marketplace lenders are responding to the more challenging market

Marketplace lending is a term used to describe the market mechanisms, usually online, that link lenders and borrowers. Previously this was commonly referred to as Peer-to-Peer lending, but as institutional investors have become the main source of available finance this is increasingly inappropriate. This section reviews developments in this market using data from Brismo. Brismo covers consumer, business, property, invoice financing and crowdfunded debt. This section focusses on business lending and invoice financing, which is predominantly to SMEs.

GROSS LENDING CONTINUES TO GROW BUT THE SECTOR HAS EXPERIENCED ITS FIRST REAL HEADWINDS

Marketplace business lending continued to grow in 2019 providing an alternative source of finance for SMEs seeking debt finance. According to Brismo, it increased in the first three quarters of the year to £1.9bn. This is 12% higher than the same period last year (figure B.67), in contrast to gross bank lending flows which have declined slightly in 2019. However, the rate of growth has slowed compared to previous years and the H1 figure of £1.27 billion was down 1% from H2 2018, the first half-year on previous half-year fall since the data series began in 2010.

Marketplace invoice financing also continued to grow in 2019, though only just at 1%, following a restatement of historic numbers. Figures for 2016-2018 have been significantly reduced with growth in 2018 adjusted down from 105% to 29% following a 2% decline in 2017. The total value of aggregate marketplace invoice finance now stands at £362m for 2019.

The sector has however experienced headwinds and press scrutiny in 2019. In May, Lendy fell into administration, following months of questions and concerns over the level of arrears and defaults. FundingSecure, a marketplace pawnbroker and property lender, also went into administration in October after concerns around the management of client account funds as well as the weak performance of its loan book.

Slowing growth has also impacted established lenders and is reflected in Funding Circle cutting its forecast revenue growth in half to 20%. Broader economic concerns in the face of Brexit uncertainty have impacted both business and consumer lending, meaning many lenders have seen reduced demand for loans (see section 2.2: Use of external finance). In addition, Funding Circle has tightened its lending criteria, a move designed to protect returns for those who have invested via the platform.[172]

FIG B.67

GROSS UK MARKETPLACE LENDING, SPLIT BY TYPE

Source: British Business Bank analysis of Brismo data, Funding Circle and MarketFinance
(a) Business lending 2019 data up to and including Q3

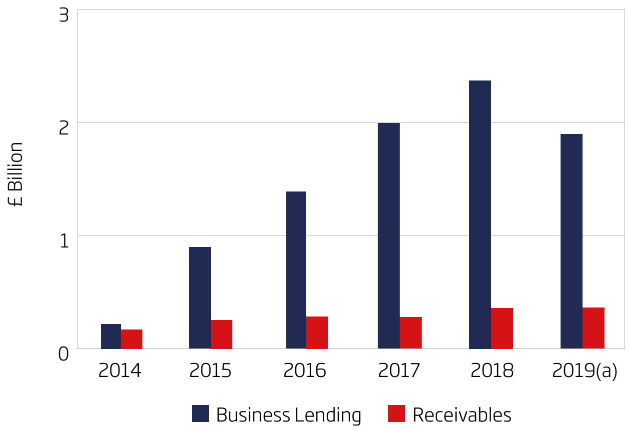
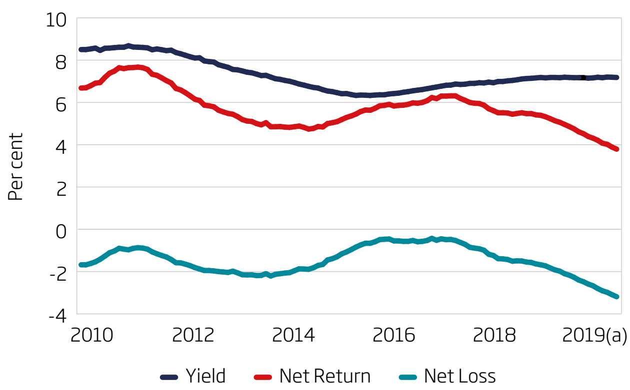


FIG B.68

MARKETPLACE LENDING RETURNS, YIELDS AND LOSSES

Source: Link Marketplace Lending Index, powered by Brismo
(a) 2019 data is up to and including Q2



RETURNS HAVE FALLEN ACROSS THE INDUSTRY, BUT NET YIELD HAS REMAINED STEADY

Funding Circle's tightening of lending criteria arrived against a backdrop of falling returns across the industry according to the Link Group Marketplace Lending Index. Link Group, in association with Brismo, have attempted to build a true picture of the investment performance of all-sector marketplace loans for investors, taking into account fees, costs, term length, and losses. Accounting for these factors, the Link/Brismo Marketplace Lending index shows that the net return on a portfolio made up of all loans originated by the constituent platforms now stands at 3.8%, the lowest on record. This has fallen from 5.5% in the second quarter of 2017 and is now a distance from its most recent peak of 6.3% in 2016 (figure B.68).

This fall in net returns has been driven by an increase in loss rates on loans. In the latest figures, losses reduced the net return by 3.4 percentage points, well above the 2.1 percentage point reduction seen last year. Analysis by Link/Brismo puts this down to a combination of the weaker economic environment impacting a growing minority of businesses and consumers' ability to repay loans and the rapid growth of some platforms exposing them to riskier borrowers. They also note this has been exacerbated by the dwindling usage of contingency funds among platforms, exposing more loans to losses.

The second component in net returns is the net yield (which accounts for the initial interest rate and platform fees). This has remained steady at 7.2%. Although risk has increased in the sector, growing competition among lenders has also created a tougher pricing environment. Despite the impact of rising loss rates, returns remain healthy compared to other fixed income assets of a comparable term, which should help to underpin demand.

Whilst these numbers are for all sectors of marketplace lending rather than just business lending, given the fact that is the largest sector it is unlikely returns and yield on business lending will have behaved significantly differently.

FCA HAVE STRENGTHENED THE UK REGULATORY REGIME BUT RESPONDENTS SUGGEST MORE COULD BE DONE

Following a consultation, in June the FCA confirmed new rules for the industry. These included "placing a limit on investments in P2P agreements for retail customers new to the sector of 10 per cent of investable assets." However, this investment restriction will not apply to new retail customers who have received regulated financial advice.

Despite this rule not coming in until December 2019 the above changes have already had an impact on investors as well as on marketplace lenders. Market contacts report a few retail investors have been deterred from investing in marketplace lending leading to a reduction in new retail investor flows and several lenders have also implemented the rule early, albeit in differing ways. Due to one or both of these reasons, a number of lenders are seeking to expand their investor base across institutional investors to have a deeper and more permanent pool of capital.

In addition to the above restriction, the new rules also cover a requirement to clarify governance arrangements, systems and necessary controls; a strengthening of rules on plans for the wind-down of platforms if they fail; and setting out the minimum information that platforms need to provide to investors. In general, these changes have been welcomed, particularly following the marketplace lender failures observed earlier in the year leaving retail investors exposed to significant amounts of capital losses.

The new rules aim to push those lenders who do not already have mature systems in place to move towards more suitable governance arrangements, systems and controls as the industry and lenders transition from being start-ups. Should the worst still happen, the strengthening of rules on plans for the wind-down of platforms will lead to a more orderly outcome for all involved.

However, some respondents to the FCA's consultation and market contacts have expressed concerns these changes do not go far enough. Whilst the above policies mostly impact the running of the platforms, the main concern expressed appeared to be about the lack of clarity investors have when choosing where to put their money in the first place.

Several respondents to the consultation considered the nature of the information to be disclosed and the lack of a prescribed format could potentially make it difficult for borrowers and investors to compare information across platforms. Against the backdrop of recent challenges, this could be key for the sector as it matures further if it is to attract greater institutional investment and retain the faith of its existing and potential retail investors.

Perhaps as a result of the feedback the FCA note that this is the one element of the regulation that they will keep under review.[173] They go on to say with respect to reporting of historic performance, ".... we agree that a convergence in standards across the industry would be beneficial.... we consider that there may be a role for industry participants to discuss best practice and promote consistency of interpretation in some key areas, perhaps via relevant trade associations."

Following the implementation of the enhanced FCA rules, the 36H Group has been launched by Innovate Finance, the industry body which represents UK FinTech.[174] The new Group succeeds the Peer-to-Peer Finance Association (P2PFA) – a self-regulatory body established in 2011 to lobby for regulation. Membership of the Group is open to all lending platforms that are authorised and regulated by the FCA under Article 36H legislation. Initial members are Funding Circle, RateSetter, Zopa, Lending Works and CrowdProperty.

MARKETPLACE LENDERS ARE RESPONDING TO THE MORE CHALLENGING MARKET

Marketplace lending has grown rapidly providing an alternative source of finance for many SMEs. The sector has however reached a pivotal period with some key challenges facing the industry.

First and foremost, marketplace lenders continue to seek scale whilst also attempting to make a profit. Lenders have taken several approaches to achieve this. These have included diversifying product offerings and target audiences, expanding overseas, partnerships with large banks, partnerships with challenger banks, creating specific funds to encourage institutional investment and seeking banking licences.

At some point we will see the industry go through its first full credit cycle which will test the strength and reliability of sector funding. How it prepares, to diversify and deepen the funding base, will be key.

GLOSSARY

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

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

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

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

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

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

CHALLENGER BANKS
Usually defined as those banks outside of the Big Five UK banks. Challenger banks include new entrants to the market, spin-offs or dis-investments from large banks and existing smaller banks seeking to grow. Some are regionally based, whilst others provide only personal or small business banking rather than the wide range of services provided by the larger banks.

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

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

CROWDFUNDING
Equity fundraising for businesses where relatively small amounts of money are lent or invested by large numbers of individuals, typically facilitated by online platforms.

DEBT FUNDS
A limited liability investment vehicle which invests in businesses using debt instruments. Debt funds provide businesses with bespoke debt finance that is often focused on providing flexible finance for 'event driven', growth orientated companies.

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

ENTREPRENEURIAL ECOSYSTEM
A set of entities such as businesses, investors and public institutions that are connected through relationships and processes that influence entrepreneurial outcomes in a given area.

ENTERPRISE INVESTMENT SCHEME (EIS)
This is a tax relief scheme designed to increase the amount of equity finance available to high growth potential businesses by offering investors tax relief.

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

FINTECH
Finance providers or financial service providers which use technology and /or innovative delivery and assessment models within the financial services industry.

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

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

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

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

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

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

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

INITIAL PUBLIC OFFERING (IPO)
The first time a private owned company sells its shares publicly on a listed stock exchange.

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

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

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

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

LOCAL AUTHORITY DISTRICT (LAD)
These are sub-regional authorities that make up local government.

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

LOWER MIDDLE MARKET
The middle market sector comprises of companies sized between larger SMEs and companies that have access to wider capital markets.

MANAGEMENT BUYOUT (MBO)
The senior management of a company buying all of the company's outstanding shares. The management of the company will not usually have sufficient money to buy the company outright themselves, but will use private equity funding to support the purchase.

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

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

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

PEER-TO-PEER LENDING (P2P)
Peer-to-peer finance involves the use of internet-based platforms to match online lenders with borrowers. Given the increased investment from institutional investors, the Bank typically now refers to marketplace lending.

PRIVATE EQUITY (PE)
Equity ownership in a business that is not publicly-traded. Private equity involves investing in privately held companies and most of the time, private equity investors invest institutional money. Venture capital is a type of private equity finance.

PUBLICLY LISTED COMPANY (PLC)
A company issuing shares, which are traded on the open market, through a stock exchange. Individual and institutional shareholders constitute the owners of a publicly listed company, in proportion to the amount of shares they own as a percentage of all outstanding shares.

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

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

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

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

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

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

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

VENTURE CAPITAL (VC)
The provision of funding to a start-up or young business with high growth potential. Venture capital differs to business angels in that they invest other people's money (mainly institutions). These investments are very risky, and so venture capitalists are looking for high financial returns.

WORKING CAPITAL
Money available for the day to day cash flow operations of a company.

ENDNOTES

1. Nominal bank lending flows adjusted by the GDP deflator
2. British Business Bank, BVCA and Diversity VC (2019), "UK VC and Female Founders"
3. See the following link for details: https://www.gov.uk/cma-cases/review-of-banking-for-small-and-medium-sized-businesses-smes-in-the-uk
4. https://www.british-business-bank.co.uk/finance-hub/
5. The OECD definition is taken from their Entrepreneurship at a Glance publication
6. See section 3.3 of British Business Bank Small Business Finance Markets 2016/7
7. All complete catalogue of British Business Bank evaluations is available at https://www.british-business-bank.co.uk/research/
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9. Available at: https://www.british-business-bank.co.uk/wp-content/uploads/2019/07/NPIF-early-assessment-report-FINAL_24-July-2019.pdf
10. To be published in Spring 2020.
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51. External finance includes overdrafts, credit cards, bank loans, commercial mortgage, leasing or hire purchase, loans or equity from family and friends or directors, invoice finance, grants, loans from other third parties, export or import finance, crowd funding, asset-based lending, or any other loan or overdraft facility.
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114. PwC UK, Who are you calling a 'challenger bank'?, 2017 https://www.pwc.co.uk/industries/banking-capital-markets/insights/challenger-banks.html
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122. B-North aims to focus on lending to SMEs in northern England https://specialistbanking.co.uk/article-desc-7166_b-north-submits-its-banking-licence-application
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128. https://www.bdo.co.uk/en-gb/news/2020/lending-to-customers-by-uk-challenger-banks-reached-record-115bn-last-year
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The British Business Bank's mission is to help drive economic growth by making finance markets work better for smaller businesses – wherever they are in the UK and wherever they are on their business journey – enabling them to prosper and grow.

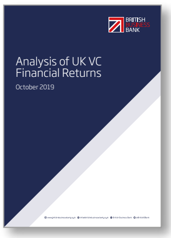
In 2019/20 one of our key objectives is being the centre of expertise on smaller business finance in the UK, providing advice and support to the Government. Being the centre of expertise on smaller business finance gives us the knowledge and credibility to achieve our other objectives, and to help the Government deliver key policy priorities.

We use insights gained from our extensive research and analysis programme to produce publications about UK smaller business finance markets, take part in policy debates, and to provide input into cross-governmental projects.

OUR LATEST RESEARCH

ANALYSIS OF UK VC FINANCIAL RETURNS REPORT

This report provides the most comprehensive and robust approach to date for assessing the comparative performance of UK Venture Capital (VC) funds compared to US VC funds since 2002. It draws together data from existing data sources including PitchBook and Preqin, and from the British Business Bank's own programmes. The report provides as comprehensive a picture as possible of the Venture Capital asset class and its performance and makes a specific case for UK VC within global VC allocations.



https://www.british-business-bank.co.uk/analysis-of-uk-vc-financial-returns

THE FUTURE OF DEFINED CONTRIBUTION PENSIONS

This report provides an in-depth assessment of the case for defined contribution (DC) pension scheme investment in venture capital and growth equity and proposes solutions to overcome key risks and challenges to access. It aims to enable better long-term retirement outcomes for the UK's defined contribution pension savers, with a focus on commercial solutions that could be implemented in the private sector.

https://www.british-business-bank.co.uk/research/the-future-of-dc-pensions-enabling-access-to-venture-capital-and-growth-equity

GOING DIGITAL: THE CHALLENGES FACING EUROPEAN SMES – EUROPEAN SME SURVEY 2019

The National Promotional Institutions of France (Bpifrance), Germany (KfW), Poland (BGK), Spain (ICO) and the United Kingdom (British Business Bank) collaborated on a study examining the challenges of digitalisation for European small and medium-sized enterprises. The study is based on a first-time joint survey of more than 2,500 SMEs in the participating countries, the *European SME Survey*.

SMEs create a large share of employment in Europe, generally are in sound shape and experience robust revenue growth. This is not least due to their competitiveness on both national and international markets.

To remain a driving force of the European economy, SMEs must increasingly invest in digitalisation. For European SMEs to advance further in the digital transformation process, a variety of obstacles must be overcome, including IT security concerns and a lack of digital infrastructure. A quarter of SMEs perceive a lack of appropriate financing possibilities as a key barrier to digitalisation in their company. Another important problem from the point of view of European SMEs are insufficient digital skills – both among their own workforce and on the external labour market.

https://www.british-business-bank.co.uk/going-digital-is-a-challenge-for-european-small-and-medium-sized-enterprises-but-key-to-remain-competitive/

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