HOW MEDIUM-SIZED BUSINESSES ACCESS FINANCE:

Lessons for tomorrow's medium-sized businesses

Qualitative Report

Research Series

British Business Bank

Unlocking finance for smaller businesses

Contents

1. Introduction

This report presents the findings from the qualitative phase of the research study conducted for the British Business Bank to investigate issues around mid-sized businesses accessing finance. The definition of mid-sized businesses used in this study is those with a turnover of between £10 million to £500 million.

This phase of the research has been followed by a larger quantitative survey. The combined study explores in detail the steps mid-sized businesses go through in accessing finance and the difficulties they experience. It is part of a wider consultation in the run up to the launch of the Business Bank in 2014.

1.1 Aims of the research

There were three objectives to this initial qualitative phase of the research:

- To understand the customer journey of mid-sized businesses (i.e. the steps businesses go through when considering raising external finance, and the process by which they obtain this finance)

- To find out what prompts mid-sized businesses to seek finance in the first place; and

- To explore mid-sized businesses' awareness and usage of alternative non-bank sources of finance, including non-bank debt finance and equity.

1.2 Methodology

Ipsos MORI conducted 31 in-depth interviews with representatives of mid-sized businesses between 26th June and 27th August 2013. All participants were responsible for obtaining finance for their mid-sized business. In most cases this was the CFO, Finance Director, CEO or Managing Director. All had obtained financing (i.e. lending) for their company in the past year either from a bank/building society, private equity, personal lenders, Government scheme or other source.

Interviews were conducted either face-to-face (12) or via telephone (19). Each lasted approximately 60 minutes. The 31 interviews included a mix of different types of mid-sized businesses around the country and broke down as follows:

Table 1.1: Interview breakdown	
Location: London/SE	14
Rest of UK	17
Turnover (pa): £10m to less than £25m	14
£25m to £500m	17
Industry sector: Manufacturing	8
Retail/wholesale	4
Recruitment	4
ICT/hi-tech	4
Financial services	3
Creative industries	3
Food services	2

Real Estate activities	2
Others	3
Legal status: Private limited company	23
Family-owned	5
Private equity	5
PLC	3
LLP	2
Charity owned	2
Foreign ownerships	1
Group status: Parent companies	14
Parents & subsidiaries	4
Subsidiaries	3
Independent	10
TOTAL	**31**

NB: Within the 31, there is some overlap between ownership structure (e.g. a firm can be a private limited company, private equity and foreign owned) and sector (e.g. a firm can be involved in both manufacturing and retail/wholesale).

Throughout this report, verbatim comments from each interview are used to illustrate key points and themes. To aid understanding of the different types of businesses involved in the research, quotations have been grouped into six business types. Each has their own individual characteristics, outlined below.

Table 1.2: Types of businesses involved in the research	
Type of business	**Details**
Medium-sized founder director or family-run	▪ Turnover £10m to less than £25m ▪ Directors want to retain control of business ▪ Informal management style ▪ Focus on selling out in future ▪ Slow and steady growth prioritised to protect value
Larger founder director or family-run	▪ Turnover £25m to £500m ▪ Original directors taken back seat but may still sit on the board ▪ Major financial decisions run past them ▪ Focus on protecting the long-term stability of the company and its employees
PLC / Large Groups	▪ Run in long-term interests of shareholders ▪ Relatively formal management style
Third Sector	▪ Like PLC/Large Groups but owned by members/charity so financial decisions protect long-term interests of members/charity ▪ Relatively traditional, formal management
Private equity – growing	▪ Priority is growth with a view to selling in 3-5 years ▪ Private equity representatives sitting on board mean focus on short-term profits and tight monitoring of financial positions ▪ Warrants sophisticated FD/CFO ▪ Takes external advice
Private equity - struggling	▪ As above but business is not growing ▪ Currently addressing and attempting to remedy current business practices and losses

1.3 Interpretation of the data

Qualitative research is designed to be detailed and exploratory and provides insight into perceptions, feelings and behaviours. It is important to note that qualitative findings are not statistically representative of the views of all mid-sized businesses.

Case studies have been used throughout this report to illustrate a point or theme from the research. They are not intended to be representative of the whole mid-sized business community. All have been anonymised to protect the identity of the businesses involved.

2. Executive summary

The economic downturn of the late 2000s and its subsequent fall out affected all mid-sized businesses in some way, whether directly or indirectly. However, even companies that appear to be struggling were still focused on growth.

Mid-sized businesses seek external finance for two reasons: to fund working capital or to fund investment.

Working capital finance tends to pay wages, suppliers and other fixed costs, such as rent. In an ideal world, most businesses would fund their working capital internally. When this is not possible, the most common forms of external finance are overdrafts and invoice discounting/factoring:

- Overdrafts are seen as an extension of a company's internal finance. In many cases the facility is unused and acts as a safety net for potential unforeseen risks to the business.

- Invoice discounting and factoring appear to be increasingly common as banks look to minimise risk and secure lending guarantees. Like overdrafts, invoice discounting is also seen as an extension of internal finance. However, some firms perceived using such facilities as a bad reflection on the sustainability of a business.

Investment finance tends to be used for new equipment, acquisitions, premises, entering new markets, digital platforms or restructuring a business. Firms often prefer to fund investment with external finance. The most common forms of investment finance are hire purchase or leasing, loans and equity finance

- Hire purchase and leasing are the preferred methods of financing new equipment and machinery. They allow firms to retain cash in the bank, providing another safety net, and some perceive this to mean banks are more likely to provide additional finance in the future.

- Loans are used for acquiring businesses or property and are sought primarily from banks. Many report banks increasingly asking for security against loans, for example a director's house as collateral for a relatively small sum.

- Equity finance divides opinion. Businesses unable to get finance elsewhere (e.g. start-ups) or those looking for external expertise find private equity a valuable resource. However, the majority of mid-sized businesses have not used it. For them, it has negative connotations of short-term profit focus and ceding control of your business.

For some mid-sized businesses, there is no clear distinction finance for working capital and finance for investments; they are the same thing. These firms tend to operate a project-based business model, early or late stage start-ups focused on growth, or firms with a lag in their business models creating considerable cashflow fluctuations.

This research covers only those who have been able to obtain external finance. Yet many businesses face challenges accessing finance, in particular those with lower turnovers, no proven track record for a new product or service, minimal assets or that are currently making a loss.

The ideal banking relationship for mid-sized businesses is with a single provider. But businesses can be forced into multiple relationships because of the need to secure finance. There are signs of new, challenger banks coming into the market e.g. Aldermore, Shawbrook, Silicon Valley Bank and Handelsbanken. They offer more tailored products, access to finance and superior service, in particular relationship managers.

3. Current issues facing mid-sized businesses

The economic situation since the late 2000s recession affected all companies in some way. If they have not been directly affected, their customers and suppliers had. The main effects had been:

- **Potential investment is being deferred**, particularly taking on more staff or longer-term, more speculative investments such as R&D. Indeed, many say they would be encouraged to take more risks and grow quicker if finance was more readily available.

  > *"Our biggest thing that we are really nervous about it is investment in people, and yet that's what we need to grow. It's so expensive if you make a mistake." (Medium founder director or family run)*

- **Profit is being diverted into cash reserves 'just in case'** to meet declines in sales, increase in late payments, higher costs or counteract declines or withdrawals of overdraft facilities.

  > *"The guys who've gone bust recently… their profitability hasn't been an issue. [It's been] either they hadn't got the cash, or not got the cash on the right day to pay the wages." (Medium founder director or family run)*

- **Finance facilities (e.g. hire purchase, overdrafts or invoice discounting) have been set up** to allow businesses to meet short-term declines in cash flow.

  > *"What drove [the overdraft facility] up to the £2m was [our customer]... The size of that one account could have a major impact on our business if the money didn't come in, so it meant we rely on one individual on the other side paying me on time… My cash reserves are not strong enough. That would impact my business without question…. In extreme, it would take me under." (Medium founder director or family run)*

- **Venture capital and private equity backers have had to remain involved** in the business longer than anticipated.

  > *"When you are owned by private equity funds, it's not a long-term hold position, it's an investment. And there should be some change in control. It's not going to happen imminently, but if you put a 3-5 year timeframe on it… I think our current investors never imagined for a second that they'd invest for 13 years, but these things take time." (Private equity - growing)*

Despite these issues, all mid-sized businesses are currently looking to the future and to growth. Even businesses who appear outwardly to be struggling, or who have suffered significant losses in recent years, are focused on growth rather than simply surviving. This may in part be due to the culture of business and its need to constantly evolve to survive. As one loss-making, off-site learning provider explains:

> *"We need to change to survive, but we actually do have genuine growth opportunities to sustain this organisation and to further its charitable objectives… but the fact that our traditional business model is on this constant declining path means that there's more of an urgency to do that." (Third sector)*

Future planned growth seems to take on several forms. Firms are either looking to acquire other companies, develop or launch new products, acquire new customers or enter new markets. To meet these growth plans, many companies are looking beyond the traditional Western markets of the UK, US and Europe. In particular, companies are exploring opportunities in India and South America e.g. Brazil. Some are working with local partners in these regions through low-risk joint ventures (JVs). In many ways, JVs fit the current mood of mid-sized businesses. They require little upfront investment or financing. But (as shown in case study 1 below) JVs also enable growth and opportunity in a relatively risk-free environment, benefiting from the local knowledge and language skills British businesses may not have.

Case Study 1: Low risk JV in India

- A recruitment company based in central London with a turnover of £30m specialises in public sector, financial services, retail and the third sector.

- It recently set up two joint ventures; one in a solar panel company and another with a recruitment company in India. The Indian JV required no capital outlay. It pays a license fee for the company's branding and processes, but benefits from the local knowledge and language.

> *"We are absolutely through and through an entrepreneurial business. [A JV] allows us to try things… It allows us to go out and play… It's really important that the guys on the ground own a piece of that business and operate it as if it's theirs."*

4. Current use of finance

4.1 Factors considered when obtaining finance

Several factors are important to mid-sized companies when they make decisions about obtaining finance. However, which factors is largely dependent on the type of business.

Businesses that are exposed to risk, either through restructuring, falling incomes, reduced margins or periodic shortfalls in cash flow, feel that there is a scarcity of finance available in the market. For these firms, by far the most important factor is availability. Whether a particular source is available to that company or not determines many of the decisions made. Those with only one option for finance have only two options; to take the finance or not.

> *"I have quite a big network of financial people including a couple of people who sit on the credit, on the national credit committees for two of the big banks and I actually had a debate with them about our circumstances and the appropriateness of using a mortgage and availability of this and they basically confirmed my feelings on this that, a) they wouldn't do it and b) if they did do it then the terms were so onerous that we'd be actually digging ourselves a black hole." (Third sector)*

In contrast, well-capitalised businesses have numerous finance options available to them. Mainstream banks and other financial institutions are keen to lend to them. In this environment, these firms are able to look beyond availability and compare different types of finance by other factors. In their decisions, cost (i.e. the total cost of the finance over the amount received) and speed (i.e. the time taken to fill in paperwork or the number of hoops to jump through to receive the finance) play a much larger role.

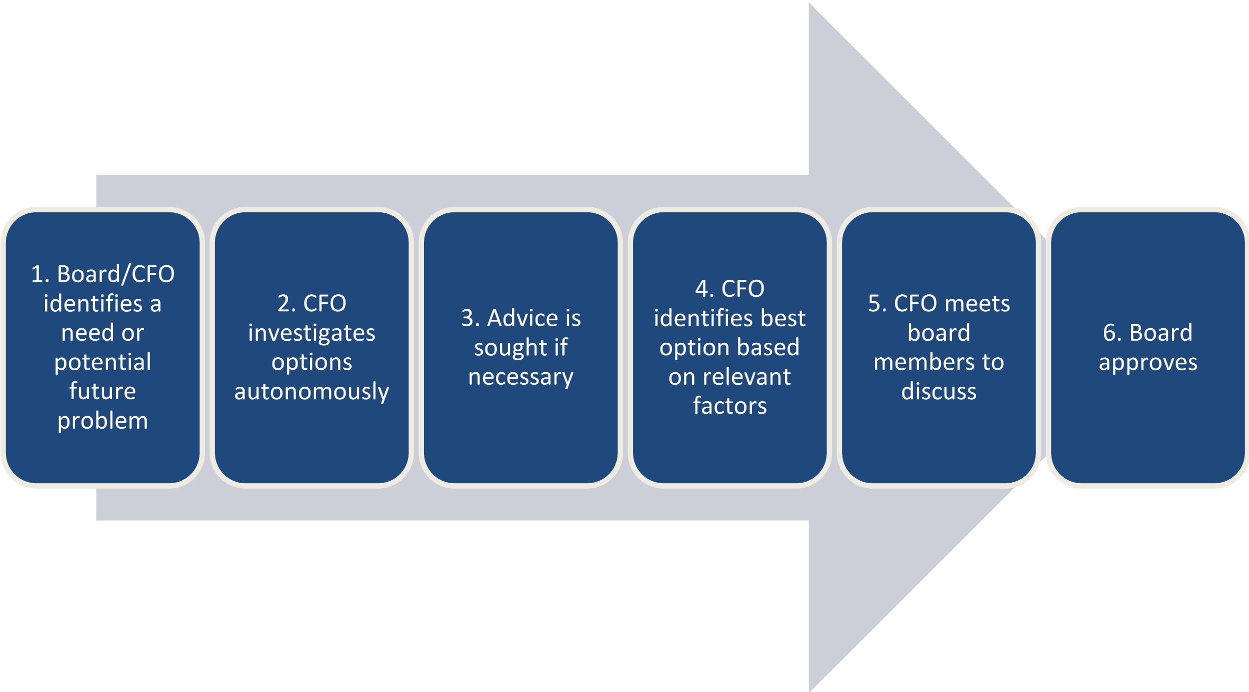
> *"Over the last few years we've been in the capital markets issuing long term debt because it's been the cheapest historical, long term rates, so it's a very strategic decision going back to, what, 50 year horizon. We don't need money right now. Not for two years, right, but we still went in the capital markets." (Large founder director or family run)*

In addition, many founder director or family-owned businesses are concerned about retaining equity and few are comfortable with relinquishing control to outside parties. Other factors such as tenor, fees or payback periods appear much less important in the mid-sized business market.

4.2 How decisions are made about obtaining finance

Across all types of mid-sized businesses, the decision-making process to obtain finance is broadly similar, as outlined in Figure 4.1 below.

Figure 4.1: The decision making process for seeking finance among mid-sized businesses



While the sequence of events remains the same, there are key differences in the formality of the decision-making and its openness to external advice.

Medium-sized founder director or family-run businesses (with turnover under £25m) tend to take a more informal approach, making decisions in a conversational manner with only verbal agreements to proceed. They also adopt a more insular approach to advice. These firms are more likely to trust their own gut instinct and consult only trusted peers.

In contrast, all other business types will seek advice from a range of sources e.g. banks, accountants, lawyers. They are more likely to make key decisions in board meetings and have procedures for signing off particular values of funding. In some cases, larger businesses also have risk committees to assess whether a particular source of finance exposes the business to any undue risk.

Case study 2 shows how the advice sought will often be a combination of both formal (banks, accountants, external experts) and informal sources (peers, colleagues, friends).

Case study 2: Seeking advice

- A limited company runs alongside a charity founded over 100 years ago. Its primary activity is education and it is currently loss making.
- It has a declining business model based on off-site learning. The trend in education is for on-the-job, virtual learning. To meet this challenge, it needs external finance to fund new delivery platforms.
- In reaching the decision to sell and leaseback its offices, the Executive Director consulted widely. He consulted two peers on credit committees at major banks who told him they would not lend or would offer very stretching covenants, and had a similar conversation with his own bank. He also spoke to accountants and two property companies for valuations and an idea of what deals may be possible.

4.3 Why mid-sized business seek finance

Mid-sized businesses seek finance for two reasons. Either they need to fund their working capital and are using finance to manage potential risks to the business, or they are looking to fund an investment in the business and grab an opportunity.

Working capital finance

Working capital finance tends to be used for:

- Paying wages or suppliers e.g. if there is a lag between when wages or suppliers need to be paid and when a customer pays an invoice;
- Paying other fixed costs e.g. rent; and
- A safety net for unforeseen circumstances e.g. having an overdraft in place should a business run into any difficulty.

Many businesses believe that working capital should be funded from within a business i.e. from retained profits. It is seen as good business practice by many. And those who are unable to fund their working capital in this way are seen by some as problematic businesses.

> *"Finance is expensive and none of us have seen anybody go bust who hasn't first financed their working capital…. If we found ourselves having to do that one day it would be a big eye opener that we've let something go wrong here and it's time to re-evaluate." (Medium founder director or family run)*

When it is not possible to fund working capital internally, the most common forms of external finance are overdrafts, invoice discounting or factoring, and occasionally director loans. These are discussed in more detail in sections 4.4, 4.5 and 4.7.

Investment finance

Investment finance tends to be used for:

- New equipment e.g. machinery;
- Acquisitions of other businesses;
- New premises;
- Moving into new markets e.g. investing in new factories or businesses overseas;
- Digital e.g. websites, online payment, new service or delivery platforms; and
- Restructuring the business e.g. realising the value of assets or property within the business

Unlike working capital, there is a general reluctance among businesses to fund investment internally. This is even the case among well-capitalised and cash-rich firms. Companies prefer to safeguard any available money 'just in case' of unforeseen circumstances. In some respects, this may be a sign of risk aversion among firms, having seen their business model threatened during the economic downturn.

> *"We're in a lucky position, we've got the funds that we can do it, we can put it down, but I don't permanently want to, I don't permanently want to tie the money up in the fixed capital, because who knows." (Medium founder director or family run)*

The only exception to this rule is the initial riskier stage of a new development, for example a new product or service concept that is unproven in the market. Some companies feel this should be funded internally because they think it unlikely banks or other external financiers would (or indeed should) take on this level of risk. However, it should be noted this is assumed rather than based on personal experience of being rejected for finance for this particular stage of a new project.

> *"We find an idea and we develop it and that is the riskiest part of film making… We understand that and so that's where we will use our own funds…. The next stage, the development capital, is when we go out and look outside." (Medium founder director or family run)*

The most common forms of external finance are hire purchase, leasing, secure loans or mortgages and private equity. Each of these types of finance are discussed in more detail in sections 4.4, 4.6, 4.8.

When working capital and investment finance overlap

For some firms, there is no distinction between working capital and investment. As such, there is no distinction between working capital finance and investment finance. This anomaly tends to exist within three particular business models:

Table 4.1 Three particular business models with no distinction between working capital finance and investment finance

1. Early or late-stage start-ups	▪ These firms focus solely on growth, whether market share or turnover, and this growth requires constant investment. ▪ These firms tend to be found in the fast-growing ICT and tech sectors.
2. Businesses who run individual projects	▪ These firms run a series of individual projects, each requiring new investment and without this investment, there is no on-going business. ▪ They tend to be found in the real estate and film/creative industries.
3. Businesses with a lag between large expenditure and payment	▪ These firms have large expenditure (e.g. paying interim staff in companies or equipment for a new customer) but can wait weeks or months for payment from customers to cover these expenses. ▪ External finance is often used to bridge this gap. ▪ These firms tend to be found in manufacturing and recruitment sectors.

Case study 3 details a business that falls into the second category – one whose business model relies on externally funded, individual projects.

Case study 3: Working capital is the same as investment

- A film production company (LLP) with a turnover of over £10m. Around 8% of this is profit. It currently makes films with up to £5m budgets but it is looking to progress to films with up to £10m budget.

- All profits are reinvested in ideas for new films i.e. the earliest, riskiest stages of development. But each new film made requires new, external investment; *"without finance, there is no business!"*

- Each film is funded by a mixture of hard finance (i.e. from private equity, individuals and film funds through IFAs) or soft finance (i.e. from film industry e.g. Film Four).

4.4 Loans

Loans tend to suit acquisitions, either of property or other businesses. Loans are sought primarily from banks and are used by more traditionally-minded companies. Banks are increasingly asking for guarantees and security against which to lend. For example, one firm was asked by a bank to pay £2m in cash for an overdraft facility of £1.5m. In another example, a director was asked by a bank to use his property as collateral for a loan of only £10,000.

> *"I need ten grand over two years, and I don't expect to have to put my house on the line. I expect this money to be there to actually help businesses, a business to grow… Banks will not give you money unless they know they can get it back from somewhere else."*
> *(Medium founder director or family run)*

In some isolated cases, a director may lend their own money to their business. Case study 4 below highlights one such example.

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Case study 4: Director's loan to fund working capital

- A family firm, set up in the early 1980s, sells mobile phone accessories with several branches around the UK. Over £15m turnover and around £150k profit (excluding director dividends).
- The margins for importing and selling accessories tightened three years ago and the Finance Director was forced to inject a director loan.
- The firm sought bank finance to replace this. They spoke to main bank provider and received a £800k loan at 2.5% above LIBOR over 10 years. Invoice finance was discounted as too costly – around £10k more expensive.

4.5 Overdrafts

Overdrafts are used primarily to fund working capital. They are seen as an extension of internal finance i.e. an extension of a business's current account. For many companies, overdrafts are a safety net and the facility remains untouched. However, their presence reassures directors that they are able to weather any potentially problematic circumstances in the future.

> *"We have an overdraft in place with Triodos, which has been there for nearly three years now. . . . We haven't actually used this yet. I think there was one day that we dipped into it. It was a precautionary measure when we needed help with cash flow. We did approach NatWest … and NatWest's approach was very bureaucratic … Triodos it felt like you were having a long-term supportive relationship."* (PLC)

Perhaps unsurprisingly, overdrafts are only sought from a company's main bank account providers. However, some firms report banks turning down or not renewing existing overdraft facilities. In many of these cases, banks have offered invoice discounting instead, perhaps in an attempt to secure some guarantees against which to lend.

Case study 5 shows the impact a withdrawn overdraft can have on a business.

Case study 5: Withdrawal of overdraft forces restructure

- A stationery manufacturing firm with a long history and turnover of c. £50m and profit of c. £2m. Sales have been declining as people turn to digital technology.
- There is an inherent lag in cashflow. Manufacturing occurs in Q1 but retailers only pay for products in Q4. High street bank provided a £5m working capital overdraft to manage this.
- In January 2013, the bank refused to renew the overdraft facility and encouraged asset-backed finance instead. However, there were no assets in the business on which to lend.
- The business explored potential overdrafts with other banks but all demanded huge fees. They were forced to restructure and the company is now over 80% private equity owned.

4.6 Leasing and hire purchase

Hire purchase and leasing are the preferred methods of funding large fixed assets e.g. machinery in the manufacturing sector. This type of finance offers several advantages over paying for assets directly. Mainly, it allows businesses to retain cash in the bank; reflecting well on its credit rating, but also enabling it to address any potential risks or grab any potential opportunities that may arise. Some businesses also believe that having cash in the bank makes it more likely banks will lend to them again in the future.

> *"If you buy the machine outright then you don't have the cash in the bank… You lose your buffer and two things, 1) your performance isn't as good, the bank won't lend to you again. 2) your asset, instead of being brand new is then two years old, the bank doesn't really want to lend on an old asset." (Medium founder director or family run)*

Leasing or hire purchasing finance is part of a revolving facility. For example, a company can borrow up to £2m at any one time on a range of assets. A range of providers are used for hire purchase or leasing, including the traditional banks, Lombard (a subsidiary of RBS) and Close. However, as explained in Case study 6, some businesses have found these providers less interested in lending smaller amounts.

Case study 6: Asset finance amount too small for large banks

- A group of waste management companies set up in the last 10 years with over £10m turnover.
- Its main bank account and invoice discounting facility are with a high street bank. It needed asset finance to buy £100k of attachments to delivery vehicles for new contract worth over £1m. The contract was contingent on acquiring these.

> *"[The bank] said that we were too small for them so we looked for other asset finance providers."*

- The Finance Director identified three alternatives. Two offered onerous conditions and wanted personal guarantees. He chose a particular company because it did not stipulate any conditions and specialises in smaller amounts.

> *"They were brilliant with us. It was a nice easy one for them. We had a three-year contract, put together business forecasts, we paid off the asset finance over two years and that created a good model for us."*

4.7 Invoice discounting and factoring

Invoice discounting and factoring appear to be increasingly common and may even have become mainstream types of finance. Banks seem to prefer the guarantees of invoices as they look for collateral against which to lend, especially to mid-sized businesses with turnover of £10m up to 25m.

> *"For a bank like HSBC or Barclays to extend finance to a company like ours, the only way they'd do it is on the basis of invoice factoring and invoice discounting." (Private equity – growing)*

Like overdrafts, invoice discounting and factoring are seen as an extensions of internal finance by those that use them. They are largely used for working capital rather than investment.

> *"In our mind we've got factoring available… It's still my working capital in my head." (Medium founder director or family run)*

However, some companies associate these financial instruments with struggling or badly managed businesses.

> *"Invoice discounting is the last chance saloon… It's harder to get out of… and it could turn nasty." (Medium founder director or family run)*

In some cases, people believe such facilities will reflect badly on their overall credit rating & 'bankability'. Invoice discounting and factoring are also seen by some as more costly & complex to administer than bank loans. Others question whether it is appropriate for a bank to be getting paid a fee to just collect some money.

> *"I mean the banks are quite happy to lend us money for all kinds of things, but not long term. They'll lend it to us short term, not the*

whole amount of money but they'll lend it to us. But then what they really want you to do is factor it, and we don't want to factor our debt, we don't want anybody holding part of our money and we don't want anyone taking fee for acting as someone else's banker, it's just a nonsense." (Medium founder director or family run)

4.8 Equity finance

Looking at equity finance, there is a large distinction between the views of businesses who have used equity finance and those who have not.

The majority of businesses do not use equity finance and their views of it are mostly negative. Private equity is seen by this group as:

- Too focused on short-term profits and not committed to growing sustainable businesses.

  "They come in like vultures and pretty quickly, from time to time, they can ruin companies. I've seen it happen." (Medium founder director or family run)

- Driven by numbers and reporting, meaning private equity does not understand the business or its performance.

- And, forcing firms to relinquish control of the strategy and operational decisions of the business.

For many businesses, the final point about ceding control is the most important. This size of business is often still run by those that originally set it up and they are used to making all the decisions themselves, as outlined in case study 7.

Case study 7: Views of private equity in a founder-owned business

- A print firm founded by two directors in 1960s. It acquired a competitor four years ago, buying it out of administration. The combined turnover is around £65m.

- The two founders are the sole directors – one focusing on sales, the other operations. Both are cash rich and should the business need it, would be able to inject cash into the business e.g. forgoing rent on the premises they own.

- Private equity is not appropriate for this business because the directors would never want to cede control:

  "These two guys have worked for 40 years to build it up, they're not going to do anything that risked control or risk losing it and that partly is the Venture Capital problem."

However, among those that have used equity finance, views are quite different. These companies are more pragmatic in their appraisal and see the benefits private equity can bring. It can give:

- Finance for businesses that have been turned down for finance from mainstream financial institutions.
- External expertise that may be lacking within the company.
- Finance for high-risk start-ups who have no alternatives.

  "As an early stage company, that was the only option really. So businesses like ours would not have got off the ground were it not for equity investment. The fact that we employ 220 people today, you could directly link back to that investment." (Private equity – growing)

- The ability and experience required to float a business.
- And, for struggling businesses, a much needed focus on growth and profit.

Case study 8 highlights the benefits private equity can bring when traditional finance routes are not available.

Case study 8: Equity finance for investment

- An exclusive designer shoe, bag and accessories retailer with over 30 stores was founded in the 1990s. It currently has 250 staff and a turnover of £25m.
- It has grown significantly in past few years by carefully targeted acquisition of stores in areas that attract high net worth customers.
- It raised capital from consortium of private individuals, who put in over £2m over five years. One of the consortium sat on the board.
- Its main bank was not prepared to lend that amount given the business was only worth £4m at the time. However, its private equity backers were paid back early because of success of the business since.

As a form of equity finance, mezzanine is not widely used. Most mid-sized businesses are aware of it but it is not seen as mainstream. Many see mezzanine as only applicable to large amounts of money, for example £5m may be deemed too small an amount. Those with greater knowledge of it also have reservations about it as a particularly expensive debt with a large number of stretching covenants and restrictions.

Case study 9 shows how one firm has decided to seek private equity in the next few years rather than mezzanine finance.

Case study 9: Preference for private equity over mezzanine

- A manufacturer of car and truck gear boxes and turbo chargers with a long history has a turnover of over £50m. It is currently working with well-known car manufacturers and has a joint venture in South East Asia.

- Finance is essential to the business as every new product or contract needs new equipment, mainly bought on hire purchase. The board is considering taking on some private equity in next few years as a way of taking the business further, beyond current levels of profitability.

- The board recognise the burden this may bring i.e. lost equity and loss of control. But they value the outside thinking it will bring and questioning of their strategic decision-making.

- The board are familiar with mezzanine finance but see it as expensive (interest rates) and risky (stretching covenants). It may be fine for stable businesses but only as a last resort (which stable businesses shouldn't find themselves in!).

5. Difficulty obtaining finance

For most businesses within this research, obtaining finance has not been difficult. Indeed, all of those interviewed have been successful in securing finance in the previous 12 months. However, even among this group, many mid-sized businesses have experienced difficulties accessing finance. This is especially true of those with lower turnovers of £10m to less than £25m, those with no proven track record (of a new product, service or market), with minimal assets (e.g. start-ups) or who are currently making a loss (e.g. they may be chasing market share).

As Case study 10 shows, a lack of available finance can even dictate the whole business model of some companies.

Case study 10: Unable to obtain finance

- An engineering/manufacturing firm sells bespoke oil and fat filtration systems to fast food chains, restaurants and pubs. One director personally owns the patent to the equipment.
- In the current business model, machines sell for £300k but success relies on customers expanding outlets, which means "we're only as good as our last sale".
- Directors want to build value in the business by leasing equipment for a monthly fee over 25 years but no banks or private equity are interested in funding this. They see the equipment as "debt in transit" i.e. an asset that is not under the control of the company.
- The company has been trying to obtain finance for 5 years but is caught in a vicious circle. Because there is no value in the business, it can't obtain finance to build value in the business.

Many mid-sized businesses report that banks have become very risk averse. It is felt banks are currently unwilling to lend without some sort of guarantee. These may be personal guarantees (e.g. a director's home as collateral) or the increased use of invoice discounting / factoring. A reluctance or inability to meet these guarantees means many businesses are forced to seek alternatives. These may be specialist asset-backed lenders, private equity or foreign banks that specialise in particular sectors (see section 6).

In contrast, well-capitalised or asset-heavy businesses are not experiencing difficulty obtaining finance. However, these firms tend to not need much external finance beyond basic overdrafts and leasing/HP or less frequently, loans for acquisitions.

> *"Borrowing is cheap so it's a no brainer really… We don't have any problems getting finance." (PLC / Large group)*

6. Relationship with banks

As discussed throughout section 4, for most financial needs, banks are the first port of call for mid-sized businesses. This is the case whether businesses are seeking finance for working capital or investment. And the banks used by most companies tend to be traditional high-street names such as HSBC, RBS, Barclays and Lloyds TSB (as it was named during this research in the summer of 2013).

Most businesses have a lead banking relationship. This is the bank that operates the everyday banking and current account side of their business. These relationships are established over a number of years. Having the same bank for 10-20 years is not uncommon and some relationship stretch back hundreds of years.

> *"The main bank is XXX, and it's funny when everyone asks how long's the relationship. The relationship goes back 340 years… We are the longest serving relationship to XXX" (Large founder director or family owned)*

For most businesses, the ideal relationship is with a single, traditional high-street bank. Being backed by one of these conservative institutions legitimises the business as robust and sustainable. It also makes the day-to-day administration of a company's finances far less burdensome.

> *"I've got three UK bank accounts, which is a pain … because you're constantly moving money between accounts, we [have] got different customers paying into different accounts, and it's an overhead and a hassle for the finance team. What you want is really a unified relationship, where you've got all that day to day stuff, plus you've got an overdraft or a term loan, or something of that sort [with one bank]. But really, we as a business are a few years away from being on a sound enough footing to have that sort of a relationship." (Private equity – growing)*

However, at the same time, almost all businesses dealt with more than one bank.

> *"We actually have three bank accounts. [RBS, HSBC, NatWest] … I think ultimately we are going to try and put this under one roof, it's just that [the owner of the business] banks with HSBC for the American stuff and NatWest for the UK stuff, and because obviously NatWest's representation in the States presumably is not as good as it could be." (Medium founder director or family owned)*

Different banks serve different purposes and there are several reasons why businesses choose to have multiple banking relationships:

- **Funding** - the main reason for additional relationship is that businesses have decided to (or been forced to) seek funding from alternative sources to their main bank.

> *"[Aldermore Bank, Securitrust, Shawbrook Bank and others – the new current crop of challenger banks, not constrained by Basle III] - are the ones pushing growth at the moment. They have relatively clean balance sheets and can increase volumes." (Private equity - growing)*

- **International reach** - some banks only cover the domestic market and global banks are needed for conducting business overseas or in different currencies.

  "[As well as Triodos Bank], we do also do some banking with NatWest because they just can't handle the foreign exchange." (Large group / PLC)

- **Legacy** – original banking relationships or links to old/acquired businesses have been allowed to persist and have not been closed down.

  "We do actually have three bank accounts …But the main bank is actually NatWest. Which is all changing because of we're getting rid of (a founding director) so we're going away from her preferred bank to the banks that we're going to be using. I think ultimately we're going to try and put all this under one roof." (Medium founder director or family owned)

- **Reduced exposure** – businesses feel that diversification reduces reliance on a single banking partner and provides them with greater security.

  "Half of our funding came from one bank, which is really not a good place to be in if that bank was in trouble… So I diversified away from XXXX, so now our funding there is only £500m, but our funding has grown from £2bn to £4.4bn, so as a percentage, so we've halved the amount with XXXX but we've increased our exposures to lots of other sources of financing, and now it's only 12%. But it's still our main bank." (Large founder director or family owned)

Among these secondary banks, mid-sized businesses are increasingly turning to new challenger banks to meet their funding needs. Firms turn to these banks either because are more willing to lend against different business models (e.g. start-ups, innovative tech firms, high-growth firms), they offer a superior service (in particular in the form of a relationship manager with greater authority and discretion to lend) or they offer products that meet the needs of that business.

Examples of these new challenger banks include:

Table 6.1: Examples of new challenger banks	
Product specialists	Triodos Bank Make your money make a difference Triodos specialises in financing institutions and projects that benefit society and the environment (e.g. fairtrade coffee producer).

Superior service (including relationship managers)	Handelsbanken Handelsbanken offers an experienced bank / relationship manager with discretion to lend, only dealing with businesses within short distance of branch. Others use this bank for property or private banking.
Specialists willing to lend	SHAWBROOK aldermore invoice finance svb Silicon Valley Bank SECURITRUST Shawbrook, Aldermore and Securitrust are all based in the US and offer asset-backed lending. SVB is a specialist lender for innovative and start-up IT/digital companies e.g. SAAS.

Case Study 11 below explains why a business may need to start a relationship with a new challenger bank.

Case Study 11: New challenger bank

- An e-invoicing business founded around ten years ago, SAAS (software as a service) business. It has a private equity and venture capital structure with over 100 shareholders. It is growing 30-40% pa and is currently breaking even.
- The firm is constantly investing to increase its share of a relatively new market i.e. in platforms (usability), new territories, staff and complementary services
- Its business model is unattractive to high street banks who prefer cash in the bank and wouldn’t offer invoice discounting because invoices are for services not yet delivered.
- The business sought finance from Silicon Valley Bank – a specialist in dealing with SAAS and understands their business model – and obtained an invoice discounting facility of over £2m.

INCREASING THE FLOW OF FINANCE

IMPROVING CHOICE AND AWARENESS

SUPPORTING GROWTH

SIMPLIFYING ACCESS

WORKING WITH THE MARKET

BUILDING FOR THE LONG TERM

The British Business Bank programme is currently run directly by the Department for Business, Innovation and Skills and is not authorised or regulated by the Financial Conduct Authority or the Prudential Regulation Authority.

Once HM Government has received European Commission State aid clearance, which is expected in 2014, this programme will be transferred in its entirety to the British Business Bank plc, which will operate as a Government-owned financial institution.

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