

# EXECUTIVE SUMMARY

The UK has enjoyed seven quarters of economic growth with forecasters suggesting this will continue, despite continuing global downside risks. This is reflected in the increasing and evolving appetite for finance among smaller businesses.

The importance of smaller businesses to this recovery is paramount, accounting as they do for almost half of turnover in the private sector and 60% of all employment. Increasingly, these companies expect to grow: our new 2014 SME Journey Survey found that 46% intend to grow turnover in the next year, suggesting there is optimism about future prospects.

The government established the British Business Bank to bring together a number of programmes that have played an important role in unlocking finance for smaller businesses. Our Strategic Plan, published in June 2014, provided information on all those programmes. The stock of lending and investment provided by British Business Bank programmes stood at £2.7bn as at end of September, with over 38,000 businesses supported.

But as the economy continues to recover the financing needs of smaller businesses will grow, and structural issues remain in the supply of finance, suggesting there is more to be done.

This report seeks to capture the current state of the changing market for small business finance and to highlight the environment in which the British Business Bank is operating.

## More smaller businesses will seek finance for growth

**As smaller businesses seek to grow, and investment begins to pick up, the demand for finance is likely to revive**

External finance is important for funding business start-ups, investment and growth despite being used by a minority of businesses. With OBR forecasts showing investment growing at an average rate of 6.7% over the next four years, access to appropriate sources of external finance will be essential for start-ups, growth firms, and viable but underfunded businesses alike.

In the UK, smaller businesses account for a smaller share of total business investment (38%) than in other major European economies. But, evidence from our new SME Journey Survey suggests that demand for finance is likely to increase in the future.

## Use of finance has been shifting from working capital to funding fixed assets

New evidence shows that the profile of demand for finance changed between 2012 and 2014. While 45% of businesses who sought finance two years ago did so to fund working capital, that figure fell to 33% this year. Now 43% of those seeking finance are looking to purchase fixed assets (up from 33%). The proportion seeking funding for expansion also increased to 11% from 6% in 2012.

## For businesses with high growth potential, gaps remain in the supply of finance

Many smaller businesses seeking to grow will succeed, but many will not. For example, over 40% of new business close within three years of starting up. For some of those with the potential to succeed, traditional loans and overdrafts are not suitable for all their financing needs. This underlines the importance of continued diversification of the range of financial products used by smaller businesses, reflecting

the growth and risk profiles of individual businesses. These products are likely to be supplied by many providers including banks, other existing providers and new entrants.

Access to growth capital for high growth potential businesses matters. New private equity market data collated for the British Business Bank & BIS finds that visible equity investment in SMEs increased from £1bn in 2010, to £1.6bn in 2013 due to strong seed and growth activity, with more deals unreported. However the evidence suggests that the well-known equity gap persists, especially at the venture stage.

Private debt funds also fund growth but they generally aim to invest in lower risk companies than equity or venture funds. Nonetheless, they are still a source of support for growing businesses. There are a limited number of these funds investing in smaller businesses due to a number of structural market failures. Mezzanine finance may also help to fill the gaps between senior debt and pure equity finance for growing firms, but market gaps exist in this area.

The increase in investment has also been reflected in asset finance markets - with an estimated £13bn of gross flows of asset finance to SMEs in 2013. But specific market failures exist, as well as potential imperfect competition in funding markets, which may act to constrain supply.

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## A more diverse and vibrant supply of finance is needed

### Traditional bank lending remains the predominant source of finance in the UK

The majority of businesses are able to access finance for their day-to-day needs without difficulty, but this disguises the fact that supply of finance to young and growing firms is constrained. This is due to structural information failures and lack of diversity of supply.

As shown on page 9, flows of bank lending are much larger than other forms of finance. The recession saw a tightening in credit conditions which disproportionately affected lending to smaller businesses. And while the decline in traditional loans and overdrafts to SMEs has slowed, any recovery is tentative.

### A wider range of finance sources would offer more options to smaller businesses

Challenger banks have entered the market in recent years, but lending to SMEs is still concentrated. In addition, refinancing SME loans through capital market techniques, including securitisation, could play a role in increasing the supply of finance to SMEs in future.

### New sources of finance which serve to improve diversity of supply exist and are growing, but from a low base

Online technology has enabled the emergence of Fintech companies, an example being Online Platforms (e.g. peer-to-peer lending and crowdfunding platforms), with lenders and investors able to meet the finance demands of small businesses in innovative ways.

Business financing through those platforms has grown significantly, with recent research from Nesta-University of Cambridge indicating that gross financing will total around £1.7bn this year, a 161% increase from 2013.

However it should be noted that this is exponential growth from a low base and the footprint of Online Platforms remains very small compared to more established forms of finance. Current volumes on these platforms are less than 2% of bank lending.

Despite their current small scale, these platforms also have the potential to diversify small business finance markets, by competing on non-price aspects.

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## Awareness and understanding of the range of finance options is not yet comprehensive enough

### Awareness among smaller businesses of the full range of external finance options is limited

Most small businesses are not aware of the full range of external finance options. This varies significantly across different types of finance. 85% are aware of leasing or hire purchase, but the figures are much lower, although rising, for alternative funding sources, with 32% aware of crowdfunding and 35% aware of peer-to-peer lending.

### Discouragement is still an issue for a significant number of smaller businesses

While businesses are beginning to view finance as less difficult to obtain (26% viewed it as very difficult in 2014 compared to 43% in 2012), there remains a gap between perceptions of the chances of obtaining finance and actual approval rates. The proportion of businesses discouraged from applying for finance remains significant and recent data from the SME finance monitor suggested the number of SMEs in this bracket could be as large as 160,000.

Furthermore, evidence suggests that smaller businesses fail to sufficiently shop around or plan ahead when seeking finance – potentially limiting their ability to obtain finance.

### Conclusion

In summary, the market analysis presented in this report confirms the continued importance of the strategic objectives of the British Business Bank. The following table relates the main themes identified in the report to the objectives and key performance indicators of the Bank.

Report theme	British Business Bank Objective	KPI
More smaller businesses will seek finance for growth as the economy recovers. Demand will grow and gaps remain in the supply of finance	To increase the supply of finance available to smaller business in areas where markets do not work well	Up to £10bn stock of finance facilitated through our programmes over 5 years Clear demonstration that activities are focused on market imperfections
A more diverse and vibrant supply of finance is needed – offering more choice of suppliers and products to small businesses	To create a more diverse finance market for smaller businesses	Over 50% of finance facilitated through providers other than the 4 largest banks over 5 years Clear demonstration that a broad range of options and providers has been supported
Awareness and understanding of the range of finance options is patchy with some small businesses discouraged from applying	To help ensure better provision of information in the market connecting smaller businesses and finance providers	Evidence that information about finance options has improved