BRITISH BUSINESS BANK

# SMALL BUSINESS FINANCE MARKETS

2015/16

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# CONTENTS

# FOREWORD

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The British Business Bank has a clear mission: to change finance markets for smaller businesses, so they work more effectively and dynamically. By doing so, we play our part in supporting wider efforts to increase the UK's productivity and long-term growth. This, our second 'State of the Market' report, shows how those finance markets for small businesses have developed over the past year, and the progress we have made in achieving our ambition.

Working with over 80 finance partners, we aim to unlock finance for smaller businesses in three ways: by increasing existing sources of finance; by catalysing new channels of funding; and by improving smaller businesses' understanding of their finance options. By doing so, we help stimulate competition and increase the chances that businesses find the right sort of finance for their particular stage of development. Importantly, where we act is informed throughout by an in-depth understanding of the finance markets, as well as a thorough analysis of how these businesses contribute to the UK economy.

This report is therefore vital in guiding our work. It underlines again the fundamental importance of small businesses in the UK economy and, with the appropriate finance and support, the potential they have to raise the UK's productivity and growth performance. In that regard, I am pleased to see encouraging signs across a broad range of finance markets. As the recovery has continued and balance sheets have been strengthened, bank lending is gradually improving, with more firms getting the finance they asked for. Asset finance has seen solid expansion over the past year, and equity deal flows are strong. And as has been well documented, the UK's peer-to-peer sector is growing rapidly, building on the UK's leading position in the area of financial technology.

Through a range of well-judged interventions, the Bank has played its part in developing these markets. Examples are our support of equity investors through our investments in early stage venture capital, so important for innovative businesses with high growth ambitions; our new ENABLE product that encourages participating banks to lend more to smaller businesses; and our Investment Programme which has provided funding to peer-to-peer lenders and other marketplace lenders. While these are all positive, we fully recognise there are areas of the market that still require attention.

One priority for the Bank is to ensure that effective finance solutions are available for innovative businesses wishing to scale-up. To support those ambitions, we are working with private sector delivery partners to roll-out the innovative 'Help to Grow' pilot. A further priority is regional growth. As the report shows, there are regional imbalances to the finance landscape. Our research demonstrates that no one region has a monopoly on growth businesses: smaller businesses with growth potential exist in all regions of the UK. To ensure that finance is available for such firms, we are delighted to be supporting the new £400million Northern Powerhouse Investment Fund.

Awareness of the range of finance options is important too, so businesses know where to get the right finance for them. Whilst levels of awareness have improved, in particular for newer types of finance, it is striking that over half of UK smaller businesses still go only to their main bank and do not shop around for finance. We will therefore continue to work with our partners to promote the successful 'Business Finance Guide', an excellent resource for financing options, and will finalise our advice to HM Treasury on the designation of new finance platforms, through which smaller businesses declined facilities by their banks will be referred to alternative providers who may be able to help.

I believe that alongside our existing programmes, these new initiatives will deliver further improvements in the UK's finance markets, making them more dynamic and diverse. I look forward to working with our partners and the small business community to put these in place.

# EXECUTIVE SUMMARY

This report highlights the continued importance of smaller businesses to UK economic growth and the recent evolution of the finance markets that support those businesses.

Encouragingly, flows of finance to smaller businesses have increased since the British Business Bank's previous Small Business Finance Markets report last year. However, our analysis finds that structural problems persist. The continued importance of the British Business Bank's objectives in addressing these issues and unlocking finance for smaller businesses remains clear. We will continue to:

- Increase the supply of finance available to smaller businesses in areas where the markets do not work well
- Create a more diverse finance market for smaller businesses
- Help ensure better provision of information in the market connecting smaller businesses and finance providers

Our understanding of finance markets for smaller businesses as presented in this report will be used by the Business Bank to help refine our strategy and to further support smaller businesses achieve their ambitions.

## SMALLER BUSINESSES ARE ESSENTIAL TO ADDRESSING THE UK'S PRODUCTIVITY CHALLENGE

The UK economy has continued to perform well relative to other developed nations, and although risks remain, central annual growth forecasts are 2.2% for 2016. This expected growth has supported business sentiment over the last year – the majority of smaller businesses have said that they are confident about growth, with around 56% intending to grow in 2016.

Behind this positive recent performance lurk long-term challenges for the UK economy, most notably the importance of raising productivity. UK productivity lags those of its G7 peers and by focusing on this area of relative weakness an opportunity exists to convert growth into rising standards of living. As SMEs employ the majority of the UK private sector workforce, creating a dynamic smaller business sector is critical to enhancing national productivity.

What is clear is that the rate of entrepreneurial activity is high: the UK has seen remarkably strong rates of new business (start-up) formation in recent years. There were around 350,000 new enterprises registered in 2014 and the UK now has a record population of 5.4 million smaller businesses. However, that is counterbalanced by the fact that fewer UK smaller businesses have made the leap to materially grow (scale-up) than similarly sized businesses elsewhere. The UK is near the bottom of OECD tables of the percentage of start-up businesses that grow to more than 10 employees after three years.

Research has shown that successfully increasing the number of firms that scale-up would substantially impact job creation, productivity and growth. Therefore, it is a priority to understand what is needed for a more supportive and cohesive ecosystem that enhances the capability and ambition to grow amongst high potential smaller businesses in the UK.

The British Business Bank will focus more of our attention and resources towards finding effective financing solutions for smaller businesses to allow them to scale-up and achieve their growth ambitions.

## FLOWS OF FINANCE TO SMALLER BUSINESSES HAVE IMPROVED. HOWEVER, SIGNIFICANT GAPS IN THE MARKET REMAIN.

At an aggregate level, flows of both debt and equity finance to smaller businesses grew in 2015 showing that finance markets have improved. Notably, after several years of contraction, net bank lending to smaller businesses has increased for four consecutive quarters. Asset finance has also continued to grow strongly. Alternative finance business lending, though still less than 3% of gross lending, grew by 75% to £1.26bn in 2015.

While the overall market has undoubtedly improved, our detailed analysis indicates that weaknesses and structural imperfections persist in specific areas of the market. Evidence suggests that a material portion of smaller businesses who apply for finance are still rejected as a result of problems in small business finance markets. This reflects the likelihood of information asymmetries between borrowers and lenders where it may be costly or difficult for lenders to secure the information they need to make an informed investment decision, as well as other structural issues. It applies to small businesses at all stages of development, whether they are starting-up, scaling-up or seeking finance to stay-ahead in their particular area of the market.

The British Business Bank will continue to refine our programmes designed to address this gap, notably through our long-running Enterprise Finance Guarantee programme which helps viable smaller businesses who lack sufficient collateral to borrow.

Even with an increase in the availability of finance nationally, our research shows that local distribution is uneven. In particular fewer equity deals occur for smaller businesses located in regions outside of London and the South East than inside. Given that finance is vital for growth, this can only entrench regional differences and stymie efforts to rebalance national economic activity.

The British Business Bank will help address this weakness through our targeted regional efforts, such as our support for a new £400m Northern Powerhouse Investment Fund.

## FINANCE FOR START-UPS CONTINUES TO BE IMPORTANT BUT INCREASING ACCESS TO CAPITAL FOR HIGH GROWTH SMALLER BUSINESSES IS AN EMERGING PRIORITY

Rejection rates for start-ups seeking new loans exceed 50%, in part reflecting lenders' difficulty in accurately assessing the viability of smaller businesses with limited track records and in part reflecting the inability of very new businesses to make regular debt repayments. While friends and family remain the most common funding source (used by 34% of start-ups), not all entrepreneurs with good ideas have equal access to this kind of social and financial capital.

The British Business Bank remains committed to expand the number of Start Up Loans in order to continue to address the structural disadvantage that some of the UK's newest businesses face in securing finance to maximize their potential.

For smaller businesses looking to grow rapidly, equity finance is often the most appropriate funding to drive their growth during the most risky periods of their development. Equity investors are typically more active than lenders in the day-to-day operations of the business and are prepared to take on higher levels of risk. Increasing equity flows therefore can play a useful role in improving smaller businesses' ability to scale-up.

Markets for this type of funding have improved, with seed stage equity flows growing 48% p.a. since 2012, and UK equity providers investing a healthy £2.2bn a year in 2014. Nonetheless, the UK early equity market remains a fraction of the US market which is seven times larger than the UK market as a share of GDP and surveys show that many entrepreneurs for whom equity might be most appropriate remain averse to taking on external equity.

This ongoing disparity emphasises the British Business Bank's commitment to maintain and expand our early stage equity interventions – both the Angel Co-Fund and the Enterprise Capital Fund – to continue to address this area of under-development. We have also supported the establishment of funds through our VC Catalyst Fund.

Once established, high growth potential small businesses often require additional external finance to achieve their aspirations. Although, flows of UK venture and growth capital increased in 2015, there is not a firmly established market for debt-based growth finance in the UK market. Long-standing information asymmetries remain where a business's past is not an accurate reflection of its future potential. This makes it more difficult for firms with high growth potential to obtain enough debt finance to realise their potential.

The British Business Bank will help address this situation through the planned pilot of our new Help to Grow scheme targeted towards high growth smaller businesses in 2016.

This situation can be exacerbated where a smaller business is seeking growth via exporting to new markets and thus requires more complex finance. As our work with Goldman Sachs last year demonstrated, exports are particularly significant because internationalisation is often associated with higher productivity; yet UK smaller businesses lag behind France and Germany in terms of the propensity of SMEs to export.

The British Business Bank is working with UK Export Finance to help identify unmet finance needs of small business exporters and to coordinate offerings to better address gaps.

In contrast, the availability of finance for mid-cap businesses (businesses with £25m-500m turnover) has improved markedly. The European leveraged loan market has grown from €28.5bn in 2008 to €80bn in 2015 reflecting the inflow of institutional funding in recent years. Our survey also finds mid-cap businesses reporting relatively little difficulty in obtaining finance.

The British Business Bank will review our current portfolio of mid-cap exposure to determine whether our continued support is required.

## THERE IS STILL LIMITED DIVERSITY IN THE SUPPLY OF SMALLER BUSINESS FINANCE SO NEW PROVIDERS AND NEW PRODUCTS NEED NURTURING

The preliminary findings of the Competition & Markets Authority retail banking market investigation indicate that the four largest UK banks had a combined market share of 80% for general-purpose business loans, excluding peer-to-peer lending, in 2014. Diversity of supply of traditional bank lending is clearly limited, but we believe that increasing the diversity of choice goes beyond just traditional bank lending.

Other channels provide appropriate finance for the range of small business needs, and there are tentative signs that the market is shifting. Use of asset and invoice finance is increasing. Financial innovation and new delivery channels give smaller businesses more choice of products and how to access them. The range of finance providers is also growing with new challenger banks and technology-enabled online lenders entering markets. These grew rapidly in 2015, but from low bases, and so are still small on an absolute scale.

Although we have seen positive momentum in terms of market diversity, some new entrants face structural disadvantages when offering small business loans relative to incumbents related to funding costs and capital efficiency, slowing down their development. More time and further nurturing of the market is needed before these newer offers become everyday alternatives for smaller businesses of all sizes across the UK.

The British Business Bank will help improve diversity of supply of finance for smaller businesses by expanding our support for challenger banks, non-bank debt funds, online platforms, invoice and asset finance providers. Our ENABLE programmes have now supported over £225m of lending and our Investment Programme has committed £353m of support to these growing participants.

## REAL DIVERSITY AND CHOICE IN SUPPLY WOULD BE ACCELERATED BY GREATER AWARENESS OF, AND CONFIDENT DEMAND FOR, FINANCIAL ALTERNATIVES

Awareness of the range of finance options has risen amongst smaller businesses, in particular for newer types of finance and providers, including peer-to-peer lending (up from 24% in 2012 to 40% in 2015) and crowd funding (up from 13% to 49%). Awareness of alternatives is affecting behaviour as well, with the percentage of smaller businesses who contact only one provider having fallen from 71% in 2012 to 66% in 2014 and now 61% in 2015.

But even with recent improvements, over half of UK smaller businesses immediately go to their main bank when they first identify a financing need and do not shop around for finance. It is clear that more can be done to increase small business engagement with the market. For example, only a minority of smaller businesses use external advisors when applying for finance.

This emphasises the importance of the British Business Bank's commitment to improving the understanding of finance options amongst smaller businesses in the UK. We continue to collaborate with partners such as the ICAEW to develop and distribute information guides to smaller businesses and with HM Treasury to implement new information-based interventions such as the referral of rejected smaller business applicants to new finance platforms.

# INTRODUCTION

This is the second annual British Business Bank report on Small Business Finance Markets, setting out the latest evidence on the ways in which finance markets support smaller business and help them contribute to improving productivity and growth in the UK economy[1].

Our understanding of smaller business finance markets, both in terms of smaller business demand for finance and the finance providers' supply of finance is essential in shaping our business planning and the design of our programmes and products.

The Business Bank aims to support businesses, whether they are looking to start-up, grow to the next level or stay ahead of the competition. Therefore, this year we have focused on the different market segments that the Business Bank seeks to serve, namely Start-Up, Scale-Up and Stay Ahead firms.

## NEW EVIDENCE

As well as drawing on established data sources, the British Business Bank looks to add to the evidence base by bringing new evidence to the debate on smaller business finance markets. In particular:

- The Customer Journey survey from 2012 and 2014 has been refreshed and run again in 2015 to give fresh insight into smaller businesses experience in accessing finance
- New calculations have been produced using data from the SME Finance Monitor to investigate rejection rates for core bank lending products
- The Business Bank has commissioned updated private equity market data from Beauhurst which focuses on visible smaller businesses external equity deals

This report also draws on the evidence gathered for the recent report "Unlocking Productivity Internationalisation and Innovation in SMEs" on which the British Business Bank collaborated with Goldman Sachs and the Enterprise Research Centre.

Chapter 1 provides an overall assessment of the small business finance markets, reviewing developments on both the demand and supply sides of the market to assess whether, as the economic recovery continues, finance markets are improving.

Chapter 2 looks at the market for finance for start-ups in more detail, recognising the additional difficulties these firms encounter in raising finance.

Chapter 3 presents an analysis of external finance sources that are appropriate for growing firms that are looking to scale up rapidly, with a focus on debt funds and equity markets. The role finance plays in helping small businesses export, the experience of mid-cap businesses and the role of long-term finance are also explored.

Chapter 4 considers take-up of finance that is used widely across all the Business Bank market segments such as asset finance and alternative finance. It then looks at the latest evidence on the diversity of supply of finance and the rise of the challenger banks.

CHAPTER ONE

# OVERALL ASSESSMENT OF MARKET DEVELOPMENTS

Chapter 1 provides an overall assessment of a number of smaller business debt and equity finance markets, reviewing developments on both the demand side and the supply side of the market to assess whether, as the economic recovery continues, finance flows are improving.

The overall picture, set out in section 1.1, is an encouraging one with flows of finance to smaller businesses increasing across a wide range of financial products.

However, there is a still unmet demand for finance from smaller businesses. Section 1.3 presents a new approach to calculating the value of rejected applications for traditional banking products. We will be developing this methodology to increase our understanding of the market for small business finance and welcome input from interested parties.

Section 1.4 looks in more detail at the demand for finance from smaller businesses. Good progress continues to be made in awareness of finance products amongst smaller business, although the evidence suggests increased information about the suitability of specific products and how to apply for them would increase effective demand.

Subsequent sections look at developments in the main bank lending (section 1.5) and equity finance markets (section 1.6). These are used by smaller businesses across all three of the market segments used by the Business Bank. Bank lending has shown further signs of recovery in 2015 compared to previous years. In equity finance there has been strong growth in 2015. Other products are explored in more detail in subsequent chapters.

The chapter concludes with regional analysis of smaller businesses and finance flows (section 1.7). This evidence provides support for Business Bank involvement in supporting provision of finance in regions.

Despite the positive developments in smaller business finance markets structural problems remain that demonstrate the need for the Business Bank's continued role. These structural problems result in finance markets not functioning effectively, with an allocation of finance to smaller businesses at less than optimal levels, resulting in lost output and growth. The structural problems arise in a number of ways.

### 1. Information problems between small businesses and finance providers

Lenders or investors need information on smaller businesses to make sound investment decisions. Information asymmetry between business and finance providers necessitates costly due diligence in advance of any deal; this cost is relatively fixed, meaning it accounts for a greater share of smaller deals, which drives funds toward larger deal sizes and larger/less risky firms. In the case of start-ups, lack of track record makes it even more difficult for finance providers to assess the riskiness of the finance sought by small businesses.

Smaller businesses may also lack information that is needed for them to understand the financial products available to them and how to access them.

### 2. Market competition

Lack of competition between market participants may prevent markets operating effectively. This may lead to a lower availability of finance, or a rise in the price of finance resulting in less finance being provided to smaller businesses.

### 3. Spill-overs

These arise from the difference between private and social returns to investment. Investment generates positive externalities, or spill-overs, to the rest of the economy in the form of innovation or knowledge transfer. These spill-overs are particularly significant for smaller firms, which find it more difficult to appropriate the value of their new knowledge, and high-tech firms, which rely more on innovation for their profitability.

The external benefits are not taken into account in the decision-making of private investors. This results in an under-provision of equity finance in societal terms, to projects which do not offer sufficient returns to private investors but generate significant social benefits.

### 4. Unintended consequences of regulation

The introduction of regulations or other government interventions may have unintended consequences leading to inefficient outcomes in markets. For example, whilst regulations designed to improve financial stability are required they may raise the cost of finance resulting in less use of finance by smaller businesses.

It is important to recognise that in many cases businesses inability to obtain finance does not represent a problem in the market.

1.1

# AGGREGATE FLOWS OF FINANCE TO SMALLER BUSINESSES ARE ENCOURAGING

- Net flow of 'core' banking lending products turns positive
- Other types of finance show strong growth
- Usage rates amongst SMEs has stabilised

This section brings together the latest data from a range of sources on the volume and value of various types of finance provided to smaller businesses. Consistent and comprehensive data outlining the value of the aggregate stocks and flows of all forms of external finance to smaller businesses is not readily available however the table provides a reasonable snapshot of the situation.

While flows of different types of finance are not directly comparable, the data shows that bank lending remains the single largest form of external finance for smaller businesses, albeit with other forms of finance continuing to increase their share.

## NET FLOW OF 'CORE' BANKING LENDING PRODUCTS TURNS POSITIVE

The net flows of bank loans (new loans, excluding overdrafts) has turned positive with four consecutive quarters of growth totalling £1.6bn through to Q3 2015. This suggests a recovery in net lending, however the improvement in credit availability is less pronounced amongst smaller SMEs and driven by improvements in new finance flows to medium-sized businesses.

The stock of bank loans and overdrafts was estimated at £163bn at end of November 2015, reflecting a decline in the value of loans whilst overdraft levels were more stable.[2]

## OTHER TYPES OF FINANCE SHOW STRONG GROWTH

More positively, data commissioned by the British Business Bank shows that the value of new equity deals with known amounts grew to £2.2bn in 2014, and expanded further in 2015 with nearly £2.4bn in the first three quarters of 2015, continuing the strong upward trend since the data series began in 2011.

FIG 1.1

## ESTIMATES OF THE FLOWS OF SOME TYPES OF EXTERNAL FINANCE FOR UK SMES [A]

| | | 2011 | 2012 | 2013 | 2014 | 2015 | |
|---|---|---|---|---|---|---|---|
| **Bank Lending Stock** | Outstanding Amount [c] | 189 | 176 | 166 | 167 | 163 | to Nov 15 |
| *Source: Bank of England [b]* | | | | | | | |
| **Bank Lending** | Net flows £ billions [d] | - | -8 | -4 | -4 | 2 | |
| *Source: Bank of England [b]* | Gross flows £ billions [e] | - | 38 | 43 | 53 | 53 | to Nov 15 |
| **Other Gross Flows of SME Finance** | | | | | | | |
| **Private external Equity £ billions** | | 1.04 | 1.32 | 1.62 | 2.20 | 2.39 | |
| *Source: Beauhurst [f]* | No. of Reported Deals | 386 | 625 | 863 | 1060 | 870 | |
| | No. of Deals (Known Amounts) | 279 | 435 | 612 | 804 | 699 | to Sep 15 |
| **Asset Finance £ billions** | | - | 12.7 | 13.5 | 14.8 | 16.3 | 12 months to Nov 15 |
| *Source: FLA [g]* | | | | | | | |
| **Peer-to-Peer Business Lending £ billions** | | 0.02 | 0.06 | 0.25 | 0.72 | 1.26 | to Dec 15 |
| *Source: Alt Fi Data [h]* | | | | | | | |

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

{b} Statistics taken from Bank of England Bankstats Table a8.1 - Available: http://www.bankofengland.co.uk/statistics/Pages/bankstats/2015/nov.aspx

{c} Amounts outstanding data include overdrafts and loans in both sterling and foreign currency, expressed in sterling. Non-seasonally adjusted. Movements in amounts outstanding can reflect breaks in data series as well as underlying flows. For further details see www.bankofengland.co.uk/statistics/Pages/iadb/notesiadb/Changes_flows_growth_rates.aspx. For changes and growth rates data, please use the appropriate series or data tables from

Bankstats, available at www.bankofengland.co.uk/statistics/Pages/bankstats/current/default.aspx.

(d) Data includes overdrafts and loans in both sterling and foreign currency, expressed in sterling. Net flows does not always reconcile with change in stock due to differences in statistical reporting. The reported stock can include other adjustments made by banks but not detailed when reported, whereas flows data does not include these adjustments.

{e} Data exclude overdrafts and covers loans in both sterling and foreign currency, expressed in sterling. The total may not equal the sum of its components due to rounding.

{f} Beauhurst is a market data provider that records visible equity deals including crowdfunding deals. Data will be available in forthcoming Business Bank / Beauhurst publication.

{g} The Finance & Leasing Association (FLA) whose members make up 90-95% of the market. Data obtained from FLA Asset Finance Confidence Survey.

{h} Figures do not represent the entire market. Data obtained from AltFi Data.

Data from the Finance and Leasing Association suggests that new asset finance volumes with SMEs was almost £15 billion in 2014, an increase of more than 9% on 2013. The latest data points toward continued strong growth in 2015.

The value of invoice finance advances outstanding at end of September 2015 totalled £15.9bn, although the published data series does not separate out SME recipients from other firms.[3] It should be noted that given the short-term nature of invoice financing, the total volume of funding within a quarter is much higher than the advances outstanding at the quarter end.

It is difficult to quantify the value of smaller business financing from debt funds, although evidence of the increased number of deals suggest it is an increasingly important source of finance.

Gross flows of lending to businesses via online platforms continue to grow at a strong rate. reaching £1.26bn in 2015. However the value of these non-bank sources of finance remain small in comparison to traditional sources of bank finance.

## USAGE RATES AMONGST SMES HAS STABILISED

Survey evidence suggests that the share of SMEs using finance has stabilised. The SME Finance Monitor survey shows that across all SMEs, the number using 'core' bank products has declined from 40% of SMEs in Q1 2012 to 29% in Q3 2015, but this has been stable since the end of 2013, indicating that the decline in use of such products has tailed off.

The share of SMEs using any other forms of finance, e.g. leasing or invoice financing, also remains relatively stable. On the value of the stocks and flows of credit card lending to smaller businesses, survey evidence suggests that around 15% of smaller businesses use credit cards. However nearly 80% of these credit card users pay off the full balance each month. This suggests that a greater number of smaller businesses use credit cards for short-term working capital rather than for long-term financing needs.

In terms of other financial products, 17% of smaller businesses use leasing or hire purchase and loans from directors or family & friends. Invoice finance is only estimated to be used by 2% of smaller businesses. Use of leasing or hire purchase and invoice finance is significantly more common amongst small and medium sized business than it is amongst micro businesses.

1.2

# EXTERNAL FINANCE FOR SMALLER BUSINESSES CONTRIBUTES TO GROWTH AND PRODUCTIVITY

- Smaller businesses continue to form a large part of the UK economy and make an important contribution to economic growth
- Whilst the UK performs well in terms of creating new start-up businesses, it is less effective at growing them compared to other countries
- The UK faces a major productivity challenge compared to historical and international comparisons.
- Increased innovation and exporting could help to increase productivity amongst smaller businesses

## SMALLER BUSINESSES FORM A LARGE PART OF THE UK ECONOMY AND MAKE AN IMPORTANT CONTRIBUTION TO ECONOMIC GROWTH

Smaller businesses[4] continue to account for 99.9% of the UK business population and are an important part of the UK economy. At the start of 2015, private sector smaller businesses:

- Employ an estimated 15.6 million people which forms more than half of total UK private sector employment (60%);
- Create a high share of new jobs - between 2008 and 2013 85% of new jobs in the UK were created by businesses with fewer than 50 employees[5]; and
- Account for almost half of UK private sector turnover (47%).[6]

The ability of businesses to access external finance is important for facilitating new business start-ups as well as funding business investment and expansion, ensuring businesses reach their full growth potential. A lack of finance can also constrain cash flow and hamper businesses' survival prospects. Access to the right finance is particularly important for innovative businesses and high-growth businesses. By increasing the supply of external finance to viable businesses affected by problems in finance markets, the British Business Bank can influence improvements in the underlying drivers of productivity such as investment, as well as facilitate start-ups and business expansion.

## THE UK FACES A MAJOR PRODUCTIVITY CHALLENGE BY HISTORICAL AND BY INTERNATIONAL STANDARDS

Although, GDP and employment in the UK have recovered since the recession with GDP now 6.1% above its pre-recession level, it has been accompanied by relatively poor productivity performance, which threatens long-term prospects for the UK's standard of living. As is well documented, a significant productivity gap exists between the UK and most other leading advanced economies, which worsened in 2014 compared to the previous year.

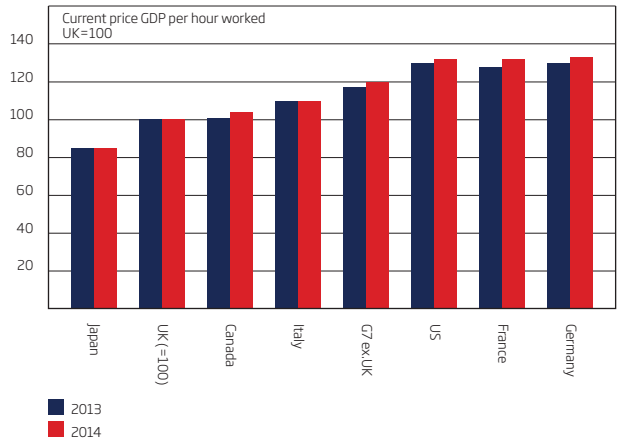
A reduction in productivity is expected to happen during a financial crisis and deep recession, as businesses reduce production by more than the fall in their work force. The recovery in the UK's productivity performance has been particularly weak following the recession.

That weakness in productivity performance is clearly illustrated by output per hour worked across countries. For every hour worked, the US produced 32% more output relative to the UK in 2014 and G7 countries (excluding the UK) are on average 20% more productive than the UK.[7] Given that SMEs employ most of the labour force, overall improvements in UK productivity will require improved SME productivity, especially as larger businesses tend to be more productive than smaller businesses. Recently published productivity data shows micro-businesses of fewer than 10 employees have experienced faster growth in output per worker than larger businesses since 2009. Productivity levels (as measured by output per worker) of larger businesses in 2014 is still below 2008 productivity levels, but since 2013 medium sized businesses have been more productive per worker than large businesses.[8] Smaller businesses can play a vital role in raising productivity in the UK economy by spurring innovation, facilitating productive churn, and stimulating stronger competition.

FIG 1.2

**PRODUCTIVITY PER HOUR WORKED IN G7 COUNTRIES**

*Source: ONS*



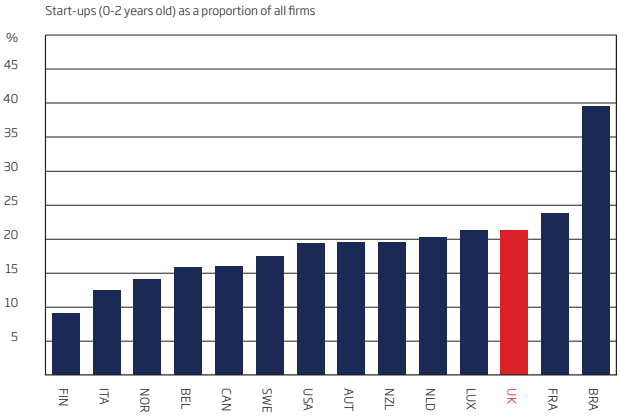

## WHILST THE UK PERFORMS WELL IN TERMS OF CREATING NEW START-UP BUSINESSES, IT IS LESS EFFECTIVE AT GROWING THEM COMPARED TO OTHER COUNTRIES

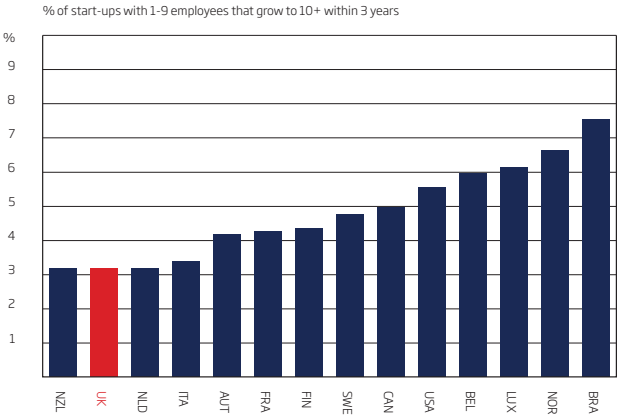
The UK is ranked third out of 14 OECD countries in terms of the proportion of start-up businesses less than two years old in the business population.[9] 21% of the UK business population is made up of business less than two years old, which is higher than the US (19%). However, the UK is ranked 13th when it comes to the proportion of start-up businesses with 1-9 employees that grow to 20 employees plus within three years. Just 3% of start-up businesses grow to having more than ten employees compared to 5.5% of businesses in the US. Raising the productivity of the whole economy depends on facilitating the growth of new and existing businesses with the greatest potential.

FIG 1.3

**START-UPS AS A PROPORTION OF ALL BUSINESSES AND PROPORTION OF START-UPS THAT GROW BEYOND 10 EMPLOYEES IN THREE YEARS**

*Source: OECD*




## INCREASED INNOVATION AND EXPORTING MAY HELP TO INCREASE PRODUCTIVITY AMONGST SMES

The challenge then is how to increase productivity for SMEs so as to build a strong foundation for long-term prosperity. Recent research[10] indicates a positive relationship between businesses that engage in international activity and innovation and business performance – including productivity performance. However, UK SMEs lag behind their international peers in many of these areas, giving room for improvement. The performance of UK small business sectors in exporting is discussed in more detail in chapter 3.

1.3

# ANALYSIS OF NEW DEBT APPLICATIONS

- Survey evidence suggests nearly 100,000 SMEs and approximately £4bn worth of applications for debt are estimated to be rejected each year
- Start-ups are more likely to be unsuccessful in their applications for new debt facilities, compared with scale-up and stay ahead firms
- However, by value of rejected applications, start-ups are the smallest segment
- Assessment of the potential viability of rejected loans is inherently difficult

Problems in access to finance markets for smaller businesses have been discussed earlier in this chapter. They focus on reasons why finance markets may not work efficiently for some smaller businesses, for example: information asymmetries between a business and a lender, levels of market competition, and unintended consequences of regulation. These problems are typically structural in nature, but can be exacerbated by cyclical issues. Often, in a commercial context, the rejected decision may have been the correct outcome, but the commercial decision does not incorporate the wider economic impacts that may arise as a result of the provision of finance to viable smaller businesses. This can mean that not all productive smaller businesses' demand for finance is met, which can lead to sub-optimal levels of economic activity.

It is useful to consider the outcomes of finance applications. Where applications are rejected, it is worthwhile to consider a measure of 'viability', i.e. where a potentially productive or viable small business could have received finance, but a structural problem in finance markets for smaller businesses meant that this finance was not available. However, it is recognised that many rejections will have been based on a rational commercial decision and, in many cases, the economic and commercial decisions on finance are likely to be aligned.

This section summarises the results of our proposed new methodology for quantifying the volume of SMEs rejected for new debt (loan and overdraft) applications and the value of those applications. SME Finance Monitor data is used for the purpose of this analysis,[11] drawing on a ten quarter dataset (period ending Q2 2015) to determine the number of SMEs rejected for a new loan or overdraft and multiplying these by the mid-point of the application value band. The underlying methodology is explained in a separate note, which also contains a discussion on a potential approach to estimating 'viability'. The British Business Bank would welcome discussions on such a methodology with any interested stakeholder.

Furthermore, we recognise that there are other methodologies that aim to calculate the size of the finance gap for debt funding. Some of these other approaches are considered in the benchmarking discussion. It should be noted that our methodology focuses on new applications for traditional debt products and, therefore, does not consider the extent of an 'equity gap' or specific gaps for other lending products, nor where smaller businesses have been discouraged from applying. Therefore, this is a starting point from which we aim to develop the methodology further for valuing finance gaps.

## SURVEY EVIDENCE SUGGESTS NEARLY 100,000 SMES AND APPROXIMATELY £4BN OF APPLICATIONS FOR DEBT ARE ESTIMATED TO BE REJECTED EACH YEAR

SME Finance Monitor data indicates that 16%[12] of SMEs had any 'borrowing event' in a 12-month period. A funding event can be initiated by the SME or the SME's bank and relate to existing or new finance. The proportion of SMEs applying for a new debt facility is smaller still (less than 3% for each of loans and overdrafts).

Applications for new debt facilities have much lower approval rates on average than those relating to renewal of existing facilities. For example, SME Finance Monitor[13] analysis of combined loan and overdraft applications indicates that success rates for renewed facilities are consistently high (>94%). Success rates for new money are more variable over the period (and are relatively high in 2014 – equal to or above 65%). Provisional results for Q1 2015 indicate that 55% of SMEs were successful in applying for new money.

In quantifying the value of rejected debt applications, we focus on new facilities, where the lower than average success rates suggest that structural problems in accessing finance markets are more likely. For example, where a business is renewing an existing facility, we assume that the relevant finance provider has additional information or insight to make the credit decision (e.g. information on principal and interest payments) and it is less likely that there are information asymmetries between borrower and lender.[14]

Our specific analysis of SME Finance Monitor data suggests that of all SMEs seeking a new loan facility, roughly 55% were successful whilst 45% were unsuccessful in obtaining external finance for their business over the 10 quarter period.[15] This equates to around 55,000[16] SMEs rejected for new loans in a 12-month period. Using data on the mid-point of value bands applied for, this equates to roughly £3.7bn worth of rejected loan applications. This compares with around £24bn of loan approvals reported by the BBA in the four quarters to Q2 2015.

FIG 1.4

**NUMBER OF SMES AND VALUE OF REJECTED DEBT APPLICATIONS**

*Source: BBB analysis, SME FM*

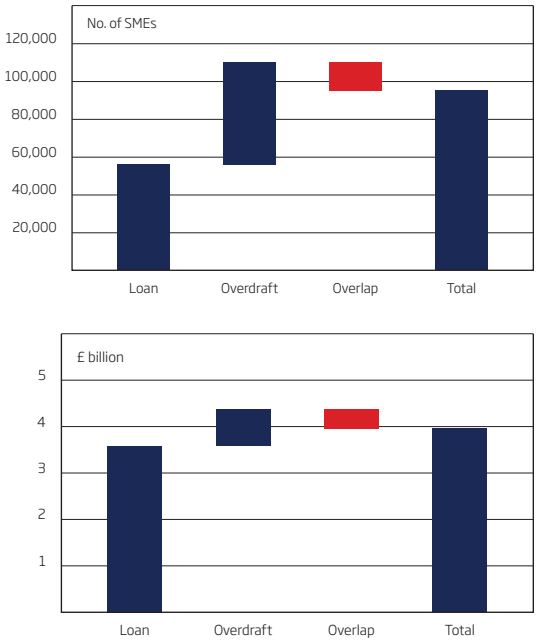
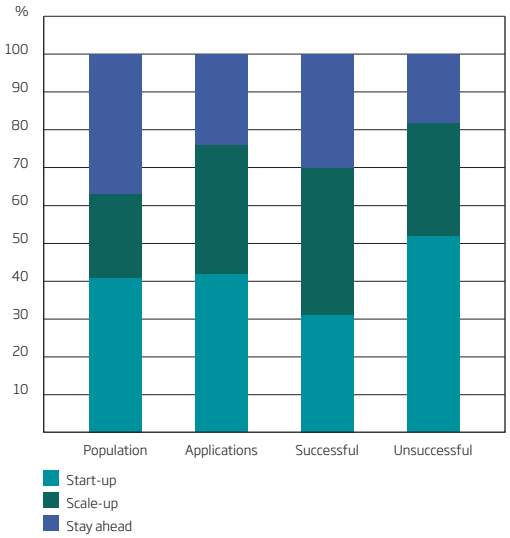



FIG 1.5

**NEW LOANS - SHARE OF POPULATION / APPLICATIONS / SUCCESSFUL AND REJECTED APPLICATIONS BY BBB SEGMENT**

*Source: BBB analysis, SME FM*




A slightly lower proportion of SMEs applying for a new overdraft are unsuccessful (c40%, compared with nearly 60% that were successful) in obtaining some form of external funding for their business following their new overdraft application. This equates to a similar number of SMEs being rejected for a new overdraft in a 12-month period than for loans (c55,000). However, the value of those rejected applications is significantly lower than for loans at c£0.8bn, reflecting lower average application values. This compares with around £5bn of overdraft approvals reported by the BBA in the four quarters to Q2 2015.

Some SMEs apply for both loans and overdrafts in a 12-month period. For prudence, we exclude the rejection for one type of facility (where the other application was successful) or the 'duplicate' rejection (where both applications were unsuccessful) from the analysis. Approximately 15,000 SMEs are excluded on this basis, with an equivalent rejected application value of c£0.5bn. Therefore, the total number of SMEs rejected for new debt applications is just under 100,000 per year and the equivalent value of rejected finance is c£4bn per year.

## START-UPS ARE MORE LIKELY TO BE UNSUCCESSFUL IN THEIR APPLICATIONS FOR NEW DEBT FACILITIES, COMPARED WITH SCALE-UP AND STAY AHEAD FIRMS

The British Business Bank focuses on three main segments of SMEs:

- Start-up – SMEs trading up to 5 years.[17]
- Scale-up – SMEs trading for more than 5 years with some ambition to grow.
- Stay ahead – SMEs trading for more than 5 years with no ambition to grow.

Cutting the SME Finance Monitor data in line with the above definitions indicates that c40% of SMEs are classified as start-ups, just over 20% are scale-ups, with the remaining being stay ahead SMEs. Start-Ups were defined as up to 5 years to reflect finance providers' preference for several years financial track record when considering applications.

The application rate amongst start-ups for new loans is in line with their proportion of the population (i.e. c40% of new loan applications are made by start-ups). Scale-ups are over-represented (making up about one-third of applications) and stay ahead businesses under-represented (about one quarter of applications).

Both scale-ups and stay ahead SMEs are more likely to see their new loan application approved (success rates are around 60%), while start-ups are more likely to be unsuccessful. Again this is consistent with economic theories of information problems for lenders attempting to assess loan applications.

FIG 1.6

**VOLUME AND VALUE OF NEW LOAN REJECTIONS BY BBB SEGMENT**

*Source: BBB analysis, SME FM*

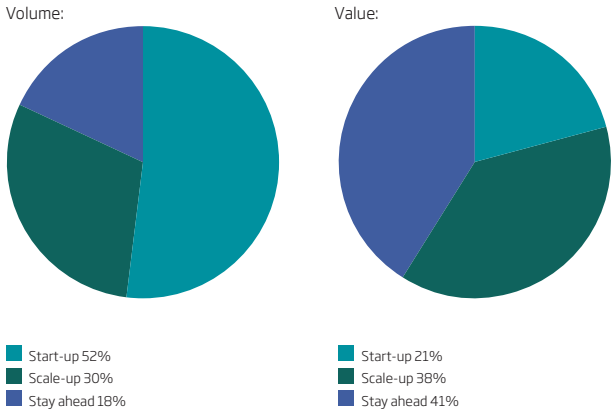
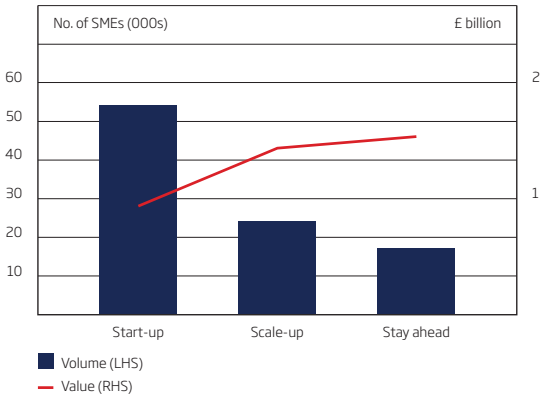



FIG 1.7

**VOLUME AND VALUE OF TOTAL REJECTED NEW DEBT (LOAN AND OVERDRAFT) APPLICATIONS BY BBB SEGMENT**

*Source: BBB analysis, SME FM*




When considering new overdrafts applications, a similar trend is evident where scale-up and stay ahead SMEs are more likely to be successful.

## HOWEVER, BY VALUE OF REJECTED FINANCE, START-UPS ARE THE SMALLEST SEGMENT

Given the share of unsuccessful applications between the segments, start-ups account for the largest share of new loan rejections by volume. However, scale-ups and stay ahead businesses are more likely to apply for higher loan values on average. Therefore, by value, start-ups have the smallest share of rejected new loan applications.

Start-ups also represent the largest share of rejected overdraft applications by volume. Due to lower variances in average application values for new overdrafts between the segments, start-ups are also the largest group by value.

The combined volumes and values of rejected debt applications (loans and overdrafts with overlap removed) mirror the trend for unsuccessful loan applications.

## ASSESSMENT OF THE POTENTIAL VIABILITY OF REJECTED LOANS IS INHERENTLY DIFFICULT

In many cases, the decision made by the bank (or other lending provider) will be legitimate based on their assessment of an SME's ability to service the loan requested. However, there will be a proportion of facilities that were declined due to structural problems in the market, meaning that there is a mis-match between supply and demand.

It is inherently difficult to determine potentially 'viable' demand from 'non-viable' demand (i.e. those rejected based on sufficient information about the viability of the loan) – if this were an easy exercise, costs associated with assessing creditworthiness would be minimal and loan applications would not be rejected due to information asymmetries or other structural problems.

The established theory suggests that an SME's lack of track record (ability to prove they can service the finance based on historic performance) and lack of collateral (to de-risk the lending) are symptomatic of a lack of information in the credit decision process. This can be particularly problematic for young businesses, or SMEs looking for a step-change in their business performance. In both cases, the relevant track record and, in some cases, value of security is still being accumulated.

The cost to the lender of verifying the credit worthiness of a smaller business and/or the required return due to potential higher risk can start to outweigh the income that can be derived from lending. In a commercial sense, the rejected loan outcome is therefore reasonable, particularly where some SMEs will have higher risk

ratings. However, this does provide a rationale for government intervention, where the wider economic benefits of financing these businesses outweigh the costs of doing so.

We would therefore expect that potentially viable demand within rejected new debt applications would be higher for the start-up segment compared with scale-up or stay ahead businesses. However, we would also expect that scale-up businesses would be prone to structural problems, particularly information asymmetries, where their existing track record does not verify their intended performance.

## BENCHMARKING AGAINST OTHER METHODS

In putting forward this methodology as a starting point for estimating the value of rejected new debt applications, we recognise that other methodologies and attempts have been made.[18,19] There are also ways in which the results of our analysis can be sense-checked against other benchmarks.

A 2013 staff working paper from the European Commission makes an ex-ante assessment of the EU SME Initiative. In the report, there is an assessment of SME financial gaps in the EU. This methodology also draws from survey data, noting that, "Survey data, with all their limitations, are used extensively in studies on financing gaps when time and data constraints prevent the quantitative assessment of demand and supply through deep analyses of the data."

The methodology adopted in the working paper aims to identify the number of financially viable SMEs – benefitted from turnover growth in the last six months – that were unsuccessful in obtaining loan financing. Unsuccessful is determined by need and, therefore, does not differentiate between SMEs that have or have not applied for a loan[20]. The value of the financing gap is determined by deriving an average loan amount that is or would have been requested.

The working paper indicates a comparatively higher finance gap for the UK than that suggested by our analysis, bearing in mind that the £4bn value for rejected new debt applications is not adjusted for 'viability'. This difference may be partly explained by the earlier time period for which the analysis was undertaken, when cyclical factors were compounding underlying structural issues in SME access to finance. The estimated interval for the SME loan financing gap was €1.3bn - €8.8bn for the UK during 2009 - 2011. It is worth noting that the upper bound reflects the definitions outlined above (e.g. positive turnover growth in last six months and unsuccessful, where unsuccessful is based on need). The lower bound represents the debt finance needs of high growth SMEs unsuccessful in obtaining loan finance.

A different approach was considered in the RBS Independent Lending Review (2013), completed by Sir Andrew Large. Here, the funding gap was estimated by assessing UK SME debt capacity compared with actual bank lending to UK SMEs. UK SME debt capacity was considered in the context of the level of bank debt that SMEs could prudently support, based on Debt Service Coverage Ratio of 1.5 and pricing at economic cost . This methodology estimated that the funding gap in 2013 was c£30bn -£35bn. Again, cyclical factors were likely to have increased the size of the gap in 2013, so it is reasonable to expect that this gap would have reduced since 2013.

Data on the appeals process, which commenced in 2011, is another way of assessing a possible benchmark for potential viability within rejected applications. Data collection is in its fifth year, with the report noting that, "Appeals numbers continue to be steady and the overturn rate continues to fall." The report indicates that in year 1 (Apr 2011 – Mar 2012), the overturn rate was 39.5% (32.6% excluding credit cards) compared with 24.4% (17.5% excluding credit cards) for the six months ending September 2015, giving support for the view that a small but significant percentage of rejected loans may be viable.

Furthermore, the 2014 full year appeals process report notes that, "In terms of the size of lending, size of company and the relation that this has to the number of declines, appeals, and overturns, [...] those SMEs who have the resource and the experience to have more informed discussions with lenders tend to do better than others." The data suggest that overturn rates are highest for smaller businesses with a turnover of less than £100k and for businesses that request lending values of less than £10k. Indeed, the reasons for rejection appear to be different for loan requests below and above £25k.

1.4

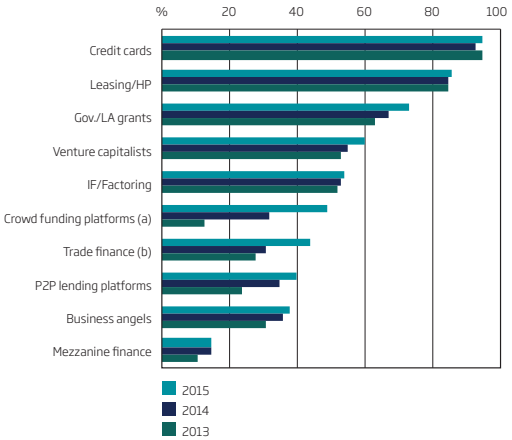
# DEMAND SIDE – AWARENESS & DEMAND FOR FINANCE

- Awareness of alternative sources of finance outside of banks continues to increase, but only a small proportion of businesses are actually using these sources of finance
- Increased information about suitable types of finance and how to apply could help to make SME finance markets work more effectively
- Smaller businesses reduced their use of external finance during the recession, but there is some evidence that demand for finance has begun to increase
- Business confidence has increased and the main reason for seeking finance is to fund working capital
- Businesses continue to underestimate the likelihood of obtaining finance, with a small but significant proportion of businesses being discouraged from seeking finance

FIG 1.8

**AWARENESS OF DIFFERENT TYPES OF EXTERNAL FINANCE**

*Source: British Business Bank 2015 Finance Survey*




For finance markets to work effectively, both the supply and demand side need to interact efficiently. This chapter summarises new survey evidence which provides an overview of demand for external finance from smaller businesses.[21]

## AWARENESS OF ALTERNATIVE SOURCES OF FINANCE OUTSIDE OF BANKS CONTINUES TO INCREASE OVER THE YEAR, BUT ONLY A SMALL PROPORTION OF BUSINESSES ARE ACTUALLY USING THESE ALTERNATIVE SOURCES

There have been significant increases in business awareness of finance products such as venture capital, crowd funding platforms and Peer to Peer platforms since 2014, which builds on the previous increases seen from the 2012 survey. For instance, 49% of SMEs have now heard of crowd funding platforms in 2015, a significant increase from 13% recorded in 2012.

Whilst awareness of sources of finance has improved, roughly half of businesses that are aware of the type of finance are actually aware of a specific supplier of that type of finance, suggesting better awareness is needed. For instance, whilst 60% of smaller businesses are aware of Venture capital as a finance type, only 22% are aware of a specific fund to approach. Similarly 40% are aware of peer to peer lending but 19% are aware of a specific platform.

Importantly higher awareness has not translated into higher use of these alternative sources of finance, which remains low compared to other sources. For instance, only 1% of businesses had used equity finance and 1% had used finance from a peer to peer lender in the previous three years.

## INCREASED INFORMATION ABOUT SUITABLE TYPES OF FINANCE AND HOW TO APPLY COULD HELP TO MAKE SME FINANCE MARKETS WORK MORE EFFECTIVELY

Information is needed for SME finance markets to work effectively, but only a minority of SMEs (19%) use external advice when applying for finance, largely unchanged from previous years. Whilst SMEs are largely confident in assessing financial products offered by their own bank, they are less confident assessing other providers' products. This may explain why 61%

of SMEs only contact one provider of finance when seeking finance. Though high, this is a decline from 66% contacting one provider in 2014 and 71% in 2012, suggesting more SMEs are engaging with the market and are shopping around for external finance than previously.

## SMALLER BUSINESSES REDUCED THEIR USE OF EXTERNAL FINANCE DURING THE RECESSION, BUT THERE IS SOME EVIDENCE THAT DEMAND FOR FINANCE HAS BEGUN TO INCREASE

Demand for external finance from smaller businesses reduced during the recession, as businesses became more cautious about taking on additional debt and scaled back their expansion plans. Furthermore, as the recovery took hold, businesses have increased cash reserves in the business, which has further led to a decline in the use of external sources of finance.[22]

Confidence is needed for a sustained increase in the number of businesses investing for expansion. This may be beginning to happen as the latest British Business Bank Finance survey shows there has been an increase in the proportions of businesses using external finance to 60% up from 56% in 2014. This increase is seen across both zero employee businesses and businesses with employees. This is likely to be driven by the proportion of businesses seeking finance in the last 12 months. This has increased from 12% in 2014 to 18% in the latest survey giving further evidence of the change in demand, albeit to the same level seen in 2012.[23]

However, this increase must be put into context as a large proportion of the observed increase is due to the greater use of credit card finance (28% up from 22% in 2014) and also loans from increased borrowing from family and colleagues (23% up from 13% in 2014). These are likely to be flexible short term borrowing on already agreed facilities and informal sources of finance, which are not likely to show up in other lending data sources.

## BUSINESS CONFIDENCE HAS INCREASED AND THE MAIN REASON FOR SEEKING FINANCE IS TO FUND WORKING CAPITAL

Furthermore, survey evidence suggests overall business confidence continues to improve with businesses positive about future economic conditions. For instance, 44% of businesses expect trading conditions will improve in the next 12 months, compared to only 11% expecting them to get worse. This has contributed to a higher proportion of businesses planning to grow their turnover in the next 12 months compared to a year ago. 56% of small businesses plan to grow their turnover in the next 12 months, a significant increase from 46% a year ago. However, it is important to note most (68%) will not use any external finance to fund this growth.

The previous 2014 survey identified a change[24] in the profile of demand for finance, shifting away from finance for working capital to finance to fund fixed assets. This latest survey shows a swing back to seeking finance for working capital, which is predominantly being driven by SMEs with no employees which make up the majority of the business population by number, but have different characteristics to employer businesses. It is too simplistic to assume the increase in businesses seeking finance for working capital implies a deterioration of businesses seeking funding for investment and growth.

Working capital covers a wide range of different reasons, including cash flow to fund growth, as well as cash flow to cover unexpected expenses. Of those seeking working capital, there has been an increase in businesses seeking working capital to fund business growth (33% up from 27% in 2014), which is consistent with an expansionary macro-economic climate.

Whilst the overall proportion of businesses seeking finance for working capital has increased from 33% to 53% of those seeking finance, there has not been a decline in the proportion of businesses with employees seeking finance for assets as this remains at 38% of those seeking finance in 2015 compared to 2014. Therefore, it is not the case that fewer employer businesses are investing than previously.

Recent ONS data supports the robust trends in business investment as business investment has increased by 6.6% compared to a year ago in Q3 2015.[25] This was the fourth consecutive quarter of positive growth in business investment.

The reversal in the reason for seeking finance has also led to a decline in the proportion of businesses seeking bank loans, which are predominantly used to fund assets. There has been an increase in the proportions of businesses seeking grants and loan / equity from friends and other providers, which may explain some of the increase in finance sought seen in this survey, but not seen in other data sources.

## BUSINESSES UNDERESTIMATE THE LIKELIHOOD OF OBTAINING FINANCE, WITH A SMALL BUT SIGNIFICANT PROPORTION BEING DISCOURAGED FROM SEEKING FINANCE

Following the recession and on-going coverage of lending conditions in the media, there remains a continued perception amongst smaller businesses that banks are not lending sufficiently. For instance, 55% of businesses perceive that it is fairly, or very difficult to obtain funding, a slight improvement from 58% in 2014. In 2015 small businesses perceived that (on average) 38% of those that apply for bank finance were successful in getting it, slightly lower than the level reported in 2014 (42%), but higher than levels reported in 2012 (32%). This is despite the majority (over 70%) of smaller businesses that actually applied for finance in the three years prior to 2015 getting the full amount requested from the first provider they approached (86% getting some finance).

Other survey evidence from the SME Finance Monitor survey shows 75% of SMEs aim to pay down debt and remain debt free, and less than half (44%) are happy to use external finance to help business growth.[26] This confirms that many smaller businesses remain cautious about using external sources of funding.

A mismatch in perception remains and is likely to be a barrier holding some businesses back from applying for finance. A small but significant proportion of these small businesses are discouraged from applying for finance. The latest British Business Bank finance survey estimates this to be around 4% of all SMEs, predominantly micro businesses.

FIG 1.9

**MAIN REASON FOR SEEKING FINANCE (LAST OCCASION IN LAST THREE YEARS)**

*Source: British Business Bank Finance Survey*

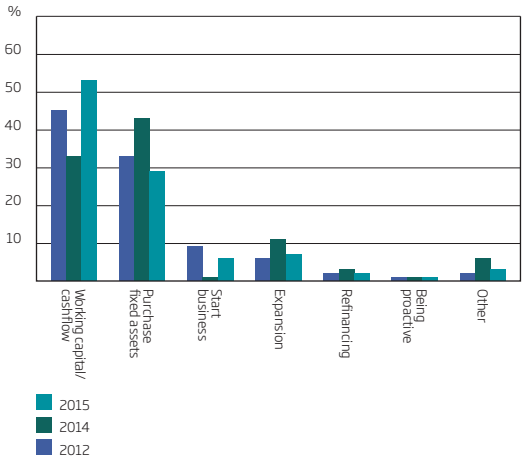
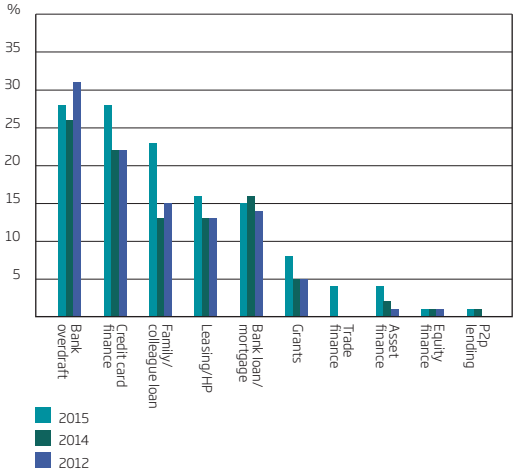



FIG 1.10

**TYPE OF FINANCE SOUGHT (LAST OCCASION IN LAST THREE YEARS)**

*Source: British Business Bank Finance Survey*



1.5

# SUPPLY SIDE – BANK LENDING

- The availability of bank lending for smaller businesses is improving
- Gross lending to SMEs has exceeded repayments resulting in four quarters of positive net lending
- Use of overdrafts has stabilised, but SMEs continue to strengthen balance sheets by increasing deposits
- Latest research finds that the market for loans to smaller businesses remains concentrated

## THE AVAILABILITY OF BANK LENDING FOR SMALLER BUSINESSES IS IMPROVING

Bank lending remains the single largest form of lending to smaller businesses, and thus developments in this sector have a major impact on SMEs' access to finance. This section explores how bank lending has developed as the UK economy continues to recover from the recession. Recent debate has focused on whether lending markets are improving. The Bank of England noted in its Q3 Credit Conditions Review[27] that both its Credit Conditions Survey and the Federation of Small Businesses Voice of Small Business Index were consistent with reports from the Bank's Agents that credit availability for smaller firms had increased, and was approaching normal, although it remained tighter than for other firms.

This section reviews the evidence, which supports the conclusion that small businesses bank credit markets have improved over 2015. But accepting the argument that the cyclical impact of recession on credit availability has retreated does not mean that structural problems in the market have been resolved. Additionally, issues around the diversity of supply of finance are long-standing (see chapter 4 for discussion).

It has long been accepted that structural issues in accessing finance markets exist, meaning that there is a proportion of viable smaller businesses that are underserved. Where a lack of information impedes a credit decision, firms with limited track record or insufficient security are more likely to be denied bank loans or overdrafts, because they are less able to demonstrate the viability of their business to banks. A restricted supply of finance to viable businesses, caused by this information failure, is likely to lead to lower levels of investment, and therefore growth, by those businesses. In aggregate, this may lead to lower levels of economic output and employment in the short and long-term.

## GROSS LENDING TO SMES HAS EXCEEDED REPAYMENTS RESULTING IN FOUR QUARTERS OF POSITIVE NET LENDING

According to the Bank of England (BoE) bank lending data, the gross flow of loans (exc. overdrafts) to SMEs reached £53bn by the end of November, continuing the upward trend of recent years.[28] Repayments have followed a similar trend. However, gross loans have exceeded repayments in each of the last four quarters for which full data is available resulting in an increase in net lending.

## LENDING TO MEDIUM-SIZED BUSINESSES IS DRIVING THE IMPROVEMENT IN SME NET LENDING

Evidence from the BBA allows an analysis of flows of bank lending within the wider SME, or smaller business, population. The data suggests that improvements in overall lending to smaller businesses is much more pronounced among medium firms compared to the smallest firms, where the value of quarterly gross term loans is yet to pick up and net lending remains negative.[29]

According to the BBA, the commercial real estate sector (CRE) accounts for around 29% of the stock of loans in September 2015 for overall smaller business lending. Since at least late 2011, negative net lending in the form of term loans to CRE has dragged on overall net lending figures for SME loans, as banks typically looked to reduce their exposure to this sector. In general, this trend has been less prominent in 2015 when net CRE lending has been positive.

## USE OF OVERDRAFTS HAS STABILISED IN 2015, BUT SMES CONTINUE TO STRENGTHEN BALANCE SHEETS BY INCREASING DEPOSITS

The value of outstanding overdrafts has been decreasing over time, as SMEs reduce their levels of debt. The decline in the stock of overdrafts seems to have slowed in 2015. According to SME Finance Monitor, in H1 2015 16% of SMEs had an overdraft, compared with 26% in 2011, and applications as well as renewals of overdraft facilities by SMEs have declined since 2011.[30]

Deposits however have continued to grow in 2015 as SMEs continue to strengthen their balance sheets, supported by positive trading conditions. In Q3 2015 80% of smaller businesses reported a profit in their latest trading period and 23% of all smaller businesses held a credit balance over £10,000 in 2015, up from 17% in 2011.[31]

FIG 1.11

### QUARTERLY GROSS AND NET FLOWS OF BANK LOANS TO SMES

*Source: Bank of England Bankstats table A8.1*

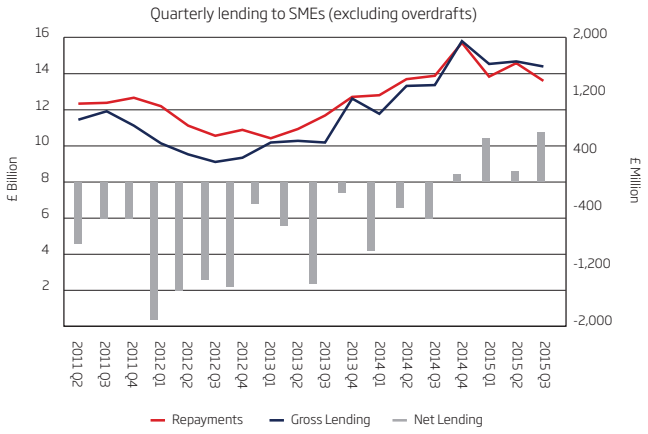
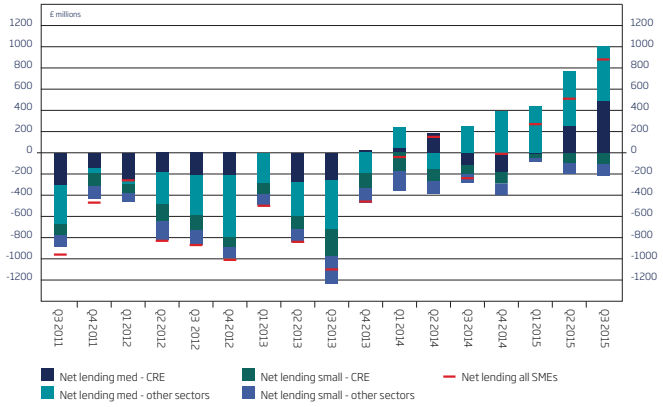



FIG 1.12

### NET LENDING TO MEDIUM AND SMALL SMES

*Source: BBA SME Statistics: https://www.bba.org.uk/news/statistics/sme-statistics/*



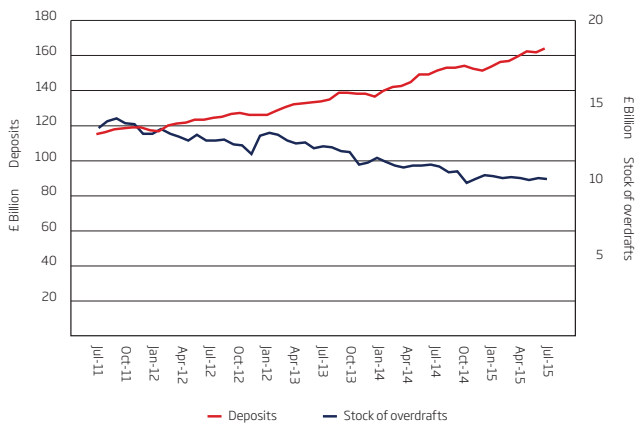

Notes:

Loans exclude overdrafts. Commercial real estate sector refers to SIC code 10a in BBA statistics: Buying, selling & renting own or leased real estate

FIG 1.13

**STOCK OF OVERDRAFTS AND VALUE OF DEPOSITS, ALL SMES**

*Source: BBA SME Statistics*




This chapter so far has reviewed the latest evidence from 2015 in small business finance markets. Overall flows of finance have increased, with a rise in net bank lending to smaller businesses and stronger growth in flows of finance in areas such as asset finance and other debt products.

The analysis of rejected loans applications suggests that a proportion of rejected businesses may potentially be viable lending opportunities, but that a lack of track record or lack of collateral may have prevented them from obtaining finance.

Economic growth is expected to continue with a significant number of smaller businesses expecting to grow. Survey evidence suggests that, whilst awareness of finance products in rising, effective demand would increase if smaller businesses had more information and understanding of how to obtain finance.

This provides evidence for the Business Bank to continue to pursue its objectives. Existing programmes are already helping to reduce the extent to which potentially viable smaller businesses have problems in accessing finance. However, the Business Bank will continue to develop and refine its programmes to help address the gap in the provision of debt finance. For example, in helping to support bank lending, the Enterprise Finance Guarantee can continue to facilitate successful applications for new lending and Help to Grow will enable expanding businesses to obtain finance where their proposition may be considered higher risk for a commercial provider.

Furthermore, the continuation of the Start-Up Loans programme will help to ensure that funding is available for new businesses, where the lending proposition is inherently subject to greater risk, and sometimes beyond the reasonable appetite of commercial lenders, but where the benefits to the economy of these new starts are measurable.

1.6

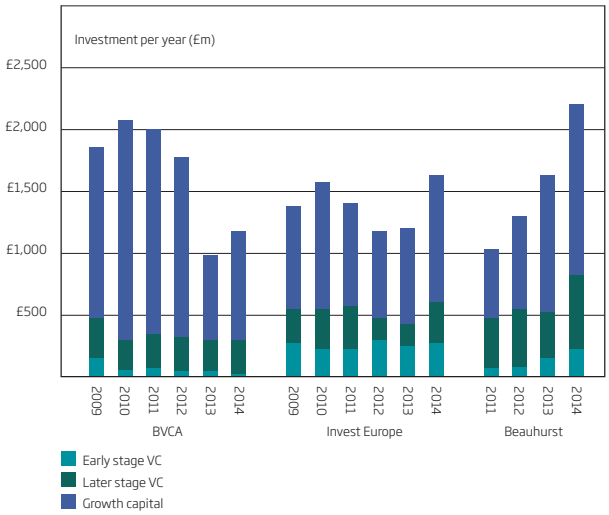
# SUPPLY SIDE - EQUITY FINANCE

- The volume of equity investment is increasing in 2015 with increases seen in all stages of funding, but is particular driven by increased venture stage financing
- The UK performs relatively well in terms of VC activity compared to rest of Europe, significantly lags behind the US

FIG 1.14

**COMPARISON OF TRENDS IN DIFFERENT EQUITY DATA SOURCES**

*Source: BVCA, Invest Europe and Beauhurst*




Equity finance[32] is used by a small proportion (around 1% in the previous three years[33]) of smaller businesses, but it is particularly important for start-up businesses and business with high growth potential. These businesses may be too risky or lack security and track record for debt finance. Trends in the different equity stages (start-up, venture and growth) are explored in specific sections later on in the report, but this section provides a brief overview of how equity markets have changed overall over the last year.

This section uses data from Beauhurst[34] on the number and value of published equity investments which covers a wider range of equity investors than just VC funds.[35] It is important to acknowledge that a number of other data sources also cover equity investments including the British Venture Capital Association (BVCA) and Invest Europe. These predominantly measure the investment activities of their members, which are mainly comprised of private equity and venture capital funds.

Therefore, the data sources have different coverage of investors and are not always consistent with one another. There are likely to be differences in observed trends and scale of investments. For instance:

- BVCA shows a decline in the value of funding between 2011 and 2014, but funding is increasing in the Beauhurst data, which is due to the presence of other equity investors like crowd funders and business angels. Beauhurst data shows a decline in the number of investments made by Private Equity/ Venture Capital funds between 2011 and 2014, which is consistent with the wider trends seen in the BVCA data.
- In fact the proportion of deals involving private equity funds declined from 56% of the total equity market in 2011 to 30% in Q1-Q3 2015 showing the increasing importance of other providers in the equity market. The other consideration for explaining some of the trends in the BVCA data is that BVCA membership has declined between 2007 and 2014, so that fewer deals are picked up in the figures.
- It is important to acknowledge that Invest Europe investment volumes are originally derived in Euros and are converted back to Sterling at current exchange rates. This may obscure underlying trends due to exchange rate movements. However the Invest Europe data does tell a similar story to the Beauhurst data, with activity in the later stage VC relatively weak, but early and growth stages are increasing.

- BVCA also shows a decline in growth capital between 2011 and 2014, which is not seen in the Invest Europe and Beauhurst data. Growth capital investments are very volatile due to the small number of very large deals. It is possible that differences in the way deals are classified may explain some of this divergent trend with some of the BVCA later stage VC deals falling under Beauhurst's definition of growth stage.[36]

The British Business Bank has used data from Beauhurst to explore detailed trends in equity markets in the UK. This is because Beauhurst has a wider coverage of investors beyond VC/ PE funds and also because the data is available at the micro investment level, allowing more detailed analysis. BVCA and Invest Europe data is only available at an aggregated level.

However, the Beauhurst data presented includes only published deals, but many deals are not formally made public by their investors.[37] This therefore means that the Beauhurst data (alongside other data sets) does not have complete coverage of the total equity market. For instance, the UK Business Angel Association estimates that private investors account for between £800 million and £1 billion of early stage investment each year in the UK – the single largest source of early stage capital in this country.[38]

FIG 1.15

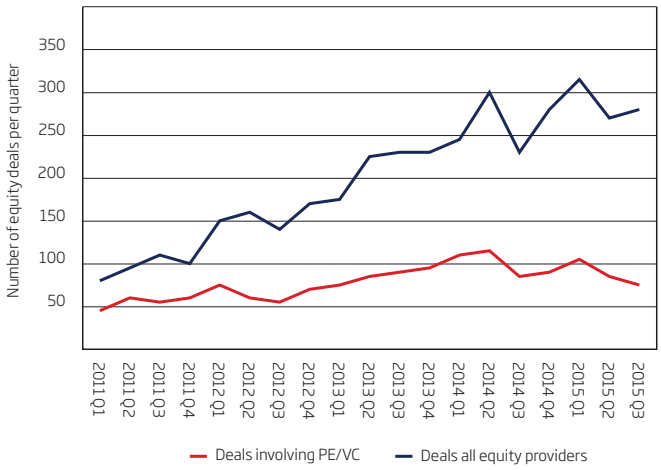
**NUMBER OF EQUITY DEALS AND VALUE OF INVESTMENT OVER TIME**

*Source: Beauhurst*


FIG 1.16

**EQUITY DEALS INVOLVING VENTURE CAPITAL/PRIVATE EQUITY**

*Source: Beauhurst*




## THE VOLUME OF EQUITY INVESTMENT IS INCREASING IN 2015 WITH INCREASES SEEN IN ALL STAGES OF FUNDING, BUT IS PARTICULAR DRIVEN BY INCREASED VENTURE STAGE FINANCING

Overall, UK equity markets have performed well over 2014 with increased number and value of investments and have performed even more strongly over the first three quarters of 2015. Beauhurst data shows 870 equity deals in Q1-Q3 2015 compared to 779 in the same quarters in 2014, a 12% increase by number. In value terms for known investment amounts, the increase seen in the first three quarters of 2015 is even greater at 43% compared to the same time period in 2014. The total investment volume for the first three quarters of 2015 (£2.4bn) already exceeds the total for 2014 with one quarter figures still to go.

Whilst the increases in venture stage funding have been relatively low between 2011 and 2014, venture stage financing has also seen a large increase in 2015. Venture stage financing increased by 118% compared to the first three quarters of 2014. The first three quarters data (£882m) exceeds 2014 whole year figures (£595m), suggesting 2015 will be a very strong year for venture category overall. This is explored further in the venture section but caution is needed as it is being distorted by a small number of pharmaceutical companies with deal sizes significantly exceeding £10m. In fact one pharmaceutical company received funding of £205m in

2015, which forms a substantial proportion of the increase in value seen in the first three quarters of 2015.[39, 40]

It is widely recognised that equity investments in 2015 are attracting higher valuations than previously due to greater confidence in the market, which is leading to larger deal sizes. For instance, the average deal size for venture stage was £3.6m in 2015, up from £2.4m in 2014. For growth capital investments, average deal sizes are now £9.8m, up from £6.9m in 2014. However, seed stages remains smaller, with average deal sizes remaining around £600,000 to £700,000. The increase valuations, particularly at later VC stages have led to market commentators to focus their attention on the growing number of "unicorn" businesses,[41] of which the UK currently has 5 out of the world wide total of 145.[42]

## THE UK PERFORMS RELATIVELY WELL IN TERMS OF VC ACTIVITY COMPARED TO REST OF EUROPE, SIGNIFICANTLY LAGS BEHIND THE US

The best way to assess international differences in venture capital is to look at VC investment as a proportion of GDP, as this takes into account differences in the size of a country's economy. Combining Invest Europe data with NVCA data shows the UK performs relatively well in terms of VC activity compared to rest of Europe, but Europe lags behind the US.

The US has a Venture Capital to GDP ratio of 0.29% in 2014, which is significantly higher than European average of 0.024%. The UK's Venture Capital to GDP ratio of 0.038% is higher than the European average, but is lower than Sweden (0.066%), Finland (0.060%) and Ireland (0.049%). It is important to acknowledge that VC activity in the US in 2014 was very strong increasing by 68% from the previous year due to higher valuations. Whilst the Venture Capital to GDP ratio is lower at 0.180% in 2013 which is more typical of the US performance, this does not change the main conclusion of the analysis that VC activity levels are much higher in the US.

## CONCLUSIONS

Beauhurst data shows UK equity markets continue to perform strongly in terms of the overall number and value of deals. In part this is due to the strong start-up environment and investors' confidence of improving conditions. More evidence is provided on the extent to which equity investment supports start-ups and businesses with high-growth potential in chapters 2 and 3 respectively.

Furthermore, the British Business Bank will publish a more detailed assessment of equity markets covering investments over the full 2015 year in spring 2016 through the Equity Tracker Report.

FIG 1.17

### 2011-14 PERCENTAGE CHANGE IN VALUE OF INVESTMENTS BETWEEN DIFFERENT EQUITY DATA SOURCES

*Source: British Business Bank analysis of BVCA, Invest Europe and Beauhurst data*

| % | BVCA | Invest Europe UK | Beauhurst |
|---|---|---|---|
| Early Stage VC | -60 | 31 | 200 |
| Later Stage VC | -5 | -11 | 46 |
| Growth Capital | -49 | 26 | 142 |

FIG 1.18

### VALUE OF INVESTMENT OVER TIME BY STAGE

*Source: Beauhurst*

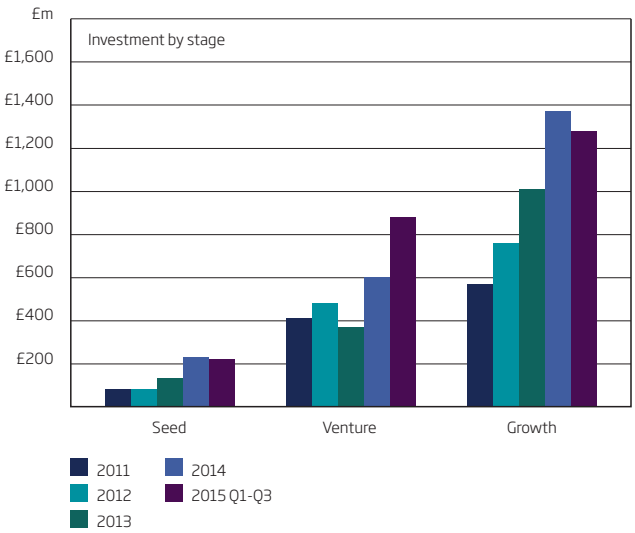
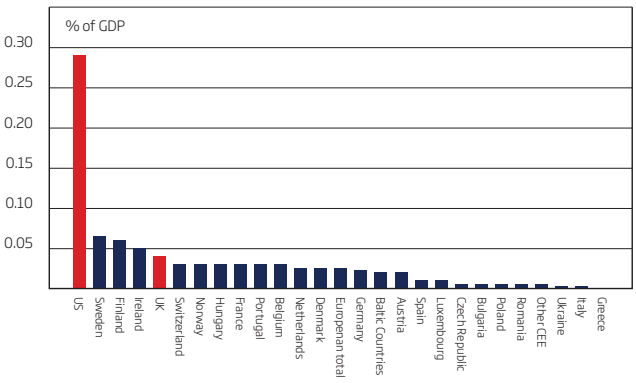



FIG 1.19

### 2014 VENTURE CAPITAL INVESTMENTS AS A PROPORTION OF GDP

*Source: Invest Europe, NVCA, World Bank*



1.7

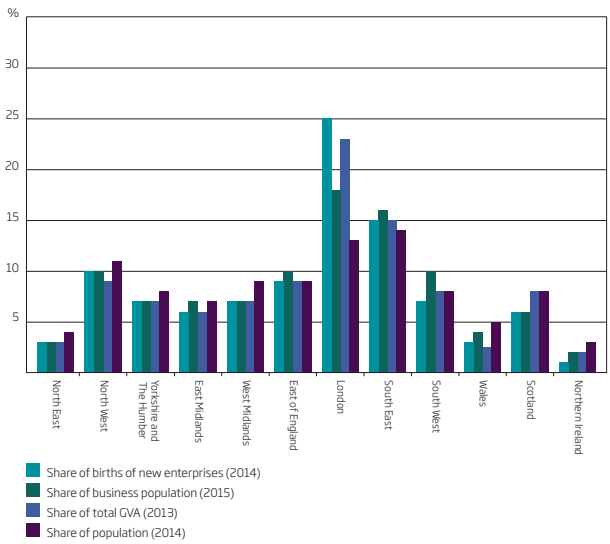
# REGIONAL PERSPECTIVE

- New business births are concentrated in London, with variation between other regions relatively less marked
- The regional share of high growth businesses shows little variation outside of London but there are wide variations in business performance in sub-regional areas
- The flow of bank lending to smaller businesses largely follows the background share of businesses
- Private Equity finance is concentrated in London and South East but is under-represented in some regions

FIG 1.20

**PROPORTION OF BUSINESS START-UPS, BUSINESS POPULATION, GROSS VALUE ADDED AND POPULATION BY REGION**

*Source: ONS*




This section explores regional differences in smaller business growth performance and flows of finance.

Growth performance is measured by proportion of businesses achieving high growth and also the proportion of start-ups scaling up in three years. The distribution of bank lending and equity investments across different regions in the UK is then considered. To take into account differences in the relative size of regions, the analysis calculates the regional share of bank lending and equity investment and then compares it to the share of business start-ups and number of enterprises located in the region.

This provides insight into the question of whether lending and investment are under or over represented compared to the smaller business population, but it does not determine what the optimal level of finance is for that region as it may be explained by sectoral differences.

## NEW BUSINESS BIRTHS ARE CONCENTRATED IN LONDON, WITH VARIATION BETWEEN OTHER REGIONS RELATIVELY LESS MARKED

Growing businesses are located in all regions and sectors within the UK. The following chart shows the regional share of business start-ups, business population and Gross Value Added (GVA) against the share of the population. The proportion of business start-ups and the number of businesses overall is clearly overrepresented in London (25% and 18% respectively) compared to the share of population (13%). For other regions the share of start-ups is relatively in line with business population and GVA, albeit lagging behind its population share. This may reflect London's role as the capital city, which can lead to head offices being located here, even if business activity occurs throughout the UK.

## THE REGIONAL SHARE OF HIGH GROWTH BUSINESSES SHOWS LITTLE VARIATION OUTSIDE OF LONDON BUT THERE ARE WIDE VARIATIONS IN BUSINESS PERFORMANCE IN SUB-REGIONAL AREAS

Whilst London has one of the highest proportions of fast growing businesses (18.6%), high growth businesses are found in all regions of the UK with variation relatively low between regions. Excluding London, the proportion of high growth businesses is approximately 15% in most English regions. Similarly the proportion of businesses reaching £1m turnover is relatively constant (around 6%), whereas the figure for London is 7.9%.

Regional figures obscure the high variation in business performance that occurs within regions, as some areas perform relatively well. For instance, there are a number of areas in the Midlands and North with an above average proportion of fast growing firms. This includes Leicester and Leicestershire (17%), Greater Birmingham and Solihull 16%), Greater Manchester (16%).[43]

However some sub-regional areas in the North perform very poorly. For instance, North East, Sheffield City, Humber, Tees Valley and Cheshire and Warrington LEP perform relatively poorly in terms of the proportion of fast growing businesses compared to 16% for England as a whole.

A similar picture exists for start-ups showing high growth by reaching turnover greater than £1m in three years of start-up. Again London is one of the highest areas (7.9%), but Northern cities including Newcastle, Leeds, Manchester and Sheffield are also near the top the rankings. This demonstrates that there are high quality businesses in these areas capable of achieving high growth, but there are large variations in business performance.

Cumbria lags behind on the proportion of start-ups scaling up where just 2% of start-up businesses in 2011 reached £1m turnover in three years. Similarly in York, North Yorkshire and East Riding the figure was 5% compared to 6% for England as a whole. This variation shows there is room for improvement in these regions.

More recent business confidence surveys show a divergence in business confidence between some northern and southern regions, which suggests smaller businesses face more challenging conditions in some northern regions. The ICAEW/ Grant Thornton Business Confidence Monitor[44] shows confidence has been steady in London, South East and South West over 2015, but in some regions in northern England has been declining since the start of 2014. An optimism reading of +12.8 was recorded in the latest quarter (Q4 2015) for Northern England, down from +25.1 a year before and from a high of +45.5 at the beginning of 2014.

## THE FLOW OF BANK LENDING TO SMALLER BUSINESSES LARGELY FOLLOWS THE BACKGROUND SHARE OF BUSINESSES

Figure 1.22 shows the regional share of bank lending to smaller businesses largely reflects the business population in most regions, although the share of lending in the South East (9%) lags the share of businesses located in the region (17%). To a lesser extent, this is also the case for the North West and South West regions.

FIG 1.21

**PROPORTION OF FAST GROWING BUSINESSES AND SURVIVING START-UPS GROWING TO £1M TURNOVER IN THREE YEARS**

*Source: Enterprise Research Centre Growth Dashboard 2015*

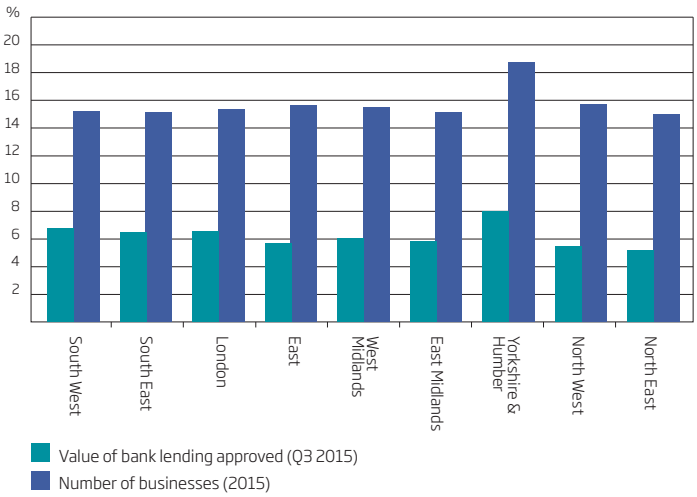


FIG 1.22

**PROPORTION OF BANK LENDING APPROVED BY REGION**

*Source: BBA Q3 2015 and BIS*

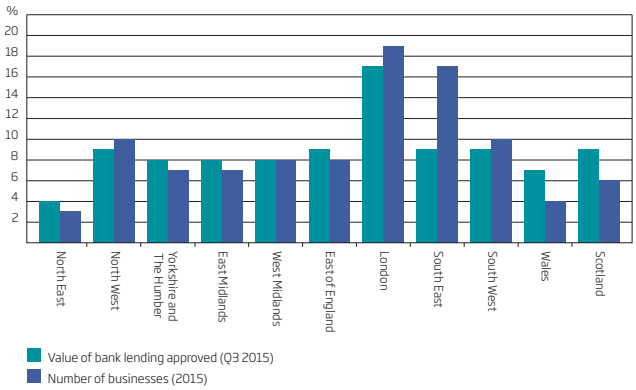
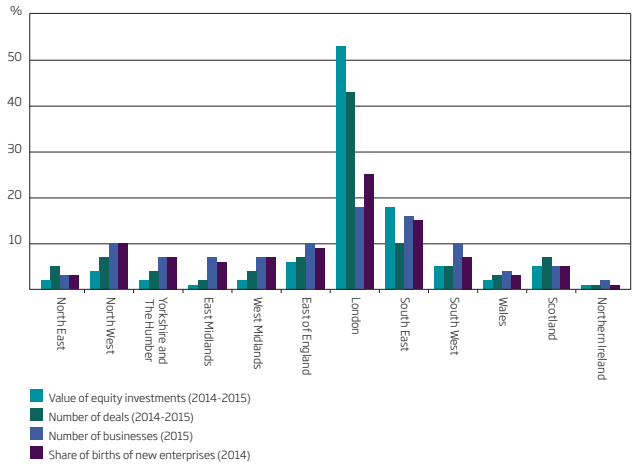



FIG 1.23

**PROPORTION OF EQUITY DEALS BY REGION**

*Source: Beauhurst*




## PRIVATE EQUITY FINANCE IS CONCENTRATED IN LONDON AND SOUTH EAST BUT IS UNDER-REPRESENTED IN SOME REGIONS

Equity deals are not spread uniformly across the UK. Equity investment is heavily concentrated in London and the South East, with 53% of deals worth 71% of investment in 2014 and Q1-Q3 2015. In comparison, 34% of all businesses are located in London and the South East, showing these regions are over represented compared to the background population of businesses and share of business start-ups. The existence of other equity providers like crowdfunding platforms and private investors in the Beauhurst data offsets slightly the Private Equity industry being concentrated in London and the South East. Focusing on investments made by Private Equity funds only, London and the South have a share of 60% by number and 73% by value.

Interpreting the regional differences in equity finance is difficult as the use of equity finance is related to both supply and demand side factors. For instance, many of the major Venture Capital funds are located in London and the South East, which can lead to innovative businesses clustering around other innovative businesses and funders. It is possible that fund managers are more likely to invest closer to their geographic location, especially for smaller deal sizes. Additional care is also needed as the overall equity figures are likely to include sources of government funding; some of it such as ERDF funding is mandated to be targeted at specific regions. The Northern Powerhouse Investment Fund announced at Autumn Statement 2015 will help increase the supply of finance in Northern Regions.

Although demand side factors may explain some of the differences, smaller businesses outside of London and the South East are relatively under-supplied with Venture Capital finance compared to the distribution of business start-ups and the business population.

CHAPTER TWO

# START-UP BUSINESSES

Start-up businesses play a crucial role in the economy. They bring new innovations to market, increase competition and fill gaps in the market. They play an essential part in supporting economic growth and job creation. For the purposes of analysis using the Business Bank segments, start-ups are defined as having no more than 5 years trading activity. However, it is recognised that such definitions are fluid, because it can be difficult to define when a business has been created versus an activity that is a hobby of an individual.

Start-up businesses are most likely to have difficulties raising external finance. Lenders and investors will have less information on which to assess the potential creditworthiness of new businesses, and the businesses may have less collateral to offer as security. Particularly for those applying for finance the first time there may be a knowledge barrier for the entrepreneur, meaning that the relevant information is less likely to be presented to the potential finance provider.

Chapter 2 therefore looks at the finance market for start-ups in more detail. Section 2.1 reviews the evidence on new business start-ups finding that in 2014 new enterprise numbers remained high by recent historical comparisons.

Section 2.3 reviews the results of the Business Bank Finance Survey to identify where start-ups experience in accessing and using finance is different to the wider small business population. Findings include that start-ups are more likely both to apply, and be rejected, for finance, unsurprising given the expected greater market problems facing start-up businesses.

Section 2.4 provides a start-up breakdown of experience of applying for traditional debt finance. Older start-ups (2-5 years) have a similar experience to younger start-ups (0-2 years).

Finally, the evidence on seed stage equity investment is reviewed in section 2.5. This highlights the increased number and value of seed stage deals and the increased use of crowdfunding platforms as a mechanism by which start-ups obtain equity finance.

2.1

# TRENDS IN START-UPS

- The fluid nature of the start-up process means there is no definitive measure of start-up activity
- ONS data suggest similar number of business births in 2014 to 2013, when strong growth was recorded
- Business births are concentrated in London, with variation between other regions relatively less marked
- Business births as a proportion of total active enterprises has increased since 2009

## THE FLUID NATURE OF THE START-UP PROCESS MEANS THERE IS NO DEFINITIVE MEASURE OF START-UP ACTIVITY

There is no definitive indicator of the number of new business starts in the UK economy, because measuring the number of start-ups in an economy can be very difficult. This is due to two main factors:

- The process of starting up a business is very fluid, and it can be difficult to define when a hobby of an individual becomes a 'start-up'.
- Many datasets do not capture initial start-up activity, although these ventures could legitimately be considered to have been created.

ONS business demography data on births of new enterprises captures businesses that have reached certain thresholds (i.e. registering for VAT or PAYE). However, the process of starting up a business can take many months and/or years, with different entrepreneurs reaching those thresholds at different times, or differences in business models influencing the relevance of registration. Some legitimate businesses will never meet the thresholds to be included in ONS data.

## ONS DATA SUGGEST SIMILAR NUMBER OF BUSINESS BIRTHS IN 2014 TO 2013, WHEN STRONG GROWTH WAS RECORDED

ONS business demography data on births of new enterprises – a measure of businesses registering for VAT or PAYE – indicates that new business creation in 2014 (c350,000 new businesses) was broadly unchanged from 2013 (although there was a slight decrease in the birth rate[45] from 14.1% in 2013 to 13.7% in 2014). However, underlying this is a general increase in new business starts in recent years, where the number of births in 2014 was c50% higher than in 2010.

However, as indicated above, ONS data may not pick up some very early stage start-ups, or those that do not trigger thresholds to be included in official statistics. BankSearch statistics, which cover the opening of new

business bank accounts, potentially offer a fuller picture of earlier start-up activity. BankSearch data, in contrast to ONS data, indicate that the number of new starts fell in 2014, continuing the trend since the 2011 peak, with levels lower than those recorded in 2010.

The Global Entrepreneurship Monitor (GEM), measures entrepreneurial activity in the UK and other countries. It breaks down entrepreneurial activity into categories:

- Intend to start a business in next three years
- Nascent entrepreneurs (paying wages for no more than three months, therefore can be considered to be early/initial set-up stage)
- New business owner (paying wages for more than three months, but less than 42 months – still likely to be a relatively new venture, but likely to be further progressed in the start-up process

GEM UK 2014 data suggests that the proportion of the UK working age adult population that intended to start a business increased in each year between 2010 and 2012, but then reduced in 2013 and 2014. The percentages of nascent entrepreneurs and new business owners also decreased in 2013, but rose in 2014 and remain relatively strong.

Combined, it would seem that increased levels of entrepreneurialism during the economic downturn have helped to boost new business creation, with relatively strong levels of VAT/PAYE registrations still being recorded.

## BUSINESS BIRTHS ARE CONCENTRATED IN LONDON, WITH VARIATION BETWEEN OTHER REGIONS RELATIVELY LESS MARKED

The regional ONS business demography data suggest that London and the South East lead the way in terms of births of new enterprises (new VAT and PAYE registrations), contributing 40% of new starts between them in 2014. Furthermore, the proportion of new UK businesses registering for VAT or PAYE in London outweighs the proportion of deaths (or de-registrations), which should add to the business stock and competitive environment.

The North East continues to have the lowest share of new enterprises of the English regions, with Northern Ireland and Wales also seeing relatively low levels. However, when looking at the number of new businesses for each 10,000 people in a specific region, the disparity between the regions is lessened. London still outpaces other regions in terms of new registrations and active enterprises, and has about 60% more businesses per 10,000 population than the UK average.

## BUSINESS BIRTHS AS A PROPORTION OF TOTAL ACTIVE ENTERPRISES HAS INCREASED SINCE 2009

Business births as a proportion of active enterprises (which includes births and deaths) have increased since 2009. In 2014, new enterprises represented 13.7% of active enterprises.

Each of the broad sectors – production, construction and services – also recorded an increase in the proportion of new enterprises since 2009. However, comparing 2014 with 2013 a small decrease in new registrations as a proportion of active enterprises was reported for services and production was flat, while the construction sector saw a further increase in its proportion of business births.

FIG 2.1

**BIRTHS OF NEW ENTERPRISES PER 10,000 POPULATION**

*Source: BBB analysis, ONS Business Demography Data*

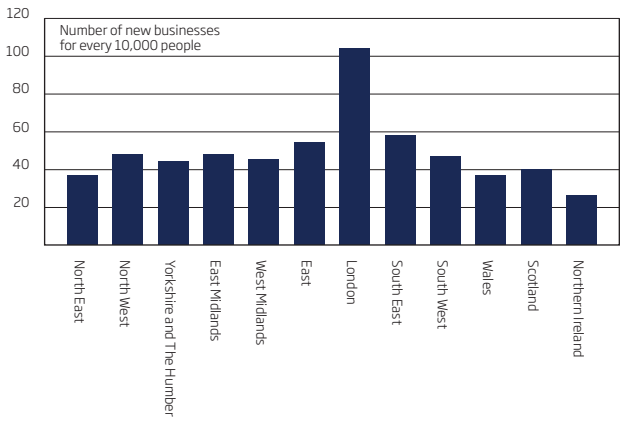
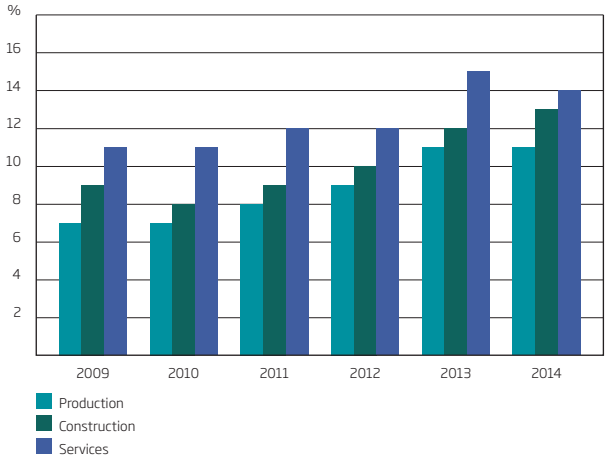



FIG 2.2

**NEW ENTERPRISES AS A PROPORTION OF ACTIVE ENTERPRISES**

*Source: BBB analysis, ONS Business Demography Data*



2.2

# START-UPS AND THE ECONOMY

- A small percentage of new starts survive for 15 years, with an even smaller proportion of these contributing disproportionately to job growth
- Country comparisons would suggest that growth of micros could be better, but ambition appears to hold this back
- Access to finance can be an enabler for increasing productivity

## A SMALL PERCENTAGE OF NEW STARTS SURVIVE FOR 15 YEARS, WITH AN EVEN SMALLER PROPORTION OF THESE CONTRIBUTING DISPROPORTIONATELY TO JOB GROWTH

Data would suggest that the number of new enterprises in the economy is encouraging. However, it is important to ensure that new businesses survive and continue to develop and grow, supporting UK productivity growth.

Analysis conducted by the Enterprise Research Centre[46] indicates that, over a 15-year horizon (1998-2013), just 11% of start-up firms born in 1998 survived until 2013, adding about 230,000 net jobs. Underlying this, about 60% of surviving firms were net job creators, with the bulk of these born very small (less than five employees) and remaining very small. However, within this class of start-ups (less than 5 employees), around 6% account for 90,000 added jobs (40% of job creation from all 15-year survivors).

## COUNTRY COMPARISONS WOULD SUGGEST THAT GROWTH OF MICROS COULD BE BETTER, BUT AMBITION APPEARS TO HOLD THIS BACK

A small rise in the percentage of very small start-ups disproportionately contributing to net job creation over that 15-year period could have had a large impact on the absolute number of jobs created. Evidence from other OECD countries would suggest there is potential to improve growth of micro enterprises (less than 10 employees), with a recent publication noting, "The UK has one of the lowest proportions of micro enterprises that grow to more than 10 employees in three years."[47] Therefore, young businesses could play an even bigger role in boosting UK growth and productivity.

However, the growth ambition of early stage entrepreneurs in the UK, "Lags behind in terms of growth expectation compared to all but one of the G8 countries".[48] The gap between start-up activity in the US and the UK is often cited. The Global Entrepreneurship Monitor measure of 'high job expectation'[49] indicates that around 18% of early stage entrepreneurs in the UK met this definition in 2014 compared with 27% in the US.

These expectations are much higher for early stage entrepreneurs compared with those of established business owners (18% early stage vs 4% established business owners). Therefore, to the extent that these high growth ambitions will be met, harnessing this potential from early stage entrepreneurs is important.

## ACCESS TO FINANCE CAN BE AN ENABLER FOR INCREASING PRODUCTIVITY

Another way of boosting the productivity of smaller businesses in the UK is to increase the proportion engaged with internationalisation and innovation.

The Global Entrepreneurship Monitor suggests that roughly 25% of early stage entrepreneurs in the UK report that they operate in new product markets. This is compared with 40% in France and 37% in the US. Similarly, 16% of early stage entrepreneurs report that more than 25% of their customers are outside of the country. This compares with 22% and 21% in France and Germany, respectively, although is above the 15% reported by early stage entrepreneurs in the US.

Access to finance (and capital) is one enabler that could help boost entrepreneurial ambition to export and innovate, where evidence suggests that international and innovative activity enhances firm performance and productivity growth.

2.3

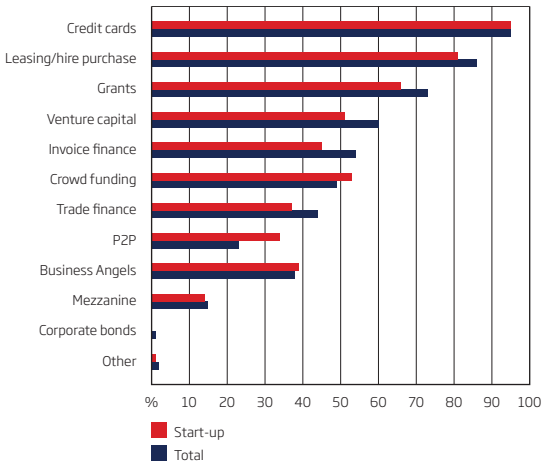
# START-UPS DEMAND FOR FINANCE

- Start-ups more likely than other SMEs to have sought finance in last 12 months and to have been rejected
- Awareness of alternative sources of finance is above the SME average
- Start-ups remain more dependent on loans from family than other SMEs
- Start-ups are more likely to be first time seekers of finance, but are no more likely to obtain advice

FIG 2.3

**AWARENESS OF EXTERNAL FORMS OF FINANCE**

*Source: Business Bank Finance Survey*




The analysis in this section is based on the Business Bank segments of SMEs. Therefore, start-ups are defined as SMEs with trading activity of no more than five years.

## START-UPS MORE LIKELY THAN OTHER SMES TO HAVE SOUGHT FINANCE IN LAST 12 MONTHS AND TO HAVE BEEN REJECTED

The proportion of SMEs seeking external finance in the last 12 months has increased since 2014 (2015: 18%, 2014: 12%). There has also been a rise in the proportion of start-ups seeking external finance in the last year, increasing from 12% to 25%. However, success rates remain lower for start-ups than for SMEs as a whole. For all applications for external finance in the last three years, 61% of start-ups were offered what they wanted compared with 71% for the overall SME population.

## AWARENESS OF ALTERNATIVE SOURCES OF FINANCE IS ABOVE SME AVERAGE

Awareness of traditional debt products amongst start-ups is high and broadly in line with levels reported for the overall SME population. However, awareness of other debt products, such as invoice and trade finance, and sources of growth capital (e.g. venture capital) is lower. In contrast, awareness of newer channels of finance (e.g. peer-to-peer lending) are higher than those reported by SMEs on average.

Awareness of who to approach for particular forms of finance was generally in line with that of the overall small business population.

## START-UPS REMAIN MORE DEPENDENT ON LOANS FROM FAMILY THAN OTHER SMES

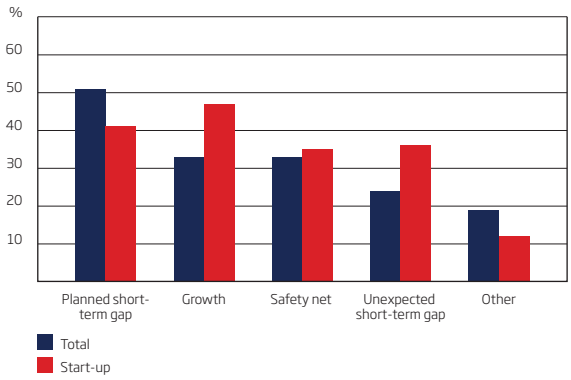
For the total SME population, bank overdrafts and credit cards are the two most used forms of external finance over the past three years. Start-ups have reported increased usage of credit cards in 2015. However, loans from family or business colleagues remain the most used form of funding for start-ups (usage has risen compared with last year for both start-ups and the overall SME population). Notably, where an entrepreneur does not have access to funds from family or business colleagues, they may be at a significant disadvantage.

Mirroring the overall trend in SME applications for finance, where finance was sought, this was most likely to be for working capital purposes. However, there were differences in the purpose for which the working capital was required, with start-ups more likely to report that this was for growth or to fund unexpected short-term gaps (i.e. addressing the effects of late payments).

FIG 2.4

**REASONS FOR SEEKING WORKING CAPITAL**

*Source: Business Bank Finance Survey*




## START-UPS ARE MORE LIKELY TO BE FIRST TIME SEEKERS OF FINANCE, BUT ARE NO MORE LIKELY TO OBTAIN ADVICE

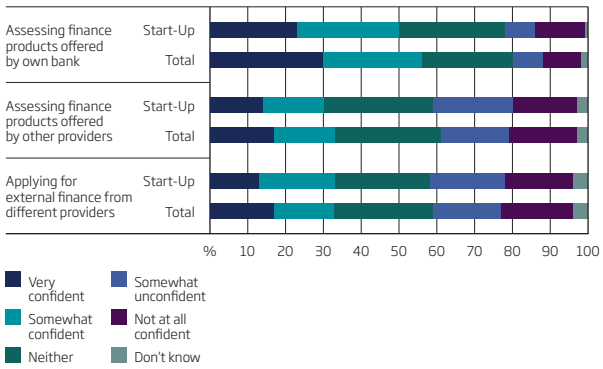
Start-ups are just as confident in their ability to apply for external finance from different providers as other SMEs (based on those rating themselves as 'very confident' or 'somewhat confident'). They are less likely to rate themselves as 'very confident' in assessing finance products offered by their own bank.

Approximately one in five start-ups would be 'very likely' to take advice if they were to have difficulties in obtaining finance (a similar proportion to the total SME population). However, they are more likely to be first time applicants for finance and to be unsuccessful in their application. This may imply that their propensity to seek advice should be higher should they have difficulties obtaining finance, which in turn may increase the rate of successful applications.

FIG 2.5

**CONFIDENCE IN ASSESSING AND APPLYING FOR FINANCE**

*Source: Business Bank Finance Survey*



2.4

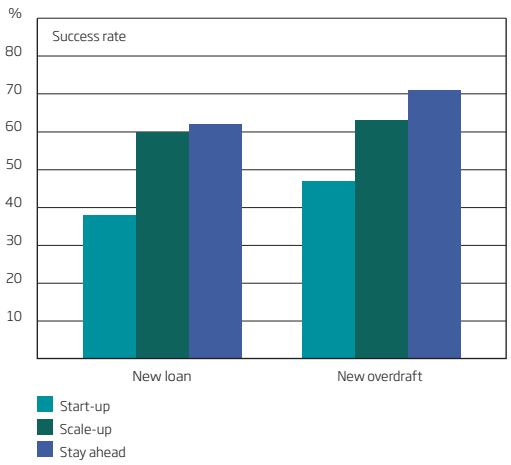
# ANALYSIS OF NEW DEBT FINANCE APPLICATIONS BY START-UPS

- Start-ups are more likely than the average SME to be unsuccessful in their application for new debt finance
- Start-ups have the lowest value of total rejected demand of the segments
- Problems in accessing finance remain for early stage businesses with 2-5 years trading history

FIG 2.6

**RELATIVE SUCCESS RATES FOR NEW LOANS AND OVERDRAFTS**

*Source: BBB analysis, SME FM*




The analysis in this section is based on the Business Bank segments of SMEs. Therefore, start-ups are defined as SMEs with trading activity of no more than 5 years.

## START-UPS ARE MORE LIKELY THAN THE AVERAGE SME TO BE UNSUCCESSFUL IN THEIR APPLICATION FOR NEW DEBT FINANCE

Our analysis of rejected new loan and overdraft applications using SME Finance Monitor data suggests that start-ups are more likely to be rejected in seeking new debt finance than the average SME. Of the three Business Bank market segments, start-ups also have the highest number of applications for new debt (c40% of new loan applications and nearly 50% of new overdraft applications are made by start-ups), meaning that they also represent the largest share of rejected demand by volume.

## START-UPS HAVE THE LOWEST VALUE OF TOTAL REJECTED DEMAND OF THE SEGMENTS

On average, start-ups apply for lower values of finance than other SMEs. The disparities in average new loan values between the three Business Bank segments mean that, despite notably higher numbers of start-ups being rejected, the value of rejected new debt applications from start-ups is lower than for the other Business Bank segments.

However, start-ups are also likely to be particularly prone to structural problems in accessing finance markets that will persist even when cyclical pressures ease. This is due to the high risk proposition that they present to lenders, given high failure rates of new business starts. Compounding this, new starts are still accumulating a performance record and/or security. Therefore, demonstrating that business plans are achievable is likely to be particularly difficult for this group of businesses.

## PROBLEMS IN ACCESSING FINANCE REMAIN FOR EARLY STAGE BUSINESSES WITH 2-5 YEARS TRADING HISTORY

In the Business Bank's segmentation, 'start-ups' encompass any SME trading for no more than five years. As noted earlier in the section, the start-up process is quite fluid and some businesses may trade for many years before reaching the thresholds that trigger their appearance in official statistics, or they may never reach those thresholds.

Conceptually, it may be considered that the start-up phase is complete before five years of trading has elapsed. However, many finance providers require 2-3 years of trading history in order to be able to consider applications for finance. As already noted, in the very early stages of start-up there may not be sufficient activity for the business to be able to produce meaningful records. This means that businesses that have been trading between 2 and 5 years are likely to find the ability to prove their track record when applying for finance similarly challenging. On that basis, our analysis of SME Finance Monitor data includes the 2-5 age group within the definition of start-up, as well as the 0-2 age group.

Splitting down the start-up segment between SMEs trading up to 2 years (new starts) and those trading between 2-5 years (early stage businesses) is difficult, because a low underlying sample size prevents robust analysis of the new starts sub-segment.

While caution should be exercised regarding the robustness of the results, the analysis indicates that early stage businesses (2-5 years) actually have a lower success rate when applying for a new loan, and a broadly similar success rate for new overdraft applications, compared with new starts. Both sub-segments have relatively low success rates compared with scale-up or stay ahead businesses.

## CONCLUSIONS

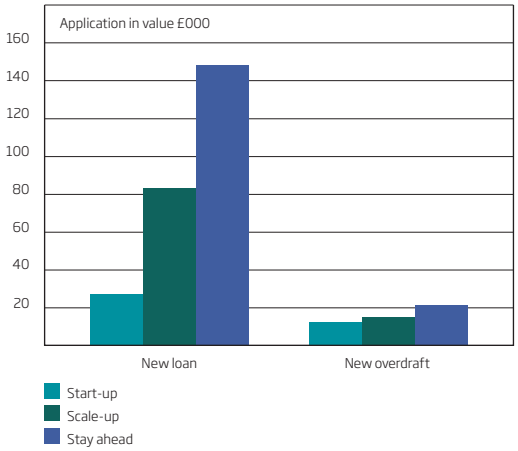
The British Business Bank oversees the Start-Up Loans programme on behalf of the Department for Business, Innovation and Skills. The Start-Up Loans programme is focused on new starts trading up to two years and provides access to finance and pre-application and post-loan support. The start-up analysis suggests there is continuing need for access to finance for new starts as well as skills provision to help ensure that viable new businesses start on the best possible course for survival and contribution to economic growth.

Despite the segment definition, the focus of the Start-Up Loans programme on the newest businesses remains relevant to help sustain the strength of the flow of new starts in the economy. However, a continued need for support in accessing finance markets for early stage businesses is also recognised, particularly where achieving growth ambitions can be particularly beneficial for UK productivity. At this stage, supporting the progression of young businesses is of key importance. Many of the products offered by the British Business Bank are available to these businesses from the Enterprise Finance Guarantee to equity schemes and other initiatives such as Help To Grow aimed at boosting the supply of finance to smaller businesses.

FIG 2.7

**AVERAGE APPLICATION VALUE**

*Source: BBB analysis, SME FM*



2.5

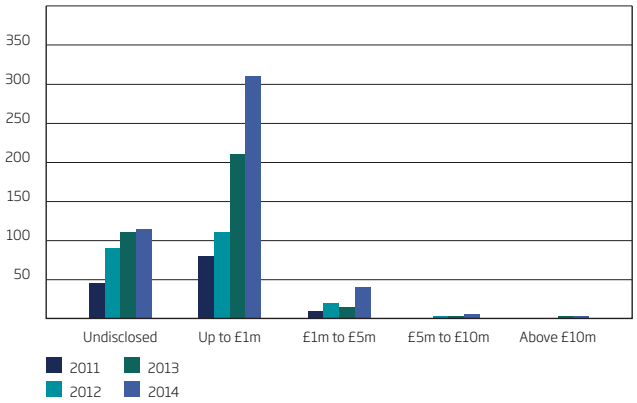
# EQUITY FINANCE FOR START-UP BUSINESSES

- Strong increases seen in seed stage funding set to continue in 2015 and beyond
- Crowdfunding has grown to become the largest funder of seed stage businesses in terms of number of business funded, although deal sizes are much smaller than other equity funders

FIG 2.8

**NUMBER OF SEED STAGE DEALS BY DEAL SIZE**

*Source: Beauhurst*




Equity finance is an important source of funding for new business start-ups that offer the potential for high growth. These businesses are very risky as they may not yet have a working product or have any customers leading to a high likelihood of business failure. However, if they are successful they have the potential for generating very high returns, which is why equity finance is a suitable form of finance for high growth potential start-ups. Early stage funding is known as seed funding.

## STRONG INCREASES SEEN IN SEED STAGE FUNDING SET TO CONTINUE IN 2015 AND BEYOND

Seed stage investments are generally very small with average deal sizes of less than £700,000. In 2015 to date, 87% of seed investments (for known deal sizes only) were below £1m in size, although on value terms they only formed 31% of the market. This is because while some seed stage investments can be very large, for instance seed stage pharmaceutical companies developing new products require a larger amount of capital before the product is viable, most are very small.

Seed stage funding has shown strong increases over time from 2011 to 2014, increasing by 236% by number and 200% by value. This positive trend looks to continue in 2015 with the first three quarters data being 21% higher by number and 49% by value compared to the first three quarters of 2014.

## CROWDFUNDING HAS GROWN TO BECOME THE LARGEST FUNDER OF SEED STAGE BUSINESSES IN TERMS OF NUMBER OF BUSINESS FUNDED, ALTHOUGH THEIR DEAL SIZES ARE MUCH SMALLER THAN OTHER EQUITY FUNDERS

There has been a sustained increase in the number of crowdfunding deals over time, so that by 2014 crowdfunding platforms funds the largest number of publicly known seed stage businesses, even more than

private equity funds. In the first three quarters of 2015 there were 136 deals involving crowd funders compared to 71 involving private equity funds. However, crowd funding platforms generally provide smaller amounts of finance than other types of equity funding so private equity funds still provide twice as much seed funding as crowd funding platforms (£80m compared to £34m in Q1-Q3 2015). Nevertheless, only 17% of seed investments now involve private equity investors down from 29% in 2011.

Private investors, including business angels are investing in a growing number of deals. Research by the Enterprise Research Centre finds that angels are making more investments than before, with the median number of investments rising to 5. The UK Business Angel Association estimates that private investors account for between £800 million and £1 billion of early stage investment each year in the UK – the single largest source of early stage capital in this country.

## CONCLUSION

Whilst there have been improvements in equity funding conditions for seed stage businesses over the last few years, there remain a number of structural issues in the supply of equity finance to SMEs which restricts potentially viable SMEs from raising finance. This is noted by the Private equity funds only being involved in a minority of seed stage deals, with their share of the market declining in numbers terms. This partly is a result of increasing importance of other equity providers including private investors and business angels, and the use of crowdfunding.

This demonstrates there is an ongoing need for continued British Business Bank involvement in in the early stage equity market. For instance, Enterprise Capital Funds (ECF) has an important role for encouraging Venture Capital Fund managers to establish Venture Capital funds making smaller equity investments businesses affected by the 'equity gap'. The Angel Co-Fund also makes initial investments of between £100K and £1M into growing companies, alongside syndicates of business angels to increase the supply of finance high potential businesses. In addition, HMT and HMRC's Seed Enterprise Investment Scheme (SEIS) is an important source of funding for seed stage companies and further information on tax relief schemes is contained in section 3.4.

FIG 2.9

**NUMBER AND VALUE OF SEED INVESTMENTS OVER TIME**

*Source: Beauhurst*

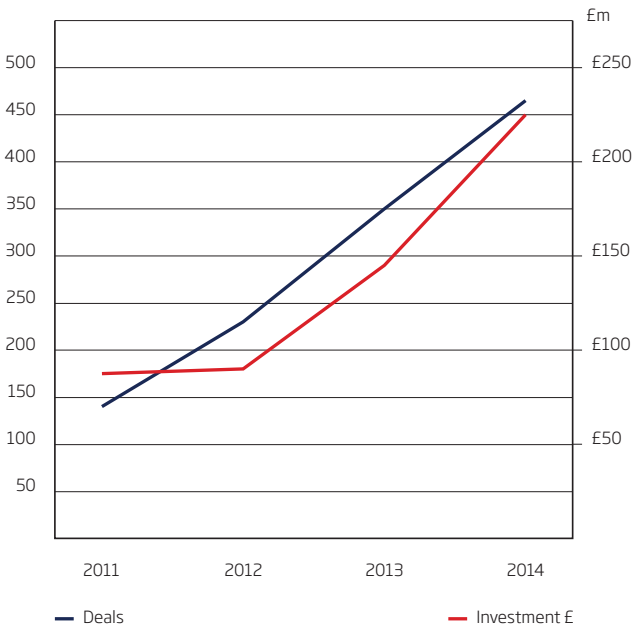
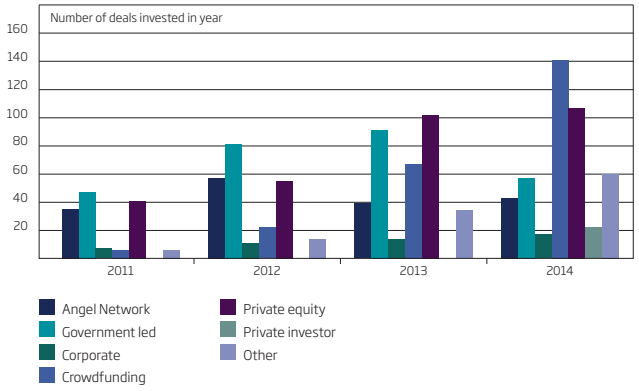



FIG 2.10

**NUMBER OF DEALS BY TYPE OF INVESTOR**

*Source: Beauhurst*



CHAPTER THREE

# SCALE-UP BUSINESSES

Scale-up businesses are defined as businesses older than 5 years that are looking to grow. It can be more difficult for finance providers to assess the business propositions of growing businesses if they involve new products and processes or moving into new markets, without incurring greater due diligence costs. These particularly affect smaller loans and equity investments. Expansion may also be more risky with uncertain outcomes.

Scale up businesses have slightly lower success rates obtaining finance than stay ahead businesses, but are more likely to obtain finance compared to start-up businesses. Whilst senior debt funding from a bank or peer to peer lending platform meets the funding needs of most growing businesses, some growing businesses are looking to expand more aggressively and in these instances, specialist debt and equity finance is more suitable.

Chapter 3 presents analysis of external finance sources that are appropriate for innovative growing firms that are looking to scale up rapidly. This chapter will focus on flexible debt provided by debt funds (section 3.2). The increased availability and use of finance by mid-cap businesses is also discussed (section 3.3).

The role external finance plays in helping small businesses export is discussed in more detail, as exporting can help unlock increased growth. Equity finance is a suitable source of finance for smaller businesses with high growth potential and is covered in section 3.5. The chapter concludes with a discussion of the availability of long-term finance including 'patient capital' (section 3.6).

3.1

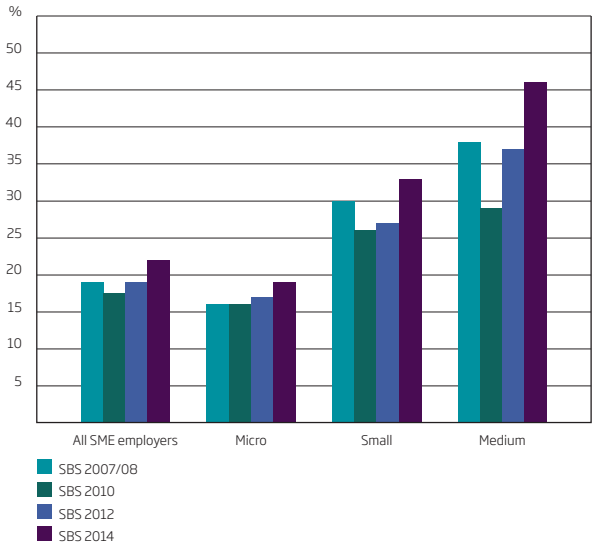
# GROWTH PERFORMANCE OF SME SECTOR

- Many businesses experience growth and this is increasing over time as the economic recovery is sustained
- Increased numbers of businesses are now aiming to grow compared to 2014, with some external finance being used to fund it
- Although only a small proportion of businesses are high growth businesses, they are very important for job creation

FIG 3.1

**PROPORTION OF SME EMPLOYER BUSINESSES THAT INCREASED NUMBER OF PEOPLE EMPLOYED OVER PREVIOUS 12 MONTHS**

*Source: BIS Small Business Survey 2014: Business with employees*




The contribution of business start-ups to the economy has been discussed in an earlier chapter, but it is also important to consider the growth performance of established businesses as they also make a large contribution to economic growth and job creation. This is because many start-up businesses will close early in their life. Of those businesses that started in 2009, only 62.5% survived for three years. In addition, many start-up businesses remain small and do not grow sufficiently large. For instance, only 4.1% of the businesses started in 2009 grew to at least £1m turnover in the three years.[50] Business growth can be measured in a number of ways, but the main ways for looking at growth are through increases in employment or turnover.

## MANY BUSINESSES EXPERIENCE GROWTH AND THIS IS INCREASING OVER TIME AS THE ECONOMIC RECOVERY IS SUSTAINED

Survey evidence from the BIS Small Business Survey 2014[51] shows 22% of SME employers employed more people than they did 12 months earlier. The majority of business (62%) employed the same number, but 16% employed fewer. The proportion of businesses reporting employment growth was higher in 2014 than previously, showing the economic recovery has been sustained.

Growth has occurred in all sizes of business but the larger the business, the more likely it is to have grown in the last 12 months, with 46% of medium businesses having increased their employment in 2014 compared to a year ago.

Growth performance is even more positive when looking at turnover. 40% of SME employers had greater sales turnover than a year previously, 39% had approximately the same turnover, but 18% had lower turnover. Compared with 2012, there has been a significant increase in the proportion with higher turnover (up 11% points), and a decrease in the proportion reporting lower turnover (down 13% points). This increase occurred across all size bands, but was most notable in the micro population of businesses.

The strength of the SME sector can also be considered by looking at profitability. The SME Finance Monitor survey shows 74% of SMEs were profitable in the last trading year, with just 9% making a loss.[52] The proportion making

FIG 3.2

**PROPORTION OF SME EMPLOYER BUSINESSES THAT INCREASED TURNOVER OVER PREVIOUS 12 MONTHS**

*Source: BIS Small Business Survey 2014: Business with employees*

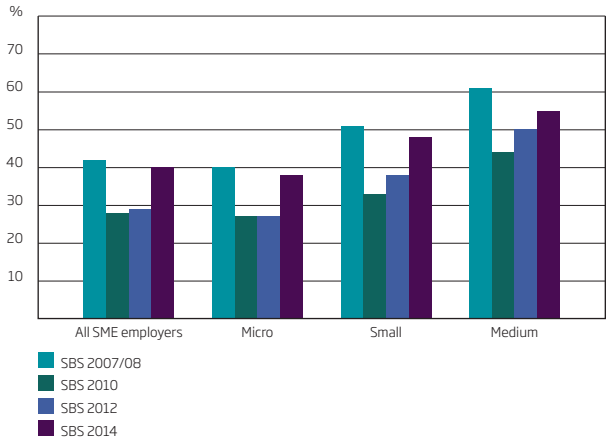
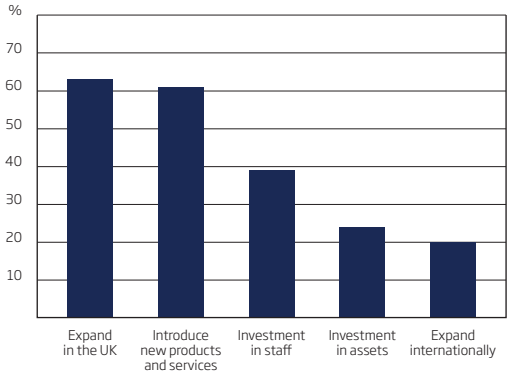



FIG 3.3

**WAYS IN WHICH FUTURE GROWTH WILL BE ACHIEVED IN 2015**

*Source: Business Bank 2015 Business Finance Survey*




a profit has increased from 62% in Q3 2012 to 75% in Q3 2015, reflecting the improved economic environment.

## INCREASED NUMBERS OF BUSINESSES ARE NOW AIMING TO GROW COMPARED TO 2014, WITH SOME EXTERNAL FINANCE BEING USED TO FUND IT

The British Business Bank Finance survey shows over half of businesses (56%) are aiming to grow their business turnover in the next 12 months. This is an increase from the 46% reported in the 2014 SME Journey surveys, showing businesses are more confident. Medium sized businesses are the most likely by size to want to grow (77%) compared to 54% of zero employee businesses.

Of those aiming to grow, most will do this through domestic expansion or by introducing new products and services. Fewer will achieve this by investing in staff and assets or by expanding internationally.

Whilst external finance is important for supporting business growth, the majority of businesses (68%) will only use internal sources of finance to fund it, i.e. from built up cash reserves. Only 29% of businesses intend to use some sources of external finance to support future growth. There is some indication that a greater proportion of businesses in 2015 will now consider using external sources of finance to support growth compared to previously.

## ALTHOUGH ONLY A SMALL PROPORTION OF BUSINESSES ARE HIGH GROWTH BUSINESSES, THEY ARE VERY IMPORTANT FOR JOB CREATION

High growth businesses are defined as businesses with annualised average growth in employment of 20% or more over a three year period. There were over 10,000 high growth businesses in 2011-14, forming 7% of the business population of businesses that survive for at least three years.

The incidence of high growth businesses averaged 7.2% between 2002-05 and 2007-10, but declined to 5.9% during the economic downturn before recovering to 6.6% in 2010-13. Therefore, the proportion of high growth businesses has recovered to the level it was before the recession.

High growth businesses have a large and disproportionate impact on job creation. Of all the new jobs created amongst established businesses, high growth SMEs contribute 20% of all job growth in the economy. This proportion has remained virtually unchanged since the late 1990s and was not affected by the recession.[53] It will be important to ensure these high growth businesses, and businesses with the potential for high growth can access the external finance they need.

3.2

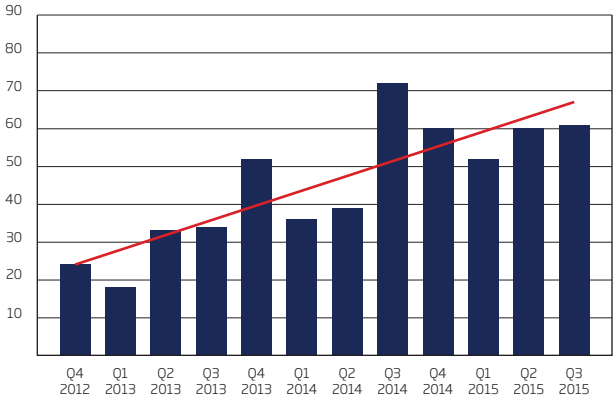
# DEBT FINANCE FOR HIGH GROWTH BUSINESSES

- Debt funds offer a variety of flexible debt products to growth orientated businesses and have become established in the UK market, although most of these funds focus on mid-caps businesses
- Institutional investors have become an important source of funding in the European leveraged loan market for mid-market businesses
- The British Business Bank has a number of programmes designed to increase the supply of debt finance for growing smaller businesses

FIG 3.4

**NUMBER OF EUROPEAN PRIVATE DEBT DEALS PER QUARTER**

*Source: Deloitte LLP*




Debt funds provide businesses with bespoke debt finance that offers an alternative source of funding to banks. Whilst senior debt lending from banks is targeted at businesses within a well-defined risk spectrum with relatively lower margins, debt funds tend to accommodate greater levels of risk and lend at higher interest rates. The speed of lending, flexibility in deal structure including deferral of capital and interest repayments and greater leverage are also key factors why this type of finance meets the needs of some growing businesses.

## DEBT FUNDS OFFER A VARIETY OF FLEXIBLE DEBT PRODUCTS TO GROWTH ORIENTATED BUSINESSES AND HAVE BECOME ESTABLISHED IN THE UK MARKET, ALTHOUGH MOST OF THESE FUNDS FOCUS ON MID-CAPS BUSINESSES

While the total volume of capital raised for private debt in Europe is relatively low compared to other types of debt finance, there has been a large increase in the number of funds investing in mid-market businesses over the last few years. The Deloitte Alternative Lender Deal Tracker shows the private debt market is well established in Europe with increased numbers of deals over time. For instance there were 212 deals in 2014, up from 118 in 2013.[54] These mainly relate to mid-market companies, but there is limited data available on the activity of debt funds to smaller businesses.[55]

The UK remains the largest market for private debt funds in Europe with 45% of the transactions, followed by France (24%) and Germany (12%). The majority of deals are structured as first lien (senior debt or unitranche), with the remaining 16% of deals are subordinated (mezzanine and second lien) behind other lenders. There is an increasing trend of sponsor less deals with 25% of deals not involving a private equity sponsor in the latest quarter, up from the 21% long-term average.

FIG 3.5

**EUROPEAN LEVERAGED LOAN MARKET BROAD INVESTOR TYPE**

*Source: LCD Leveraged Loan Review, Q3 2015.*[57]

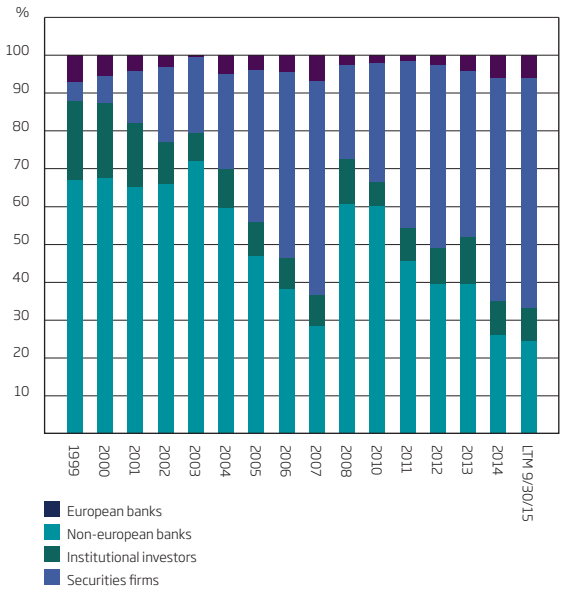
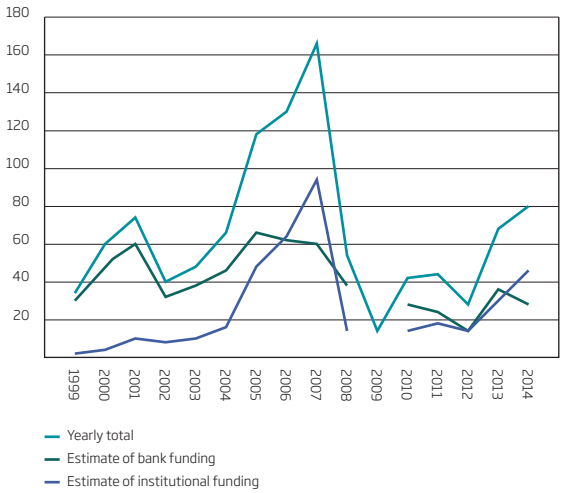



FIG 3.6

**EUROPEAN LEVERAGED LOAN MARKET FUNDING AMOUNTS**

*Source: LCD Leveraged Loan Review, Q3 2015.*[59]




## INSTITUTIONAL INVESTORS HAVE BECOME AN IMPORTANT SOURCE OF FUNDING IN THE EUROPEAN LEVERAGED LOAN MARKET FOR MID-MARKET BUSINESSES

Part of the reason for the increase in debt funds in Europe is that there has been an increase in the involvement of institutional investors in the mid-market space. The share of institutional funding increased from 25% in 2008 to 61% in 2015. In Q3 2015, 78% of deals involved institutional funding. As a result, banks have a declining share in the provision of finance to the European leveraged loan market. In the first three quarters of 2015, banks had a 33% share of the market down from 72% in 2008.

The decline in bank lending in this market is partly due to European banks having to hold a greater amount of capital compared to investment grade lending, which reduces its relative attractiveness. The European market is becoming more comparable to the US market where institutional investors form 86% of the US leveraged loan market. This is expected to continue. A recent survey[56] shows Europe has overtaken North America as the most sought-after region for investment in private debt funds with 73% of investors considering investing in funds focusing on this region over the next 12 months compared to 68% for North America.

The role of institutional investors in the leveraged loan market in the US is well established, but in Europe banks traditionally originated loans. Whilst leveraged lending became established in the early part of 2000's it declined sharply in 2008 and 2009 as the impact of the financial crisis triggered the unwinding of the excess leverage built up on bank and hedge funds balance sheet assets and securitisation markets closed. This led to a further downward spiral in loan asset prices triggering further selling.[58] The leveraged loan market has now recovered increasing to €80bn, up from €28.5bn in 2012, restoring the mid-market loan market liquidity.

## THE BRITISH BUSINESS BANK HAS A NUMBER OF PROGRAMMES DESIGNED TO INCREASE THE SUPPLY OF DEBT FINANCE FOR GROWING SMALLER BUSINESSES

Whilst mid-market funding conditions are relatively strong, structural issues remain for smaller businesses. The Investment Programme along with its predecessor the Business Finance Partnership Small Cap Tranche aims to promote diversity of lending supply through supporting a variety of potential finance providers including private debt. A number of commercial debt funds focusing on SMEs have been supported including Beechbrook, BMS Finance, Boost, Praesidian, Muzinich and European Capital. The British Business Bank has also announced the Help to Grow pilot to specifically encourage the provision of smaller growth loans between £0.5m and £5m, with a focus on sub £2m deal sizes.

In addition to the above programmes focusing on smaller businesses, the Business Finance Partnership Mid-cap Tranche has invested £863m alongside over £1bn from private investors across 6 debt fund managers focused on direct lending to mid-caps. The mid-cap tranche was announced in 2011 to improve liquidity conditions for mid-cap businesses and has been catalytic in developing the asset class in the UK and is recognised in the industry as having played a meaningful role in accelerating investment in direct lending funds.

The above asset class has grown significantly over the last few years, with an estimated €50 billion of capital now committed to European direct lending funds and a further €15 billion targeted in fundraising over the next twelve months. Given market liquidity we are currently exploring options for building on the success of the portfolio. The characteristics of mid-cap businesses are explored further in the next section.

3.3

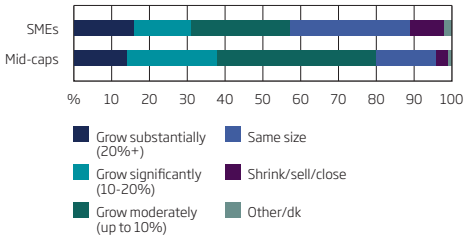
# MID-CAP BUSINESSES

- Mid-cap businesses make an important contribution to the UK economy
- Mid-cap businesses have complex organisational structures, and are more likely to have formal business processes and dedicated finance staff compared to SMEs
- Mid-cap businesses are more confident in their ability to raise finance and also have greater awareness of different types of finance products available to them than smaller businesses
- Mid-cap businesses are significantly more likely to use external finance than SMEs
- Finance markets for mid-cap businesses generally work well with very few businesses having problems raising finance

FIG 3.7

**TURNOVER GROWTH OBJECTIVES OVER NEXT 12 MONTHS**

*Source: British Business Bank 2015 Finance Survey*




## MID-CAP BUSINESSES MAKE AN IMPORTANT CONTRIBUTION TO THE UK ECONOMY

Mid-cap businesses are generally larger than SMEs and cover businesses with an annual turnover of between £25m-£500m, but have not yet reached the size of the largest businesses.[60] Mid-cap businesses have different characteristics and financing needs compared to SMEs, and this section explores these further using findings from the latest Business Bank finance survey which surveyed 300 mid-cap businesses.

There are around 10,000 mid-cap businesses in the UK, contributing £875bn turnover and employing 4.5m people.[61] There has been significant interest in the performance of mid-cap businesses from Government and stakeholder organisations[62] over the last few years, as this group of businesses can help deliver growth to the UK economy. For instance, more mid-cap businesses are aiming to grow in the next 12 months (79%), compared to 56% of SMEs. This is despite mid-cap businesses having broadly similar expectations as SMEs about future trading conditions in the next 12 months. A higher proportion of mid-cap businesses are already exporting and innovating which can lead to further economic benefits including improvements in productivity. For instance, 57% of mid-cap businesses export and 40%[63] innovate by introducing a new or significantly improved good or service in the last three years. In comparison 20% of SMEs export and 26% have introduced new products.

## MID-CAP BUSINESSES HAVE COMPLEX ORGANISATIONAL STRUCTURES, AND ARE MORE LIKELY TO HAVE FORMAL BUSINESS PROCESSES AND DEDICATED FINANCE STAFF COMPARED TO SMEs

Mid-cap businesses have more formalised business processes than SMEs. For instance, 99% of mid-cap businesses produce regular monthly or quarterly management accounts, 95% have a dedicated finance person that manages the accounts or compiles tax returns, 93% make regular cash flow forecasts and 84% have a formal written business plan.

## MID-CAP BUSINESSES ARE MORE CONFIDENT IN THEIR ABILITY TO RAISE FINANCE AND ALSO HAVE GREATER AWARENESS OF DIFFERENT TYPES OF FINANCE PRODUCTS AVAILABLE TO THEM THAN SMALLER BUSINESSES.

Whilst only a slightly lower proportion of mid-cap businesses are using external advice when seeking finance (17% of mid-caps compared to 19% of SMEs), mid-cap businesses largely have dedicated finance directors who are responsible for overseeing the business cash flow and seeking external finance on behalf of the business. As such, mid-cap businesses are more confident in raising finance than SMEs. 82% of mid-caps are confident at assessing products offered by own bank, with just 3% not being confident.

Mid-caps also have higher awareness of different types of finance. For instance, 69% of mid-caps are aware of crowdfunding platforms, 63% are aware of peer to peer lending, 63% are aware of business angels, and 52% are aware of mezzanine finance.

There is also evidence to suggest mid-cap businesses are more likely to shop around for finance than SMEs. Only 37% of mid-cap businesses only contacted one provider of finance compared to 61% of SMEs. Mid-caps contacted 2.43 providers on average compared to 1.7 for SMEs. However, 51% of mid-caps only contacted providers from the four largest banks, a similar proportion to SMEs, showing the four largest banks are still a very important source of finance for mid-cap businesses.

## MID-CAP BUSINESSES ARE SIGNIFICANTLY MORE LIKELY TO USE EXTERNAL FINANCE THAN SMES

The majority of mid-cap businesses (85%) have used external finance in the previous three years compared to 60% of SMEs. Mid-cap businesses are most likely to have used leasing or hire purchase (61%), followed by credit cards (53%) and overdrafts (42%). In contrast, SMEs are most likely to use credit cards (28%), bank overdrafts (28%) and loans from friends / colleagues (23%).

The higher use of finance also translates into higher demand for external finance, with 47% of mid-cap businesses having sought external finance in the last year. This compares to just 18% of SMEs seeking finance over the same time period, showing external finance is

FIG 3.8

**MID-CAP BUSINESSES USE OF FINANCE IN LAST THREE YEARS**

*Source: British Business Bank 2015 Finance Survey*

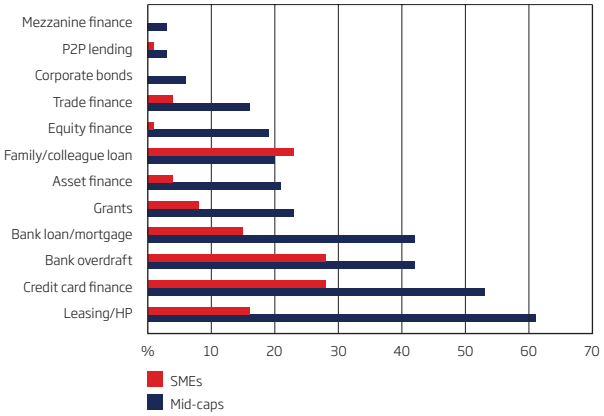


FIG 3.9

**FINANCE PRODUCTS SOUGHT IN LAST THREE YEARS**

*Source: British Business Bank 2015 Finance Survey*

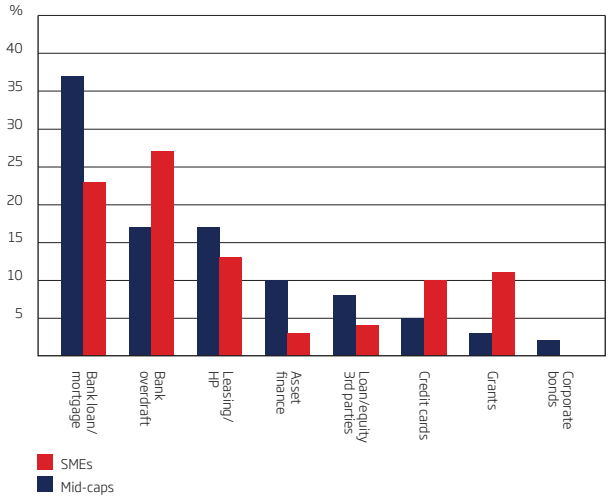
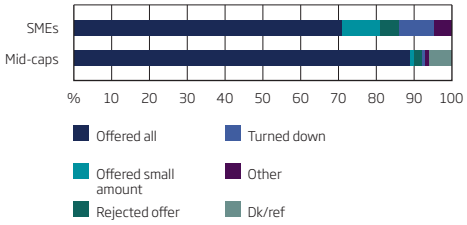



FIG 3.10

**FINANCE INSTITUTION'S INITIAL RESPONSE TO THE FINANCE APPLICATION**

*Source: British Business Bank 2015 Finance Survey*




very important for larger businesses. The main reason mid-caps seek finance was for working capital/ cash flow (45%), followed by purchase of fixed assets (27%) and expansion (11%). 7% were seeking finance for acquisition of another firm. Of those seeking working capital, over half of businesses were seeking it to fund general growth, whilst 37% were seeking finance to cover a short term funding gap due to late payment by customers.

Of those seeking finance, mid-cap businesses are most likely to have sought bank loans, followed by hire purchase and overdrafts. This is similar to SMEs, who are more likely to seek overdrafts, but SMEs are much more likely to seek grant finance compared to mid-cap businesses. Unsurprisingly, mid-caps seek larger amounts of finance than SMEs with the median average amount of finance sought being £2.78m compared to £12,000 for SMEs.

There is some evidence to suggest mid-caps demand for external finance has increased compared to 2010,[64] when 32% sought external finance, but similar to 2009 levels when 41% sought external finance. There has also been a move away from overdrafts which formed 60% of finance products sought in 2010.

## FINANCE MARKETS FOR MID-CAP BUSINESSES GENERALLY WORK WELL WITH VERY FEW BUSINESSES HAVING PROBLEMS RAISING FINANCE.

92% of mid-cap businesses obtained some finance from their initial application, with just 1% being unsuccessful. This is much higher than for SMEs where 86% were successful overall (71% were offered what they wanted), but 9% were rejected.

There is evidence to suggest the availability of finance to mid-cap businesses has improved over time from 2009 and 2010.[65] Whilst it is not possible to compare individual finance products in the latest survey due to small sample sizes, in 2010 8% of loans and 5% of overdrafts were completely refused from the initial source approached. In 2009 rejection rates were even higher at 22% for loans and 14% for overdrafts.

Given mid-caps higher awareness of finance products and greater resources, there is currently no indication of mid-cap businesses being discouraged from seeking finance. Of those mid-cap businesses that did not apply for finance only 1% reported they had a need for finance in the last 12 months, but did not seek any finance.

3.4

# SMALLER BUSINESSES EXPORTS AND EXPORT FINANCE

- Exporting is associated with improved productivity and higher growth
- Around 1 in 5 smaller businesses export, more could do so
- Access to finance is an important enabler of exporting but there are many other barriers
- Finance for exports comes in many different forms, not just specialist export finance products

FIG 3.11

**EXPORTING BY FIRM SIZE**

*Source: ONS Annual Business Inquiry*

| Firm Employment | No.of Enterprises | No. of exporters | Exporters as share of enterprises |
|---|---|---|---|
| 1 | **838,000** | **70,200** | **8.4** |
| 2-9 | **963,700** | **96,300** | **10.0** |
| 10-19 | **132,000** | **23,700** | **18.0** |
| 20-49 | **70,100** | **16,700** | **23.8** |
| 59-99 | **21,700** | **6,700** | **30.9** |
| 100-249 | **11,800** | **4,400** | **37.8** |
| 250+ | **7,800** | **3,200** | **40.8** |

## EXPORTING IS ASSOCIATED WITH IMPROVED PRODUCTIVITY AND HIGHER GROWTH

British Business Bank research with Goldman Sachs and Enterprise Research Centre[66] suggests there are a number of mechanisms by which exporting may improve the productivity of smaller businesses. These include:

- Competition in non-domestic markets forces exporters to increase productivity
- Smaller businesses 'learn by exporting'
- Spreading fixed costs over a larger geographical market helps reduce costs
- Exporting spreads risk over a greater number of markets

Causation may work both ways, with high productivity helping businesses to become more competitive in export markets, as well as exporting helping to improve productivity. The evidence also shows that growing firms were much more likely (37%) to be exporters than the average smaller business (19%).[67]

For those smaller businesses that have plans to grow, a significant number expect exports to account for part of that growth. For example, the SME Finance Monitor[68] finds 12% of all SMEs planning to grow thought they would do so by selling more overseas. Many of these were already exporting, highlighting that increased overall smaller business exports will frequently be driven by existing exporters increasing their overseas sales.

## AROUND 1 IN 5 SMALLER BUSINESSES EXPORT, MORE COULD DO SO

Available data suggests that approximately 1 in 5 smaller businesses export. For example, the BIS Small Business Survey found that 19% of SMEs were exporters in both 2012 and 2014.

Smaller businesses, both in the goods and services sectors, are less likely to export than large businesses. For example ONS Annual Business Survey data finds that small businesses are much less likely to export than medium sized businesses, which are in turn less likely to export than large firms.

FIG 3.12

**EXPORTERS AND POTENTIAL EXPORTERS BY FIRM SIZE**

*Source: British Business Bank 2015 Business Finance Survey*

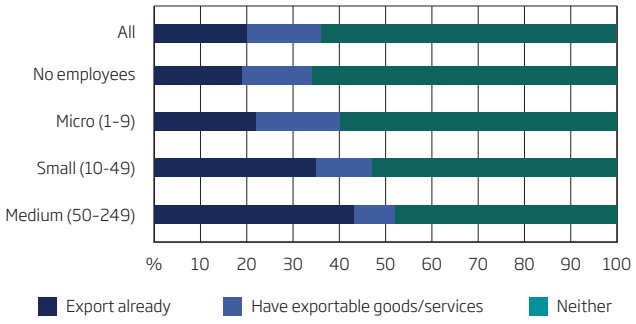
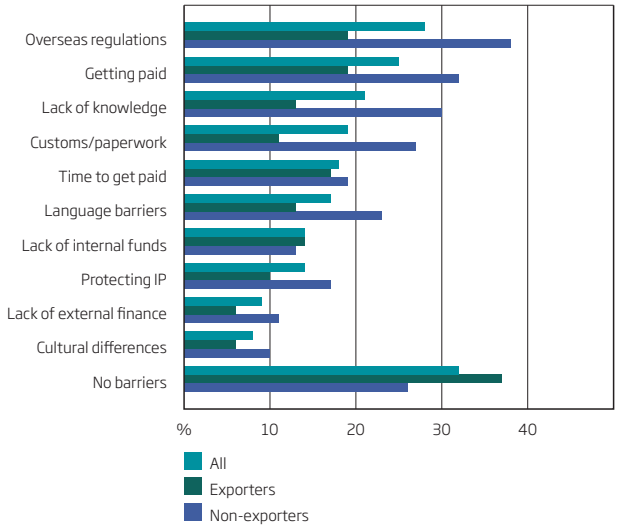



FIG 3.13

**BARRIERS TO EXPORTING**

*Source: British Business Bank 2015 Business Finance Survey*




While smaller businesses have a lower propensity to export than larger ones, SMEs made up over 90% of all UK exporters in 2012. However, by value just over 35 per cent of total UK exports came from businesses with less than 250 employees.[69]

And as business size increases, it becomes less likely that SMEs who have exportable products do not export. This suggests that micro and small businesses find it more difficult to export, compared to medium-sized businesses.

There are a significant proportion of smaller businesses that believe they have the potential to export. Exporting may not be suitable for all businesses - around 65% of smaller businesses not exporting reported they did not have a product or service suitable to export.

A recent report suggested that some businesses may lack the ambition to export.[70] And there is evidence that some smaller businesses are not fulfilling their potential:

- Amongst smaller businesses not exporting, around 20% said it was not part of their business plan, and just over 10% stated that they had sufficient business in the UK already. In some cases this could hold back firms' growth potential.
- Only around 10 per cent of smaller businesses receiving an unsolicited enquiry from an overseas buyer think it likely that they will make any export sales as a result of these enquiries.

## ACCESS TO FINANCE IS AN IMPORTANT ENABLER OF EXPORT BUT THERE ARE MANY OTHER BARRIERS

Survey evidence does not typically find that a lack of external finance is amongst the most important barriers to exporting. The latest British Business Bank survey reports that only 9% of SMEs cite external finance as a barrier.

Overseas regulations are the most frequently cited barrier, but it is noticeable that three of the top seven barriers relate to finance – getting paid (25%), time to get paid (18%) and lack of internal funds (14%). This suggests that finance and financial products, could play a role in helping overcome problems around payment and lack of funding for exports.

However structural problems in finance markets are more likely to apply when smaller businesses are looking to export. Well known information asymmetries – when viable businesses are sometimes denied finance, or charged higher prices than their true risk profile should reflect – can be amplified for firms looking for external finance for exporting, as the finance provider finds it more difficult to assess the potential repayment risk.

## FINANCE FOR EXPORTS COMES IN MANY DIFFERENT FORMS, NOT JUST SPECIALIST EXPORT FINANCE PRODUCTS

There are specific trade finance products available that help facilitate international trade. However, SMEs make relatively little use of these products, for example only 1% of all exporters applied for trade finance in the past 3 years.[71] By far the most common approach to financing exports is to use general business cashflow.

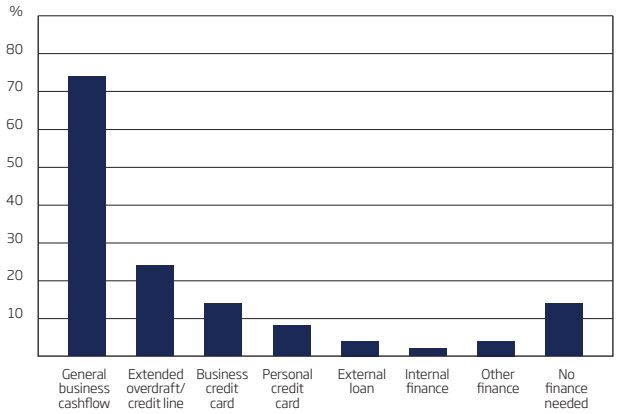
Smaller businesses also make use of core traditional lending products, most notably overdrafts and other forms of credit line. This suggests that for smaller businesses looking to grow who also export, making sure that they have access to general finance products is particularly important.

The Business Bank is working with UK Export Finance, to consider options for increasing the availability of finance products for those firms involved in export related activity, including those in export supply chains. As part of this, the Business Bank is considering options for increasing working capital finance for exporters.

FIG 3.14

**APPROACH TO FINANCING EXPORTS**

*Source: British Business Bank 2015 Business Finance Survey*



3.5

# EQUITY FINANCE FOR GROWING BUSINESSES

- Whilst Venture stage funding has lagged the increases seen in other equity stages in recent years, 2015 has been an exceptionally strong year, although partly driven by a small number of very large deals
- Large increases in growth funding over time, although market appears to have stabilised in 2015
- The financial returns from investing in Venture Capital have improved in 2014 due to the strong exit environment but Venture Capital returns still lag private equity returns
- Demand side issues combine with supply side structural issues to impede the effectiveness of equity markets for SMEs
- The British Business Bank and Government more generally are active participants in smaller business equity markets targeting specific market problems

This section provides an overview of recent trends in venture and growth capital funding up to Q3 2015 using data from Beauhurst. The British Business Bank will publish a more detailed assessment covering investments over the full 2015 year in spring 2016 through its Equity Tracker Report.

- Whilst Venture stage funding has lagged the increases seen in other equity stages in recent years, 2015 has been an exceptionally strong year, although partly driven by a small number of very large deals

Although equity finance[72] is used by a small proportion (around 1%) of all small businesses, its use increases with business size. It is particularly suitable for growing businesses that are either too risky or over leveraged to secure debt finance. Equity finance is therefore an important source of finance to unlock business growth, enabling the business to significantly scale up.

## WHILST VENTURE STAGE FUNDING HAS LAGGED THE INCREASES SEEN IN OTHER EQUITY STAGES IN RECENT YEARS, 2015 HAS BEEN AN EXCEPTIONALLY STRONG YEAR, ALTHOUGH PARTLY DRIVEN BY A SMALL NUMBER OF VERY LARGE DEALS

Venture stage financing covers companies that are more developed than seed stage companies, with developed products and some commercial sales but which are not yet profitable. Equity funding can therefore help these companies to scale up to become the household names of tomorrow. Venture stage investments are generally larger than seed stage investments. In 2015, 89% of venture investments (for known deal sizes only) were below £5m in size, although in values terms only formed 30% due to larger deals.

Although venture stage funding has increased by 101% in number of deals and 46% by value from 2011 to 2014, the increase over time has been much lower than for seed and growth stages. However, the upward trend looks set to accelerate with the first three quarters of 2015 data being 31% higher by number and 118% by value compared to the first three quarters of 2014.

Whilst 2015 has seen a large increase in the values of venture stage investments more generally, caution

is needed as it is being distorted by a small number of pharmaceutical companies with deal sizes significantly exceeding £10m. In fact one pharmaceutical company received funding of £205m in 2015, which forms a substantial proportion of the increase in value seen in the first three quarters of 2015.[73] Some other recent data sources, for instance Pitchbook and CBI Insights have shown VC funding declining in Q4 2015, which may suggest the Venture Capital market is beginning to slow down. It will be important to assess and monitor these market changes carefully in the forthcoming Equity Tracker Report.

## LARGE INCREASES IN GROWTH FUNDING OVER TIME, ALTHOUGH MARKET APPEARS TO HAVE STABILISED IN 2015

Growth stage financing covers companies that are more established than venture stage companies with developed products. The companies are likely to be profitable, but looking to expand significantly and to enter new markets. Growth stage investments are larger than venture stage funding with an average deal size of £7m, although can easily stretch up to £10-£20m or higher for companies larger than the SME definition.[74]

Growth stage funding has shown strong increases between 2011 and 2014 with 206% increase and 142% by value over this time period. However, this trend now looks set to stabilise with the first three quarters of 2015 being 23% lower by number and 15% higher by value compared to the first three quarters of 2014. It will be important to see how Q4 2015 figures compare, to see to what extent the growth capital market is slowing.

## THE FINANCIAL RETURNS FROM INVESTING IN VENTURE CAPITAL HAVE IMPROVED IN 2014 DUE TO THE STRONG EXIT ENVIRONMENT BUT VENTURE CAPITAL RETURNS STILL LAG PRIVATE EQUITY RETURNS

Venture capital returns have improved in recent years due to the strong exit environment, with increased numbers of IPO and trade sale exits. Whilst 2015 figures are slightly lower than 2014 figures, there is an expectation that the buoyant exit environment will continue throughout the rest of 2015 and beyond.[75] VC funds have begun to divest significant amounts of capital, with divestments exceeding the value of new investments. For instance, BVCA members invested £13.4bn globally in 2014, but £21.6bn of capital was returned in the same time period. However, published VC returns figures lag the recent upturn in divestment activity and VC market returns still look to perform relatively poorly. BVCA figures show the 10 year IRR return for venture is 4.6% which is lower than the 7.6% return from investing in public market returns.[76]

FIG 3.15

**NUMBERS OF VENTURE STAGE DEALS BY DEAL SIZE**

*Source: Beauhurst*

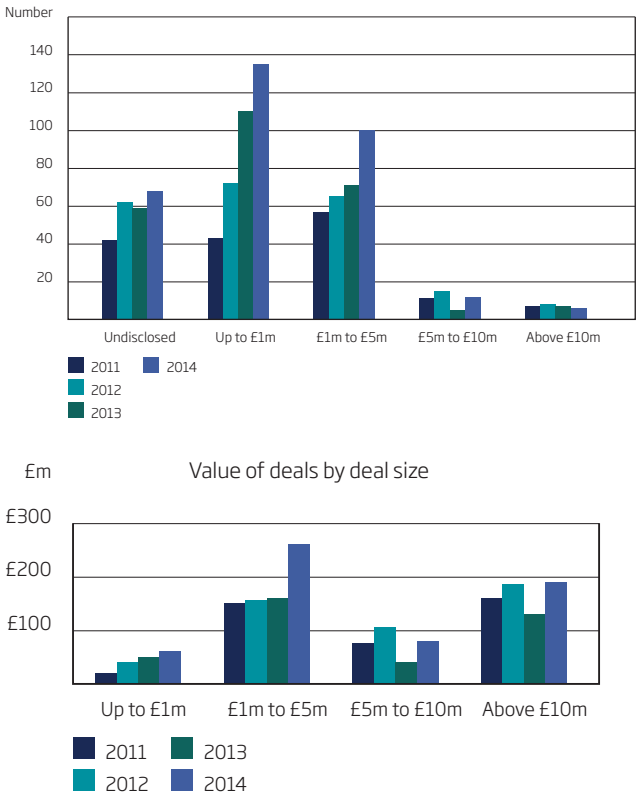



FIG 3.16

**NUMBER AND VALUE OF VENTURE STAGE DEALS OVER TIME**

*Source: Beauhurst*

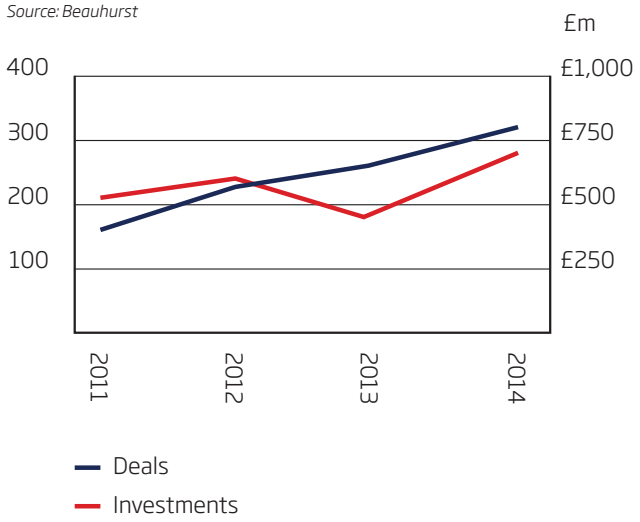
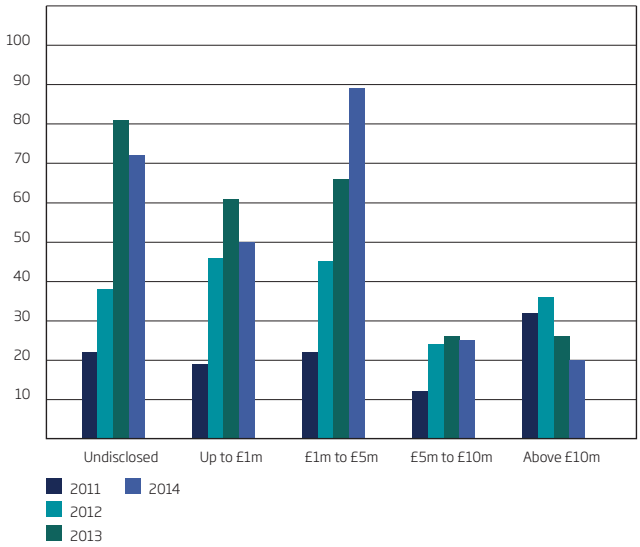
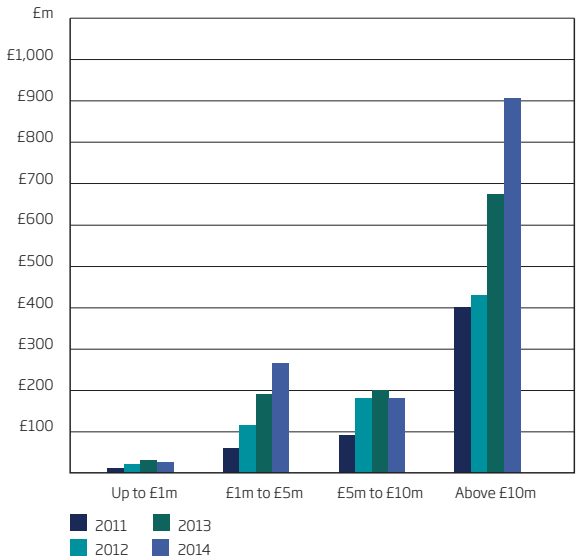


FIG 3.17

**NUMBER AND VALUE OF GROWTH DEALS BY DEAL SIZE**

*Source: Beauhurst*




These 10 year figures are lowered further by pre-2002 vintage funds affected by the dot com bubble bursting in 2001, but post-2002 vintage VC funds perform much better at 7.1% IRR although are well below the broader private equity returns figure of 14.9%. Nevertheless it is expected that long-term VC fund returns will continue to improve going forward, as indicated by the shorter term 3 and 5 year returns being higher.

It is important to recognise that VC fund returns have a high degree of variance with top quartile VC fund performers generating high returns raising the market average, but many VC funds perform poorly. Of VC funds with a 2002 vintage onwards, upper quartile funds generate a return of 8.4% IRR (upper decile funds generate a return of 18.5%), whilst the median fund has an IRR of 0% showing it just returns its investors capital. Lower quartile funds have an IRR of -7.4% showing that they lose money for their investors.

It is too soon to tell,[77] but the improving financial returns from investing in VC should encourage greater VC fundraising as the asset class becomes more attractive to institutional investors after a long period of disappointing financial returns, however returns still lag wider private equity returns.

## DEMAND SIDE ISSUES COMBINE WITH SUPPLY SIDE STRUCTURAL ISSUES TO IMPEDE THE EFFECTIVENESS OF EQUITY MARKETS FOR SMES

There remain a number of structural issues in the supply of equity finance to SMEs. These structural market problems are well established[78] and are due to imperfect information between the investor and business which leads to the existence of due-diligence costs. Due diligence costs are a higher proportion of smaller deals, leading to some funds to move up stream to focus on a smaller number of larger later stage investments. There is some evidence to support this as the proportion of venture stage deals involving PE/ VC funds has declined from 63% in 2011 to 31% in Q1-Q3 2015.

Market problems also exist on the demand side as a result of imperfect information, which leads to SMEs not understanding who to approach and how best to seek it.

- First, whilst 60% of SMEs are aware of venture capitalists and 38% are aware of business angels, an increase from 55% and 36% in 2014, a lower proportion are aware of specific suppliers of equity finance. Only 22% of businesses are aware of a specific venture capitalist to approach and 18% are aware of a business angel to approach. There is some evidence from the latest British Business Bank Finance Survey to suggest business awareness of Government equity schemes including VCTs, EIS and ECF has increased recently.

- Second, many SMEs are unwilling to seek external equity finance because they are unwilling to give up control of their business, despite the additional value to the business that external investors could unlock.[79]
- Third, businesses may also lack the knowledge or experience to make a good quality investment proposition to potential investors, which prevents them from raising finance despite their business being potentially viable. This affects the overall efficiency of equity markets.

## THE BRITISH BUSINESS BANK AND GOVERNMENT MORE GENERALLY ARE ACTIVE PARTICIPANTS IN SMALLER BUSINESS EQUITY MARKETS TARGETING SPECIFIC MARKET PROBLEMS

The British Business Bank has a number of programmes targeted at improving specific areas of the smaller business equity market and targeted at addressing specific market problems. For instance, the Enterprise Capital Fund (ECF) programme is specifically targeted at funds making investments in the 'equity gap' for businesses seeking smaller amounts of equity finance. Previous Business Bank research[80] highlighted British Business Bank supported funds were involved in around 6% of all deals (7% by value).

HMT and HMRC have a number of equity schemes including Enterprise Investment Scheme (EIS), Seed Enterprise Investment Scheme (SEIS) and Venture Capital Trusts (VCTs). These schemes provide tax relief for investors and are designed to increase the overall supply of equity finance to smaller businesses raising equity finance.

The Enterprise Investment Scheme (EIS) was introduced in 1994 by HMT and HMRC and is designed to help smaller, higher-risk companies raise finance by offering a range of tax reliefs to investors who purchase shares in those companies. EIS is important for supporting business angels and other private investors investing in small growing companies. In 2013-14, £1,529m was invested in 2,770 companies (1,355 were raising EIS funding for the first time) showing it has a large coverage of the overall market. This is an increase from the previous year, although lower than 2012-2013 when there was a significant increase in the annual investment limit per company increasing from £2m to £5m, which enabled larger deals.

The Seed Enterprise Investment Scheme (SEIS) was introduced in 2012 to complement EIS and is intended to recognise the particular difficulties which very early stage companies face in attracting investment, by offering tax relief at a higher rate than that offered by EIS.[82] 1,160 companies raised funding for the first time in 2012-13 increasing to 1,725 in 2013-14.[83] The total amount of

FIG 3.18

**NUMBER AND VALUE OF GROWTH STAGE DEALS OVER TIME**

*Source: Beauhurst*

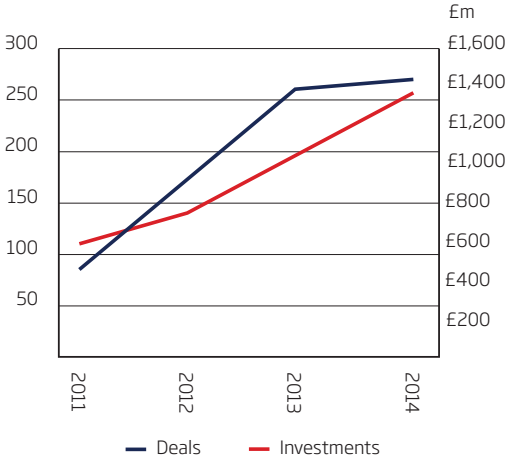



FIG 3.19

**LONG-TERM RATES OF RETURN BY INVESTMENT CATEGORY AND SELECTED MARKETS**

*Source: BVCA*

| IRR % p.a. | 3 years | 5 years | 10 years |
|---|---|---|---|
| **Private equity total** | **12.9** | **11.5** | **14.9** |
| Venture capital | **10.9** | **9.2** | **4.6** |
| Pre-2002 vintage funds | **8.7** | **7.8** | **0.7** |
| 2002 vintage funds onwards | **11.4** | **9.6** | **7.1** |
| Small MBO | **10.6** | **12.0** | **39.2** |
| Medium MBO | **17.7** | **14.3** | **19.1** |
| Large MBO | **11.8** | **10.9** | **14.5** |
| **Selected comparators** | | | |
| Total pension fund | **10.3** | **9.4** | **7.8** |
| **Assets** | | | |
| FTSE all share | **11.1** | **8.7** | **7.6** |
| FTSE small cap | **19.6** | **13.2** | **7.4** |
| Cash | **1.6** | **1.9** | **3.3** |
| Retail price index | **2.5** | **3.4** | **3.1** |

FIG 3.20

**EIS INVESTMENT OVER TIME**

*Source: HMRC[81]*

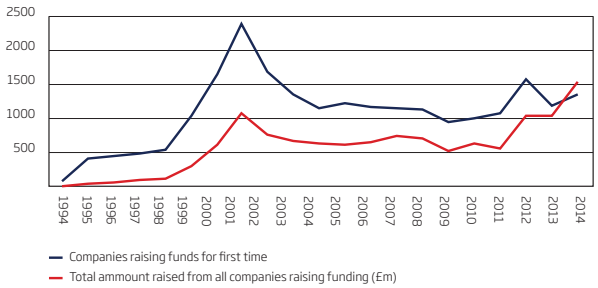
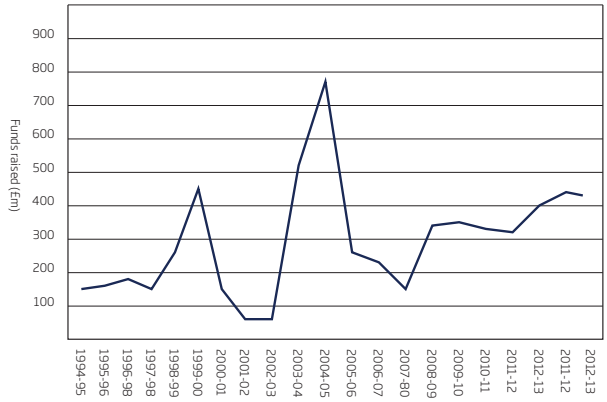


FIG 3.21

**VCT FUND RAISING OVER TIME**

*Source: HMRC*[85]




funding raised through the scheme has also increased from £86m to £166m showing it is an important source of funding for early stage companies.

Venture Capital Trusts (VCTs) were introduced in 1995 to increase the supply of finance to high growth potential companies by encouraging potential investors to invest by giving tax incentives.[84] Since their introduction they have raised nearly £6 billion of funds. In 2014-15, VCTs issued shares to the value of £435m. This was a slight fall of just over one percent from the value of £440m in 2013-14, but is high by historical levels. The number of VCTs raising funds also fell in 2014-15 from 66 in 2013-14 to 57. The decrease in VCTs raising funds is likely to be due to some VCTs merging with others and some VCTs being wound up.

Recent changes announced in Finance Act 2015 (2)[86] are designed to 'encourage VCTs to only make investments intended to grow and develop small businesses at an early stage of their life' and are likely to have a significant impact on the VCT market. Changes include the amount of qualifying funding that a VCT or EIS-qualifying company can receive over its lifetime being reduced to £12 million, or £20 million for 'knowledge intensive' companies. To be eligible for VCT or EIS investment, companies will now have to have made their first commercial sale in the past seven years, or ten years for 'knowledge intensive' companies. In addition, VCT or EIS can no longer be used to fund management buyouts or acquisitions. The new rules only apply to investments made from November 2015, but will have a significant impact on the investment strategy of existing VCTs and should benefit young businesses.

## CONCLUSION

Whilst there is evidence to suggest cyclical improvements in equity funding conditions over the last few years, there remain a number of structural issues in the supply of equity finance to smaller businesses which restricts potentially viable smaller businesses from raising finance. These structural market problems are well established and provide a rationale for Business Bank programmes like the Enterprise Capital Funds, Angel Co-Fund and VC Catalyst Fund. It is important to acknowledge that government action through the Business Bank and tax based investment schemes such as EIS, SEIS and VCTs have helped contribute to the recent positive funding conditions.

# 3.6 LONG-TERM FINANCE

- Average loan tenor for bank loans is 3-4 years but the majority of businesses obtain loans at the loan tenor they require
- Patient Capital is a type of long-term finance that funds capital intensive businesses developing products or processes with long lead times
- Patient Capital comes from a variety of different funding sources including angels, Venture Capital funds, listed investment vehicles, corporate investors and public equity markets.
- Venture Capital is an important source of patient capital, but the UK market is less developed than the US
- There are number of established listed investment vehicles providing patient capital, together with recent new fund raising suggesting an increase in the supply of patient capital over the next few years
- Public equity markets have opened up with increased numbers of Initial Public Offerings in 2014, although volumes are slowing down in 2015

## AVERAGE LOAN TENOR FOR BANKS LOANS IS 3 - 4 YEARS BUT THE MAJORITY OF BUSINESSES OBTAIN LOANS AT THE LOAN TENOR THEY REQUIRE

New survey evidence[87] reveals bank loans (excluding mortgages) to smaller businesses typically have a tenor of 3-4 years with only five percent having a period last longer than 7 years. In fact, 33% of loans have a tenor of less than 2 years showing lending is relatively short term.

Although some businesses may require longer term funding, there is no indication that the majority of businesses want longer term loans as the majority (75%) of smaller businesses get the loans at the tenor they requested.

Obtaining a shorter tenor may reflect lenders being reluctant to provider long-term finance. However only 8% of smaller businesses got a loan at a shorter tenure than they requested, the same proportion that got it at a longer tenor than requested. Longer tenor may result from a longer repayment period for the borrower to be able to afford the payment. The desire, particularly of smaller businesses, to reduce debt holdings may be reflected in the frequency of shorter loan periods. Some businesses, especially mid-cap businesses, may want to seek longer loan tenors. Over half of mid-cap businesses seeking bank loans were seeking loans of longer than 7 years tenor and 94% of mid-cap businesses obtained a loan at the tenor they required. Only a small proportion (3%) wanted a loan at a longer tenor than the one provided by the financial institution. The European Commission is due to report in 2016 on the appropriateness of Capital Requirements Regulations in relation to long-term financing as part of its consultation on how revised bank capital requirements have affected lending.[88]

## PATIENT CAPITAL IS A TYPE OF LONG-TERM FINANCE THAT FUNDS CAPITAL INTENSIVE BUSINESSES DEVELOPING PRODUCTS OR PROCESSES WITH LONG LEAD TIMES

The British Business Bank has recently undertaken primary research[89] and analysis of secondary data sources to explore the supply and demand of patient capital. This section provides a summary of the research.

There is no single definition of patient capital, but it is commonly used to describe the 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.

FIG 3.22

**SME AND MID-CAP LOAN TENOR SOUGHT**

*Source: British Business Bank 2015 Finance Survey*

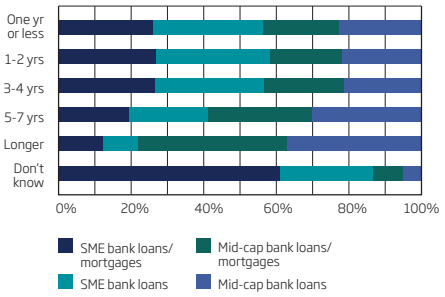
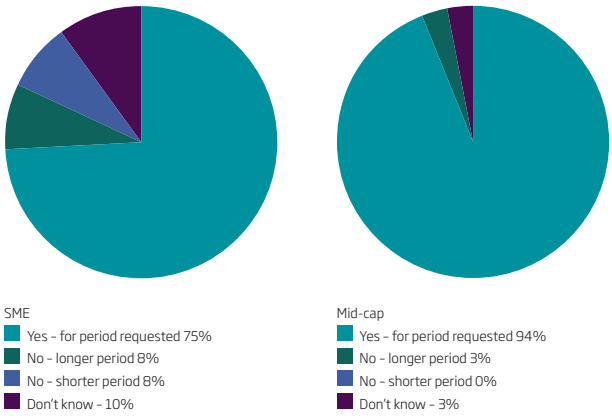



FIG 3.23

**PROPORTION OF SME AND MID-CAP BUSINESS OBTAINING LOAN AT TENOR REQUESTED**

*Source: British Business Bank 2015 Finance Survey*




Empirical analysis confirms certain sectors require greater amounts of Venture Capital finance than others. For instance, life science companies require three times as much VC funding as IT companies, whilst clean technology companies require twice as much funding as IT companies to generate a successful exit.[90] However, there is little difference observed in VC investment duration between different sectors with the average investment being around five and half years. This may reflect the existence of early stage funding e.g. grants and angels prior to VC funding.

PATIENT CAPITAL COMES FROM A VARIETY OF DIFFERENT FUNDING SOURCES INCLUDING ANGELS, VC FUNDS, LISTED INVESTMENT VEHICLES, CORPORATE INVESTORS AND PUBLIC EQUITY MARKETS.

Patient capital comes from a variety of different funding sources.[91]

- BUSINESS ANGELS and other private investors are an important source of funding and were involved in around 140 deals in 2014 (£230m).
- VC INVESTORS fund the greatest number of businesses and were involved in 400 deals (£1.7bn) in 2014. Some of these investors can be identified as providers of patient capital due to their investment strategy of providing finance to capital intensive sectors with long lead times.
- There are around 70 deals involving Corporate Investors in 2014. Corporate venturing is growing in the UK market forming around 6% of the total equity market.[92]
- UK PUBLIC EQUITY MARKETS (LSE main market and AIM) funded 137 businesses in 2014 (£13.8bn). Whilst public markets provide the greatest amount of funding to companies, not all of this is patient capital and many of these companies are at a later stage of their development.

Long-term debt finance is also a source of patient capital. Growth loans have greater flexibility than senior debt, and are suitable for established companies that are able to service debt repayments. It is not suitable for early stage businesses that are not yet generating sales. Mezzanine

finance involving an equity stake aligns investor interests with the long-term growth of the company.

## VENTURE CAPITAL IS AN IMPORTANT SOURCE OF PATIENT CAPITAL, BUT THE UK MARKET IS LESS DEVELOPED THAN THE US

The supply of Venture Capital has increased since the recession. The US VC market is seen by many to work effectively at funding the needs of early stage businesses, and so comparisons are made to the US market. The US VC Market is more developed than the UK market with greater number of venture capital funds and greater fund specialisation reflecting the US market being more established and also its greater market size. British Business Bank analysis of Preqin shows the US funds are on average 1.6 times larger than UK funds, which contributes to US companies receiving nearly twice as much funding as UK companies (average investment size of £29m compared to £16m for UK investments). This can result in businesses finding the process of raising finance as difficult and time consuming, and adopting coping mechanisms to smooth their journey towards raising finance.

There is no evidence to suggest the UK Venture Capital market is less patient than in the US as there is a similar broad sector composition of deals and also similar average investment durations of around five and a half years. For instance, over half of all VC investments are in IT related sectors, with UK being similar to the US in terms of the sectoral breakdown of investments (52% compared to 56% for the US). Healthcare forms 17% of all UK VC investment and clean technology forms 3%, the same proportion as the US.[93]

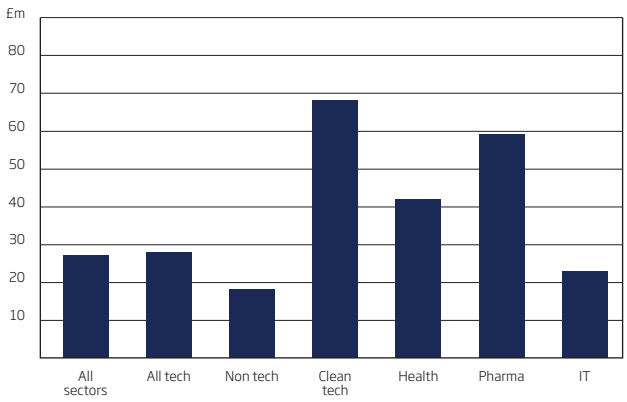
## THERE ARE A NUMBER OF ESTABLISHED LISTED INVESTMENT VEHICLES PROVIDING PATIENT CAPITAL, WHICH TOGETHER WITH RECENT NEW FUND RAISING SUGGESTING AN INCREASE IN THE SUPPLY OF PATIENT CAPITAL OVER THE NEXT FEW YEARS

Whilst VCs provide a substantial amount of patient capital funding, evergreen investment vehicles may be better able to provide patient capital compared to fixed life LLP fund structures, as they help overcome the problem of holding illiquid assets.[94]

FIG 3.24

**AVERAGE AMOUNT OF FUNDING PER SUCCESSFUL EXIT**

*Source: BBB analysis of Preqin*



There are at least two well-known established listed investment vehicles focusing on the commercialisation of early stage technology (Imperial Innovations and IP Group). These spun out from university commercialisation offices and offer a range of commercialisation activities to add value to portfolio companies, often with close links to universities. Portfolios appear to be more early stage, and investments planned to be held for longer to allow companies time to develop. However, they have a small share of the overall patient capital equity market.

In the last 12 months there has also been significant capital raised by a number of listed Patient Capital providers including Woodford Patient Capital Trust (£812m in April 2015)[95], Oxford Sciences Innovation (£320m in May 2015)[96] and Mercia Technologies (£70m in Dec 2014)[97] suggesting an increase in the amount of new funding ready to deploy in next few years.[98] Whilst this is a positive market development, the market would benefit from even greater diversification.

FIG 3.25

**NUMBER OF ADMISSIONS ON AIM OVER TIME**

*Source: London Stock Exchange*


## PUBLIC EQUITY MARKETS HAVE OPENED UP WITH INCREASED NUMBERS OF INITIAL PUBLIC OFFERINGS IN 2014, ALTHOUGH VOLUMES ARE SLOWING DOWN IN 2015

Following difficult trading conditions during the recession, public equity markets have finally opened up. There were 95 admissions on AIM in 2014, the highest level since 2007, with £5.9bn raised in total. Full year 2015 figures are not yet available, but there appears to be a slowdown in number of IPOs on AIM in 2015 with 47 UK admissions up to December 2015. Whilst the US has the greatest number of IPOs, UK companies backed by VC are just as likely to IPO as US companies with around 10% of all successful Venture Capital exits being an IPO.

Whilst listing on UK public markets is seen as relatively attractive in terms of ease and cost, the AIM market is more volatile than the main LSE market due to lower liquidity.

CHAPTER FOUR

# FINANCE PRODUCTS AND DIVERSITY OF SUPPLY

A well-functioning finance market for smaller businesses requires a competitive market in the provision of finance. This requires not only a range of available products that suit the differing finance needs of small businesses but also a diversity of sources of supply to ensure that there is a competitive market. Increasing the diversity of supply of finance for small businesses is a key strategic objective of the Business Bank.

Chapter 4 considers use of finance that is used widely across all the Business Bank market segments such as asset finance (section 4.1) and alternative finance, in particular peer to peer lenders (section 4.2).

This chapter therefore summarises the latest evidence of the diversity of debt finance supply, drawing in particular on the evidence gathered and summarised by the Competition & Markets Authority. Section 4.4 then looks in more detail at the development of challenger banks.

4.1

# ASSET FINANCE

- The strong recovery and further growth of asset finance through the provision of leasing and hire purchase continued in 2014 and through 2015
- Asset Finance remains a widely used form of external finance, particularly for medium-sized SMEs and mid-caps
- A high percentage of businesses who apply for asset finance are successful in obtaining it, but there continues to be some viable businesses that are unable to secure asset finance as a result of problems in the market

This section provides an update on developments in the asset finance market in 2014 and 2015 highlighting the continued increase in asset finance volumes, and also identifying where market gaps remain.[99] Further information on the diversity of supply in the asset finance market is included in the general discussion of diversity of supply later in the chapter.

## THE STRONG RECOVERY AND FURTHER GROWTH IN ASSET FINANCE THROUGH THE PROVISION OF LEASING AND HIRE PURCHASE CONTINUED IN 2014 AND THROUGH 2015

Figures from the Finance & Leasing Association (FLA) show that asset finance volumes have continued to grow strongly. As business confidence in the economy increased and investment picked up during the recovery so has new asset finance business. Asset finance new business for deals up to £20m grew to £25.2bn in 2014, up 13% on 2013. The first eleven months of 2015 have seen sustained growth, with total asset finance new business for deals of up to £20m in 2015 as a whole likely to reach £27.7bn, 10% higher than in 2014.

The FLA Q4 2015 Confidence Survey shows that the asset finance industry expects new business in 2016 to grow by up to 10%. The OBR forecast growth in business investment of 7.4% in 2016 providing further support for the likely growth in demand for asset finance.

Asset finance remains an essential part of the investment recovery story as it increases small businesses capacity to invest. Total asset finance provided by FLA members is equivalent to almost 32% of UK investment in machinery, equipment and purchased software.

The FLA estimates that SME asset finance accounts for approximately 60% of the total value of new business, almost £15bn of asset finance was provided to SMEs in 2014 and forecast to increase to more than £16bn in 2015. The latest data also shows that the shift towards hire purchase from finance leasing and operating leasing

also continued in 2014 and 2015, reflecting, in part, increased investment in plant and machinery.

Growth during 2015 has been particularly marked in IT equipment finance, which exceeded £1.7bn in the 12 months to November 2015, up 15% on the previous year. Plant and machinery finance and car finance closely followed the overall market with 11% and 10% growth respectively in the year to November, whilst business equipment fell slightly to £2.1bn.

## ASSET FINANCE REMAINS A WIDELY USED FORM OF EXTERNAL FINANCE PARTICULARLY FOR MEDIUM SIZED SMES AND MID-CAPS

Medium sized businesses are more likely to be using leasing, hire purchase and vehicle finance compared to small sized businesses. The SME Finance Monitor finds that in the year to end of Q2 2015, 12% of micro businesses used leasing or hire purchase, rising to 23% for medium sized businesses. The 2015 British Business Bank Finance Survey results show that of the mid-cap businesses surveyed 61% used leasing or hire purchase over the last three years.

The SME Finance Monitor finds that the share of SMEs using asset finance remains stable. For micro-businesses this is similar to the use of bank loans, but lower than the use of overdrafts or credit cards. However, for small and medium-sized businesses the use of leasing is more likely than bank loans and similar to the use of overdrafts.

Oxford Economics[100] has examined the use of lease financing amongst European SMEs. They find of the SMEs surveyed across eight European countries (Germany, Spain, France, Italy, Netherlands, Poland, Sweden and the UK) 42.5% used leasing in 2013 compared to 40% in 2010, with UK usage exceeding the European average. The Oxford Economics report also finds that exporting SMEs, whose investment needs are generally higher, make greater use of leasing than other firms in the UK.

Asset finance is most popular in capital-intensive sectors such as transport, agriculture and manufacturing. This is likely to be linked to the appropriateness of leasing/hire purchase for the financing of equipment that tends to be used at a sector level.

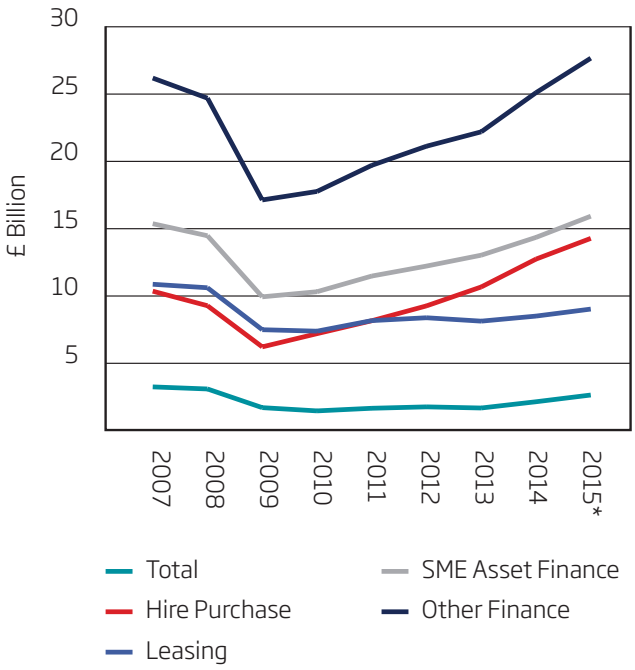
## A HIGH PERCENTAGE OF BUSINESSES WHO APPLY FOR ASSET FINANCE ARE SUCCESSFUL IN OBTAINING IT, BUT THERE CONTINUES TO BE SOME VIABLE BUSINESSES THAT ARE UNABLE TO SECURE ASSET FINANCE AS A RESULT OF PROBLEMS IN THE MARKET

As described in our 2014 Small Business Finance Markets Report, leasing can be seen as a market solution to a market failure in the small business lending markets with the asset being financed acting as the security, i.e. in the event of a default the asset finance provider can

FIG 4.1

**SIZE OF UK ASSET FINANCE MARKET FOR BUSINESSES 2007-2015**

*Source: FLA, BBB. New business written by FLA members, deal size up to £20m*



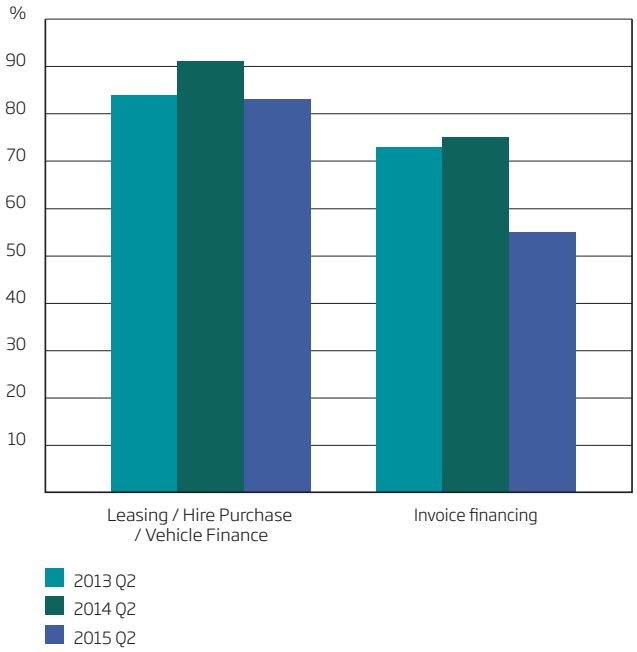

Notes:

SME asset finance before 2012 is assumed to be 60% of the total size of the asset finance market; *estimates based on published figures for 12 months to November 2015.

FIG 4.2

**PERCENTAGE OF SMALLER BUSINESS APPLICANTS WHO SUCCESSFULLY APPLIED FOR ASSET FINANCE**

*Source: FLA, BBB. New business written by FLA members, deal size up to £20m.*




reclaim the asset back. This is corroborated by the wider literature on asset finance - Chigurupati and Hegde (2010) find that 'lessee firms with higher information asymmetry rely more on lease financing'.[101]

This is reflected in success rates for small businesses applying for asset finance which are higher than other forms of finance. The SME Finance Monitor reports lower success rates for the 12 months to Q2 2015, at 83% down from 91% in the previous year, although this is still high compared to other forms of finance.

Lower rejection rates for asset finance compared to other external finance implies that the pool of underserved businesses seeking asset finance is smaller than other types of finance. However, younger firms with limited ability to fund deposits and who have assets that are of low value and with a limited secondary market, will face greater scrutiny when seeking to access asset finance. For such firms other criteria, especially affordability, also need to be demonstrated.

This is only a market failure where businesses are viable and unable to obtain finance as a result of information asymmetries between the lender and borrower. Where it is a 'hard asset' that requires funding (e.g. wheeled assets such as vehicles), an asset that is business critical (e.g. barrels in a brewery) or a revenue generating asset (e.g. coffee machine), with strong secondary markets, greater reliance can be placed on the strength of the collateral for the finance provided.

Discouraged and latent demand are also important in potential demand for asset finance, i.e. those who do not apply because they are not aware of the options or not confident of success.

Awareness of asset finance is relatively high, with around 85% of smaller businesses aware of leasing and hire purchase as a finance option.[102] Amongst those likely to seek finance, there is significant share of smaller businesses that would consider asset finance. The SME Finance Monitor finds that around 1 in 4 smaller businesses seeking finance would consider leasing or hire purchase. This rises to 1 in 3 for medium sized businesses.[103] This limited willingness to consider asset finance may point to demand side constraints due to imperfect information for businesses seeking finance.

4.2

# ONLINE PLATFORMS

- Approximately £2.8bn gross lending facilitated by online platforms in 2015
- P2P business lending has the greatest share of gross flows of finance at around £1.3bn
- P2PFA estimate £90m of net lending flows facilitated by members to SMEs in Q3 2015, excluding property lending
- Online platforms can play an increasingly important role in diversification of SME finance markets
- Finance facilitated through UK online platforms outstrips amounts recorded for other European countries

Encouragingly for SMEs, P2P business lending volumes in the UK remain strong and were the largest sub-set of overall online platform activity in 2015, accounting for approximately 45% of the total funding of £2.8bn facilitated.

P2P business lending enabled through online platforms continued to grow strongly in the UK, with gross flows of approximately £1.3bn recorded in 2015, according to AltFi Data. Nonetheless, this remains a very small proportion of overall gross lending to SMEs by banks (£53bn gross lending Jan-Nov 2015). However, the continued growth in this channel of funding is important for the diversification of SME finance markets in the UK.

The amount of funding enabled by UK platforms is significantly higher than those seen in other European countries. In absolute terms, the US market for online lending is estimated to be approximately five times larger than in the UK. However, adjusted per capita, average values facilitated in the US and UK are broadly similar.

## APPROXIMATELY £2.8BN GROSS LENDING FACILITATED BY ONLINE PLATFORMS IN 2015

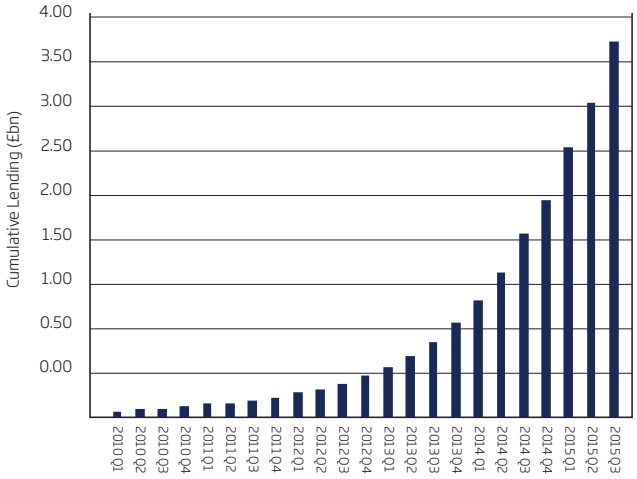
The value of new finance originated through UK online platforms continues to rise exponentially. The Liberum AltFi Volume Index recorded cumulative gross funding of approximately £2.8bn through UK platforms at the end of 2015. This represented a doubling of the cumulative index (which started in 2005) to roughly £5.5bn.

Year-on-year growth of funding facilitated was also impressive. AltFi Data estimate that 2015 lending values were approximately 76% higher than those in 2014.

FIG 4.3

**P2PFA CUMULATIVE LENDING**

*Source: BP2PFA*




## P2P BUSINESS LENDING HAS THE GREATEST SHARE OF GROSS FLOWS OF FINANCE AT AROUND £1.3BN

Crowdfunding,[104] which generally refers to the raising of equity, represents a very small portion of overall platform activity (c5%), but has recorded the fastest rate of year-on-year growth in finance facilitated of around 135%.[105]

Peer-to-peer (P2P) lending, where investors lend money online usually to individuals or SMEs, continues to represent the greatest share of overall lending volumes (approximately 95%). Growth in lending values in 2015 were broadly in line with that recorded by the headline index (c75%).

P2P lending activity can be broken down by: business lending (£1.3bn), consumer lending (£1.1bn) and online invoice financing (£0.3bn).

Historically, P2P consumer lending was the dominant sub-category of online platform activity. However, the balance tipped in favour of business lending in early 2014, with both channels combined representing the majority of all funding recorded by the AltFi Volume Index (P2P business lending (c45%), P2P consumer lending (c40%)). However, gross flows of finance to businesses remain an extremely small percentage of gross flows of lending to SMEs from banks which totaled £53bn from January to November 2015..

## P2PFA ESTIMATE £90M OF NET LENDING FLOWS FACILITATED BY MEMBERS TO SMES IN Q3 2015, EXCLUDING PROPERTY LENDING

The Peer-to-Peer Finance Association (P2PFA) is an industry body representing peer-to-peer lending platforms. It aims to promote high standards of conduct and consumer protection. The P2PFA reports that it represents over 90% of the peer-to-peer lending market in the UK, including consumer lending, business lending and invoice finance funding for small businesses.

The P2PFA collects data from its members. Cumulative lending reported at Q3 2015 was c£3.7bn (there will be variances compared with the Liberum AltFi Volume Index due to differences in coverage).

The P2PFA estimates net lending flows from member data. It reports that net lending in Q3 2015 was c£250m (gross lending was c£600m). Just over one-third of net lending was estimated to be to SMEs (c£90m), although property lending includes lending to both SMEs and consumers. Bank of England data indicate net flows of new loans to SMEs in Q3 2015 of c£750m. Therefore,

assuming the figures on net flows are comparable, lending originated through online platforms remains a small percentage of bank lending at 12%, albeit higher than that indicated by the comparison of gross flows. Over the last four quarters, net lending to SMEs by P2PFA members is estimated to be broadly consistent and between £75-£90m.

## ONLINE PLATFORMS CAN PLAY AN INCREASINGLY IMPORTANT ROLE IN DIVERSIFICATION OF SME FINANCE MARKETS

The relatively small, but increasing volume of finance facilitated through online platforms highlights the value that they have in diversifying finance markets for SMEs. This is both in terms of the range of finance available (from loans to equity) and in terms of providing the competition required to innovate and improve the functioning of markets for SMEs.

Last year we noted that more established SMEs with lower risk ratings were more likely to be successful in their funding bid on an online platform. An analysis of the latest two quarters of data from SME Finance Monitor[106] suggests that users of alternative forms of funding are less likely to be sole traders, more likely to be using other forms of external finance, to have an appetite for finance generally and to be planning to grow. However, when compared with results from H1 2014, the data would indicate that users are now no longer more likely to have a minimal/low risk rating.

## FINANCE FACILITATED THROUGH UK ONLINE PLATFORMS OUTSTRIPS AMOUNTS RECORDED FOR OTHER EUROPEAN COUNTRIES

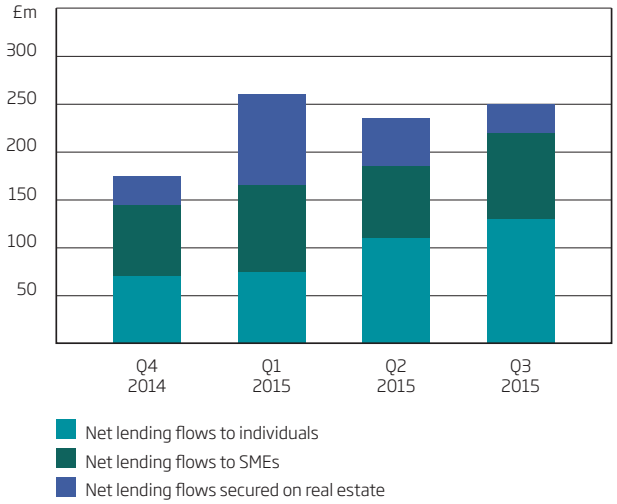
The UK has by far the largest online marketplace for funding, when compared with other European countries. However, this channel of funding is relatively young, particularly in mainland Europe, with the potential for continued high growth across Europe.

European Commission research analysed crowdfunding activity in a number of EU countries, where crowdfunding refers to general online platform activity encompassing a variety of models including loans, equity and rewards. Analysis was broken down by funding type. Loan projects were the largest funding type, with the UK seeing the largest amount of lending facilitated. Estonia had the second largest amount of loan funding raised in 2014, but this was only 1% of that raised in the UK in the same year.

FIG 4.4

**P2PFA NET LENDING FLOWS**

*Source: P2PFA*



Crowdfunding for equity finance is also most prevalent in the UK, although the extent of the gap to the second largest country is narrower than for loan funding. France saw the second largest amount of equity finance facilitated during 2014, which was 20% of that enabled through UK platforms.

Nonetheless, when considering global markets, values of finance facilitated through online platforms in the US (estimated by Morgan Stanley to be $12bn in 2014) are larger than UK values (equivalent estimated figure is $2.3bn). However, when these values are adjusted for the general population, amounts of finance per capita are broadly similar in the US and UK.

## CONCLUSIONS

The British Business Bank partners with a number of online platforms that facilitate lending to smaller businesses in the UK, to help catalyse volumes of lending through these channels. The continued growth of lending facilitated through online platforms overall are encouraging indicators for a more diversified finance market for SMEs (and other beneficiaries of finance facilitated through online platforms). However, as a channel of finance, online platforms are still relatively young and values of funding remain small compared with traditional sources of finance. This points to continued involvement in this area for the British Business Bank.

Alternative finance platforms also stand to benefit for the Small and Medium Sized Business (Finance Platforms) Regulations 2015 which aims to open up the market for lending to both businesses seeking finance and lenders willing to provide finance. HM Treasury has requested that the Business Bank conduct a process to assess the suitability of finance platforms (FPs) for designation under the Regulations. An FP is defined in section 7(2) of the Act as an organisation that "provides a service for the exchange of information between finance providers and businesses that require finance".

# 4.3 DIVERSITY OF DEBT FINANCE SUPPLY

- Latest research finds that the market for debt finance provision to smaller businesses remains concentrated
- The provision of general purpose business loans to smaller businesses remains concentrated in the four largest providers
- Asset finance shows greater diversification than general business lending but concentration remains significant

The range of financial products used by smaller businesses has been discussed earlier in the report, in particularly in the review of aggregate flows of finance to small businesses in section 1.1. This highlighted the rapid growth in the use of some forms of finance, in particular asset finance and alternative finance which were then discussed in more detail in the first two sections of this chapter.

As well as a diverse range of products, competition between suppliers of specific products is also important for delivering a competitive market. This section therefore reviews the evidence of diversity of suppliers drawing on the latest evidence from the Competition & Markets Authority (CMA).

## LATEST RESEARCH FINDS THAT THE MARKET FOR DEBT FINANCE PROVISION TO SMALLER BUSINESSES REMAINS CONCENTRATED

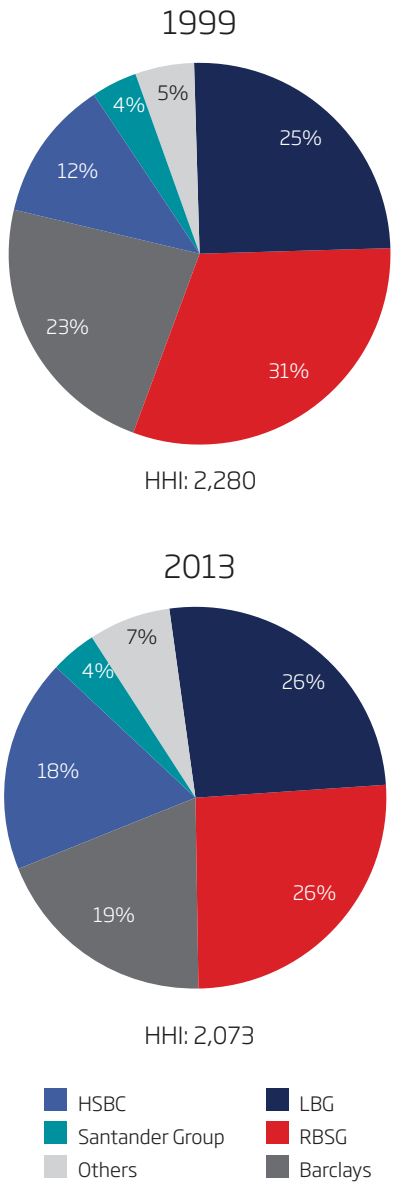
Diversity of supply in SME bank lending has long been a concern with numerous studies reviewing aspects of competition in the UK SME banking sector. The current focus is on the CMA market investigation in to the supply of retail banking services to SMEs in the UK which is due to conclude in 2016.[107]

The latest CMA research published in their provisional findings report[108] finds continued concentration among a small number of large banks. In Great Britain and Northern Ireland, the largest four banking groups account for over 80% of business current accounts (BCAs). Around 90% of SMEs go to their main BCA bank for overdrafts, general purpose business loans and credits cards. Furthermore, the CMA research also finds that 60% of SMEs considered only one provider when seeking lending.

FIG 4.5

**VOLUME SHARES OF BUSINESS LOANS IN ENGLAND AND WALES, YEAR TO Q1 2013**

*Source: CMA market study: 1999 figures from CC, 2013 figures from Charterhouse release Q1 2013*




Notes:

Percentages may not sum to 100 because of rounding. All banks in the 'others' as a single entity for the purposes of calculating the HHI in 2013. However, if others were treated separately and it was assumed that they each had a market share of less than 1%, then the HHI figure would drop to 2,057. There are methodological differences between the calculations made in 1999 and 2013, including the inclusion of commercial mortgages in the 1999 figures.

The CMA report identifies three reasons why SMEs use their existing bank when seeking finance:

- Firstly, the value of their existing relationship. SMEs believe banks are more likely to lend to existing customers, and banks have access to a more detailed financial history of the SME and are thus able to better assess the risk of default.
- Secondly, SMEs are wary of the time, effort and convenience of approaching another provider with 25% not considering other providers because of the hassle associated with applying for finance.
- Thirdly, there are barriers to searching, with difficulties in comparing the pricing and other terms and conditions associated with lending products across different finance providers.

The above reasons may mean that SMEs find it difficult to distinguish between suppliers, hence SMEs have relatively little incentive to shop around. One possible interpretation[109] of this is that many lenders who do not have an existing relationship with the SME will offer a similar price based on their limited ability to assess credit risk.

These findings are backed up by the results of the Business Bank's SME Finance Survey which looks at the extent to which smaller businesses shop around when seeking finance. The survey finds that more than 60% of smaller businesses only contact one provider, with the main reason being that they already have long standing relations with their main bank.[110] This figure has improved since 2012, when more than 70% of smaller businesses contacted only one provider, but it is clear that shopping around is still limited.

This inertia amongst SMEs explains why the high concentration in provision of BCAs feeds through into a high concentration of traditional lending products supplied to SMEs. The tendency for SMEs to approach their BCA provider for traditional lending products, is found, albeit to a lesser extent for other products, with 69% of SMEs going to their main BCA bank for invoice discounting and factoring, and 76% for commercial mortgages.

## THE PROVISION OF GENERAL PURPOSE BUSINESS LOANS REMAINS CONCENTRATED IN THE LARGEST FOUR PROVIDERS

The market for general purpose business loans has been concentrated for some time. The previous Small Business Finance Markets Report, reported data on volume shares of SME loans for 1999 and 2013. There had been a slight decline in the Herfindahl-Hirschman Index (also known as HHI), a measure of the size of firms in relation to the industry and an indicator of the amount of competition among them.

The CMA provisional findings report published in October gives information on SME general purpose business loan shares for 2014,[111] presented in market share size brackets. Figure 4.6 provides that data for the both stock of loans and the value of new loans granted.

Outside of the four largest banks only Clydesdale exceeds 5% of the market for the stock of loans. On a flow, rather than stock measure, Handelsbanken also exceeded 5% of the market by value.

Not all lenders provided lending data by size of SME. However, CMA calculations suggest that the market for loans to smaller SMEs, defined here as those with turnover of less than £2mn, is more concentrated than the market for business loans with higher turnover. For these SMEs, RBS and Lloyds each account for more than 30% of the stock of loans.

While concentrated markets do not necessarily imply a lack of competition, or that total lending is reduced, the CMA provisional finding is that a combination of issues including barriers to SME searching, information asymmetries and other incumbency advantages within the UK SME lending market lead to an adverse effect on competition.

FIG 4.6

**MARKET SHARES IN SME FINANCE MARKETS, 2014, BY VALUE**

*Source: : CMA Retail banking market investigation: provisional findings report, Appendix 6, pages 11 & 12*

| Banking Group | General purpose Business Loans | Value of new loans granted |
|---|---|---|
| RBS | **20-30** | **20-30** |
| LBG | **20-30** | **10-20** |
| Barclays | **20-30** | **30-40** |
| HSBC | **5-10** | **5-10** |
| Clydesdale | **5-10** | **5-10** |
| Santander | **0-5** | **0-5** |
| BoI | **0-5** | **0-5** |
| Danske | **0-5** | **0-5** |
| Handelsbanken | **0-5** | **5-10** |
| TSB | **0-5** | **0-5** |
| AIBG | **0-5** | **0-5** |
| Co-op | **0-5** | **0-5** |
| Metro | **0-5** | **0-5** |
| Aldermore | **0-5** | **0-5** |

FIG 4.7

**UK ASSET FINANCE MARKET SHARES IN 2014**

*Source:: CMA Retail banking market investigation: provisional findings report, Appendix 6, pages 11 & 12*

| Banking Group | Asset finance |
|---|---|
| RBS | **30-40** |
| LBG | **10-20** |
| HSBCG | **5-10** |
| Barclays | **10-20** |
| Aldermore | **10-20** |
| Clydesdale | **0-5** |
| Danske | **0-5** |
| Shawbrook | **5-10** |
| Santander | **0-5** |
| Close Brothers | **0-5** |
| Hitachi | **5-10** |
| BoI | **0-5** |
| AIBG | **0-5** |
| Investec | **5-10** |

## ASSET FINANCE SHOWS GREATER DIVERSIFICATION THAN GENERAL BUSINESS LENDING BUT CONCENTRATION REMAINS SIGNIFICANT

The table in 4.7 reproduces the CMA market share for asset finance. This suggests a more diversified market than for general purpose business loans, Aldermore, Shawbrook, Hitachi and Investec from outside the big four exceed 5% of the market.

The structure of the asset finance market was covered in more detail in the Small Business Finance Markets report 2014. Chapter 2.4 of that report set out a structure of the asset finance markets highlighting that the large number of asset finance providers were separated into three tiers:

- Tier 1 comprises banks and large non-bank asset finance providers. Borrowers with strong repayment capacity and track record are targeted and assets that are typically 'hard' such as wheeled assets are sought.
- Tier 2 comprises lenders with a broad range of appetites from those focusing on near prime deals to lenders with specific specialisms in asset classes or market segments.
- Tier 3, the 'non-prime' end of the market is the smallest in value terms, as deal sizes tend to be smaller. These lenders are more likely to serve businesses funding 'soft' assets such as catering equipment, software and fixtures and fittings (i.e. with limited resale value) and with weaker balance sheets/ track record.

Many of the smaller lenders in asset finance markets obtain funding from other finance providers. The availability of such funding may be limited, or may place constraints on the ability of those asset finance providers to grow their activity in certain parts of the market. This may hamper competition in asset finance markets, particularly at the more high risk end of markets.

The Business Bank has developed the ENABLE Funding programme to address funding issues in asset finance markets in order increase significantly the supply of leasing and asset finance to smaller businesses in the UK.

# 4.4 THE RISE OF CHALLENGER BANKS

- Challenger banks have adopted a wide variety of business models
- Financial technology plays an important role in the development of challenger banks
- Financial regulation and other government interventions may impact on the growth of challenger banks

Challenger banks increase the diversity of potential suppliers of finance for smaller businesses, and have adopted a wide range of business models in their efforts to increase market share. Both technology and regulation have impacted on the ability of the challenger banks to grow and compete with long established finance providers.

## CHALLENGER BANKS HAVE ADOPTED A WIDE VARIETY OF BUSINESS MODELS

Challenger banks include new entrants to the market, spin-offs or dis-investments from large banks and existing smaller banks seeking to grow. Given the differing backgrounds of challenger banks, it is not surprising that they have adopted a wide range of business models in terms of the range of products and the methods of delivery. 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. Some focus on digital delivery channels whilst others embrace branch banking.

KPMG analysis[112] distinguishes the Big Five Banks from the large challengers, for example Clydesdale, and the smaller challenger banks. New entrants continue to seek authorisation to enter the market. As highlighted in the previous section the larger challengers have significant markets shares in business lending business. For example, Clydesdale reported that its business lending portfolio, focused principally on SME lending, was £7.1bn at end September 2015.[113]

Some of the smaller challenger banks are growing rapidly. For example, Aldermore, established in 2009 as an SME focused bank, grew it's overall lending to SMEs by 32% to £2.2 billion in 2014,[114] whilst Shawbrook's asset finance volumes for SMEs grew by 27% to £564m and its business credit advanced reached £170m in 2014.[115]

## FINANCIAL TECHNOLOGY PLAYS ARE IMPORTANT ROLE IN THE DEVELOPMENT OF CHALLENGER BANKS

Developments in financial technology, often referred to as Fin-Tech, have the potential to introduce innovations in the smaller business bank lending market. These innovations in some instances can reduce market entry costs and operational costs for challenger banks, increasing their competitiveness in the market by reducing the cost to more accurately assess risk. Technology led innovation may also reduce asymmetry of information problems in the smaller business lending market which can create opportunities for both established and challenger banks.

As part of the current CMA retail banking market investigation Deloitte were commissioned to examine the impact of innovation in the UK retail banking market.[116] The objective of the Deloitte study was to understand innovations in the banking sector, the drivers and barriers to innovation and the potential implications for competition. The report focused on five areas of technological innovation which were mobile banking, digital wallet, aggregators, big data and bank in a box. These services are evolving rapidly which made it difficult to collect up-to-date data on take-up of these services and SME usage of technology. Deloitte's main findings and conclusions which affect challenger banks are presented below.

- 'Digital wallet' is a service that facilitates the storage of payment (and possibly other) credentials and enables users to make payments, either online or via a mobile, e.g. PayPal.
- Aggregators are services that collect and collate information from a number of sources in order to facilitate comparisons. Deloitte considered two types, comparison aggregators and account aggregators (allows customers to collate information across multiple accounts). Aggregators have the potential to provide a more cost-effective channel for challenger banks to reach customers and compete alongside traditional banks.
- Big data is a term used to describe a vast amount of data, complex data or frequently updated data in which traditional software such as spreadsheets are unable to process. Established banks may face high costs of updating IT systems. Therefore new entrants could have an advantage in setting up big data systems as they don't face the burden of updating legacy IT systems.
- Bank in a box refers to licensed application software providing deposit taking and lending functionality. Users of bank in a box are usually new entrants rather than large established banks, for example Hampden & Co a new bank launched in the UK in June 2015 uses cloud-based services provided by Oracle. Bank in a box can reduce costs of entry. Barriers to entry are therefore lowered but there are constraints on product differentiation which could limit bank in a box user's ability to grow.

The Deloitte report suggests the impact of these technology developments on challenger bank will take some time to play out. However, the combined effect has the potential to help increase the diversity of supply of finance products to small businesses.

## FINANCIAL REGULATION AND OTHER GOVERNMENT INTERVENTIONS MAY IMPACT ON THE GROWTH OF CHALLENGER BANKS

The ability of challenger banks to enter small business markets, and subsequently to grow within these markets is influenced by the regulation of the banking sector. The process for new banking authorisations has been reformed in recent years to introduce a more flexible approach.[117] As discussed in last year's report, the Financial Conduct Authority (FCA) has launched 'Project Innovate' with the aim of encouraging innovation in the interests of consumers and promote competition through disruptive innovation. And more recently the New Bank Start-up Unit has been established as a joint initiative from the Prudential Regulation Authority (PRA) and the FCA.

Challenger banks have also argued that the regulatory capital requirements have the potential to distort competition between banks by putting them at a cost disadvantage and will therefore limit the ability of some banks to expand their activity. The CMA is undertaking further analysis on the impact of the capital regulatory regime on SME lending.

Some challenger banks have also made use of the Bank of England's Funding for Lending Scheme[118] (FLS) to provide additional funding for their SME lending activities. FLS is currently used by 36 participants with total drawdowns on £63.6bn giving rise to net extensions to SMEs of £10.6bn.

The largest user of FLS is Lloyds Banking Group with £26bn of total FLS drawdowns. Challenger banks that make use of FLS include Aldermore with £750m of total outstanding drawings and net drawings of £265m in 2015, Close Brothers with£375m of outstanding drawings all of which took place since Q4 2014 and Shawbrook with £277m outstanding drawings, with £137m net drawing since Q4 2014.

The scheme has recently been extended until February 2018, although there will be gradual phasing out, with borrowing allowances reduced over time.

## CONCLUSION

The evidence presented in chapter four has shown the importance increasing the diversity of supply amongst finance providers.

The British Business Bank will help improve diversity of supply of finance for smaller businesses by expanding our support for challenger banks, non-bank debt funds, marketplace lenders, invoice and asset finance providers. Our ENABLE programmes have now supported over £225m of lending and our Investment Programme has committed £353m of support to these growing participants.

# 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.

BANK CAPITAL REQUIREMENTS Standardized 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 Smaller and newer banks which provide competition to the large established big banking groups.

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 Fundraising for businesses and projects, often where small amounts of money are lent or invested by large amounts of individuals. Debt crowdfunding is where lenders buy a security in return for interest and capital repayments, equity crowdfunding is where investors buy shares in early-stage businesses and start-ups with the expectation of capital growth and dividends. This is generally 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').

EQUITY GAP An estimated range of equity deal sizes which receive relatively little investment from private investors, often due to structural issues or features of the economy disincentivising investment.

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

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

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

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

HIRE PURCHASE 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.

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.

INVOICE FINANCE When a third party agrees to buy a business's unpaid invoices for a fee. There are two types of invoice financing; Factoring and Discounting. Factoring is when the 3rd party gives a percentage of the invoice and once the initial customer pays out, the rest is paid to the businesses. This incurs fee and/or interest charges. Discounting is when a third party lends against the businesses unpaid invoices. The third party then recieves the money and allows the business to borrow more, up to an agreed percentage of the total unpaid invoices.

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.

MANAGEMENT BUYOUT (MBO) The senior management of a company buying all of the company's outstanding shares. A management buyout gives the management complete control of the company and allows it to operate without recourse to shareholders.

MARKET FAILURE A situation whereby the allocation of resources via the free market is not efficient. Failures result in a loss of both social and economic welfare which could be captured if the market was structured differently.

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.

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

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

ONLINE PLATFORMS Peer to Peer lending, crowdfunding and invoice finance websites where the majority of transactions take place online. These facilitate the matching of lenders/investors and borrowers.

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) Where individuals lend money to other individuals or businesses in return for interest and capital repayments. This is often achieved via an online platform that facilitates the matching of differing lenders and borrowers via a network of peers.

PRINCIPAL-AGENT PROBLEMS Sub-optimal outcome as a result of asymmetric information and misaligned incentives between the principal and the hired agent. For instance, moral hazard and adverse selection.

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.

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.

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.

SOVEREIGN WEALTH FUNDS A state-owned investment fund

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. British Business Bank (2014) 'Small Business Finance Markets 2014'http://british-business-bank.co.uk/research/small-business-finance-markets-2014/
2. Note that changes in stock and flow numbers do not reconcile due to differences in statistical reporting
3. Figures for invoice financing are not included in the table as the share accounted for by smaller businesses is not precisely quantified over the time period.
4. There is no standard definition of a small business and a number of definitions exist. For instance, the UK government defines a smaller business as comprising of less than 250 employees. An alternative definition that is used by some financial institutions is based on businesses having an annual turnover of less than £25m. There is also a European definition of small businesses.
5. Enterprise Research Centre, Goldman Sachs and British Business Bank (2015) 'Unlocking UK Productivity – Internationalisation and Innovation in SMEs' http://www.enterpriseresearch.ac.uk/wp-content/uploads/2015/11/Internationalisation-and-Innovation-Report-web-pages-.pdf
6. BIS (2014) 'Business population estimates for the UK and Regions 2015' https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/467443/bpe_2015_statistical_release.pdf
7. ONS (2015) 'International Comparisons of Productivity - First Estimates, 2014' http://www.ons.gov.uk/ons/dcp171778_416704.pdf
8. ONS (2016) 'Economic Review, January 2016' http://www.ons.gov.uk/ons/dcp171766_429935.pdf?format=hi-vis
9. Organisation for Economic Co-Operation and Development (OECD) (2014) 'The Dynamics of Employment Growth: New Evidence from 18 Countries' http://www.keepeek.com/Digital-Asset-Management/oecd/science-and-technology/the-dynamics-of-employment-growth_5jz417hj6hg6-en#page1
10. Enterprise Research Centre, Goldman Sachs and British Business Bank (2015) 'Unlocking UK Productivity – Internationalisation and Innovation in SMEs' http://www.enterpriseresearch.ac.uk/wp-content/uploads/2015/11/Internationalisation-and-Innovation-Report-web-pages-.pdf
11. It should be noted that this analysis applies only to core lending, i.e. term loans and overdrafts that are covered in detail by the SME Finance Monitor survey. SME Finance Monitor is considered to be the most comprehensive dataset in the UK on which to base this analysis.
12. BDRC Continental (2015) 'SME Finance Monitor Q2 2015' http://bdrc-continental.com/wp-content/uploads/2015/09/BDRCContinental_SME_FM_Q2_2015-FINAL.pdf
13. BDRC Continental (2015) 'SME Finance Monitor Q2 2015' http://bdrc-continental.com/wp-content/uploads/2015/09/BDRCContinental_SME_FM_Q2_2015-FINAL.pdf
14. In some cases, a decision to withdraw a facility may be due to factors beyond the SME's control, e.g. a bank's risk appetite. However, identifying these cases would be difficult and approval rates suggest less of a problem compared with new facilities.
15. Definition of successful is consistent with SME Finance Monitor. Rejected applicants, for the purpose of this analysis, are SMEs not obtaining a facility or obtaining funding from family/friends or in a personal name. Subsequently, a very small percentage of SMEs that obtain funding from elsewhere (but not family/in a personal name) are not included in the successful or rejected definitions.
16. Proportions are grossed up using BIS population estimates.
17. SMEs trading up to 5 years is used for the start-up definition, because anecdotal evidence suggests that finance providers often required at least 2-3 years of performance data in order to assess creditworthiness. Some very young SMEs will not be producing these, therefore information asymmetries are likely to be issues faced by businesses trading between 2 and 5 years.
18. European Commission, Commission Staff Working Document, Ex-Ante Assessment of the EU SME Initiative, 2013
19. RBS Independent Lending Review, 2013
20. Business Bank analysis excludes SMEs discouraged from applying for finance.
21. Unless otherwise stated, the figures quoted in this section are from the 'British Business Bank 2015 Business Finance survey', a survey of 1608 smaller businesses. The survey was undertaken by BMG Research and was specifically commissioned by the British Business Bank to see how the market has changed since 2014, building on from the previous SME journey surveys undertaken in 2012 and 2014.
22. SME Finance monitor Q3 2015 shows since 2012, the proportion of SMEs holding over £10,000 in credit has increased from 16% to 23%, and within this group, use of external finance has declined from 51% to 43% and use of overdrafts specifically from 18% to 14%.
23. Although this increase in demand is not seen in the SME Finance Monitor survey, this may be because the SME Finance Monitor focuses on bank finance applications, whilst the Business Bank finance survey covers all types of external finance including grants. Therefore, there are likely to be differences between the two surveys
24. Whilst there is some overlap between the survey time periods, further analysis of the reason for seeking finance over time confirms finance sought in the last year was more likely to be funding working capital than previously.
25. ONS (2015) 'Business Investment, Quarter 3 (July to Sept) 2015 Provisional Results' http://www.ons.gov.uk/ons/dcp171778_425505.pdf
26. BDRC Continental (2015) 'SME Finance Monitor Q3 2015' http://bdrc-continental.com/wp-content/uploads/2015/11/SME-charts-Q3-2015-FINAL.pdf
27. Bank of England (2015) 'Credit Conditions Review 2015 Q3' http://www.bankofengland.co.uk/publications/Documents/creditconditionsreview/2015/ccrq315.pdf
28. Bank of England (2015) 'Credit Conditions Review 2015 Q4' http://www.bankofengland.co.uk/publications/Documents/creditconditionsreview/2016/ccrq415.pdf
29. Note that the reporting population differs between Bank of England and BBA reporting data, hence net lending numbers are not directly comparable.
30. BDRC Continental (2015) 'SME Finance Monitor Q2 2014' and BDRC Continental (2015) 'SME Finance Monitor Q3 2012' http://bdrc-continental.com/products/sme-finance-monitor/
31. BDRC Continental (2015) 'SME Finance Monitor Q3 2015' http://bdrc-continental.com/wp-content/uploads/2015/11/SME-charts-Q3-2015-FINAL.pdf
32. This section focuses on equity finance for private companies rather than public equity on markets.
33. British Business Bank (2016) '2015 Business Finance Survey'
34. Beauhurst is a provider of market data on equity investment. See http://about.beauhurst.com/ for more information.
35. These numbers are consistent with those published in in the 2014 Smaller Business finance market report and equity tracker report. These numbers differ to those published by Beauhurst themselves as they are based on SMEs only (at the time of investment), and also exclude MBO/MBI and other Private Equity investments that are not directly linked to business growth.
36. Page 71 in British Business Bank (2015) 'Small Business Investment Equity Tracker' contains a description on how the different investment stage classifications were matched across the different data equity sources. http://british-business-bank.co.uk/wp-content/uploads/2015/03/050315-Equity-tracker-FINAL.pdf
37. Beauhurst does identify unpublished deals, but there is no consistent time series currently available.
38. Wright, Hart and Fu (2015) 'A Nation of Angels: Assessing the impact of angel investing across the UK' http://www.ukbusinessangelsassociation.org.uk/sites/default/files/media/files/erc_nation_of_angels_full_report.pdf
39. The increase is likely to be even larger as new investments become identified by Beauhurst.
40. http://www.immunocore.com/news/2015/07/immunocore-secures-320-million-205-million-in-europes-largest-private-life-sciences-financing
41. Unicorn businesses are defined as venture-backed private technology companies valued at over $1 billion.
42. CB Insights (2015) 'The Unicorn List' (accessed 08/12/2015/) https://www.cbinsights.com/research-unicorn-companies
43. Enterprise Research Centre (2015) 'Growth Dashboard June 2015' http://www.enterpriseresearch.ac.uk/wp-content/uploads/2015/06/2015-UK-Growth-Dashboard-Report.pdf
44. ICAEW/Grant Thornton (2015) 'UK Business Confidence Monitor Q4 2015' http://www.icaew.com/~/media/corporate/files/about%20icaew/what%20we%20do/business%20confidence%20monitor/2015/bcm%20q4%202015.ashx
45. The number of births as a proportion of active enterprises.
46. Enterprise Research Centre (2014) 'Moving on from the 'Vital 6%'' http://www.enterpriseresearch.ac.uk/wp-content/uploads/2014/02/ERC-Insight-No_3.pdf
47. Enterprise Research Centre, Goldman Sachs and British Business Bank (2015) 'Unlocking UK Productivity – Internationalisation and Innovation in SMEs' http://www.enterpriseresearch.ac.uk/wp-content/uploads/2015/11/Internationalisation-and-Innovation-Report-web-pages-.pdf
48. Enterprise Research Centre, Goldman Sachs and British Business Bank (2015) 'Unlocking UK Productivity – Internationalisation and Innovation in SMEs' http://www.enterpriseresearch.ac.uk/wp-content/uploads/2015/11/Internationalisation-and-Innovation-Report-web-pages-.pdf. Note: excludes Japan.
49. Early stage entrepreneurs who have created more than ten jobs and expect more than 50% growth in jobs in the next five years.
50. Enterprise Research Centre (2015) 'Growth Dashboard June 2015' http://www.enterpriseresearch.ac.uk/wp-content/uploads/2014/06/ERC-Conference-LEP-Growth-Dashboard-final.pdf
51. BIS (2015) 'Small Business Survey 2014: SME Employers' https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/414963/bis-15-151-small-business-survey-2014-sme-employers_v1.pdf
52. BDRC (2015) 'SME Finance Monitor Q3 2015' http://bdrc-continental.com/wp-content/uploads/2015/11/SME-charts-Q3-2015-FINAL.pdf
53. Enterprise Research Centre (2015) 'Contribution to Job Creation by High Growth SMEs' http://www.enterpriseresearch.ac.uk/wp-content/uploads/2015/07/ERC-HGF-Pre-Budget-Insight-Final.pdf
54. Deloitte (2015) 'Deloitte Alternative Lender Deal Tracker Q3 2015' http://www2.deloitte.com/uk/en/pages/financial-advisory/articles/deloitte-alternative-lender-deal-tracker.html
55. British Business Bank (2015) 'Analysis of the UK Smaller Business Growth Loans Market' http://british-business-bank.co.uk/wp-content/uploads/2015/03/Growth-loan-research-report-FINAL-VERSION.pdf
56. Preqin (2015) 'Preqin Quarterly Update Private Debt' https://www.preqin.com/docs/quarterly/pd/Preqin-Quarterly-Private-Debt-Update-Q3-2015.pdf

57. No data points available for 2009.
58. BNY Mellon Asset Management (2011) 'Investing in Debt: Opportunities in Leveraged Loans' http://www.alcentra.com/news/research/investing-in-debt-opportunities-in-secured-bank-loans.pdf
59. No data points available for 2009
60. The UK Government defines SMEs according to the number of employees (249 employees or less), and so there is some possible overlap between the two definitions for some businesses.
61. BIS (2014) 'MSB Demographics' https://www.gov.uk/government/statistics/msb-demographics
62. For example CBI.
63. 49% of mid-cap businesses expect trading conditions will improve in the next 12 months compared to 14% expecting it to be worse (giving a net balance of 35%). In comparison, 44% of SMEs expect conditions to improve but 11% expect conditions to worsen giving a similar net balance of 33%.
64. BIS (2010) 'Results from the 2010 Finance Survey of mid-cap Businesses' https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32248/10-p108-results-2010-finance-survey-mid-cap-businesses.pdf
65. BIS (2010) 'Results from the 2010 Finance Survey of mid-cap Businesses' https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32248/10-p108-results-2010-finance-survey-mid-cap-businesses.pdf
66. See Enterprise Research Centre, Goldman Sachs and British Business Bank (2015) 'Unlocking UK Productivity – Internationalisation and Innovation in SMEs' and UKTI (2013) 'Bringing Home the Benefits: How to Grow Through Exporting'
67. Young firms: those trading less than 3 years. Growing firms: those that had increased employee numbers or turnover by at least 5 per cent in the last year. Data available at: https://www.gov.uk/government/collections/small-business-survey-reports
68. BDRC Continental (2015) 'SME Finance Monitor Q3 2015' http://bdrc-continental.com/wp-content/uploads/2015/11/SME-charts-Q3-2015-FINAL.pdf
69. Eurostat (2015) 'International Trade by Enterprise Characteristics' http://ec.europa.eu/eurostat/statistics-explained/index.php?oldid=72936
70. Enterprise Research Centre, Goldman Sachs and British Business Bank (2015) 'Unlocking UK Productivity – Internationalisation and Innovation in SMEs' http://www.enterpriseresearch.ac.uk/wp-content/uploads/2015/11/Internationalisation-and-Innovation-Report-web-pages-.pdf
71. British Business Bank (2016) 'Business Finance Survey'
72. This section focuses on equity finance for private companies rather than public equity on markets.
73. Immunocore. See http://www.immunocore.com/news/2015/07/immunocore-secures-320-million-205-million-in-europes-largest-private-life-sciences-financing
74. It is important to note that this analysis excludes MBO/MBI transactions and only cover investments for companies that are defined as an SME based on the EC definition of less than 250 employees and either turnover of less than €50m or balance sheet total of less than €43m
75. The number of European VC backed IPOs has increased by 289% between 2013 Q1-Q3 and 2015 Q1-3, whilst trade sales have increased by 17%. Dow Jones VentureSource(2015) 'Venture Capital Report Europe 3Q 2015' http://images.dowjones.com/wp-content/uploads/sites/43/2015/10/26092335/Dow-Jones-3Q15-Europe-VentureSource-Report-final.pdf
76. BVCA (2015) 'Performance Measurement Survey 2014' http://www.bvca.co.uk/Portals/0/library/documents/Performance%20Measurement%20Survey/2014%20Performance%20Measurement%20Survey.pdf
77. BVCA data shows the amount of funding raised for VC in 2014 (£288m) is slightly higher than that raised in 2013 (£259m), although less than 2012 levels (£428).
78. See Business Bank (2015) 'Equity Research Report: Review of Equity Investment in Small Business' http://british-business-bank.co.uk/wp-content/uploads/2015/03/050315-Equity-report-FINAL.pdf
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82. Relief is available at 50% of the cost of the shares, on a maximum annual investment of £100,000. Companies must have raised no more than £150,000 in total from SEIS.
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84. Currently income tax relief of 30% is available to investors subscribing to new VCT shares and there is tax-free dividends
85. HMRC (2015) 'Venture Capital Trusts: number of trusts and amount of funds raised (September 2015)' https://www.gov.uk/government/statistics/venture-capital-trusts-number-of-trusts-and-amount-of-funds-raised
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89. This market analysis has included interviews with 35 stakeholders including fund managers, patient capital providers, life science companies and business representative organisations.
90. For the purposes of the analysis, a successful exit is defined as being either a trade sale, IPO or secondary sale to another fund.
91. There is some double counting between angels, corporates and VC deals due to syndicated deals involving combination of different investors.
92. British Business Bank analysis of Beauhurst
93. British Business Bank analysis of Preqin
94. Whilst VCTs have a large impact on the market 97 VCT funds in existence, of which 66 have raised £440 million funding in 2013/14 a substantial proportion of the investment has gone to lower risk sectors, and so falls out of the broad definition of patient capital used.
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98. Some of this funding is going into other patient capital providers, so care is needed to avoid double counting.
99. The Small Business Finance Markets Report 2014 provides more detailed coverage of asset finance, providing definitions for the different types of asset finance and more detailed discussion of the rationale for market failures in that sector.
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