

# SMALL BUSINESS FINANCE MARKETS

2016/17

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# FOREWORD

KEITH MORGAN  
CEO, BRITISH BUSINESS BANK

Since its establishment just over two years ago, the British Business Bank has made an important contribution to supporting small business growth in the UK. Our mission is to change finance markets for smaller businesses so they work more effectively and dynamically. We do this by operating through the market, with a range of both debt and equity providers, to support small businesses and help meet their finance needs.

This publication, our Small Business Finance Markets report, is central to shaping our programmes and providing the evidence base for all our interventions. The report tracks developments in the market and sets out where market gaps exist. It is fundamental to the design of our interventions and where we direct our resources and efforts.

Since the Business Bank was launched, our programmes have delivered over £4bn in new lending and investment, which will generate an estimated additional turnover of £8.5bn in small businesses across the UK and around £3bn of additional gross value-added in the economy. In total, we are supporting over 54,000 small businesses.

At the same time, we have continued to play a catalytic role in helping to create a more diverse finance market, by supporting new segments such as peer-to-peer lending and newer entrants to the lending market, including challenger banks. Today, over 90% of our finance is deployed through smaller, newer or alternative finance providers with the balance of less than 10% coming from the big four banks.

In addition to supporting more finance through a diverse range of providers, we believe that well-informed small businesses are required for dynamic and competitive markets. We are committed to ensuring that small businesses know about the finance options available to them and our interactive online Business Finance Guide, co-published with the ICAEW and supported by over 20 leading business bodies, reaches thousands of businesses every month. A further important innovation is the recently-launched Government Designated Finance Platforms Referral scheme, whereby small businesses who are unsuccessful in their application for finance from the main banks, are referred to platforms that offer alternative finance solutions.

This year's Small Business Finance Markets report shows an improvement in flows of finance to small businesses in a range of markets. Encouragingly, smaller businesses' awareness of finance products available to them has continued to improve. Small businesses are broadly positive about their own business development and growth plans for the coming year and, in the light of the EU referendum, businesses are not stalling or contracting operations.

All that said, the macroeconomic outlook is uncertain, growth forecasts are lower compared to pre-referendum levels and, while many smaller businesses are still planning to grow, there have been some signs of weaker demand for finance in 2016. Economic headwinds can over time affect a business's ambition and confidence.

The availability of equity finance, especially important for growing businesses, remains unevenly spread across the UK and has fallen from its peak in 2015. The Bank has responded to these regional imbalances through the creation of the Northern Powerhouse Investment Fund, launching this month, which will be followed later this year by the Midlands Engine Investment Fund. Combined, these will provide a total of £650m to these regions, of which around 40% will be in the form of equity finance. Whilst these funds are a start, tackling the underlying causes of regional imbalances will remain an ongoing priority for the Bank. The Government's recent Industrial Strategy Green Paper rightly raises a number of questions aimed at generating a better understanding of where access to finance is a barrier to growth, and we will continue to consider how we might further address these issues.

Although brought into sharper focus in regions outside of London, insufficient scale-up or growth finance is a problem across the whole of the UK. The ability of businesses to scale-up has a substantial impact on productivity and job creation but evidence indicates that the UK lags its international peers in scaling up ambitious businesses. We believe a gap in later stage growth funding is one barrier to businesses wishing to expand, and we were very pleased to receive an extra £400m for later stage venture capital in November's Autumn Statement. The Bank looks forward to contributing to the recently announced 'Patient Capital' review and to considering how its programmes might support subsequent recommendations if required.

We continue to work with our partners across the small business finance markets to deliver additional volumes and choice of finance in key segments across the UK. I hope you find this report and our assessment of the marketplace interesting and informative.

# EXECUTIVE SUMMARY

Our latest annual Small Business Finance Markets report again highlights the crucial role that smaller businesses play in UK economic growth, and the importance of access to finance in enabling that growth. Through looking at a range of finance markets, this report provides a unique, in-depth picture of the way small businesses use and interact with finance providers and how those markets have developed. As well as informing the wider policy debate around small business access to finance, it is a key document that guides the Bank in advancing its strategy, including towards supporting the emerging Industrial Strategy.

## GREATER ECONOMIC UNCERTAINTY AND SOFTENING OF EQUITY MARKETS

Since our last report, a number of significant events have taken place that have, or will, shape small business finance markets. On a broad level, there is a greater degree of macroeconomic uncertainty, in part due to the UK's decision to leave the European Union, and SME investment intentions remain subdued. Such uncertainty impacts on market sentiment, with equity finance, often used by firms scaling up, particularly sensitive to these changes. Whilst equity finance remains available, late 2015 represented a peak in activity and value and deal flow has eased in the past year. The Bank will continue to monitor carefully these markets to judge whether further policy action is required.

## A CHANGING POLICY CONTEXT

The policy context the Bank works in has also evolved in a number of important ways. The Competition and Markets Authority (CMA) published its inquiry into SME retail banking last summer, with a range of remedies proposed to make markets work better. A central insight from that inquiry was that, on the whole, small businesses are poorly engaged with finance markets despite their importance to the health of businesses, perhaps best illustrated by the very low levels of switching between providers. A similar conclusion was reached by a BEIS Select Committee Access to Finance inquiry that reported in October 2016 – that businesses need better information so they can engage with the market and better understand their options.

## ENCOURAGING GROWTH BY ALTERNATIVE FINANCE PROVIDERS

Notwithstanding those conclusions and the clear need for further action, some encouraging signs are provided in this research that businesses are increasingly using, and are aware of, alternative providers. That should be given a further boost by the Government's innovative referrals scheme which was launched in November 2016. Over time, by introducing smaller businesses to a wider range of possible providers of finance, the initiative will have an important role to play in creating a more dynamic market and in ensuring viable firms get the finance they require.

## LOWER CREDIT APPLICATIONS AND SOME DEFERRED GROWTH EVIDENT

Behind the overall picture, two features of the SME finance market remain striking: the declining trend in applications for new debt facilities and the high proportion of businesses (over 70%) that would accept slower growth rather than take on external finance. Shifting these trends, partly caused by the erosion of trust in financial institutions during the credit crisis, will be an important task if SME growth aspirations are to be raised and realised through investment and job creation. It further underscores the view taken by the CMA and the BEIS Select Committee that the demand side of the access to finance equation should not be ignored.

## BRITISH BUSINESS BANK - SUPPORTING WIDER GOVERNMENT OBJECTIVES

Looking ahead, the Government's recently published Industrial Strategy Green Paper, where the Bank's work was highlighted, will shape our work and we look forward to supporting the Government's ambitions set out in the Strategy. The Strategy echoed many of the themes the Bank has identified in previous and in this latest research. We welcome the focus on the financing needs of scale-up businesses, an area where the Bank has long placed an emphasis, and addressing regional imbalances most markedly seen in equity finance. With the latter, the Bank is already putting in place two significant regional funds (the Northern Powerhouse Investment Fund and Midlands Engine Investment Fund) to tackle regional financing needs.

At Autumn Statement 2016 the Bank received a further £400 million to step up our activity in later stage venture capital, an area of the market our research showed needed attention if the UK is to support ambitious businesses scaling up. Important work related to this issue is also underway through the Patient Capital Review, led by HM Treasury, to consider whether UK companies are constrained by a lack of patient finance. The Bank looks forward to contributing to the Review and playing a part

in delivering any recommendations it makes, if required.

Taking account of these developments and based on the research presented in this report, summarised below, the Bank will continue to focus on three broad areas that we believe will support smaller businesses' ambitions and raise the growth potential of the UK economy:

- **Supporting scale-ups:** Through helping small businesses with the potential to scale-up, and who are scaling up, to obtain the growth finance they need, and ensuring that they are aware of and understand the options available to them. Research shows that the UK's performance in scaling up firms has lagged its international peers.
- **Closing regional imbalances:** Making sure that finance reaches smaller businesses across all regions of the UK economy is important to delivering widespread growth. Evidence in this report continues to show that the flow of equity finance, which can be especially important for growing businesses, is not evenly spread across all regions of the UK.
- **Raising awareness:** Supporting policy goals, such as those set out in the CMA retail banking market investigation, by improving information in the market and links between smaller businesses and finance providers so that businesses get the finance that best meets their needs. Many businesses still turn to their bank for finance and use traditional loans, whilst there is an increasing range of providers and products on the market that may be better suited to their needs.

## KEY FINDINGS OF THE 2016/17 REPORT

### THE ECONOMIC ENVIRONMENT AND SMALL BUSINESS CONFIDENCE

Smaller businesses account for 60% of private sector employment and nearly half of private sector turnover. They are a critical source of growth and job creation for the UK economy. The SME sector has been characterised by

the rapid growth in the number of enterprises over the last few years, most markedly in the number of sole traders, with slower growth in small and medium sized businesses that have employees.

The UK economy delivered strong growth in 2016 with unemployment at its lowest level since mid-2005. Whilst official forecasts suggest that the economy will continue to grow, surveys suggest that small business confidence has been in decline from a high in 2015. That decline in confidence reflects a combination of factors, including uncertainty surrounding the economic environment, with the EU referendum result last year introducing a further element of uncertainty to SMEs' outlook; and also the impact of domestic policy decisions on the SME sector. Inflationary pressures largely flowing from the depreciation of sterling are also emerging in the UK economy having been absent for a considerable period. Such uncertainty and policy impacts combined with future input cost rises make it more difficult for businesses, and in particular smaller businesses, to plan and invest and these factors appear to have fed through to SMEs' investment intentions.

Despite these emerging headwinds and weakening investment intentions, surveys of SMEs show that many smaller businesses remain resilient. Many still continue to aim for growth and a positive balance of small businesses increased employee numbers in the fourth quarter of 2016. The latest data on high growth firms shows that rapidly scaling up firms continue to be spread across all regions of the economy. These scale-up businesses have the potential to play a key role in supporting economic growth through this period of macro-economic uncertainty. But as this report finds, more needs to be done to ensure they have access to growth capital, particularly equity, wherever they are located.

#### DEMAND FOR FINANCE SOFTENED IN 2016, ALTHOUGH NET LENDING REMAINED POSITIVE

Use of external finance by smaller businesses includes those who use financial service

providers and those using trade credit. Core debt products such as bank loans, overdrafts and credit cards remain the most frequently used.

A clear trend has emerged of fewer smaller businesses using these products since 2012. Applications for new debt facilities fell to 6% of SMEs in the first half of 2016 (down from 11% in 2012) with the fall seen across a range of SMEs, from start-ups to older small businesses and those businesses specifically looking to scale-up. In part these changes reflect the wider economic environment noted earlier; they may also be a change in preferences, where smaller businesses generally prefer holding positive bank balances and funding growth plans from their own resources.

Such SME behaviour has impacted on gross flows of bank lending, which fell back slightly in the second and third quarter of 2016. However, despite this fall, overall gross bank lending grew year-on-year with the first quarter of 2016 marking a post-financial crisis peak. Once repayments are taken into account, there has been eight consecutive quarters of positive net bank lending to smaller businesses from the fourth quarter of 2014 to the third quarter of 2016.

Alternative forms of lending such as asset finance and peer-to-peer lending showed continued growth in 2016. Asset and asset based finance grew healthily through 2016, with hire purchase in particular well above pre-financial crisis levels. Gross flows of lending to business via marketplace lenders reached £1.3bn in 2016. Despite this growth, they remain relatively small in comparison to sources of debt finance from banks. Elsewhere, private debt funds have continued to play an important role in finance for those firms looking to scale-up, an area of the market the Bank has been active in supporting through commitments to a variety of funds over the past year.

One feature of SME finance has been the significant increase in flows of equity finance to smaller businesses over the last five years. 2016 did however see a decline following a

very strong 2015. Latest data shows that the number of deals in the first three quarters of 2016 fell by 17% and the value of investment fell by 9% compared to the same quarters in 2015. As noted, the EIF has made a significant contribution to UK SME finance markets, committing approximately £470m per year on average directly into the UK over the period 2011-15 comprising £390m per year for UK funds and £78m per year for UK guarantees.<sup>1</sup> As such this activity supports scale-up businesses and the Bank will monitor closely market developments in this area.

#### GAPS IN THE SUPPLY OF FINANCE REMAIN, PARTICULARLY FOR THOSE LOOKING TO SCALE-UP

Despite evidence of weaker demand and the continued availability of credit in 2016, there is continued evidence of market gaps where structural problems exist in the market. Bank analysis of rejected loan applications continues to show higher rejection rates for younger small businesses and for those looking to scale-up – the latter being important because these businesses are shown to have a high positive impact on job creation. Furthermore, problems in access to finance can be particularly important in some sectors, for example housebuilding.

On the equity side, the Bank has looked closely at the equity finance used by businesses looking to scale-up, particular later stage venture capital. New analysis has provided support for the hypothesis that UK businesses are less likely to seek and obtain multiple rounds of later stage equity funding compared to their counterparts in the US, suggesting the issues associated with the early stage equity gap also extends to later stage funding rounds.

The British Business Bank is therefore focusing more resource towards finding effective financing solutions for innovative smaller businesses to allow them to scale-up and achieve their growth ambitions. Those efforts have been given a significant boost with the announcement at Autumn Statement 2016 of an additional £400 million of venture capital funding. Additional

efforts are being made through our Help to Grow scheme that will provide debt finance to scale-up businesses, with two delivery partners signed up already to our bank guarantee scheme. In addition, our regional efforts through the Northern Powerhouse Investment Fund (NPIF) and Midlands Engine Investment Fund (MEIF) initiatives will be supporting equity and debt to smaller businesses looking to grow in those areas.

Furthermore, to help further develop understanding of the extent to which equity finance supports the long-term growth of scale-up businesses, the Bank will contribute to the Patient Capital Review announced by HM Treasury at Autumn Statement 2016.

#### REGIONAL IMBALANCES IN EQUITY FINANCE STILL PERSIST

Research presented in this report again highlights regional imbalances in funding across the UK. For core bank lending products, funding is in broadly in line with the distribution of small business across the UK. However, in equity finance, a clear regional imbalance is evident, where investment (by volumes and value) is concentrated in London and the South East. The nature of demand also varies across regions, with businesses in London and the South East more likely to be aware of business angels and venture capital as sources of finance. Given equity finance can be vital for growth, this can only help entrench regional growth 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 the NPIF and MEIF, and as recommended in the Industrial Strategy, consider what more can be done to stimulate demand for equity finance in regions outside London and the South East.

#### GREATER ENGAGEMENT OF SMES IN FINANCE MARKETS NEEDS TO BE ENCOURAGED

The Bank's latest survey shows that smaller businesses awareness of finance products



available to them has continued to improve, with notable increases in the awareness of peer-to-peer lending platforms. As noted earlier, improvements in credit availability for SMEs have been sustained in 2016 and the majority are confident in their ability to obtain finance when required. Growth in awareness of specific providers to approach has however plateaued. For those looking more widely, external advisors are a frequent source of advice and the use of the internet to explore their options is increasing.

The extent of the challenge in this area is illustrated by the fact that a large majority of small businesses continue to approach only their existing supplier, often the bank who provides their current account, when they identify additional financing needs. That is despite the benefits that alternative finance or greater searching across providers may bring to the business. A further feature of SME behaviour in the market is that around one-third of smaller businesses give up when the first provider (usually their main bank) they apply to does not give them the finance they require. Moreover there is still a small, but significant, number who are discouraged from seeking finance altogether. Together these factors will impact on SMEs' ambitions and growth potential.

To overcome these obstacles it will be important to ensure better provision of information in the market, to allow smaller businesses to identify the best type and source of finance suitable for their needs.

The British Business Bank continues to play a central role in this area including supporting the launch of the Government Designated Finance Platforms Referral scheme, and launching an updated and interactive Business Finance Guide.

#### THE BENEFITS OF ACCESSING A WIDER RANGE OF FINANCE PROVIDERS AND PRODUCTS

Diversity in finance markets is created by the mix of products used and the range of finance providers available. New technology

(often known as FinTech) is reducing barriers to entry for new players and introducing new business models to the market. It is also helping established finance providers improve the diversity of finance available to small businesses and to adapt their own service models to the benefit of their customers.

Diversity of finance has a number of positive impacts for SMEs and the wider economy. These include:

- **Improving access to finance for a wider range of smaller businesses. This aspect is particularly important at different points in the credit cycle. The credit crisis of 2008 and the years following highlighted the problems of relying on a small number of large financial institutions, with consequent implications for macroeconomic stability;**
- **Speeding up access to finance, an aspect of service SMEs particularly value and where new peer-to-peer entrants have made good use of technology to quicken processes and improve the ease of use of their services for their customers;**
- **Improving the terms of finance and increasing competition;**
- **Finally, and potentially most importantly, improving the appropriateness of the type of finance used by smaller business.**

All of these factors can help improve the outcomes for smaller businesses, whatever their stage of development and ambitions, and ultimately leave the UK economy stronger.

The British Business Bank will continue to grow the number and range of new delivery partners, helping to increase the diversity of finance providers. Examples during 2016 include the addition of new asset finance providers and debt funds in our Investment Programme, and an expansion of the eligibility criteria for our EFG and ENABLE programme to include asset finance providers and peer-to-peer lenders respectively.

# INTRODUCTION

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

Our understanding of smaller business finance markets, both in terms of demand for finance and the finance providers' supply of finance, is essential to shaping our business plan and the design of our programmes and products. For more information about our programmes and products see our website.

Macro-economic developments in 2016 have reinforced the need to ensure that small businesses have the finance they need to make a strong contribution to economic growth across all three of the British Business Bank market segments – start-ups, small businesses that require finance to stay-ahead and those looking to rapidly scale-up their activities. The latter segment in particular will be important in delivering continued growth at a time of economic uncertainty.

## NEW EVIDENCE

The British Business Bank looks to add to the evidence base by bringing new evidence to the debate on SME finance markets.<sup>2</sup> In particular:

- Our Business Finance Survey has been run again to give up to date insight into smaller businesses, their awareness of the finance options available to them and how they go about obtaining that finance.
- The Business Bank has commissioned updated private equity market data from Beauhurst which demonstrates the range of equity finance used by small businesses to grow.

- We have undertaken additional research on the volume of later stage equity finance for small businesses that require more than one round of finance to deliver their growth potential.
- Our analysis has been informed by more research into the benefits of diversity of supply of finance for small businesses.

This report also references a wide range of evidence drawn from government, market and academic research. Unless otherwise stated, the report uses data available as at 11 January 2017. The Business Bank is pleased that in 2016 we became a funder of the Enterprise Research Centre which conducts research into a wide range of determinants of small business performance including access to finance.

## STRUCTURE OF THE REPORT

Following an overall assessment of market developments and the aggregate flow and stock of finance to smaller businesses, Chapter One provides an overview of macro-economic developments and the implications for small business finance needs.

Chapter Two looks at developments in the demand for finance over 2016, with a focus on the awareness of different finance options.

Chapter Three examines the volumes of finance used by smaller businesses in 2016, and looks in detail at developments in the market for different types of debt and equity finance.

Chapter Four presents a consideration of the benefits of diversity of supply to smaller businesses, and developments in the challenger bank market.

## CHAPTER ONE

# OVERALL ASSESSMENT OF MARKET DEVELOPMENTS

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Chapter One provides an overall summary assessment of a number of smaller business debt and equity finance markets. This chapter also includes a discussion of how smaller businesses contribute to the wider economy, and an overview of important macro-economic developments.

The overall picture of flow and stock of finance to smaller businesses, set out in section 1.1, is an encouraging one with net bank lending remaining positive, despite a softening in demand. Also, there has been growth in some alternative types of finance.

Growth in the number of smaller businesses is presented in section 1.2, along with a discussion of how smaller businesses play an important role in improving UK productivity. Section 1.3 sets out key macro-economic developments, including output growth, and labour market performance. This section includes a discussion of future macro-economic challenges likely to affect small businesses and economic growth forecasts.

The final section of this chapter looks at regional analysis of smaller businesses and finance flows. This evidence provides continued support for Business Bank involvement in supporting provision of finance regionally.

## 1.1

# AGGREGATE FLOW AND STOCK OF FINANCE TO SMALLER BUSINESSES

- Net flow of bank lending products remains positive
- Equity finance slowed down following a strong 2015, but asset finance and marketplace lending continue to grow
- Small business confidence and demand for finance are declining, although many still hope to grow

This section brings together the latest data from a range of sources on the volume and value of various types of external finance provided to smaller businesses. Consistent and comprehensive data outlining the value of the aggregate stock and flow of all forms of external finance is not readily available. However, the summary table (figure 1.1) provides a reasonable snapshot.

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.

FIG 1.1

## ESTIMATES OF THE FLOW & STOCK OF EXTERNAL FINANCE FOR UK SMES £ BILLIONS <sup>(a)</sup>

		2011	2012	2013	2014	2015	2016	
Bank lending stock £ billions Source: Bank of England	Outstanding Amount (b)	<b>189</b>	<b>176</b>	<b>166</b>	<b>167</b>	<b>164</b>	<b>164</b>	to end Nov 16
Bank lending flows £ billions Source: Bank of England	Net flows	-	<b>-6</b>	<b>-2</b>	<b>-2</b>	<b>2</b>	<b>3</b>	to end Nov 16
	Gross flows	-	<b>38</b>	<b>43</b>	<b>53</b>	<b>58</b>	<b>54</b>	to end Nov 16
Other gross flows of SME Finance								
Private external equity investments £ billions Source: Beahurst (e)		<b>1.28</b>	<b>1.49</b>	<b>1.53</b>	<b>2.32</b>	<b>3.58</b>	<b>2.50</b>	to end Sep 16
	Number of reported deals	<b>462</b>	<b>706</b>	<b>972</b>	<b>1309</b>	<b>1408</b>	<b>880</b>	
Asset finance flows £ billions Source: FLA (f)		<b>11.4</b>	<b>12.2</b>	<b>12.9</b>	<b>14.4</b>	<b>15.8</b>	<b>16.8</b>	to end Nov 16
Peer-to-Peer Business Lending flows £ billions Source: AltFi Data (g)		<b>0.02</b>	<b>0.06</b>	<b>0.20</b>	<b>0.59</b>	<b>1.01</b>	<b>1.31</b>	to end Dec 16

(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) Data includes overdrafts and loans. Movements in amounts outstanding can reflect breaks in data series as well as underlying flows. Note that changes in stock and flow numbers do not reconcile due to differences in statistical reporting including the treatment of write-offs.

(c) Net flows do 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.

(d) 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.

(e) Beahurst is a market data provider that records equity deals including crowdfunding deals in UK companies.

(f) The Finance & Leasing Association (FLA) whose members make up 90-95% of the market. Data obtained from FLA Asset Finance Confidence Survey. SME asset finance is assumed to represent 60% of total asset finance in 2011.

(g) Figures do not represent the entire market. Data obtained from AltFi Data.

### NET FLOW OF BANK LENDING PRODUCTS REMAINS POSITIVE

The net flow of bank loans (new loans, excluding overdrafts) to smaller businesses has continued to grow with eight consecutive quarters of positive net lending totalling £5.3bn through to Q3 2016. Net lending in the first three quarters of 2016 is already larger than over the four quarters of 2015. Gross bank lending to smaller businesses has been growing from late 2012, reaching a peak of £15.4bn in the first quarter of 2016, before falling back somewhat in the last two quarters. The Bank of England (BoE) Credit Conditions Review noted the availability of credit to businesses was little changed in Q4 2016, having improved over the past few years.<sup>3</sup>

The stock of bank loans and overdrafts was estimated at £164bn at the end of November 2016.<sup>4</sup>

### EQUITY FINANCE SLOWED DOWN FOLLOWING A STRONG 2015, BUT ASSET FINANCE AND MARKETPLACE LENDING CONTINUE TO GROW

New equity data commissioned by the British Business Bank shows there has been a slowdown in equity markets in 2016, relative to a strong previous year. The value of new equity deals with known amounts totalled £3.6bn in 2015, growth has slowed to £2.5bn in the first three quarters of 2016.

Data from the Finance and Leasing Association (FLA) suggests that new asset finance volumes to smaller businesses was over £16bn in 2015, an increase of over 11% on 2014. Figures to the end of November 2016 show volumes of £16.8bn.

The number of businesses utilising asset based finance has remained almost flat over the last year, and remains below pre-crisis levels. Total advances to smaller businesses continue to rise, particularly for the smallest businesses. Quantifying the value and volume of financing for smaller businesses from debt funds is not readily available. However, anecdotal evidence suggests debt funds continue to have an important role as a source of finance for smaller businesses, especially for businesses that are scaling-up.

Gross flows of lending to businesses via peer-to-peer platforms continue to grow, albeit at a slower rate, reaching £1.31bn in 2016. Non-bank sources of finance are important for diversity of supply; however they

remain small in comparison to traditional sources of bank finance. Chapter Three provides a detailed discussion of the trends in volumes for different types of finance.

### SMALL BUSINESS CONFIDENCE AND DEMAND FOR FINANCE ARE DECLINING, ALTHOUGH MANY STILL HOPE TO GROW

Demand for external finance by UK smaller businesses has declined over recent years. The SME Finance Monitor shows in 2012, 11% of smaller businesses reported an application for new or renewed loan or overdraft. This then reduced to 7% in 2015 and 6% in the first half of 2016, across all business size bands.<sup>5</sup> This has been matched by a build-up of cash reserves over the same period. In Q2 2016, 21% of SMEs reported holding more than £10,000 in credit balances, an increase from 16% in 2012.

The Federation of Small Business (FSB) Voice of Small Business reported decreasing business confidence over 2016, which rebounded in Q4 to a positive net balance of 8.5, returning to a similar level as in the first quarter of 2016.<sup>6</sup> The domestic economy remained a major barrier to growth aspirations in Q4 2016, with 57% small businesses reporting it as an obstacle to achieving growth aspirations. This is up from 46% a year ago, but notably it is below the 62% seen in Q3 2016. This suggests that signs of UK economic resilience in recent months, such as better than expected GDP data, have reduced concerns in the small business community.

The British Business Bank 2016 Business Finance Survey shows a decrease in the proportion of smaller businesses expecting to grow in the next 12 months, from 56% of SMEs in 2015 to 37% of SMEs this year. This is lower than the FSB Voice of Small Business survey where just over half (53%) of small businesses reported an aspiration to grow over the next year.

Economic uncertainty since the EU referendum result makes it more difficult for businesses to plan and invest for the future. Business investment has been resilient since the EU Referendum, with a 1% increase between Q2 and Q3 2016; however comparing Q3 2016 with the same period in 2015 business investment has declined by 2.2%.<sup>7</sup>

## 1.2

## SMALLER BUSINESS CONTRIBUTION TO THE ECONOMY

- Smaller businesses continue to form a large part of the UK economy
- There has been considerable growth in the number of UK businesses since 2000
- Smaller businesses are important for improving UK productivity

FIG 1.2

## CONTRIBUTION OF SMALLER AND LARGE BUSINESSES TO TOTAL BUSINESS POPULATION, EMPLOYMENT AND TURNOVER AT THE START OF 2016

Source: BEIS Business Population Estimates 2016

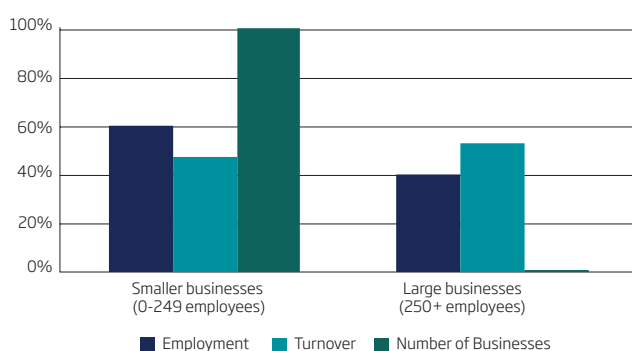
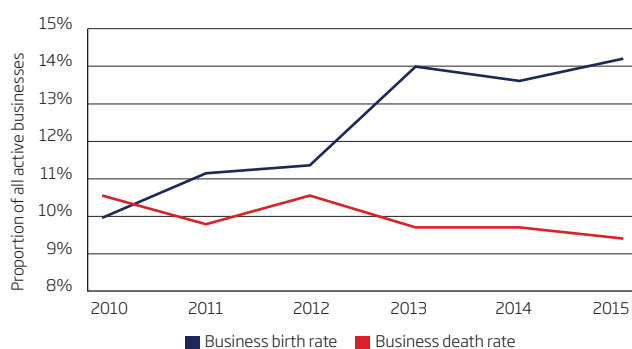


FIG 1.3

## BUSINESS BIRTH RATE AND BUSINESS DEATH RATE FROM 2010-2015

Source: ONS Business Demography, UK 2015



## SMALLER BUSINESSES CONTINUE TO FORM A LARGE PART OF THE UK ECONOMY

Smaller businesses are an important part of the UK economy, with a record 5.5 million private sector businesses at the start of 2016.<sup>8</sup> Smaller businesses:

- Accounted for 99.9% of all private sector businesses in the UK;
- Employed 15.6 million people, equivalent to 60% of all private sector employment in the UK;
- Accounted for almost half (47%) of private sector turnover in the UK.

There are a number of different estimates of the number of businesses operating in the UK; the ONS publishes statistics on the number of businesses registered in the UK for VAT and tax purposes, whereas the Department for Business, Energy and Industrial Strategy (BEIS) produces estimates which seek to provide full coverage of the UK business population, including an estimate of unregistered businesses.<sup>9</sup> These estimates are complementary and are used in this publication to provide an overview of the UK business population.

Since 2011, the rate of business births has exceeded the rate of business deaths, and led to an increase in the overall business population. Business births now account for 14% of all active businesses in 2015, up from 10% in 2010.<sup>10</sup> Company insolvencies have continued to decline, with the insolvency rate now at the lowest level since comparable records began in 1984.<sup>11</sup>

## THERE HAS BEEN CONSIDERABLE GROWTH IN THE NUMBER OF UK BUSINESSES SINCE 2000

The increase in the business birth rate, coupled with increasing survival rates, has contributed to considerable growth in the total number of businesses in the UK. Numbers have increased by over two million since 2000 and by 97,000 between 2015 and 2016.<sup>12</sup> The growth

in the UK private sector business population has mainly been driven by increasing numbers of non-employing businesses. These have increased by 77% since 2000, alongside growth in numbers of micro, small and medium businesses of 18%, 25% and 24% respectively.

Long term economic growth cannot solely rely on increasing the number of start-ups; business survival and expansion are also critical. The British Business Bank 2016 Business Finance Survey<sup>13</sup> reported that 37% of SMEs were planning to grow over the next 12 months, a similar level to that noted in the SME Finance Monitor of 41%.<sup>14</sup> However, only around half of businesses (54%) set up in 2012 were still operating in 2015 and amongst businesses established in 2012, only 4% had grown their turnover to £1 million or more by 2015.<sup>15</sup>

ONS analysis estimates there were approximately 12,500 high growth firms in the UK in 2013.<sup>16</sup> Analysis from the Enterprise Research Centre (ERC) indicates that the rate of high growth firms in the UK has remained relatively stable over the past decade. They also find that despite high growth SMEs representing less than 1% of established businesses, they generate 20% of all job growth amongst established businesses that grow.<sup>17</sup> However the ERC recognises that firms classified as high growth, in terms of employment and turnover, may not experience productivity gains at the same time. Only one in five firms that increased employment between 2008-2015 also managed to increase productivity.<sup>18</sup>

Businesses need access to the right support and finance to achieve their growth ambitions. The British Business Bank plays a critical role in facilitating access to finance for new business start-ups as well as for business investment and growth.

#### SMALLER BUSINESSES ARE IMPORTANT FOR IMPROVING UK PRODUCTIVITY

Smaller businesses in the UK account for more than half of UK private sector employment and therefore these businesses play a vital role in overall UK productivity and economic growth.

Overall the UK performs poorly in terms of productivity when compared to the majority of leading advanced economies. The UK lagged 18% behind the G7 country average in 2015, the same level as in 2014.<sup>19</sup> In effect this means that countries such as Germany, the US and France could produce the same amount as the UK in four working days compared to the five days it would take workers in the UK.

This is a trend that has been increasing over time. Figure 1.5 summarises productivity growth for a selection of the G7 countries compared to each country's productivity in 2007. Productivity in the UK was around 1% higher in 2015 than in 2007 following a relatively steep decline in productivity over the recession. This compares to countries such as Germany and the US that have achieved growth of 5.5% and 8.6% when compared to their respective productivity levels in 2007.<sup>20</sup>

FIG1.4

#### CHANGE IN NUMBER OF BUSINESSES 2000-2016, BY SIZE OF BUSINESS

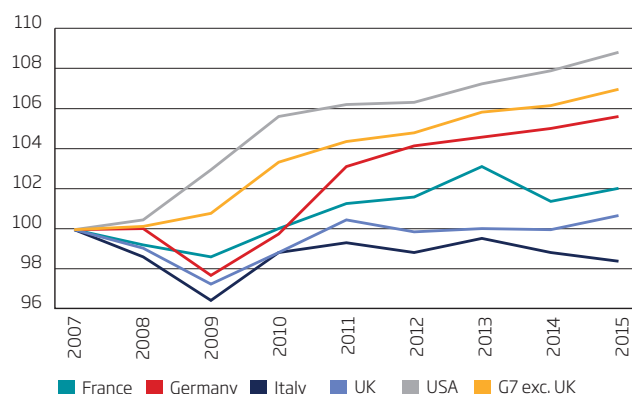
Source: BEIS Business Population Estimates 2016

SIZE OF BUSINESS	NUMBER OF BUSINESSES 2000	NUMBER OF BUSINESSES 2016	% CHANGE 2000-2016
No employees	2,355,900	4,172,200	77%
Micro 1-9	914,300	1,081,400	18%
Small 10-49	162,900	203,500	25%
Medium 50-249	26,800	33,300	24%
Large 250+	7,200	7,200	0%

FIG1.5

#### PRODUCTIVITY PER HOUR WORKED IN SELECTED G7 COUNTRIES

Source: ONS International comparisons of productivity 2015





## 1.3

## MACRO-ECONOMIC DEVELOPMENTS

- 
- The UK economy has continued to grow over 2016, with employment rates remaining high and unemployment at its lowest level since mid-2005

- 
- Economic forecasts have been downgraded since the EU referendum result and business confidence has declined

- 
- There is some indication that smaller businesses have tempered their growth expectations for the next 12 months although many still aspire to grow over 2017

- 
- Future challenges affecting small businesses include inflationary pressures, exchange rate fluctuations and expected weaker consumer demand

---

#### THE UK ECONOMY HAS CONTINUED TO GROW OVER 2016, WITH EMPLOYMENT RATES REMAINING HIGH AND UNEMPLOYMENT AT ITS LOWEST LEVEL SINCE MID-2005

UK GDP growth over 2016 exceeded the majority of independent forecasts and has remained positive over 2016.<sup>21</sup> UK GDP was 2.2% higher in the third quarter of 2016 compared with the same quarter a year ago and is now 8.1% above its pre-downturn peak in the first quarter of 2008.<sup>22</sup> Employment is also strong with the employment rate in August-October 2016 at 74.4%. The unemployment rate over the same period was at its lowest level (4.8%) since July-Sept 2005.<sup>23</sup> The third quarter of 2016 was the joint highest level (74.5%) of employment since comparable records began in 1971 and more small businesses increased employee numbers than decreased them in the fourth quarter of 2016.<sup>24</sup>

#### ECONOMIC FORECASTS HAVE BEEN DOWNGRADED SINCE THE EU REFERENDUM RESULT AND BUSINESS CONFIDENCE HAS DECLINED

The OBR<sup>25</sup> has revised its growth forecasts for 2017 downwards from 2.2 to 1.4% due to lower expected levels of business investment and weaker growth in private consumption. The OBR forecasts inflation to increase to above 2% in 2017, which is expected to squeeze real household income and lower consumption growth.

Overall, business activity growth remained resilient in the third and fourth quarters of 2016, although surveys of businesses suggest mixed business confidence for the coming 12 months.<sup>26</sup> Generally, smaller businesses appear to be more confident of future trading prospects than larger businesses, with the ICAEW Confidence Index in Q4 2016 only slightly negative at -3.3 for smaller businesses compared to -14.4 for larger FTSE 350 companies.<sup>27</sup> The FSB Voice of Small Business reported decreasing business confidence over 2016.<sup>28</sup> This rebounded in Q4 to a positive net balance of 8.5, returning to a similar level as in the first quarter of 2016.



THERE IS SOME INDICATION THAT SMALLER BUSINESSES HAVE TEMPERED THEIR GROWTH EXPECTATIONS FOR THE NEXT 12 MONTHS ALTHOUGH MANY STILL ASPIRE TO GROW OVER 2017

The British Business Bank 2016 Business Finance Survey observed a decrease in the proportion of small businesses expecting to grow in the next 12 months, from 56% of SMEs in 2015 to 37% of SMEs this year. Those businesses with no employees had the lowest average growth expectations, with only 32% of this group reporting an expectation of growth over the next 12 months. In contrast, the Q4 2016 Federation of Small Business Survey reported that the majority of small businesses (53%) still aspired to grow.

While the result of the EU Referendum may seem a likely reason for explaining the downturn in growth expectations, the majority of small businesses (59%) did not expect the referendum result to impact on business growth in the next 12 months. However, of those that did expect a change, lower growth was more commonly expected than greater growth, particularly amongst businesses with employees.

FUTURE CHALLENGES AFFECTING SMALL BUSINESSES INCLUDE INFLATIONARY PRESSURES, EXCHANGE RATE FLUCTUATIONS AND EXPECTED WEAKER CONSUMER DEMAND

Alongside the positive GDP and employment figures, there have also been challenges facing small businesses over 2016 which could impact growth prospects over 2017 and beyond.

#### INFLATIONARY PRESSURES

A number of factors have contributed to inflationary pressures for businesses, including rising crude oil prices and increasing input costs. The ONS reports rising input prices in the manufacturing sector which have been steadily increasing since August 2015. Core input inflation measures for this sector were 11.5% higher at the end of November 2016 than at the start of 2016.<sup>29</sup>

Rising input prices for businesses can translate into higher prices for households, and the latest CPI estimates indicate a rise of 1.2% in consumer prices in the year to the end of November.<sup>30</sup> The BCC's Quarterly Economic Survey reported that 52% of manufacturing firms and 30% of service firms surveyed expect their prices to increase over the next three months.<sup>31</sup> In an environment of limited real earnings growth, higher inflation squeezes household earnings and can restrict consumer demand as set out in the OBR's latest economic outlook.

#### EXCHANGE RATE FLUCTUATIONS

The significant depreciation of the pound since the EU referendum has contributed to rising input costs.

FIG1.6

GDP (£ BILLIONS RHS) AND QUARTER-ON-QUARTER GROWTH (LHS) Q1 2003-Q3 2016

Source: ONS Quarterly National Accounts: Quarter 3 (July to Sept) 2016

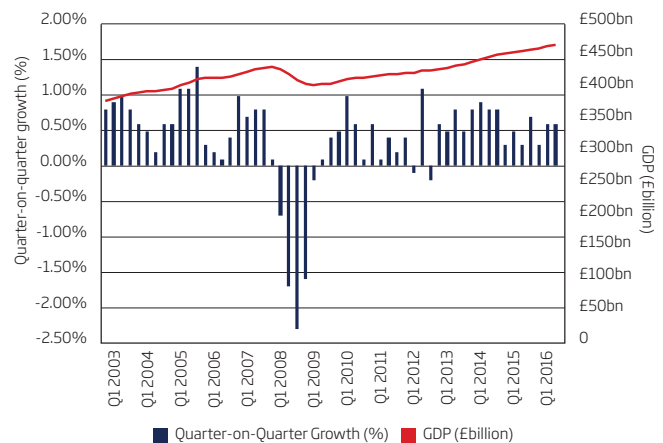


FIG1.7

SMALL BUSINESS CONFIDENCE Q3 2010-Q4 2016

Source: FSB Voice of Small Business Index Q4 2016

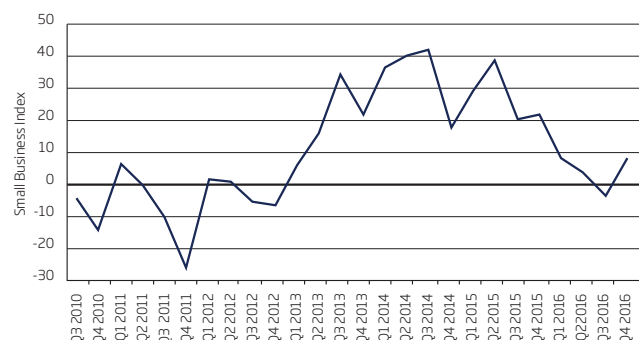


FIG 1.8

**STERLING EXCHANGE RATE AGAINST THE EURO AND US DOLLAR**

Source: Bank of England data on GBP/EURO/USD exchange rates 1st June 2016-10th January 2017

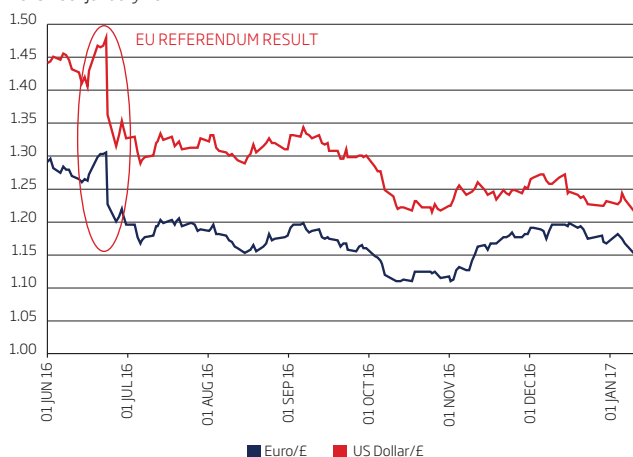
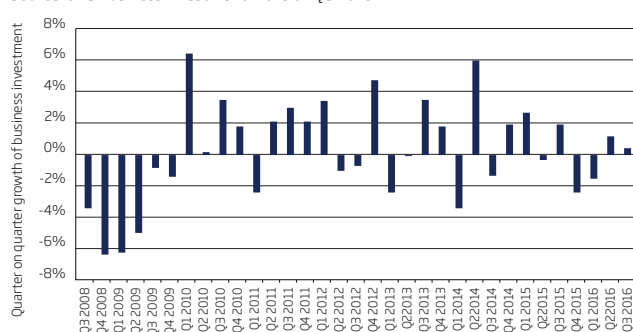


FIG 1.9

**QUARTER ON QUARTER GROWTH OF BUSINESS INVESTMENT Q3 2008-Q3 2016**

Source: ONS Business Investment in the UK Q3 2016



The latest available data (as at the 10 January 2017), shows the exchange rate of the pound against the Euro was 12% lower and 18% lower against the dollar compared to the day of the EU referendum on the 23 June 2016.<sup>32</sup>

UK firms that import foreign goods will see their costs rise as Sterling depreciates. Currency fluctuations can have a disproportionate impact on smaller businesses as their ability to offset exchange rate changes is more limited; amongst small businesses 28% cited exchange rates as one of the main causes of rising business costs, up from 5% in Q2 2016.<sup>33</sup>

The depreciation of Sterling also creates opportunities as UK exports are now comparatively cheaper for foreign buyers. Exports have increased over 2016 with data for the three months to November 2016 increasing by 2.9% compared to the three months to August 2016. However imports have also increased and the UK continues to have a trade deficit. In the three months to November 2016 the trade deficit reduced slightly to £11 billion.<sup>34</sup> Currently only around one in five smaller businesses in the UK export their goods or services, which could limit the benefits to the UK economy from the depreciation of Sterling.<sup>35</sup>

Uncertainty with regards to future input costs, prices and currency fluctuations make it more difficult for businesses, and in particular small businesses, to plan and invest for the future. Businesses have continued to invest since the EU Referendum, with a 0.4% increase in business investment between Q2 and Q3 2016; however, business investment has declined by 2.2% between Q3 2015 and Q3 2016.<sup>36</sup> This is a long running issue: the recently published Government consultation on Industrial Strategy reports that the UK invests on average two to three per cent of GDP less than France, Germany and the United States in fixed capital, such as plant and machinery.<sup>37</sup> The UK has ranked in the lowest 25 per cent of all OECD countries for business investment in 48 out of the last 55 years.

The British Business Bank 2016 Business Finance Survey indicates the majority (90%) of smaller businesses have not made any changes to their business since the EU referendum result.<sup>38</sup> However, a small proportion (6%) reported they are planning to change their investment plans over the next 12 months, with 70% of these firms expecting to invest a smaller amount.

Overall the OBR expects a weaker outlook for business investment, forecasting shrinkage of -2.2% in 2016 and -0.3% in 2017.<sup>39</sup>

Business investment is critical to increasing longer term productivity which in turn contributes to growth for the UK economy; a reduction in business investment could contribute to lower growth in the future.

## 1.4

## REGIONAL PERSPECTIVE

- 
- Economic growth, new start-ups and successful scale-ups continue to be concentrated in London, with the majority of other UK areas under-represented on these measures
- 

- Fast growing businesses are located in all regions and nations across the UK
- 

- Business confidence declined over 2016; however, many small businesses are aspiring to grow over the next year
- 

- Flows of bank lending to smaller businesses broadly follows the share of businesses in UK areas
- 

- Awareness of equity finance remains higher in London and the South than other English regions
- 

- Equity investment continues to be concentrated in London and the South East with the majority of equity deals and investment occurring in these two English regions over the past 12 months
- 

This section explores differences in economic growth, smaller business growth performance and flows of finance across the four nations of the UK and by English region.

To take into account differences in the relative size of the countries and regions in the UK, the analysis calculates each area's UK share of different measures, such as bank lending, and then compares it to the UK share of the number of businesses in that area. For example 18% of all UK businesses are located in London but this region only accounts for 13% of the UK population. This provides insight into whether business activity and lending are under or over represented compared to the area's share of the UK small business population.

#### ECONOMIC GROWTH, NEW START-UPS AND SCALE-UPS CONTINUE TO BE CONCENTRATED IN LONDON, WITH THE MAJORITY OF OTHER UK AREAS UNDER REPRESENTED ON THESE MEASURES

Economic and productivity growth is vital for maintaining and improving living standards over time. A clear and persistent feature of the UK economy is that economic prosperity and growth is concentrated in London and the South East. In 2015, Gross Value Added (GVA) per head in London was £43,600, which is 72% higher than the UK average of £25,400.<sup>40</sup> Conversely, Wales and the North East had GVA per head that were more than 25% lower than the UK average. The North West region had the highest level of growth in 2015 at 3.6%, followed by London and the South East at 3.2%.

Within the English regions, economic activity is concentrated in a number of key cities where Greater Manchester accounted for almost 40% of total GVA in the North West in 2015, followed by Birmingham and Leeds which contributed around 20% of GVA to their respective region's total. These cities also recorded higher than average growth in GVA per head in 2015.<sup>41</sup> This profile is consistent with network theory, which posits that hubs

FIG1.10

**GROSS VALUE ADDED PER HEAD 2015 (UK AVERAGE=100)**

Source: ONS Regional Gross Value Added 2016

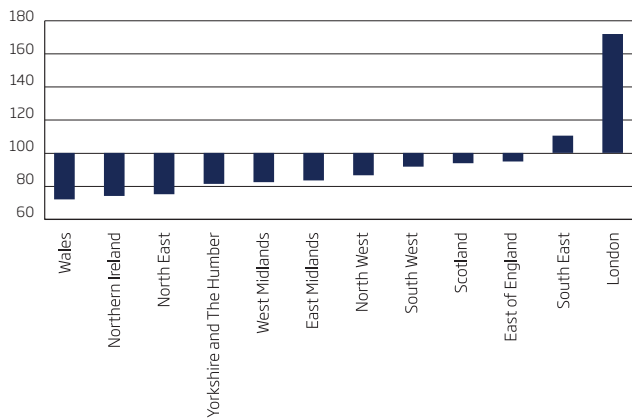
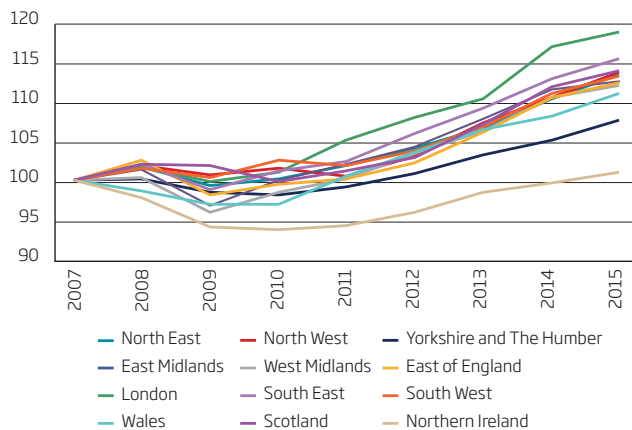


FIG1.11

**GROSS VALUE ADDED PER HEAD OF POPULATION AT CURRENT BASIC PRICES 2007=100**Source: ONS Regional Gross Value Added 2016 <sup>44</sup>

with critical mass and connectivity will outperform and attract more people / capital as they grow.

Overall the disparity between London and other UK countries and English regions has been growing over time (see figure 1.11). Since 2007 the economy in London has grown by 16% compared to growth of 1% in Northern Ireland, 8% in Yorkshire and the Humber and 11% in Wales. Analysis by the Office for National Statistics (ONS) shows that London has been around 30% more productive than the UK average on a per hour basis since 1997.<sup>42</sup> London's strong growth in GVA has been driven by maintaining this productivity advantage combined with a significant increase in total hours worked compared to the rest of the UK.

The Government's recently published consultation on the UK's Industrial Strategy recognises there are a number of key factors affecting growth across the country.<sup>43</sup> These include weaknesses in infrastructure, varying qualification levels and lower levels of research and development across the UK. The Strategy identifies 10 pillars which drive growth and the British Business Bank plays an important role in contributing to Pillar 4, supporting businesses to start and grow and Pillar 9, driving growth across the whole country. We also support Pillar 1, investing in science, research and innovation, Pillar 2 cultivating world-leading sectors, and Pillar 10 creating the right institutions to bring together sectors and places.

The overall share of business births continued to be concentrated in London in 2015 as London accounted for 26% of all new enterprises.<sup>45</sup> London is also over represented in terms of the share of total UK businesses (18%)<sup>46</sup> and UK GVA (23%) when compared against its share of the UK population (13%).<sup>47</sup>

In spatial areas outside of London the business birth rate is broadly similar, at around 12-14% of all active enterprises.<sup>48</sup> The share of new enterprises in each area broadly matches the area's share of business population and GVA. However, some English regions are clearly under-represented in these measures compared to their share of the UK population, such as the North West and West Midlands.

### FAST GROWING BUSINESSES ARE LOCATED IN ALL REGIONS AND NATIONS ACROSS THE UK

A high business start-up rate is only the beginning of the story; businesses need the right conditions to grow. Fast growing businesses are located in all nations of the UK, with Scotland, Wales and the Southern and Western parts of Northern Ireland performing strongly.<sup>49</sup> In England, London has the highest rate of fast growing firms, with the North, South West and Midlands areas also recording above average proportions of fast growing firms.

A further indicator of economic growth is the presence of business scale-ups. Northern Ireland records the highest rate of businesses (9%) which were established in 2012 and achieved turnover of £1 million by 2015. In England just over 5% of businesses in the Greater Cambridge and London Local Enterprise Partnership (LEPs) areas had managed to exceed turnover of £1 million by 2015; this was closely followed by three LEPs in the Northern Powerhouse region; Greater Manchester (5%), Sheffield (4.9%) and Leeds (4.9%) compared to the UK average of 4.3%.<sup>50</sup>

### BUSINESS CONFIDENCE DECLINED OVER 2016 HOWEVER MANY SMALL BUSINESSES ARE ASPIRING TO GROW OVER THE NEXT YEAR

Business confidence surveys indicate mixed business sentiment for the next year.<sup>51</sup> The FSB's Voice of Small Business Index showed a decline in business confidence over 2016; however, there was a rebound in the index in Q4 2016 to a positive net balance of 8.5, almost matching the 8.6 in Q1 2016.<sup>52</sup>

The index highlights differences in business confidence across different parts of the UK; confidence was negative for businesses in Scotland (-29) and London (-2), but positive in Wales and the remaining English regions. Businesses in the North East were most confident about business prospects over the next three months (+44). The British Business Bank 2016 Business Finance Survey reported that 37% of SMEs were planning to grow over the next 12 months; this is in contrast to the FSB survey which reports that more than half of small businesses (53%) are aspiring to grow over the next 12 months.<sup>53</sup>

The ICAEW Business Confidence Monitor reported an overall decline in business confidence over 2016, falling from +11.4 in Q1 2016 to -9.8 in Q4 2016. Scotland, Wales and all English regions followed this trend, with business confidence lower at the end of 2016 than at the start; however, in some English regions this decline was more pronounced, with confidence in London falling to -17.4, its lowest level since 2009.<sup>54</sup>

### FLows of BANK LENDING TO SMALLER BUSINESSES IN UK AREAS BROADLY FOLLOWS THE SHARE OF BUSINESSES

Bank lending broadly matches the business population in the majority of English regions, although some, such as the South East, have proportionately lower share of lending by value and volume (9%) compared to the share of businesses in the region (16%).<sup>55</sup> This may be due to the availability and accessibility of alternative sources of finance in this region, such as equity (see figure 1.15). London has the greatest share of total business population, but a higher share of the value of loan

FIG1.12

### PROPORTION OF TOTAL UK BUSINESS START-UPS, BUSINESS POPULATION, GROSS VALUE ADDED AND POPULATION BY REGION

Source: ONS Business Demography, UK: 2015, BEIS Business Population Estimates 2016, ONS Population Estimates 2016

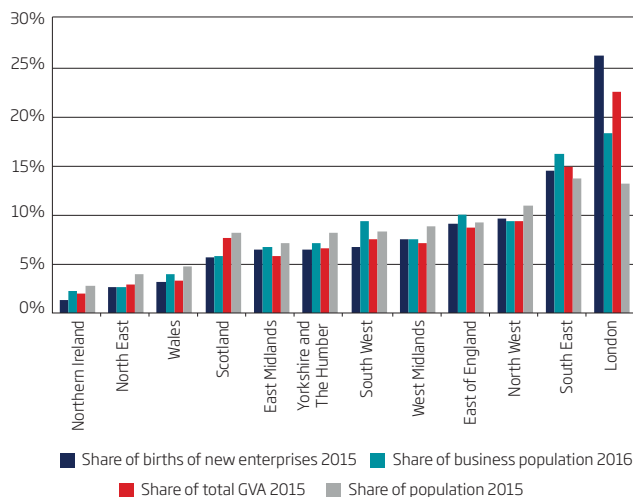


FIG1.13

### GB SHARE OF VALUE AND VOLUME OF BANK LENDING BY REGION AND GB SHARE OF BUSINESS POPULATION

Source: BEIS Business Population Estimates 2016, BBA Bank Lending data Q3 2016

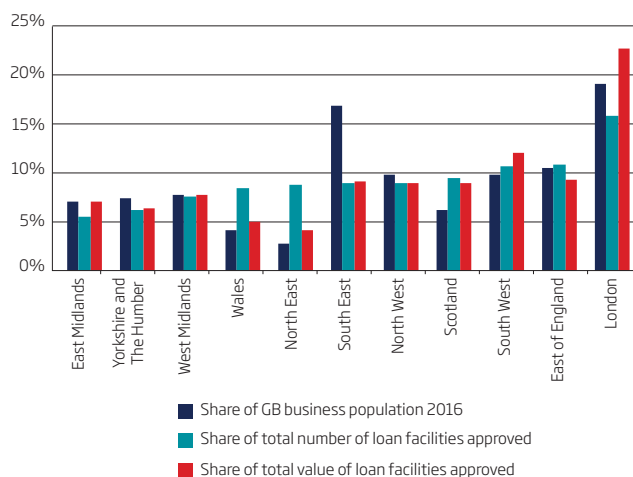


FIG 1.14

### AWARENESS OF DIFFERENT SOURCES OF FINANCE BY ENGLISH REGION

Source: British Business Bank 2016 Business Finance Survey - Ipsos MORI

Notes: Base: ask all SMEs, n = 1535

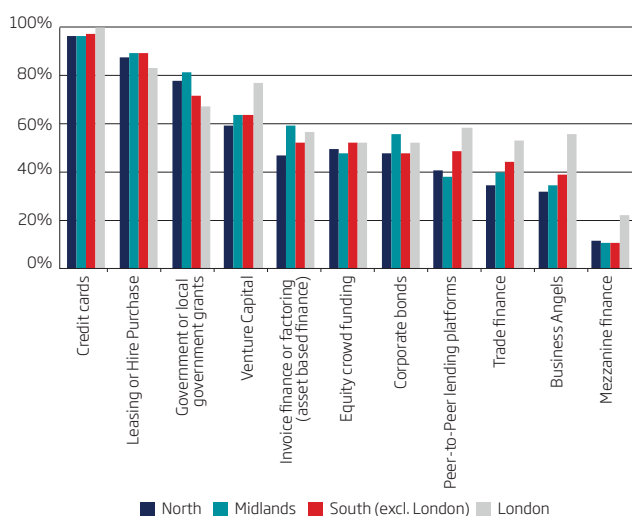
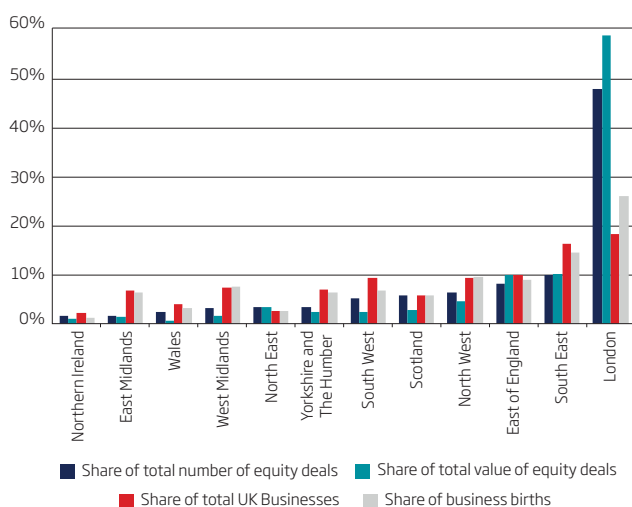


FIG 1.15

### PROPORTION OF EQUITY DEALS BY NUMBER AND VALUE BY UK COUNTRIES AND ENGLISH REGIONS

Source: British Business Bank analysis of Beahurst data (Q4 2015 - Q3 2016)



facilities. A variety of factors could explain this; London accounts for 20% of all UK high growth firms and there is evidence to suggest such firms are more likely to apply for finance and use a mix of different types of finance.<sup>56</sup> The North East, South West, Wales and Scotland all indicate higher shares of bank lending by both value and volume compared to their share of the business population, which is consistent with trends in recent years.

### AWARENESS OF EQUITY FINANCE REMAINS HIGHER IN LONDON AND THE SOUTH THAN IN OTHER ENGLISH REGIONS

One explanation for higher shares of bank lending compared to share of businesses may be due to business awareness and availability of different types of finance in different areas. In a recent British Business Bank survey, businesses in London indicated greater awareness of equity based finance such as venture capital and Business angels, whereas businesses in the North of England and Midlands showed higher awareness of government/local government grants.<sup>57</sup> Differences in sectoral composition across the different English regions could explain some of the differences in finance awareness, with businesses in the production or construction sectors more likely to have sought finance through leasing or hire purchase over the past three years.

### EQUITY INVESTMENT CONTINUES TO BE CONCENTRATED IN LONDON AND THE SOUTH EAST WITH THE MAJORITY OF EQUITY DEALS AND INVESTMENT OCCURRING IN THESE TWO ENGLISH REGIONS OVER THE PAST 12 MONTHS

Equity investment continues to be concentrated in London and the South East with 58% of total deals and 69% by value over the past 12 months occurring in these two English regions.<sup>58</sup> London's share of equity investment by both number of deals (48%) and value (59%) is significantly overrepresented when compared to its share of UK businesses (18%) and share of business births (26%). London and the South East have increased their share of equity investment over recent years. In 2011, 44% of equity deals were completed in London and the South East, but by 2015 this had risen to 61% (see figure 1.16).

Equity investor type also varies by UK area. Private Equity, venture capital and crowdfunding investors were involved in more than half of equity deals in London (52%). In the North East, Local and Regional Government were involved in more than half (55%) of equity deals in this region, closely followed by the North West where they were involved in 46% of deals.

As discussed earlier in this chapter, lower levels of equity funding outside of London and the South East are not just

driven by limited supply; there is also lower awareness of and demand for equity finance outside of London and the South East. The British Business Bank 2016 Business Finance survey of smaller businesses indicated that of those that were aware of equity finance only 4% of small business in the North of England and 3% in the Midlands had considered raising equity finance compared to 11% and 7% in London and the South of England respectively.<sup>60</sup>

## CONCLUSIONS

There is a role for the British Business Bank to raise awareness and increase understanding of alternative sources of finance, and specifically equity finance in regions where awareness is low. The evidence presented in this chapter supports two Investment Funds announced by the British Business Bank; the Northern Powerhouse Investment Fund (NPIF) and the Midlands Engine Investment Fund (MEIF). Both of these funds aim to boost the economy and support the growth ambitions of businesses in their respective areas.<sup>61</sup>

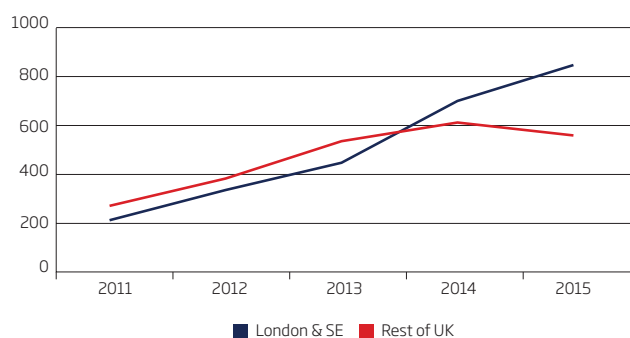
The Investment Programme of the Bank's commercial subsidiary company, British Business Bank Investments Ltd, has a number of partners that are located outside London and the South East. Platform lenders Funding Circle and RateSetter are utilising technology to increase their routes to market; in addition to its on-line business model, MarketInvoice has opened a regional office in Manchester.

Asset finance companies Haydock Finance and Kingsway Asset Finance are based in the North West of England, and Shire Leasing in the East Midlands and Ultimate Finance Group are in Bristol. Specialist US fund Manager, Muzinich, has also increased its reach in the North by opening an office in Manchester in support of its fund launched in 2016, following British Business Bank Investments Limited backing of the fund.

FIG1.16

### NUMBER OF EQUITY DEALS FROM 2011 TO 2015<sup>59</sup>

Source: British Business Bank analysis of Beahurst data



## CHAPTER TWO

# SME AWARENESS AND THE DEMAND FOR DEBT FINANCE

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Chapter Two provides an overview of developments in small business awareness of finance options, the level of demand for debt finance and the latest evidence on the SME customer journey when applying for finance.

The chapter begins with a review of the latest evidence on smaller businesses' awareness of different finance products and providers and the first steps that they take when they identify a financing need.

Section 2.2 then reviews the evidence on the trend in demand for finance amongst smaller business, finding clear evidence that demand remained weak during 2016.

Section 2.3 explores the extent to which success rates have increased for businesses that do apply for finance. It also discusses the perceptions of success rates amongst the smaller business population, and the extent to which smaller businesses still use major banks for finance. Finally the section reviews the latest British Business Bank evidence on the extent to which small businesses shop around for debt finance.



## 2.1

DEMAND SIDE AWARENESS  
OF FINANCE OPTIONS

- Awareness of different finance products continues to improve amongst smaller businesses, albeit at a slowing pace. Awareness of specific providers is lagging behind
- Increased information about suitable types of finance and how to apply could help to make finance markets work more effectively for smaller businesses

For finance markets to work effectively, both the supply and demand side need to come together efficiently.

The annual British Business Bank Business Finance Survey measures awareness across the spectrum of external finance options, so that we can assess changes in awareness within the smaller business population over time. The statistics referred to throughout section 2.1 are from this survey unless otherwise stated.

#### AWARENESS OF DIFFERENT FINANCE PRODUCTS CONTINUES TO IMPROVE AMONGST SMALLER BUSINESSES, ALBEIT AT A SLOWING PLACE. AWARENESS OF SPECIFIC PROVIDERS IS LAGGING BEHIND

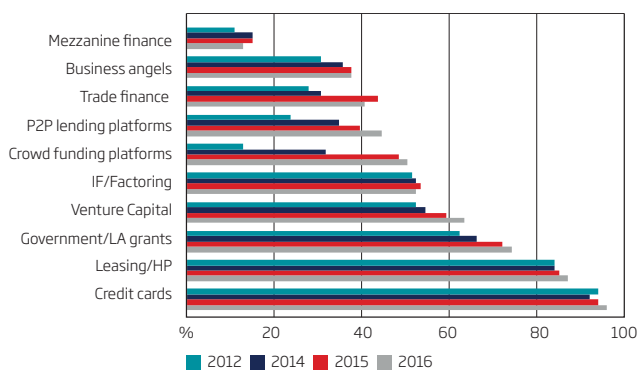
FIG 2.1

#### AWARENESS OF DIFFERENT TYPES OF EXTERNAL FINANCE: 2012 - 2016

Source: British Business Bank 2016 Business Finance Survey - Ipsos MORI

Notes: Multicoded, prompted question. Base: all SMEs

(n=1,535 in 2016, n=1,608 in 2015, n=1,000 in 2014, and n=1,508 in 2012)



Awareness of different forms of finance among smaller businesses has continued to increase in 2016, with small increases in reported awareness across the majority of finance types, as illustrated in figure 2.1.

In particular, an increase in awareness of peer-to-peer lending platforms amongst smaller businesses was observed this year, up from 40% in 2015 to 45%. This change was statistically significant at the 95% confidence level. There was also a significant increase in awareness of credit cards, which continues to creep up towards universal awareness with 97% of smaller businesses reporting awareness of these in 2016.

Awareness amongst smaller businesses of crowdfunding, venture capital, and leasing/hire purchase increased slightly this year but these changes were not statistically significant. For equity crowdfunding, the increase in awareness appears to have plateaued after several years of rapid growth. Mezzanine finance remains the least well known finance type with only 13% of survey respondents reporting awareness of it; this has not changed materially since 2012. This may reflect the different names mezzanine finance is widely known by.<sup>62</sup>

Awareness was higher amongst scale-ups compared to the start-up and stay-ahead groups, and this result is

FIG 2.2

**AWARENESS OF PRODUCTS AND SPECIFIC PROVIDERS**

Source: British Business Bank 2016 Business Finance Survey - Ipsos MORI

Notes: Base: all SMEs (n=1,535 in 2016). Multicoded, prompted question.

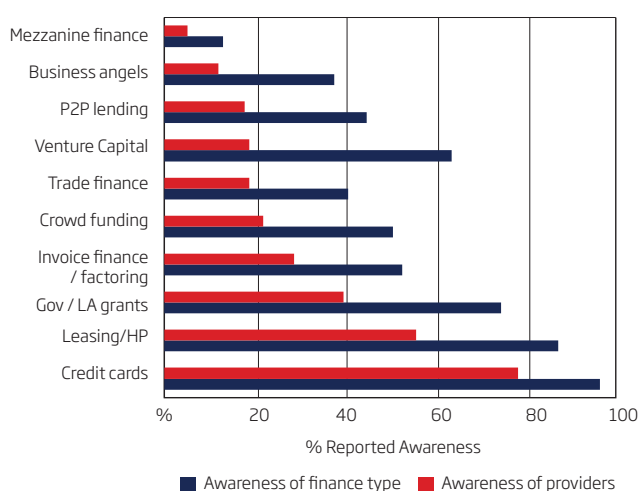
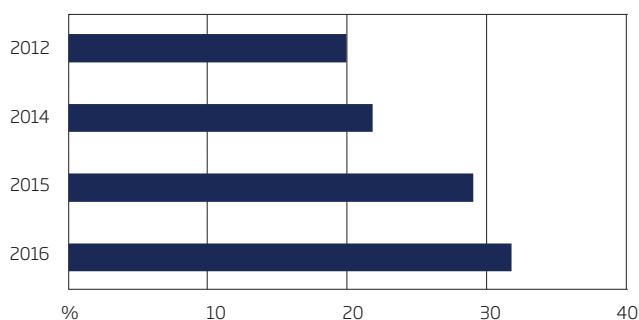


FIG 2.3

**PROPORTION OF SMALLER BUSINESSES THAT REPORT ENGAGING IN INFORMATION SEEKING WHEN THEY FIRST REALISE THEIR BUSINESS HAD A NEED FOR FINANCE**

Source: British Business Bank Business Finance Survey - 2012 - 2016

Notes: Base: all SMEs that sought finance for reasons other than being proactive in the last three years (n=858 in 2016, n=706 in 2015, n=296 in 2014, n=552 in 2012). Single coded, unprompted.



consistent across finance products. This could be because scale-ups have greater motivation in exploring the range of finance types available in order to find suitable finance to achieve their growth plans.

While awareness of different finance products shows continued progress, awareness of specific providers within each finance type has not increased significantly. As a result, the gap between awareness of the existence of finance types and awareness of specific providers (i.e. who to contact) is increasing.

For instance, although awareness of venture capital has increased to 64% in 2016, the results of our survey suggest that less than one in five smaller businesses can name a specific provider. Similarly, while crowdfunding awareness has risen to 51% amongst smaller businesses, less than a quarter of this group can name a specific platform, as shown in figure 2.2.

This gap suggests that smaller businesses are absorbing information regarding finance products more readily than on finance providers. This relative lack of knowledge of specific providers may be caused by the small proportion of this group that are actively considering using these various finance options at any given time. Given the evidence on usage of different types of finance, it follows that the gap between awareness of finance types and providers is much lower for debt products than equity finance.

**INCREASED INFORMATION ABOUT SUITABLE TYPES OF FINANCE AND HOW TO APPLY COULD HELP TO MAKE FINANCE MARKETS WORK MORE EFFECTIVELY FOR SMALLER BUSINESSES**

Access to trusted information is needed for finance markets to work effectively. The observed increases in awareness in recent years among smaller businesses of the range of finance types implies that information about alternative finance options is beginning to reach this group. Information on finance options is not a 'magic bullet' for increasing diversity in demand for finance amongst smaller businesses, it is a pre-requisite for ensuring that these businesses obtain the right finance for their business needs.

The main bank is still the most likely first port of call for smaller businesses when a finance need is identified.<sup>63</sup> However, in 2016, around one in three smaller businesses reported that the first step they took when realising the business had a financing need related to what could be classed as 'information gathering' (such as talking to an accountant or other advisor, asking family and friends or researching on the internet), and this proportion is slowly increasing over time as shown in figure 2.3.<sup>64</sup>

Start-ups were the group most likely to report taking an 'information gathering' first step, with 44% of start-ups compared with 31% of scale-ups and 29% of stay ahead smaller businesses. Searching and information gathering by users can help to drive competition in finance markets, especially as pricing is opaque.<sup>65</sup>

While the total proportion of smaller businesses taking steps to seek information on finance is increasing, the kinds of steps taken are changing. Only a minority of SMEs (13%) reported using external advice when applying for finance in 2016 and this figure has fallen from previous years (around 19% in 2015). Use of the internet to research options as a first step has increased to 10% in 2016, an increase on previous years.

In 2016 information obtained from previous experience within the business (or from other staff), is the most common source of information that influenced an SME finance decision. 21% of SMEs reported that previous experience within the business or other staff influenced the decision on type of finance, and 30% said it influenced the decision on when specific provider to approach.

## CONCLUSION

Awareness of different finance products continues to improve amongst smaller businesses, although awareness of specific providers is still lagging behind. Providing smaller businesses with access to trusted, unbiased information about their finance options is an essential first step in enabling them to shop around for the best finance for them, driving competition and improving the way finance markets operate for them.

To help smaller businesses find out more about their finance options the Business Finance Guide, developed by the British Business Bank, the ICAEW's Corporate Finance Faculty and 23 other organisations, was refreshed and relaunched alongside an interactive online version in June 2016. Working with the Guide's contributors and other distributors, the British Business Bank is leading a range of activity to promote the Guide to smaller businesses across the country, including through Growth Hubs and our partners in the Devolved Nations.

The recent implementation of the Bank Referrals to Designated Finance Platforms scheme is a welcome addition to efforts to help raise awareness of finance providers. If a smaller business makes an unsuccessful application for finance to one of the nine designated banks the business will automatically be offered a referral to the designated referral platforms who may be able to help the business find finance.<sup>66</sup> If the business agrees to the referral their details will be passed on to the finance platforms who will then attempt to match the

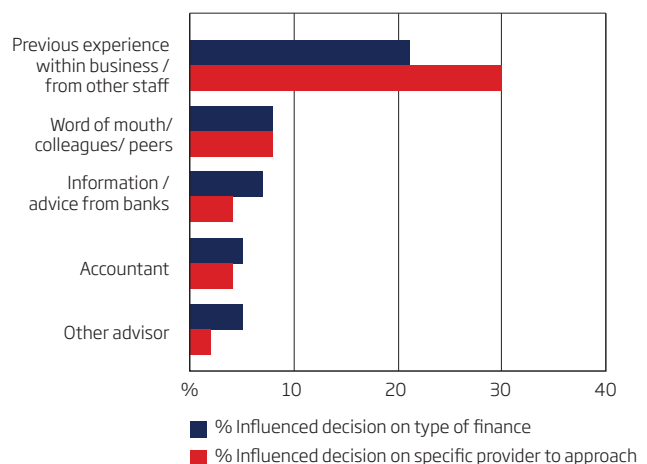
smaller business' finance needs with one or more finance providers on their lender panels.<sup>67</sup> This complements services provided by the private sector, including brokerages and comparison platforms, and initiatives such as the HM Treasury, British Chambers of Commerce and Federation of Small Businesses-sponsored Business Banking Insight and the BBA's Better Business Finance website.

FIG 2.4

### SOURCES OF INFORMATION THAT INFLUENCED DECISION

British Business Bank 2016 Business Finance Survey - Ipsos MORI

Notes: base = all SMEs that sought finance in the last 3 years (n=886 in 2016). Question A16/A19 (single code, prompted)



## 2.2

## DEMAND FOR FINANCE

- 
- Competition and Markets Authority Retail Banking Market Investigation draws attention to the importance of demand-side issues
- 
- Usage of external finance remains concentrated in core debt products
- 
- A very small proportion of SMEs applied for a new loan or overdraft facility in the last 12 months
- 
- Over time, demand for external finance has softened and SMEs appear cautious with regards to taking on new external finance

---

This section explores SMEs' demand for external finance. We draw on both SME Finance Monitor data and the British Business Bank 2016 Business Finance Survey to understand SME demand for finance.

Many SMEs prefer to finance themselves through internal resources rather than seek external finance. SME Finance Monitor data reports that the proportion holding credit balances of more than £10,000 has increased since 2012. Therefore, only a minority of SMEs currently use external finance (34% in H1 2016) and an even smaller proportion seeks funding in any given year.<sup>68</sup> It is rational to use internal resources before seeking relatively more expensive external finance.<sup>69</sup> However, data indicates that demand for new finance has softened in recent years, despite low interest rates, with SMEs' attitudes trending towards a growing preference to 'live within their means'. This could have a detrimental impact on the economy and UK productivity if investment is delayed or not carried out at all.

#### COMPETITION AND MARKETS AUTHORITY RETAIL BANKING MARKET INVESTIGATION DRAWS ATTENTION TO THE IMPORTANCE OF DEMAND-SIDE ISSUES

Developments in the SME finance landscape in recent years have led to an increase in the awareness of finance options (see previous section), with use of alternative finance growing. However, surveys point to continued reliance on 'traditional', bank-provided finance and an overall reduction in application volumes. This may indicate sub-optimal use of finance by some smaller businesses.<sup>70</sup>

Addressing demand-side factors is inherently complex. Demand for finance could be viewed in the aggregate or for specific products. Demand may be driven by a lack of understanding of potential options and the benefits of those options or simply a strong preference driven by risk aversion. Upskilling SMEs to improve their probability of applying for an appropriate form of finance and their likelihood of success thereafter may be necessary, but not sufficient.

The CMA's final remedies following the conclusion of its investigation into retail banking markets stressed the need to improve SMEs' knowledge on the choice of providers and sources of finance available to them as a way to make markets work better.<sup>71</sup>

#### USAGE OF EXTERNAL FINANCE REMAINS CONCENTRATED IN CORE DEBT PRODUCTS

The vast majority of SMEs that use external funding continue to rely on core debt products, e.g. bank loans and overdrafts and credit cards.

SME Finance Monitor data indicates that 28% of SMEs were using any core debt product in H1 2016 (compared with 34% that were using any external finance). Bank overdrafts and credit cards were the most commonly utilised. Despite increased awareness of alternative products, the British Business Bank 2016 Business Finance Survey indicates that usage of alternative finance remains relatively low (for example, less than 1% of smaller businesses sought equity funding or a loan via a peer-to-peer platform in the last three years).

The percentage of SMEs that use external finance has decreased since 2012 (44% used external finance in 2012 compared with 34% in H1 2016), primarily due to falling use of bank loans and overdrafts. All sizes of SME (by employment) have reported lower usage of external finance as well as across all SME risk profiles. Of the high level sectors, only 'Health and Social Work' and 'Other Community, Social and Personal Service Activities' have not seen notable reductions in their use of external finance since 2012.

Approximately one-third of SMEs were using trade credit from suppliers in the 12-months to H1 2016, with many of those reporting that this had reduced their need for external finance. Around one-half of those using trade credit were also using external finance. SME Finance Monitor data indicates that usage of trade credit has been relatively stable in recent years (collected from Q1 2014).

FIG 2.5

#### BRITISH BUSINESS BANK SEGMENTS: SHARE OF POPULATION AND NEW LOAN AND NEW OVERDRAFT APPLICATIONS

Source: British Business Bank Analysis, SME Finance Monitor

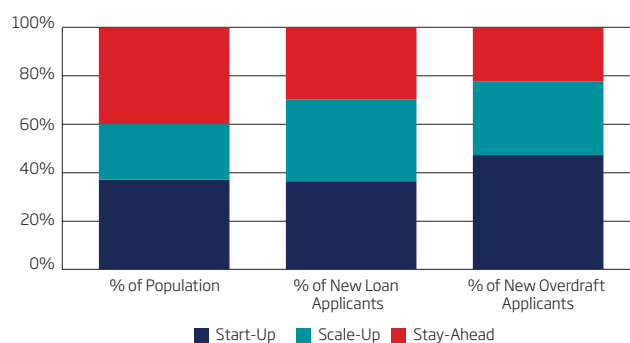
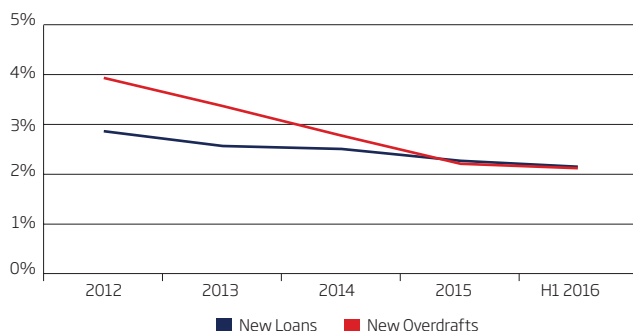


FIG 2.6  
NEW DEBT APPLICATION RATES (2012 - H1 2016)

Source: British Business Bank Analysis, SME Finance Monitor



### A VERY SMALL PROPORTION OF SMES APPLIED FOR A NEW LOAN OR OVERDRAFT FACILITY IN THE LAST 12 MONTHS

Focusing on latest data, only 6% of SMEs interviewed in H1 2016 applied for a new or renewed loan or overdraft facility in the previous 12 months (12% including auto-renewals of overdrafts). This was split evenly between new and renewed facilities. Where SMEs were applying for a new facility, there was a roughly even split between loans and overdrafts, while those renewing their facility were more likely to be renewing an overdraft.

As with last year's Small Business Finance Markets report, we have cut the data by the British Business Bank segments: start-up, scale-up and stay-ahead.<sup>72</sup> For the purposes of our analysis, start-ups are defined as SMEs trading up to five years. Scale-up and stay-ahead SMEs have all been trading for more than five years, but scale-up SMEs have some growth ambition.

Of those that applied, start-ups and scale-ups represented the highest proportions of new loan applications (36% and 34% respectively), while start-ups accounted for nearly 50% of new overdraft applications. Scale-up SMEs were over-represented in the populations applying for both new loans and new overdrafts, compared with their share of the overall SME population, whereas start-ups were over-represented in the population applying for a new overdraft. Demand for new debt products appears to be lowest for stay ahead SMEs.

### OVER TIME, DEMAND FOR EXTERNAL FINANCE HAS SOFTENED AND SMES APPEAR CAUTIOUS WITH REGARDS TO TAKING ON NEW EXTERNAL FINANCE

Data from the SME Finance Monitor indicate a softening in demand for external finance by SMEs since 2012, resulting from reduced application volumes for bank loans and overdrafts.

The percentage of SMEs applying for a new or renewed debt facility (loan or overdraft) has decreased from 11% in 2012 to the 6% reported in H1 2016. Figure 2.6 shows the decline in the rate of new loan and new overdraft applications since 2012. There has been a faster reduction in the rate of new overdraft applications, with the 2016 level consistent with that of new loan applications. To ensure sufficient sample sizes, a ten quarter dataset ending at the end of each period is used, which will act to smooth the trend.

Overall, the proportion of SMEs in each segment seeking a new facility has decreased between 2012 and H1 2016. The reduction in the rate of new overdraft applications is also reflected in each of the segments. In terms of new loan application rates, this has been relatively flat for stay-ahead SMEs since 2012. Conversely, start-ups and scale-ups have reduced their application rates for new loans.

Responses to certain attitudinal questions contained in the SME Finance Monitor provide insight into why demand for external finance may be softening. For example, 80% of SMEs agreed that their current plans for their business are based entirely on what they can afford to fund themselves and 71% would accept a slower rate of growth rather than borrow to grow faster.

Similarly, 48% of SMEs were classed as 'permanent non-borrowers' of finance in H1 2016.<sup>73</sup> This has increased from 34% in 2012, with the gap between permanent non-borrowers and users of external finance widening.

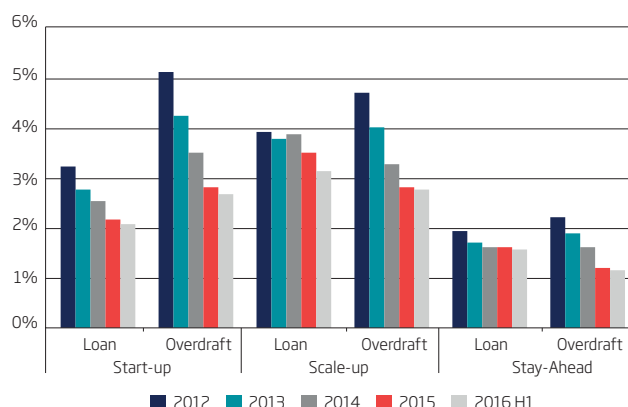
Would-be seekers represent latent demand for finance, because they have a need for finance but have not applied.<sup>74</sup> In H1 2016, 3% of SMEs were would-be-seekers (down from 10% in 2012). While this is a small percentage of the SME population, if the demand had been realised, it would have had a notable impact on application volumes, representing a 50% increase on new applications (6% of the SME population actually applied).

The biggest reported barrier to application was discouragement (41% of the 3% of would-be-seekers), i.e. the perception of being 'put-off' by a bank or that the application would be rejected. Approximately one in five would-be-seekers were deterred due to perceived issues with the process of borrowing while 17% were deterred due to perceived issues with the principle of borrowing.

FIG2.7

### DEMAND FOR NEW DEBT FACILITIES BY BRITISH BUSINESS BANK SEGMENT

Source: British Business Bank Analysis, SME Finance Monitor



## 2.3 CUSTOMER JOURNEY

- The perception remains for smaller businesses that it is difficult for them to obtain external finance
- Major banks remain significant players in the market for smaller business finance
- The proportion of smaller businesses that contact one provider when seeking finance increased to 69% in 2016, partly reflecting a higher rate of successful first applications

This section presents findings from the British Business Bank 2016 Business Finance survey, unless stated otherwise.

### THE PERCEPTION REMAINS FOR SMALLER BUSINESSES THAT IT IS DIFFICULT FOR THEM TO OBTAIN EXTERNAL FINANCE

Success rates of finance applications have been increasing, according to both the SME Finance Monitor, and the British Business Bank 2016 Business Finance Survey. A fuller discussion of application success rates based on SME Finance Monitor data can be found in section 3.2.

Despite an increase in success rates, our survey results suggest that smaller businesses continue to perceive it difficult to obtain finance, although there are signs that this sentiment is slowly improving. In 2016, an estimated 56% of smaller businesses perceived finance to be difficult to obtain, compared with only 13% that reported perceiving it easy to obtain. Figure 2.8 shows a slow improvement in perceptions amongst smaller businesses on the ease of obtaining finance over recent years. Note that as the average SME does not regularly apply for finance, perceptions are slow and difficult to shift.

Furthermore, of those that reported it being difficult, there is a declining number of smaller businesses reporting the perception that it is 'very' difficult, and a corresponding increase in those reporting it being 'fairly' difficult, and this shift was statistically significant in 2016. At the margin, these results suggest that there is some improvement in the perceptions of how difficult it is to obtain finance.

The perceptions amongst smaller businesses regarding bank finance success rates are also improving slowly over time. In our 2016 survey, smaller businesses estimated that on average, 41% of those that apply for



bank finance succeed. This compares to 38% in 2015, 42% in 2014 and 32% in 2012 which suggests a slow, improving trend over time.

The survey data show that a clear mismatch between perceptions and observed outcomes for debt applications remains, with smaller businesses around twice as likely to obtain finance (on average) than they think they are.

#### MAJOR BANKS REMAIN SIGNIFICANT PLAYERS IN THE MARKET FOR SMALLER BUSINESS FINANCE

Market concentration of the major banks in the UK retail banking market has long been a focus of concern for policymakers, evidenced for example by the recent Competition & Markets Authority Retail Banking Market Investigation. Around 80% of the market share for general purpose business loans (excluding peer-to-peer lending) remains with the four largest UK banks. Survey evidence from 2016 suggests that small businesses continue to rely on these well-established providers, although there are some positive signals that this dependence is slowly diminishing at the margin.

Our survey results estimate that 43% of smaller businesses that sought finance in the past three years only approached the four largest banks. While this figure remains high, it is a statistically significant improvement on last year's survey result (2015: 50% of SMEs approached only the four largest banks).

Based on our survey results for 2016, SMEs appear to be more focused on relationships than on price. The most common reason SMEs offer for choosing their finance provider is "trusted brand", with 28% citing this as their main reason. By contrast, only 17% reported a cost-related answer (such as long term costs of finance 11%, costs/charges/being the cheapest 6%).

FIG2.8

#### REPORTED PERCEPTION ON WHETHER EXTERNAL FINANCE IS EASY OR DIFFICULT TO OBTAIN BASED ON BRITISH BUSINESS BANK 2016 BUSINESS FINANCE SURVEY RESULTS

Source: British Business Bank 2016 Business Finance Survey - Ipsos MORI

Notes: base all SMEs surveyed, n=1,535 in 2016, n=1,608 in 2015, n=1,000 in 2014, n=1,508 in 2012

	PERCEPTIONS ON EASE OF OBTAINING FINANCE AMONGST SMALLER BUSINESSES	
	EASY (%)	DIFFICULT (%)
2016	13	56
2015	15	55
2014	11	58
2012	8	69

This is further supported by responses given by SMEs that only contacted one provider. The main reason given for SMEs not shopping around was a longstanding relationship/trust with its finance provider at 45%, while only 4% reported that they only approached one provider because it had the best deal. Around one in ten cited the hassle of contacting multiple providers as their reason for not shopping around. This proportion has been stable over time and is consistent with other data suggesting that SMEs feel time constrained.

The benefits of having more diverse sources of finance is covered in more detail in section 4.1 and the role that challenger banks are playing in lending markets is considered in section 4.2.

#### THE PROPORTION OF SMALLER BUSINESSES THAT CONTACT ONE PROVIDER WHEN SEEKING FINANCE INCREASED TO 69% IN 2016, PARTLY REFLECTING A HIGHER RATE OF SUCCESSFUL FIRST APPLICATIONS

The proportion of SMEs that reported just contacting one provider on the last occasion of seeking finance (based on the survey, asking all SMEs that sought finance in the previous three years) has increased to 69% in 2016, compared with 61% in 2015.

The number of smaller businesses that contact multiple providers is in part driven by the increase in success rates, as some of those that shop around will be acting out of necessity, because they have been rejected or discouraged by their first point of contact. In our survey, we also asked how many finance providers the business 'considered'. This metric has been consistent over time with around 60% of SMEs considering just one provider. The movement in providers contacted, without a corresponding fall in the number of providers considered, is supportive of the higher success rate explanation for less physical shopping around.

Another potential factor that affects the number of smaller businesses that contact multiple providers,

is the extent to which SMEs are seeking information and external advice, when a finance need is first identified. Our survey shows an increase in the proportion of SMEs who are seeking information or external advice when a first finance need is identified, including research on the internet. This could partly be explaining the rise in share of SMEs that are contacting one provider (on the last occasion of seeking finance), in 2016 compared to 2015.

Our survey also unveiled some positive results on the confidence of smaller businesses in assessing finance products. The majority reported being confident in assessing finance products offered by their own main bank (68%), in assessing finance products offered by other providers (52%), and in applying for external finance (54%). These figures are consistent with the results of the SME Finance Monitor survey for Q2 2016, which estimates that 61% of SMEs are confident in assessing financial products from another bank.

Around two thirds (65%) of SMEs reported confidence in knowing where to obtain information on the types of finance available to them. Similarly, two thirds (65%) also report confidence in their ability and skills to obtain external finance from finance providers. The confidence reflected in these responses may be related to smaller businesses seeing less need to contact multiple providers, as they are confident that they have the information and skills to approach the 'right' provider in the first instance.

Despite increases in confidence, there remains a large group of smaller businesses that report giving up or cancelling plans on being rejected by the first finance provider contacted. This proportion has remained fairly constant at around 38% from 2012-2016, suggesting that the impact of the positive trends noted, including increasing awareness of finance options outside of the main banks, and of increased diversity of supply for external finance, has yet to reach this group.

## CONCLUSION

The proportion of smaller businesses that only contact one provider increased to 69% in 2016 partly reflecting a higher rate of successful first applications. The latest evidence suggests that there has been some improvement in success rates for those that apply, but that there remain aspects of the customer journey that could be improved.

In 2016, the most common response by SMEs to not receiving the full amount of finance applied for is to give-up or cancel plans. In order to help smaller businesses access finance from the widest range of finance providers the British Business Bank has helped establish the Bank Referrals to Designated Finance Platforms scheme.<sup>75</sup>

## CHAPTER THREE

# VOLUMES OF FINANCE

---

A key objective of the British Business Bank is to increase the supply of finance available to smaller businesses where markets don't work well. Chapter Three explores the latest stock and flow of different types of finance used by smaller businesses. Bank lending remains the largest form of external finance used by smaller businesses. However, the volumes of many alternative types of finance have continued to increase in parallel.

Developments in bank lending are set out in section 3.1, this includes international evidence on loan availability. This is followed by a sectoral case study of the house building industry. Building more homes remains a high priority for Government, and access to finance for smaller house builders is an important factor in enabling growth in the building of new homes.

Section 3.2 builds on the British Business Bank's analysis of debt applications that appeared in last year's publication. This section presents evidence suggesting that there is still unmet demand for commercially viable propositions from smaller businesses.

Equity finance is an important source of finance for businesses who are seeking to scale-up. Section 3.3 presents developments in equity finance markets from business angel activity through to Growth Capital. It includes new evidence of a later stage venture capital funding gap in the UK, which is holding back some growth companies from scaling-up.

Volumes of lending in asset and asset based finance are presented in section 3.4 and 3.5. These types of finance show continued growth in 2016 with hire purchase in particular well above pre-financial crisis levels. Section 3.6 sets out evidence of continued growth in marketplace business lending. These non-bank sources of finance are important for diversity of supply; however they remain small in comparison to bank finance.

Finally, section 3.7 looks at developments in debt funds and other types of structured debt which in recent years have played an increasingly important role in finance for those firms looking to scale-up.

## 3.1

## SUPPLY SIDE – BANK LENDING

- 
- Credit conditions have improved for smaller businesses in recent years
- 
- Strong levels of gross bank lending in 2016 to smaller businesses, resulting in a continuation of positive net lending
- 
- Changes in bank capital requirements are likely to be affecting lending volumes over the short-term
- 
- Use of overdrafts has fallen, and the value of deposits held by smaller businesses continues to increase
- 
- Smaller business loan availability has improved in most European countries in 2016

---

#### CREDIT CONDITIONS HAVE IMPROVED FOR SMALLER BUSINESSES IN RECENT YEARS

Bank lending remains a core source of finance for smaller businesses. As presented in our aggregate stock and flow of finance table, gross bank lending to smaller businesses was £53.9bn between January 2016 and November 2016, and remains the single largest source of SME finance. Access to finance for smaller businesses is important as these businesses are an important source of economic growth (see Chapter One).

The Bank of England (BoE) Credit Conditions Review noted the availability of credit to businesses was little changed in Q4 2016, having improved over the past few years, according to Credit Conditions Survey (CCS) respondents.<sup>76</sup> Some major UK lenders noted a marginal tightening in supply to a small number of specific sectors, including commercial real estate.

The cost of credit to most businesses appears to have fallen alongside recent decreases in reference rates. The effective rates on both outstanding and new floating-rate loans to businesses fell over the three months to November 2016 and are at levels below recent years. The FSB's Voice of Small Business Index, shows that the net percentage balance of respondents who perceived credit to be 'affordable' and 'available' in Q3 was at its highest level since the series began in 2012. Both of these FSB indices fell back in 2016 Q4, but remain at a higher level than at the start of 2016.

On balance, survey evidence from the Bank of England CCS suggests that corporate credit demand continued to soften in Q4. Nevertheless, growth in bank lending to UK businesses continued at rates similar to those in 2016 H1.<sup>77</sup> A fuller discussion of demand for finance is explored in Chapter Two.

FIG 3.1  
CUMULATIVE SME GROSS LENDING

Source: Bank of England Bankstats table AB.1

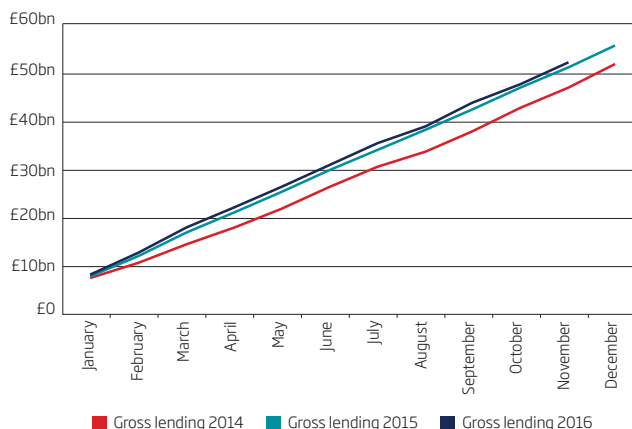
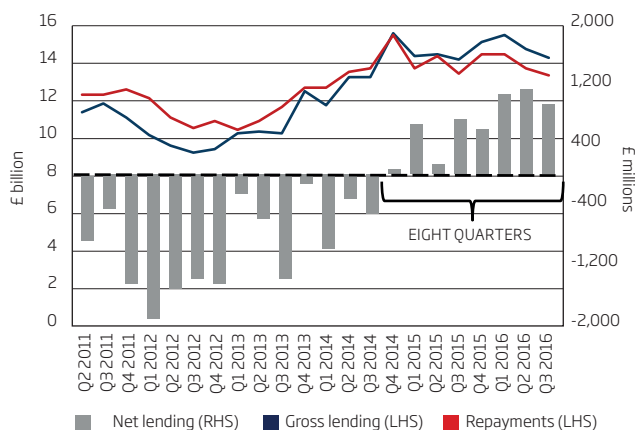


FIG 3.2  
QUARTERLY GROSS AND NET FLOWS OF BANK LOANS TO SMES

Bank of England Bankstats table AB.1



### STRONG LEVELS OF GROSS BANK LENDING IN 2016 TO SMALLER BUSINESSES, RESULTING IN A CONTINUATION OF POSITIVE NET LENDING

According to the BoE bank lending data, the gross flow of loans (excluding overdrafts) to smaller businesses reached £53.9bn between January and November 2016, this is slightly larger than the same period in 2015 which in turn showed stronger gross flows than in 2014 (see figure 3.1). Gross loans continued to exceed repayments in 2016, resulting in eight consecutive quarters of positive net lending to smaller businesses (see figure 3.2).

BBA data on lending by the main High Street banks to SMEs in Great Britain, show a distinction between smaller and medium businesses. The 2016 data suggests that positive net lending is driven mainly by medium sized businesses.

According to the BBA, the commercial real estate sector (CRE) accounts for around 28% of the stock of loans in September 2016 for overall smaller business lending. Net lending for medium sized CRE businesses has been falling over the last year and became negative in Q3 2016. Negative net lending amongst smaller sized CRE businesses continues to drag down total net lending in 2016.

The share of new gross lending can be compared against the proportion of the business population, by sector. This comparison identifies which sectors are receiving a disproportionate amount of lending, although more information would be required to comment on relative access to finance as different sectors have different financing requirements and options. Figure 3.4 shows agriculture, hunting and forestry and fishing had a much larger share of new lending in the year ending Q3 2016, compared to its business population. In contrast, sectors such as recreational, personal and community service activities, transport storage and communications, and wholesale and retail trade account for a much lower share of new lending compared to the proportion of businesses within these sectors.

### CHANGES IN BANK CAPITAL REQUIREMENTS ARE LIKELY TO BE AFFECTING LENDING VOLUMES OVER THE SHORT-TERM

Since the 2007/08 financial crisis there have been significant changes in global financial regulations, much of it led by the Basel Committee on Banking Supervision. The core motivation of these regulatory changes was to improve financial stability. In the UK new prudential policy regimes have been constructed which include higher minimum capital ratio requirements for banks. The impact of these regulations might be expected to appear through a price increase to bank customers, or a decrease in the supply of finance to less profitable sources.

A recent 2016 International Monetary Fund (IMF) staff discussion paper has assessed the benefits and costs of bank capital requirements. The study reviewed a number of international academic papers, including from the UK, which used modelling, calibration, and empirical methods to estimate the impact of changing capital requirements. An overall conclusion was that, in a steady-state, the impact of higher capital requirements on lending rates is extremely small. However, when examining the costs of transitions to higher capital requirements, studies have found evidence of large costs. A one percentage point increase in capital requirement is associated with a 5-8 percentage point contraction in lending volumes over the short-term. But there is also evidence that costs tend to be lower if banks are allowed to adjust to the new regime gradually.<sup>78</sup>

### USE OF OVERDRAFTS HAS FALLEN, AND THE VALUE OF DEPOSITS HELD BY SMALLER BUSINESSES CONTINUES TO INCREASE

The value of outstanding overdrafts for smaller businesses has been decreasing over time. BBA data shows stock of overdrafts in 2016 remained low. According to the SME Finance Monitor, in Q2 2016 16% of smaller businesses had an overdraft, compared with 26% in 2011. Applications as well as renewals of overdraft facilities by smaller businesses have declined since 2011.<sup>79</sup>

Deposits, conversely, have continued to grow in 2016 as smaller businesses continue to strengthen their balance sheets. In Q2 2016, 80% of smaller businesses reported a profit in their latest trading period. Almost all smaller businesses hold some credit balances. The proportion of SMEs holding more than £10,000 in credit balances increased from 16% to 24% between 2012 and 2015 but was slightly lower (21%) in the first half of 2016.<sup>80</sup>

### SMALLER BUSINESS LOAN AVAILABILITY IMPROVED IN MOST EUROPEAN COUNTRIES IN 2016

Making international comparisons of finance markets for smaller businesses is complicated by differences in sector and size distribution of businesses across countries, and different approaches to the balance between private sector finance and public sector interventions. Hence, some caution is needed when comparing smaller business lending across countries.

The Survey on the Access to Finance of Enterprises (SAFE) from October 2016 reports a positive four percentage point net improvement in the availability of UK bank loans (excluding overdrafts), over the last six months. This compares to a net improvement of 11 percentage points for all smaller businesses in the EU28, with Germany (11 percentage points), France (seven percentage points), and Italy (10 percentage points) also

FIG 3.3

### NET LENDING TO MEDIUM AND SMALL BUSINESSES

Source: BBA SME Statistics

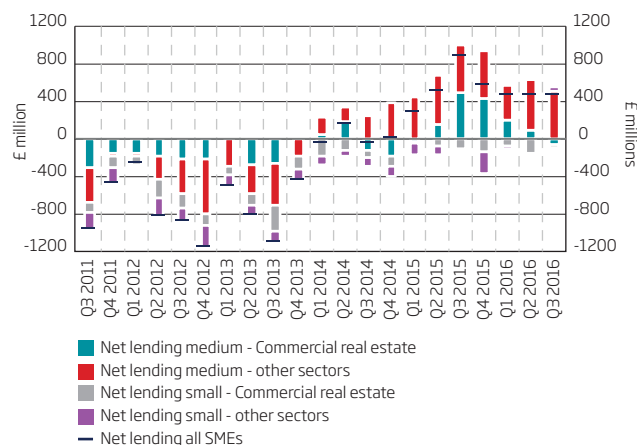


FIG 3.4

### PROPORTION OF NEW LENDING AND SME BUSINESSES, BY SECTOR

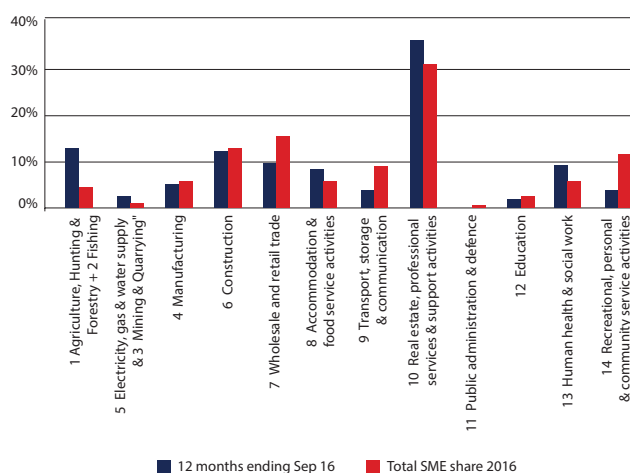


FIG 3.5

### STOCK OF OVERDRAFTS AND VALUE OF DEPOSITS, SMALL AND MEDIUM SIZED BUSINESSES

Source: BBA SME Statistics

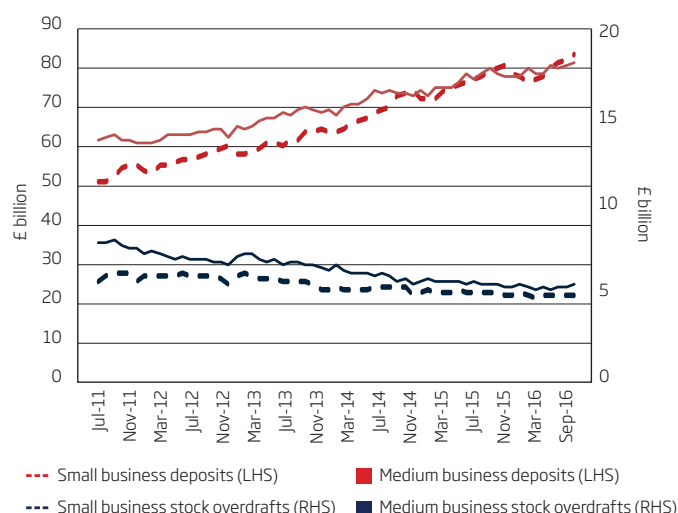


FIG 3.6

**AVAILABILITY OF BANK LOANS, 2016**

Source: Survey on the Access to Finance of Enterprises (SAFE) September to October 2016 (wave 15)

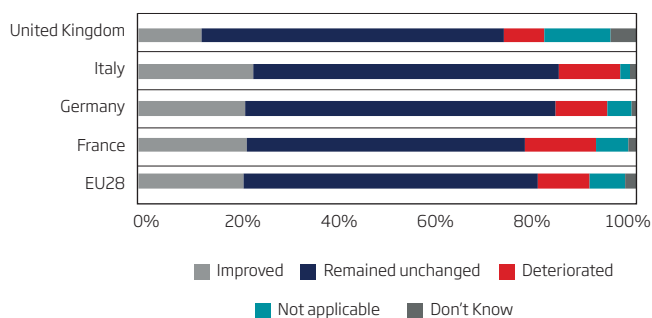
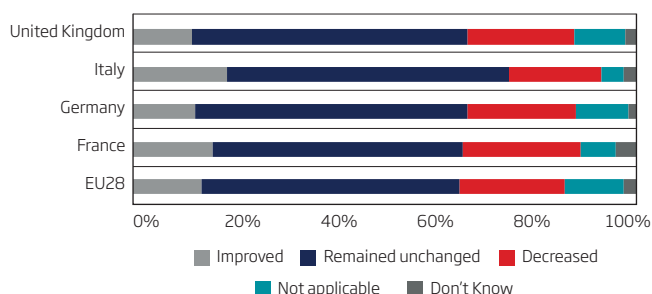


FIG 3.7

**CHANGES IN DEBT COMPARED TO ASSETS, 2016**

Source: Survey on the Access to Finance of Enterprises (SAFE) September to October 2016 (wave 15)



showing net improvement in bank loan availability.<sup>81</sup> SAFE 2016 results also show a net reduction in smaller business debt to asset ratios. Small businesses in the EU28 had a seven percentage point net reduction in company debt compared to company assets, the equivalent net reduction in the UK was nine percentage points.

In 2016, the Department for Business, Energy and Industrial Strategy published a study which compared smaller business lending markets in the UK, US, Italy and Germany.<sup>82</sup>

Germany has the most similar smaller business profile to the UK, while Italy, with its high proportion of microenterprises, has the least similar profile to the UK. The study found, despite the market being relatively concentrated, that SME loan availability is relatively high in the UK and UK smaller businesses are less likely to be dissuaded from applying for credit than smaller businesses in Germany and Italy.

While limited availability of data on SME loan pricing makes cross-country comparisons difficult, UK loans appear to be relatively inexpensive by international standards. For example, in December 2014, the mean nominal interest rate on SME loans was estimated to be 3.42% in the UK, while ECB estimates of interest rates on small loans with terms of up to five years for Germany and Italy were 3.67% and 5.97% respectively, and OECD estimates for the USA were between 3.2% and 3.7%.

OECD analysis of smaller business bank lending shows that in the aftermath of the financial crisis, smaller business lending fell in a majority of countries, and while credit lending rebounded in some countries, this pattern is not reflected across all countries. Despite a general recovery in economic growth and relatively favourable financial conditions in most countries, growth in SME lending remained mixed in 2014.<sup>83</sup> The same OECD international study shows smaller business loan interest rates increased in the majority of countries between 2007 and 2008, but then almost universally declined, especially between 2012 and 2014 with 2014 levels often less than half 2008 levels.<sup>84</sup>



## CONCLUSION

In aggregate, credit conditions for bank loans to smaller businesses have improved further in 2016, with gross lending higher than a year ago, and a continuation in positive net lending to smaller businesses.

However, despite credit conditions improving, structural supply problems remain in the smaller business bank lending market due to information asymmetry. Section 3.2 covering analysis of debt applications presents evidence which suggests some potentially viable finance requests are still not receiving funding because of a lack of proven track record, or lack of security. Also, with economic uncertainty (see section 1.3), it's important that scale-up businesses have access to bank loans to support growth, although for some of these businesses equity finance may be more appropriate. Hence, a strong rationale for British Business Bank products such as the Enterprise Finance Guarantee (EFG) and Help to Grow Programme still remains.<sup>85</sup> The 2015/16 strategic and operational design review of EFG demonstrated EFG continues to meet a need in the UK market for smaller business finance.<sup>86</sup>

Changes in bank capital requirements are likely to be affecting lending volumes over the short-term. The British Business Bank ENABLE Guarantee programme encourages participating banks to lend more to smaller businesses by reducing the capital they need to hold to support such lending.

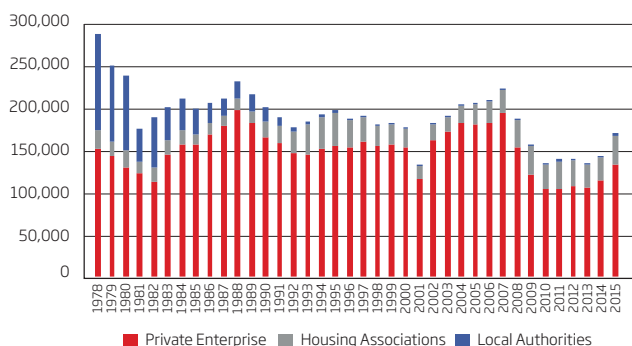
## CASE STUDY: HOUSE BUILDERS

- Housing demand is outstripping supply, with prices continuing to rise especially across the East of England, the South East and London
- The number of small builders has been in long-term decline, leading to a more concentrated industry
- Access to finance has improved over the last year, although half of smaller house builders still struggle to raise finance
- British Business Bank is reviewing how its programmes can support small house builders

FIG 3.8

### UK HOUSING COMPLETIONS BY TENURE, 1978-2015

Source: DCLG Live tables on house building, table 211



This section explores the UK smaller house builder market and factors affecting access to finance in this sector. House building remains a high priority for Government. The Department for Communities and Local Government (DCLG) single departmental plan sets out Government's ambition of delivering one million new homes over the next five years. To achieve this Government will focus on accelerating housing supply by speeding up the planning process, bringing forward release of public sector land, and by helping small house builders.<sup>87</sup>

### HOUSING DEMAND IS OUTSTRIPPING SUPPLY, WITH PRICES CONTINUING TO RISE ESPECIALLY ACROSS THE EAST OF ENGLAND, THE SOUTH EAST AND LONDON

DCLG household projections suggest there will be an additional 1.33 million UK households in 2020 compared to 2015.<sup>88</sup> This equates to around 265,000 additional households every year.<sup>89</sup> There were 170,670 housing completions in the UK in 2015, up 25,690 units (17.7%) compared to the previous year. However, UK completions remain below Government's ambition of 200,000 new homes to be built each year. The UK has been increasingly reliant on private sector developments since the 1980s, with local authorities cutting back new completions almost entirely (accounting for 2% of completions in 2015).

Housing starts have increased for the last three years and grew to 176,960 in 2015. The growth in housing starts is encouraging but is still below levels needed to match housing demand.

A lack of housing supply is sustaining house price growth. Average house prices in the UK increased by 6.9% in the year to October 2016, continuing the strong growth seen from the end of 2013. The UK figure masks some stark regional variations in house price growth. Highest annual average house price growth occurred in the East of England 12.3%, the South East 9.1% and London 7.7%. With wage growth below house price growth,

affordability has been stretched further, especially in London where the house price-to-earnings ratio is now greater than 10.<sup>90</sup> The Office for Budget Responsibility (OBR) November 2016 forecasts predict UK house prices to increase by 4% in 2017, this is higher than OBR forecasted average earnings growth of 2.4%.

### THE NUMBER OF SMALL BUILDERS HAS BEEN IN LONG-TERM DECLINE, LEADING TO A MORE CONCENTRATED INDUSTRY

Small house builder numbers have been falling since the late 1980s. The house building industry classifies small builders as those who complete fewer than 100 units a year. Within this completion size bracket, over four-fifths produce fewer than 10 units a year. Evidence provided by the Federation of Master Builders (FMB) to the House of Lords Select Committee on 'building more homes' shows that the number of small sized house builders peaked at over 12,000 in 1988.<sup>91</sup> Since then the number of small house builders has been steadily declining to around 2,400 in 2014, a fall of 80% from the peak.

Industry concentration is higher now than in 2009. The house building industry currently consists of four builders that complete over 5,000 units a year. This is followed by six large sized house builders which all complete more than 2,000 units a year. British Business Bank calculations based on company data and DCLG completion statistics show that the top ten house builders accounted for 27% of completions in 2009, rising to 47% in 2015.

### ACCESS TO FINANCE HAS IMPROVED OVER THE LAST YEAR, ALTHOUGH HALF OF SMALLER HOUSE BUILDERS STILL STRUGGLE TO RAISE FINANCE

Access to finance has persistently been a key barrier to building more homes, along with land availability, the planning system, and availability of skilled labour. FMB represents small house builders and surveys its members annually. The 2016 FMB survey asks respondents to highlight main factors that will constrain their ability to build more houses.<sup>92</sup> The top three issues were lack of available and viable land (67%), lack of finance to the company (50%) and the planning system (50%).

There has been a decrease in the proportion of builders citing lack of finance to the company as a main constraint to building more houses. The FMB small house builders survey revealed in 2012 that 72% of smaller builders reported lack of finance as a problem, this fell to 62% in 2014, and 50% in 2015 (see figure 3.13). Respondents to the 2016 FMB survey were asked to assess current lending conditions, 16% of small house builders thought SME lending conditions on residential property development had improved compared to a year ago, three quarters reported no change.

FIG 3.9

### UK STARTS, ALL DWELLINGS, 1978-2015

Source: DCLG Live tables on house building, table 211

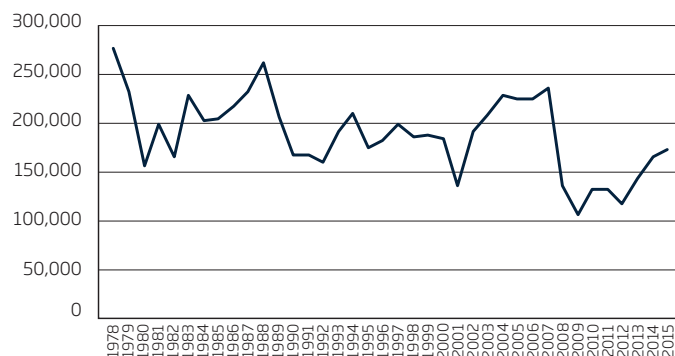


FIG 3.10

### AVERAGE PRICE BY COUNTRY AND GOVERNMENT OFFICE REGION, OCTOBER 2016

Source: UK House Price Index summary, October 2016

PRICE, ANNUAL CHANGE BY COUNTRY AND GOVERNMENT OFFICE REGION

COUNTRY AND GOVERNMENT OFFICE REGION	PRICE	ANNUAL CHANGE (OCT 2015-OCTOBER 2016)
England	£232,655	7.4%
Northern Ireland (Quarter 3 - 2016)	£124,093	5.4%
Scotland	£143,131	4.0%
Wales	£147,065	4.4%
East Midlands	£176,084	7.5%
East of England	£279,148	12.3%
London	£474,475	7.7%
North East	£124,749	2.7%
North West	£148,586	4.6%
South East	£312,509	9.1%
South West	£240,322	7.2%
West Midlands Region	£177,937	6.2%
Yorkshire and The Humber	£150,401	4.2%

FIG 3.11

### NUMBER OF FIRMS REGISTERING LESS THAN 100 COMPLETIONS PER YEAR, 1988-2014

Source: Federation of Master Builders (FMB)

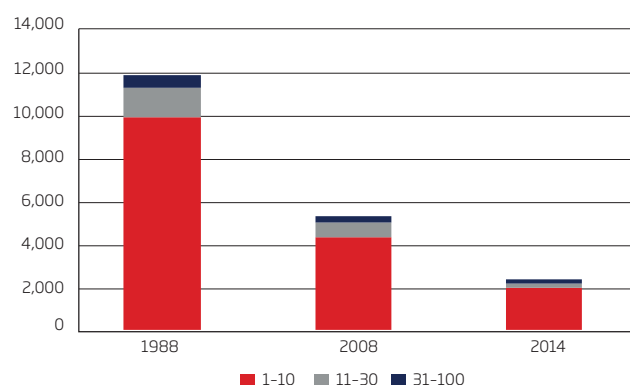


FIG 3.12

### COMPLETIONS AND MARKET SHARE OF TOP TEN HOUSEBUILDERS, 2009 TO 2015

Source: Company data and CLG completion statistics (live table 209)

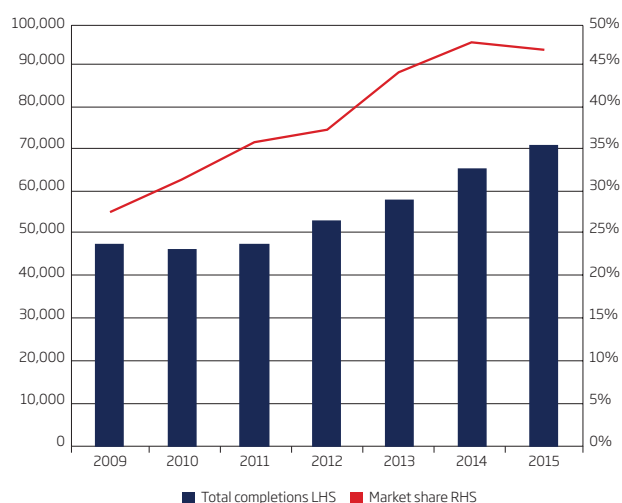


FIG 3.13

### MOST REPORTED ISSUES WHICH ARE CURRENTLY THE MAIN CONSTRAINTS TO BUILDING MORE HOUSES

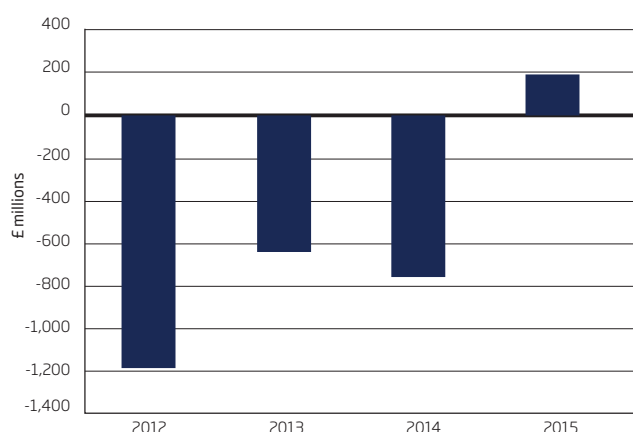
Source: FMB Small House Builder surveys

CONSTRAINTS	2016	2015	2014	2013	2012
Lack of finance to the company	50%	62%	62%	60%	72%
Lack of available and viable land	67%	68%	51%	55%	n/a
The planning system	50%	57%	43%	48%	41%
Shortage of skilled workers	39%	27%	n/a	n/a	n/a

FIG 3.14

### CHANGES IN NET LENDING, CONSTRUCTION OF DOMESTIC BUILDINGS

Source: Bank of England, series RPMB3IZ



The greatest level of concern cited in the 2016 FMB survey was loan to asset value ratios on offer. This replaced concerns over business overdraft facilities as the most significant finance related issue small builders face. Overdraft facilities have tended traditionally to be an important source of finance for smaller house builders. For those who work only as contractors, limitations on overdraft facilities remain the greatest cause of concern.

Net lending to the house building sector turned positive in 2015, it had been negative in 2012, 2013 and 2014. According to the Bank of England, net lending to the house building sector was £637 million in the first three quarters of 2016. These figures include all sizes of house builders including larger builders.

### BRITISH BUSINESS BANK IS REVIEWING HOW ITS PROGRAMMES CAN SUPPORT SMALL HOUSE BUILDERS

Evidence from the sector suggests a finance gap exists particularly for the smallest house builders. FMB surveys indicate flows of finance have improved over the last year. However, access to finance remains a key issue for small house builders. The British Business Bank has been working with the Homes and Communities Agency to explore how access to finance can be improved for small house builders.

The Bank has highlighted the potential use of the Enterprise Finance Guarantee (EFG) for house building, as there are circumstances where an EFG loan can address lack of collateral, and support additional lending. The CBI have endorsed greater use of EFG in the house building sector.<sup>93</sup>

We have also contributed to the National Housing Taskforce, which is a sectoral and political coalition convened by the Royal Institute of Chartered Surveyors (RICS) and the All-Party Parliamentary Group (APPG) for Housing and Planning. In 2016, a specific supply side access to finance strand was led by BBA and RICS with support from the British Business Bank. The British Business Bank welcomes further joint working in the future, as highlighted in the 2016 housing white paper, 'Fixing our broken housing market'.

## 3.2

## ANALYSIS OF DEBT APPLICATIONS

- 
- Success rates for new debt applications have improved since 2012
- 
- Young businesses find it harder to obtain new debt finance than more established businesses, a consistent trend in recent years
- 
- Analysis suggests an undersupply of finance to some rejected applicants and those discouraged from applying
- 
- Factors symptomatic of information asymmetries between lender and applicant remain important
- 
- Non-receipt of finance reported to have a negative impact on business performance
- 

---

The British Business Bank targets its programmes to where they will have the most impact. This means that to enhance economic growth, funding should be provided to viable SMEs that otherwise would not have received it. It is important that we have a view on the scale of the market failure and what types of SMEs are most acutely affected so that our programmes can be most effectively targeted.

Despite rising debt application success rates over the last few years, structural supply problems remain, particularly for young and growing SMEs. There is evidence that applications are turned down due to factors that are symptomatic of an information asymmetry between prospective lender and borrower, for example, a lack of representative track record or security.<sup>94</sup> This suggests that potentially viable finance requests are not receiving funding.

We discussed in section 2.2 that the softening in demand for finance is becoming a more prominent issue for the SME access to finance agenda. This is in the context of caution with regard to taking on new funding and could be caused by a number of factors, for example: wider, external aspects (e.g. economic conditions) or business specific issues (e.g. insufficient information on the most suitable finance options).

Information asymmetries can impact demand for, as well as supply of, finance and can arise, for example, due to misperceptions over likely chances of success if an application were to be made. 3% of smaller businesses are discouraged or deterred from applying for finance (would-be-seekers), despite identifying a need for it. This suggests that specific information asymmetries relating to demand for finance exist and mean that the extent of the market failure is not restricted to those SMEs that apply, and are rejected, for finance.

Furthermore, there remains a heavy reliance on traditional forms of funding by SMEs. This is likely to lead to an efficient outcome for the majority of smaller

FIG 3.15

**SUCCESS RATES FOR DEBT APPLICATIONS  
(18-MONTH PERIODS)**

Source: British Business Bank analysis, SME Finance Monitor

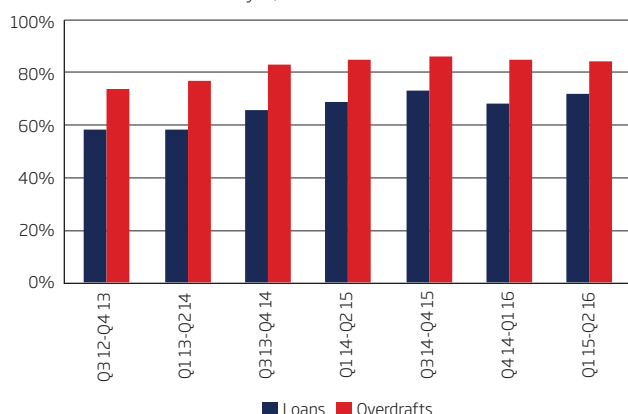


FIG 3.16

**SUCCESS RATES FOR NEW DEBT APPLICATIONS**

Source: British Business Bank analysis, SME Finance Monitor

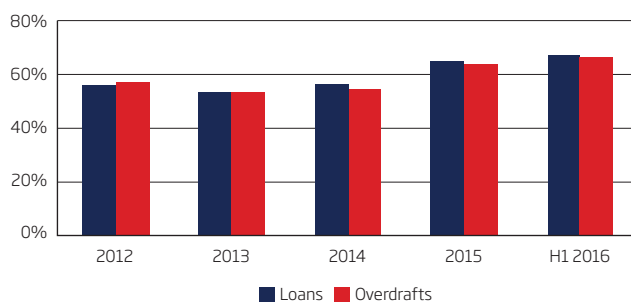


FIG 3.17

**APPROXIMATE SUCCESSFUL/UNSUCCESSFUL NEW DEBT  
APPLICATIONS BY BRITISH BUSINESS BANK SEGMENT**

Source: British Business Bank analysis, SME Finance Monitor

	START-UP	SCALE-UP	STAY-AHEAD
Successful	54,000	55,000	47,000
Unsuccessful	44,000	21,000	14,000

businesses. However, some SMEs may have benefitted from an alternative product, despite being successful, and others might have achieved success had they applied for more appropriate finance. A specific discussion on the 'equity gap' is covered in section 3.3.

In last year's Small Business Finance Markets report, we detailed the economic theory underpinning SME access to finance market failures. We also reported our analysis of rejected new debt applications and published a separate methodology consultation that sought views on how best to assess the market failure. This year's report provides a brief update on this work.

**SUCCESS RATES FOR NEW DEBT APPLICATIONS HAVE  
IMPROVED SINCE 2012**

The SME Finance Monitor indicates that roughly eight in ten applications for new and renewed debt facilities were successful in the 18 months to Q2 2016.<sup>95</sup> Overdraft applications were slightly more successful (84%) than loan applications (72%).

Successful is defined as receiving the facility applied for, either with or without issues. The unsuccessful categories are where the applicant ended the process with no facility or took funding from elsewhere (i.e. they were not successful in accessing the original facility applied for). This equates to nearly 300,000 successful applications for debt finance (155,000 for new debt finance) and approximately 80,000 unsuccessful applications in a 12-month period.<sup>96</sup>

Over time, quarterly data tends to be relatively volatile and shows no fixed trend in success rates over the last two years. However, looking back further to 2012 would suggest a general improvement in success rates for both loan and overdraft facilities. This is reflected when pooling data over 18-month time periods, with more consistent rates of success seen in recent 18-month time periods.

However, almost all applications relating to renewals of existing facilities are successful, which pulls up the overall success rate. In terms of considering where market failures are most likely to occur, the British Business Bank is most interested in new applications for finance. The rest of the analysis in this section focuses on new debt applications and uses a ten quarter dataset to ensure sufficient underlying sample sizes, therefore, there may be some small variations to SME Finance Monitor reported figures.

Looking at the whole ten quarter dataset to Q2 2016, the success rate for new and renewed loan applications was 70%. For new and renewed overdrafts it was 84%. When renewals are excluded, success rates for new loan applications were 67% and 66% for new overdraft

applications. Success rates have increased over time, rising from 56% for loans and 57% for overdrafts in 2012.<sup>97</sup>

### YOUNG BUSINESSES FIND IT HARDER TO OBTAIN NEW DEBT FINANCE THAN MORE ESTABLISHED BUSINESSES, A CONSISTENT TREND IN RECENT YEARS

Breaking down the 10 quarter Q2 2016 dataset by British Business Bank segment, less than 50% of start-ups were successful in their new loan application.<sup>98</sup> However, the rate of success has changed little since 2012. Scale-ups and stay-ahead SMEs were notably more successful in their new loan applications (73% and 82% respectively) than start-ups in the latest period. In contrast to the start-up group, scale-up and stay-ahead businesses have seen their success rates increase since 2012.

Success rates for new overdraft applications show a similar gap between start-ups and other SMEs, although in the last two periods this has been less pronounced than for new loan applications. Furthermore, the success rate for start-ups has improved since 2012 (in contrast to new loan applications). Scale-ups and stay-ahead SMEs reported broadly similar rates of success in their new overdraft applications in the last two periods and their approval rates have been relatively more consistent over time.

By breaking down the aggregate success rates, underlying variations between groups of SMEs are apparent. Comparing the characteristics of successful and unsuccessful applicants confirms this and suggests that older, more stable businesses are more likely to be successful, particularly when applying for loans.

The variation is most apparent for age, where around 50% of the SME population applying for a new loan were established less than ten years ago, with only 35% successful. Similarly, 65% of new loan applicants had some growth ambition for the next 12 months, but this corresponds to approximately 55% of successful applicants with some growth ambition.

It is rational from a commercial or profit-maximising perspective to lend to the businesses where it is easiest to predict the probability of default (or likelihood of repayment) and where pricing and risk appetite can be set and managed accordingly. However, this does indicate that young and growing companies that are crucial for the strength of the economy are still more likely to face issues when trying to access finance, particularly where it can be hard to assess their probability of default based on historic or limited information.

Supported by the British Business Bank, The Start Up Loans Company helps new and early stage UK businesses access affordable finance and mentoring support. This scheme is designed to support businesses who struggle to access other forms of finance.

FIG 3.18

### NEW LOAN APPLICATION SUCCESS RATES, BY BRITISH BUSINESS BANK SEGMENT

Source: British Business Bank analysis, SME Finance Monitor

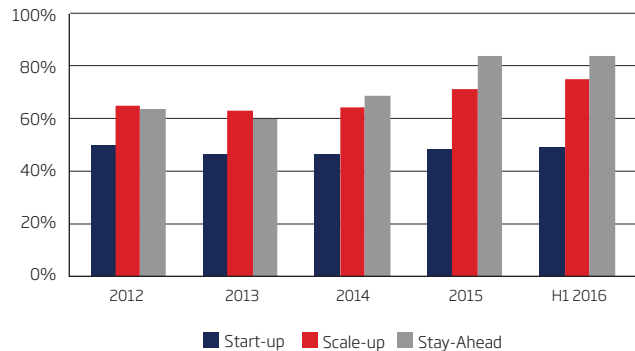


FIG 3.19

### SUCCESS RATES FOR NEW OVERDRAFT APPLICATIONS, BY BRITISH BUSINESS BANK SEGMENT

Source: British Business Bank analysis, SME Finance Monitor

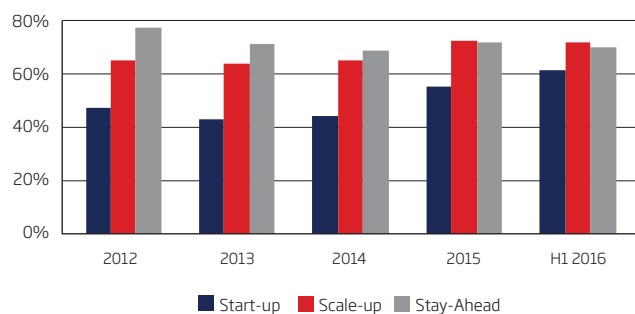


FIG 3.20

### DISTRIBUTION OF SMEs BY AGE OF BUSINESS

Source: British Business Bank analysis, SME Finance Monitor

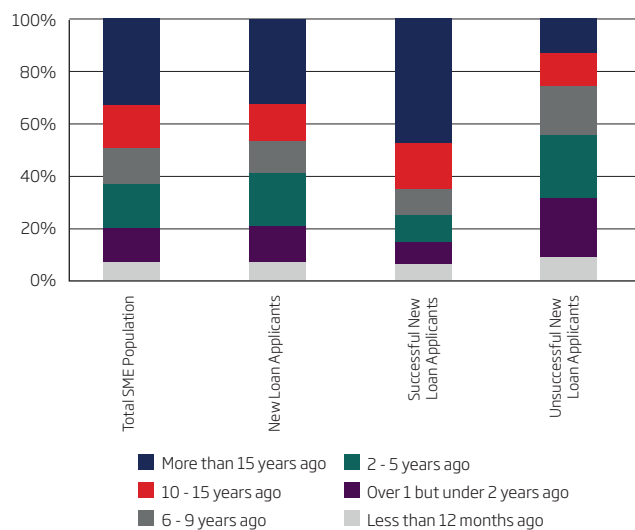


FIG 3.21

**REASONS FOR REJECTED APPLICATION**

Source: British Business Bank analysis, SME Finance Monitor

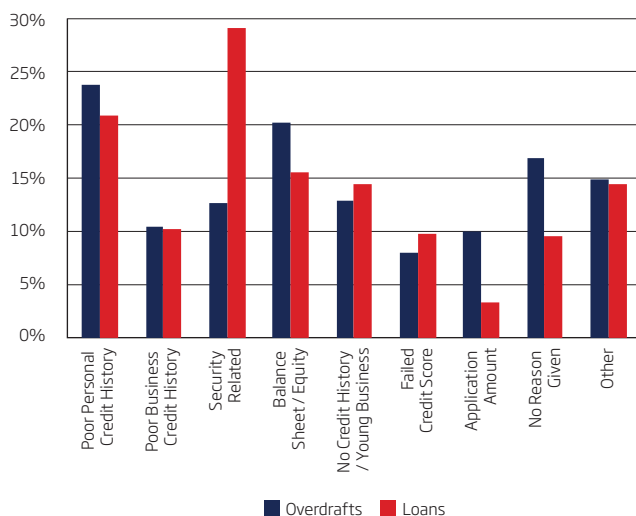
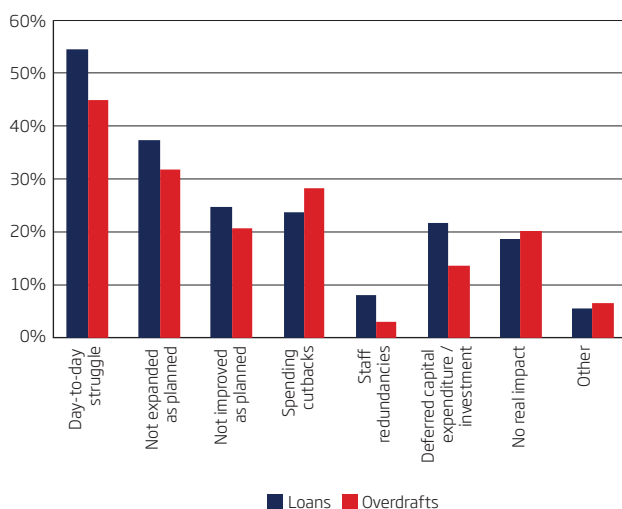


FIG 3.22

**REPORTED IMPACT FROM UNSUCCESSFUL APPLICATION**

Source: British Business Bank analysis, SME Finance Monitor

**ANALYSIS SUGGESTS AN UNDERSUPPLY OF FINANCE TO SOME REJECTED APPLICANTS AND THOSE DISCOURAGED FROM APPLYING**

The British Business Bank commissioned BDRC Continental to undertake further analysis to better assess the factors affecting success using a predictive regression model. While we acknowledge the commercial reality of lending decisions, the output of the model indicates that around 35% of SMEs that were unsuccessful in their application for finance had similar characteristics to those that were successful, based on their responses to the SME Finance Monitor. This could imply that they were commercially viable propositions, or that a factor beyond those captured by the SME Finance Monitor affected the application outcome, e.g. not applying for the most appropriate type of finance or to the best provider.

We reported in section 2.2 that 3% of SMEs were would-be-seekers of finance in H1 2016, i.e. they had a need for finance but did not apply. The predictive model built by BDRC Continental suggests that around 70% of this group of smaller businesses had characteristics similar to successful applicants.<sup>99</sup> While we don't know what these would-be-seekers would have applied for, had they made a debt application, the model suggests that an additional 2% of all SMEs may have been successful in obtaining that finance. In a low demand era, that would increase the number of new and renewed successful applications by approximately 40% (75% for new applications only).

**FACTORS SYMPTOMATIC OF INFORMATION ASYMMETRIES BETWEEN LENDER AND APPLICANT REMAIN IMPORTANT**

The literature on access to finance market failures tends to link problems in obtaining finance with information asymmetries between potential borrower and the provider of finance. Information asymmetries occur where finance providers are unable to make cost effective assessments of probability of default, and this is most likely to be the case for younger and growing businesses without a representative track record. The transaction costs faced by the provider then make the lending proposition sub-commercial, particularly if the business cannot provide collateral to de-risk the lending.

Smaller businesses that were not successful in obtaining the facility applied for reported many reasons for rejection. However, no or insufficient security was the most frequently reported reason for being rejected for a new loan applicant (29%). Furthermore, 14% noted a lack of credit history or being a young business.



Unsuccessful new overdraft applicants reported a similar level of rejection on the grounds of track record or being a young business (13%). However, security, or the lack of, appeared to be less of an issue for new overdraft applicants, with this cited by just 13% of respondents.

Interestingly, 16% of rejected overdraft applicants and 11% of loan applicants cited a weak balance sheet or the need for more equity. A weak balance sheet could also be indicative of insufficient collateral; however, this could also indicate that other types of finance may have been more suitable.

#### NON-RECEIPT OF FINANCE REPORTED TO HAVE A NEGATIVE IMPACT ON BUSINESS PERFORMANCE

Where smaller businesses have not received the finance sought, SME Finance Monitor data would suggest that this has had some detrimental impact in the majority of cases. Approximately 55% of unsuccessful new loan applicants (45% unsuccessful new overdraft applicants) reported that the day-to-day running of the business had been a struggle. Of course, problems with the normal running of the business could have been the reason for requesting finance in the first place. However, crucially for the consideration of wider economic implications, 38% of unsuccessful loan applicants (32% overdraft) cited they had not expanded as planned and 25% of unsuccessful loan applicants (21% overdraft) noted that they had not improved as planned. Only around 20% of unsuccessful applicants (both loan and overdraft) reported no real impact from not receiving their requested facility.

The impacts on expansion and improvement plans appear to be more accentuated for start-ups. However, stay-ahead businesses were more likely to report that running the business was more of a day-to-day struggle, potentially reflecting different phases of business development.

## 3.3

## SUPPLY SIDE - EQUITY FINANCE

- There has been a slowdown in the number of UK equity deals over the first three quarters of 2016 following a strong 2015
- The UK performs relatively well in terms of VC compared to the rest of Europe, but lags behind the US
- Business angels are a significant source of equity funding for early stage and growing companies
- There is evidence of a later stage VC funding gap in the UK, which is holding back growth companies from scaling-up
- The British Business Bank is currently investigating the supply of growth capital to established businesses looking to expand
- The financial returns from investing in VC continue to improve but published long term returns still lag the returns from investing in MBOs

Equity finance is an important source of funding for businesses that have the potential for high growth. It is a suitable funding source for early stage businesses that are too high risk to be supported by debt finance due to their risk profile, lack of collateral or unstable cash flows. Equity finance is also suitable for established businesses looking to scale-up by expanding or entering new markets, which may not be able to obtain debt finance due to their leverage or risk profile. Many companies also favour equity over debt financing due to the additional benefits and expertise outside equity investors bring to the business which helps them to grow.

This section provides an overview of recent trends in equity finance using data from Beauhurst. The British Business Bank first collaborated with Beauhurst in 2015, to produce an equity tracker covering the number and value of UK equity investments from the full range of equity investors. Beauhurst data is built from the bottom up covering equity deals made by VC funds, business angels, crowd funders, corporate investors, government funds and other equity investors. The data is updated for this report and covers equity deals up to Q3 2016. The presented data is based on announced equity deals only.<sup>100</sup> Figures for full 2016 calendar year will be published in the forthcoming 2017 Equity Investment Tracker in spring 2017 and the Equity Tracker report will provide a more detailed overview of UK equity deals than the high level summary published in this market report.

It is important to note that the equity deal and investment numbers included in this report are revised from those published in the previous 2016 Equity Tracker due to ongoing methodological improvements in identifying deals. This report therefore supersedes the previous analysis. The equity figures published in this report also differ to those published by Beauhurst themselves,<sup>101</sup> due to large businesses being removed from the data through an "SME filter" being applied.<sup>102</sup>

No dataset has complete coverage of all equity deals. Figure 3.23 shows how Beauhurst compares to other data sources like the British Venture Capital Association (BVCA) and Invest Europe, which shows the investment activities of their members, which are mainly Private Equity funds. The Beauhurst data only covers the UK, and so Invest Europe data is used elsewhere in this section for making comparisons to other countries. Data from commercial VC data providers like Preqin is also used in this report to provide a further insight into UK equity markets.

### THERE HAS BEEN A SLOWDOWN IN THE NUMBER OF UK EQUITY DEALS OVER THE FIRST THREE QUARTERS OF 2016 FOLLOWING A STRONG 2015

The number and value of equity investments in the UK grew between 2011 and 2015 showing UK equity markets have performed well during this period. Following strong performance in Q3 2015 with 362 deals in the quarter, the number of equity deals has declined in each of the four subsequent quarters to 276 deals in Q3 2016. As a result, the number of equity deals has fallen 17% between the first three quarters of 2016 and the same three quarters a year ago. With one quarter's data still to go, the number of deals in 2016 overall is expected to be lower than the annual figures for 2015, but still higher than the total number of deals in earlier time periods. This will be explored further in the 2017 Equity Tracker report, alongside other changes in the market.

The slowdown in UK VC deals is also seen in US VC markets, where Q4 2016 marked the sixth quarterly decline in the number of companies receiving venture capital. There has been a wider global slowdown as funds become more critical of their investment opportunities.<sup>103</sup> Global technology markets are closely connected and there a strong perception that factors affecting US markets also affect UK and European markets.<sup>104</sup>

The greatest decline in the UK has been seen in venture stage deals (-25%) and growth stage deals (-24%). In comparison seed stage investments have declined by 9% compared the first three quarters of 2015.

Whilst equity deal numbers have declined sharply, the decline in equity investment amounts has been more modest. For instance, there has been a 9% decline in investment amount from Q1-Q3 2015 to Q1-Q3 2016. As a result investment amounts have declined from £2.7bn in Q1-Q3 2015, to £2.5bn in Q1-Q3 2016.

The greatest decline has been seen in the venture stage, with funding amounts declining by 35% over the same time period. On first glance, this trend appears worrying, but is partly due to a small number of very large life science deals inflating the overall Q3 2015 figure, amplifying the scale of the decline. The decline

FIG 3.23

### COMPARISON OF TRENDS IN DIFFERENT EQUITY DATA SOURCES

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

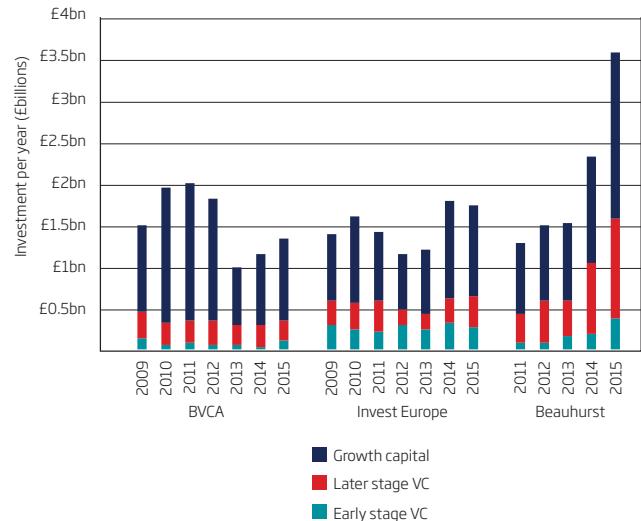


FIG 3.24

### NUMBER OF EQUITY DEALS AND VALUE OF INVESTMENT PER QUARTER

Source: British Business Bank analysis of Beauhurst

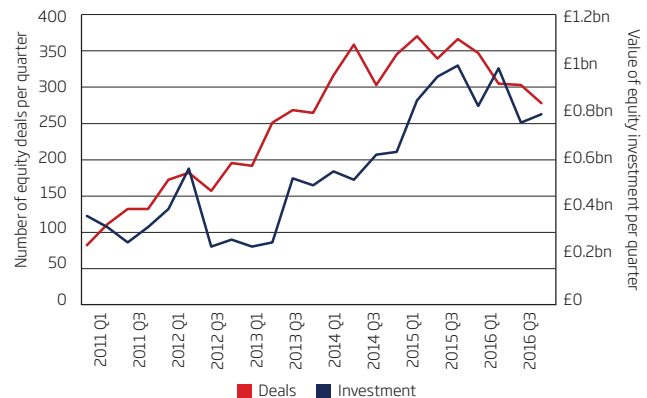


FIG 3.25

### NUMBER OF EQUITY DEALS BY STAGE PER QUARTER

Source: British Business Bank analysis of Beauhurst

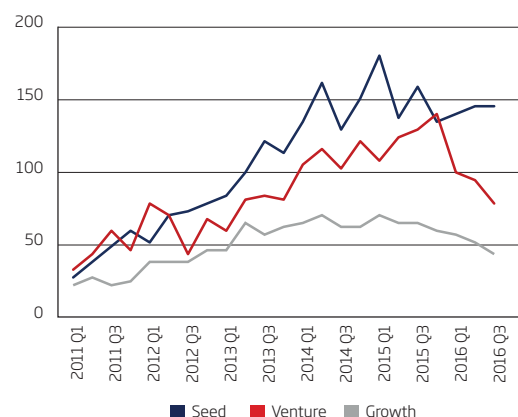


FIG 3.26

## VALUE OF EQUITY INVESTMENT BY STAGE PER QUARTER

British Business Bank analysis of Beahurst

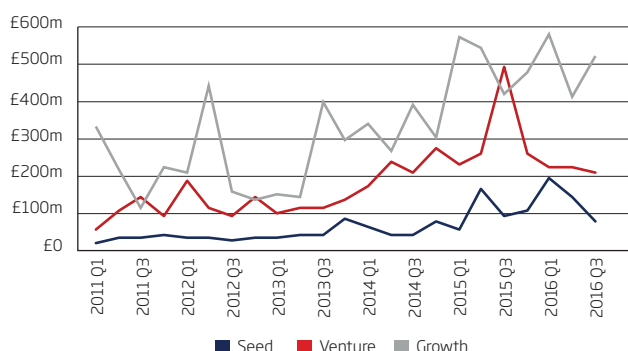


FIG 3.27

## NUMBER OF DEALS PER QUARTER INVOLVING EQUITY INVESTORS BY TYPE

Source: British Business Bank analysis of Beahurst

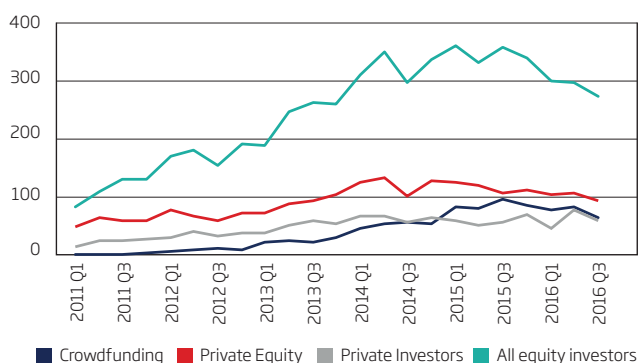
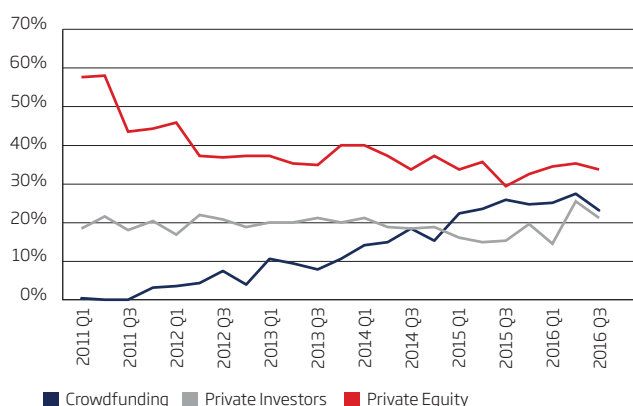


FIG 3.28

## PROPORTION OF DEALS PER QUARTER INVOLVING EQUITY INVESTORS BY TYPE

British Business Bank analysis of Beahurst



is smaller if a comparison is made over the first two quarters of 2015 and 2016 where there was a 10% decline in investment amounts. Growth investment has been relatively stable over time and has only declined by 1% between Q1-Q3 2015 and Q1-Q3 2016. In comparison, funding going to seed stage investments have actually increased compared to the first three quarters of 2015 by 35%. Declining seed stage deal numbers, but increasing investment amounts imply that average seed deal sizes are getting larger.

Over the last few years, there has been a trend towards larger deal sizes due to higher company valuations and maturing of companies coming through the investment pipe line. The trend for larger deal sizes continues in the first three quarters of 2016. The average deal size for growth stage deals was £6.5m in 2014, but has nearly doubled to £12.5m in 2016.

Whilst seed stages remain smaller than other stages, average deal sizes have also increased from £440,000 in 2014 to £1.1m in 2016. In comparison, venture stages have remained relatively constant in size over the same time period at around £2.5m.

Around 45% of all equity deals (56% of disclosed amount deals) were less than £1m in size in 2016, roughly the same level as 2013. Larger deal sizes are partly the result of increases in very large deal sizes of £10m or more, with the largest deal sizes increasing in size. Despite forming 8% of all deals in 2016 (10% of disclosed amount deals), they now form 66% of the total investment amount, up from 50% in 2014. This in part reflects the emergence of a number of successful companies raising large amounts of later stage funding. For instance, Deliveroo raised £210m of equity funding in Q3 2016. There are now seven UK unicorn businesses (private VC backed businesses valued over \$1bn), up from five a year ago.<sup>105</sup> This takes into account Skyscanner leaving the UK unicorn list due to its recent trade sale exit.

Around 35% of equity deals in 2016 involve private equity funds, showing that they are an important source of equity funding in the market.<sup>106</sup> The European Investment Fund (EIF) has contributed a large amount of funding into UK equity funds, having supported 144 UK equity funds since 1996. The European Investment Fund has committed approximately £390m per year on average into UK VC and PE funds over 2011-15.<sup>107</sup>

Crowdfunding has emerged from being involved in 1% of all equity deals in Q1 2011 to 28% in Q2 2016. However, the number of deals involving crowd funders peaked in Q3 2015, at 97 deals, and has declined to 66 deals in Q3 2016. It is important to examine to what extent this market trend will continue, given the importance of crowdfunding to early stage companies seeking seed stage funding.

The 'technology & intellectual property (IP) based business' sector continues to dominate equity investment in the UK, with 469 equity deals equivalent to £1.4bn in the last four quarters (Q4 2015 to Q3 2016). Within this technology sector, software formed the largest sub sector with 337 deals. The next largest sector was the 'business and professional services' sector (267 deals) and the 'industrials' sector (145 deals).

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

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

The US had a VC to GDP ratio of 0.33% in 2015 which is significantly higher than the European average of 0.02%. The UK's VC to GDP ratio of 0.03% is lower than a number of other European countries including Finland, Switzerland, Sweden and Ireland. However, the UK remains Europe's largest single VC market, receiving 22.6% of all VC investment in 2015.

It is important to acknowledge that VC is unevenly distributed globally, including in the US. 60% of all US VC deals (78% by investment value) in 2015 were made in just three states (California, New York and Massachusetts). It is therefore misleading to assume that VC is available and widely used in all areas of the US because its VC to GDP ratio is so much higher.<sup>108</sup> This suggests that in the absence of any interventions, the 'natural' growth trajectory of VC in the UK would also result in even more and larger VC transactions being undertaken in one or two areas that benefit from network effects, as well as being connected globally.

The British Business Bank has recently joined other European development banks in undertaking research assessing the similarities and differences in individual VC markets in Europe, with ideas for strengthening the European VC market. The report found a wide divergence in individual markets in Europe and also clear differences with the US.<sup>109</sup>

Of the European countries considered, VC investments in Germany have recovered the most since 2007, reaching the pre-recession level by 2015. In comparison, VC investments in Spain and Italy have fallen by approximately 40% of their pre-crisis levels. In France and the UK, VC investments followed the European average reaching 60% of their 2007 levels in 2015. In contrast, the US market has shown strong recovery and exceeds its pre-crisis level. VC investment in the US tripled by 2015 after its decline in 2009.

FIG 3.29

### NUMBER OF DEALS AND INVESTMENT AMOUNT BY SECTOR (Q4 2015 - Q3 2016)

Source: British Business Bank analysis of Beauhurst

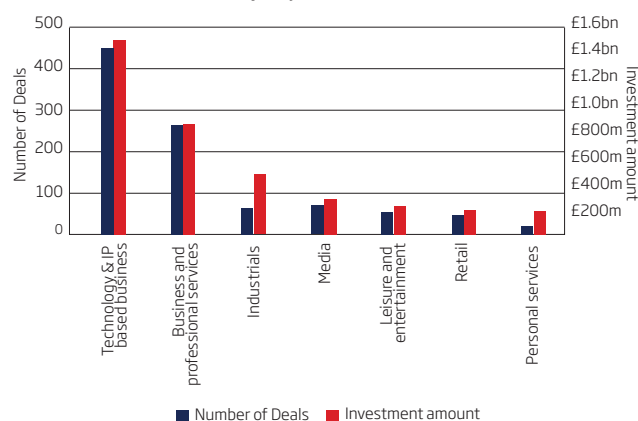


FIG 3.30

### VC FUNDING AS A PROPORTION OF GDP

Source: British Business Bank analysis of Invest Europe and NVCA data

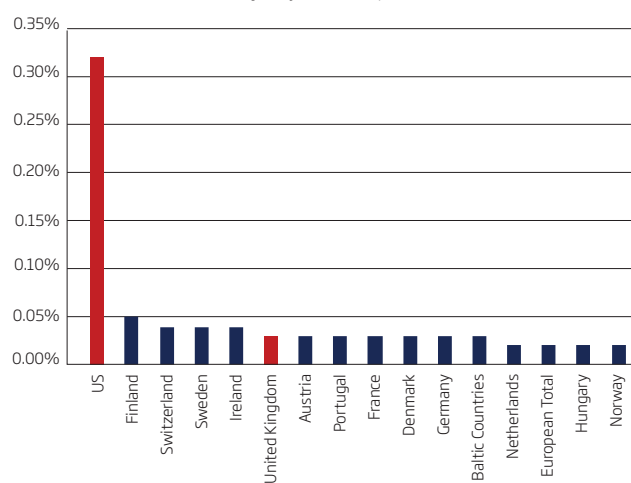


FIG 3.31

### INTERNATIONAL TRENDS IN VC INVESTMENT (2007 = 100)

Source: Building Momentum in Venture Capital across Europe (Invest Europe and NVCA data)

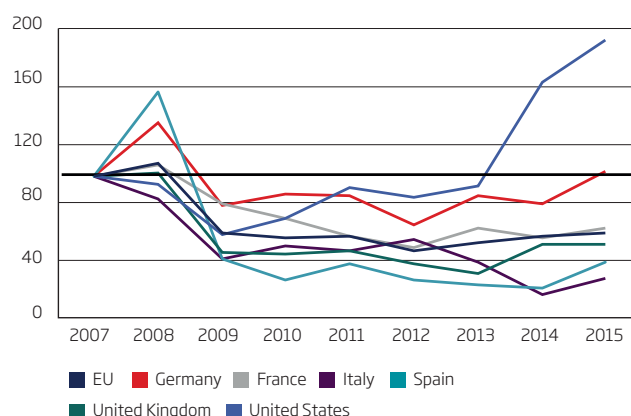
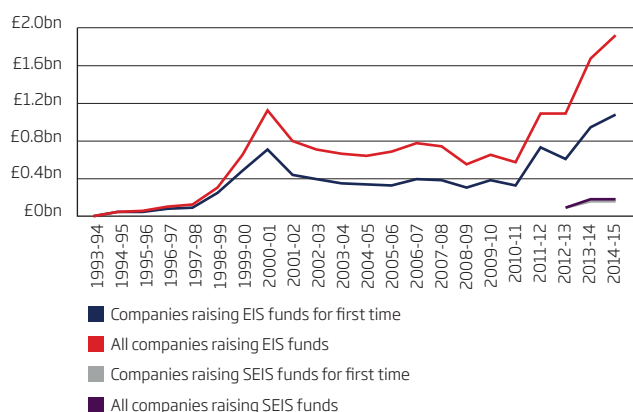


FIG 3.32  
EIS AND SEIS INVESTMENT OVER TIME

Source: HMRC



### BUSINESS ANGELS ARE A SIGNIFICANT SOURCE OF EQUITY FUNDING FOR EARLY STAGE AND GROWING COMPANIES

Whilst the Beahurst dataset has good coverage of equity deals involving institutional investors, business angels are less likely to be driven to seek publicity on completing investments, and so are largely missing from the investment numbers.<sup>110</sup> Quantifying the number of deals involving business angels is more difficult, but the emergence of crowdfunding and wider use of social media is increasing the visibility of the angel market.<sup>111</sup>

Angel investors continue to become more professional, with growth in the number of angel investing through syndicates. The UK Business Angel Association (UKBAA), which covers 18,000 investors mainly investing through 54 groups, confirms that there are no robust statistics on the annual number of deals undertaken by angel investors in the UK. Recent research showed that angel syndicates are increasingly investing alongside other investment sources, with over 40% of angels involved in co-investment as part of a larger deal.<sup>112</sup> UK angels are also joining other angels to invest as Limited Partners in VC fund structures that provide early stage funding.

There are a number of ways to estimate the contribution of angel investors to UK equity markets. Many business angels use Enterprise Investment Scheme (EIS) tax relief within their investments, which can provide an estimate for the total amount of business angel activity in the UK. The 'Nation of Angels' report confirms that 90% of angels in the visible market are using the EIS/SEIS scheme for 79% of their deals.<sup>113</sup>

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. 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.

HMRC data shows that 3,265 companies raised a total of £1.8bn of funding in 2014-15 under the EIS scheme.<sup>114</sup> This was higher than in any previous year and is nearly three times higher than the average EIS investment levels between 2001 and 2010. This also shows the importance

of angel funding to UK companies. An additional 2,290 companies also received investment through the Seed Enterprise Investment Scheme (SEIS) in 2014-15 raising £175m of funding.

Together with the Angel CoFund, HMRC administered tax based investment schemes have helped increase the supply of early stage venture capital to UK companies. The forthcoming 2017 Equity Tracker will explore the characteristics of angel investors and their investments in more detail.

#### THERE IS EVIDENCE OF LATER STAGE VC FUNDING GAP IN THE UK, WHICH IS HOLDING BACK GROWTH COMPANIES FROM SCALING-UP

Later stage VC involves the financing of companies entering new markets or expanding their market share with new innovative products and services that they have previously developed.<sup>115</sup> If growing companies do not have access to later stage funding to build on the early stage funding they have previously received, their current and future growth and success will be constrained. This may also reduce the returns made to early stage investors. Therefore, a well-functioning funding eco-system is required covering all investment stages from start-up to scale-up and beyond.

Whilst the supply of early stage VC funding has increased over the last few years in the UK, in part facilitated by the success of British Business Bank programmes like Enterprise Capital Funds (ECFs), Angel CoFund, and VC Catalyst, and also through investor tax relief schemes like EIS, SEIS and VCTs, the increases in later stage funding have been lower. As a result, Invest Europe and NVCA data for 2013 to 2015 shows the UK has a lower share of later stage deals (38%) compared to the US (44%). The UK also lags behind the US in terms of later stage funding as a proportion of GDP, although the UK performs relatively well compared to the rest of Europe. UK later stage VC is 11 times smaller than the US (0.019% compared to 0.213%) based on later stage VC as a percentage of GDP.

It is widely recognised that there is now a good flow of early stage companies coming through the investment pipeline.<sup>116</sup> These companies will shortly be requiring later stage funding to build on their success.<sup>117</sup> The supply of later stage funding will therefore need to be responsive to meet this increased demand for funding, but there are concerns that the supply of later stage funding is



FIG 3.33

### COHORT ANALYSIS OF COMPANIES RECEIVING SERIES A/ SEED FUNDING IN 2008-2010

Source: British Business Bank analysis of Preqin

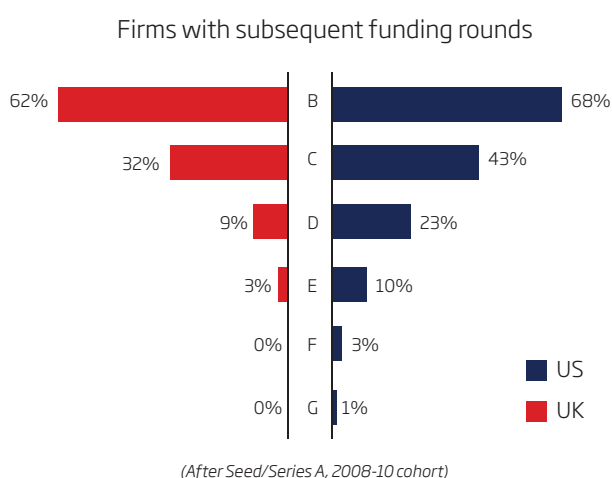
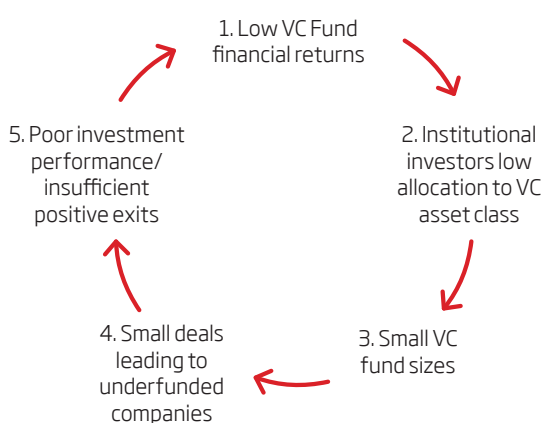


FIG 3.34

### CURRENT EQUILIBRIUM POSITION OF SMALL UK VC FUNDS AND UNDERFUNDED SCALE-UP COMPANIES



constrained, which impacts on the ability of businesses to obtain funding required to scale-up.<sup>118</sup>

The Barclays Scale-up report shows that the median fund size in the UK is smaller than the US, but the US has significantly more funds greater than \$100m in size and also above \$250m.<sup>119</sup> Smaller UK funds tend to focus their investment activity on early stage funding rounds and are then unable to provide sufficient follow on funding needed to build scale-up businesses. The Scale-up report found that early stage rounds sizes are similar between the UK and US, but rapidly diverge in size at the later stage. UK companies raise 15% less in funding rounds D and 23% less in funding rounds E compared to their US counterparts.

British Business Bank's own analysis of a cohort of companies receiving early stage funding between 2008 and 2010 confirms the divergence in deal sizes in the later round but also identified UK VC backed companies received fewer later stage follow on rounds than US companies. This is shown in figure 3.33 where 62% of UK series A/ seed deals received a follow on round of finance compared to 68% in the US. This approach assumes UK and US early stage companies are of equal quality, but the lack of follow on rounds may hold back the rate of growth of UK companies. This is in addition to UK follow on rounds being of smaller size to the US.

Cyclical factors affecting the UK and European VC industry has developed into wider structural issues, so that the European VC industry is in a sub-optimal cycle, as illustrated by figure 3.34.

Although historic financial returns from investing in European VC are low when compared to the risk-reward profile of alternative asset classes, low financial returns are not directly a market failure by itself. However, low financial returns reduce the attractiveness of investing in VC, so that institutional investors devote a smaller proportion of their commitments to VC than they otherwise would have done.<sup>120</sup>

This leads to smaller VC fund sizes which in turn undertake smaller deals, and are constrained from providing adequate amounts of follow on funding to their most promising investments. This impacts on the business performance of investments whose growth is slower than it might otherwise have been which then contributes to poorer financial returns at the fund level. This then contributes to a self-reinforcing sub-optimal investment cycle.



The British Business Bank has recently expanded its VC Catalyst programme to broaden its support for investments in later-stage venture.<sup>121</sup> This will help to create funds of sufficient scale (addressing stage three in figure 3.34), which can provide later stage VC funding to growing companies, helping to develop a positive investment cycle. Funding will be deployed on a fully commercial basis to prove to institutional investors that positive financial returns are possible in the longer run (stage five in figure 3.34). British Business Bank funding can therefore help generate a positive investment cycle.

#### THE BRITISH BUSINESS BANK IS CURRENTLY INVESTIGATING THE SUPPLY OF GROWTH CAPITAL TO ESTABLISHED BUSINESSES LOOKING TO EXPAND

The British Business Bank has identified gaps in the supply of later stage VC, but the bank is also currently looking at the supply of Growth Capital in the UK. Whilst there are overlaps between later stage VC, growth capital and buyout deals due to the terminology often being used interchangeably, growth capital is a type of PE investment in relatively mature companies that are looking for capital to expand or enter new markets. It is usually provided through a minority equity stake and does not involve a change of control of the business.

British Business Bank analysis of growth capital and later stage VC deals confirms there are observable differences between growth capital deals and later stage VC deals.<sup>122</sup> For instance, around 40% of businesses receiving growth capital are profitable, they are likely to be around 10 years old and have around 130 employees. It is likely that they have not previously received equity investment from an outside PE investor. In comparison companies receiving later stage venture capital investments are much less likely to be profitable and are more likely to have been previously funded by a range of equity investors. Later stage VC Companies are also more likely to be growing at a faster rate than growth capital companies.

The Business Growth Fund is recognised as the leading provider in the supply of growth capital in the UK, having invested over £1bn of funding in more than 165 companies to date.<sup>123</sup> Business Growth Fund targets established companies with turnover of between £5m to £100m that are looking to expand, making initial growth capital investments of between £2m and £10m. The British Business Bank will investigate conditions in the

FIG 3.35

#### CHARACTERISTICS OF 2013-2014 GROWTH CAPITAL AND LATER STAGE VENTURE CAPITAL COMPANIES AT TIME OF INVESTMENT

Source: British Business Bank analysis of Preqin and FAME

	GROWTH CAPITAL	LATER STAGE VENTURE CAPITAL
% which are profitable	40%	4%
Average age of business	10 years	7 years
Average number of employees	130	90
Median turnover	£10m	£7m
Average number of investors	1.4	3.1
Median turnover growth	10%	38%
Median employment growth	11%	20%
Number of companies (matched companies only)	48	61

FIG 3.36

### LONG TERM RATES OF RETURN (% PA) BY INVESTMENT CATEGORY AND SELECTED MARKET COMPARATORS

Source: BVCA (2016) 'Performance Measurement Survey 2015'

IRR (% P.A)	3 YEAR	5 YEARS	10 YEARS
<b>Private Equity</b>			
Venture capital	16.0	9.2	5.1
pre-2002 vintage funds	19.5	4.3	-0.3
2002 vintage funds onwards	15.5	10.4	7.9
Small MBO	14.2	10.7	23.5
Medium MBO	22.3	15.0	16.0
Large MBO	11.6	8.8	12.9
<b>Selected comparators</b>			
Total Pension Fund Assets	8.5	7.5	6.2
FTSE All Share	7.3	6.0	5.6
FTSE Small Cap	13.5	10.3	6.2
Cash	1.4	1.7	3.0
Retail Price Index	1.8	2.7	3.0

Growth Capital market further and we welcome ideas on methodologies and data sources for estimating the supply and demand for growth capital in the UK.

### THE FINANCIAL RETURNS FROM INVESTING IN VC CONTINUE TO IMPROVE BUT PUBLISHED LONG TERM RETURNS STILL LAG THE RETURNS FROM INVESTING IN MBOS

Exits are important for early stage equity investors in order to realise financial returns. Venture capital returns have continued to improve over recent years due to a resilient exit environment, but IPO markets are showing some signs of slowing in 2016. The number of European VC backed IPOs was 32% lower in first three quarters of 2016 compared to same quarters in 2015, but nearly 50% lower than the same three quarters in 2014. This is similar to US markets where the number of IPOs has been lower in 2016 compared to earlier years.<sup>124</sup>

European acquisition markets have continued to be strong with the number of trade sales increased by 6% in the first three quarters of 2016, compared to the same quarters in 2015.<sup>125</sup> European companies are making acquisitions of smaller technology companies for commercial and strategic reasons, but Europe has fewer large technology companies compared to the US and China.<sup>126</sup>

Published VC returns figures lag the recent upturn in divestment activity but the gap is closing. For instance, BVCA figures show the 10 year IRR return for venture is 5.1% which is slightly lower than the 5.6% return from investing in public market returns.<sup>127</sup> The 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 7.9% IRR. This is still well below the broader private equity returns figure of 13.2%. The shorter term 3 and 5 year returns figures are much stronger than the 10 year returns, suggesting the long term VC fund returns may improve further in the future as older vintage years drop out.

Aggregate market returns figures obscure the high returns that are possible from making, developing and exiting a successful investment. Whilst the median VC fund (2002 vintage funds onwards) generates an IRR of just 0.3%, upper quartile funds generate IRR of 10.1% based on since inception returns.<sup>128</sup> For individual investments the returns can be even higher. For instance,

the recent acquisition of the on-line flight booking service Skyscanner for £1.4bn has provided a large positive return for the company's early investors. Scottish Equity Partners (SEP) first invested £2.5m in 2008 and has subsequently provided a total of £9m of funding to Skyscanner. The recent trade sale is reported to have generated a return for SEP that is close to 50 times its original investment.<sup>129</sup>

## CONCLUSION

Although VC markets have grown over the previous five years, the recent slowdown in equity markets marks a possible return to cyclical factors affecting the availability of equity finance to growing businesses. The British Business Bank will maintain its monitoring of market conditions closely. It is critical that start-up companies and companies in the investment pipeline continue to have the funding they require to grow.

Equity finance has an important role in contributing to the Government's Industrial Strategy by supporting businesses to start-up and grow (Pillar 4) and cultivating world class sectors (Pillar 9). Equity finance is an important source of funding for innovative companies, and many of the sectors identified in the Industrial Strategy including but not limited to life science and digital sectors.<sup>130</sup>

The British Business Bank continues to have a role in addressing structural issues in the market, which impedes the overall effectiveness of equity markets for smaller SMEs. These structural market failures are well established and relate to imperfect information between the investor and business which leads to the existence of due-diligence costs.<sup>131</sup> Due diligence costs are a higher proportion of smaller deals, leading to funds focusing on larger investments. There is a continued role for the bank's ECF programme, which incentivises funds to focus on smaller deal sizes and supports new fund manager teams, thus increasing the overall supply of VC finance. The Angel CoFund also targets the equity gap to target smaller deal sizes and helps to professionalise business angel investments.

The analysis presented earlier in the chapter also points to a structural funding gap extending to later stage investments. The additional £400m of funding announced in the recent 2016 Autumn Statement, will be used by The British Business Bank to expand the VC

Catalyst programme to focus on later-stage venture capital.<sup>132</sup>

Market failures also exist on the demand side as a result of imperfect information, which leads to SMEs not understanding who to approach for equity finance and how best to seek it. 64% of SMEs are aware of venture capital and 38% are aware of business angels, but only 19% of businesses are aware of a specific venture capitalist and 12% are aware of a business angel to approach. This therefore limits the effectiveness of these types of finance as alternative funding sources, as businesses will require greater effort to identify potential investors.<sup>133</sup> Recent developments, such as equity crowdfunding, represent an effort to overcome this 'thin market' structural issue. However, there may be intractable demand side issues if some SMEs are unwilling to even consider the benefits of using external equity providers.

Of those businesses that are aware of equity finance, only 6% have considered using it. 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. This is especially the case for Growth Capital investments where many businesses have not previously received equity investment from outside investors. Further work is required to understand underlying SME attitudes, how this links to behaviour and therefore how to change 'hearts and minds' with regards to using equity finance.

The British Business Bank is also contributing to the new Patient Capital Review, led by the Treasury, which aims to understand the barriers to the growth of long-term investment. The Bank is represented both on the Steering Committee and in the Secretariat for this review and the review will be supported by a panel of leading investors and entrepreneurs, chaired by Sir Damon Buffini.<sup>134</sup>

## 3.4

## ASSET FINANCE

- 2016 saw asset finance continue its strong post-crisis recovery
- The first post-EU referendum quarterly results showed the strongest rate of new business growth for more than a year
- 2016 has seen the business equipment finance and commercial vehicle finance sectors lead the way
- Hire purchase has been a key driver, more than 40% higher in 2016 than pre-crisis levels, partly driven by changes to Annual Investment Allowances
- FLA confidence survey suggests a stable outlook for 2017

This section and the next provides an update on developments in the asset finance market (leasing and hire purchase) and asset-based finance market (factoring and invoice discounting) in 2016, highlighting the continued increase in volumes in both markets. Further information on the diversity of supply in the asset finance and asset-based finance markets is included in the general discussion of diversity of supply in Chapter Four.

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

The most recent SME Finance Monitor covering Q2 2016 suggests that asset finance was the alternative finance instrument used by the largest proportion of smaller businesses across the full range of business sizes surveyed in keeping with previous findings.<sup>135</sup> Figure 3.37 shows the full list of the different types of funding being used YE Q2 2016. As with the usage rate the success rate for those applying for asset finance during the 12 months prior to being interviewed is also the highest of the alternative finance instruments at 94%.

#### 2016 SAW ASSET FINANCE CONTINUE ITS STRONG POST-CRISIS RECOVERY

Data published by the Finance & Leasing Association (FLA) shows that around 60% of annual asset finance new business is provided to small and medium sized enterprises (SMEs). The annual level of asset finance new business provided to SMEs passed its pre-crisis peak in 2015. The FLA estimates that in 2016 £16.8 billion was provided to SMEs to support investment in equipment, and plant and machinery, almost £1.0 billion more than in 2015.<sup>136</sup>

### THE FIRST POST-EU REFERENDUM QUARTERLY RESULTS SHOWED THE STRONGEST RATE OF NEW BUSINESS GROWTH FOR MORE THAN A YEAR

FLA figures for Q3 2016, the first post-EU referendum quarterly results, showed that asset finance new business grew by 12% compared with the same quarter in the previous year. This is the strongest rate of growth for more than a year.

More recent figures for October and November 2016 showed that the asset finance market continued to grow. In the eleven months to November 2016, asset finance new business increased by 7% compared with the same period in 2015, to reach £27.6 billion. Over that period, asset finance new business for deals of up to £20 million grew by 6% to reach £26.4 billion.

### 2016 HAS SEEN THE BUSINESS EQUIPMENT FINANCE AND COMMERCIAL VEHICLE FINANCE SECTORS LEAD THE WAY

The FLA's most recent figures also showed that new finance for plant and machinery and business equipment in the three months to November 2016 grew by 14% and 26% respectively, compared with the same period in 2015. In the eleven months to November 2016, most asset sectors reported new business growth. Business equipment finance increased by 17%; commercial vehicle finance by 9%; IT equipment finance and business car finance each by 4%; and plant and machinery finance by 3%.

### HIRE PURCHASE HAS BEEN A KEY DRIVER, MORE THAN 40% HIGHER IN 2016 THAN PRE-CRISIS LEVELS, PARTLY DRIVEN BY CHANGES TO ANNUAL INVESTMENT ALLOWANCES

Hire purchase and leasing make up the majority of asset finance new business, but the growth in these two products following the financial crisis of 2008 looks very different. FLA estimates suggest that asset finance new business provided through hire purchase contracts in 2016 was more than 40% above the pre-crisis high, while leasing new business remained 8% below its pre-crisis peak (figure 3.38).<sup>137</sup>

This could be partly explained by both the type of asset typically purchased using hire purchase and the impact of changes to the Annual Investment Allowance (AIA) since 2012. Plant and machinery, cars and commercial vehicles each make up around 30% of new business written through hire purchase contracts and 77% of asset finance new business for deals of up to £20 million. Post 2009, these have been the three fastest growing sectors.

Under the AIA, businesses can deduct the full value of qualifying assets, such as most plant and machinery, from their profits before tax. The AIA may be claimed

FIG 3.37

### EXTERNAL FINANCE CURRENTLY USED BY SMES

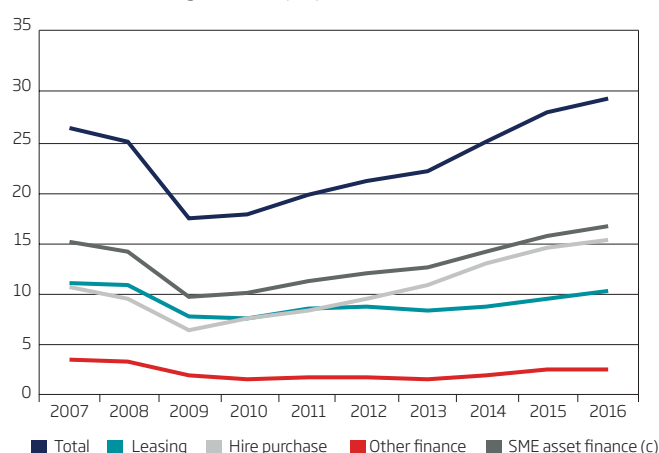
Source: SME Finance Monitor

YE Q2 16 - ALL SMES	TOTAL	Number of employees			
		0	1-9	10-49	50-249
Unweighted base:	19,007	3800	6203	6103	2901
Core products (any)	29%	25%	39%	51%	55%
-Bank overdraft	16%	14%	21%	24%	22%
-Credit cards	16%	13%	22%	34%	40%
-Bank loan	5%	4%	8%	12%	14%
-Commercial mortgage	2%	1%	4%	7%	8%
Other forms of finance (any)	16%	12%	26%	36%	37%
-Leasing or hire purchase	8%	6%	12%	22%	22%
-Loans from directors, family & Friends	6%	4%	10%	9%	6%
-Equity from directors, family & Friends	2%	2%	4%	5%	5%
-Invoice finance	2%	1%	4%	9%	12%
-Grants	2%	1%	3%	5%	6%
-Loans from other 3rd parties	2%	1%	3%	5%	5%
Any of these	36%	31%	49%	60%	62%
None of these	64%	69%	51%	40%	38%

FIG 3.38

### SIZE OF UK ASSET FINANCE MARKET FOR BUSINESSES 2007-2016 - NEW BUSINESS IN £ BILLIONS (a) (b)

Source: Finance & Leasing Association (FLA)



a. Asset finance new business for deals of up to £20 million.

b. 2016 estimates based on actual figures up to November 2016.

c. 2007-2011 SME figures estimated as 60% of total asset finance new business excluding high value transactions of £20 million or more and public sector finance.

against qualifying assets financed under hire purchase contracts, but not if these assets are leased.<sup>138</sup> In 2012, the allowance was £25,000, but this was increased to £250,000 in 2013 and to £500,000 in 2014.

In 2014, plant and machinery asset finance new business grew by 18%, but breaking this down by type of finance product shows that leasing decreased by 9% while hire purchase grew by 24%. The AIA has since reduced to £200,000, but there is still a significant tax incentive to own via hire purchase, rather than to lease qualifying assets.

Commercial vehicles such as lorries, vans and trucks (the fastest growing major asset finance sector since 2012) qualify under the AIA. Whilst cars typically do not qualify under the AIA, businesses can claim capital allowances on cars they buy and use for the business as this is based on the CO2 emissions under the first year allowances regime or the main rate allowances.

#### FLA CONFIDENCE SURVEY SUGGESTS A STABLE OUTLOOK FOR 2017

The FLA's Q4 2016 Asset Finance Confidence Survey suggests a broadly stable outlook for asset finance new business overall in 2017. Two-thirds of respondents expect new business provided through the direct finance channel to remain stable. Respondents providing new business through brokers and the sales finance channel are more optimistic, with 78% and 42% respectively expecting some increase in new business over the next year.

This is despite most forecasts showing that UK business investment is likely to fall in 2017, and suggests that the asset finance market should continue to increase its contribution to share of funding UK investment. The most recent data from the Office for National Statistics (ONS) showed that FLA members funded 32.9% of UK investment in machinery, equipment and purchased software in the twelve months to September 2016, the highest level in more than seven years.

In order to help the asset finance market expand further, the British Business Bank has opened up the Enterprise Finance Guarantee Scheme to include asset finance providers. Funding for asset finance providers is also available through the British Business Bank's ENABLE Funding and Investment Programmes.

## 3.5 ASSET BASED FINANCE

- The total number of businesses utilising asset based finance has remained flat over the last year and remains below the pre-crisis levels which marked a historic high
- Total advances to smaller businesses continue to rise and particularly for the smallest businesses
- As such, the increase in total advances has been driven by increases in the average advance size
- For the smallest of businesses, this meant an increase in average advance of around £10,558 to £49,423, a post-crisis high

FIG 3.39

### NUMBER OF SMALLER BUSINESSES USING ASSET BASED FINANCE IN THE UK

Source: Asset Based Finance Association (ABFA)

Notes: 2016 data up to and including Q3

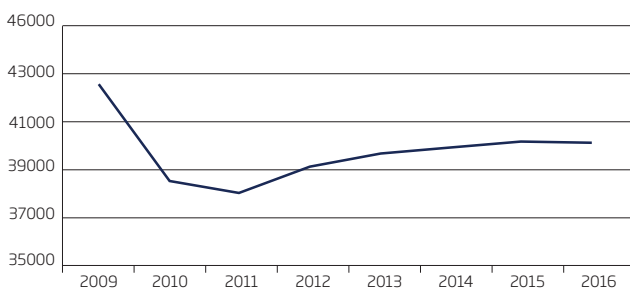
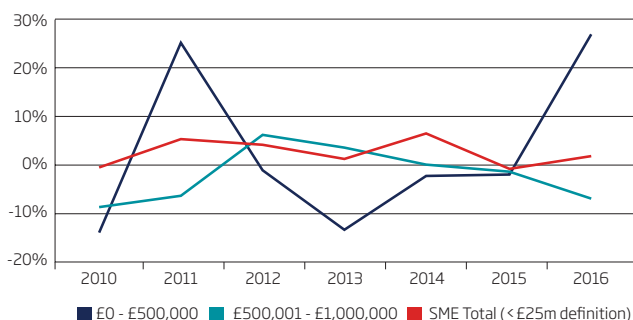


FIG 3.40

### YEAR ON YEAR CHANGES IN QUARTERLY AVERAGE STOCK OF ADVANCES BY COHORT

Source: Asset Based Finance Association (ABFA), Bank of England and British Business Bank calculations

Notes: 2016 data up to and including Q3



Asset based finance is a term used to describe funding against a range of business assets including accounts receivable, inventory, plant and machinery, real property and even (sometimes) intellectual property and brands. The most common types of asset based finance include factoring and invoice discounting (collectively referred to as invoice finance) and asset based lending.

The British Business Bank has worked with the Asset Based Finance Association (ABFA) this year to include data on small business usage of these finance products.

ABFA figures show aggregate numbers of all their members who contribute data. As such, they are the most complete statistics on the UK asset based finance market. The data includes the end of quarter stock of advances to smaller business and the number of unique smaller businesses utilising asset based finance at the end of a quarter. The ABFA uses an annual turnover measure to identify smaller client businesses (turnover less than £25m) and breaks these down further into five cohorts.<sup>139</sup>

**THE TOTAL NUMBER OF BUSINESSES UTILISING ASSET BASED FINANCE HAS REMAINED FLAT OVER THE LAST YEAR AND REMAINS BELOW THE PRE-CRISIS LEVELS WHICH MARKED A HISTORIC HIGH**

The Q3 2016 ABFA figures show the year-to-date quarterly average number of smaller businesses utilising asset based finance is little changed at 40,201 compared to 40,197 for the 2015 year end average (figure 3.39). This was common across the 5 annual turnover cohorts and the average number of smaller businesses receiving advances remains around 2,000 (4%) below the 2009 level.

**TOTAL ADVANCES TO SMALLER BUSINESSES CONTINUE TO RISE AND PARTICULARLY FOR THE SMALLEST BUSINESSES**

Despite this, they also show year-to-date quarterly average total advances to smaller businesses up to Q3



FIG 3.41

### LEVELS OF QUARTERLY AVERAGE STOCK OF ADVANCES BY COHORT

Source: Asset Based Finance Association (ABFA), Bank of England and British Business Bank calculations

Notes: 2016 data up to and including Q3

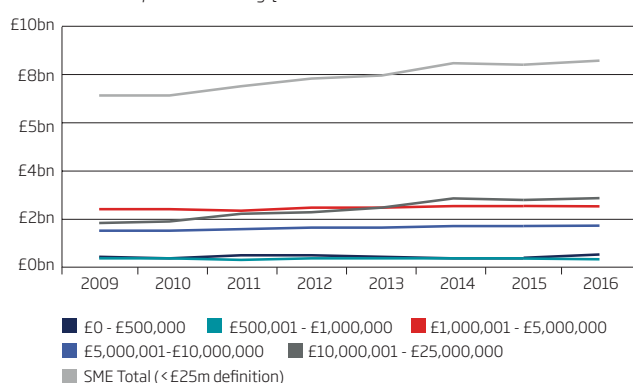


FIG 3.42

### LEVELS OF QUARTERLY AVERAGE ADVANCES

Source: Asset Based Finance Association (ABFA), Bank of England and British Business Bank calculations

Notes: 2016 data up to and including Q3

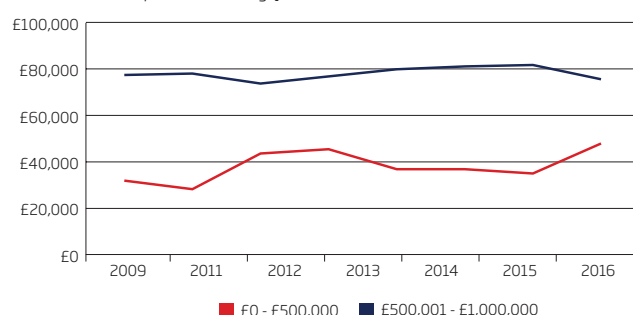
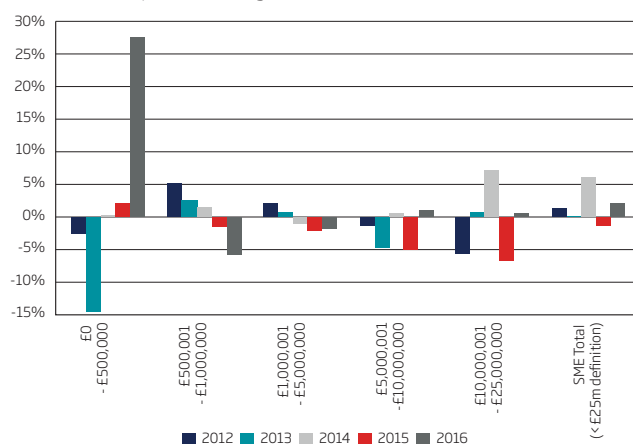


FIG 3.43

### YEAR ON YEAR PERCENTAGE CHANGES IN THE QUARTERLY AVERAGE ADVANCE - LAST 5 YEARS

Source: Asset Based Finance Association (ABFA), Bank of England and British Business Bank calculations

Notes: 2016 data up to and including Q3



2016 were slightly up on the same three quarter period average in 2015 at £8.8bn, an increase of just over 2.1%. This masked some variance amongst smaller businesses cohorts. Advances to the very smallest UK businesses, the most erratic cohort, increased significantly (26%) compared to the same period in 2015 whilst advances to the next size cohort decreased by 7% (figure 3.40).

Total advances for the other cohorts remained broadly flat, though the largest companies marginally outperformed the average with 2.6% growth. Advances to those client businesses with an annual turnover of between £10m and £25m averaged a total of £3bn in the first three quarters of a year for the first time (figure 3.41).

### AS SUCH, THE INCREASE IN TOTAL ADVANCES HAS BEEN DRIVEN BY INCREASES IN THE AVERAGE ADVANCE SIZE

The changes in the total value of advances reflected significant changes in the quarterly average advance for the two smallest business cohorts. The smallest businesses' advances were £10,558 (+27%) higher at £49,423 on average, a post-crisis record. The next cohort received on average £75,405, 5% lower than in 2015 (figures 3.42 and 3.43). The largest cohort received an average advance size of around £1.2m.

Unfortunately, the data the ABFA currently collects does not allow further exploration of this increase in average advances to the smallest cohort. For example, it could be more of the smallest size client businesses coming 'new' to the industry and using more of the finance facilities available to them whilst replacing less intensive client businesses.

Alternatively, it could be predominately the same clients using more of the finance available to them and, as recently suggested by the ABFA, using a wider range of assets to unlock more working capital as well. Anecdotally, the latter seems more likely but the current dataset does not allow more quantitative analysis of this type.

### CONCLUSION

The total number of businesses utilising asset based finance has remained flat over the last year, and remains below the pre-crisis levels. However, total advances to smaller businesses continue to rise, and particularly for the smallest businesses. As such, the increase in total advances has been driven by increases in the average advance size. The British Business Bank continues to support asset based providers through its ENABLE Guarantee and Investment Programmes.



## 3.6 MARKETPLACE LENDING

- There was approximately £3.9bn gross lending facilitated by online platforms in 2016
- Fluctuation in growth of P2P business lending
- Innovative finance ISA may encourage growth in P2P lending
- Evolving structure of the marketplace lending sector

### DEFINITIONS

Marketplace Lenders (MPLs) are online platforms that enable investors to lend to retail and commercial borrowers. Unlike banks, MPLs do not generally take deposits or lend themselves. They make money from fees and commissions received from borrowers and lenders.<sup>140</sup>

Online platform activities are split into three broad types of activity based on the AltFi MarketWatch dataset used in this section of the report.

1. Peer-to-peer (P2P) finance involves the use of internet-based platforms to match online lenders with borrowers. This is broken down into
  - Business lending
  - Property lending
  - Consumer lending
2. Online invoice finance where businesses can selectively sell unpaid invoices
3. Equity Crowdfunding- this is covered in section 3.3 of the report.

Marketplace lending, is a term increasingly used to describe the market mechanisms, usually online, that link lenders and borrowers. This section reviews developments in this growing market, with a focus on business lending.

### THERE WAS APPROXIMATELY £3.9BN GROSS LENDING FACILITATED BY ONLINE PLATFORMS IN 2016

Origination volumes via marketplace lending platforms continues to grow, with total gross finance facilitated reaching £3.9bn in 2016.<sup>141</sup> This reflects strong growth of 34% on 2015 volumes. Peer-to-peer (P2P) business lending to SMEs makes up the highest proportion of this total with £1.31bn of lending facilitated in 2016. P2P consumer lending, accounted for £1.26bn of the gross lending facilitated.

The data on online platform volumes has evolved from previous Small Business Finance Market reports. The AltFi MarketWatch dataset used in this report has been broken down in a more granular way to best reflect the volumes of business lending to SMEs. As a result, the historic data included in this report does not exactly match that of previous years.

The continued growth observed in P2P business lending remains encouraging and contributes to increased diversity in the supply of finance to smaller businesses. These greater flows reflect the increase in awareness of P2P lenders in recent years (see section 2.1).

However, 2016 has however seen a flattening of growth rates. Growth in gross P2P business lending to SMEs for 2016 was 34% up on 2015 volumes, while the corresponding growth rate for 2014 and 2015 were 144% and 79%, respectively.

P2P business lending remains a small proportion of lending to SMEs. Estimates vary, but the gross flows of P2P business lending in the first three quarters of 2016 totalled around £0.9bn, which is equivalent to 2%

FIG 3.44

## CUMULATIVE P2P BUSINESS LENDING - Q3 2010 - Q4 2016

Source: AltFi Data

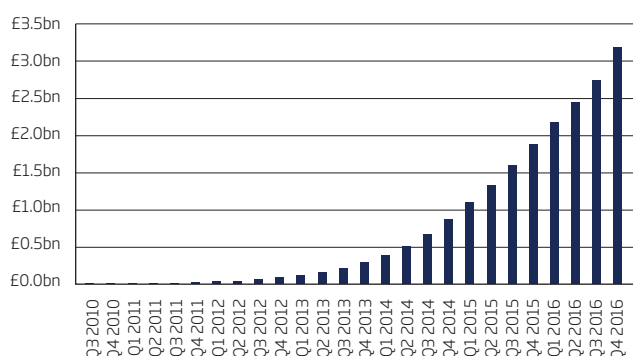
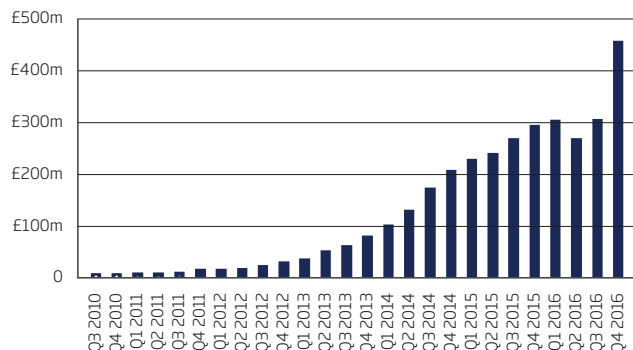


FIG 3.45

## QUARTERLY (NON-CUMULATIVE) P2P BUSINESS LENDING - Q3 2010 - Q4 2016

Source: AltFi Data



of gross flow of all bank lending over the same period as reported in the Bank of England data discussed in section 3.1. If the comparison focuses on the gross flow of term loans only, then the P2P business lending share is significantly higher.

## FLUCTUATION IN GROWTH OF P2P BUSINESS LENDING

As seen in figure 3.45, P2P volumes have been more volatile in 2016 than previous years. Reports of record volumes in March 2016, partly driven by upcoming policy changes to UK property tax law seeing a push-through of real estate backed lending, were followed by a summer slowdown. By September, volumes of finance facilitated by platforms had resurged with record origination volumes for each of the four largest platforms, according to AltFi MarketWatch data. Quarter four also saw a return to strong growth.

Mixed explanations have been offered for the rebounding sector in late 2016. Seasonal variation plays a part, with summer being typically a slower period in the UK while September and October are strong months. Some platforms have also reported spending<sup>142</sup> the early part of 2016 shifting attention inwards to developing infrastructure, new marketing channels and processes, taking the emphasis off growth temporarily and coming back strong through the back end of 2016.<sup>143</sup>

## INNOVATIVE FINANCE ISA MAY ENCOURAGE GROWTH IN P2P LENDING

On 6 April 2016, certain P2P loans became eligible for a new type of Individual Savings Accounts (ISA), the Innovative Finance ISA. However, eligible platforms are required to obtain approval from the Financial Conduct Authority in order to offer this new ISA. This has proved to be a lengthy process. In the medium term, the inclusion of P2P loans should increase choice and flexibility to retail ISA investors, and is expected to stimulate growth in P2P lending markets.

## EVOLVING STRUCTURE OF THE MARKETPLACE LENDING SECTOR

As a relatively new sector, the competitive dynamics continue to shift in online platforms markets. Large players are seeking to entrench their position, for example by vertical and horizontal integration and by innovation in service offering as well as competing on price. Zopa (the largest consumer P2P platform) in particular has been very active in growing its reach, partnering with an online mobile phone shop to provide financing, as well as offering its own provision of car finance. It has also partnered with Airbnb to offer their hosts a discount on their Zopa loan balances, as a form of

reward points for Airbnb rental (hosting) activity. Zopa announced in November 2016 plans to launch an online-only bank challenging high-street lenders, to offer deposit accounts and overdrafts to customers.

At the same time, commercial banks are responding. For example, Barclays launched a direct-to-consumer platform “Barclays Direct Investing” which will offer savings, current accounts and investments.

In the US, where online platforms are more established, this trend is more developed. For example, Wells Fargo launched “FastFlexSM” to offer small business loans; American Express has also launched a short term lending platform for businesses in the US, called “Working Capital Terms”; JP Morgan partnered with P2P platform OnDeck; while Goldman Sachs is launching an online lender for consumers and businesses called “Marcus”.

Marketplace invoice finance platforms have increased in popularity with smaller businesses over recent years. Unlike with traditional invoice financing providers, which are reflected in the asset based finance figures reported in section 3.5, marketplace invoice financing platforms do not provide the funding themselves. After an initial application and approval, a company’s invoices and other trade receivables are instead sold in trading sessions to an investor pool. Whilst the value of advances made via these platforms are not published, the value of the receivables advanced against increased by 44% in 2016 from 2015 to around £480mn.<sup>144</sup>

## CONCLUSION

Gross flows of lending to smaller business via marketplace lenders has continued to grow in 2016, reaching £1.3bn. This type of alternative finance remains an important source of finance for smaller businesses, although it is still relatively small compared to traditional sources of debt finance.

The British Business Bank supports market based lenders through its Investment Programme. Also in 2016, British Business Bank updated its request for proposals to allow peer-to-peer lenders which facilitate the provision of finance to smaller businesses to apply for the ENABLE funding programme. Opening up the ENABLE Funding programme to these providers will give them a similar opportunity to access capital markets more efficiently, increasing the amount of finance that they can provide to smaller UK businesses.

## 3.7

## DEBT FINANCE FOR HIGH GROWTH BUSINESSES

- 
- Private debt funds continue to have an important role in UK finance markets
- 
- Private debt has become an attractive asset class for institutional investors with large increases in fund raising in 2015 and 2016
- 
- The number of venture debt deals are increasing, with new providers entering the market

---

#### PRIVATE DEBT FUNDS CONTINUE TO HAVE AN IMPORTANT ROLE IN UK FINANCE MARKETS

Debt funds provide bespoke debt finance, offering businesses an alternative source of funding to banks. Whilst debt funds tend to accommodate greater levels of risk and lend at higher interest rates than banks, debt funds also offer greater speed in their lending, greater flexibility in deal structure and greater leverage. Preqin shows there are now 133 private debt managers located in the UK, showing private debt is firmly established as an asset class in the UK market.<sup>145</sup> Private debt includes all type of non-bank lending including direct, distressed, mezzanine, special situation and venture debt.

However, data on private debt deals involving SMEs is very limited, and market data is only available on deals involving mid-market companies which does not tend to include deals involving SMEs. It is not possible to provide an up-to-date estimate of the amount of private debt lending going to SMEs as SME markets are not yet fully developed.<sup>146</sup> Private debt lenders continue to increase their deal flow to mid-market companies, although there are signs of the market slowing in 2016 due to wider global uncertainty and evidence of the European private debt market maturing. The Deloitte Alternative Lender Deal Tracker,<sup>147</sup> covering mid-market debt deals in Europe, shows there were 201 European deals overall in the first three quarters of 2016.<sup>148</sup> This was up from 190 in the same three quarters of 2015. However, the number of UK based deals in the last 12 months up to Q3 2016 (91) is 21% lower than the comparable period in 2015.

In the last 12 months, 42% of UK private debt deals were used to finance M&A activity; 23% was for refinancing, and 16% of deals were used for growth capital purposes. Therefore, wider trends in M&A activity are likely to affect business demand and use of lending from private debt funds.

The UK remains the largest market for private debt funds in Europe with 41% of all transactions since Q4 2012, followed by France (25%) and Germany (11%). The majority of UK deals (75%) are structured as first lien (senior debt or unitranche), with the remaining deals are subordinated behind other lenders (mezzanine and second lien). Sponsorless deals are increasing in prevalence in the market. Around 27% of deals in the last 12 months did not involve any PE sponsor.

A number of implemented and proposed regulatory changes are opening up loan origination in a number of European countries, which is likely to grow the European market direct lending market further.<sup>149</sup> Although these changes will not directly affect funds in the UK market, there has been support from the European Securities and Markets Authority for common EU level regulatory framework on direct lending.<sup>150</sup>

#### PRIVATE DEBT HAS BECOME AN ATTRACTIVE ASSET CLASS FOR INSTITUTIONAL INVESTORS WITH LARGE INCREASES IN FUND RAISING IN 2015 AND 2016

The UK private debt market has grown since its emergence in 2010 in response to tighter bank lending conditions and low interest rate environment for investors. Private debt has become an attractive asset class for institutional investors with returns that can outperform some equity investments, provision of ongoing yield and low volatility and correlation with other finance asset classes.<sup>151</sup> Insurance, pension, private wealth, banks and sovereign wealth funds have been the main investors into private debt funds. UK based investors currently have around 6% of their current allocation to private debt making a small but significant part of their investment portfolio.<sup>152</sup>

The UK private debt industry continues to raise greater amounts of funding from investors, reflecting its attractiveness with institutional investors. In 2015, UK based funds raised \$16.2bn (£11bn), up from \$11.9bn (£7.6bn) the year before. This follows wider trends in the European private debt market, which is also growing rapidly. European fund managers have record amounts of funding (\$61bn, £48.8bn) ready to deploy over the next few years. Most debt funds are European in focus, which will also benefit UK businesses looking for funding to support growth.

FIG 3.46

#### NUMBER OF EUROPEAN MID-MARKET DEALS PER QUARTER FROM ALTERNATIVE DEBT LENDERS

Source: Deloitte Alternative Lender Tracker

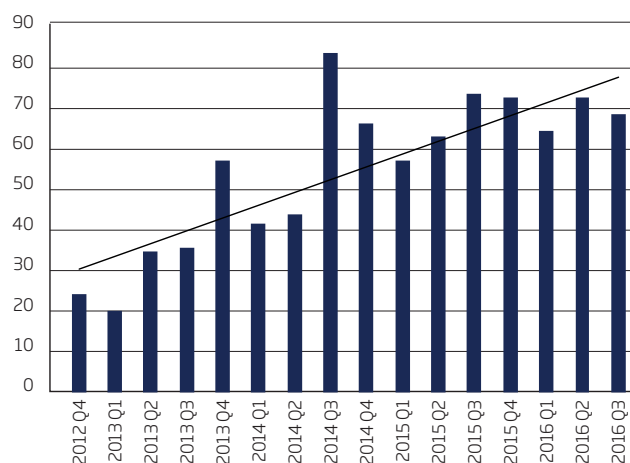


FIG 3.47

#### ANNUAL UK BASED PRIVATE DEBT FUNDRAISING

Source: Preqin "Private Debt in the UK" (September 2016)

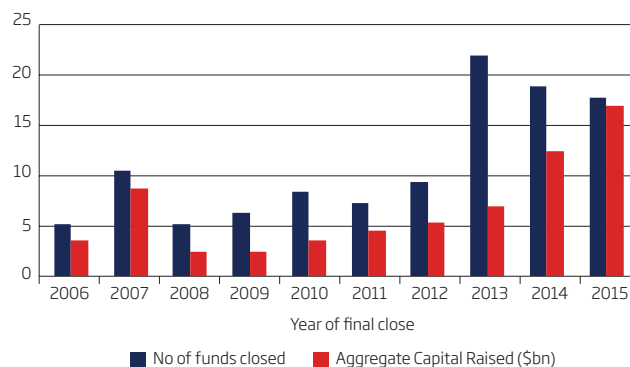
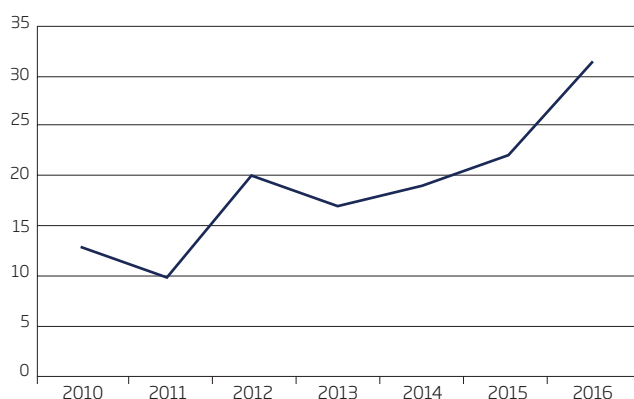


FIG 3.48

**NUMBER OF VENTURE DEBT DEALS IN THE UK PER YEAR***Source: British Business Bank analysis of Preqin<sup>155</sup>*

The success in fund raising is leading to a number of fund managers successfully raising second funds. In many cases, these funds are larger than the first fund. However, with increased fund raising there are also signs that the European market has become more competitive as new fund managers try to raise funds. Preqin shows 42% of private debt funds have been fundraising for 13-18 months, showing some fund managers are experiencing difficulties in closing funds in this competitive environment.

The positive outlook for direct lending looks set to continue. A recent Preqin survey of international investors shows 94% expect the private debt market to increase in the next five years.<sup>153</sup> 46% of institutional investors expect to increase their capital commitment to private debt in the next 12 months compared to the previous 12 months. 84% of investors were happy with the performance of the private debt investments over the previous 12 months. This suggests private debt markets are set to grow further in the years ahead.

**THE NUMBER OF VENTURE DEBT DEALS IS INCREASING, WITH NEW PROVIDERS ENTERING THE MARKET**

Venture debt is often defined as lending to companies that have received some form of equity finance, often venture capital. These companies are usually innovative and at an early stage of their development. They have negative cash flows and limited physical assets to act as collateral. This makes them too risky for most senior debt lenders to lend to. Venture debt is attractive to companies as it does not dilute ownership, whilst providing access to additional funding, often relatively quickly compared to raising another equity round or finding another equity investor. Venture debt is often structured as a mezzanine loan which includes equity warrants.

British Business Bank analysis of Preqin data shows an increase in the number of UK venture debt deals over time, with 2016 being particularly strong, although venture debt deals form a relatively small proportion of the overall VC market. Venture debt was established in the US, and it is clear that the US has a greater number of venture debt deals compared to the UK. For instance, there were 268 venture debt deals in 2016 in the US compared to just 31 in the UK. The average size of UK venture debt deals was around £12m in 2016. Barclay's analysis of Preqin suggests 20% of venture capital

backed companies in the US obtained venture debt at some point, compared to 8.4% in the UK and 5.4% in the rest of Europe, with venture debt most likely to be used in later stage VC investments.<sup>154</sup> This is therefore important for enabling businesses to scale-up given UK companies receive less later stage equity funding than US companies.

The UK has a number of established venture debt providers including Silicon Valley Bank and Kreos, but a number of new providers have also recently entered the market to provide finance to innovative high growth businesses. These include finance providers funded by the British Business Banks's Investment Programme including BMS Finance<sup>156</sup> and BOOST&Co, who undertake a range of private debt lending including some venture debt.<sup>157</sup> In addition, Barclays also launched a debt fund in 2015<sup>158</sup> that targets young innovative high growth business and has recently extended it to £200m.<sup>159</sup>

## CONCLUSIONS

The British Business Bank through its Investment Programme is focusing on supporting funds targeted at SMEs to help this part of the market to develop and grow. The Investment Programme, along with its predecessor, the Business Finance Partnership Small Cap Tranche, promotes diversity of lending supply. To date, the British Business Bank has committed a total of £250m to eight private debt funds focusing on SMEs. These include Beechbrook, BMS Finance, BOOST&Co, Praesidian, Muzinich, European Capital and Cordet Capital Partners. These funds provide a range of different types of debt including senior secured loans to flexible mezzanine and unitranche debt.

The British Business Bank's Help to Grow programme aims to increase the provision of smaller growth loans to SMEs with expected loan sizes of between £0.5m and £2m. Providers are due to start lending to businesses in early 2017.

The European Investment Fund has made a number of investments in private debt funds based in UK including Beechbrook, as well as European Funds that lend to UK companies.<sup>160</sup>

## CHAPTER FOUR

# DIVERSITY OF SUPPLY

The OECD described an effective financial system as one that can supply financial resources to a broad range of companies in varying circumstances and channel financial wealth from different sources to business investments.<sup>161</sup> During the financial crisis the effectiveness of the UK smaller business finance markets came under strain and the supply of finance to smaller businesses reduced significantly.

Whilst during the crisis this was partly a cyclical issue, structural issues in the supply of finance to SMEs have long been identified, with the latest being the Retail Banking Market Investigation by the Competition and Markets Authority (CMA).<sup>162</sup>

A core objective of the British Business Bank is to create a more diverse and vibrant finance market for smaller businesses with a greater choice of options and providers. Chapter Four presents a framework for assessing the benefits of having diversity within smaller business finance markets.

Section 4.1 explains the importance of having a diverse set of finance providers, and how diverse funding is essential to achieve this. The impact of having different methods to deliver finance to smaller businesses is discussed from both a demand and supply perspective.

Challenger banks can be a source of great diversity for smaller business finance markets. Challenger banks are usually defined as those banks outside of the Big Four clearing banks - or Big Five including Santander UK. Challenger banks include new entrants to the market, spin-offs 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. Section 4.2 presents the latest developments for challenger banks and comments on their near-term prospects.



## 4.1

THE BENEFITS OF DIVERSITY IN  
SME FINANCE MARKETS

- 
- Who: diverse finance providers and diverse funding sources are required to increase diversity of products which can increase the range of SMEs who can access finance
- 
- When: diverse products and providers can deliver finance at a range of speeds to better suit the needs of an SME
- 
- What: greater diversity of providers can lead to improved terms that benefit SMEs
- 
- How: how a smaller business applies, receives or pays for funding can be a very real restriction on access to finance, so flexibility and variety can benefit SMEs
- 
- Appropriateness: even if a particular product or provider has the lowest price or the most appealing terms, it doesn't necessarily mean they are the most appropriate finance solution

## INTRODUCTION

Diversity of finance can increase access to finance for a wider range of smaller businesses throughout the credit cycle and can improve smaller business financial market stability. Diversity of finance can also improve the terms and ease of use of finance available to smaller businesses and the appropriateness of the finance including for those who already have access to at least one finance product or provider. Indeed, the recent British Business Bank 2016 Business Finance Survey highlighted the range of reasons that drive smaller businesses when choosing a provider. Figure 4.1 highlights that there is no 'standard' smaller business and no one size fits all funding solution.

This chapter is divided into the impact diversity has on who, when, what and how SMEs access finance and these are defined at the start of the respective sections. Across each section we look at the impact of diversity within products, providers, and where applicable sources of funding (see figure 4.2).

## WHO

Who refers to which smaller businesses can access finance (at any given time or through the credit cycle). External finance is important for funding start-up, scale-up and stay-ahead businesses, and can be used for everything from working capital to investment in fixed assets. Ultimately finance helps to preserve or create jobs and wealth for the UK economy. Without external finance these businesses become heavily reliant on savings, friends and family for finance. This is not an option for many and can mean stagnation or failure.

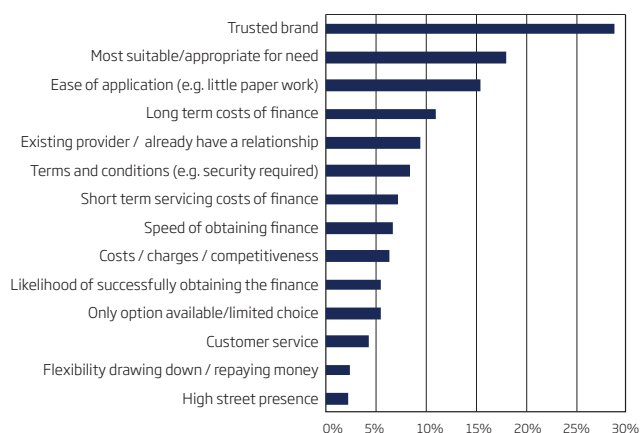
While the overall market has undoubtedly improved, British Business Bank analysis indicates that weaknesses and structural imperfections persist in specific areas of the market across the UK. Local distribution is uneven. As such the first question for many SMEs is simply can they get finance?

FIG 4.1

**REASONS FOR CHOOSING A PROVIDER**

Source: British Business Bank 2016 Business Finance Survey - Ipsos MORI

Notes: Base: all SMEs that contacted only one provider (n=461 in 2016). Multicode, unprompted.

**FOR AN SME TO GET FINANCE THERE HAS TO BE A PRODUCT AVAILABLE THEY QUALIFY FOR**

The more diverse available products are, the more likely an actively searching and financially sophisticated smaller business will be able to find finance. Taking the example of a young business, it may struggle to get access to core products as they often require a demonstrable track record that many young businesses do not have.<sup>163</sup> However, these firms may be able to receive finance via alternative products with different qualifying criteria. For example funding based on the value of specific assets rather than on their own credit rating may be available. They may also be able to take equity, rather than debt, where the investors can accept higher risk in exchange for potentially greater returns.

Access to finance and finance products is also not consistent across the UK with uneven local distribution. In particular, fewer equity deals occur for smaller businesses located in regions outside of London and the South East. As a result, a much smaller number received equity given the population of businesses in these regions that may be suitable for equity finance.

**IT IS NOT AS SIMPLE AS JUST HAVING LOTS OF DIFFERENT PRODUCTS AVAILABLE IN THE MARKET**

The British Business Bank has consulted with several challenger banks, who have explained how they design their products and how they differ from those available from the big banks.

Using the example of asset finance, the big banks underwrite using probability of default as the starting point, whilst many challenger banks underwrite using loss given default first and foremost. This leads to very different products being offered by the two types of provider. This focus on loss given default, which is an asset focused measure rather than a borrower focused measure, means a different cohort of smaller businesses are potentially eligible for such products.

Furthermore some specialist or niche markets are seen as too small or too complex for larger, multi-product providers to offer a product at all. This is because the resources they would need to spend creating an appropriate product would be disproportionate to the potential returns and volumes. For other providers with different cost structures however, there is potentially enough return that it is profitable for them to offer a product that provides access to finance for the impacted smaller businesses.

Having a diverse range of providers can also increase stability within finance markets. Providers from the same industry, or sharing key characteristics, can be adversely impacted by a single market event. The recent financial crisis highlighted systemic risks within the western banking system, with banks across Europe and the US

FIG 4.2

### TYPOLGY OF ADDITIONALITY OF DIVERSITY OF FINANCE

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

suffering losses and struggling to access their traditional market funding sources.

Following the crisis, lending conditions were further impacted by stricter regulations around capital adequacy. Smaller business lending attracted a high risk-weighting in the adequacy calculations which decreased margins and reduced lending to the heavily bank lending reliant smaller business sector.<sup>164</sup> Having more diverse providers willing and able to lend significant amounts (as non-banks are not impacted by the same capital adequacy requirements) could in the future limit the impact on smaller businesses.

### IT IS NOT AS SIMPLE AS JUST HAVING LOTS OF DIFFERENT PROVIDERS ACTIVE IN THE MARKET

Despite diversity of supply in the retail provision of asset and asset based finance to SMEs, volumes of lending from asset and asset based finance providers also reduced significantly between 2007 and 2009 (see figure 3.8 – section 3.4).

A contributing factor to the constrained supply is likely to have been the degree of concentration in the sources of funding for asset and asset based finance providers. Knock-on effects are caused by reliance of asset and asset based finance providers on funds from other lenders such as banks.<sup>165</sup> This is particularly the case for many mid-sized to smaller non-bank providers of asset and asset based finance. Therefore, if an asset finance provider cannot get funding from an alternative source, then adverse banking conditions can impact the supply of credit from non-bank finance providers as well.

In some cases alternative funders can support products that would otherwise simply not exist. These products can include grants, funded by public sector bodies or charities, and provided via delivery partners with the aim of improving access to finance for those sectors, regions or demographics seen as underserved by traditional SME finance markets.

### WHEN

For some smaller businesses who have established they can access finance, the next question is when they can get it. The need can often be the result of a shock failure of a supplier or customer, an unexpected cost, inaccurate financial planning or positive reasons like an unexpected new order or opportunity (see figure 4.3).

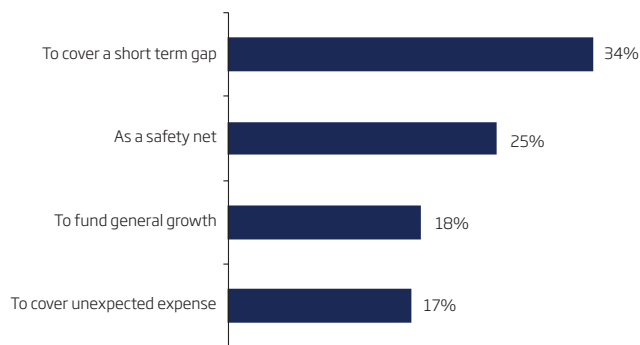
The quickest way to access funding is usually via an overdraft or line of credit. These are only quick if they are already in place meaning many smaller businesses will not have these available to them when they need finance in a hurry. This is sometimes given as a reason why SMEs maintain cash reserves, if they can. For many forms of finance there is often a time lag between applying and receiving finance due to non-standardisation, i.e. a bespoke response and/or product is required or because of due diligence requirements. Regardless of cause, the end result may mean that an SME cannot get finance fast enough to meet their needs, which is effectively no access to finance at all.

FIG 4.3

**MOST COMMON REASONS FOR SEEKING WORKING CAPITAL**

Source: British Business Bank 2016 Business Finance Survey - Ipsos MORI

Base: all seeking finance for working capital, n=304

**HOWEVER, THERE ARE PRODUCTS WHERE A DECISION CAN BE MADE WITHIN DAYS AND FINANCE CAN BE DELIVERED TO THE SMALLER BUSINESSES QUICKLY**

One example is invoice finance, a term which covers both invoice discounting and factoring, which can offer a way for businesses, in particular smaller ones, to raise finance against their receivables and often in a short period of time. Invoice finance is provided through a framework agreement which sets out the terms. Once that is agreed and the finance provider understands the business, the raising of an invoice will ordinarily release funding on the day of receipt.

**WHILST THE NATURE OF SOME PRODUCTS CAN INFLUENCE THE SPEED OF FINANCE AVAILABILITY THE SAME CAN BE THE CASE FOR FINANCE PROVIDERS, EVEN FOR THOSE OFFERING CORE PRODUCTS**

For an SME who needs finance in a hurry, many traditional lenders can take too long to make a decision and/or deliver significant amounts of finance. Whilst a business' main bank potentially has most of the data it requires to make a decision on a finance request, it may still require the SME to resubmit documentation and information. This is either due to compliance rules or because they are unable to utilise the data due to legacy technology and processes.

Some peer-to-peer (P2P) lenders can provide responses to initial term loan applications within hours, and a loan can be deliverable within days. Rather than investing their own funds, P2P lenders match borrowers and investors and make money from fees charged to the borrower and/or from commission on the interest received by the investors. For such firms, it is a business model based on the flow of new loans. As such many P2P lenders' systems are built for speed to aid the flow of new loans and maintain this point of difference.

P2P lenders are typically online orientated and use technology to streamline their processes. They can achieve quick decisions by making one or more changes to the traditional face-to-face models prevalent in banks. For example they can accept online applications, albeit with associated risks, instead of in-person applications. This may seem trivial, but it can have a significant impact on delivery times as it can be difficult to get an immediate appointment with a traditional lender or the applicant may not have time to attend an appointment during business hours.

## WHAT

Once a smaller business has ascertained that they can access finance and within the timeframe they require, the next question is often on what terms they can get that finance. Terms cover not just the headline cost, but also the duration of the finance, collateral requirements and any other conditions or restrictions imposed once an agreement is in place. For many SMEs, if the price or the terms (such as collateral requirements) of the finance are too high, this can lead to them either turning down the finance or can offset some or all of the value of receiving the finance.

### THE PRESENCE OF A DIVERSE RANGE OF PRODUCTS SHOULD NOT RESULT IN IMPROVED TERMS PER SE

In consumer theory, substitutes are products that a consumer, in our case an SME looking for finance, perceives as similar or comparable, meaning they would require one or the other rather than both. Formally, X and Y are substitutes if, when the price of X rises, the demand for Y rises.

Whilst it is difficult to argue differing finance products are perfect substitutes, it is easier to argue that differing finance products can be used for the same purpose. For example, overdrafts, invoice finance and certain P2P products may be competing for some of the same customers. However, whilst there is evidence of differing products impacting each other's terms in the consumer finance markets, evidence of diversity of product improving the terms available in the small business finance markets is hard to find.<sup>166</sup>

### GREATER DIVERSITY OF PROVIDERS CAN LEAD TO IMPROVED TERMS FOR SMES VIA TWO MAIN CHANNELS

Competition, in the absence of market imperfections, should bring about efficient outcomes. With competition, the market mechanism works by encouraging new providers or products to enter more profitable market segments, driving out excess returns or terms, while also driving out firms that are operationally inefficient or unable to innovate. Nearly every non-monopolistic market, financial or not, has at some time witnessed competitors attempting to increase profit, market share or to drive out competition via offering better terms.

Competition based on price has most commonly been seen at the low risk end of the smaller business financial markets and amongst larger providers. A previous report noted a number of companies in the asset finance space indicated that prices offered to businesses had reduced in recent years by 2-3%, because of intense price competition due to the lower cost of borrowing and the volume of available cheaper funding.<sup>167</sup>

The second channel is via differentiation. When deciding what to offer a potential customer, a provider will take into account many factors. Key drivers are internal factors like their own cost of funding, their business model, incentives, risk appetite and skillsets. The combination of these can lead to innovation and/or improved terms on existing products.

## HOW

A final consideration can be how a smaller business applies, receives or pays for funding. This can impose real restrictions on access to finance for some, and represent the difference between deciding whether to seek and/or accept finance. Recent technological developments and the low interest rate environment have led to innovations for both borrowers and funders.

### FOR SOME SMALLER BUSINESSES, THE OPPORTUNITY TO NOT ONLY RAISE FINANCE BUT ALSO ENGAGE DIRECTLY WITH THE INVESTOR IS VERY APPEALING

Over the past few years, a significant number of companies ranging from start-up restaurants to established department stores have issued mini-bonds as a way of securing debt-based finance. Mini-bonds can offer flexibility in payment terms and investor interaction not usually available to an issuer in more traditional funding markets.

Several high profile deals have used payment in kind - such as gift boxes or instore discounts - instead of, or at least partially replacing, the monetary payments usually associated with more standard bonds. Not only can this be cheaper for the issuer, but it can also be a way of engaging with their investor and customer base, potentially encouraging investors to become regular customers and advocates for the brand, or turning their customer base into loyal investors.

As well as the flexibility in payments and scope for enhanced interaction with investors, mini-bonds also offer a further benefit to the issuer. Mini-bonds cannot be traded and are not listed on any market. As such, the regulatory requirements are much less stringent than for listed bonds. This can reduce the set up costs, in terms of both time and fees for the issuer. However, as they are less regulated, they could potentially require a greater amount of knowledge and due diligence on the part of a prospective retail investor to ascertain whether a specific mini-bond is a suitable investment.

#### FINALLY, HOW A SMALLER BUSINESS ENGAGES WITH ITS PROVIDER CAN BE JUST AS IMPORTANT

This may be due to a variety of reasons including something as simple as having a branch conveniently located for an SME. For the smaller or less financially sophisticated SMEs, a relationship with their finance provider(s) can involve a significant amount of business support. This can be driven by comfort / familiarity, a need for guidance or simply convenience. The opposite case can also be true. A smaller business may require a provider with an excellent online offering, due to an inability or unwillingness to go to a branch, or time constraints. It could also be because they know what they want, when they want it, and simply need it delivering in the most convenient and efficient manner.

Whilst not finance providers in themselves, finance platforms can be very beneficial for SMEs who might not know what type of finance is available to them or which finance providers are out there, but are financially sophisticated enough to understand their options if presented with them. The ability to search multiple products and providers quickly and easily via a single process can be very useful for time constrained SMEs. Many finance platforms offer the SME an opportunity to fill in one set of questions in an attempt to work out what finance the SME requires, and which products, and providers from their panel of lenders may be the best fit.

#### APPROPRIATENESS

Every small business and every circumstance is different, meaning there is no one size fits all product or provider. As described above, a potential myriad of factors need to be taken into account when deciding which finance option is the most appropriate for any given small business at any given time. If an SME chooses

an inappropriate finance product or provider, it can lead to restrictions on their future growth potential.

#### EVEN IF A PARTICULAR PRODUCT HAS THE LOWEST PRICE, THE MOST APPEALING TERMS, OR IS SIMPLY THE EASIEST TO GET, IT DOESN'T NECESSARILY MEAN IT IS THE MOST APPROPRIATE PRODUCT FOR AN SME

Whilst bank lending is the most common source of external finance for many smaller businesses to fulfil their start-up, cash flow and investment needs, traditional bank finance can pose challenges. In particular, this can pose a challenge to newer, innovative and fast growing companies, with a higher risk-return profile. These firms may be better suited to alternative forms of finance.

A British Business Bank report further explored the difficulties faced by growing smaller businesses when looking for finance.<sup>168</sup> It found that senior debt providers typically require collateral and that high growth businesses can soon exhaust their available collateral. In addition, interest payments on senior debt can constrain the cash flow available for investment at growth orientated businesses in the early stages of growth.

Equity financing - where cash is injected but without the expectation of regular payments coming out of the business' cash flow - can be more appropriate for such companies. Seed and early stage equity finance can boost firm creation and development, whilst other equity instruments can provide financial resources for growth-oriented and innovative SMEs.

#### IN SOME CASES A PARTICULAR PROVIDER MAY BE MORE APPROPRIATE FOR AN SME

For some smaller businesses their choice of finance may be as much about the provider as the product. Dragons Den is a high profile TV example which offers entrepreneurs the chance to secure equity investment. But many of the entrepreneurs that go on the show are not there because it is the cheapest or easiest route to finance. In addition to the cash on offer to successful applicants, they hope to benefit from the exposure, expertise and contacts that being on the show can offer.

But this isn't limited to TV shows; many equity investors and venture capital companies contribute value over and above simply supplying funds. They are often led by individuals or management teams with expertise

and a track record in growing and building a business in a specific sector, with deep networks. For some smaller businesses, this advice and access to partners or customers can be more valuable than the finance itself.

Advice can be particularly important in areas where the smaller business has limited knowledge within the company. Research has highlighted the importance of professional advice and the related positive impacts it can have on smaller businesses' performance.<sup>169</sup> Accountancy is often highlighted as the most sought after external advice. For business owners and management, awareness of the choices available allows the business to make well-informed financing and planning decisions. For others, access to an adviser or funders' network or contacts can be a key driver of success.

In addition, recent assessments of the needs of fast growth firms suggest that supporting sustained growth requires a holistic model that combines the development of the business with the development of the capabilities of the firm's leadership team. Moreover, advice that builds capability within the firm is likely to require a face-to-face interaction because of its greater breadth of impact on a wider set of aspects of the firm's operations and behaviour. Professional advice when focussed on a company's need works – and more intensive advice works better.<sup>170</sup>

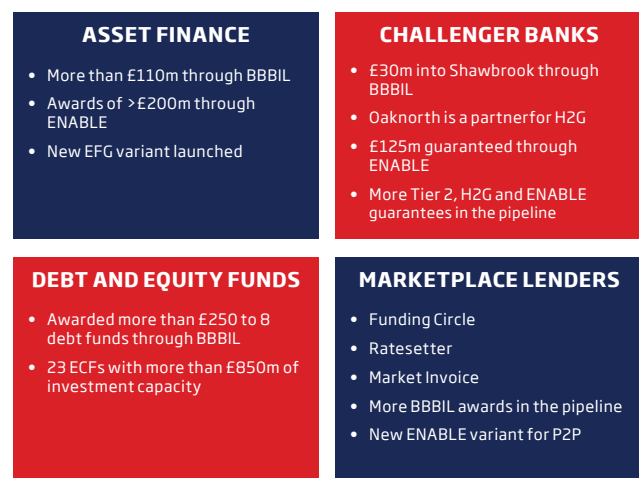
The British Business Bank has invested through a diverse range of finance providers over the past two years, including those mentioned above (figure 4.4). Nevertheless, smaller businesses remain heavily dependent on the big banks and there remains much work still to be done to create a truly diverse smaller business finance market.

FIG 4.4

#### BRITISH BUSINESS BANK KPI2: CREATE A MORE DIVERSE, SMALLER BUSINESS FINANCE MARKET

Source: British Business Bank

Notes: British Business Bank Investments Ltd (BBBIL)





## 4.2

## CHALLENGER BANKS

- 
- Challenger banks are a great source of diversity in finance markets
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- After several years of growth and improving credit conditions 2016 saw challenger banks face their own challenges

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#### CHALLENGER BANKS ARE A GREAT SOURCE OF DIVERSITY IN FINANCE MARKETS

2016 has seen more new challengers entering the market. Whilst not all are currently active in the small business finance markets, 10 brand new UK banks have been authorised since May 2015, with several more in the pipeline.<sup>171</sup> In addition to competition, challenger banks can bring innovation to existing products, as well as varied business models, ranging from seven days a week branches to digital only offerings, that can suit a wider range of smaller businesses.<sup>172</sup> Furthermore, rather than directly challenging the big banks, they often target previously underserved niche markets.

Some of the big technology companies are also active, albeit in a limited fashion, within the SME space. For example, Amazon has started targeted lending to vendors in the Amazon Marketplace. Some industry commentators expect such companies to become a growing presence in the SME finance industry over time as they utilise the transactional data they have available to compensate for information asymmetries when deciding whether to lend to an SME. These big data approaches, of course, have yet to be tested over a credit cycle.

#### AFTER SEVERAL YEARS OF GROWTH AND IMPROVING CREDIT CONDITIONS 2016 SAW CHALLENGER BANKS FACE THEIR OWN CHALLENGES

Several of the challenger banks, and the smaller ones in particular, saw their share prices fall significantly compared to the big four following the EU referendum result in June 2016 (figure 4.5). This was due to the domestic focus of this group, which often has a significant proportion of UK assets linked to property loans and UK house builders, compared to the more global outlook of the bigger banks. It is also a function of the expectations of lower growth for the UK economy.

A secondary impact was at least one challenger bank that had previously intended to enter the UK SME finance market publically stated it had deferred plans to lend to



smaller businesses because of the economic uncertainty post-referendum. It said it would instead focus on preserving the quality of its existing loan book.

A further impact of the referendum vote was the announcement of the Bank of England's Term Funding Scheme (TFS). The TFS will provide funding to eligible institutions (UK banks and building societies that are participants in the Bank's Sterling Monetary Framework and signed up to the Discount Window Facility) that choose to participate.<sup>173</sup>

These institutions will be able to borrow central bank reserves at close to Bank Rate. The lowest cost of funding (Bank Rate) will be for banks that maintain or expand net lending to the real economy. Conversely, if their lending shrinks, they will face a higher fee. As such, the impact on challenger banks - and whether that impact will be positive or negative - will depend on two things: whether they have access to the TFS and whether they expand, hold steady or decrease their net lending over the period that TFS is operational.

As discussed in section 4.1, capital requirements can impact lending volumes, particularly to businesses attracting a higher risk-weighting in the calculations. The Capital Requirements Directive currently applies Basel standards to all banks and building societies regardless of size. Small banks using the standardised approach to credit risk must hold much more capital against similar lending than larger institutions using the Internal Ratings Based (IRB) approach. This is because smaller and newer banks do not have the data required to demonstrate to the regulator that they are lending prudently. As a result, some challenger banks say they cannot compete effectively in some market segments, including lending to small businesses.

## CONCLUSION

With around 20% of gross lending to SMEs estimated to be currently provided by challenger banks, these potential headwinds will be keenly followed by market participants. They are the first real challenges to the sector post-crisis.<sup>174</sup>

Whilst the recent economic uncertainty has impacted share prices, and short-term strategies, funding costs and capital requirements remain amongst the most commonly cited obstacles to challenger banks increasing their lending to smaller businesses.

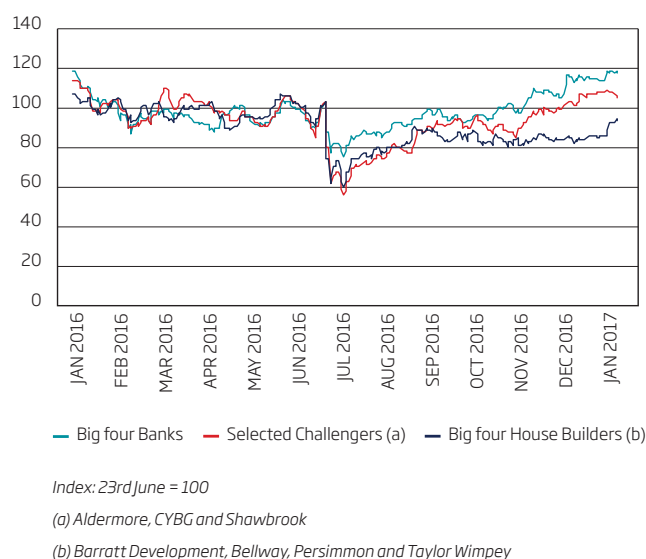
The British Business Bank's ENABLE Guarantee programme is designed to encourage additional lending to smaller businesses. Challenger banks who participate in the scheme are able to lend more to smaller businesses as the guarantee reduces the capital they need to hold against their loan portfolio.

In addition challenger banks are also eligible to apply to the British Business Bank's Investment Programme.

FIG 4.5

### CHALLENGER BANK EQUITY PRICES FELL FURTHER THAN THE BIG BANKS POST EU REFERENDUM

Source: Bloomberg and British Business Bank calculations



# GLOSSARY

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

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

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

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

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

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

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

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

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

**CROWDFUNDING** 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 of these values.

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

**FINTECH** Finance providers or financial service providers which use technology and /or innovative delivery and assessment models are applied to the financial services industry.

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

**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 receives 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.

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

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

**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.

**NON-AMORTISING** Payments which 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)** Peer-to-peer finance involves the use of internet-based platforms to match online lenders with borrowers. This can be broken down into business lending, property lending and consumer lending. Peer-to-peer lending platforms make money from fees charged to the borrower and/or from commission on the interest received by the investors.

**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

## EXECUTIVE SUMMARY

1. British Business Bank calculations of figures contained in "EIF in the UK" converting EUR to GBP and calculating average committed per year from total committed amounts. [http://www.eif.org/news\\_centre/publications/country-fact-sheets/EIF\\_Fact-sheet\\_UK.pdf](http://www.eif.org/news_centre/publications/country-fact-sheets/EIF_Fact-sheet_UK.pdf)

## CHAPTER ONE

2. This report contains published evidence as at 11th January 2017.
3. Bank of England, Credit Conditions Review, 2016 Q4.
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15. Enterprise Research Centre UK Local Growth Dashboard 2016. <http://www.enterpriseresearch.ac.uk/uk-local-growth-dashboard-2016/>
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39. OBR Economic and Fiscal outlook November 2016 <http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/>
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41. Growth GVA per head in Greater Manchester (3%), Birmingham (4.2%) and Leeds (3.5%) was higher than across England (2.1%) and the United Kingdom (1.8%) in 2015.
42. ONS A Review of Regional and Sub-Regional Productivity Statistics. <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/labourproductivity/articles/areviewofregionalandsubregionalproductivitystatistics/2016-04-06>
43. Building our Industrial Strategy January 2017. <https://www.gov.uk/government/consultations/building-our-industrial-strategy>
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48. The Business birth rate is calculated based on the total number of business births in a region divided by the total number of active businesses in that region.
49. Fast growth is defined as annualised average growth in employment of 20% or more over a three year period (data from 2012-2015). Source: Enterprise Research Centre UK Local Growth Dashboard 2016. <http://www.enterpriseresearch.ac.uk/uk-local-growth-dashboard-2016/>
50. Northern Ireland records much higher rates of scale-ups (average 9.1% compared to 4.4% in England); however this may be in part due to the proportionately smaller number of businesses in Northern Ireland. Scale-up data is also from the Enterprise Research Centre Growth Dashboard.
51. The two business confidence Indexes referred to here only cover businesses in Great Britain; Northern Ireland is not included in these surveys and therefore not reported.
52. FSB Voice of Small Business Index Q4 2016. <http://www.fsb.org.uk/DFA0DED8-BE66-4620-BD96-DE706E02C2A4>
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55. BBA SME Bank Lending Data Q3 2016 (4 quarter average). <https://www.bba.org.uk/news/statistics/sme-statistics/>
56. Funding issues confronting high growth SMEs in the UK. <http://eprints.lse.ac.uk/DFA0DED8-BE66-4620-BD96-DE706E02C2A4>
57. British Business Bank 2016 Business Finance Survey (Ipsos MORI).
58. British Business Bank analysis of Beahurst data covering Q4 2015 - Q3 2016, the most recent 12 month period where data is available.



59. The data in figure 1.16 only covers up to 2015 as the final quarter data of 2016 is not yet available. It would be misleading to include only three quarters of data for 2016 in the figure as it would not be comparable with the previous years of data that cover four quarters.
60. British Business Bank 2016 Business Finance Survey (Ipsos MORI).
61. NPIF covers 10 English LEP areas; Cheshire and Warrington LEP, Cumbria LEP, Greater Manchester Combined Authority, Lancashire LEP, Liverpool City Region LEP, Humber LEP, Leeds City Region LEP, Sheffield City Region LEP, The York, North Yorkshire and East Riding LEP and Tees Valley Unlimited LEP. MEIF covers 10 English LEP areas; Greater Birmingham and Solihull LEP, Worcestershire LEP, Black Country LEP, Stoke & Staffordshire LEP, Coventry & Warwickshire LEP, The Marches LEP, Derby and Derbyshire, Nottingham and Nottinghamshire LEP, Greater Lincolnshire LEP, Leicester and Leicestershire LEP and South East Midlands LEP.

## CHAPTER TWO

62. For example growth loans, development capital, flexible debt, on-lending, stretched debt, cash-flow lending, venture debt, subordinated finance, synthetic equity, hybrid instruments, etc. Analysis of the UK Smaller Business Growth Loans Market (2015).
63. 38% of smaller businesses went directly to their main bank when they first identified a financing need in the most recent occasion, based on the British Business Bank 2016 Business Finance Survey. The base for this question was all that sought finance for reasons other than being proactive in the last three years, single code, unprompted.
64. The responses included in this total are: Researched finance types and products on the internet, researched finance types and products in magazine/newspaper articles, spoke to accountant, spoke to finance advisor, sought advice from other businesses/friends, spoke to board/directors/seniors, looked into finance options, spoke to colleagues/directors, spoke to local council, spoke to the supplier/deal/manufacture about available finance options.
65. See CMA Retail banking market investigation, Final Report, 9 August 2016 p. 304 para 8.201 <https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf>
66. For more information see <http://british-business-bank.co.uk/bank-referrals/>
67. The 9 current designated banks are: AIB Group, Bank of Ireland, Barclays Bank, Danske Bank, HSBC Bank, Lloyds Banking Group, Royal Bank of Scotland Group and Santander UK. The 3 current designated finance platforms are: Business Finance Compared, Funding Options and Funding Xchange.
68. BDRC Continental (2016), 'SME Finance Monitor Q2 2016'. <http://bdrcc-continental.com/products/sme-finance-monitor/>
69. Due to the addition of interest payments, albeit the cost of external debt finance is historically low.
70. Sub-optimal could be in terms of propensity to use where a good investment opportunity has been identified and/or in terms of selecting a product that is not most appropriate for the SMEs' requirements. For example, use of an overdraft to purchase a tractor - this could be funded using asset finance, where better/more suitable terms and pricing are likely.
71. CMA Retail banking market investigation, Final Report, 9 August 2016 <https://www.gov.uk/cma-cases/review-of-banking-for-small-and-medium-sized-businesses-smes-in-the-uk>
72. A 10 quarter dataset is used to ensure sufficient underlying sample size.
73. Permanent non-borrowers are not using external finance, haven't used it in the past 5 years, have not applied for any finance in the last 12 months or had a need to, and have no intention to apply in the next 3 months.
74. Would-be seekers are those SMEs that had not had a borrowing event but where something had stopped them applying in the previous 12 months.
75. For more information see <http://british-business-bank.co.uk/bank-referrals/>
85. EFG facilitates lending to smaller businesses that are viable but unable to obtain finance from their lender due to having insufficient security to meet the lender's normal security requirements.
86. British Business Bank, Enterprise Finance Guarantee (EFG) scheme strategic and operational design review 2015/16. <http://british-business-bank.co.uk/wp-content/uploads/2016/04/Enterprise-Finance-Guarantee-Review-20-Apr-2016-final.pdf>
87. DCLG Single Departmental Plan 2015 <https://www.gov.uk/government/publications/dclg-single-departmental-plan-2015-to-2020>
88. 2014 DCLG Household projections. <https://www.gov.uk/government/collections/household-projections#2014-based-projections>
89. Household projections are trend-based and indicate the number of additional households that would form if recent demographic trends continue.
90. Source Department for Communities Local Government (DCLG).
91. <http://www.parliament.uk/economics-uk-housing-market>
92. FMB House Builders Survey September 2016.
93. CBI No place like home, delivering new homes for a more prosperous Britain, October 2016.
94. Typically used in economics where one party has more or better information than another. BIS Economics Paper No. 16 refers to, "A structural market failure exists in the provision of debt finance to SMEs due to asymmetric information between the lender and the business. It is difficult for the lender to distinguish between high and low risk entrepreneurs without incurring significant costs. To avoid the costs associated with gathering this information, lenders often require borrowers to provide evidence of a financial track record and/or collateral as security for the finance. Therefore, a market failure exists because the financial institution's decision to lend is based on collateral and track record, rather than the economic viability of the business."
95. The SME Finance Monitor is produced by BDRC Continental. Full details of criteria for qualifying SMEs are detailed in their reports and available on the BDRC Continental website.
96. SME Finance Monitor asks about applications in the 12-months prior to interview. Application and success rates are applied to BEIS Business Population Estimates to obtain estimates of absolute numbers.
97. Using a seven quarter dataset for the period ending Q4 2012.
98. Start-ups are SMEs established in the last five years. Scale-ups and stay-ahead SMEs were established more than five years ago. Scale-ups have growth ambition.
99. Success in this scenario includes applicants who took funding from elsewhere, but not from family or friends or in their personal name.
100. Beahurst also has data on unannounced equity deals from 2015 onwards, but these are excluded from the presented analysis.
101. <http://about.beahurst.com/the-deal-q3-16>
102. For more information on Beahurst's methodology including SME filter and stage classification, please see the appendix section of the 2016 Equity Tracker report. <http://british-business-bank.co.uk/wp-content/uploads/2016/05/97-Small-Business-Equity-Investment-Tracker-Report.pdf>
103. <http://nvca.org/pressreleases/peaking-2015-venture-investment-activity-normalizes-2016-according-pitchbook-nvca-venture-monitor/>
104. For instance, Atomico (2016) 'The State of European Tech' suggests 75% of European investors believe that 'the health of Europe's tech ecosystem is dependent on the health of the US tech ecosystem'.
105. <https://www.cbinsights.com/research-unicorn-companies> (accessed 09/12/2016)
106. Private equity here is used to describe venture capital funds.
107. British Business Bank calculations of figures contained in "EIF in the UK" converting EUR to GBP and calculating average committed per year from total committed amounts. [http://www.eif.org/news\\_centre/publications/country-fact-sheets/EIF\\_Fact-sheet\\_UK.pdf](http://www.eif.org/news_centre/publications/country-fact-sheets/EIF_Fact-sheet_UK.pdf)
108. 2016 NVCA Yearbook. <http://nvca.org/?download=2963>
109. National Development Banks of France, Germany, Italy, Spain and the UK (2016) "Building Momentum in Venture Capital across Europe" <http://british-business-bank.co.uk/wp-content/uploads/2016/12/Building-Momentum-in-Venture-Capital-across-Europe.pdf>
110. The 2016 Equity Tracker showed Beahurst announced deals dataset has 61% coverage of equity deals based on coverage of deals by fund supported by the British Business Bank.
111. UKBAA (2016) 'The Angel Ecosystem: Developments, challenges and opportunities' <http://www.ukbusinessangelsassociation.org.uk/wp-content/uploads/2015/09/Angel-Ecosystem-Roundtable-Outcomes.pdf>
112. Enterprise Research Centre (2015) 'A Nation of Angels: Assessing the impact of Angel Investing across the UK' [http://www.ukbusinessangelsassociation.org.uk/wp-content/uploads/2015/09/ERC\\_Nation\\_of\\_Angels\\_Full\\_Report.pdf](http://www.ukbusinessangelsassociation.org.uk/wp-content/uploads/2015/09/ERC_Nation_of_Angels_Full_Report.pdf)
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114. <https://www.gov.uk/government/statistics/enterprise-investment-scheme-and-seed-enterprise-investment-scheme-statistics-october-2016>

## CHAPTER THREE

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78. IMF staff discussion note, Benefits and costs of bank capital, Jihad Dagher, Giovanni Dell'Ariccia, Luc Laeven, Lev Ratnovski, and Hui Tong. <https://www.imf.org/external/pubs/cat/longres.aspx?sk=43710.0>
79. BDRC Continental (2016), 'SME Finance Monitor Q2 2016' and BDRC Continental (2016) 'SME Finance Monitor Q3 2012'. <http://bdrcc-continental.com/products/sme-finance-monitor/>
80. BDRC Continental (2016), 'SME Finance Monitor Q2 2016' Monitor Q3 2012'. <http://bdrcc-continental.com/products/sme-finance-monitor/>
81. The Survey on the Access to Finance of Enterprises (SAFE) 2015. q9a. Bank loans (excluding overdraft and credit lines) - For each of the following types of financing, would you say that their availability has improved, remained unchanged or deteriorated for your enterprise over the past 6 months?
82. BIS RESEARCH PAPER NO. 270, SME lending and competition: an international comparison of markets, May 2016.
83. Financing SMEs and Entrepreneurs 2016, an OECD Scoreboard.
84. Financing SMEs and Entrepreneurs 2016, an OECD Scoreboard.

## ENDNOTES

115. There is no standard definition of what constitutes later stage funding. Many data sources leave it to fund managers to classify their investments. The Barclays report defines Later Stage funding as including Series B funding rounds onwards.
116. For example of later stage companies in the digital sector see Tech City's Future fifty Programme: <http://futurefifty.com/#companies>
117. This is also identified by Balderton Capital, an early stage VC Capital funder, who estimates an increased demand for later stage funding in Europe from companies raising early stage funding in 2015. [https://medium.com/@jp\\_wise/the-european-series-a-crunch-is-gone-so-what-does-the-future-hold-for-the-class-of-15-2cabedc2ae25#.kyn1v31p6](https://medium.com/@jp_wise/the-european-series-a-crunch-is-gone-so-what-does-the-future-hold-for-the-class-of-15-2cabedc2ae25#.kyn1v31p6)
118. The Atomico (2016) 'State of European Tech' report shows Europe as a whole has a growing pipeline of early stage companies since 2011, but there has been a reduced number of investment rounds greater than \$25m in 2016. <http://www.atomico.com/>
119. Barclays (2016) 'Scale-up UK: Growing Businesses, Growing our Economy'. <https://www.home.barclays/content/dam/barclayspublic/docs/BarclaysNews/2016/April/Scale-up-UK-Growing-Businesses-Growing-our-Economy.pdf>
120. Financial returns are higher in the US compared to Europe. For instance, Pitchbook data shows the US has a 10 year horizon IRR of 9.1% compared to 6.6% for VC funds located elsewhere. Pitchbook (2016) '3Q 2016 Global PE & VC Global Benchmarking & Fund Performance Report'.
121. <http://british-business-bank.co.uk/british-business-bank-investments-ltd-makes-400m-autumn-statement-available-venture-capital-funds/>
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123. <http://newsandinsights.businessgrowthfund.co.uk/bgf-reports-record-growth-in-2016>
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125. <http://www.dowjones.com/press-room/dow-jones-venturesource-3q16-europe-venture-capital-report/>
126. Atomico (2016) 'State of European Tech'.
127. BVCA (2016) 'Performance Measurement Survey 2015'. <http://www.bvca.co.uk/Portals/0/library/documents/Performance%20Measurement%20Survey/2015%20Performance%20Measurement%20Survey%20Summary.pdf>
128. BVCA (2016) 'Performance Measurement Survey 2015'. <http://www.bvca.co.uk/Portals/0/library/documents/Performance%20Measurement%20Survey/2015%20Performance%20Measurement%20Survey%20Summary.pdf>
129. <http://realbusiness.co.uk/funding/2016/11/24/skyscanner-acquisition-nets-massive-windfall-venture-capital-investor/>
130. HMG (2017) 'Building our Industrial Strategy'. [https://beis.gov.uk/citizenspace.com/strategy/industrial-strategy/supporting\\_documents/buildingourindustrialstrategygreenpaper.pdf](https://beis.gov.uk/citizenspace.com/strategy/industrial-strategy/supporting_documents/buildingourindustrialstrategygreenpaper.pdf)
131. See British Business Bank (2015) 'Equity Research Report: Review of Equity Investment in Small Business'.
132. <http://british-business-bank.co.uk/british-business-bank-investments-ltd-makes-400m-autumn-statement-available-venture-capital-funds/>
133. British Business Bank 2016 Business Finance Survey (Ipsos MORI).
134. <https://www.gov.uk/government/publications/patient-capital-review>
135. Alternative finance instruments are all non-core instruments. Core instruments are defined as bank loans, overdrafts and credit cards.
136. FLA estimates based on actual data up to November 2016.
137. Asset finance new business for deals of up to £20 million.
138. Asset finance new business for deals of up to £20 million.
139. The 5 ABFA cohorts are smaller businesses with annual turnover of £0-500,000, £500,001-1,000,000, £1,000,001-5,000,000, £5,000,001-10,000,000 and £10,000,001-25,000,000.
140. This definition is taken from Deloitte, "Marketplace lending - A temporary phenomenon?"
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143. [http://www.altfi.com/article/2291\\_uk\\_alternative\\_finance\\_back\\_on\\_song](http://www.altfi.com/article/2291_uk_alternative_finance_back_on_song)
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150. <https://www.ft.com/content/664e83ee-00b9-11e6-ac98-3c15a1aa2e62>
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155. Preqin does not have full coverage of all venture debt deals.
156. <http://www.bms-finance.com/about-us/>
157. <http://boostandco.com/venture-debt/>
158. <http://www.newsroom.barclays.co.uk/releases/ReleaseDetailPage.aspx?releaseId=3158>
159. <http://www.privateequitywire.co.uk/2016/09/22/243903/barclays-boosts-high-growth-technology-fund-uk-scale-ups-gbp200-million>
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## CHAPTER FOUR

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