BRITISH BUSINESS BANK

SMALL BUSINESS FINANCE MARKETS

2017/18

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FOREWORD

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The British Business Bank was established at the end of 2014, with a mission to improve finance markets so they more effectively serve the needs of smaller UK businesses.

This report, our fourth Small Business Finance Markets report, highlights a continued and welcome growth in finance flow to smaller business outside of traditional bank lending products. The value of equity investment (up 79% in 2017), asset finance (up 12%) and peer-to-peer business lending (up 51%) used by smaller businesses all showed significant growth in 2017, while net bank lending remained relatively flat.

That smaller businesses are using an increased range of finance options is relevant to two of the British Business Bank's key objectives: to increase the diversity of supply by supporting new finance market entrants and innovative funding models; and to build smaller businesses' confidence and awareness of their finance options, including through our popular Business Finance Guide, co-published with the ICAEW.

Although traditional banks are still the predominant source of finance, it's encouraging to see smaller businesses considering and using an increased range of finance options to meet their funding needs. We strongly believe that matching smaller businesses with appropriate finance options will ultimately help them, and the UK economy, develop more successfully.

The British Business Bank uses evidence and research to shape and develop our programmes. Three themes from this year's Small Business Finance Markets report are already bringing significant change to our activities: enabling greater provision of patient capital in the forms of equity and wider growth capital; stimulating demand for finance; and tackling regional imbalances in finance supply.

PATIENT CAPITAL

This report highlights strong evidence that our scale-ups need more long-term patient capital throughout all stages of their development if we want to compete with the US, for example, in producing world-beating companies. It echoes the themes explored in detail in last year's Patient Capital Review, led by HM Treasury and supported by a separate industry panel chaired by Sir Damon Buffini. The evidence shows there are some key areas where improvements can be made – for example, compared to their US counterparts, UK Venture Capital funds are smaller on average (£118m compared to £180m), and UK businesses that exit receive fewer funding rounds (an average of 1.9 rounds compared to 2.7 rounds).

Although the Bank had already begun increasing its resources allocated to supporting equity for scale-up companies, the Autumn Budget, represented a step change in our capabilities. In an innovative package, the government allocated £2.5bn of additional resources to the British Business Bank, an increase of around two thirds on our existing capacity. Along with existing resources, this significant increase will unlock up to £13bn of finance to help UK smaller businesses realise their full potential and, over time, help broaden and deepen these markets through attracting private sector capital – the central goal of the Patient Capital Review, and one we share.

Two key elements of the Budget announcement are being implemented this year:

- A new £2.5bn Patient Capital entity, incubated within the Bank, which will invest commercially into venture and growth capital with a view to flotation or sale – subject to a value for money assessment – once it has built its portfolio and track record
- Using up to an additional £500m, we will cornerstone a small number of large scale, private sector managed funds of funds, which will in turn catalyse patient investment into high potential businesses.

STIMULATING DEMAND

Supply of finance is, however, just one side of the equation and other activities need to be undertaken to build capacity and capabilities amongst SMEs. One such area is information, which is a fundamental building block for efficient, well-functioning markets. Our research shows that this is an aspect of smaller business finance markets that could be strengthened as, too often, businesses either aren't aware of or don't understand the variety of finance choices available to them.

The Bank has already taken action to address this problem. Thousands of businesses a week access the British Business Bank/ICAEW Business Finance Guide, which provides information about finance options for businesses at all stages of their development.

We recognise, however, that there's more to be done. We are introducing a more targeted new digital information hub in Spring 2018, and will be backing it with a substantial promotional campaign to maximise its use by smaller businesses. The new hub, which will set out finance options in a simple to use format, aims to go further in equipping businesses, and especially those with growth ambitions, with the know-how to find the finance best suited to their needs, enabling them to become the global success stories of tomorrow.

TACKLING REGIONAL IMBALANCES IN FINANCE SUPPLY

Demand variations are also apparent on a regional basis, compounding the imbalance in supply of growth capital across the UK. In 2017 the volume and value of equity received by London-based businesses exceeded that for the rest of the country combined. Angel deals are also concentrated in London and the South East. Increasing such activity in regions outside London and the South East has the potential to help close well-documented imbalances in regional growth.

The Bank is addressing some of these imbalances directly through our Northern Powerhouse and Midlands Engine Investment Funds – with a fund for Cornwall and the Isles of Scilly expected in 2018. Whilst these supply-side activities are important, we see a significant potential to rebalance activity through better provision of information and building capacity in the regions to support firms' growth ambitions. Awareness and consideration of different forms of finance varies significantly across the country, and our renewed efforts to close information gaps will have a strong regional element. In response to the government's 2017 Industrial Strategy, we are also developing an investment programme to support the development of clusters of business angels outside London, and will be putting in place a network of British Business Bank regional managers by Autumn 2018.

Strong research, evidence and analysis provides the basis for our interventions to improve finance markets for smaller UK businesses. This report highlights areas where we have already begun to respond to current challenges, and where we might respond further to those that lie ahead. We look forward to working with our partners and stakeholders to address the growing needs of smaller businesses as we do so.

EXECUTIVE SUMMARY

The fourth edition of our Small Business Finance Markets report comes at a time when the government's Industrial Strategy has reiterated the productivity and regional challenges facing the UK economy, and the outcome of the Patient Capital Review has identified the need for additional action to finance growth in innovative firms.

Improving the growth and productivity of smaller businesses is central to improving the performance of the economy as a whole. This makes it even more important that finance markets are effective in supplying funding to smaller businesses when it is needed, and that smaller businesses across the UK have the ability and confidence to attain finance appropriate to them.

This report provides a unique, in depth picture of the smaller business finance market. It is intended not only to inform the development of the British Business Bank's own strategy, but also to inform wider developments in both the market and government policy.

The report structure has been refined this year, to highlight the major cross cutting themes in Part A, with Part B providing a more detailed review of the small business sector and developments in specific finance product markets. Five key themes emerge from our analysis.

EQUITY AND ALTERNATIVE FINANCE DEMONSTRATED STRONG GROWTH IN 2017, WITH BANK LENDING VOLUMES RELATIVELY FLAT

Despite the modest macroeconomic environment, small business finance markets have continued to provide significant volumes of finance to smaller businesses. Aggregate flows of finance saw significant double digit increases for many products, however bank lending was relatively flat, resulting in an increasingly diversified finance market for smaller businesses.

Most notably, values of external equity finance received by smaller businesses rose rapidly, increasing by 79% in the first 3 quarters of 2017. Although deal sizes have increased across all equity stages, this was partly due to a small number of very large deals. The 10 largest equity deals alone account for over £1.6bn of the £4.5bn invested in the first 3 quarters of 2017. The number of deals however were also up by 12% compared to weaker deal activity seen in 2016. This development is particularly welcome as equity finance is an important input to enabling many businesses to deliver their growth potential.

Peer-to-peer business lending also showed continued rapid growth, rising by just over 50% in 2017. Such lending is challenging traditional bank-based models of lending, although it remains around only 3% of gross bank lending flows. Finally, asset finance has continued the consistent low double-digit growth which has been apparent for several years.

This growth demonstrates increased diversity in small business finance markets. As previous British Business Bank research on diverse finance markets has argued, this helps small businesses get the finance best suited to their needs. The Bank's support for alternative lenders continued to grow in 2017 with the Investment Programme investing through challenger banks, debt funds, asset finance providers and marketplace lenders. 2018 has already seen two ENABLE Funding transactions with asset finance providers.

CONTINUED EXCELLENT UK PERFORMANCE IN GENERATING START-UPS, IMPROVING IN SCALE-UPS

The UK economy has a strong track record in generating start-ups. The latest available international comparisons show the UK leading the G7 in terms of birth rates of new businesses. Although death rates have edged up slightly the UK small business population has continued to increase, rising to an estimated 5.7m businesses by the start of 2017.

International comparison of the share of high growth enterprises, who are a key driver of innovation and employment, shows a slight increase in the UK, whereas it has fallen in countries such as Germany, Denmark and Sweden. There remains more to do, but it is encouraging to see some signs of better scale-up performance in the UK.

The incidence of high growth enterprises in the UK has been relatively stable since the 1990s. Yet research by the Enterprise Research Centre suggests that a focus on high growth episodes experienced by enterprises over their life cycle is helpful in predicting future growth potential. Very few firms have prolonged high growth, but those that have a high growth episode are more likely to do so again at a later stage.

Because of their positive impact on the economy, the British Business Bank has increased its support for smaller businesses with high growth potential, by increasing funds allocated to equity schemes and debt products that are suited to those firms. The Bank has also played a role in taking forward the recommendations of the Scale-Up Task Force.

THE PATIENT CAPITAL REVIEW IDENTIFIED A NEED FOR MORE EQUITY INVESTMENT AT ALL STAGES

The evidence included in the Patient Capital Review consultation drew on British Business Bank analysis from our 2017 Equity Tracker Report published in August 2017. Despite recent improvements in the availability of equity finance in the UK, the UK external equity finance to GDP ratio is lower than some of our international competitors. The Patient Capital Review focused on the availability of late stage VC, where funding provision in UK markets was noticeably below that in the US and therefore potentially hampered UK businesses' growth potential.

2016 and 2017 have also seen relatively high aggregate amounts of fund raising, but an ongoing decline in the number of VC funds closing. This demonstrates the continued difficulty emerging fund managers have in raising new funds which our Enterprise Capital Fund (ECF) programme seeks to address.

As a result of this and other analysis, the Patient Capital Review included a number of recommendations for British Business Bank equity activity to broaden and deepen markets, including:

- Establishing a new £2.5bn investment fund incubated in the British Business Bank with the intention to float or sell once it has established a sufficient track record
- Investing in a series of private sector fund of funds of scale, with the British Business Bank seeding the first wave of investment with up to £500m
- Continuing to back first-time and emerging fund managers through the ECF, supporting at least £1.5bn of new investment.

NEW 2017 DATA HIGHLIGHTS REGIONAL GAPS IN SOME PRODUCTS

Previous Small Business Finance Market reports have highlighted that equity investment tends to be clustered in certain cities, particularly but not exclusively London, where innovative companies, skilled labour and equity investors come together. The evidence from 2017 showed that this continued to be the case, with the volume and value of equity received by London based businesses exceeding that for the rest of the country combined. As equity is often an important ingredient for growth, increasing equity activity in regions outside London and the South East could help close disparities in regional growth.

The joint British Business Bank – UK Business Angels Association survey of angel activity, published in December 2017, confirmed that angel investment is similarly concentrated in London and the South East.

The British Business Bank is taking a number of steps to address these imbalances. It is continuing to implement the geographically focused funds in the Northern Powerhouse and Midlands Engine regions. In addition, and as announced at the Autumn Budget 2017, the British Business Bank is developing a commercial investment programme to support the development of clusters of business angels outside London.

The Bank will also be developing a network of British Business Bank regional managers to be in place by autumn 2018 to ensure businesses across the UK know how to access sources of investment. That will be complemented by a new digital hub developed by the Bank, offering authoritative, impartial information around access to finance for firms with scale-up ambitions. This is due to launch in Spring 2018.

RECORD LOW DEMAND FOR TRADITIONAL BANK LOANS IN 2017

Data on loan application rates has showed a continuing decline in the share of SMEs seeking new loans to 1.7% of smaller businesses, the lowest figure since the SME Finance Monitor began in 2011.

In addition, there has been a decline in SMEs confidence that they will get a loan when they apply, down to 43% in the 3 months to November 2017, compared to 58% in the previous 3 months which mirrors the broad decline in smaller business confidence levels. This contrasts with loan approval rates which remain quite high.

There is also evidence that the attitudes against borrowing are becoming more entrenched across SMEs of all size bands, with around 70% willing to accept a slower growth rate rather than borrowing to grow faster. Combined with the increase in positive cash balances held by SMEs, this suggests a broader reticence to invest to grow.

This highlights that, particularly for smaller businesses with growth potential, there would be benefit in improving the information available to them about their finance options.

INTRODUCTION

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

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. Macro-economic developments in 2017 have reinforced the need to ensure that small business have the finance they need to make a strong contribution to economic growth.

NEW EVIDENCE AND ANALYSIS

During 2017, the British Business Bank has developed new evidence and analysis to deepen our understanding of smaller business finance markets. In particular:

- Our Small Business Finance Survey has been run again to give up to date insight into smaller businesses, awareness of the finance options available to them and how they go about obtaining finance
- We created a framework to give a better understanding of the potential impact of diversity in the supply of finance for small businesses[1]
- A new segmentation analysis has been created to give more insight into smaller businesses who use, or are open to using, external finance
- We carried out more detailed analysis of the UK equity markets to inform the Patient Capital Review
- Examples, which were published in our 2017 Equity Tracker, include detailed analysis of venture capital fundraising and portfolio company exits
- The British Business Bank and UK Business Angel Association commissioned a new survey of Business angel investors to give a more up to date understanding of the angel landscape in the UK
- We draw on externally commissioned evaluations of British Business Bank products, most notably, our recent evaluation of the Enterprise Finance Guarantee.

This report also references a wide range of evidence drawn from government, market and academic research. This year we made greater effort to pull together the international evidence in the report, so that UK small business finance markets are compared to the best around the world.

STRUCTURE OF THE REPORT

The report begins with an overall assessment of the aggregate flows of finance, macro-economic developments and the implications for small business finance needs.

Part A provides a thematic overview looking in turn at the drivers of demand, regional finance variations, the evidence on patient capital and international comparisons of small business finance markets.

Part B examines in more detail developments in the small business and high growth firm populations. It then considers the market for different types of debt and equity finance most widely used by smaller businesses, identifying where further improvements can be made.

AGGREGATE FLOW AND STOCK OF FINANCE TO SMALLER BUSINESSES

- Net flow of bank lending products remained positive in 2017 but weaker than the previous 2 years
- Equity finance rebounded in 2017, whilst asset finance and marketplace lending continue to grow, increasing the diversity in smaller business finance markets
- Small business confidence and demand for finance are declining along with the number of smaller businesses hoping 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 stocks and flows of all forms of external finance is not readily available. However, the summary table below 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.

FIGURE 1

ESTIMATES OF THE FLOW & STOCK OF EXTERNAL FINANCE FOR UK SMEs (£ BILLION) (a)

		2012	2013	2014	2015	2016	**2017**	
Bank lending stock *Source: Bank of England*	Outstanding Amount (b)	176	166	167	164	166	**165**	to end Dec 17
Bank lending flows *Source: Bank of England*	Net flows (c)	-6	-2	-2	2	3	**1**	to end Dec 17
	Gross flows (d)	38	43	53	58	59	**57**	to end Dec 17
Other gross flows of SME finance								
Private external equity investments *Source Beauhurst (e)*		1.49	1.53	2.31	3.58	3.42	**4.47**	to end Sep 17
	Number of reported deals	706	972	1309	1408	1148	**984**	to end Sep 17
Asset finance flows *Source: FLA (f)*		12.2	12.9	14.4	15.9	16.7	**18.6**	to end Dec 17
Peer-to-peer business lending flows *Source: AltFi Data (g)*		0.06	0.20	0.41	0.73	1.18	**1.78**	to end Dec 17

(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, except number of reported equity deals, and have been rounded appropriately.

(b) Movements in amounts outstanding can reflect breaks in data series as well as underlying flows.

(c) Net flows does not always reconcile with change in stock due to differences in statistical reporting. The reported stock can include other adjustments made by banks but not detailed when reported, whereas flows data does not include these adjustments.

(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) Beauhurst is a market data provider that records visible equity deals including crowdfunding deals.

(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 annual net flows of bank loans (new loans, excluding overdrafts) to smaller businesses has continued to grow, albeit at a slower pace. However, following 12 consecutive quarters of positive net lending, Q4 in 2017 was slightly negative. In 2017 net lending stood at £0.7bn, well down on the £3bn for the equivalent period in 2016. Quarterly gross bank lending to smaller businesses, which reached a peak of £15.4bn in the first quarter of 2016, averaged £14.3bn in 2017. The Bank of England (BoE) Credit Conditions Review noted the availability of credit to businesses was little changed in 2017.[2]

The stock of bank loans and overdrafts was estimated at £165bn at the end of 2017, broadly unchanged from 2016.

EQUITY FINANCE HAS BOUNCED BACK FROM A WEAKER 2016 WHILST ASSET FINANCE, INVOICE & ASSET-BASED LENDING AND MARKETPLACE LENDING CONTINUE TO GROW

Equity data shows there has been a resurgence in equity markets in 2017 following a weaker 2016. The value of new equity deals with known amounts has reached £4.5bn in 2017 by Q3, up from the £3.4bn figure for the entire of 2016.

Data from the Finance and Leasing Association suggests that new asset finance volumes with smaller businesses was over £18.6bn by the end of 2017, an increase of 12% on 2016.

Total invoice & asset-based lending advances to smaller businesses continue to rise and across all sizes of smaller businesses. 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 reaching £1.78bn in 2017, an increase of 51%. Equity raised by businesses through equity-based crowdfunding continues to fall but remains an important source of business finance and, along with the other non-bank sources of finance, an important source of diversity within smaller business finance markets. Part B provides a detailed discussion of the trends in volumes for different types of finance.

SMALL BUSINESS CONFIDENCE AND DEMAND FOR FINANCE ARE DECLINING, WITH THE NUMBER OF SMALLER BUSINESSES HOPING TO GROW DECREASING

Demand for external finance by UK smaller businesses has continued to decline. Our analysis of the SME Finance Monitor shows new debt application rates have fallen every year since 2012 (4% for overdrafts and 2.9% for bank loans) and H1 2017 has continued this trend with only 1.7% of smaller businesses applying, a record low.[3,4] This has been matched by a build-up of cash reserves over the same period. In Q2 2017, 26% of SMEs reported holding more than £10,000 in credit balances, an increase from 16% in 2012 and 21% the same time last year.

The Federation of Small Business (FSB) Voice of Small Business reported decreasing business confidence over 2017, with confidence declining in each quarter.[5] The FSB Small Business Index fell from +1.1 in Q3 2017 to -2.5 in Q4. This is only the second negative index reading in 5 years with continuing cost pressures and wider economic uncertainty the key drivers. The share of businesses expecting to downsize, close or hand on the business over the coming 12 months stood at 14.6% in Q4. This is up from 9.4% a year ago, and the largest share since data collection began in 2012. The ICAEW confidence index has also been lower during 2017 and has been in negative territory for the last 2 quarters of the year.

The domestic economy remained a major barrier to growth aspirations in Q4 2017, with 55% of small businesses reporting it as an obstacle to achieving growth aspirations. This is slightly down from 56.7% a year ago. The British Business Bank Business Finance Survey for 2017 shows a small decrease in the proportion of smaller businesses expecting to grow in the next 12 months, from 37% of SMEs in 2016 to 35% of SMEs this year. Both these numbers are well below the 2015 number of 56%. This is lower than the FSB Voice of Small Business where just under half of small businesses reported an aspiration to grow over the next year in Q4 2017.

MACRO-ECONOMIC DEVELOPMENTS

- The UK economy has continued to grow over 2017, albeit at a slower pace than other advanced economies
- Productivity and business investment growth both revised down
- SME Confidence surveys suggest the picture is unlikely to change in the medium-term
- A majority of SMEs expect no impact from leaving the EU though fewer than last year think they'll grow more
- Credit conditions have remained accommodative overall

THE UK ECONOMY HAS CONTINUED TO GROW OVER 2017, ALBEIT AT A SLOWER PACE THAN OTHER ADVANCED ECONOMIES

The UK economy has continued to grow over 2017 whilst employment rates have remained high and unemployment is at its lowest rate since the 1970s. In 2017, the ONS estimated the economy expanded by about 1.8% compared with the previous year, higher than the OBR's Autumn forecast of 1.5%, but down from a rate of 1.9% in 2016, and the slowest pace of annual growth since 2012. The slowdown in UK GDP growth contrasts with a pick-up in other advanced economies. In the euro area, US, Canada and Japan, quarterly growth has been stronger than in the second half of 2016 and stronger than in the UK. Sterling's fall has seen inflation pick up more rapidly in the UK than in the other major economies, contributing to weaker real growth.

The fall in the pound that followed the EU referendum has pushed up consumer price inflation and squeezed households' real incomes and spending whilst public spending cuts and political and Brexit-related uncertainties have also weighed on the economy. The OBR has now downgraded its growth forecasts for the medium-term, saying the UK economy would grow by just 1.4% in 2018, 1.3% in 2019 and 2020, and 1.5% in 2021. The growth figure is now in line with the Bank of England's assessment.

Bank Rate increased by 0.25% in November 2017 to 0.5%, the first increase in a decade. Interest rates are expected to rise slowly.

PRODUCTIVITY AND BUSINESS INVESTMENT GROWTH BOTH REVISED DOWN

Leading much of the downward revision is potential productivity growth. The OBR now expects productivity growth to fall from 1.8% to 1% in 2020. Productivity has stalled since the financial crisis in 2008, with output per hour rising just 0.2% a year in the last decade, compared to an average of 2.1% a year over the preceding 35 years. This decision to revise down trend or potential productivity growth is a major reason the OBR's growth forecast is now more pessimistic than many external forecasters.

Growth is still expected in business investment, a crucial driver of long-term growth. The OBR now expects business investment to remain stable between 2.3% and 2.4% between 2018 and 2022. However, confidence surveys suggest that the anticipation of Brexit and related uncertainties are weighing on investment. For instance, in a recent survey on investment intentions by the Bank of England's Agents, economic uncertainty, expected changes to future UK trading arrangements and other Brexit factors were the most commonly cited factors weighing on investment plans.

SME CONFIDENCE SURVEYS SUGGEST THE PICTURE IS UNLIKELY TO CHANGE IN THE MEDIUM-TERM

During 2017, most SME confidence surveys were down. The Markit UK Business Outlook recorded its lowest business confidence since October 2011 during the summer and several other surveys recorded multi-year lows. Alongside political uncertainty, businesses faced the twin pressures of a weakening domestic economy, as well as rising costs of doing business. The former was driven by low consumer demand whilst, with regards the latter, purchase price inflation hit record highs at the start of the 2017 as the devaluation of Sterling fed through.

Headline figures did hide a divergence between the manufacturing and service sectors however. Whilst the service sector posted multi-year low confidence figures manufacturing firms often remained more upbeat about their growth prospects as they sought to take advantage of the devaluation of Sterling and the improving world economic picture and surveys such as the Federation of Small Business (FSB) Voice of Small Business Index reported increased values of exports throughout the year. This is backed up by official figures which show manufacturing output is at its highest level since February 2008.

A MAJORITY OF SMEs EXPECT NO IMPACT FROM LEAVING THE EU THOUGH FEWER THAN LAST YEAR THINK THEY'LL GROW MORE

As with the results from 2016, according to our 2017 Business Finance Survey, the majority of SMEs expect no impact from leaving the EU. This is perhaps unsurprising given the limited number of UK SMEs that import or export. However, the number of SMEs who expect to grow as a result of the UK leaving the EU has halved this year and now stands at 5% across those that do, and do not, employ staff.

Unsurprisingly given these findings, on balance, a greater proportion of employers are looking to reduce investment and staff as a result of the UK leaving the EU. In a similar picture to 2016, only 4% of respondents plan to make changes to their investment plans and 3% plan to make changes to their recruitment plans as a result of Brexit. Of these, 54% said they were looking to invest a smaller amount and 51% expected to hire fewer staff than would have otherwise have been the case. In contrast only 19% expected to invest a greater amount and 10% expected to hire more staff than would have been the case.

DESPITE THE MODEST ECONOMIC PERFORMANCE IN 2017 CREDIT CONDITIONS HAVE REMAINED ACCOMMODATIVE OVERALL

Throughout 2017, availability of credit to the corporate sector was reported to have been unchanged and broadly accommodative. However, unlike FSB's survey, which noted improved credit conditions, a Bank of England Credit Conditions Survey and Agents Report stated some smaller companies reported greater difficulty in gaining access to banks' relationship managers in recent months.

PART A
THEMES

1.1 DEMAND FOR FINANCE

- Information failures exist on the demand side
- SMEs prefer to avoid external finance…
- …and SMEs prefer to self-fund their growth where possible
- Changing the narrative on control may be required to affect change

BRITISH BUSINESS BANK ANALYSIS ACKNOWLEDGES IT IS IMPORTANT TO CONSIDER THAT:

- SMEs are heterogeneous, with different ambitions and aspirations to grow
- SMEs who use finance, or are open to using finance, fall into 4 distinct segments
- SME segmentation insights enable policy responses to be targeted and more effective

FACTORS LIMITING DEMAND

Smaller businesses are a vital part of the UK economy and a dynamic, growing SME sector is an essential element of future economic growth. SMEs play a key role in raising low productivity in the UK by spurring innovation, adopting new practices and encouraging 'productive churn' through competition.

The ability of SMEs to access finance is critical for funding business investment which in turn allows businesses to start-up and achieve their full growth potential. An inefficient market in SME finance with fewer businesses getting the right finance can constrain business development and reduce business survival rates.

Lower than expected volumes of SME finance transactions in the UK can reflect market failures in the supply-side, demand-side, or both sides of small business finance markets. As the supply of SME finance has improved following the global financial crisis, the British Business Bank has turned its attention to examining in greater detail demand-related market conditions in UK SME finance, and considering the best policy interventions to address these.

Demand in the UK for SME finance, in the form of new debt applications for bank loans and overdrafts, has been falling in the 5 years since 2012. For example, the percent age of SMEs applying for a new loan has fallen from 2.9% in 2012 to only 1.7% in H1 2017.[6] There is evidence that this decline is the result of on-going demand-side market failures.

INFORMATION FAILURES EXIST ON THE DEMAND SIDE

There are information market failures which affect the demand for SME finance. For example, if key business decision makers hold imperfect or inaccurate information on the types, costs, benefits, and their likelihood of securing external finance, then demand may be suppressed.

FIG A.1

AWARENESS OF PRODUCTS AND SPECIFIC PROVIDERS

Source: British Business Bank 2017 Business Finance Survey - Ipsos MORI
Base = all SMEs (n=2,070 in 2017)

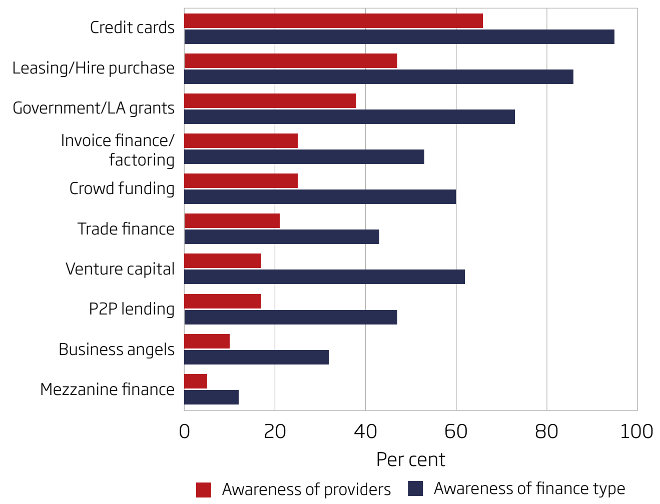
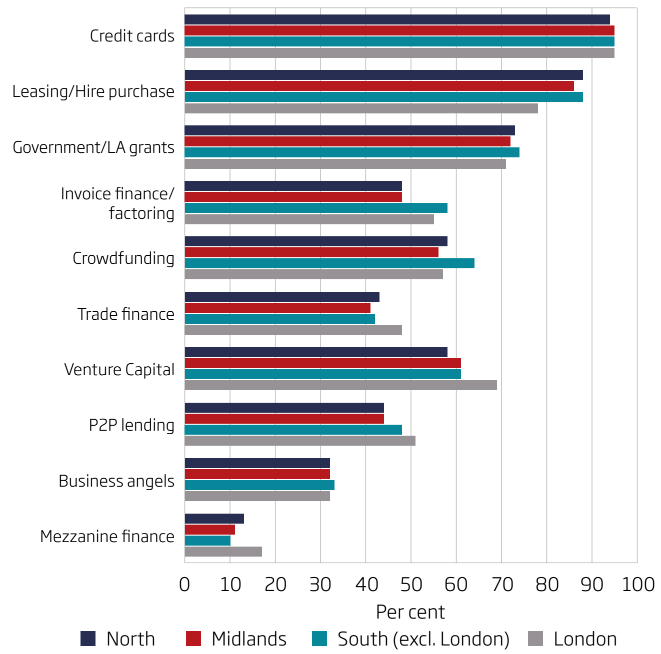


FIG A.2

AWARENESS OF TYPES OF FINANCE BY REGION

Source: British Business Bank 2017 Business Finance Survey - Ipsos MORI
Base = all SMEs (n=2,070 in 2017)



Anecdotal evidence suggests that some UK entrepreneurs do not fully consider the different options available to them to support their long-term growth. This reduces the efficiency by which capital is allocated to growing firms, meaning that high growth potential firms sometimes struggle to obtain the right finance that they need to grow to scale.

This is corroborated by survey data which has consistently shown that most UK SMEs are not aware of financial products beyond standard term bank loans, overdrafts and credit cards. And, even where they are aware of a product, often they may not practically know a trusted provider of that product to contact (figure A.1).

Furthermore, there are regional variations to awareness. Awareness of alternative financial products is generally lower outside of London and the South East (figure A.2). This may reflect a lack of availability of such products, or could be one of the contributing factors for the lack of critical mass to support product availability, or both.

Product (and provider) awareness is necessary for a functioning market, but not sufficient. An SME should also understand the costs and benefits of a financial product before being willing to use it. A survey carried out by the Wesleyan Bank suggests that SMEs often don't have a good enough understanding of the financial options available to them to make sound borrowing decisions.[7]

The 2016 Wesleyan Bank SME Attitudes to Finance survey highlights only 24% of SMEs would feel comfortable to borrow from an alternative finance provider in comparison to 63% who would feel comfortable borrowing from a bank. Even then, only 45% and 37% stated that they had a full understanding of overdrafts and bank loans respectively. Furthermore, confidence amongst SMEs planning to apply for bank finance has declined towards the end of 2017. In 2016, 55% of SMEs planning to apply for bank finance were confident of success, with confidence increasing in the latter half of the year. During 2017 confidence has been more volatile, but declined to 43% in the 3 months ending November 2017.[8]

Even amongst those SMEs who are confident that they understand which financial product is best suited to their needs, there may be imperfect information around their self-assessed probability of successfully applying for that product. Surveys show that smaller business owners systematically view getting finance as difficult and over-estimate their probability of being rejected. Such perception gaps may not reflect reality at present, with around 80% of bank loan and overdraft applications being approved (the rate for first time applications is lower, at around 50%).[9] The 2016 British Business Bank Business Finance Survey highlighted 56% of SMEs reporting a perception that obtaining external finance is 'difficult'.

Data shows that a small but significant proportion of SMEs who say that they require finance remain discouraged from applying for finance because they believe they will be rejected. This translates into 1% of all SMEs.[10]

Taking external advice when seeking external finance, given the lack of awareness and understanding of the products available, would appear to be one solution to addressing these demand-side market failures. However, British Business Bank survey data shows that most SMEs do not seek advice when applying for finance (figure A.3).

SMEs PREFER TO AVOID EXTERNAL FINANCE…

Lack of awareness and understanding of financial products can also reflect a more fundamental apathy and perceived absence of relevance to business owners. There is, after all, no reason for an entrepreneur to take the time to educate themselves on forms of finance if they have no intention of ever requiring or applying for external finance. Not least, doing so is time consuming and any ultimate first-time application is fraught with the real possibility of rejection. Also, there is a proportion of smaller businesses who have a perception that obtaining finance takes a lot of effort. In Q2 2017, 7% of future would-be seekers of finance cited the hassle of borrowing as the reason for not planning to seek finance, despite having a need to do so.

Indeed, we find that a perceived lack of relevance is the case for a large portion of the UK SME population. For some business owners, this is driven by a general aversion to external finance options even if that means sacrificing growth opportunities. For other business owners, this is driven by access to other more attractive ways of funding their growth plans.

There is significant reported aversion to external finance amongst UK SMEs. 42% of surveyed UK SMEs do not currently use finance and are unwilling to do so (figure A.4). This aversion is concentrated amongst SMEs with no employees, but even amongst SMEs with 50 to 249 employees, 21% neither use nor express a desire to use external finance in the future.

For many UK SMEs, their ultimate aspiration is to be debt free. In 2016, 68% of smaller businesses agreed that "their aim was to pay down debt and remain free if possible".[11]

FIG A.3

WHAT WAS THE FIRST THING YOU DID WHEN YOU REALISED YOU HAD A FINANCING NEED?

Source: British Business Bank 2017 Business Finance Survey - Ipsos MORI
Base = all SMEs that sought finance in the last 3 years (n=932)

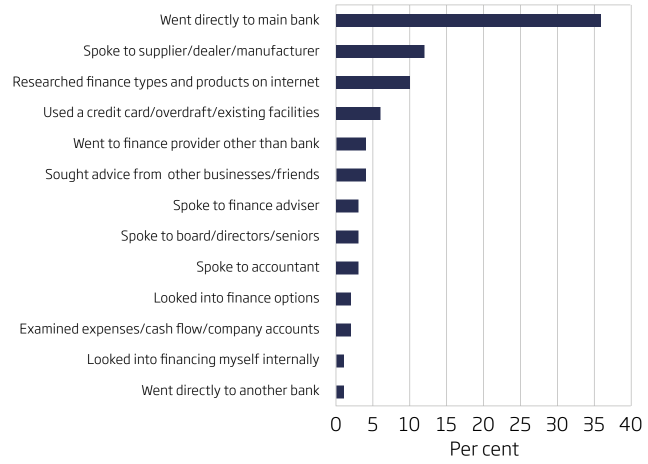


FIG A.4

USE OF EXTERNAL FINANCE AND WILLINGNESS TO USE IN THE FUTURE

Source: BDRC Continental, SME Finance Monitor Q2 2017

	Total	0 emps	1-9 emps	10-49 emps	50-249 emps
Use external finance and willing to use in future	19%	16%	27%	35%	39%
Use external finance but not willing to use in future	20%	19%	21%	26%	28%
Do not use it but willing to	19%	19%	19%	15%	13%
Do not use it and not willing to	42%	45%	34%	26%	21%

FIG A.5

PROPORTION OF SMEs HAPPY TO USE EXTERNAL FINANCE FOR GROWTH AND DEVELOPMENT

Source: BDRC Continental, SME Finance Monitor Q2 2017

	Total	0 emps	1-9 emps	10-49 emps	50-249 emps
Strongly agree	7%	6%	9%	10%	13%
Agree	31%	29%	36%	40%	39%
Neither/nor	23%	23%	22%	25%	29%
Disagree	28%	29%	24%	20%	15%
Strongly disagree	11%	12%	9%	6%	3%
Total "Agree"	**38%**	**35%**	**46%**	**49%**	**52%**

FIG A.6

CREDIT BALANCES HELD OVER TIME FOR ALL SMEs

Source: BDRC Continental, SME Finance Monitor Q2 2017

	2012	2013	2014	2015	2016	H1 2017
None	4%	4%	5%	3%	3%	4%
Less than £5,000	66%	64%	58%	55%	57%	52%
£5,000 to £10,000	14%	15%	17%	18%	18%	19%
£10,000 to £50,000	11%	12%	14%	17%	15%	18%
More than £50,000	5%	4%	6%	7%	6%	8%
Average balance held	**£25k**	**£24k**	**£31k**	**£39k**	**£30k**	**£40k**

That said, finance aversion amongst UK SMEs does not dominate in actual practice with many SMEs who express a desire to avoid finance still using it. 40% of small businesses currently used some form of external finance in Q2 2017, increasing by size of SME. 76% of medium sized businesses (50-249 employees) made use of it in comparison to 52% of micro businesses (1-9 employees).[12]

Fundamentally, finance is a means to enable growth plans (through for example purchasing assets) or to bridge cash flow shortfalls. Overall, 66% of SMEs who applied for external finance over the last 3 years did so to acquire working capital or cash flow, and 41% applied to invest in their business. Medium-sized SMEs (50 to 249 employees) were more likely to apply for external finance for investment purposes than small (10 to 49 employees) and micro businesses (1 to 9 employees) and were less likely to need finance for working capital.[13]

…AND SMEs PREFER TO SELF-FUND THEIR GROWTH WHERE POSSIBLE

Only 38% of UK SMEs agree with the statement "as a business we are happy to use external finance to help the business grow and develop" (figure A.5).[14] This suggests that the remaining 62% of businesses will turn to other alternatives first, in line with pecking order theory, and fund growth internally before using external debt and then external equity (see section 2.3, Use of external finance).

Almost all SMEs hold some credit balances, but the number holding larger credit balances has increased over time. This has enabled more business owners to self-fund, in line with their preferences.

SMEs holding balances of £10,000 or more increased from 16% to 26% between 2012 and H1 2017 (figure A.6). This increase in credit balances is also reflected in the average balance held by SMEs which increased from £25,000 to £39,000 between 2012 and 2015. In 2016, it was lower at £30,000 but then increased again to £40,000 during H1 2017. SMEs of all sizes have seen an increase in credit balances of £10,000 and above during this period. Generally, the larger the SME the more likely it is to hold such sums.

As one might expect, the SME Finance Monitor revealed that holding credit balances of £10,000 and above from Q3 2015 reduced the need for 8 in 10 SMEs to use external finance. Furthermore, 81% of smaller businesses in Q2 2017 agreed that "our current plans for the business are based entirely on what we can afford to fund ourselves".

However, we might also expect that given a choice between tapping external financing to achieve profitable growth and forgoing growth by avoiding external financing, then business owners would choose finance. This is not necessarily the case. 70% of SMEs report that they are prepared to accept slower growth if it could then be self-funded. This holds less true for medium sized businesses (50-249 employees) where only 55% were willing to accept slower growth (figure A.7).

CHANGING THE NARRATIVE ON CONTROL MAY BE REQUIRED TO AFFECT CHANGE

The evidence, whilst not conclusive, suggests that there is a demand-driven gap between optimum levels of investment in a fully functioning market and the levels found today. Root causes for this gap can be found in the preferences and practices of UK business owners.

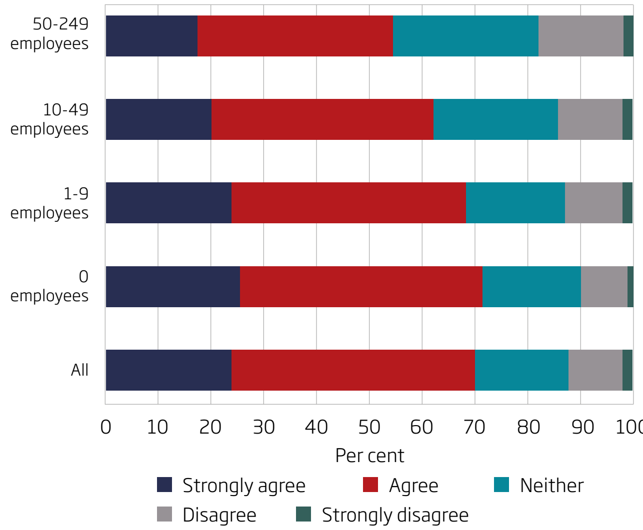
Fear of external ownership is real in the case of external equity: 55% of SMEs state that they would be worried about loss of control and 45% did not want to give a share away.[15] Other academic research shows that founders of firms appear to be more motivated over the long-term by the autonomy of being an entrepreneur and being in control of their firm rather than through financial incentives.[16] Although debt poses less obvious risk of loss of control, it can still be viewed as reducing the autonomy of a business owner.

An alternative way of viewing the trade-off between business owner control and the pursuit of growth opportunities may be required to address these demand-side market failures. Entrepreneurs must be convinced that it is preferable to own a smaller share of a larger, more valuable entity with the additional finance, support and expertise this could provide, than it is to remain in sole control of a smaller, less valuable business.

FIG A.7

WILL ACCEPT A SLOWER GROWTH RATE RATHER THAN BORROWING TO GROW FASTER

Source: BDRC Continental SME Finance Monitor, Q2 2017



SME ATTITUDINAL AND NEEDS BASED SEGMENTATION

SMEs ARE HETEROGENEOUS, WITH DIFFERENT AMBITIONS AND ASPIRATIONS TO GROW

It is at this point where speaking of smaller business owners as a single entity becomes less useful for generating insights. What may be true is not to speak of average ambition levels found across a heterogenous population of 5.7m smaller businesses in the UK, but rather the percentage of that population which does have high ambition and a growth mindset.

The British Business Bank has undertaken SME segmentation analysis so that interventions can be targeted to the highest potential and most receptive sub-group. Further details about the results of this segmentation analysis, and its application to policy can be found in this section.

SMEs WHO USE FINANCE, OR ARE OPEN TO USING FINANCE, FALL INTO 4 DISTINCT SEGMENTS

The British Business Bank worked with existing survey data of UK SMEs and commissioned a cluster-based analytical segmentation of the population based on SME attitudes and needs towards finance (see Use of external finance section 2.3 for more detail on our technical approach). Notably, this segmentation did not consider need for any single type of finance, but rather overall need for and use of different types of finance and non-finance support. It also overlaid an SME's openness to external information about finance and how to secure it.

This attitudinally based approach suggests that UK SMEs can be usefully divided into 4 distinct groups that currently use external finance or are open towards using finance, in addition to a large group which neither currently uses nor intends to use any form of finance.

This latter group of 'Permanent non-borrowers' (PNB) is very large and makes up approximately half (47%) of all UK smaller business owners. In general, a disproportionate percentage of these companies are small, with no employees. They are also less likely to expect to grow or be international or innovative. For the purposes of our segmentation, this group has been excluded; however, it has not been established yet how durable PNB intention not to use external finance is, and whether some proportion of this group shifts each year as their circumstances change.

The 4 segments amongst UK smaller business owners who use external finance demonstrate commonalities within their group in terms of needs and attitudes towards finance which make them distinct from the other groups on average (figure A.8).

FIG A.8

SME MARKET SEGMENTATION, EXCLUDING PERMANENT NON-BORROWERS

Source: British Business Bank

CONTENTED

Undemanding and unworried. The least likely to be innovative and international, and with the lowest growth ambitions. Relatively financially confident, but not informed.

FIGHTERS

Trying to overcome obstacles and grow. Tend to be somewhat ambitious, international and innovative. Most likely to report obstacles to running their businesses, including those relating to cashflow, skills, politics, the economy and access to finance.

SAVVY ENTREPRENEURS

Innovative, international and formal. The most confident in their own abilities to assess finance options. Most likely to have a financial qualification.

QUICKSILVERS

Growing, successful, but somewhat vulnerable. The fastest-growing businesses with the most ambitious growth plans. Relatively international and innovative. Somewhat confident in their abilities to assess financial options and relatively more likely to employ someone with a financial qualification. Nevertheless, have had some issues with previous rejections by a bank.

'CONTENTED'

The largest of the 4 segments, the 'Contented' make up 32% of SMEs and are broadly unworried and undemanding (figure A.9). They self-report being financially confident but objectively have lower levels of financial qualification and lower rates of awareness/understanding of financial products. Relative to other groups, the Contented are least likely to be innovative and internationally oriented businesses and have substantially lower growth ambitions. Contented have the lowest proportion of SMEs (16%) that have plans to grow by more than 20% over the next year (figure A.10). Notably, this group is also among the least happy to use external finance to grow and is least interested in new external information (figure A.11). This may reflect the reduced relevance of finance given low growth ambitions.

'QUICKSILVERS'

The segment most likely to have high growth ambitions are 'Quicksilvers', which make up 9% of SMEs. Although not all Quicksilvers have achieved 20+% growth on average over 3 years, nearly all such companies have the growth mindsets consistent with the Quicksilver attitudinal segment. Quicksilvers have the largest proportion (37%) of smaller businesses planning to grow more than 20% over the next year and Quicksilvers (62%) are also most open towards use of external finance to help growth.

These are the fastest growing businesses, with the most ambitious growth plans, and could have the largest potential positive impact on UK economic and job growth. However, as they try to scale-up, many have issues with finance applications, experiencing rejection, and an inability to borrow and raise equity. These smaller business owners are relatively well informed about financial products but less so than Savvy Entrepreneurs. Quicksilvers, furthermore, are also more open to seeking out and absorbing external information that helps them which suggests an opportunity exists to target them with useful support.

'SAVVY ENTREPRENEURS'

In contrast, the 'Savvy Entrepreneurs' segment (which is 6% of SMEs), are the most financially informed and most likely to have a financial qualification. These business owners either are or have run more than one business either in parallel or are serial entrepreneurs. These businesses tend to be more innovative, international and run with formal processes than average. Their experience and track records are valuable, visible, and verifiable. This group not only self-reports the highest confidence in their own abilities, but also the highest levels of confidence that their banks would provide finance if applied to. Perhaps consequently, 'Savvy Entrepreneurs' tend to be less open to external information and believe that they already know what they require.

FIG A.9

BRITISH BUSINESS BANK SME SEGMENTS, PERCENTAGE OF BUSINESSES

Source: British Business Bank analysis of SME Finance Monitor 10 quarter dataset ending Q2 2017

FIG A.10

PLANS FOR BUSINESS TURNOVER OVER THE NEXT YEAR, BY SME SEGMENTATION

Source: British Business Bank analysis of SME Finance Monitor 10 quarter dataset ending Q2 2017

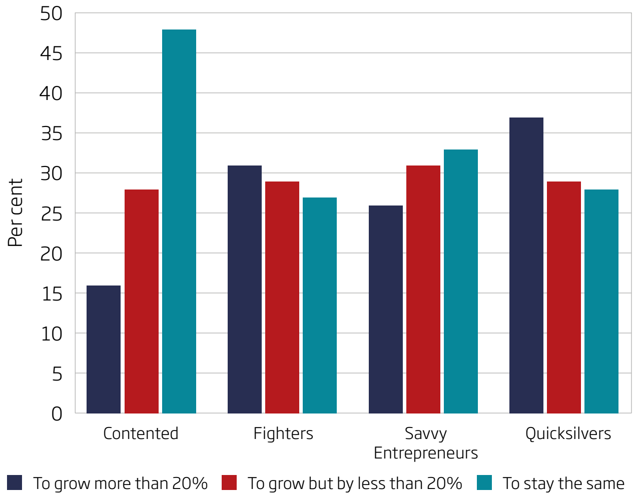


FIG A.11

ATTITUDES TOWARDS GROWING A BUSINESS AND USE OF EXTERNAL FINANCE

Source: British Business Bank analysis of SME Finance Monitor 10 quarter dataset ending Q2 2017

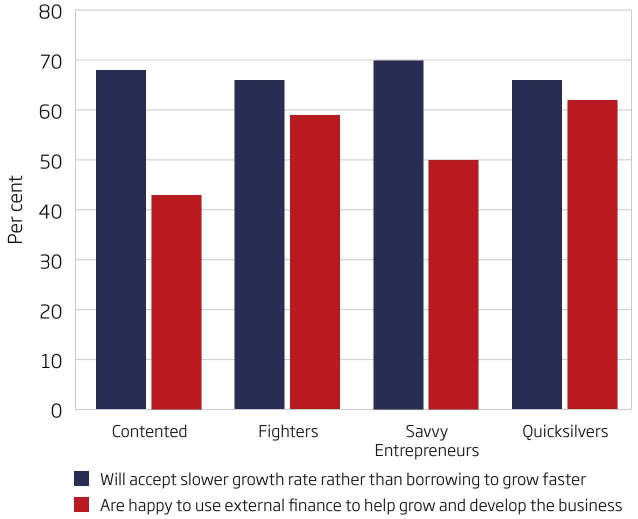
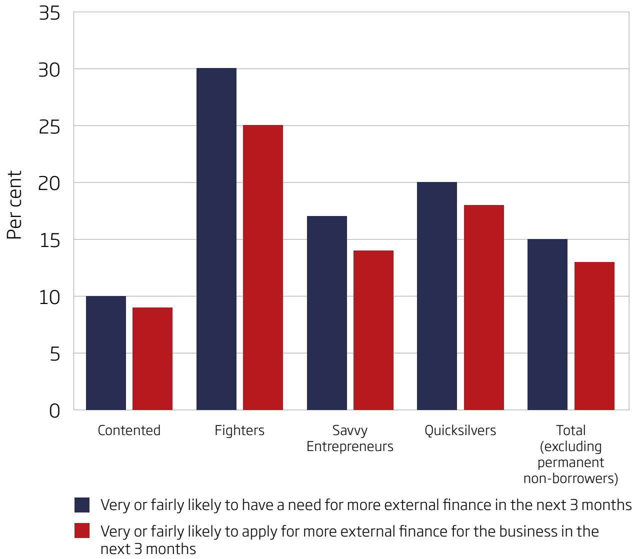


FIG A.12

SHARE OF SMEs LIKELY TO HAVE A NEED FOR MORE EXTERNAL FINANCE / APPLY FOR MORE FINANCE IN THE NEXT 3 MONTHS

Source: British Business Bank analysis of SME Finance Monitor 10 quarter dataset ending Q2 2017



'FIGHTERS'

Not all segments show such confidence. 7% are 'Fighters' and they are defined heavily by their perception of facing many obstacles. These include managing cashflow, customer late payment, skills, political shocks, economic headwinds, as well as access to finance. Nevertheless, beyond their daily concerns, some of these businesses are still trying to achieve their ambitions, including through innovation and international activity. Fighters are the most likely to identify a need for external finance (30%), or apply for more external finance (25%) (figure A.12). Clearly, not all Fighters will succeed in overcoming their immediate issues but as a group they are also very open to external information and practical support.

SME SEGMENTATION INSIGHTS ENABLE POLICY RESPONSES TO BE TARGETED AND MORE EFFECTIVE

At this point in the UK economic cycle, we believe that the Quicksilver segment is the most attractive to target from an information provision policy perspective. This is because their attitudinal openness means they have the highest potential to be influenced by policy interventions. Improving the level of awareness and understanding of the full range of financial products available to this group is likely to also improve the efficiency of capital allocation within the UK economy.

It is worth noting that Quicksilver companies are found in all industries and regions of the UK, and amongst companies of all ages and sizes. This is consistent with the findings of the ScaleUp Institute Review which found that scale-up companies that had achieved more than 20% growth over 3 years are geographically spread across the UK.[17]

Further work has been done to understand how to quickly and reliably identify which segment a company belongs to, technical details are discussed in section 2.3 (Use of external finance).

BRITISH BUSINESS BANK DEMAND SIDE RESPONSE

To tackle information failures which affect demand for SME finance the British Business Bank is implementing a new targeted information strategy. This new 'targeted approach' is intended to complement the Bank's ongoing 'whole of market' activities which provides finance information aimed at all smaller businesses.

To deliver this new targeted information strategy we are developing a digital hub which will contain best in class content. We are initially focussed on the needs of potential and high growth SMEs.

A targeted approach for information delivery will not sideline or replace the Bank's existing work to provide information for the market as a whole. It represents a first step towards a more dynamic and intelligent framework for delivery of SME finance information. We will learn from the early experience of the digital hub to continuously improve how finance information is delivered to SMEs.

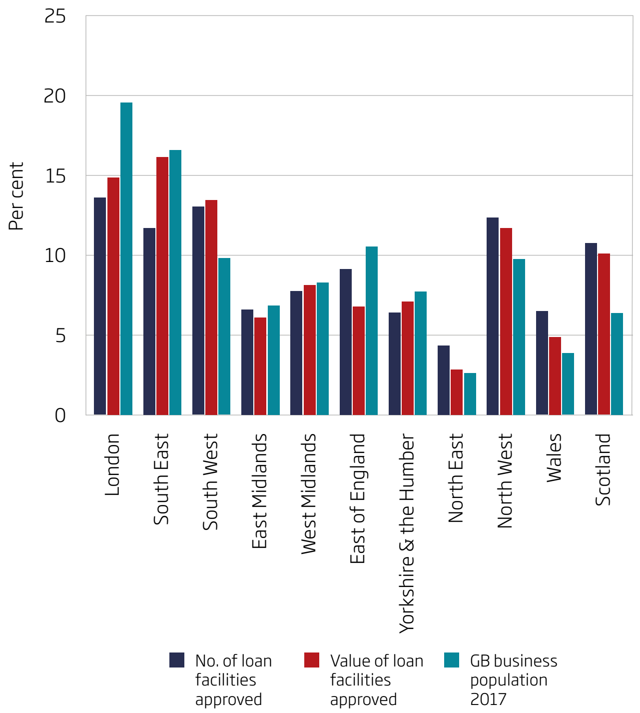
1.2 REGIONAL ACCESS TO FINANCE

- Where a smaller business is based can be an important factor in their search for finance
- Bank lending is largely distributed in the UK in line with the overall business population in most areas
- Equity deals are concentrated in London
- However, clusters of equity activity do exist throughout the country
- Business angel activity is also concentrated in London and displays different investment characteristics to those located outside of London
- Increasing the number of Business angels offers a potential solution to address regional differences in the availability of equity finance

FIG A.13

SHARE OF VALUE AND VOLUME OF BANK LENDING AND BUSINESS POPULATION ACROSS GREAT BRITAIN

Source: BEIS 2017 Business population estimates, UK Finance (year ending Q3 2017) and British Business Bank calculations



Where a smaller business is based can sometimes have a significant impact on their ability to find the finance they need. The Benefits of Diverse Smaller Business Finance Markets publication highlighted place as one of the key issues to consider when thinking about diversity from both a demand and supply perspective.[18] 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 in different areas and highlights recent bank analysis that helped inform a new programme to support developing clusters of business angels outside of London.

BANK LENDING IS LARGELY DISTRIBUTED IN THE UK IN LINE WITH THE OVERALL BUSINESS POPULATION IN MOST AREAS

Bank lending is an example of a product where the regional distribution of lending more closely matches the distribution of the business population. Of the 11 English regions and devolved administrations bank lending is close to or exceeds the share of the overall business population (figure A.13).[19] The 2 notable exceptions are London and the South East which have proportionately lower shares of bank lending in terms of the number of loan facilities approved compared to the share of businesses in the region. For London this also extends to the value of the loan facilities approved, with the South East having a slightly higher share of business population compared to share of loan value approved.

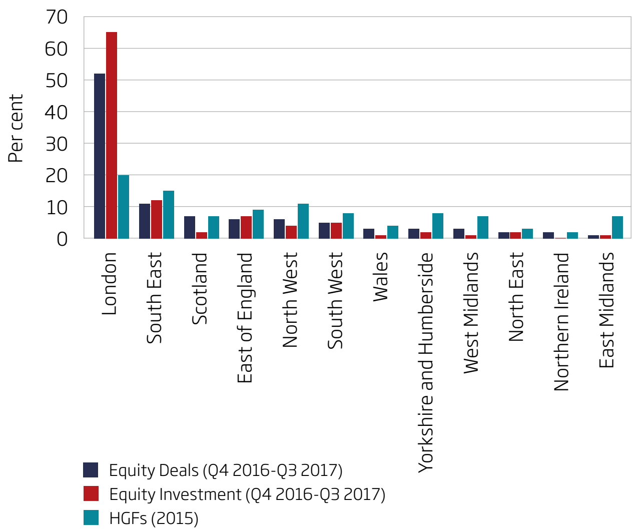
The lower share of bank lending in London and the South East (compared to business population) does not imply these regions have proportionately less access to bank lending. Two main factors are likely to drive this result, discussed below.

A recent OECD report highlighted the challenges posed when analysing regional data. Business population data can be susceptible to headquarter bias.[20] This is due to the misallocation of figures to the region of the headquarters (rather than to the region of location of the economic activity). The report notes this is particularly the case for capital city regions. Using London as our example, it is likely the number of businesses reported as being in London significantly overstates the actual number of businesses carrying out their day-to-day business in London.

FIG A.14

SHARE OF EQUITY DEALS, INVESTMENT AND HIGH GROWTH FIRMS BY REGION AND DEVOLVED ADMINISTRATION

Source: Beauhurst, ONS and British Business Bank calculations[22]



A second reason is that businesses in London and the South East may have greater access to, and awareness of, alternative sources of finance, such as equity, when compared to those in other regions so are less reliant on banks for finance.

The diverse spread of bank lending does not mean that all debt finance products are utilised to a similar level across the UK. Marketplace lending platforms are accessible by both funding providers and borrowers online, so distance should be less important. However, survey evidence suggests funders and borrowers on these platforms are concentrated in London and the South East.[21]

Furthermore, a diverse regional spread of bank lending does not imply that all smaller businesses across the UK receive the appropriate level of debt finance. The market failures that underpin the British Business Bank's debt interventions still apply.

EQUITY DEALS ARE CONCENTRATED IN LONDON

Equity is a key part of the funding mix for High Growth Firms (HGFs) so rather than comparing the usage of equity to the total business population it is better to look at the usage of equity compared to HGFs for regional comparisons.

HGFs are located in all areas of the UK. Only a small proportion of HGFs are likely to be using equity finance, but for some high growth potential firms, equity finance is the only funding source that can enable them to achieve their growth. It is therefore important that high growth potential firms have access to equity finance in order that they can reach their potential.

Despite this wide dispersion of HGFs, equity investment continues to be geographically concentrated in London with 52% of total deals and 65% of investment value over the past 12 months occurring in the capital city. London's share of equity investment by both number of deals is significantly overrepresented when compared to its share of HGFs (20%) (figure A.14).

The 2017 Equity Tracker report identified regional disparities in equity finance have worsened over time with London and the South East having increased their share of equity investment over recent years. In 2011, 44% of the UK's equity deals were completed in London and the South East, but by Q3 2017 this had risen to 63%.

This is partly due to the increased number of software deals in recent years, which may have contributed to the increased concentration of deals in London over time. For instance, the number of software deals (by unweighted count) increased by 304% between 2011 and 2015 compared to 144% for non-software. The report found 61% of all software deals are in London, compared to 43% of non-software deals.

The distribution of non-software deals is more nuanced with London having a higher density of earlier stage and smaller deals (less than £1m), but growth stage deals in non-software sectors are slightly more spread out throughout the UK and are closer to the wider distribution of HGFs. For instance, London's share of growth deals in non-software sectors is 28% which is more in line with the region's share of HGFs.

The Equity Tracker report identified specific supply side and demand side factors that have contributed to the differences in the availability and use of equity finance across regions and devolved administrations. The following numbers are updated from those previously published in the 2017 Equity Tracker report, reflecting the latest available data:

SUPPLY SIDE

- A lack of equity fund manager presence in areas outside of London could explain some of the lower availability. This is especially the case as investors often prefer to invest locally to minimise their time and travel costs.[23] British Business Bank analysis of PitchBook in January 2018 shows of the 626 active investors[24] with VC listed as one of their investment strategies, 74% have their head office listed with a London address (461).[25] There are 165 investors (including public sector backed fund managers) listed with a head office located outside of London. This may underestimate the presence of equity investors in areas outside of London as many large investors have regional offices.

DEMAND SIDE

- Smaller business awareness of equity finance from VCs and business angels is lower in areas outside of London compared to the capital. Lower awareness of equity funding options may lead to lower willingness to use equity finance, even if supply was increased. The 2017 British Business Bank Finance survey shows 69% of SMEs in London are aware of VC as a source of external finance compared to 58% in the North and 61% in the Midlands.

Whilst the overall UK market, dominated by London, has developed over the last few years, in areas outside of the capital, demand and supply side factors are likely to interact leading to a 'thin market'. Limited numbers of investors and entrepreneurial growth firms have difficulty finding and contracting with each other at reasonable costs. Thick markets are characterised by high levels of repeated interaction between VC and high-growth firms, so that human capital is built up in the sector, with a large enough market for an ecosystem of supportive activities to develop.

HOWEVER, CLUSTERS OF EQUITY DEAL ACTIVITY DO EXIST THROUGHOUT THE COUNTRY

English regions and devolved administrations obscure the large variation in equity deal numbers that occur within these areas. Equity deals tend to be grouped in geographic clusters where innovative companies, skilled labour and equity investors locate close together to minimise time and travel costs and share the benefits from greater networking.

The British Business Bank 2017 Equity Tracker report showed the top 25 Local Authority Districts by number of deals in 2016. Whilst Boroughs in London formed nearly half of the top 25 areas, there are important equity hotspots outside of the capital. This includes the established equity eco-systems of Oxford and Cambridge, but also cities like Edinburgh, Manchester, Cardiff, Bristol, Glasgow, Sheffield, Leeds and Birmingham. The continued development and expansion of these technology clusters around the UK is important, as they provide the focal point for increasing the amount of equity finance throughout the whole UK.

Tech City acknowledges that the "face-to-face networking that these [accelerators, affordable co-working spaces and experienced mentors] enable is hugely important to the growth and success of digital businesses".[26] Networks can also benefit equity investors, as greater deal syndication is found to increase the likelihood of successful exit outcomes, especially for geographic or sector specific networks of investors.[27]

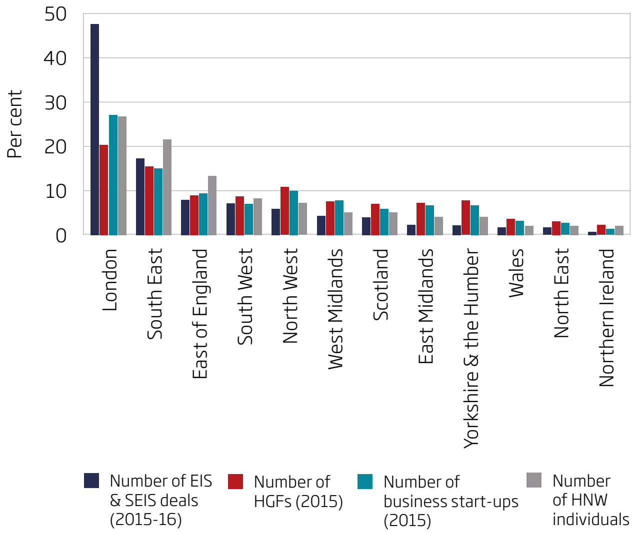
BUSINESS ANGEL ACTIVITY IS ALSO CONCENTRATED IN LONDON AND DISPLAYS DIFFERENT INVESTMENT CHARACTERISTICS TO THOSE LOCATED OUTSIDE OF LONDON

Business angels are High Net Worth Individuals that invest their own money in small growing businesses through an equity stake. Business angels are an important source of finance for SMEs. Quantifying the number of deals involving business angels is difficult as business angels are less likely to be driven to seek publicity on completing investments, and so are largely missing from investment numbers in data sources like Beauhurst.

FIG A.15

SHARE OF EIS AND SEIS DEALS, HIGH GROWTH FIRMS, NUMBER OF BUSINESS START-UPS AND NUMBER OF HIGH NET WORTH INDIVIDUALS BY REGION AND DEVOLVED ADMINISTRATION

Source: HMRC, ONS, Barclays and British Business Bank calculations



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 Angel Spotlight report produced by British Business Bank and UK Business Angel Association confirms that 87% of angels who invested in 2016 used EIS or SEIS. HMRC data shows that 3,470 companies raised a total of £1.9bn of funding in 2015-16 under the EIS scheme.[28] An additional 2,360 companies also received investment through the Seed Enterprise Investment Scheme (SEIS) in 2015-16 raising £180m of funding. This shows the importance of angel funding to UK companies, which exceeds the number of companies funded by VC funds.

EIS and SEIS deals are highly concentrated in London and the South East with 46% and 17% of all deals located in these regions respectively in 2015/16. This is despite London accounting for only 26% of start-ups and 20% of HGFs (figure A.15).

The Angel Spotlight Survey also confirms a lack of angels located in areas outside of London and the South East. 57% of business angels responding to the survey were located in London or the South East, with just 7% based in the Midlands and 7% in the North.[29]

The survey also identifies interesting differences between angels located in London and those located outside:[30]

- **Differences in experience:** Business angels located outside of London are likely to be older and more experienced than angels located in London. The average time spent investing as an angel in London is 5.8 years (median 4 years) compared to 9 years (median 7 years) for angels located elsewhere.
- **Differences in involvement in investee companies:** Angels in London are more likely to have a passive shareholder role (87%) compared to angels outside of London (63%), which reflects a lower proportion sitting on the board (30% compared to 58%). This may be due to London based business angels being more likely to use crowdfunding platforms to make investments (47% of angels in London have invested through a crowdfunding platform in 2016/17 compared to 32% outside of London).
- **Differences in factors affecting investment decision:** Investee companies' management team's skills and experience, the potential for growth and the expected financial returns are the main factors influencing the decision to invest for businesses angels wherever they are based. However, angels based outside of London are more likely to look for investments where they can add their skills and experience (46% cited it as important compared to 25% in London). Location of investments is a consideration for business angels outside of London (10%), whilst no angels in London reported this as an important factor influencing their decision to invest.

INCREASING THE NUMBER OF BUSINESS ANGELS OFFERS A POTENTIAL SOLUTION TO ADDRESS REGIONAL DIFFERENCES IN THE AVAILABILITY OF EQUITY FINANCE

Equity investors, especially those making smaller investments into smaller companies often prefer making investments in business that are geographically closer. This is because they can spend significant amount of time with their portfolio company getting to understand the business. Anecdotally, it is often reported that a two-hour travel time is often used as a guide for investing. Therefore, the supply of equity finance is likely to be linked to the location of where equity investors are based. Encouraging higher levels of business angels offers a potential mechanism for addressing regional imbalances in the availability of equity finance.

This is because business angels have the potential to be more geographically dispersed throughout the UK than other equity investors. Out of the estimated 625,000 total number of millionaires in the UK, figure A.15 shows 74% are located outside of London.[31] Not everyone will have the skills, experience or desire to become a business angel, but it does suggest the potential flow of individuals that could become business angels is more regionally dispersed than the current location of equity investors where 74% have a head office based in London.

Business angels provide non-pecuniary benefits through the expertise they share which can benefit their investee companies. Business angels often have direct sector or business experience which they share with their investment companies. This will have a positive impact on business growth in addition to the funding the company receives.

The 2017 Autumn Budget announced that the British Business Bank will shortly launch a commercial investment programme to support developing clusters of business angels outside of London.

This will add to the range of regionally focused activity in the British Business Bank's portfolio. The role out of regional funds such the Northern Powerhouse Investment Fund and the Midlands Engine Investment Fund is continuing, enabling more businesses in those regions to access debt and equity finance. The British Business Bank is also establishing the Cornwall & Isles of Scilly Investment Fund in partnership with the Cornwall & Isles of Scilly Local Enterprise Partnership. As announced in the government's Industrial Strategy the British Business Bank will be rolling out a network of regional managers by autumn 2018 to ensure businesses across the UK know how to access sources of investment.

1.3
PATIENT CAPITAL FOR SCALE-UPS

- Patient capital is long-term investment in innovative firms looking to scale up
- Analysis confirms there is a shortage in the availability of patient capital to UK high growth potential firms leading to fewer businesses scaling up
- The British Business Bank will increase the amount of longer-term finance available to innovative, high-growth smaller businesses through the package of support announced at Autumn Budget

The Government has recently published its response to the Patient Capital Consultation.[32] This section summarises the evidence on the availability of patient capital to high growth innovative firms from the Patient Capital Consultation including contributions from the British Business Bank. The section will then explain how the British Business Bank will use the additional funding it received to increase the availability of patient capital to growing businesses.

PATIENT CAPITAL IS LONG-TERM INVESTMENT IN INNOVATIVE FIRMS LOOKING TO SCALE UP

The consultation defined patient capital as "long-term investment in innovative firms led by ambitious entrepreneurs who want to build large-scale businesses".[33] Finance is typically provided through an entrepreneur's own long-term commitment to their business and in some instances through equity investment from external investors, such as business angels, venture capital funds or public markets. It is difficult to classify the investment time horizon as this varies by sector, from 3 to 5 years in some sectors like ICT to as long as 10 to 15 years in others.

Patient capital supports smaller businesses enabling them to grow into large businesses, which has an important impact on UK productivity through the diffusion of new ideas into the economy. A lack of suitable patient capital investment can hold back UK businesses from successfully commercialising their innovation leading to missed opportunities and lower economic output.

The UK has a high business birth rate and high proportion of businesses exhibiting high growth compared to other European countries, but the UK and Europe has generally performed poorly compared to the US in the process of scaling up successful start-ups.[34] The Consultation describes how this is seen in the lower number of unicorn businesses and wider evidence that the UK and other European economies show a significantly higher proportion of static firms that do not shrink or grow compared to the US.[35]

ANALYSIS CONFIRMS THERE IS A SHORTAGE IN THE AVAILABILITY OF PATIENT CAPITAL TO UK HIGH GROWTH POTENTIAL FIRMS LEADING TO FEWER BUSINESSES SCALING UP

The UK funding eco-system is currently not fully connected and able to support high growth businesses from early stage through to listing on a public market, despite recent improvements in the availability of seed stage funding in recent years. The historic shortage of risk capital available in the UK is well-documented with successive Government reviews identifying a lack of long-term capital in the UK and a shortage of investors able to make larger investments.

Empirical analysis published in last year's (2016/17) British Business Bank Small Business Finance Markets report quantified the extent to which UK VC backed companies received fewer later stage follow on rounds compared to US companies (figure A.16).[36] The report also identified subsequent deal sizes for follow on rounds are smaller in the UK compared to their US counterparts (figure A.17). This suggest UK VC backed companies could be underfunded compared to their US counterparts, which could impact on their ability to grow and scale up.

More recent analysis contained in the British Business Bank 2017 Equity Tracker report show UK VC investors appear to exit their investments at a relatively early stage compared to investors in the US, which reduces the ability of businesses to scale up (figure A.18).[37] UK VC backed companies that successfully exit receive fewer funding rounds on average compared to companies in the US (1.9 compared to 2.7) companies with differences existing across all the main exit routes. Developing a company to be a position to be able to IPO requires more funding than developing a company for a trade sale. The analysis showed that it takes 3.5 funding rounds on average to exit via an IPO compared to 2.4 for a trade sale.

Respondents to the Patient Capital Consultation confirmed a gap in follow-on investment for businesses that had already received initial investment. This was sometimes defined by stage of investment, focusing on Series "B" to Series "D" funding rounds. Other respondents referred to investment size, with £5 million to £50 million being quoted most often as the weakest range of investment. The Patient Capital Review Industry Panel also identified a specific problem for companies requiring more than £5m of equity investment.[38]

FIG A.16

COHORT ANALYSIS OF COMPANIES RECEIVING SERIES A/SEED FUNDING IN 2008-10

Source: British Business Bank analysis of Preqin

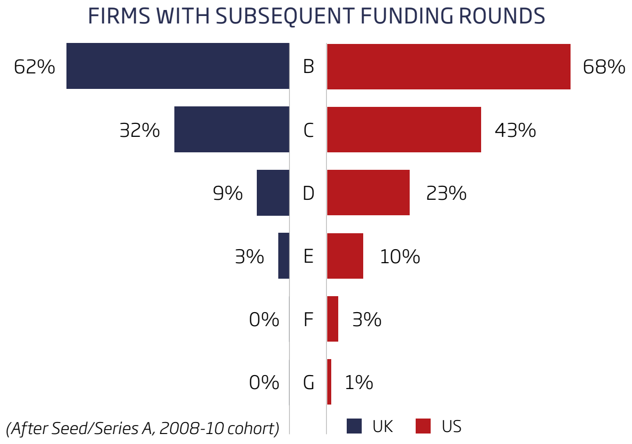


FIG A.17

AVERAGE DEAL SIZE BY FUNDING ROUND

Source: British Business Bank analysis of Preqin

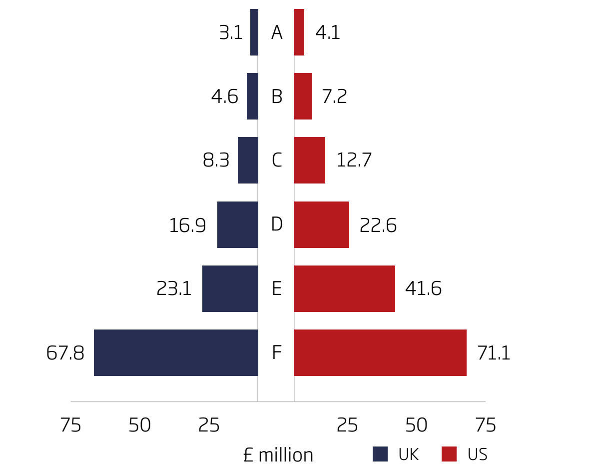
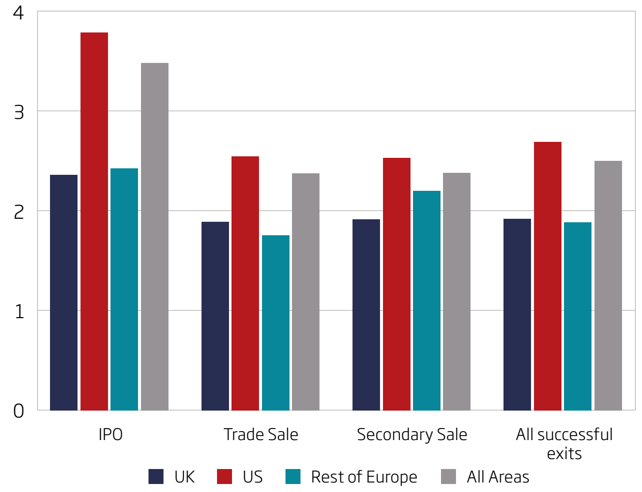


FIG A.18

AVERAGE NUMBER OF FUNDING ROUNDS BY EXIT ROUTE

Source: British Business Bank analysis of Preqin



The UK (and Europe) has a thinner VC market than the US. Last year's Small Business Finance Markets report noted that the European VC industry is trapped in a sub-optimal investment cycle with low financial returns, smaller fund sizes and smaller deal sizes. The British Business Bank 2017 Equity Tracker report confirmed:[39]

- UK VC funds are around 1.5 times smaller on average than the average US VC fund (£118m compared to £180m), which limits their ability to do larger deals
- The vast majority (98%) of US VC fundraising comes from institutional sources like pension funds, insurance companies, foundations/endowments, etc., whilst in the UK it is much lower (55%)
- The UK has fewer Limited Partner (LP) investors investing in each VC fund compared to the US. The average US VC fund has 5.2 LP investors compared to 2.9 in UK and 3.0 in Rest of Europe.

This was verified by the Patient Capital Industry Panel that observed institutional investors currently allocate most of their capital to listed (and therefore liquid) assets, with a lower exposure to equity compared to a decade ago. Only a small percentage of their assets are allocated to 'alternatives', of which a smaller proportion still is allocated to venture capital. The panel observed several reasons for the low level of investment into VC by institutional investors. The UK was perceived to have too few large VC funds and relatively unattractive financial returns. To be attractive to investors, the panel suggested VC returns need to show a premium over listed equities of at least 2-3%, to compensate for the lack of liquidity and lack of control, but historically, the average UK VC fund has been unable to achieve this. The UK pensions market was also judged to be heavily fragmented relative to other G7 countries and so less able to invest in risky or illiquid assets.

There are also barriers on the demand side. Some high growth businesses do not use equity finance because they fear losing control, thinking it is not a suitable form of finance. In addition, many reported not really knowing much about equity finance as a reason for not using equity funding.[40]

THE BRITISH BUSINESS BANK WILL INCREASE THE AMOUNT OF LONGER-TERM FINANCE AVAILABLE TO INNOVATIVE, HIGH-GROWTH SMALLER BUSINESSES THROUGH THE PACKAGE OF SUPPORT ANNOUNCED AT AUTUMN BUDGET

Following the Chancellor's announcement at Budget 2017, the British Business Bank welcomes the £2.5bn of additional funding that has been made available to it to support UK smaller businesses looking to scale-up and realise their growth potential, in order to tackle the patient capital funding gap.[41] The Bank will work to increase patient capital through the following new and existing programmes:

- **A new £2.5bn Patient Capital entity** will be incubated within the Bank to commercially co-invest alongside private sector investors into venture and growth capital funds. The entity will be designed from the outset with a view to a future sale into the private sector once it has built its portfolio and track record, subject to a value for money assessment
- **British Business Investments – the Bank's existing commercial arm – will cornerstone a small number of large scale, private sector managed fund of funds,** which will increase the availability of patient capital investment into high growth potential businesses. A 'Request for Proposals' to manage the first phase of these funds (up to £500m) will be issued early 2018, and 2 subsequent phases are possible subject to the market response
- **The Enterprise Capital Fund (ECF) programme will be maintained,** and will continue its important role in backing new and emerging fund managers unlocking at least £1.5bn of new investment. This will provide stability to the market, and publicly recognises the central role this programme plays in the Bank's equity offering.

The overall aim of these measures is to increase access to longer-term finance for innovative, high-growth smaller companies so they can achieve their full growth potential. The British Business Bank aims to achieve this by crowding in private capital, expanding investor diversity, and utilising and developing private sector fund management expertise. This will help break the current sub-optimal investment cycle by creating funds of sufficient size that can make follow on investments in their most promising companies.

We aim to use the Bank's position as the second largest Limited Partner in the UK venture capital market to demonstrate the attractiveness of this market to investors, with the longer-term ambition of supporting the development of sustainable private sector expertise in the UK.[42]

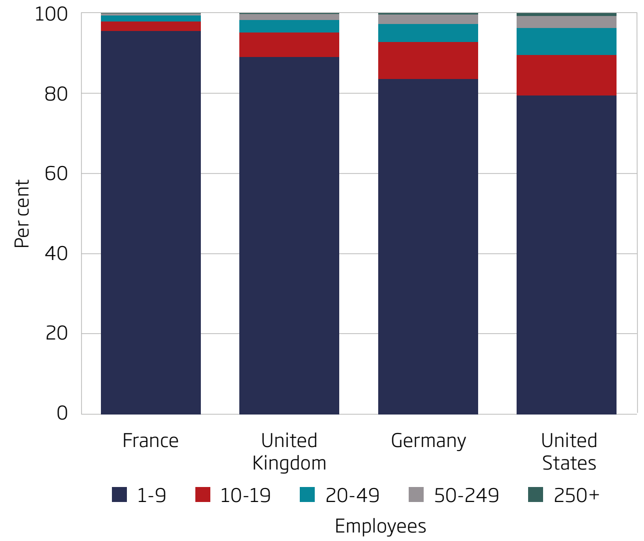
1.4 INTERNATIONAL COMPARISONS OF SMALL BUSINESS FINANCE MARKETS

- UK smaller business population concentrated in service sector and growing relatively rapidly
- The UK economy is successful at generating start-ups
- Improved performance in translating start-ups into scale-ups
- UK SMEs have similar patterns in obtaining finance to our major competitors
- Equity finance is twice as large in the US compared to the UK, but the UK performs relatively well compared to other European countries

FIG A.19

SHARE OF ENTERPRISES BY SIZE

Source: OECD, Entrepreneurship at a Glance, 2017



This section explores UK small business finance markets in comparison to those in major competitor countries. First, the current structure of the economy is examined by firm size showing that the UK has a similar concentration in micro and small businesses as in major competitors.

Second, the dynamic nature of the small business population is considered, looking at births, growth performance and deaths. This highlights the strong performance of the UK economy in generating start-ups, while the record of translating those into high growth firms has improved in recent years.

Third, the use of external finance is compared, with UK SMEs similar in their use and experience of most types of debt finance, but usage of equity finance to support scale-ups, whilst improving, still falls behind the US.

Comprehensive data allowing direct international comparisons of small businesses has traditionally been limited, not least because of differences in the precise definition of small businesses. Data availability is, however, improving.

First, the OECD produces regular publications on the overall partners of entrepreneurship[43] and finance used by SMEs. Second, the European wide survey run by the European Commission and the European Central Bank called Survey on access to finance of enterprises (SAFE) offers good insight into the experience of small businesses using external finance.[44, 45] However, relatively small individual country sample size mean that some caution is required in highlighting international differences. Where SAFE is used in this report data refers to the latest wave of the survey taking place in September and October 2017 unless otherwise stated.

The approach taken in this chapter is to make comparison with the UK's major international competitors, ie the US, Germany and France, bringing in other countries where relevant.

UK SMALLER BUSINESS POPULATION CONCENTRATED IN SERVICE SECTOR AND GROWING RELATIVELY RAPIDLY

Unsurprisingly, smaller businesses, and more specifically micro-businesses (those with fewer than 10 employees), account for the overwhelming majority of enterprises in all OECD economies.[46] The UK has a higher share of micro-enterprises than Germany and the US[47] but a lower share than France (figure A.19).

FIG A.20

VALUE ADDED BY ENTERPRISE SIZE (NUMBER OF EMPLOYEES)

Source: OECD, Entrepreneurship at a Glance, 2017

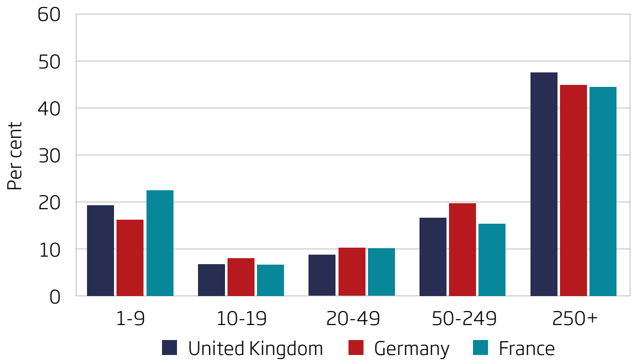


FIG A.21

INTERNATIONAL TRENDS IN SME POPULATION

Source: OECD, Entrepreneurship at a Glance, 2017

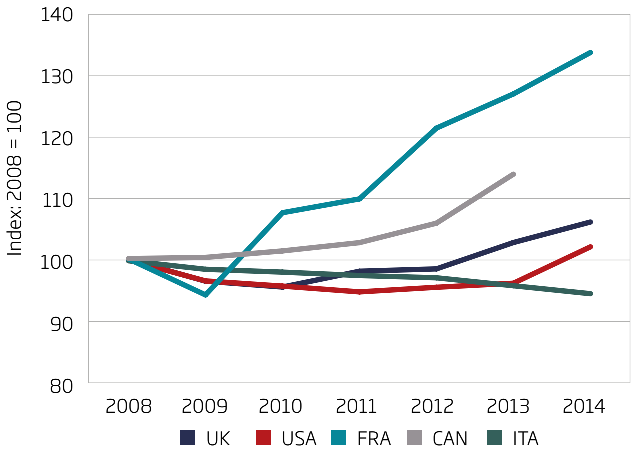
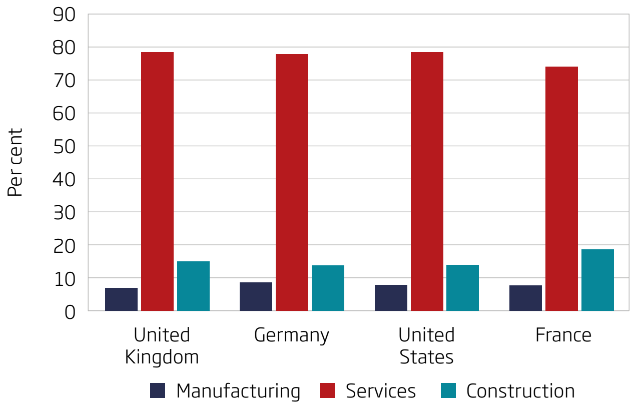


FIG A.22

SHARE OF ENTERPRISES BY MAIN SECTORS

Source: OECD, Entrepreneurship at a Glance, 2017



The OECD data also allows comparison of the value added by enterprise size. Figure A.20 shows a similar pattern for value added as that observed for share of enterprises. Compared to Germany, the UK has a higher share of value added in micro and large businesses. France, however has a slightly greater share of value added than the UK in micro and small businesses, but less in medium and large businesses.

Following a decline in enterprise numbers in 2009, there has been an upward trend in the number of SMEs in major economies since 2012. The latest available data in the OECD database reports that the UK SME population was 6% higher in 2014 than in 2008 (figure A.21). See section 2.1 for a discussion on more recent trends in the UK SME population which shows further rapid growth since then.

There is also some difference in the size and sector distribution of SMEs in some of our major competitor countries. The high-level sector distribution is shown in figure A.22. The UK is similar to the US, albeit with a slightly lower share of manufacturing in the UK (6.9% vs 7.8%) and a higher share of construction (14.9% vs 13.9%).

In comparison to France, the UK has a higher share of service sector enterprises (78.2% vs 73.8%) with construction accounting for a higher share of enterprises in France (18.6% vs 14.9%).

As is well known, the UK has a lower share of manufacturing than Germany (6.9% vs 8.6%). Manufacturing enterprises in Germany are less likely than those in the UK to be micro business, but more likely to be small businesses, particularly 10-19 employees (17.4% vs 10.4%), and medium sized enterprises (7.8% vs 4.9%) as shown in figure A.23.

It is a consistent finding across SME Finance surveys, that the larger the firm, the more likely they are to make use of certain types of external finance. The difference in distribution of manufacturing enterprise size, suggests that German manufacturers may be more frequent users of external finance than UK manufacturers.

THE UK ECONOMY IS SUCCESSFUL AT GENERATING START-UPS

International comparison shows that the UK has been effective at starting up active employer enterprises. In 2014, the UK had the highest number of births in terms of employer enterprises with nearly 300,000 births. Figure A.24 shows birth rates[48] in the UK exceeding that in France, Germany and the USA. Amongst the wider OECD dataset only Hungary and Poland exceed the UK on birth rates.

A high birth rate may not be a sign of success if the survival rates of those businesses is low. The UK however, also has a high one-year survival rate with rates in the US and the UK significantly above France and Germany (figure A.25).

And not only do the UK's start-ups have relatively good survival rates, but they also make a significant contribution to employment. The UK is the only country in the OECD database where start-ups, defined here as those up to 2 years old, account for more than 35% of employer enterprises, with those enterprises accounting for just over 10% of employment.

Finally, international comparison of death rates of employer businesses, shows the UK mid-table with the 10.1% of employer enterprises dying in 2014. In summary, this demonstrates the success of the UK economy in generating new start-ups which survive and contribute significantly to UK employment.

IMPROVED PERFORMANCE IN TRANSLATING START-UPS INTO SCALE-UPS

International comparisons of scale-ups are difficult as comparative data is limited, but there are numerous potential definitions of scale-up. OECD defines high-growth enterprises as those with average annualised growth in the number of employees greater than 20% per year, over a 3-year period, and with 10 or more employees at the beginning of the observation period.

Based on this OECD definition, there has been an improvement in the share of high growth enterprises in the UK between 2012 and 2014, with the number of high-growth firms returning to the long-term average range of 10 to 12 thousand high growth enterprises per year. Other OECD countries, such as Germany, have seen a fall in the share of high growth enterprises in the economy demonstrating the relatively better UK performance since 2012.

The relatively strong performance of the UK is confirmed in the latest Eurostat data for 2015.[49] Using a definition of high growth firms growing employees by 10% or more on average over 3 years, the UK share of high growth firms exceeds that of Germany and France.

FIG A.23

SIZE DISTRIBUTION OF MANUFACTURING FIRMS (NUMBER OF EMPLOYEES)

Source: OECD, Entrepreneurship at a Glance, 2017

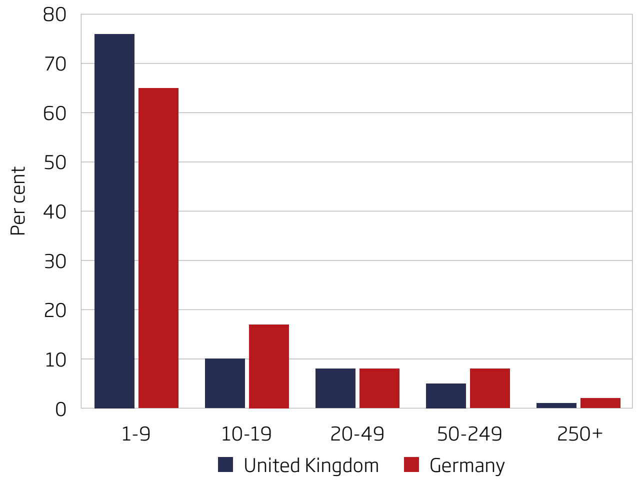


FIG A.24

EMPLOYER ENTERPRISE BIRTHS AS A SHARE OF ACTIVE EMPLOYER ENTERPRISES

Source: OECD, Entrepreneurship at a Glance, 2017

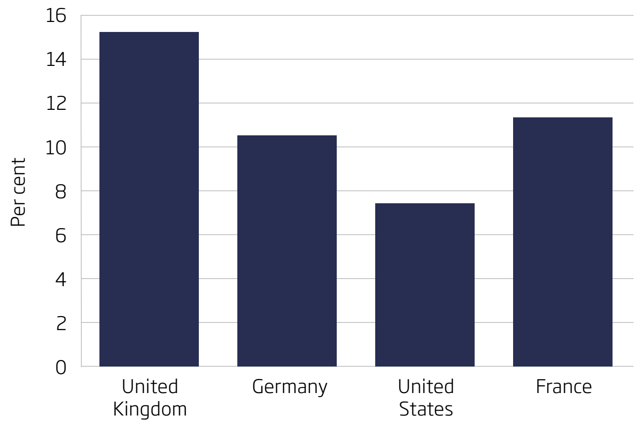


FIG A.25

SURVIVAL RATE OF ONE-YEAR OLD EMPLOYER ENTERPRISES

Source: OECD, Entrepreneurship at a Glance, 2017

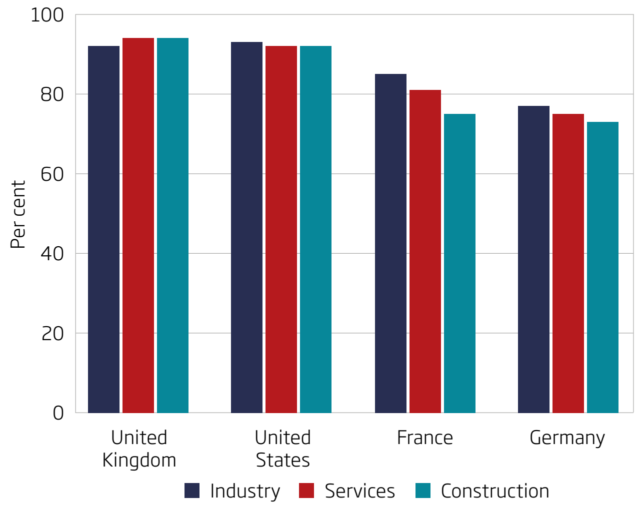


FIG A.26

SHARE OF HIGH GROWTH FIRMS OVER TIME

Source: OECD, Entrepreneurship at a Glance, 2017

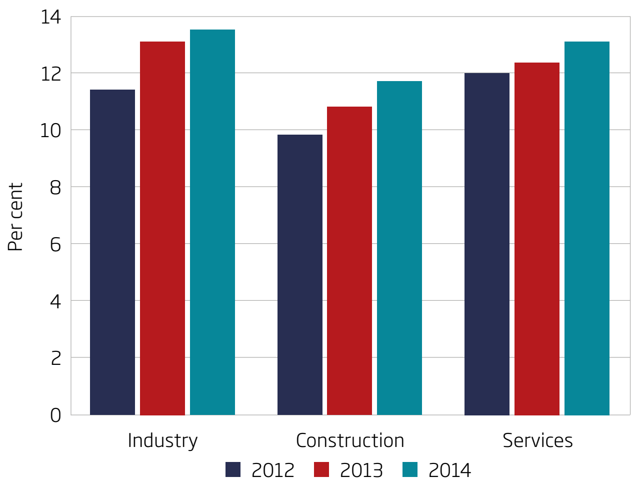


FIG A.27

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

Source: Survey on the access to finance of enterprises (SAFE), 2017

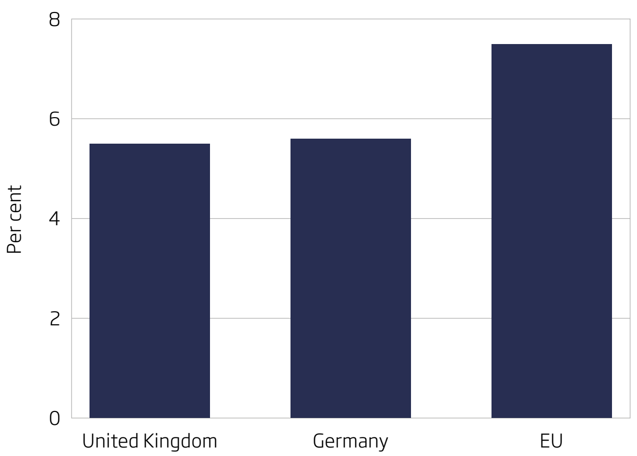


Figure A.26 shows that the recovery in the high growth firms in the UK is spread across the broad sector categories of industry, construction and services. There are a variety of other measures of high growth firms that can be used, see section 2.2 for a fuller discussion of high growth enterprise metrics in the UK and what this tells us about the scale-up performance of the UK firms.

UK SMEs HAVE SIMILAR PATTERNS IN OBTAINING FINANCE TO OUR MAJOR COMPETITORS

This section looks at international comparisons of experience in obtaining finance, drawing largely on the EU – ECB SAFE survey. The sample of firms interviewed in this survey includes some large businesses as well as SMEs, however it represents the best source of evidence for comparisons within the EU.[50]

Businesses face many barriers to growth. The SAFE survey shows the importance of access to finance as a barrier to growth across the EU. Businesses are asked to rate how important a problem has been in the previous 6 months. Access to finance ranks below finding customers, competition, regulation and both the cost and availability of labour.

That is not to say, however, that businesses do not consider the issue of access to finance to be a problem. On a scale of 1="not at all important" to 10="extremely important", access to finance scores an average of 4.4 across the EU, with the UK at 3.8. Only Denmark, Finland and Slovakia report a lower score, with Finland an outlier at 2.8.

In the UK, access to finance is rated as the most important problem by less than 6% of businesses. This is comparable to Germany, and slightly below the EU average (figure A.27).

The SAFE survey also enables identification of which groups of financial products are of 'relevance' to small businesses. Relevance in this survey is defined as the business having used the products in the past or having considered using them in the future. For products such as credit lines (including bank or credit card overdrafts) and leasing or hire purchase the UK is close to the EU average (figure A.28). A possible explanation of higher leasing or hire purchase in Germany, is the greater use of fixed assets in the relatively large manufacturing sector.

Bank loans and trade credit shows more variation with bank loans less likely to be relevant in the UK, but trade credit more likely to be relevant.

For equity capital, the UK (17%) is somewhat above the EU average (12%). Use of equity is higher in SAFE than in UK surveys of smaller businesses. This can be explained by the inclusion of large businesses, who are much more likely to use equity finance, in the SAFE survey. It is also noticeable that there is much greater range in the relevance of equity capital between EU member states, with some reporting relevance as low as 2%, whilst SMEs in 7 countries report relevance of 25% of higher, including Sweden where equity capital is used or considered by more than half of businesses. Use of equity capital is considered in more detail in section 2.3.

These cross-country variations have persisted in the data for several years suggesting that this represents structural rather than cyclical differences.

The relevance of bank lending is explored in a supplementary question, where SMEs are asked why loans are not relevant to the enterprise.[51] More than 4 out of 5 said that they did not need this type of finance, with other reasons such as lack of collateral, price, reduced control over the enterprise, too much paperwork and unavailability of loans each cited by less than 5%. This provides some corroborating evidence for the UK data showing a high and growing number of smaller businesses falling into the category of permanent non-borrowers (see section 2.3).

The SAFE survey also explores whether businesses have recently applied for a bank loan and the outcome of that application. The survey results show a high rate of applications, relative to SME survey results in the UK, which is explained by the inclusion of large businesses in the SAFE survey. However, it still possible to use the results for international comparisons.

FIG A.28

SMEs REPORTING FINANCE PRODUCTS AS 'RELEVANT' TO THE BUSINESS

Source: Survey on the access to finance of enterprises (SAFE), 2017

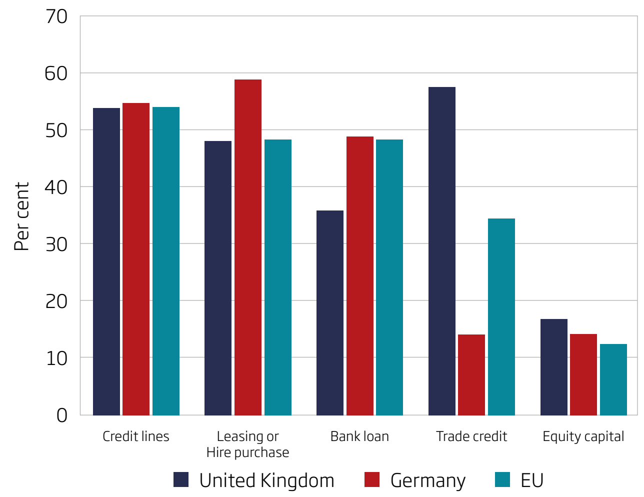


FIG A.29

HAVE YOU APPLIED FOR A BANK LOAN IN THE PAST 6 MONTHS?

Source: Survey on the access to finance of enterprises (SAFE), 2017

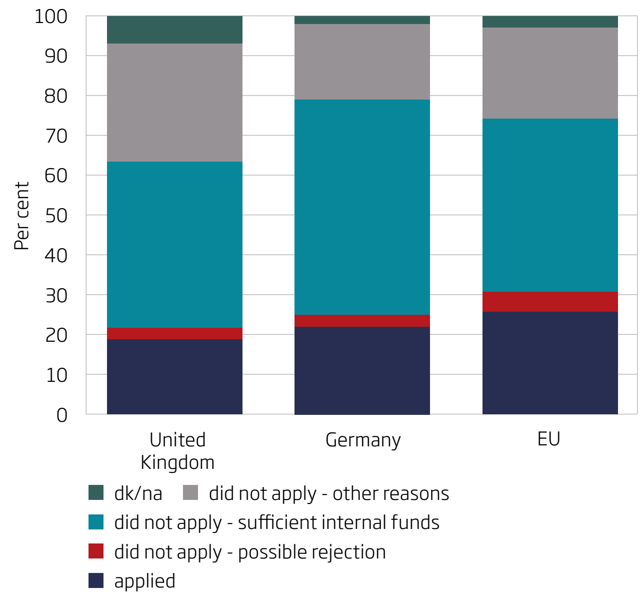


FIG A.30

RESULT OF APPLICATIONS OVER THE PAST 6 MONTHS

Source: Survey on the access to finance of enterprises (SAFE), 2017

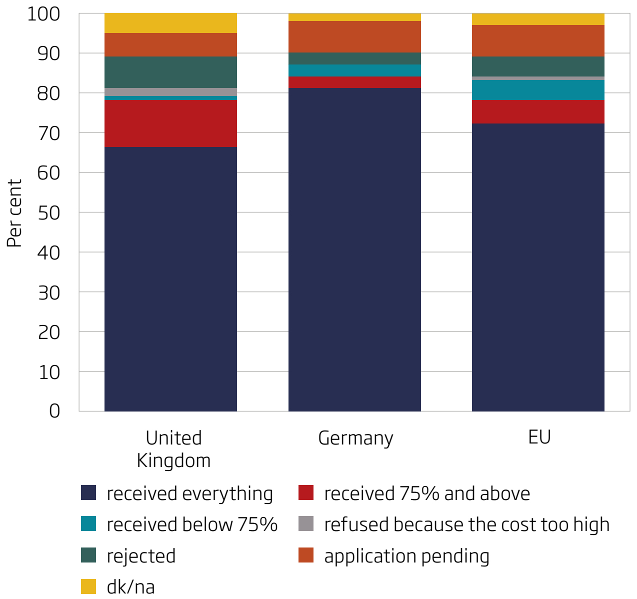
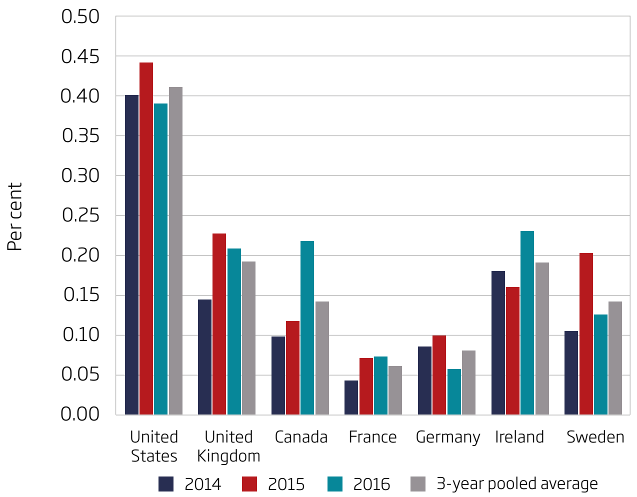


FIG A.31

EQUITY FINANCE AS A PROPORTION OF GDP

Source: PitchBook, World Bank data and British Business Bank calculations



The UK has a lower application rate for bank loans (19%) than the EU average (26%) but is closer to the application rate in Germany 22% (figure A.29). However, more of the non-applicants in Germany do not apply because they have sufficient internal funds than in the UK (54% vs 42%). Fear of rejection does not appear to be an explanation for not applying because the possibility of rejection is cited by only 3% of SMEs in both the UK and Germany.

Turning to the outcome of actual applications, UK SMEs seem slightly less likely to receive everything they applied for (67%) than both the EU as a whole (73%) and Germany specifically (82%) (figure A.30). In the 2017 survey, the gap with the EU average is closed, when adding in those that received at least 75% of what they applied for, but a gap remains with Germany. A gap in success rates between the UK and Germany was also observed in the 2016 and 2015 survey results suggesting that there is a permanent difference in success rates.

EQUITY FINANCE IS TWICE AS LARGE IN THE US COMPARED TO THE UK, BUT THE UK PERFORMS RELATIVELY WELL COMPARED TO OTHER EUROPEAN COUNTRIES

The value of equity finance in the US is twice as large as the UK after taking into account the relative size differences of the two economies, but the UK performs well compared to other countries in Europe (figure A.31).[52] Comparisons are made to the US market since it is the oldest and most established venture capital eco-system, with the overall size of the US economy minimising obstacles that are likely to affect smaller economies.

PitchBook data shows the US has an equity to GDP ratio of 0.41% in 2014-2016 which is twice as high as the UK's figure of 0.19%. The UK's three-year equity to GDP ratio is higher than many other European countries including France, Germany and Sweden, but is the same level as Ireland.[53] Ireland has a slightly higher equity to GDP ratio than the UK in 2016 (0.23% compared to 0.21%) due to recent increases in VC activity. Ireland is developing its technology markets and has many international technology companies with a presence in the country (e.g. Apple, Google, Dell) and has recently attracted large scale VC investment from overseas, particularly US investors, as well as investment from Government owned funds including Enterprise Ireland and the Ireland Strategic Investment Fund.[54] The UK remains Europe's largest single private equity market, receiving 32% of all equity deals and 38% of investment in 2016 (figure A.32).

FIG A. 32

INTERNATIONAL COMPARISONS OF EQUITY FINANCE[55]

Source: PitchBook (22nd November 2017)

INVESTMENT VALUE (£ MILLION)	2014	2015	2016
United States	42,185	51,770	52,667
United Kingdom	2,616	4,225	3,983
Canada	1,065	1,181	2,435
France	731	1,109	1,334
Germany	1,991	2,158	1,447
Ireland	278	292	501
Sweden	362	645	475

NUMBER OF EQUITY DEALS	2014	2015	2016
United States	10,416	10,468	8,631
United Kingdom	1,601	1,590	1,286
Canada	530	545	457
France	468	469	470
Germany	470	447	423
Ireland	362	166	126
Sweden	187	227	326

PART B
MARKET DEVELOPMENTS

2.1
SME BUSINESS POPULATION

- Growth of private sector businesses to 5.7 million in 2017
- Positive net growth of SMEs every year since 2011
- The business growth rate is driven by zero employee firms
- SMEs with employees comprise 99% of employers and around half of employment and turnover
- SMEs account for at least 99% of the businesses in every main industry sector, region and nation

This section looks at the UK SME business population, its share of firm numbers, employment and turnover, and how this has changed over time. It draws on information from the BEIS Business population estimates and ONS Business demography data.

GROWTH OF PRIVATE SECTOR BUSINESSES TO 5.7 MILLION IN 2017

There were 5.7 million private sector businesses at the beginning of 2017 in the UK (of which 5 million were in England). The SME sector overall (firms with 0-249 employees) represents 99.9% of all private sector firms in the UK, 60% of employment and, at £1.9 trillion, 51% of gross turnover (figure B.1).[56]

FIG B.1
SHARE OF BUSINESSES, EMPLOYMENT AND TURNOVER, BY SIZE OF FIRM (NUMBER OF EMPLOYEES)

Source: BEIS, Business population estimates, 2017

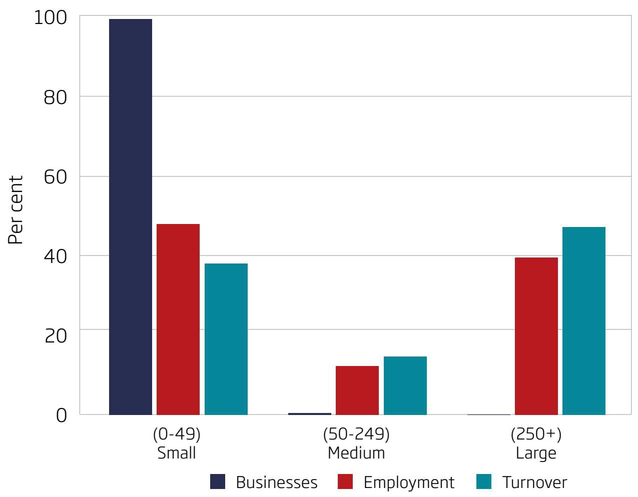


FIG B.2

NEW FIRM STARTS (BIRTHS) AND CLOSURES (DEATHS)

Source: ONS, Business Demography, 2016

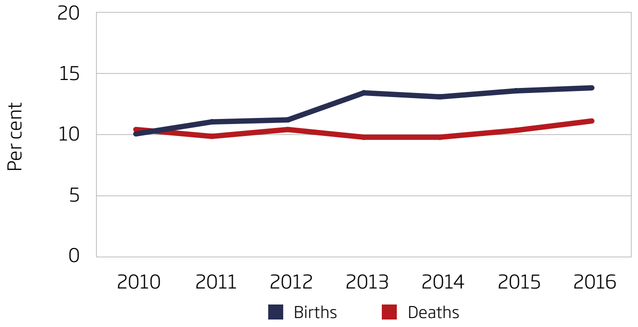


FIG B.3

GROWTH OF ALL BUSINESSES AND REGISTERED BUSINESSES

Source: BEIS, Business population estimates, 2017 and ONS, Business activity, size and location in the UK: 2017

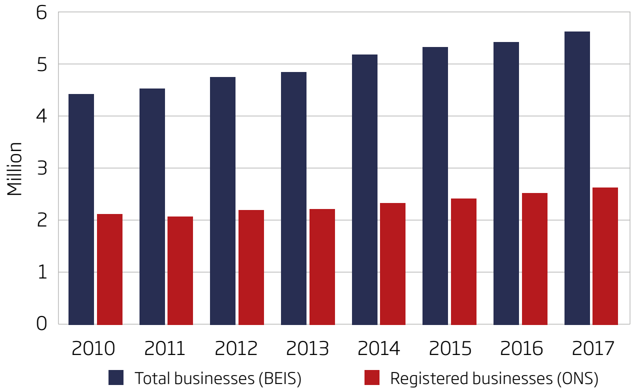
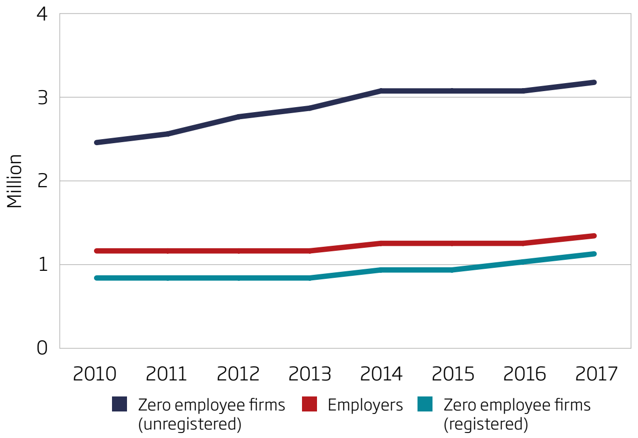


FIG B.4

NUMBER OF ZERO EMPLOYEE FIRMS AND ALL EMPLOYERS

Source: BEIS, Business population estimates, 2017



POSITIVE NET GROWTH OF SMEs EVERY YEAR SINCE 2011

Since 2011 the rate of business births has exceeded that for deaths with 2016 marking the 6th consecutive year that net firm growth has been positive.[57] In 2016, the rate of new firm formation (births) was 14.6%, the highest since comparable records began in 2010. In comparison the rate of closure (deaths) has remained relatively constant, at a little over 10%, albeit edging up in 2016 to 11.6% (figure B.2).

The latest data from Companies House on incorporated businesses shows a slight decrease in new business incorporations of 3.7% in 2017 compared to 2016.[58] Nevertheless, incorporations remain well above the levels seen in 2015, and the number of incorporations remains above the number of dissolutions.

A further measure of firm growth is the increase in registered businesses.[59] There were almost 2.7 million businesses registered for Value Added Tax (VAT) and/or Pay-As-You-Earn (PAYE) in the UK in March 2017. In comparison to businesses overall, registered businesses have exhibited a more consistent and higher rate of year on year growth during the last 3 years, of just over 4% (figure B.3).

THE BUSINESS GROWTH RATE IS DRIVEN BY ZERO EMPLOYEE FIRMS

The growth rate of zero employee firms has significantly outstripped that of employers. Net growth in the stock of zero employee firms overall (32.8%) was almost 3 times the rate for all firms with employees (11.6%) between 2010 and 2017 (figure B.4). Despite accounting for 76% of all businesses, an increase of 3% since 2010, zero employee firms account for less than 18% of all UK employment and contribute just 7% of turnover.

Within employer firms the distribution and net growth rate is not uniformly distributed by size of firm (headcount) either. Micro firms (1-9 employees) comprise 82% of all firms with employees and their number has grown by 10% between 2010 and 2017 (figure B.5). Small (10-49) and Medium (50-249) employers represent 15% and 2.5% respectively of the stock of employing firms, and have exhibited growth rates of approximately 20% and 16% during this same time.

SMEs WITH EMPLOYEES COMPRISE 99% OF EMPLOYERS AND AROUND HALF OF EMPLOYMENT AND TURNOVER

Looking only at companies with employees, collectively, micro, small and medium firms comprise 99% of all employers and 52% and 47%, respectively, of employment and turnover (figure B.6). This has changed little since the ONS has been producing comparable numbers.

SMEs ACCOUNT FOR AT LEAST 99% OF THE BUSINESSES IN EVERY MAIN INDUSTRY SECTOR

SMEs account for at least 99% of the businesses in every main industry sector, but there are substantial variations in the percentage share of businesses, employment and turnover within and between sectors (figure B.7). For example, wholesale and retail comprises a 10% share of SMEs yet 35% of turnover.[60]

In the two very different sectors of construction and professional, scientific and technical there are a lot of firms but a low average headcount. Manufacturing, in comparison, has relatively fewer firms but higher average headcount and turnover.

FIG B.5

UK EMPLOYERS, BY SIZE OF FIRM (NUMBER OF EMPLOYEES)

Source: BEIS, Business population estimates, 2017

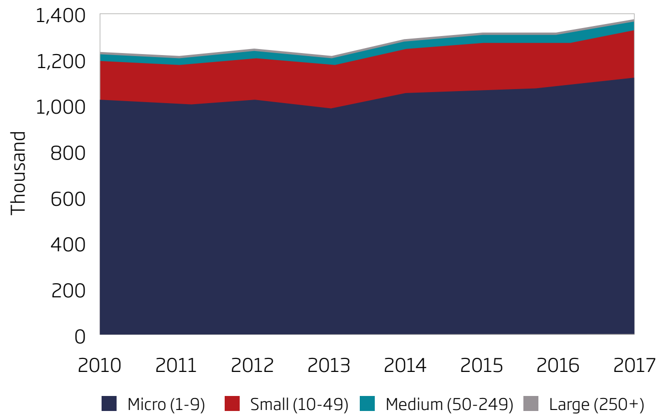


FIG B.6

EMPLOYERS: SHARE OF BUSINESSES, EMPLOYMENT AND TURNOVER, BY SIZE OF FIRM (NUMBER OF EMPLOYEES)

Source: BEIS, Business population estimates, 2017

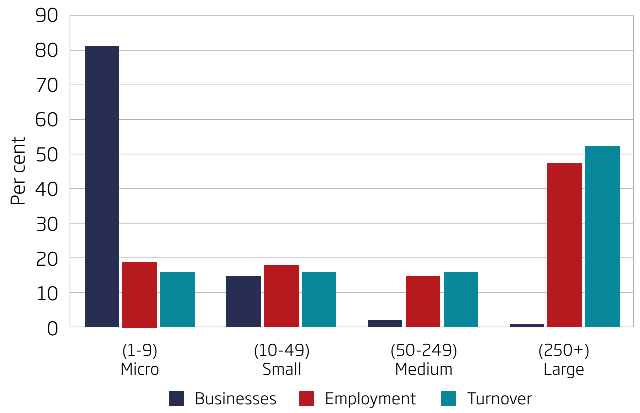


FIG B.7

SECTOR SHARE OF SME BUSINESSES, EMPLOYMENT AND TURNOVER

Source: BEIS, Business population estimates, 2017

a. Turnover data for financial and insurance activities not available on a comparable basis

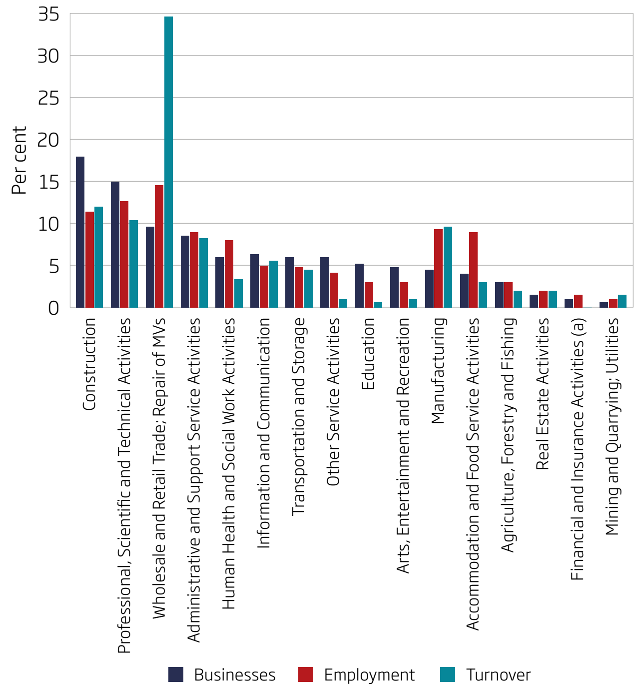


FIG B.8

REGIONAL SHARE OF SME BUSINESSES, EMPLOYMENT AND TURNOVER

Source: BEIS, Business population estimates, 2017

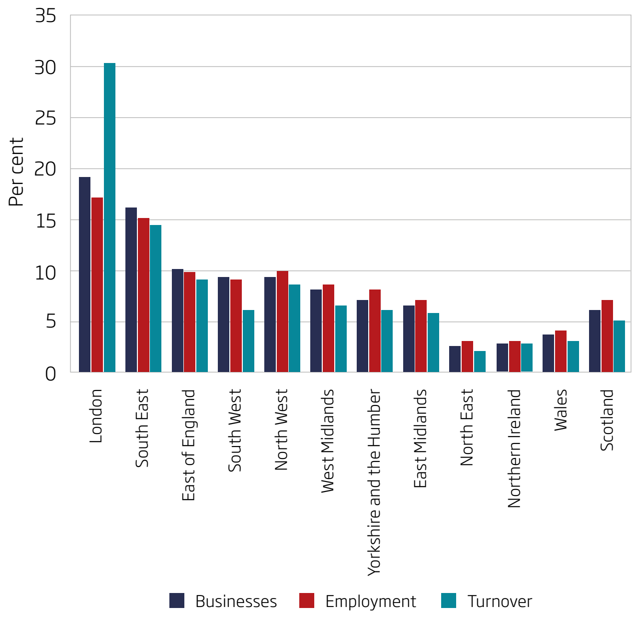
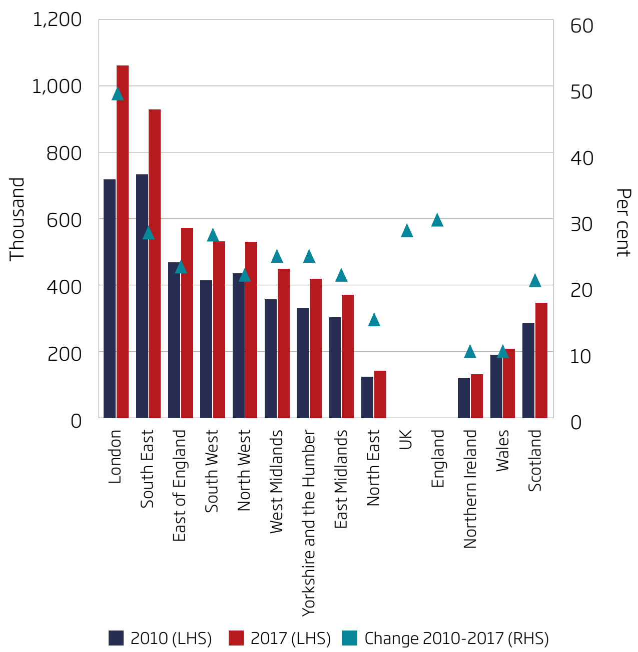


FIG B.9

GROWTH OF SMEs, BY REGION AND DEVOLVED ADMINISTRATION

Source: BEIS, Business population estimates, 2017



England has an 88% share of UK businesses, and contributes 87% of employment and 89% of turnover in the UK. Within this, London has a substantially higher share of turnover relative to both the number of SMEs and employment whilst all other English regions and the 3 devolved nations have lower turnover to SME business stock and employment ratios (figure B.8).

Percentage change in the number of SMEs in England between 2010 and 2017 has outperformed that for the UK overall (figure B.9). Within English regions, growth in the number of SMEs in this period was highest in London and lowest in the North East. Of the devolved nations, Scotland has both a more substantial SME business base and a higher growth rate than both Wales and Northern Ireland.

2.2 HIGH GROWTH FIRMS

- Scaling up can lead to firms experiencing high growth
- High growth firms are important for productivity growth and job creation
- But the definition of high growth firms that is used matters…
- High growth firms measured by increased employment often do not show immediate productivity growth
- The financing needs of high growth firms are more complex than those of average growth

SCALING UP CAN LEAD TO FIRMS EXPERIENCING HIGH GROWTH

The terms 'high growth firms' and 'scale-ups' are often used to refer to firms that either have grown, or have the potential to grow, rapidly. One way to distinguish between the two is to recognise that scaling up can lead firms to experience high growth. Scaling up can involve hiring more staff, taking on new and bigger premises, or investing in equipment. The potential for many scale-ups to do so is hindered by barriers including a lack of finance and limited access to leadership and management skills. Overcoming such barriers helps scale-ups to make their growth ambitions a reality.

Scale-ups have been the subject of a significant amount of research and analysis to identify policies that can help increase the number of them and their contribution to the economy – most notably in reports such as the Scale Up Reviews produced by the Scale Up Institute.[61]

Previous editions of the Small Business Finance Markets report have made use of the segmentation of the smaller business population into the start-ups, scale-ups and stay ahead. To give a different perspective this year, this section focuses on the contribution that firms that have recently seen episodes of high growth have made to the economy.

HIGH GROWTH FIRMS ARE IMPORTANT FOR PRODUCTIVITY GROWTH AND JOB CREATION

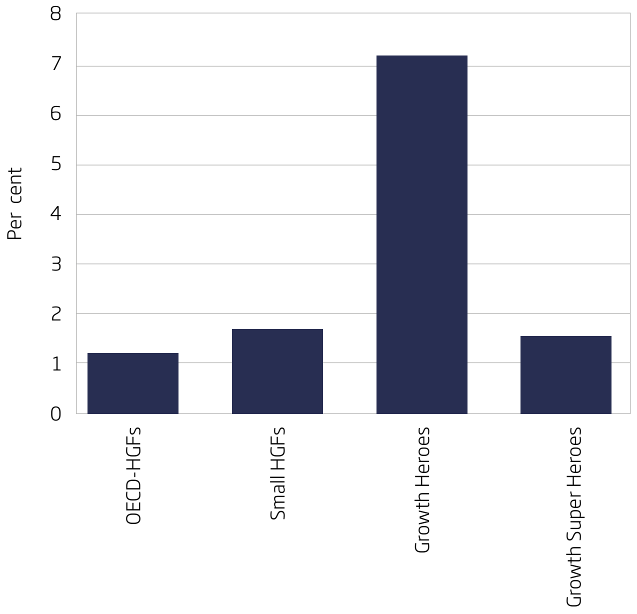
The UK's high growth firms matter because they outperform other enterprises in terms of turnover growth and job creation. Productivity growth is desirable because it makes the allocation of resources more efficient and thereby boosts the potential growth of the economy in the long-run. Essentially, higher productivity leads to lower unit costs and the resulting improvement in competitiveness helps UK exports to enter new global markets and domestically-produced goods and services to be substituted for imports. Consequently, the additional economic activity pushes up profits, wages and living standards.

At the same time, high growth firms punch above their weight in terms of job creation. Even though high growth firms account for a very small proportion of the UK's total surviving business population, they are prolific creators of jobs.[62]

FIG B.10

HIGH GROWTH FIRMS AS A SHARE OF TOTAL ENTERPRISES, AVERAGE OF ALL 3-YEAR PERIODS 1998-2013

Source: Enterprise Research Centre, Research Paper 63, October 2017



There is also evidence to suggest that having a more dynamic population with a wider distribution in terms of growing and shrinking firms is good for productivity. A NESTA working paper finds that having a 5-percentage point higher share of static firms in the business population is associated with 1-percentage point lower productivity growth.[63]

BUT THE DEFINITION OF HIGH GROWTH FIRMS THAT IS USED MATTERS...

High growth firms are generally defined in terms of their employment, turnover, or both. The most widely used is the OECD definition that focuses on firms' employment growth.[64] A variant of this definition is small high growth firms, which matches the OECD-HGFs metric but for smaller enterprises.[65] High growth firms are also defined as Growth Heroes and Growth Super Heroes, which focus on both turnover and employment to gauge labour productivity.[66,67]

The definition of high growth firms that's used matters because each captures a diverse subset of firms, eg OECD-HGFs encapsulates enterprises that experience high growth in employment while Growth Heroes are firms that increase productivity by increasing both turnover and employment. Figure B.10 highlights that each definition can tell a different story. While the presence of high growth firms in the economy under the Growth Heroes metric was approximately 7% on average over all 3-year periods between 1998 and 2013, it was only 1% for OECD-HGFs.

HIGH GROWTH FIRMS MEASURED BY INCREASED EMPLOYMENT OFTEN DO NOT SHOW IMMEDIATE PRODUCTIVITY GROWTH

Research by the Enterprise Research Centre suggests that high growth firms could be detrimental to labour productivity gains.[68] There are currently approximately 11,500 enterprises in the UK that are defined as high growth firms under the OECD-HGFs metric. The ERC study found that only 575 of these high growth firms had demonstrated positive productivity growth.[69]

Other research commissioned by the then Department for Business Innovation & Skills investigates the sequencing of employment and turnover growth.[70] This finds that for innovative firms the growth process starts with an increase in employees and continues to future turnover growth via new to market products. This suggests that some high growth firms may experience productivity gains after the three-year period of high employment growth.

A separate study by the ERC indicates raising productivity is difficult not only for high growth firms. The study was of a panel of 250,000 non-financial employer enterprises of all sizes that were alive in 2008 and survived to 2015. Aggregate productivity was found to have increased by 30% over the period, but average productivity at the level of the firm fell by 0.3%.[71,72] Most firms struggled to significantly increase turnover, jobs and productivity simultaneously, with only 5% managing to do so.

The same study found that a turnover target approach rather than employment growth is a more effective way to improve productivity. The relationship between the growth of turnover and productivity was strong and positive, with 3 out of 4 firms that grew turnover also raising productivity. Yet the link between the growth of jobs and productivity was tenuous: a mere 1 in 5 of firms that increased employment simultaneously improved productivity. The weakness highlights the fundamental tension between employment and productivity, eg productivity can suffer when firms hire additional staff rather than invest in machinery and equipment or innovations to their business models.

The relationship between turnover, employment and productivity is depicted in figure B.11 The only 'space' where the growth in turnover, jobs and productivity are all positive is the 'red zone'. However, the 'red zone' is sparsely populated with firms, accounting for only around 9%. More than half of these are within the blue triangle where there is very little productivity growth. While it's hard to raise all 3 simultaneously, higher turnover can generally improve productivity if it's accompanied by lower or unchanged employment levels.

FOCUSING ON HIGH GROWTH EPISODES RATHER THAN FIRMS MAY BE MORE APPROPRIATE

Looking solely at high growth firms fails to reflect the reality of growth for many enterprises in the UK business population. Many firms are ambitious about growing. The British Business Bank 2017 Business Finance Survey showed 35% expect to grow over the next year.[73] Yet such growth ambitions are easier said than done. While most firms grow every year, very few grow strongly. Research by the ERC found that the share of firms that deliver sustained strong growth over a 3-year period has been low over time.[74]

Separate research by the ERC indicates that the incidence of high growth firms doesn't capture the receptiveness of the UK business population to high growth.[75] Figure B.12 illustrates that the incidence rate of high growth firms has been relatively static at approximately 6% over the past 15 years including during the financial crisis. The stability has been driven by how the incidence rate is constructed, ie based on the somewhat arbitrary definitions of high growth firms such as OECD-HGFs.

FIG B.11

THE RELATIONSHIP BETWEEN TURNOVER, JOBS AND PRODUCTIVITY, 2008-2015

Source: Enterprise Research Centre, November 2016

Note: The percentages represent the productivity experience of 250,000 non-financial employer enterprises aged more than 10 years old between 2008 and 2015. The share of firms with zero productivity growth was 33%.

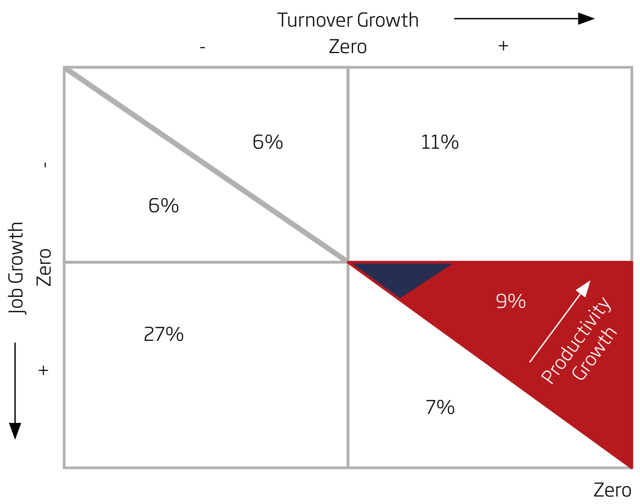


FIG B.12

HIGH GROWTH FIRMS (OECD-HGFS), NUMBERS AND RATE, 1998-2001 AND 2014-2017

Source: Enterprise Research Centre, Research Paper 62, September 2017

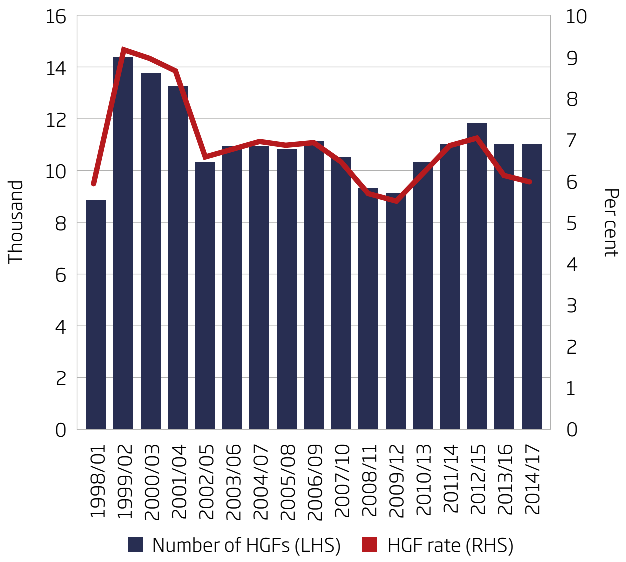
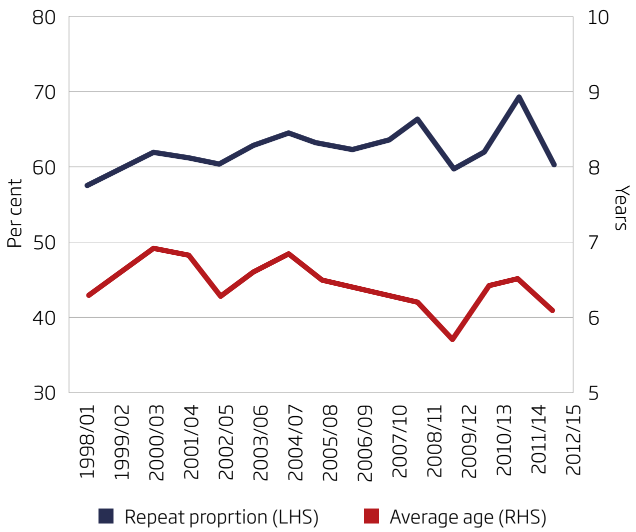


FIG B.13

HIGH GROWTH EPISODE REPEAT PROPORTION AND HIGH GROWTH FIRM AVERAGE AGE, 1998-2001 AND 2012-2015

Source: Enterprise Research Centre, Research Paper 62, September 2017



A nuanced approach that focuses on the high growth episodes experienced by a cohort of firms over their lifecycle may be more sensible. Firms that experience a high growth episode are likely to do so again at a later stage. The ERC found that on average around two-thirds of the high growth episodes experienced by enterprises defined as high growth firms and 'born' some years previously are repeat episodes.[76] By the age of 10, approximately 40% of all such firms experienced at least 1 high growth episode. Figure B.13 shows that in the most recent 3-year period from 2012 to 2015, approximately 60% of enterprises defined as high growth firms and with an average age of 6 years had a repeat episode of high growth.

The research also suggests that growth and job creation in the first episode of high growth is stronger than in repeat episodes. Enterprises categorised as high growth for the first time grow faster and make a more substantial contribution to job creation than when they have further high growth episodes. In addition, there could also be completely different reasons for each individual high growth episodes. The initial episode may be related to strategic decisions to innovate and/or engage in international activity for the first time. Later episodes may be stimulated by different factors such as the decision to look for additional debt or equity finance to consolidate and kick-on after an initial burst of high growth.

Schemes designed to support firms with high growth potential have been shown to impact both jobs and revenue. For example, evidence from the Goldman Sachs 10,000 Small Business Programme, suggests that those taking part in the scheme are on average 3 times more likely to create jobs than other UK small businesses and grow revenue at 81% per year.[77]

THE FINANCING NEEDS OF HIGH GROWTH FIRMS ARE MORE COMPLEX THAN THOSE OF AVERAGE GROWTH

Firms that are ambitious about growing often require external finance to do so. Such funding is required both for working capital and to invest in assets, eg machinery and equipment. However, high growth firms often struggle to secure core debt products such as loans from banks. Data from the SME Finance Monitor indicates that firms which scale-up tend to be turned down by banks more often than those that stay ahead.[78] Figure B.14 shows that, for only the first time in 4 years, the success rate for new loan applications by scale-ups was higher than for stay ahead firms in the 10 quarters to the end of H1 2017.[79] The reasons for banks turning down some scale-ups include that the firm's past track record or cash flow doesn't support the level of money they require for growth.

Yet the story isn't just one of some banks turning down high growth firms. It's also that the mainstream products on offer may not be suitable or relevant to their needs. High growth firms require a wider range of products and greater flexibility than firms with average growth because their financing needs are more complex. They often need the scope to switch between different types of products. High growth firms may also need specific terms and conditions of the finance such as collateral requirements and payments.

Senior debt providers typically require collateral and high growth firms can soon exhaust what they have available. Furthermore, interest payments on senior debt can constrain the cash flow of growth-oriented businesses in the early stages of expansion, blocking up the balance sheets of such firms. Consequently, there is a need among high growth firms for alternative sources of bespoke debt and/or equity finance, ie equity finance doesn't involve regular payments coming out of the firm's cash flow.

The research by the Scale Up Institute and Beauhurst highlights the benefits to companies of taking an injection of equity. Companies that receive equity investment are more likely to grow faster, particularly in terms of turnover. More of the companies with turnover growth of more than 100% each year have used equity financing than those growing less quickly. Similarly, more of the companies with employment growth of between 80% and 100% annually have taken an injection of equity.

IMPLICATIONS FOR BRITISH BUSINESS BANK

Scale-Ups have been an important segment of the market for the British Business Bank since we launched in 2014. The Bank recognises the importance of making it easier for businesses with high growth ambitions to find the finance they require by investing in a range of equity funds focused on UK businesses and supporting high growth loans.

FIG B.14

SUCCESS RATES FOR NEW LOAN APPLICATIONS, BY BRITISH BUSINESS BANK SEGMENT

Source: British Business Bank analysis of BDRC Continental SME Finance Monitor, Q2 2017

2.3
USE OF EXTERNAL FINANCE

- 37% of smaller businesses currently use external finance (excluding trade credit), with usage concentrated in core debt products
- Around a third (35%) of smaller businesses use trade credit
- SMEs remain reluctant to take on external finance
- Record low new debt application rates in 2017, although acceptance rates remain high
- Younger businesses continue to find it harder to obtain finance

This section describes current usage of external finance, including trade credit, smaller businesses' attitudes towards future use of external finance, and trends in new debt applications.

37% OF SMALLER BUSINESSES CURRENTLY USE EXTERNAL FINANCE (EXCLUDING TRADE CREDIT), WITH USAGE CONCENTRATED IN CORE DEBT PRODUCTS

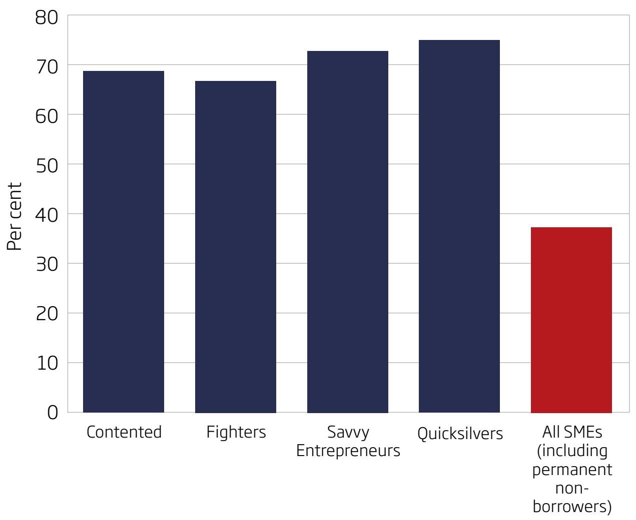
Around a third (37%) of smaller businesses currently use external finance, whilst approximately half (47%) are 'Permanent non-borrowers' (PNB).[80, 81] A Permanent non-borrower is firmly disinclined to borrow, and is not currently using finance.

The British Business Bank segments, (discussed in section 1.1) exclude PNBs, and account for the remaining 53% of smaller businesses. Current external finance usage varies from 67% to 75% amongst the segmented businesses (figure B.15).

FIG B.15

SHARE OF SMEs CURRENTLY USING EXTERNAL FINANCE, BY SME SEGMENTS

Source: British Business Bank analysis of BDRC Continental SME Finance Monitor 10 quarter dataset ending Q2 2017



ATTITUDINAL AND NEEDS BASED SME SEGMENTATION, TECHNICAL APPROACH

To better understand SMEs' attitudes to finance, particularly regarding their underlying needs and openness to receiving information, the British Business Bank commissioned BDRC Continental to produce a segmentation of small businesses. A more detailed discussion of the segments can be found in section 1.1.

BDRC Continental's approach towards segmentation is that it is has two complementary sides (science and art), both vital to producing robust segmentations and ensuring they provide insightful, actionable results.

The **science** involves considerations such as ensuring the right questions are fed in and recoded appropriately. Selecting the optimal technique out of a range of clustering schemes is vital. The **art** of segmentation is taking clusters which have been derived statistically and bringing them to life, turning these clusters into relevant, actionable, insightful segments.

BDRC Continental used Q1-Q3 2016 SME Finance Monitor data to run the segmentation. In total 34 questions fed into the clustering analysis. Prior to segmenting, BDRC Continental ran factor analysis on the questions to be included to reduce the noise in the data which provides cleaner more easily interpreted segments. A 20-factor solution was chosen, which explained 81% of the variance in the variables.

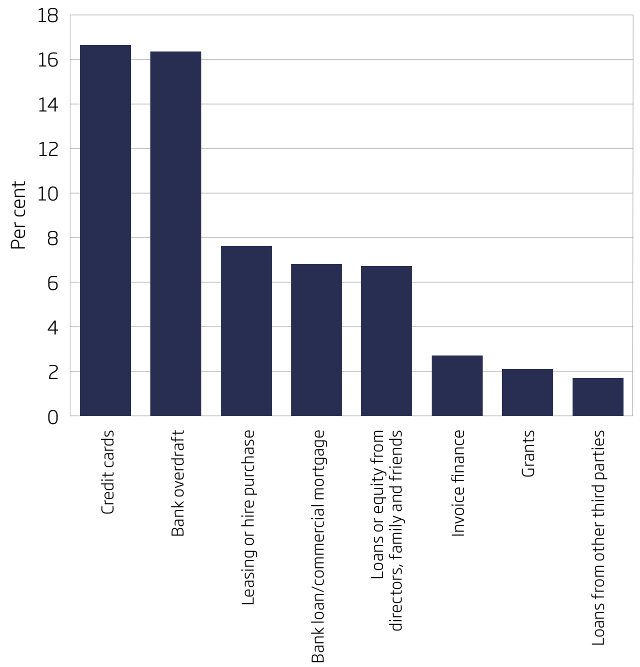
A two-stage clustering approach was chosen to ensure the final segments are both well-defined within segment, and well differentiated between segments. Stage 1 consisted of hierarchical clustering, followed by K-means clustering. This process produces a range of possible segment solutions.[82, 83]

The final step was to interpret these clusters. Only when BDRC Continental found informative, useful groups, clusters were then described as segments (the Contented, Quicksilvers, Fighters, and Savvy Entrepreneurs). Looking ahead, it is possible to identify which segment an SME belongs to through asking 8 'golden questions', derived from discriminant analysis. These questions allocate SMEs to the correct segment with an accuracy of 99% (having previously established that they are not a permanent non-borrower).

FIG B.16

SHARE OF SMEs CURRENTLY USING SELECTED EXTERNAL FINANCE PRODUCTS

Source: British Business Bank analysis of BDRC Continental SME Finance Monitor 10 quarter dataset ending Q2 2017



The type of external finance used remains concentrated in core debt products. Figure B.16 shows 17% of all smaller businesses currently use credit cards. Bank overdrafts are used by 16% of smaller businesses, and 7% are currently using a bank loan or commercial mortgage. Usage of alternative forms of finance generally remain lower than core debt products. The exception is leasing or hire purchase which is currently used by 8% of smaller businesses.

FIG B.17

SHARE OF SMEs CURRENTLY USING TRADE CREDIT

Source: SME Finance Monitor Q2 2017. All SMEs, by date of interview

	2014	2015	2016	H1 2017
All SMEs	31%	33%	33%	35%
Zero employees	26%	28%	28%	30%
1-9 employees	45%	47%	45%	48%
10-49 employees	58%	61%	59%	66%
50-249 employees	58%	60%	59%	71%

AROUND A THIRD (35%) OF SMALLER BUSINESSES USE TRADE CREDIT

Around a third (35%), of SMEs regularly purchased products or services from other businesses on credit, in the year ending Q2 2017 (SME Finance Monitor). Use of trade credit increases by size of SME, and has increased slightly over time from 31% in 2014 to 35% in Q2 2017 (figure B.17). In Q2 2017, 16% of SMEs used trade credit but no other external finance, this figure has been stable since 2014. The proportion of trade credit users reporting that it reduces their need for additional external finance has increased from 65% in Q2 2014 when the question was first asked, to 71% for year ending Q2 2017.[84] The British Business Bank is currently undertaking further research on the use of trade credit by SMEs.

SMEs REMAIN RELUCTANT TO TAKE ON EXTERNAL FINANCE

Pecking order theory suggests that smaller businesses have a preference to fund internally first, before using external finance.[85] Sources of finance can be grouped into internal funds, debt and new equity. Smaller businesses are assumed to have a set of ranked preferences, with funding internally the preferred approach. If internal funding isn't feasible, then the smaller business would seek debt finance. The business would issue new equity as a 'last resort'. Given these preferences, the type of finance sought may indicate the businesses need for finance.

The SME Finance Monitor provides evidence to suggest there is a preference towards internal finance first. Smaller businesses are asked the extent to which "their aim was to pay down debt and remain debt free if possible". In 2016, 68% agreed with this statement.[86] SME Finance Monitor also asks about agreement with the statement "our current plans for the business are based entirely on what we can afford to fund ourselves". In the year ending Q2 2017, 81% of smaller businesses agreed with this statement.

In 2017, Hitachi Capital Invoice Finance interviewed around 500 SMEs to understand SME attitudes to borrowing.[87] This survey found the main reason for not wanting to borrow money is that companies do not want to owe additional money (54%). A high proportion (72%) of the businesses surveyed had invested their own personal funds into their businesses in the past 12 months.

An alternative to debt finance is equity finance, but there are many reasons why smaller businesses could be averse to using equity finance too. Some smaller businesses may be concerned that future equity investors may not be suitably matched to their business. This could occur if the investors have a different vision for the business or a short investment horizon. Some smaller businesses may also feel like they are 'giving up control' of the business, or feel uncomfortable with selling a share of ownership.

A research paper by Fraser, Bhaumik and Wright (2013), suggests individuals can face limitations in their ability to process information, and that this may lead to shortcuts in ways of thinking.[88] This could potentially affect a businesses' financing decision for growth. The shortcuts in thinking may introduce serious biases into decision making. These biases are more likely in situations involving informational overload, novelty or uncertainty, high emotions, and time pressures. Also, cognitive biases may affect how businesses frame and evaluate options ('prospects') available to them. For example, if businesses were loss averse, this may cause them to decide not to invest to grow their business.

RECORD LOW NEW DEBT APPLICATION RATES IN 2017, ALTHOUGH ACCEPTANCE RATES REMAIN HIGH

As discussed earlier around half of smaller businesses are permanent non-borrowers, and 37% currently use external finance. These factors contribute towards a small percentage of new debt applications from smaller businesses each year.

New debt applications for loans and overdrafts have been falling since 2012 (figure B.18). Across all applications reported in the 8 quarters to Q4 2012, 4% of all smaller businesses applied for a new overdraft. Since 2012, this proportion has decreased every year. Across all applications reported in the 10 quarters to Q2 2017, only 1.7% of smaller businesses applied for a new overdraft. Over the same period and the same metric, SME applications for new loans have also fallen every year and from 2.9% to 1.7%. Since 2015 onwards the application rate for new loans and overdrafts has been almost identical.

Success rates for new debt applications remain high. A successful application has been defined as an outcome where a smaller business was offered what they wanted and took it, or they received the finance after resolving issues. Across all applications reported in the 10 quarters to Q2 2017, 72% of new loans, and 67% of new overdrafts were successful. These are similar success rates to 2016 (over a 10 quarter period ending Q4 2016). The success rate of new debt applications had been increasing between 2012 and 2016 (figure B.19).

FIG B.18

NEW DEBT APPLICATION RATES

Source: British Business Bank Analysis of SME Finance Monitor. Data is presented over all applications reported in the 10 quarters to the end of the period stated, (10 quarters have been pooled together to increase sample size). For example, '2016' represents results across all applications in the 10 quarters ending Q4 2016. Only exception is '2012', which represents all applications in the 8 quarters to the end Q4 2012 (as the SME Finance Monitor has collected data from Q1 2011).

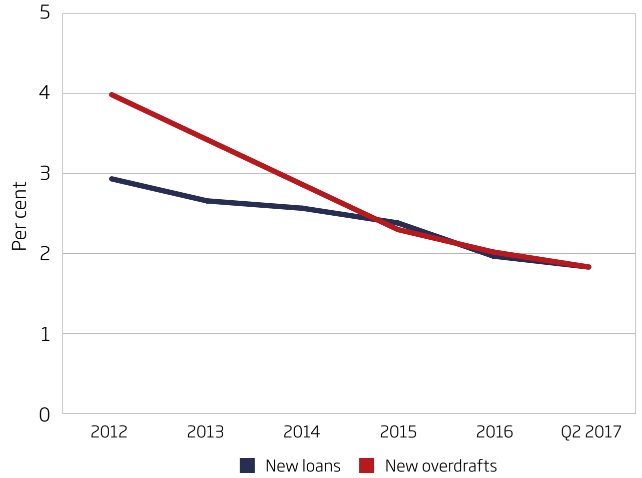


FIG B.19

SUCCESS RATES FOR NEW DEBT APPLICATIONS

Source: British Business Bank Analysis of SME Finance Monitor. Data is presented over all applications reported in the 10 quarters to the end of the period stated, (10 quarters have been pooled together to increase sample size). For example, '2016' represents results across all applications in the 10 quarters ending Q4 2016. Only exception is '2012', which represents all applications in the 8 quarters to the end Q4 2012 (as the SME Finance Monitor has collected data from Q1 2011).

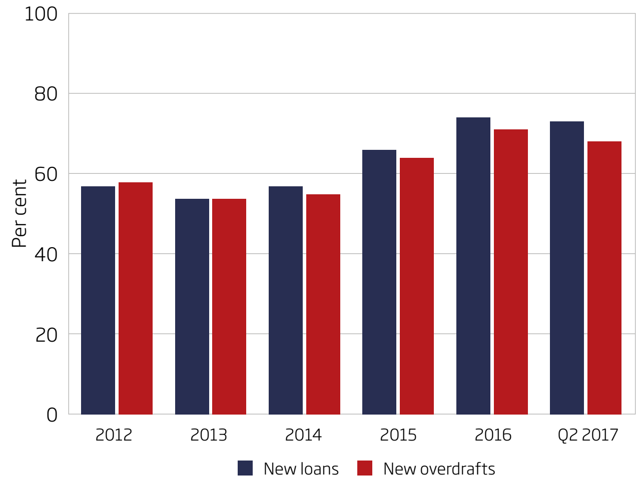
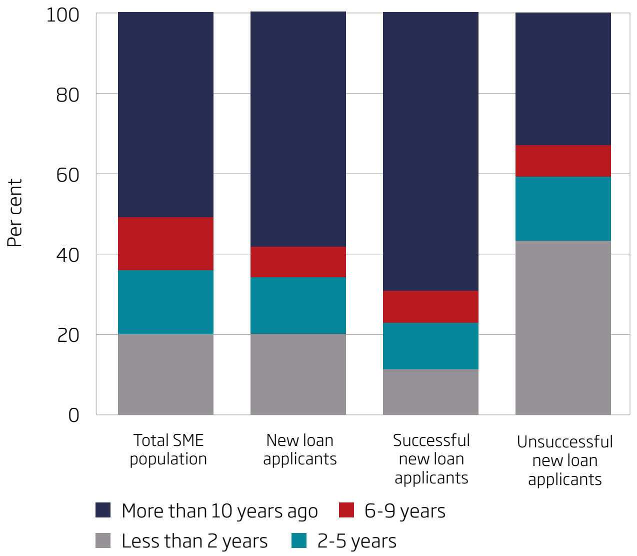


FIG B.20

SUCCESS RATES FOR NEW DEBT APPLICATIONS BY AGE OF BUSINESS

Source: British Business Bank analysis of SME Finance Monitor 10 quarter dataset ending Q2 2017



YOUNGER BUSINESSES CONTINUE TO FIND IT HARDER TO OBTAIN FINANCE

Success rates of new loan applications vary by age of business, suggesting that younger businesses find it harder to obtain finance. Smaller businesses aged under 5 years old account for 36% of the business population. However, these businesses represent 23% of successful applications (figure B.20). Across all applications reported in the 10 quarters to Q2 2017, 16% of smaller businesses said that the reason for a rejected loan was because of no credit history or being young. In addition 10% of overdrafts were rejected for the same reason.[89]

IMPLICATIONS FOR THE BRITISH BUSINESS BANK

As smaller business demand for finance has continued to decline, as observed through the record low new debt application rate, the Bank has turned its attention to improving the information available on finance options to SMEs. A new digital hub is being developed by the Bank, offering authoritative, impartial information on access to finance for smaller businesses with growth ambitions.

The evidence continues to show younger smaller businesses find it harder to obtain finance, as seen through their lower success rates for new debt applications. Supported by the British Business Bank, The Start Up Loans Company continues to help new and early stage smaller businesses access affordable finance and mentoring support. This scheme is designed to support businesses who struggle to access other forms of finance.

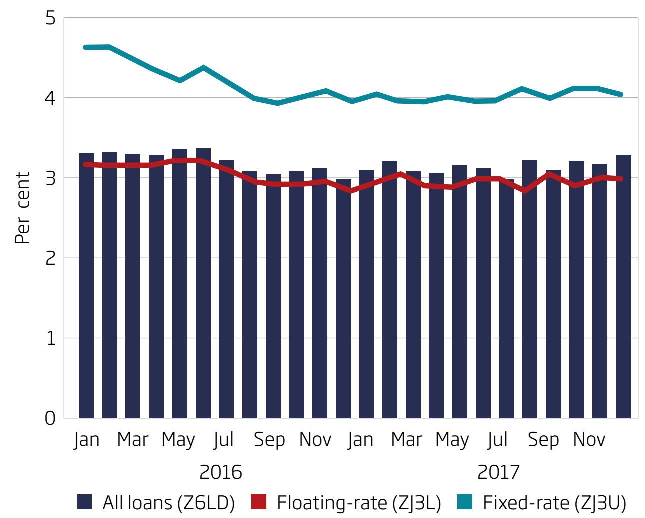
2.4
BANK LENDING

- Credit conditions remain broadly unchanged compared to last year
- In 2017, gross lending to SMEs fell slightly, although net lending remains positive
- A trend decline in overdraft usage has been accompanied by increases in deposits
- Open banking reforms have started to be introduced, and are intended to increase competition
- 'Challenger banks' provide a more diverse offering to smaller businesses
- Regulatory frameworks provide opportunities, and challenges for challenger banks

FIG B.21

EFFECTIVE INTEREST RATES (NEW BUSINESS) FOR SMEs

Source: Bank of England



As highlighted in the use of external finance section 2.3, core bank lending remains a key source of finance for smaller businesses. This section explores the supply side of the bank lending market including credit conditions, volumes of lending, and challenger banks.

CREDIT CONDITIONS REMAIN BROADLY UNCHANGED COMPARED TO LAST YEAR

Lenders reported to the Bank of England (BoE) that overall availability of credit to the corporate sector was unchanged again in Q3 2017 and Q4 2017.[90] This is consistent with the success rates of new applications in Q2 2017 being similar to 2016.

In the Q3 2017 BoE Credit Conditions Review survey, lenders reported a fall in demand for corporate lending for businesses of all sizes, and small businesses in particular. Overall demand for corporate lending from small and medium businesses was reported by lenders to be unchanged in Q4 2017.[91] The drop-in demand for finance reported by lenders is consistent with declining new loans and overdrafts application rates, observed in the SME Finance Monitor. A fuller discussion of SME demand is discussed in part A.

Effective interest rates on SME loans have increased slightly over the last 2 years, from 3.32% in January 2016 to 3.36% in December 2017 (figure B.21).[92] The effective floating rate is almost the same as the overall loan rate, which includes fixed rate loans. In November 2017, the Monetary Policy Committee (MPC), decided to increase the Bank Rate from 0.25% to 0.5%. MPC members agreed that any future increases in Bank Rate would be expected to be at a gradual pace and to a limited extent. Amongst those using external finance, a quarter (25%) felt they would struggle if the cost of borrowing were to rise by 2% or more, according to the Q2 2017 SME Finance Monitor.

The Q4 2017 FSB's Voice of Small Business Index, suggests that credit availability has deteriorated slightly over the year. The net percentage balance of respondents who perceived credit to be 'affordable' worsened slightly. This net balance was -7.6% in Q4 2016 and declined to -9.1% in Q4 2017.[93] However, the affordability index is higher than values seen between 2012 and 2016.

FIG B.22

GROSS LENDING TO SMEs

Source: Bank of England

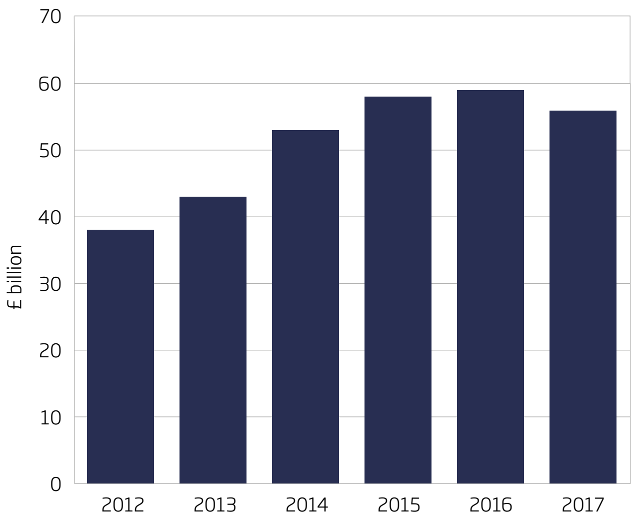
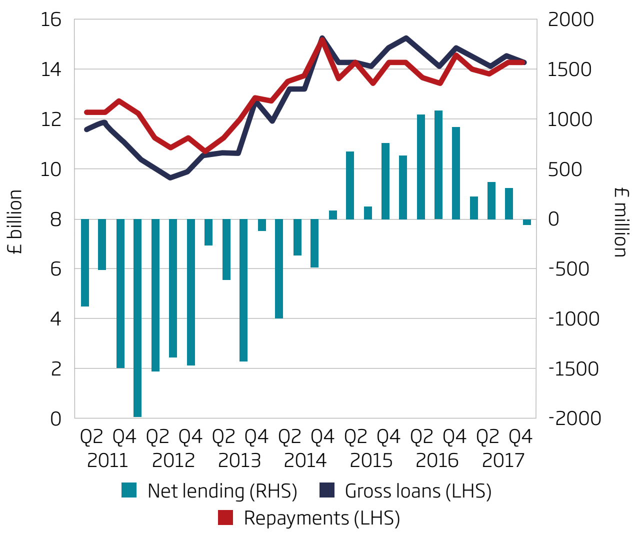


FIG B.23

QUARTERLY GROSS AND NET FLOWS OF BANK LOANS TO SMEs

Source: Bank of England



IN 2017, GROSS LENDING TO SMEs FELL SLIGHTLY, ALTHOUGH NET LENDING REMAINS POSITIVE

According to the BoE bank lending data, the gross flow of new loans (excluding overdrafts) to smaller businesses reached £57bn in 2017, this is slightly lower than 2016 (£59bn) (figure B.22). In 2017, the gap between repayments and gross lending has been narrowing, leading to a reduction in net lending. In Q4 2017, net lending turned slightly negative, ending 12 consecutive quarters of positive net lending (figure B.23). Over the year, net lending to smaller businesses was £0.7bn in 2017, this is lower than 2016 (£3bn) and 2015 (£2bn).

UK Finance data on SME lending by the main High Street banks shows medium sized businesses outside the commercial real estate sector (CRE) saw positive net lending in 2017 (figure B.24). The CRE sector accounts for around a quarter of the total stock of loans.[94] Medium and small sized CRE businesses experienced negative net lending in 2017. In the UK Finance dataset, a small business is defined as typically having less than £1m or £2m annual turnover and a medium business as having greater annual turnover, but less than £25m. Apart from Q3 2016 and Q3 2017, net lending has been negative for small businesses since Q3 2011.

A TREND DECLINE IN OVERDRAFT USAGE HAS BEEN ACCOMPANIED BY INCREASES IN DEPOSITS

There has been a trend decline in the value of outstanding overdrafts for smaller businesses since 2011 (figure B.25). According to UK Finance data, the value of overdrafts outstanding has decreased by 31% between July 2011 and September 2017, though broadly flat over the last year.

In contrast, deposits held by SMEs have grown between 2011 and 2017. Although, over the last year deposit values for medium sized businesses have decreased slightly and fallen below those of small sized businesses (figure B.25). Almost all SMEs hold some credit balances. The proportion holding £10,000 or more has increased from 16% in 2012 to 26% in Q2 2017. Most of those holding such funds said it reduced their need for external finance.[95]

OPEN BANKING REFORMS HAVE STARTED TO BE INTRODUCED, AND ARE INTENDED TO INCREASE COMPETITION

The final report of the Competition and Markets Authority's (CMA) retail banking market investigation, concludes that older and larger banks do not have to compete hard enough for customers' business, and smaller and newer banks find it difficult to grow.[96]

One of the key measures from the retail banking market investigation includes requiring banks to implement Open Banking by early 2018, to accelerate technological change in the UK retail banking sector. Open Banking will enable personal customers and small businesses to share their data securely with other banks and with third parties. This will help them to manage their accounts with multiple providers through a single digital 'app', to take more control of their funds, eg to avoid overdraft charges and manage cashflow, and to compare products on the basis of their own requirements.

Since March 2017, the larger banks have started to implement Open Banking. These banks have been building Application Programming Interfaces (APIs), making it possible to share an SME's bank account information. Open Banking is still at an early stage and it is too soon to comment on its impact on smaller businesses.

2017 saw the go-live of the Commercial Credit Data Sharing scheme under the Small and Medium Sized Business (Credit Information) Regulations 2015. The scheme helps open up access to credit data to make it easier for challenger banks and alternative finance providers to check the creditworthiness. In 2017, eight of the nine designated banks received letters from at least two of the designated Credit Reference Agencies (CRAs) to formally request the relevant data whilst the ninth designated bank received one letter with a second to follow in early 2018. As such all nine designated banks are now sharing data under the CRA scheme.

Finance providers will soon be able to use the information obtained through CRAs to better assess applications from smaller businesses. This has the potential to support SMEs who are seeking finance to grow their business.

FIG B.24

NET LENDING, SMALL AND MEDIUM SIZED BUSINESSES

Source: UK Finance, SME Statistics

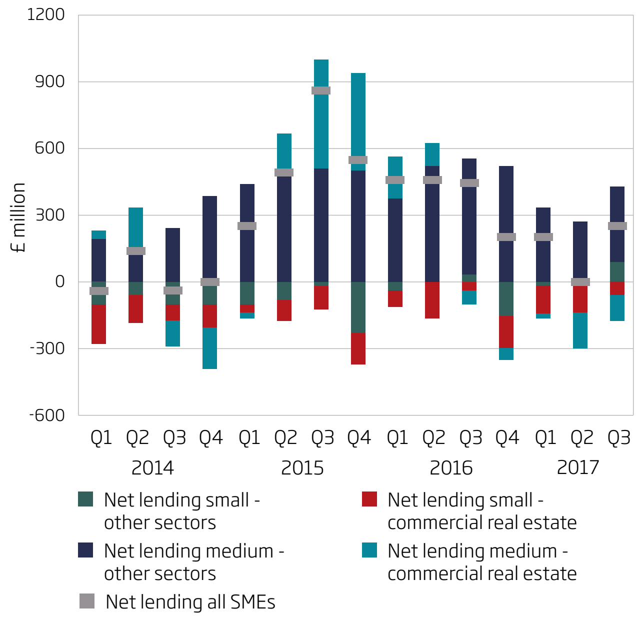


FIG B.25

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

Source: UK Finance, SME Statistics

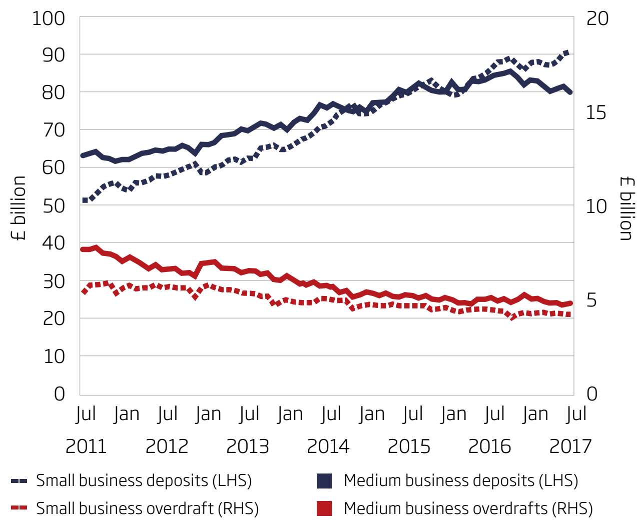
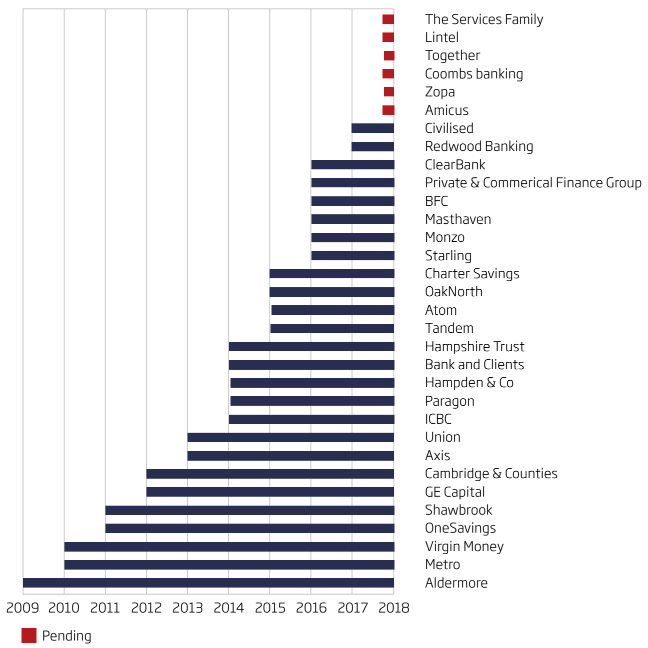


FIG B.26

NEW BANKING LICENSES AND CHANGES IN AUTHORISATIONS, 2009 -2017

RETAIL AND COMMERCIAL BANKS ONLY (NON-EXHAUSTIVE)

Source: Builds on analysis conducted by PwC presented in 'Who are you calling a 'challenger'? How competition is improving customer choice and driving innovation in the banking market.



'CHALLENGER BANKS' PROVIDE A DIVERSE OFFERING TO SMALLER BUSINESSES

Challenger banks is a collective term used to describe institutions (outside the 5 big banks), that offer services and products provided by the traditional largest banks.[97] There are many challengers, often serving niche markets, and actively differentiating themselves from the big banks. The annual KPMG challenger bank report highlights that term 'challenger bank' is increasingly becoming an inadequate description.[98] Primarily because it's doesn't capture the diversity of this group, and many challengers don't directly compete with big banks, but focus on their chosen area of opportunity.

We are still seeing new entrants to the market. Since 2008, over 50 institutions have been granted a banking licence in the UK. In 2016, there were 13 applications made to the Prudential Regulatory Authority.[99] Figure B.26 below, highlights some of the new entrants to the market since 2009, the majority of which lend to smaller businesses.

Of the existing challenger banks, some have chosen not to lend to smaller businesses, whereas others have made building an SME loan book a key strategic goal. Some of the larger challenger banks offer a wide range of products including core debt offerings such as term loans and overdrafts. There are also challenger banks who provide finance to smaller businesses, but focus on more alternative forms of finance including asset finance and invoice & asset-based lending.

REGULATORY FRAMEWORKS PROVIDE OPPORTUNITIES AND CHALLENGES FOR CHALLENGER BANKS

Capital requirements to date have been calculated differently for many challenger banks, compared to the larger traditional banks, resulting in higher capital requirements for challengers. A standardised approach towards calculating risk-weighted assets (Basel standards), is often applied by smaller sized banks, including challengers. Risk-weighted assets are a key determinant for calculating the amount of capital a bank must hold. Typically, larger banks can calculate their risk-weighted assets by using approved internal models for some SME portfolios. The combination of different methods to set capital requirements, and differences in lending composition results in risk-weighted assets representing 27.1% of total assets for the 5 largest banks, compared to 45.1% for smaller challengers.[100]

Open Banking should stimulate greater competition in the market. Challenger banks often have newer, and more agile technology systems, compared to some of the established banks. This means challengers should be able to adapt and benefit from Open Banking, especially as some challengers provide a digital only approach. A factor that will affect the impact of Open Banking is the extent to which individuals, and smaller businesses, are prepared to share their data with third parties.

The Second Payment Services Directive (PSD2), will accelerate Open Banking and subsequent use of APIs. Market participants will need to comply with the majority of the requirements set out in the PSD2 legislation from 13 January 2018.[101] Many of the challenger bank CEOs interviewed by PwC as part of their 2017 challenger bank research, viewed the PSD2 as a significant opportunity to implement new digital strategies, as they will now have access to other banks' customer data and can become an Account Information Service Provider (AISP).[102] Banks could also consolidate or aggregate data from a variety of banks and create new propositions, such as a dashboard presenting all customer account information in one place.

IMPLICATIONS FOR THE BRITISH BUSINESS BANK

Economic structural market failures, stemming from asymmetry of information, still exist in the bank lending market, and so the rationale remains for policy interventions.[103] The British Business Bank supports bank lending through its Enterprise Finance Guarantee (EFG) scheme, which addresses some of the problems that arise because of asymmetry of information. Since 2009, EFG has supported over £3bn of loans to smaller businesses.

The 2017 EFG economic impact evaluation demonstrated that the scheme creates a significant amount of economic benefits to the economy. Smaller businesses that received an EFG loan demonstrated turnover and employment growth that was 7.3% per annum and 6.6% per annum faster than a matched comparison group.[104]

Challenger banks are an important source of diversity for bank lending to smaller businesses. The current method in which risk-weighted assets are calculated for challengers means that capital requirements are generally greater, when compared against the larger banks. This comparison is considering capital arising from risk weighting, and not wider elements of the overall capital framework. The 2017 Autumn Budget report highlighted this issue, and the Prudential Regulation Authority is making capital requirements more proportionate for eligible smaller banks, helping them compete more effectively in the market.

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 SME portfolios.

Challenger banks are also eligible to apply to the British Business Investments' (BBI) programmes. In October 2015, BBI made its first investment in a UK challenger bank by investing £30 million in Shawbrook Group plc's £75 million Tier 2 note issuance. Funds raised from the issue supported Shawbrook Bank's growth with a core part of their strategy being lending to smaller businesses. In June 2017, BBI agreed a £30m Tier 2 capital committed facility with Atom bank, which will enable it grow and lend more to UK corporates and smaller businesses.

The 2016/17 Small Business Finance Markets report highlighted that half of smaller sized house builders were struggling to raise finance.[105] The 2017 FMB House Builders' survey shows that 54% of SME housebuilders reported that lack of finance to the company is a major constraint to building more houses, this is up from 50% in 2016.[106] In October 2017, the British Business Bank signed an ENABLE Guarantee deal with United Trust Bank (UTB). The Guarantee will allow UTB to increase significantly the amount of development finance it provides to UK SME housebuilders, supporting the building of new housing with a value of over £500m over the lifetime of the guarantee.

2.5
EQUITY FINANCE

- The number of UK equity deals in the first 3 quarters of 2017 has bounced back from a weaker 2016
- The financial returns from investing in VC continue to improve despite published data still showing higher returns from investing in Management Buy Outs
- There is a continued decline in the number of European VC funds closing, but fund managers are raising larger funds

This section provides an overview of recent trends in UK (private) equity finance over the last 5 years. An assessment is also made of factors affecting the financial performance of this asset class including trends in exits of VC-backed portfolio companies.[107]

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.

Some companies 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 is confirmed by new research from Beauhurst that shows the use of equity finance by businesses is associated with higher turnover growth, although it does not prove the direction of causality.[108] Of those businesses meeting the definition of high growth, 18% of growth companies growing their turnover by 20-40% per year used equity but this increased to 40% for those growing more than 100% per year.[109] In addition, the research finds the higher the amount of equity investment a high growth company receives the more likely it is to be growing its turnover by more than 100% a year.

No single data source has complete coverage of all equity deals in the market. The British Business Bank continues to use Beauhurst for data on UK equity deals, as it covers 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 in this report covers equity deals up to Q3 2017 for announced equity deals only.[110] Figures for full 2017 calendar year will be published in the forthcoming *Equity Tracker Report* in spring 2018. This report will provide a more detailed overview of the UK equity market than the higher-level summary published in this wider market report.

PitchBook data is used to assess portfolio company exits and VC fund raising activity as well as assessing trends in international equity deals (see section 1.4). The US National Venture Capital Association (NVCA) has partnered with PitchBook to produce statistics on the US VC market, which demonstrates its detailed coverage of the US.[111] There have also been recent improvements to PitchBook's coverage of European markets, which allows greater cross country comparison of equity deals to be made.[112] British Venture Capital Association (BVCA) data is used to examine the long-run financial returns from investing in VC compared to other types of Private Equity including Management Buy Outs (MBOs) and public markets.

THE NUMBER OF UK EQUITY DEALS IN THE FIRST 3 QUARTERS OF 2017 HAS BOUNCED BACK FROM A WEAKER 2016

The Business Bank 2017 Equity Tracker report identified UK equity finance was weaker in 2016 with a decline in the overall number and value of equity deals compared to earlier years, ending 5 years of annual uninterrupted growth. Deal numbers and investment amounts have bounced back in the first 3 quarters of 2017 with the number of equity deals increasing by 12% and investment amount increasing by 79% compared to the first 3 quarters of 2016 (figure B.27). The overall 2017 investment year to date of £4.5bn is already greater than the overall 2016 yearly figure of £3.4bn, with 1 quarter still to go. This is driven by strong investment amounts in Q2 and Q3 2017, where investment amounts in these quarters were over £1bn (and closer to £2bn), which is more than twice as large the average quarterly investment amounts seen in 2016.

The greatest increase compared to the first 3 quarters of 2016 has been seen in the number of venture stage deals (31%), which reverses some of the decline seen in early 2016 (figure B.28). The number of growth stage deals has also increased over 2017, albeit by a smaller rate than venture, increasing by 12% compared to the first 3 quarters of 2016. In comparison the number of seed stage deals have remained static compared to the first 3 quarters of 2016, although the low deals numbers in Q1 and Q2 2017, are obscured by strong performance in Q3 2017.

Whilst individual quarter data show a large degree of volatility from 1 quarter to the next, there are large increases (27%) in the number of equity deals overall in Q3 2017. This is seen across all 3 investment stages, but is most noticeable in terms of percentage increase at the growth stage which increased 52% compared to Q2 2017.

FIG B.27

NUMBER OF EQUITY DEALS AND VALUE OF INVESTMENT PER QUARTER

Source: British Business Bank analysis of Beauhurst

FIG B.28

NUMBER OF EQUITY DEALS BY STAGE PER QUARTER

Source: British Business Bank analysis of Beauhurst

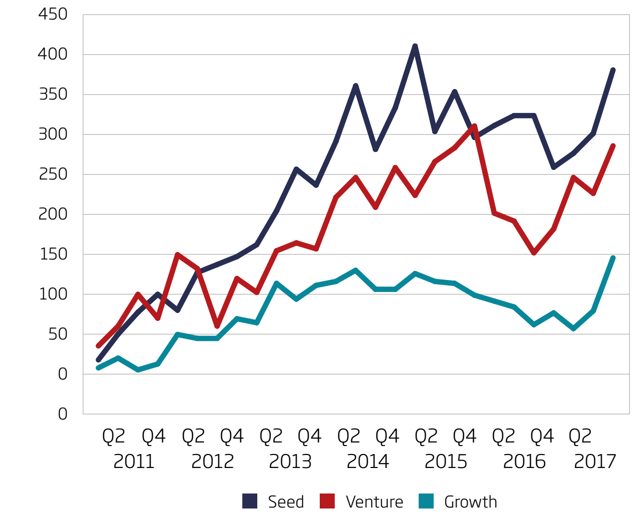


FIG B.29
VALUE OF EQUITY INVESTMENT BY STAGE PER QUARTER
Source: British Business Bank analysis of Beauhurst

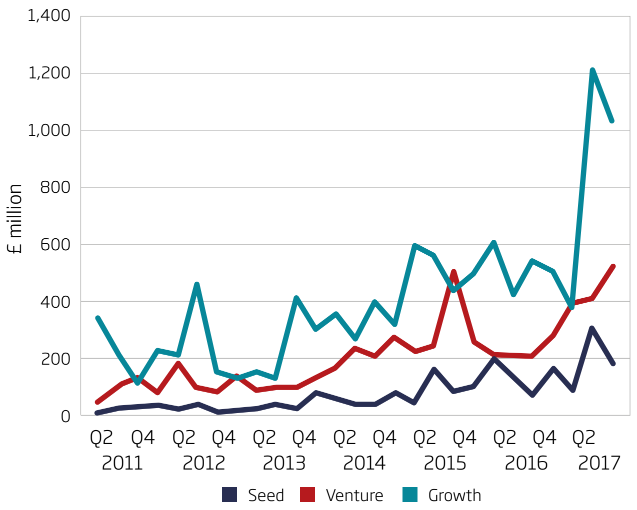
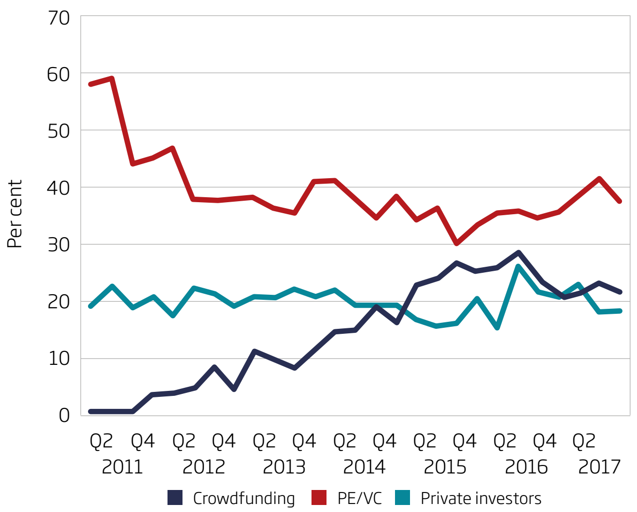


FIG B.30
PROPORTION OF DEALS PER QUARTER INVOLVING EQUITY INVESTORS, BY TYPE
Source: British Business Bank analysis of Beauhurst



Beauhurst's Q4 2017 Deal publication covering the whole of 2017 shows deal numbers have grown modestly (5% growth compared to 2016) but the investment amounts have more than doubled (113% growth).[113] Beauhurst note that 2017 has been the year of the "megadeal" with 29 deals larger than £50m in size, and 6 larger than £250m. Other market commentators also confirm UK VC deal volume has not slowed down in 2017 and is currently higher than pre-referendum levels.[114]

Whilst equity deal numbers have increased, the increase in equity investment amounts has been even more pronounced and seen across all 3 investment stages (figure B.29). Seed stage investment in Q1-Q3 2017 has increased by 45% compared to the same quarters in 2016, whilst venture stage investment has increased by 108% and growth stage investment by 75%. Growth stage investment has sharply increased in Q2 and Q3 2017, increasing from a quarterly investment average of £495m in 2016 to £1.2bn and £1bn invested in Q2 and Q3 2017 respectively.

Investment amounts have been increasing more greatly than deals numbers, which implies that average deal sizes are getting larger. Over the last few years, there has been a continued trend towards larger deals 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 3 quarters of 2017 and is seen across all 3 investment stages, but is most pronounced at the growth stage. The average deal size for growth stage deals was £6.5m in 2014, but is now over 3 times higher in 2017 at £19.9m. There are a small number of very large deals. For instance, the 10 largest equity deals alone account for over £1.6bn of the £4.5bn invested so far in 2017.

Seed stage deals remain smaller than other stages, but average deal sizes have also increased from £440,000 in 2014 to £1.5m in 2017. Venture stage deals have remained relatively constant in size over the same time period at around £2.5m.

Around 35% of all equity deals (43% of disclosed amount deals) were less than £1m in size in 2017, a slight decrease compared to 2016. Larger deal sizes were partly the result of increases in very large deal sizes of £10m or more, with the very largest deal sizes increasing in size. Having formed 4% of all deals in 2014 (5% of disclosed amount deals), they now form 9% of all deals in 2017 (11% of disclosed deals). £10m deal sizes now form 71% of the total investment amount, up from 67% of the total investment amount in 2016. In 2014, £10m deals only formed 50% of total investment value. This is seen as a positive sign that the UK is rising to the challenge of supporting companies that are scaling up to be international leaders.

This in part reflects the increasing importance of a small number of highly successful companies raising large amounts of later stage funding. For instance, 2 UK unicorn businesses (private VC backed businesses valued over $1bn) both raised funding rounds in excess of £300m in Q2 2017, Improbable and Farfetch.[115] Within the last year there has been an increase in the number of businesses gaining 'unicorn status' with 12 businesses, up from 7 a year ago. The UK contributes nearly half of Europe's total number of unicorn businesses (25), but Europe as a whole lags behind the US (108) suggesting there is more that can be done to support scale up activity.[116]

Around 39% of equity deals in 2017 involved Private Equity funds, showing that they continue to be an important source of equity funding (figure B.30).[117] Crowdfunding has emerged having been involved in only 1% of all equity deals in Q1 2011 but 28% in Q2 2016. The number of deals involving crowdfunders peaked in Q3 2015, at 97 deals, before falling to 56 deals in Q4 2016. However, this has recovered to 84 deals in the latest quarter (figure B.31).

The 'Technology/Intellectual Property (IP) based businesses sector continues to dominate equity investment in the UK, with 482 equity deals equivalent to £2.1bn in the last 4 quarters (Q4 2016 to Q3 2017) (figure B.32).

FIG B.31
NUMBER OF DEALS PER QUARTER INVOLVING EQUITY INVESTORS, BY TYPE
Source: British Business Bank analysis of Beauhurst

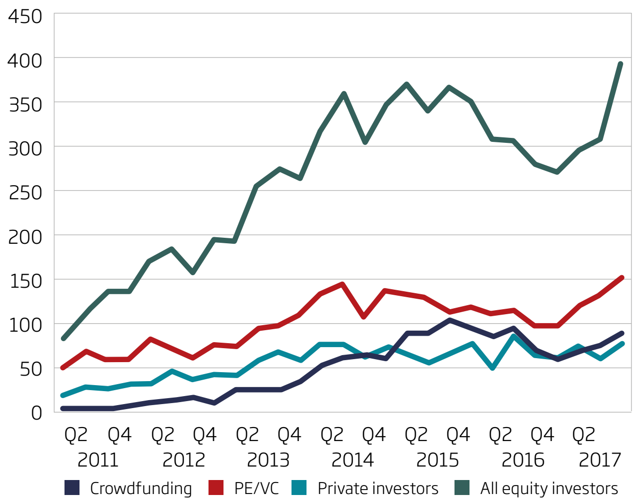


FIG B.32
NUMBER OF DEALS AND INVESTMENT AMOUNT, BY SECTOR (Q4 2016 - Q3 2017)
Source: British Business Bank analysis of Beauhurst

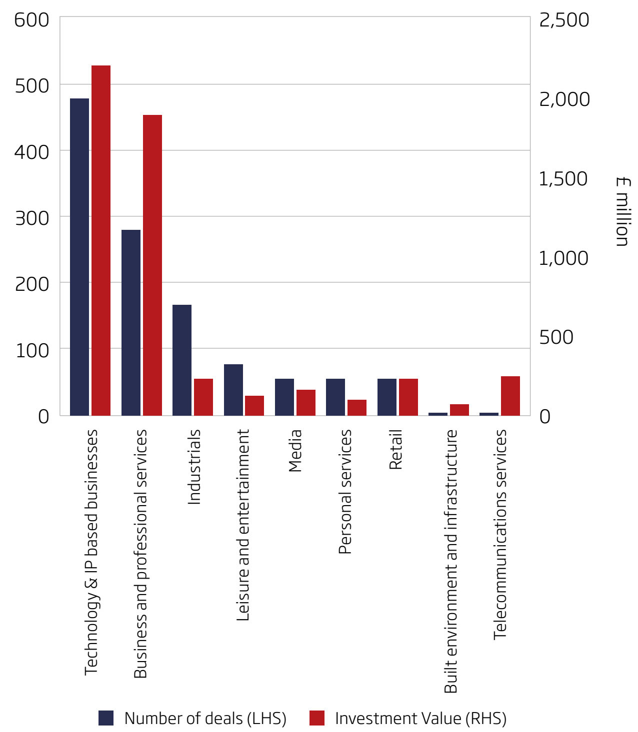


FIG B.33

NUMBER AND VALUE OF VC BACKED COMPANY EXITS

Source: British Business Bank analysis of PitchBook (15th January 2018)

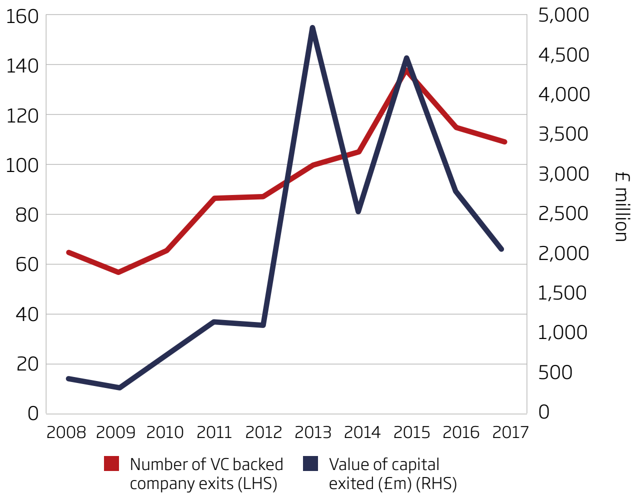


FIG B.34

LONG-TERM RATES OF RETURN, BY INVESTMENT CATEGORY AND SELECTED MARKET COMPARATORS

Source: BVCA (2017) 'Performance Measurement Survey 2016

IRR (% P.A)	3-YEAR	5-YEAR	10-YEAR
Private Equity Overall (includes VC)	12.7	13.7	11.0
Venture Capital	12.5	11.1	6.2
Venture Capital pre-2002 vintage funds	11.6	6.0	0.6
Venture Capital 2002 vintage funds onwards	12.7	12.2	8.6
Small MBO	12.1	13.1	13.4
Medium MBO	13.7	14.2	11.4
Large MBO	12.4	13.8	11.2
SELECTED COMPARATORS			
FTSE All Share	6.1	10.1	5.6

THE FINANCIAL RETURNS FROM INVESTING IN VC CONTINUE TO IMPROVE DESPITE PUBLISHED DATA STILL SHOWING HIGHER RETURNS FROM INVESTING IN MANAGEMENT BUY OUTS

Exits are an important mechanism for equity investors to realise financial returns. Venture capital returns have continued to improve over recent years due to a resilient exit environment, but exit routes have slowed down over 2016 and 2017.

PitchBook data shows there were 109 UK VC-backed company exits in 2017 (excluding bankruptcy exits), down slightly from 115 in 2016 and 137 in 2015 (figure B.33). This reverses the trend seen since 2009 where there had been continued yearly increases in the number of VC-backed company exits. Most exits (68%) in 2017 were a trade sale (merger or acquisition), but buyouts (secondary sales or investor) formed the next highest category (24%). Initial Public Offerings (IPO) form the minority of exits with just 8% of successful exits being an IPO. PitchBook lists 9 UK VC-backed company IPOs in 2017, with 4 of these being in the pharmaceutical/biotechnology sectors and one being in healthcare. UK trends appear to be consistent with wider European trends where the number of VC backed exits started declining from 2015 onwards. PitchBook (p.11) states "Although 2017 was assumed as the year many companies would finally IPO based on the age of some unicorns, IPO volume has remained sluggish. VC-backed companies continue to choose the comforts of the private markets to avoid the scrutiny of public investors".[118]

Long-run VC financial return figures continue to improve, but lag the improvements seen in VC-backed company exits over recent years (as shown by Figure B.33). For instance, BVCA figures show the 10-year IRR return for venture is 6.2%, which is up from the 5.1% reported a year ago, but only slightly higher than the 5.6% return from investing in public markets, which are likely to be lower risk (figure B.34).[119]

The overall published 10-year returns figures are lowered by the inclusion of pre-2002 vintage funds which are affected by the dotcom bubble bursting in 2001. Post-2002 vintage VC funds perform much better at 8.6% IRR. This is still well below the broader private equity returns figure of 11.0%, but is at least substantially higher than the level from investing in public markets. The shorter term 3 and 5-year returns figures are much stronger than the 10-year returns, suggesting the long-term VC fund returns will improve further in the future.

Aggregate market returns obscure the high financial 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 6.7% (up from the 0.3%), upper quartile funds generate IRR of 11.4% based on since inception returns. The top 10th percentile funds generate an IRR of 27.3%.[120]

THERE IS A CONTINUED DECLINE IN THE NUMBER OF EUROPEAN VC FUNDS CLOSING, BUT FUND MANAGERS ARE RAISING LARGER FUNDS

European VC fundraising has been strong in recent years, with £5.6bn raised in 2015 and £5.7bn in 2016. 2017 appears to show a decline in fundraising activity data with £4.3bn raised to date, although there may be a time lag before all funds submit their 2017 fund raising activity to PitchBook. The number of VC funds closing has continued to decline from its peak in 2008, where 102 funds closed, down to 54 in 2016 (35 in 2017).[121]

This suggests fund sizes are increasing. The median European VC fund size in 2016 was £87m, up from £40m in 2015. This shows European VC funds are now of sufficient scale to be able to make scale-up investments and operate commercially, which is good news. PitchBook agrees (p13) "Larger early stage funds will be a valuable resource for growing European start-ups hoping to compete with US giants and scale globally."[122]

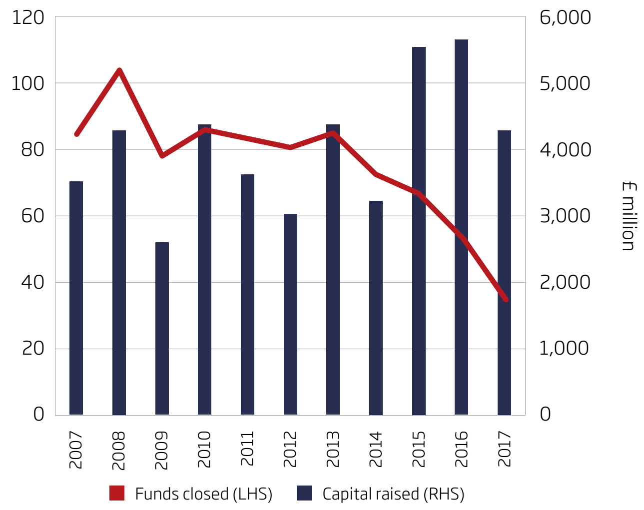
Although fund raising conditions for VC have improved, they are still difficult, especially for early stage and new fund managers. Preqin data shows the average time for European VC funds to close is currently around 19 months, which is higher than 2007 levels when it was around 15 months, but lower than 2011-2014 levels when it was around 21 months. In comparison, European buyout and growth fund managers take much less time to raise funding (14 months in 2016) showing the additional difficulties VC has in attracting LP investors. The British Business Bank's Enterprise Capital Fund (ECF) programme helps new and emerging fund managers, and the commitment at Budget 2017 provides the market with additional assurance that this will continue to be an important part of the Bank's programmes.

Yearly trends in UK VC fund raising are more volatile but show a similar picture to the European market with relatively high amounts of new fund raising in 2016 and 2017 (£2.6bn and £2.4bn) respectively, but the number of funds closing fell over the last few years (figure B.35). Where the UK and European markets differ is that the number of funds closing recovered between 2012 and 2014 in the UK market, possibly due to increased support from the British Business Bank.[123]

FIG B.35

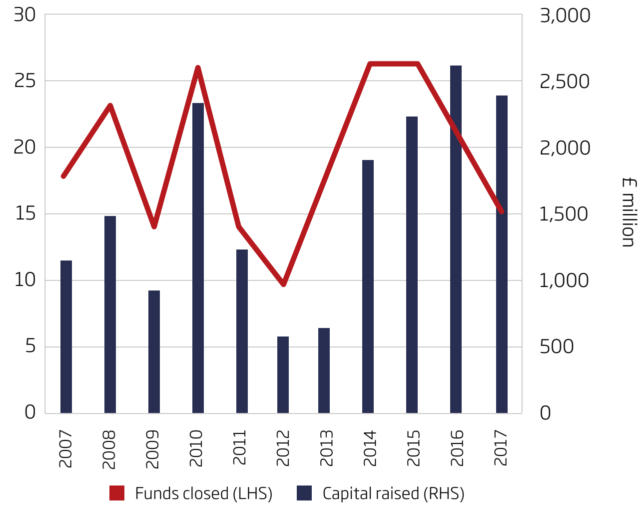
EUROPEAN VC FUNDRAISING

Source: British Business Bank analysis of PitchBook (15th January 2018)



UK VC FUNDRAISING

Source: British Business Bank analysis of PitchBook (15th January 2018)



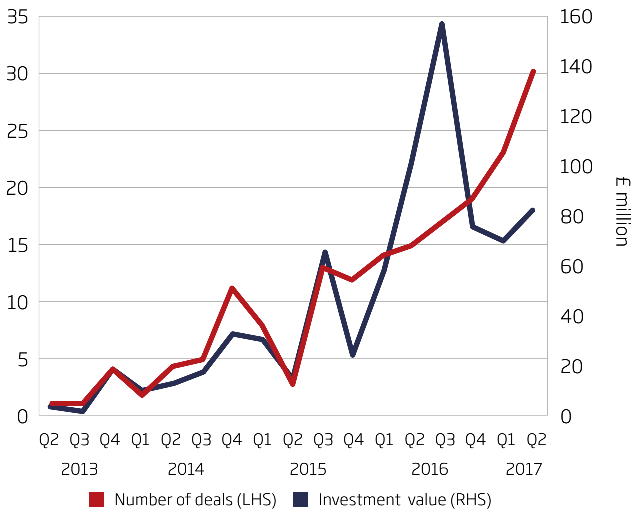
2.6
DEBT FUNDS

- Private debt funds continue to have an important role in UK lending markets, with increases seen in the number of UK deals made to smaller businesses
- The number of venture debt deals is also increasing in the UK, although the UK venture debt market is less developed than the US with fewer providers
- The British Business Bank's Investment Programme and Help to Grow pilot are designed to increase the supply of flexible debt to smaller businesses

FIG B.36

BRITISH BUSINESS BANK SMALLER BUSINESS FOCUSED PRIVATE DEBT FUNDS NUMBER AND VALUE OF DEALS PER QUARTER

Source: British Business Bank MI Data



PRIVATE DEBT FUNDS CONTINUE TO HAVE AN IMPORTANT ROLE IN UK LENDING MARKETS, WITH INCREASES SEEN IN THE NUMBER OF UK DEALS MADE TO SMALLER BUSINESSES

Private debt funds provide bespoke debt finance offering businesses an alternative source of funding to banks. Private debt funds tend to accommodate greater levels of risk and lend at higher interest rates than banks, but private debt funds offer greater speed in their lending, greater flexibility in deal structure and greater leverage, which offers growing businesses an alternative source of funding. Deals involving private debt funds make up a relatively small part of the overall lending to businesses, but the businesses funded are likely to be aiming for high growth, and so make an important contribution to the UK economy.

The UK private debt market has grown over the last few years, since its emergence in 2010 in response to tighter bank lending conditions for businesses and low interest rate environment for investors.[124] Because of its infancy as an asset class in European markets, data on private debt deals is less comprehensive compared to Private Equity deals, especially as deal coverage tends to focus on larger mid-market businesses only.

The mid-market private debt market is now well established in the UK, but coverage of deals involving smaller businesses (the focus of British Business Bank activity) is markedly lower, which makes it difficult to assess trends in this part of the market. The British Business Bank has played a catalytic role in supporting the development and growth of SME focused private debt funds in the UK through the Small Cap Business Finance Partnership and the Investment Programme. The Bank has invested in 11 SME private debt funds over time, and is involved in a significant proportion of UK SME focused private debt funds. To illustrate the growth of private debt lending over time to smaller businesses, the Bank has provided information from its own portfolio of private debt deals made through private debt funds focusing on smaller businesses (figure B.36).

British Business Bank Monitoring Information on the Small-Cap Business Finance Partnership and Investment Programme shows an increase in the activity of private debt funds focused on lending to smaller businesses from 2013 onwards. British Business Bank supported debt funds targeting smaller businesses lent £130m to 36 businesses in 2015, but by 2016 this had increased to £378m to 65 businesses, an increase of 81% by number and 192% by value. The number of deals is likely to be even higher in 2017, with strong performance seen in the first 2 quarters of 2017, suggesting continued growth in the number and value of deals over time.

The British Business Bank welcomes suggestions for improving data on private debt deals to smaller businesses beyond its existing portfolio. Existing private debt data providers like Deloitte, through its Alternative Lending Tracker, and Preqin, through its Private Debt Module, largely capture deals involving mid-market companies only.[125] Figure B.37 provides a direct comparison of these 2 datasets to show relative coverage and trends over time.

Preqin's coverage of UK private debt deals is similar to the Deloitte Alternative Lending Tracker as Preqin identified 92 private debt deals in 2016, whilst Deloitte identified 97 deals. Preqin shows there were 75 private debt deals in the first 3 quarters of 2017 compared to 90 for Deloitte. Both data sources therefore indicate the overall number of deals in 2017 is likely to be higher than in 2016, showing growth in the mid-market. Deloitte note "Direct Lending is increasingly appealing to mid-market businesses" and "there is no doubt direct lending will continue to expand across Europe in 2018".[127]

The Preqin Private Debt Module allows additional insights to be identified through the analysis of deal level data. For instance, many of the British Business Bank supported fund deals are not included in the Preqin figures, and so these should be included in any estimate of the overall size of the UK private debt market.

Preqin shows there are 92 private debt managers located in the UK and 233 private debt fund managers located in Europe showing the UK is an important location for fund managers with over 40% of them having a head office based in the UK.[128] Preqin has coverage of some SME focused managers in its private debt fund manager profiles, which suggests coverage of smaller deals involving smaller businesses is likely to increase in the future. The British Business Bank therefore encourages all private debt fund managers to disclose their deals to data providers like Preqin and Deloitte in order to enable the size of the market to be accurately quantified.

FIG B.37

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

Source: British Business Bank analysis of Deloitte (Q3 2017 report) and Preqin Private Debt module (11/12/2017)[126]

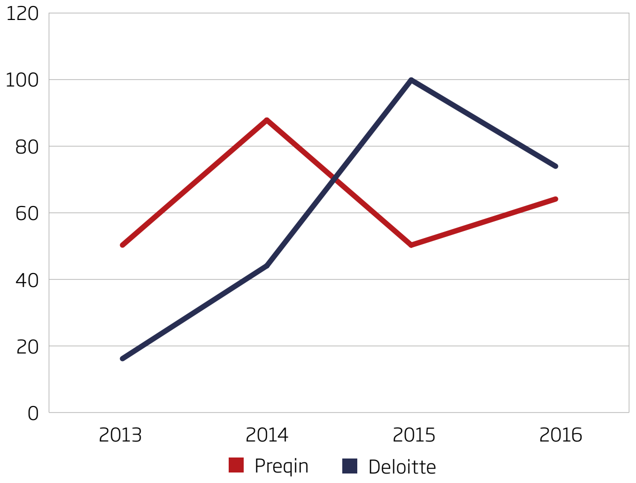
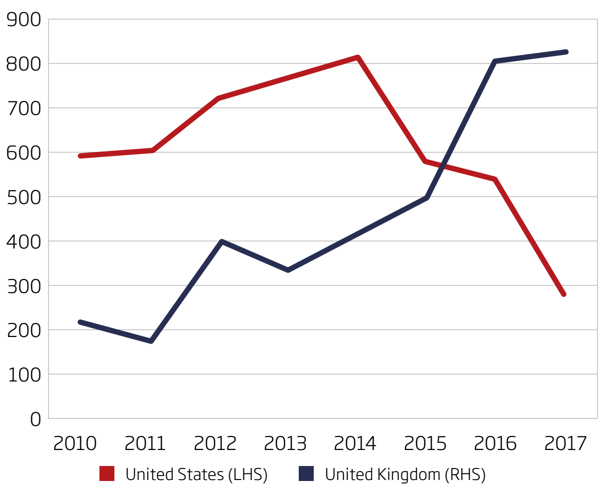


FIG B.38

NUMBER OF VENTURE DEBT DEALS PER YEAR

Source: British Business Bank analysis of Preqin (12 January 2018)



THE NUMBER OF VENTURE DEBT DEALS IS ALSO INCREASING IN THE UK, ALTHOUGH THE UK VENTURE DEBT MARKET IS STILL LESS DEVELOPED THAN THE US WITH FEWER PROVIDERS

"Venture debt is a term that broadly covers loans to early stage VC-backed companies. In return for the loan, the venture lenders receive principal and interest payments together with warrants and sometimes, depending upon the contract, the right to invest in a future round."[129]

Venture debt lenders differ to traditional lenders in that they look at the current and expected performance of a business, rather than historical balance sheets to assess if a venture loan is appropriate. Venture debt loans look to have similar characteristics to growth loans, but the main distinction between venture debt and growth loans is the involvement of the venture capitalist investor in the company.[130] Venture debt providers are largely trading off the due diligence undertaken by venture capitalists.[131]

Venture debt allows companies to unlock greater finance than they would otherwise have done so. Venture debt leverages further equity capital to increase valuations between equity rounds, reduce dilution for all current stakeholders and so enhance investor return.[132] Venture loans can generally be arranged much more quickly than equity rounds, saving management time or meeting unforeseen needs. Venture debt needs to be structured correctly to avoid constraining a company's growth or becoming an obstacle to future equity rounds.[133]

Venture debt has been established in the US since the 1980s and the venture debt market in Europe has grown at an extremely rapid pace since its beginnings in the late 1990s.[134] The number of venture debt deals in the UK has increased from 9 in 2011 to 41 in 2017, showing the market is expanding significantly albeit from a low starting position (figure B.38). In contrast, the number of venture debt deals in the US market peaked in 2014 with 813 deals, before declining to 286 in 2017. This may reflect the wider slowdown in VC company exits (IPOs and trade sales) seen in the US market between 2014 and 2017. Lower VC exits can affect the attractiveness of using venture debt.[135]

The UK market venture debt market is markedly less developed than the US with fewer providers. For instance, Preqin shows the UK has 10 active venture debt fund managers compared to 78 in the US.[136] As a result, venture debt is twice as prevalent in the US compared to the UK. British Business Bank analysis of Preqin shows between 2010 and June 2017, 22% of US VC backed companies used venture debt compared to just 10% in the UK.[137] This may be an over estimate of the size of the UK venture debt market as UK debt providers listed as providing venture debt by Preqin consist of Government-backed funds and also growth loan providers who may be providing growth loans to established businesses rather than venture debt.

It is also apparent that UK venture debt providers do not appear to show the same degree of sector specialisation and appear to be more 'generalist' in the sectors they support. This could be a function of the smaller size of the UK market (i.e. not enough deals in a sector to sustain a specialist in the UK), or a function of the maturity of the US market.

THE BRITISH BUSINESS BANK'S INVESTMENT PROGRAMME AND HELP TO GROW PILOT ARE DESIGNED TO INCREASE THE SUPPLY OF FLEXIBLE DEBT TO SMALLER BUSINESSES

Whilst private debt funding conditions remain strong for mid-market companies, structural issues remain for funds targeting smaller businesses. The British Business Bank's Investment Programme along with its predecessor programme the Business Finance Partnership Small Cap Tranche promotes diversity of lending supply through supporting a variety of potential finance. To date, the British Business Bank has committed a total of £375m to 11 private debt funds focusing on smaller businesses. These include Beechbrook, BMS Finance, Boost&Co, Praesidian, Muzinich, European Capital, Harbert, Shard Credit Partners and Cordet Capital Partners. These funds provide a range of different types of debt including direct senior secured loans to flexible mezzanine and unitranche debt. This will help the smaller business private debt market to build up a track record with investors.

The British Business Bank's Help to Grow pilot aims to increase the provision of smaller growth loans between £0.5m and £5m. The British Business Bank launched the initial phase of Help to Grow in 2016, announcing that the first £30m of Help to Grow-supported lending would be delivered to businesses through Lloyds Banking Group. In January 2017 a second lender, the challenger bank OakNorth, joined the programme, with a £30m facility. The first Help to Grow fund also closed in August 17 with a £15m fund operated by MSIF, supporting high growth SMEs across the North West.

2.7

ASSET FINANCE AND INVOICE & ASSET-BASED LENDING

- Asset finance growth is in line with industry expectations and is driven by lending to SMEs
- Asset finance providers have become more diverse
- Invoice & asset-based lending advances have continued to grow
- Discounting has overtaken factoring to become the most used product

This section provides an update on developments in the asset finance (leasing and hire purchase) markets in 2017, highlighting the continued increase in new business.

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.

Asset finance continues to be the alternative finance instrument used by the largest proportion of smaller businesses surveyed in the SME FM (Q2 2017) with only bank overdrafts and credit cards more frequently used. This is true across the full range of business sizes with the use of asset finance increasing with size (figure B.39).

Unsurprisingly, given the nature of asset finance, figure B.40 shows it is most used by firms looking to scale up. FLA calculations suggest that the industry financed more than 35% of UK investment in machinery, equipment and purchased software in the 12 months to September 2017, an 8-year high.

2017 GROWTH IN LINE WITH INDUSTRY EXPECTATIONS AND IS DRIVEN BY LENDING TO SMEs

At the start of the year the FLA's expectations were for single-digit growth in asset finance to business of all sizes for the year overall. The latest figures show growth of 5% in the total value of asset finance new business in 2017, well above growth in UK business investment which is forecast to have grown by only 2.5%. This has been driven by lending to SMEs which has grown by 12%.

FIG B.39

EXTERNAL FINANCE CURRENTLY USED BY SMEs, BY SIZE OF SME

Source: SME Finance Monitor Q2 2017

		Number of employees			
YEQ2 17 – ALL SMEs	TOTAL	0	1-9	10-49	50-249
Unweighted base:	18,007	3604	5802	5801	2800
Core products (any)	32%	28%	39%	50%	61%
-Bank overdraft	17%	15%	21%	23%	27%
-Credit cards	18%	16%	21%	32%	44%
-Bank loan	5%	4%	7%	11%	17%
-Commercial mortgage	2%	1%	3%	7%	12%
Other forms of finance (any)	18%	15%	23%	35%	40%
-Leasing or hire purchase	8%	6%	11%	21%	25%
-Loans from directors, family & Friends	5%	4%	7%	6%	4%
-Equity from directors, family & Friends	2%	2%	2%	3%	4%
-Invoice finance	4%	3%	4%	11%	15%
-Grants	3%	2%	3%	5%	7%
-Loans from other 3rd parties	2%	2%	2%	3%	3%
Any of these	39%	35%	48%	60%	69%
None of these	61%	65%	52%	40%	31%

FIG B.40

EXTERNAL FINANCE CURRENTLY USED BY SMEs, BY BRITISH BUSINESS BANK SEGMENTATION

Source: British Business Bank analysis of SME Finance Monitor 10 quarter dataset ending Q2 2017

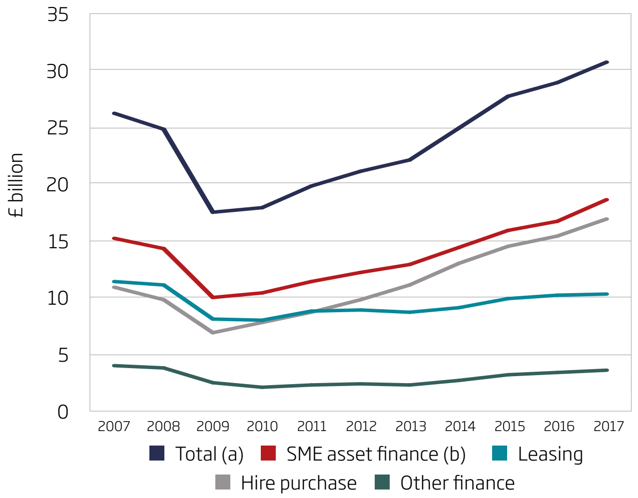
BRITISH BUSINESS BANK SEGMENTATION	ALL SMEs	START-UP	SCALE-UP	STAY AHEAD
Bank overdraft	17%	13%	23%	17%
Credit cards	16%	12%	23%	16%
Bank loan/Commercial Mortgage	8%	6%	11%	7%
Leasing or hire purchase	7%	5%	10%	6%
Loans or equity from directors, family & friends	7%	8%	9%	4%
Invoice finance	3%	3%	4%	2%
Grants	2%	2%	3%	2%
Loans from other third parties	2%	2%	2%	1%

FIG B.41

SIZE OF UK ASSET FINANCE MARKET FOR BUSINESSES - NEW BUSINESS

Source: Finance & Leasing Association (FLA)

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



It is also possible to split lending by sector. The FLA's most recent figures show growth in asset finance provided for plant and machinery up in 2017 by 12%. Within this total, new business for construction equipment grew by 21%; for production and processing equipment by 18%; and for agricultural equipment by 16%. Over this period, all the other main asset sectors reported new business growth. Business equipment finance increased by 7%; commercial vehicle finance by 2%; IT equipment finance by 2%; and business car finance by 5%.

Hire purchase and leasing make up the majority of asset finance new business. Hire purchase continued to grow in 2017, up 8%, while leasing increased by 2%, but is still below pre-crisis levels (figure B.41).

The FLA's Q4 2017 Asset Finance Confidence Survey suggests the asset finance industry is expected to record further single-digit new business growth in 2018.

ASSET FINANCE PROVIDERS HAVE BECOME MORE DIVERSE

Since the onset of the financial crisis there appears to have been a significant change in the makeup of the industry with market contacts and recent industry publications suggesting captives[138] and non-banks may have doubled their market shares whilst the largest banks' share has decreased.

This decreased share for the largest banks appears to be attributable to a variety of reasons. Post crisis, some of the larger banks decided to scale back or phase out non-core activities, and for some this may have included asset finance. A further contributing factor may have been the increase in risk weighting for SME lending meaning larger banks may have been unable to earn their required returns from asset finance due to the relatively tight margins within the industry.[139]

At the same time, industry experts have reported the growth in captives' and non-bank books, and that some brokers have started their own books. The latter has been partly aided by several brokers being backed by private equity investments. What is less clear is how the market share has changed between banks. Anecdotally, it appears challenger banks have increased their share at the expense of the larger banks.

As with other finance markets, some of this appears to have been aided by technology. Whilst there has been limited success in creating a purely online proposition for asset finance, many lenders have been able to combine the digital approaches with the more traditional human element to speed up applications and back office processes.

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.

INVOICE FINANCE & ASSET-BASED LENDING

Invoice finance & asset-based lending 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 include factoring and invoice discounting (collectively referred to as invoice finance) which accounts for approximately 80% of the finance facilitated across all sizes of businesses.

With many SMEs lacking the collateral traditionally required to gain access to finance, invoice finance products can be particularly important as they do not always rely on the SME owning any physical assets to act as security. Perhaps reflecting this, SMEs account for 96% of all firms UK Finance data reports using invoice and asset-based lending.

In addition, for those smaller or less experienced SMEs, invoice finance products can bring other benefits such as shortened and more predictable payment cycles. They may also come with optional add-ons such as bad debt protection, back-end payroll support and expertise on doing business in particular industries. These can free up time and offer some protection from late payment or default risk.

It is estimated that UK Finance (formerly ABFA) members involved in the provision of invoice finance and asset-based lending account for around 95% of the market (by client turnover). Depending on how the products are defined, they estimate there are around 60 active invoice finance and asset-based lending providers, with the 5 largest UK commercial banks responsible for writing around 75% by value of advances of the total market and servicing approximately 64% of all firms that are supported by invoice finance and asset-based lending. Their data includes the end of quarter stock of advances to smaller business and the number of unique smaller businesses utilising invoice finance and asset-based lending at the end of a quarter.

The Q3 2017 figures show that the year-to-date quarterly average number of smaller businesses utilising invoice finance and asset-based lending is little changed at 38,293 compared to 38,523 for the 2016 year-end average. Unfortunately, due to the growth in the financing of more complex business structures, including associated businesses, divisions and product lines, there has been a review and subsequent adjustment in client numbers which means it is not possible to compare client numbers pre- and post-Q1 2016 on a like-for-like basis. UK Finance does, however, report a broad consensus amongst its members that overall client numbers for the industry as a whole have remained constant over recent years.

FIG B.42

LEVELS OF QUARTERLY AVERAGE STOCK OF ADVANCES, BY SIZE COHORT (TURNOVER)

Source: UK Finance, Bank of England and British Business Bank calculations, 2017 data up to and including Q3

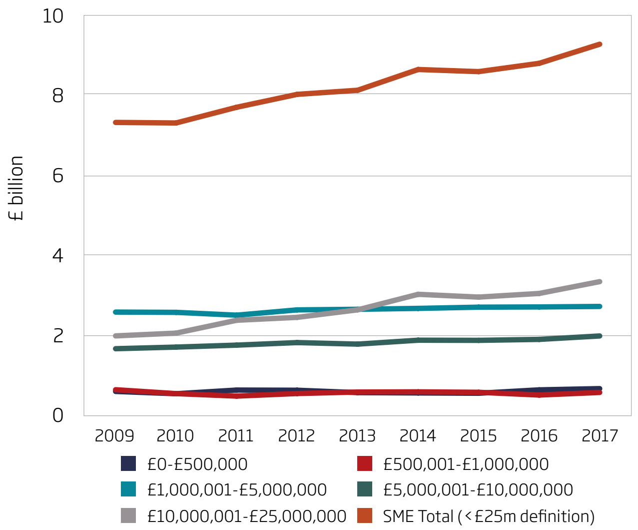
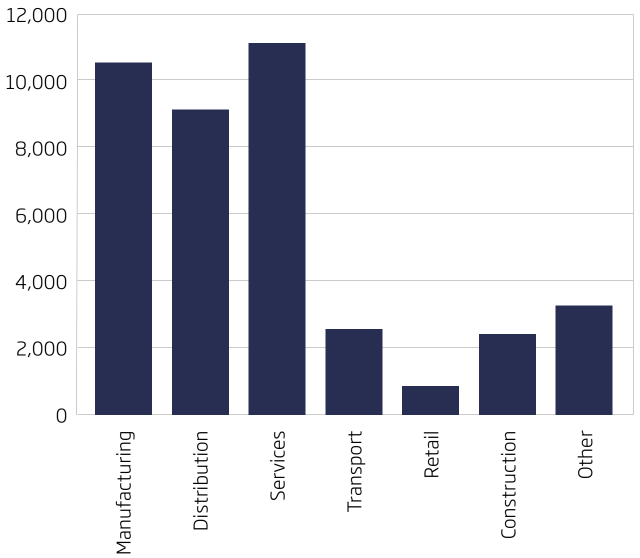


FIG B.43

NUMBER OF COMPANIES USING INVOICE FINANCE AND ASSET-BASED LENDING, BY SECTOR

Source: UK Finance, 2017 data up to and including Q3



INVOICE & ASSET-BASED LENDING ADVANCES HAVE CONTINUED TO GROW

The restated figures do not impact the values of advances though. This figure has continued to increase in recent years with the Q3 year-to-date quarterly average total advances to SMEs now at £9.3bn, up from £8.8bn for the same period in 2016, an increase of 5.6% (figure B.42).

Increases in advances were broad based across the business sizes as measured using turnover cohorts. Advances to all our cohorts grew by more than 5% with the exception of the middle cohort (£1m-£5m) which only grew by 0.5%. Average advances to the largest SMEs (£10m-£25m) grew by 10% to £3.4 billion having breached £3bn for the first time in the series in 2016.

UK Finance data also breaks down finance facilitated by the high-level business sector of the recipient business. It is not possible to cut this data by both firm size and sector, but it shows that services, manufacturing and distribution make up ¾ of all clients whilst transport, construction, retail and other account for the remaining ¼. Given the vast majority of those companies using invoice finance and asset-based lending are SMEs it is safe to assume that there is unlikely to be a significantly different picture in the SME space (figure B.43).

DISCOUNTING HAS OVERTAKEN FACTORING TO BECOME THE MOST USED PRODUCT

A further possible split is by type of finance provided. Historically invoice finance has been the product used by the most businesses – this is finance provided against debts rather than against other assets. Within that, prior to 2012, factoring was the more popular variant (figure B.44). The trend from factoring, a traditionally service-oriented proposition, to invoice discounting post 2012 is likely to have been at least partly driven by the move towards automation and standardisation, especially within the big banks and new entrants. Indeed, this general trend can be seen emerging over many years, with an increasing move away from the 'original' product of factoring.

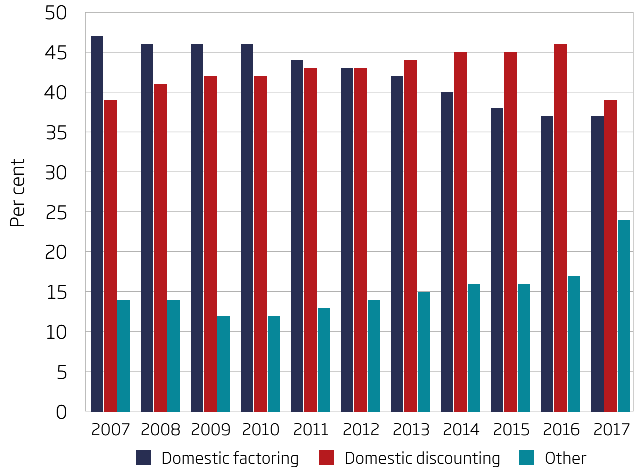
The key difference between factoring and discounting is who manages the sales ledger and collects payments. Factors - factoring finance providers - purchase a businesses' unpaid invoices and advance most of the value of the invoices, with the balance less any charges paid when the invoices are paid by the end customer. Factors also manage the sales ledger and collect payment from the end customer, giving the finance provider greater visibility and control over the payment cycle.

Invoice discounting is similar to factoring (indeed the legal mechanism by which it is typically provided - through debt purchase – is virtually identical) except the client business retains control over managing the sales ledger. In this way, the end-customers will not always be aware of the presence of the finance facility. As well as the changes around automation and standardisation identified above, it is likely that a demand-side push (from prospective clients) has driven the switch from factoring to invoice discounting over recent years.

FIG B.44

SHARE OF COMPANIES USING INVOICE & ASSET-BASED LENDING, BY INSTRUMENT

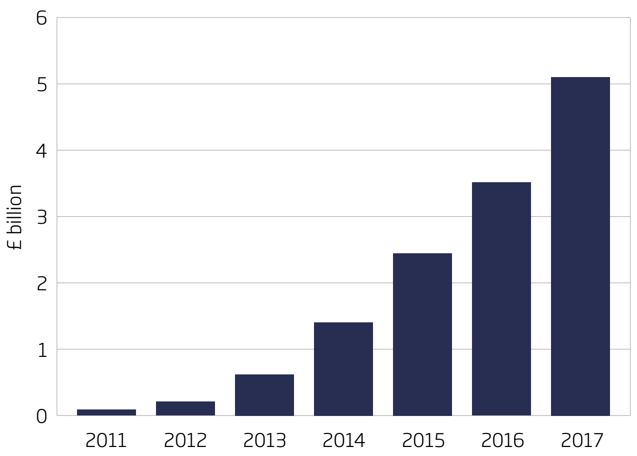
Source: UK Finance and British Business Bank calculations, 2017 data up to and including Q3



2.8
MARKETPLACE LENDING

- Marketplace lending continues to grow strongly
- UK marketplace lending is experiencing a period of consolidation
- Institutional funding is becoming more important
- As the industry matures there has been greater scrutiny

FIG B.45
GROWTH IN GROSS LENDING BY MARKETPLACE LENDERS
Source: AltFi Data



Marketplace lending is a term used to describe the market mechanisms, usually online, that link lenders and borrowers. This section reviews developments in this nascent market, with a focus on business lending, using information from AltFi Data. AltFi Data covers Peer-to-peer (P2P) consumer, P2P business, P2P property, P2P invoice financing and crowdfunding debt and equity. This section focusses on P2P business lending, which is predominately to SMEs, whilst equity crowdfunding is covered in section 2.5 Equity finance.

MARKETPLACE LENDING CONTINUES TO GROW STRONGLY

Marketplace lending values continue to grow. According to AltFi Data, total lending in 2017 exceeded £5bn, an increase of 45% on 2016.[140] This brings the total to £13.4bn since AltFi Data started recording data in 2011 (figure B.45).

Of the £5bn, P2P business lending accounted for £1.78bn, just below the level of consumer marketplace lending in 2017, an increase of 51% on 2016. Marketplace facilitated lending against invoices has also recorded a robust growth rate in 2017, closing 68% up on the previous year and contributing an additional £0.59bn of finance to SMEs (figure B.46). Combined, these 2 asset classes accounted for 46% of total marketplace lending. Cumulatively, a total of £5.9bn of funding has been intermediated via P2P business lending and P2P invoice financing since 2012.

Similarly, awareness of P2P lending platforms has increased significantly since marketplace lending first hit the public consciousness in the UK. In 2017, 47% of respondents said they were aware of these platforms, a small increase on 2016 (45%) but much higher than when the Business Finance Survey started in 2012 when it was only 24% (figure B.47). Conversely, but in keeping with other forms of external finance, awareness of who to approach to access finance has fallen over the last 3 years from 19% in 2015 to 16% in 2017.

UK MARKETPLACE LENDING IS EXPERIENCING A PERIOD OF CONSOLIDATION

In 2011, of the 28 marketplace lenders AltFi collect data on, only 5 were lending. However, the number of active lenders grew to 23 by 2014 before peaking in 2016 at 28. The most recent Cambridge Centre for Alternative Finance (CCAF) research reviews the technology and competition driven dynamics of online financial intermediation. Their research confirms this view that there are a slowing number of new entrants with the number of marketplace lenders having stabilised since FCA regulation.

CCAF reports that the peak in platform registration was in 2014. Since then, not only have substantially fewer new entrants come into the market but in 2016 at least 35 UK online alternative finance platforms became inactive, either suspending operations or exiting the market completely, whilst several others merged.[141]

Unsurprisingly given the growth in new platforms up until 2014, the share of AltFi Data total marketplace lending, including consumer lending, attributed to the 5 largest lenders declined from 100% in 2011 to 80% in 2014. This has since stayed relatively constant and has been 78% for the last 2 years (figure B.48).

Marketplace business lending has a higher concentration of supply. In 2017, 94% of lending reported by AltFi Data were originated by only 3 lenders (figure B.49). At the same time 88% of Marketplace invoice finance was supplied via a single platform.

This suggests that the leading marketplace business lenders are competing with established lenders. As reported earlier, P2P business lending in 2017 was equivalent to around 3% of gross flows of lending from banks.

FIG B.46
GROWTH IN P2P BUSINESS LENDING AND INVOICE FINANCE
Source: AltFi Data

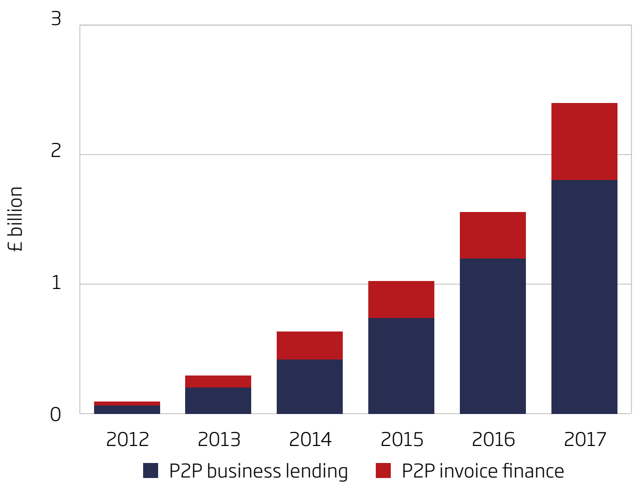


FIG B.47
AWARENESS OF ALTERNATIVE FORMS OF EXTERNAL FINANCE
Source: BDRC Continental SME Finance Monitor, Q2 2017

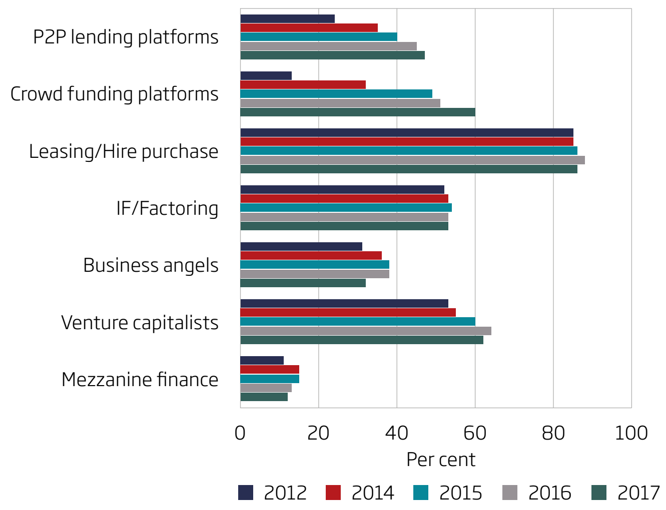


FIG B.48

5 LARGEST LENDERS' SHARE OF TOTAL MARKETPLACE LENDING

Source: AltFi Data and British Business Bank calculations

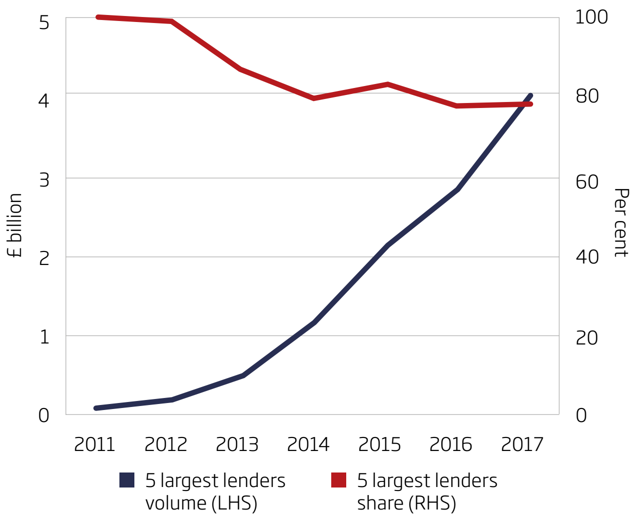
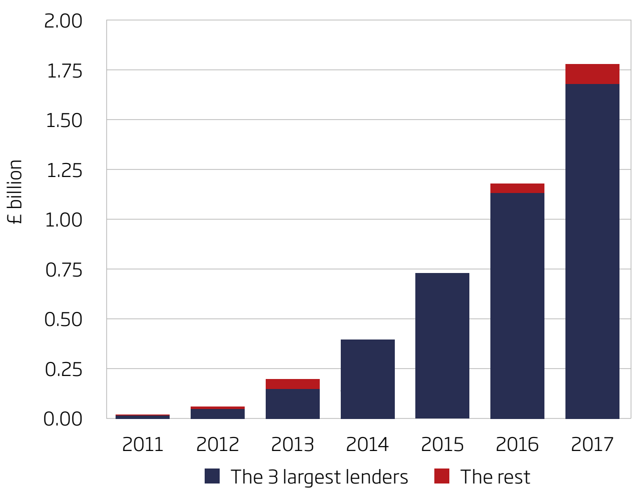


FIG B.49

CONCENTRATION IN P2P BUSINESS LENDING

Source: AltFi Data and British Business Bank calculations



INSTITUTIONAL FUNDING IS BECOMING MORE IMPORTANT

A common theme when discussing marketplace lending with market contacts is that there has been a noticeable recent trend in the institutionalisation of funding. Institutional investors include "mutual funds, pension funds, asset managers, family offices, broker-dealers and banks" amongst others. CCAF reports that in 2016 institutional funding accounted for 28% of P2P business lending and similar amounts across other marketplace asset classes.[142] AltFi Data suggests this may have increased in 2017. For the platforms that provide loan level data, across both business and consumer lenders, over 50% of funding came from institutional investors.

This is important because of the potential impact this could have on the types of businesses marketplace finance providers lend to and wider impacts on their business models. As with many funds supplied by institutional investors to other kinds of finance providers, the finance can often come with conditions about how the money is used. For example, the institutional funds may have stricter criteria around the risk profile or industry of potential borrowers.

Commentary has suggested that whilst blended funding models can bring greater stability, should institutional funding become dominant there is a potential for marketplace lenders to become more like the incumbent banks and offer more standardised products. This could in turn lead to them watering down some of their unique selling points that have driven the industry's growth post financial crisis. Perhaps the greatest indicator of this possibility seen so far is that several players have or are considering applying for a banking licence in the UK.

AS THE INDUSTRY MATURES THERE HAS BEEN GREATER SCRUTINY

AltFi Data also provides information on losses and interest rates for the reporting finance providers. In addition, from April 2018 the Peer-to-Peer Finance Association will require members to undertake and publish assessments of platform resilience in stress scenarios. As the industry matures this greater level of transparency should shine a light on the industry, its approach to risk and return and ultimately how it reacts to changing credit cycles. Alongside developments in regulation and the increased involvement of institutional investors, this could be the biggest challenge faced by a new but increasingly important industry.

British Business Bank continues to support marketplace lending through its Investment Programme, and has updated its ENABLE Funding programme to allow peer-to-peer lenders to apply to the programme.

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.

CAPITAL REQUIREMENT

Is the amount of capital a bank or financial institution has to hold as required by its financial regulator. This is usually expressed as a capital adequacy ratio of equity that must be held as a percentage of risk-weighted assets.

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 numbers 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 within the financial services industry.

FLOWS OF FINANCE

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

GROWTH CAPITAL

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

HIRE PURCHASE (HP)

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

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. Factors - factoring finance providers - purchase a businesses' unpaid invoices and advance most of the value of the invoices, with the balance less any charges paid when the invoices are paid by the end customer. Factors also manage the sales ledger and collect payment from the end customer. Discounting is like factoring except the client business retains control over managing the sales ledger.

LEASE FINANCING

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

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 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. The UK Government defines SMEs according to the number of employees (249 employees or less), and so there is some possible overlap between the two definitions for some businesses.

NON-AMORTISING

Payments 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.

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.

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 5 years, scale-up and stay ahead businesses are defined as those trading for more than 5 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

INTRODUCTION

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AGGREGATE FLOW AND STOCK OF FINANCE TO SMALLER BUSINESSES

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PART A

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PART B

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ACKNOWLEDGEMENTS

This paper was developed by the British Business Bank Economics Team including Matt Adey, Asad Ghani, Anthony Gray, Jake Horwood, Alice Hu Wagner, Bronwyn McDonald, Dan van der Schans and Zach Witton. We would like to thank all who provided input and comments on the report.

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