

ECONOMICS

BIS | Department for Business
Innovation & Skills

BIS ECONOMICS PAPER NO. 16

SME Access to External Finance

JANUARY 2012

Contents

List of tables and figures	iii
Acknowledgements	iv
Foreword	v
Executive Summary	vi
1) Introduction	1
SMEs are important to the UK Economy.....	1
SMEs seek and use a variety of different finance types.....	2
Different types of finance reflect different financing needs.....	4
Access to finance is important for growth and productivity.....	7
2) Market failures in SME finance markets	8
Market failures provide the rationale for Government intervention in SME finance markets	8
Debt financing gap for businesses lacking track record and collateral.....	9
Equity Gap for high growth potential SMEs.....	9
A financing gap also exists in the supply of growth capital.....	11
Market failures also occur on the demand side.....	12
A number of positive externalities also exist which provide further support for Government policy.....	13
3) Recent trends in finance for SMEs	14
There has been a decline in bank lending to SMEs.....	14
The decline is caused by reduction in demand.....	15
... As well as a contraction in supply.....	16
Current cyclical factors affecting the supply of bank lending to SMEs.....	17
There has been an increase in margins charged but overall cost is lower.....	18
The venture capital market has been heavily affected by economic conditions.....	19

The UK lags the US in terms of venture capital activity but is largely comparable to Europe	22
Business angels have become an important source of equity finance to SMEs	24
The use of asset based finance has also increased.....	24
There have been recent improvements to liquidity in SME public equity markets	25
4) Government policies for improving access to finance to SMEs	26
Government access to finance schemes appear to be effective, although they need to be flexible enough to adapt to changing economic conditions	27
Glossary of terms used	30
References	32
BIS Economics Papers	36

List of tables and figures

Figure 1: SMEs use of external finance	2
Figure 2: SME Employers reason for seeking finance (2007-2010 Comparison)	3
Figure 3: SME Employers type of finance sought.....	4
Figure 4: Finance Escalator for high growth potential SMEs	5
Figure 5: Illustrative mapping of risk/return profile against amount sought.....	6
Figure 6: Percentage change in the stock of lending to SMEs and corporate businesses (PNFC)	15
Figure 7: Proportion of SME Employers seeking and obtaining finance (2007-2010 comparison).....	17
Figure 8: Indicative interest rates and margins charged on SME variable rate lending	18
Figure 9: Number of UK VC Companies funded per year by BVCA members	20
Figure 10: Value of UK VC (£m) funded per year by BVCA members.....	20
Figure 11: Early Stage Venture Capital as a proportion of GDP	23
Figure 12: Number of Companies on AIM and New admissions	25

Acknowledgements

This paper was developed by Daniel van der Schans in the Enterprise and Economic Development Analysis Team in Enterprise Directorate in BIS with assistance from Carol Murray, Adam Hardy and Emma Sadler. We are grateful for all comments received, in particular to Richard Roberts and Gordon Murray in the BIS Access to Finance Expert Group for their detailed comments.

Foreword

If the UK is to continue to thrive, it is critical that entrepreneurs are able to start, finance and grow a business without any unnecessary impediments – the Government aims to make the UK one of the best places in Europe for this. The Government has already assessed the challenges facing the UK economy and published the ambitious Plan for Growth aimed at identifying the barriers to growth and addressing them to create the best conditions for private sector growth.

Since the start of the credit crunch, there has been much debate between Government, finance providers, SMEs and their representative organisations on the availability of finance and what can be done to increase it. The current economic challenges within the Euro zone increase these concerns. Access to external finance for business start-up, investment and growth is fundamental to sustainable economic growth, and we know that there are structural issues that need to be addressed.

This paper provides a critical assessment of the issues faced by businesses seeking external finance and presents the economic analysis that underpins Government policy in this area.

We hope that this paper will inform and stimulate the debate on these issues, demonstrate BIS continued commitment to ensuring that policy making is informed by strong evidence and analysis, and reaffirm the Government's commitment to ensure viable businesses can raise the finance they need to start up and grow.



Amanda Rowlatt

Chief Economist and Director of Analysis, Economics, Strategy and Better Regulation,
Department for Business, Innovation & Skills

Executive Summary

Although the majority of SMEs seeking external finance can raise it, there are structural issues affecting their access to finance

- SMEs are a vital part of the UK economy and contribute significantly to economic growth. Access to finance in particular is important for funding investment, ensuring businesses reach their full growth potential, and for facilitating new business start-ups.
- Whilst around half of businesses use external finance, a smaller proportion (around 20%) is actually seeking finance at any one time. Of those who have used external finance in the last year, bank finance is still the primary source of finance. In the last year, 28% of all SMEs have used an overdraft and 11% have used a bank loan.
- Whilst the majority of firms seeking finance do get it (74% of SME employers), there are a number of structural market failures restricting some viable SMEs from accessing finance. This is due to imperfect or asymmetric information between finance providers and small businesses. This manifests itself in a debt funding gap affecting businesses that lack collateral or track record; and in the equity gap affecting SMEs seeking between £250,000 to £5m of equity finance. There are also cyclical issues relating to the supply and demand of finance.

Access to debt finance is now harder than before the credit crunch

- Prior to 2008, the banking market was more crowded with banks competing for market share, but the market has now become more cautious about assessing risk. As a result, the stock of bank lending to SMEs peaked in 2009 and has been declining ever since. For instance, the stock of bank lending in November 2011 was 6.1% lower compared to a year ago.
- This decline in the stock of lending is affected by both demand and supply side factors. There is evidence indicating that SMEs are reducing demand by repaying existing bank debt (deleveraging), and more generally putting off investment plans in light of economic uncertainty. The value of applications by SMEs for new term loan and overdraft facilities in the six months to February 2011 was 19% lower than in the same period a year earlier. Around 3% of all SMEs have put off borrowing due to the current economic climate.
- Although most businesses can obtain the finance they need (74% of those SME employers seeking finance over the previous 12 months managed to obtain some finance), it is now harder to obtain than in 2007/08 when 90% of those seeking finance obtained it. This is equivalent to 21% of SME employers that sought finance in 2010 being unable to obtain any finance from any source, a significant increase from the 8% seen in 2007/08. This is because banks are now also more risk averse, due to the credit crunch and because they are required to hold more

capital/liquidity by new financial services regulations. In addition, there has been deterioration in the credit quality of businesses due to lower sales.

- Despite widespread perceptions that businesses are now paying more for finance than previously, most SMEs are now paying less for finance overall. Average interest rates on variable rate lending were 5.39% in November 2008 compared to 3.5% in November 2011. This is due to the decline in the Bank of England Interest rate, although margins are higher than pre-recession levels.

Equity finance is an important source of finance for high growth potential SMEs

- Although only around 1-2% of SMEs looking for external finance seek equity finance (also known as “risk capital”), it is especially important for those early stage businesses with the highest potential for growth. However, the venture capital market has been heavily affected by economic conditions with a 31% decrease in the value of investment in 2010 compared to the previous year.
- Over the last decade business angels have become a more important source of funding for early stage businesses and now supply a similar amount of equity finance to SMEs as venture capitalists (just over £300m per year).
- There has been an increase in the use of other types of SME finance including asset based finance. In addition, there have been some recent improvements in liquidity on SME public equity markets, e.g. AIM.

The Government has put in place a number of interventions to address these issues

- The Government has a range of policies for increasing the supply of finance to SMEs and addressing the market failures preventing some viable SMEs from raising finance. These include:
 - **Enterprise Finance Guarantee.** EFG is a loan guarantee scheme that addresses the market failure of lack of collateral or track record by providing a Government guarantee of up to 75% of the individual loan amount in the event of a default.
 - **Enterprise Capital Funds.** These are commercially managed venture capital funds operating in the equity gap that provide equity finance to high growth potential SMEs initially seeking up to £2m of finance. The Government provides around two thirds of the capital, with the remainder being raised from private sector sources.
- Although it is too early to evaluate the schemes, emerging evidence suggests these schemes appear to be working at providing additional finance. There have also been evaluations of older schemes, like the Small Firm Loan Guarantee Scheme and Regional Venture Capital Funds, which have helped informed the design of these newer schemes.

- There are a number of other Government interventions designed to increase the supply of bank lending to businesses including the Project Merlin lending agreements and the recently announced National Loan Guarantee Scheme.

1) Introduction

Ensuring SMEs have access to the finance they need to invest and grow is an important priority for the Government.¹ There is currently much debate between Government, finance providers, SMEs and their representative organisations on the availability of finance and what can be done to increase it.

This paper aims to contribute to the debate by providing an overview of the evidence on the availability of different types of finance and a summary of the effectiveness of Government schemes for increasing finance to SMEs.

This paper is the first in a series of papers providing an overview of the evidence underpinning Government policy for SMEs.

SMEs are important to the UK Economy

SMEs are a vital part of the UK economy and a dynamic, growing SME sector is likely to contribute significantly to future economic growth.² SMEs play a vital role in raising productivity growth in the UK economy by spurring innovation, by encouraging the process known as ‘productive churn’, and by stimulating stronger competition.³ At the start of 2011 there were around 4.5 million SMEs forming 99.9 per cent of all businesses by number, accounting for over half of private sector employment and nearly half of all private sector turnover.⁴

The ability of SMEs to access finance is important for funding business investment, ensuring businesses reach their growth potential, and for facilitating new business start-ups. However, a lack of finance can constrain cash flow and hamper businesses’ survival prospects.

External finance is an important part of the market mechanism for allocating resources within the economy by facilitating economic churn. External finance enables new businesses with innovative products or more efficient production processes to displace older less efficient businesses. This will contribute to improvements in productivity and initiates usage of underutilised resources within the economy.

¹ For instance see HMT and BIS (2010) “Financing a Private Sector Recovery”

² For instance, the majority of new jobs created in the UK are created by small businesses. Large businesses contribute just 24% to new job creation compared to 76% for small businesses. Of this, existing small businesses contribute 44% of new jobs created, whilst new business start-ups contribute 33%. (BIS (2011) “Job Creation and Destruction in the UK: 1998-2010”)

³ BIS (2010) “Internationalisation of Innovative and High Growth SMEs” BIS Economics Paper No. 5

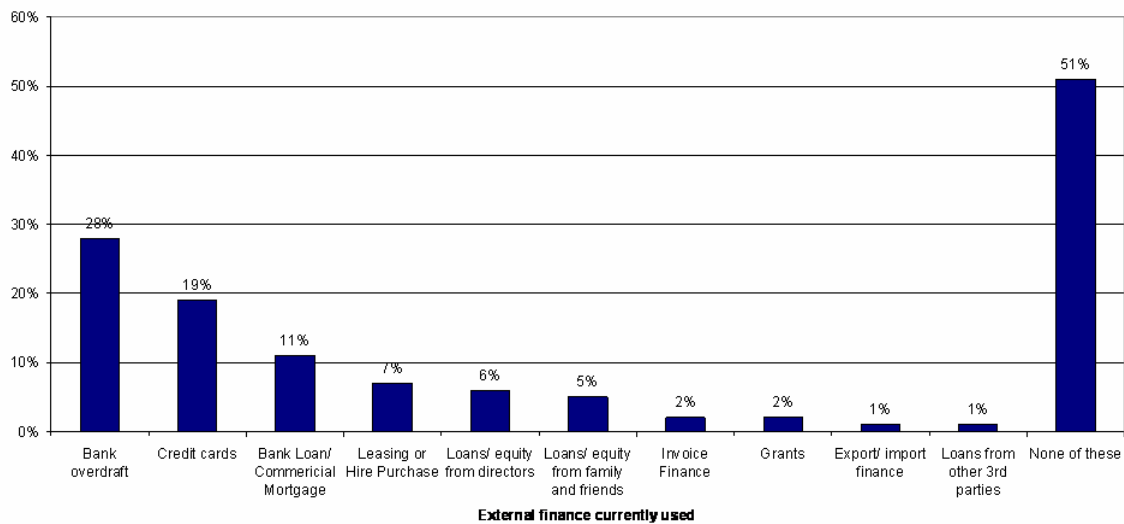
⁴ BIS (2011) “Business Population Estimates for the UK and Regions”

SMEs seek and use a variety of different finance types

Whilst access to finance is important, around half of SMEs⁵ do not use formal sources of external finance, instead relying on trade credit from their suppliers or retained earnings. Half of SMEs who use at least one form of external finance most commonly use bank funding; either loans, credit cards or overdrafts. A minority use equity finance⁶, from either venture capitalists or business angels.⁷ SMEs do not generally access capital or bond markets due to their size and the small amounts of money they are seeking.

Some smaller businesses and start-ups also use personal finance to fund investment and growth or seek finance from informal sources like friends and family.

Figure 1: SMEs use of external finance



Source: SME Finance Monitor (November 2011)

Whilst around half of businesses use external finance, a smaller proportion actually seeks finance at any one time. Survey evidence⁸ suggests around 20% of SME employers sought finance over last 6 or 12 month period. The average amount of

⁵ BDRG Continental (2011) "SME Finance Monitor Survey" (November 2011)

⁶ The proportions are too small to be shown on the graph.

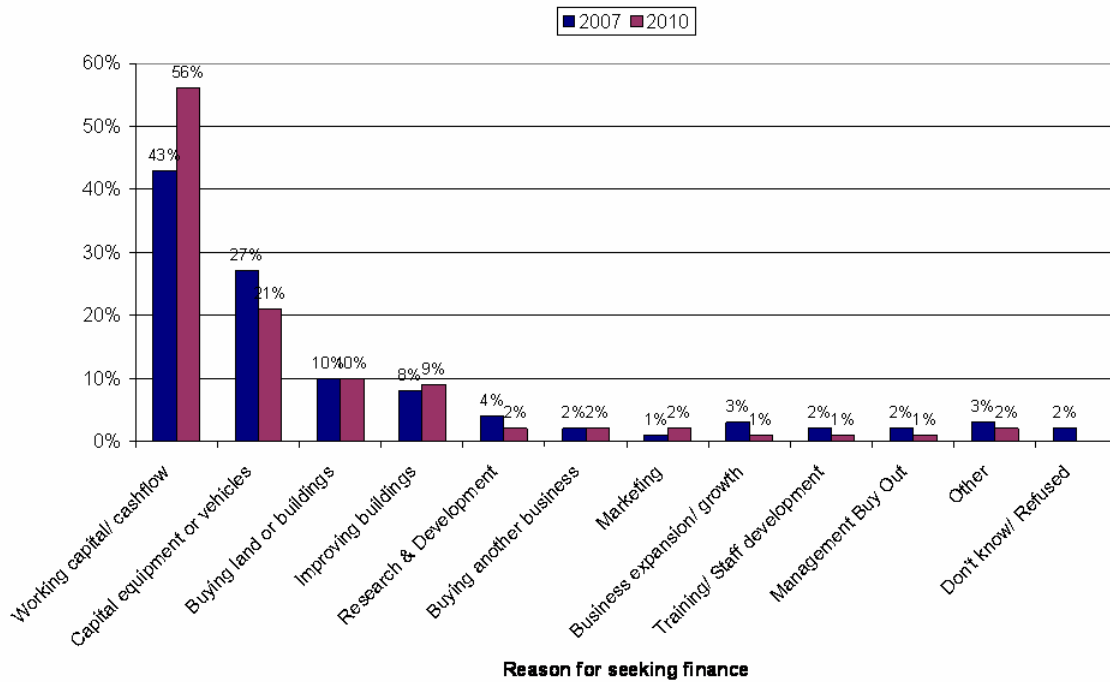
⁷ Business Angels are high net-worth individual investors that invest their own money in growing businesses. Venture Capitalists mainly invest other peoples' money through established funds into high growth potential businesses.

⁸ SBS 2010 and Barometer surveys

loan finance sought is £180,000 (Median £10,000), but overdrafts are smaller at £29,000 (median £5,000).⁹

Finance is used to fund working capital and investment. As the recession developed, a greater proportion of businesses were seeking finance for cash flow, with a lower percentage seeking finance for investment.

Figure 2: SME Employers reason for seeking finance (2007-2010 Comparison)

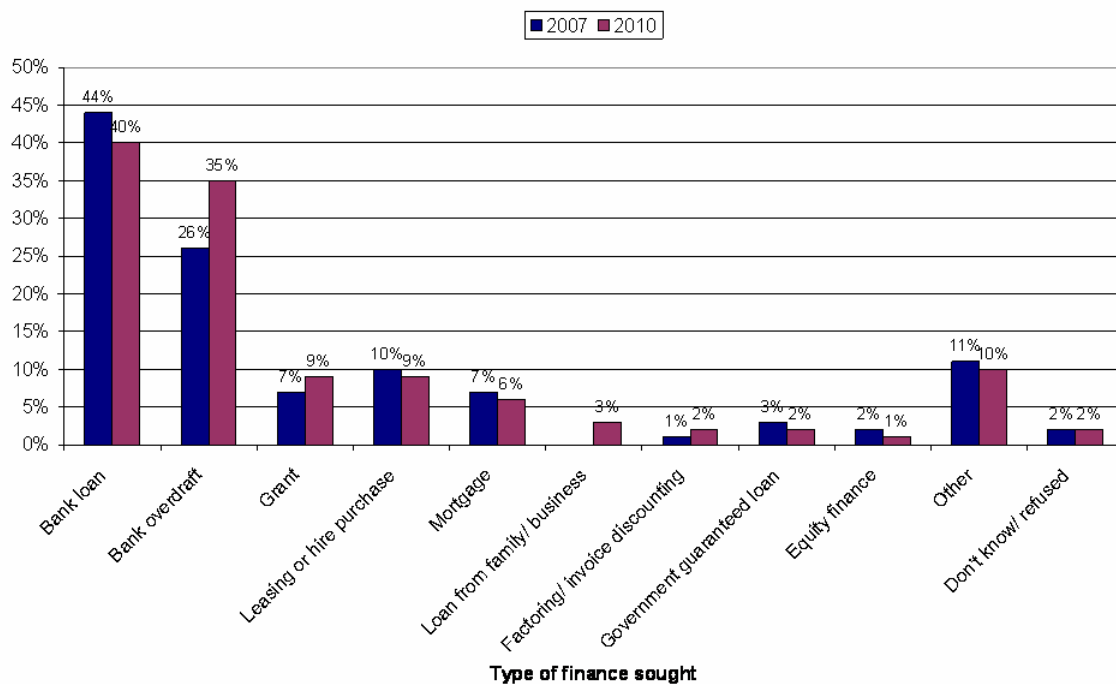


Source: BIS Small Business Survey 2010

Of those seeking finance most SME employers¹⁰ seek debt finance (40% seek loans and 35% seek overdrafts) similar to those currently using finance. Only around 1-2% of those seeking finance seek equity finance. Whilst many SMEs use a credit card, a lower proportion actually seek a new credit card, as credit card use is on-going from one year to another.

⁹ BDRC Continental (2011) SME Finance Monitor Survey (November 2011)

¹⁰ SMEs with more than one employee.

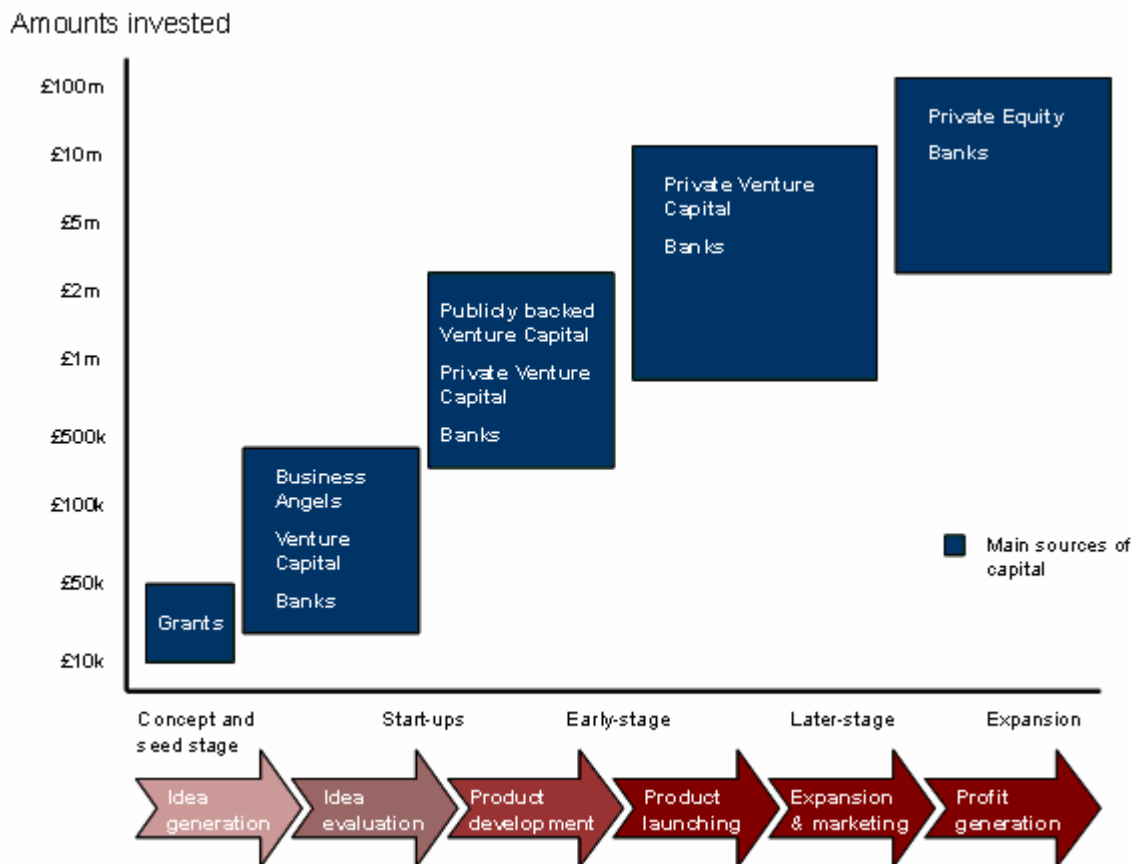
Figure 3: SME Employers type of finance sought

Source: Small Business Survey 2010

Different types of finance reflect different financing needs

The wide variety of different types of finance available reflects the diversity of SME characteristics and their specific finance needs. Within the literature a funding escalator is often put forward with different types of finance corresponding to different stages of business development.¹¹ For instance, a new business start-up with high growth potential may use grant funding to develop a product before moving onto funding from business angels, venture capitalists or banks once the product is developed. The business may then subsequently move onto private sector venture capital. However, a funding escalator may be too simplistic, as businesses do not necessarily go through each and every stage in turn.

¹¹ For instance, see NESTA (2009) "Reshaping the UK Economy: The Role of Public Investment in Financing Growth"

Figure 4: Finance Escalator for high growth potential SMEs

Source: NESTA (2009) Reshaping the UK Economy

Debt finance is the most widely used form of finance as it is generally one of the least expensive ways to raise finance.¹² It is most suitable for established lower risk businesses, with a stable cash flow in which to repay the debt. Loans and overdrafts are the most common forms of debt finance.

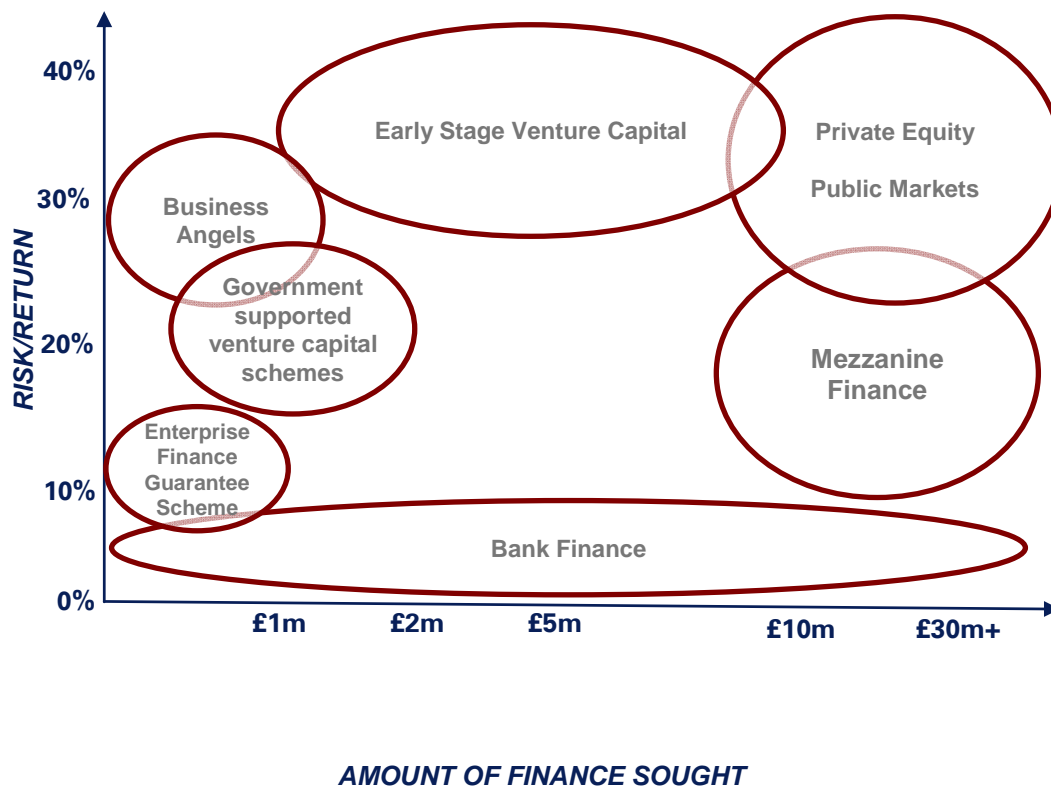
Equity finance (especially venture capital) is for higher risk businesses, a number of which have the greatest potential for growth. Venture capital investors take an equity stake in the business, with the objective of selling the stake in the future at a profit, once the business has expanded. These businesses may be at an early stage and lack cash flow and security in order to obtain debt finance. As equity sits behind debt in the event of a default, it is riskier for the investor.

¹² Debt repayments are also tax deductible.

Mezzanine finance is a hybrid of debt and equity finance. It is higher risk than debt¹³ finance but is lower risk than venture capital as it is typically used by established companies. Mezzanine finance can be structured to the individual financing needs of the business by taking the form of a loan, but with interest payments suspended for the first year or two until the investment is undertaken or may have a levy on turnover or other measure of business performance. The mezzanine deal can also be structured with an equity component or have an option for the investor to convert the investment into an equity stake if the business defaults on the loan payment or is very successful. There are also other specialist types of finance, such as invoice discounting and factoring, which help improve business cash flow, leasing and hire purchase is also available to enable a business to obtain capital equipment.

The following diagram graphically illustrates the risk/ reward profile of different financial products and representative range of average deal sizes.

Figure 5: Illustrative mapping of risk/return profile against amount sought



Source: Rowlands (2009) "The provision of growth capital to UK Small and Medium sized Enterprises"

Although not a form of external finance businesses specifically apply for from finance institutions, trade credit, the time period between business receiving goods and

¹³ Although mezzanine finance can be secured in principle, it sits below senior debt and so in the event of a default is less likely to be recovered.

services from their suppliers and paying for these, is an important mechanism for businesses to manage their cash flow.

Access to finance is important for growth and productivity

Finance is a disproportionately important obstacle for high-growth firms compared to other businesses. Eighteen per cent of high-growth firms consider funding, either short-term cash flow (13 per cent) or longer-term finance (5 per cent), to be the most important barrier to growth that they face compared to just 13 per cent of other firms.¹⁴

There is good evidence to suggest that access to finance does have a beneficial impact on business start-ups and growth, which will contribute to economic growth. For instance, a review of empirical studies exploring business growth showed that of the five studies which examined the impact of start up capital on the growth performance of businesses, three found a positive relationship, whilst two found no statistically significant relationship.¹⁵ These three empirical studies show a positive correlation between start up capital and growth after controlling for characteristics of the founder, but do not necessarily provide evidence of a causal relationship. In addition, Aghion, Fally and Scarpetta (2007)¹⁶ find that higher finance development¹⁷ increases new firm entry in sectors which are heavily dependent upon external finance. The authors find finance is most important for smaller businesses, but also enhances post entry growth of firms in sectors which are most dependent on external finance.

There is also some empirical evidence to suggest better access to finance leads to higher productivity within an economy.¹⁸ Butler and Cornaggia (2009)¹⁹ indicate access to finance has a positive impact on productivity as measured in agricultural crop yields in different US states. They find that production increases the most in states with relatively strong access to finance.²⁰

¹⁴ NESTA (2011) "Barriers to Growth: The views of high growth and potential high growth businesses"

¹⁵ Stam and Garnsey (2008) "Entrepreneurship in the Knowledge Economy"

¹⁶ Aghion, Fally and Scarpetta (2007) "Credit Constraints as a Barrier to the Entry and Post-Entry Growth of Firms"

¹⁷ The authors' use the private credit and stock market capitalization as a proportion of GDP as the measure of finance development. Regulatory banking and securities market variables are used as instrumental variables to isolate causation.

¹⁸ These studies attempt to isolate causation using statistical techniques.

¹⁹ Butler, A and Cornaggia, J. (2009) "Does access to external finance improve productivity? Evidence from a natural experiment"

²⁰ The authors take into account the impact of the 2005 Energy Policy Act on corn yields per acre, using soya bean yields as a control group which did not show an increase in demand. They control for differences in soil fertility by using county fixed effects as well as using specific weather and

2) Market failures in SME finance markets

Market failures provide the rationale for Government intervention in SME finance markets

Most businesses can obtain the finance they need, but there are a number of structural market failures²¹ affecting the supply of both debt and equity finance to SMEs.²² This leads to some potentially viable businesses being refused finance, which is sub optimal for economic growth. These market failures mainly relate to imperfect or asymmetric information. These information failures may also become exacerbated in uncertain economic conditions when lenders become more risk adverse and there is greater uncertainty.

In addition, there are information market failures affecting the demand side for businesses seeking finance. SMEs may not fully understand the potential benefits to their business of raising finance or their likely chance of success in gaining finance, which ultimately means they do not apply. This may restrict the growth of businesses. Business owners can also lack knowledge of funding sources available or lack the skills to present themselves as investable opportunities to investors, which combine with problems on the supply-side.

There is an under supply of equity finance to young high growth potential businesses due to the divergence of private and social benefits from investing in these businesses. This is because investing in early stage innovative businesses can lead to a number of positive spill-over effects²³ through innovation and knowledge transfers to other parts of the economy, which private investors do not take into account when making their decision to invest in venture capital.

temperature measures. The measure of finance is county level of bank deposits (on the grounds that small banks require deposits in order to lend) and number of bank branches in each county. Instrumental variables are used to test causality.

²¹ A market failure is “An imperfection in the market mechanism that prevents the achievement of economic efficiency.” HMT (2003) “Green Book: Appraisal and Evaluation in Central Government”.

²² These market failures affect a small proportion of viable businesses. There are also some businesses which are not commercially viable, for instance because they have inefficient production processes or inferior products, and there are sound economic reasons why these businesses have difficulties raising finance.

²³ These are known as positive externalities.

Debt financing gap for businesses lacking track record and collateral

A structural market failure exists in the provision of debt finance to SMEs due to asymmetric information between the lender and the business. It is difficult for the lender to distinguish between high and low risk entrepreneurs without incurring significant costs. To avoid the costs associated with gathering this information, lenders often require borrowers to provide evidence of a financial track record and/or collateral as security for the finance. Therefore, a market failure exists because the financial institution's decision to lend is based on collateral and track record, rather than the economic viability of the business. This means, some young businesses with viable business propositions that lack a track record or collateral are prevented from raising the finance they need.

Of those SME employers having difficulties raising finance, 20% of SME employers themselves gave insufficient security as the reason why their financial provider rejected them for finance, whilst 2% cited insufficient track record. Although the actual reason the finance institution rejected the business may differ to those perceived by the business, it does suggest market failure affects a small but significant proportion of SMEs seeking finance.²⁴

The 2004 Graham Review of the Small Firms' Loan Guarantee²⁵ concluded that despite advances in credit scoring techniques which help to lower the cost of assessing SME proposals, lenders requirement of collateral and the need for a track record remained a feature of modern debt markets as a result of information asymmetries. This particularly affects young start-up businesses.

Equity Gap for high growth potential SMEs

It is widely recognised that an 'equity gap' exists in the provision of modest amounts of equity finance to SMEs. This is also due to asymmetric information between the investor and the business on the likely viability and profitability of the business. Assessing the quality of SME proposals and associated risks is difficult and leads to the investor to incur transaction costs of undertaking due diligence. These transaction costs are generally fixed and do not vary greatly with the size of investment. For instance, typical due diligence costs are generally between £20,000-£50,000. They are therefore higher as a proportion of the investment deal size for smaller investments, and for a small investment in a technically complex company, the costs can easily account for 10% or more of the investment.²⁶

²⁴ BIS (2011) "Small Business Survey 2010"

²⁵ HMT (2004) "Graham Review of the Small Firms Loan Guarantee: Recommendations"

²⁶ BIS (2009) "The Supply of Equity Finance to SMEs: Revisiting the Equity Gap" (SQW Consulting)

This results in a structural gap in the market where investors and risk capital fund managers focus on fewer, larger investments in more established (lower risk) businesses at the expense of early stage venture capital. This leaves potentially viable businesses with growth potential not being able to obtain equity finance.

It is important to note that the imperfect information leads to the existence of transaction costs. Low or negative financial returns are not a market failure. Empirical evidence suggests average long run returns to investing in venture capital are negative (-0.3% Internal Rate of Return (IRR) for venture capital funds raised after 1996 compared to 15.2% IRR for private equity funds overall).²⁷ Therefore it may be rational for some investors to stay away from venture capital as an asset class, although the top performing venture capital funds do generate positive returns.²⁸

The equity gap is often quantified as a set of boundaries relating to the amount of equity finance sought in which potentially viable and profitable businesses are unable to raise the finance they need. In practice the boundaries of the equity gap are not rigid. It is unrealistic to assume that the supply of equity capital suddenly increases beyond the identified boundaries of the gap and in practice there is likely to be a progressing scale of difficulty.

The boundaries of the equity gap are perceived to have increased over time as private sector venture capitalists have drifted towards larger investments. In 1999, the then Department for Trade and Industry (DTI) estimated the equity gap as affecting investments up to £500,000.²⁹ The 'Bridging the Finance Gap'³⁰ consultation undertaken in 2003 identified the shortage of modest amounts of risk capital to be most acute for businesses seeking investments of between £250,000 and £1m, but extending up to £2m and for innovative businesses at an early stage of development. 97% of respondents of the consultation agreed that young growth companies continued to face a significant equity gap.

The most recent assessment confirms³¹ that even in normal market conditions a structural equity gap remains. The gap is believed to stretch for funding amounts of £250,000 to at least £2m (with some putting the ceiling at £5m). In the case of sectors requiring complex R&D or large capital expenditure, which often with long investment horizons, the gap may extend up to £15m. Most of the consultees felt the equity gap started at around the £250,000 as this was the level below which friends

²⁷ BVCA 2010 "Private Equity and Venture Capital Performance Measurement Survey 2010"

²⁸ However, investors do not take into account positive spill over effects from research, innovation and networks. Oxera (2005) suggests benefits from spill over effects are high for high technology firms and there are additional benefits through the diffusion of knowledge through mobility of labour, publications, and networking.

²⁹ DTI (1999) "Addressing the SME Equity Gap: Support for Regional Venture Capital Funds. Consultation Document"

³⁰ HMT and SBS (2003) "Bridging the Finance Gap: Next Steps in Improving Access to Growth Capital for Small Businesses"

³¹ BIS (2009) "The Supply of Equity Finance to SMEs: Revisiting the Equity Gap" (SQW Consulting)

and family, grants and most business angels provided what was necessary. Responses were, however, much more varied when asked about the ceiling. The majority of consultees felt that for deals involving low capital expenditure, the upper boundary of the gap was at least £2m. However, those with particular knowledge of the formal venture capital market advised that although some do go lower, very few private sector Venture Capitalists now invest below £5m, which leads to the gap being below this £5m ceiling.

These equity gap parameters relate to the first round of funding³², but there are additional concerns relating to the possible under funding of UK and European companies at each stage of the venture capital process relative to the US. This could constrain the growth of early stage companies which then do not fulfil their growth potential because they are undercapitalised.

A financing gap also exists in the supply of growth capital

The Rowlands Review (2009)³³ identified a gap in the provision of growth capital for viable SMEs looking to grow. Growth capital is a broad term used to describe funding that enables established businesses to expand. Growth capital is positioned between the two extremes of high risk/ high return pure equity investment and lower risk, usually fully secured, bank lending. Growth capital involves moderate risk with some security and, as a result, providers expect a moderate return.

This gap is a result of structural market failures in the provision of finance, which have been accentuated by events in financial markets over the last few years, which led to banks having retreated into more traditional lending practices. The market failures relate to asymmetric information, which leads to investors preferring larger deals in larger businesses. In addition, there is limited data on the financial returns from investing in growth capital, which makes investors more risk adverse towards this asset class. The Rowlands Review estimates up to 3,000 viable SMEs each year with characteristics suitable for growth capital may be unable to raise any of the finance required for growth.

The Rowlands Review suggests defining the growth capital funding gap in terms of amount sought by SMEs is difficult to do with any precision but identifies a gap is located in the region of £2 to £10 million. This reflects the £2 million ceiling of existing government interventions (below which start-ups or early stage funds are focused) and the £10 million threshold below which private equity and venture capital rarely invest owing to the structure of their business model.

³² Equity finance is usually raised in different stages. As a business grows and requires additional capital, subsequent rounds of shares are issued to investors. This allows investors in those subsequent rounds of financing to know where they stand in terms of the hierarchy of claims to future profits.

³³ Rowlands (2009) "The Provision of Growth Capital to UK SMEs"

Market failures also occur on the demand side

There are information market failures affecting the demand side for businesses seeking finance. SMEs may not fully understand the potential benefits to their business of raising finance or their likely chance of success in gaining finance, which ultimately means they do not apply for finance. This may restrict the growth of businesses.

Survey evidence shows a small but significant proportion of SMEs are discouraged from applying for finance because they think they will be rejected.³⁴ The November SME Finance Monitor survey estimates around 40% of would be seekers (12% of all SMEs) are discouraged, and this is equivalent to around 5% of all SMEs that are discouraged from applying for external finance.

A lack of investment readiness also leads to SMEs lacking the ability to present themselves as investable opportunities, for instance due to inadequate management skills or poor business plans. For instance, only 25%³⁵ of SMEs have a formally qualified financial manager, although this increases with the size of business to 66% of medium sized businesses. This may reflect why 41% of SME employers do not understand the way banks assess business credit risk, and why they do not feel confident in raising finance.³⁶ A greater number of SME employers perceive they are poor (38%) at accessing finance compared to those reporting they are strong (25%). However, most SMEs do not seek advice when applying for finance, with only 9% of SMEs seeking advice when applying an overdraft and 20% of SMEs seeking advice when applying for a loan.³⁷

Demand side market failures may be most acute in businesses seeking equity finance, with many SMEs lacking information on how equity finance works and where to obtain such finance. For instance, survey evidence³⁸ shows only 20% of SME Companies are aware of a local venture capital provider. Supply and demand side factors for SMEs raising external equity finance can interact leading to a 'thin market,' where a limited number of investors and high growth firms have difficulty finding and contacting each other at reasonable costs.³⁹

³⁴ The SME Finance Monitor defines discouragement as "those that have been put off, either directly (they made informal enquiries of the bank and were put off) or indirectly (they thought they would be turned down by the bank so did not ask).

³⁵ CBR (2008) "Financing UK SMEs: The 2007 Survey"

³⁶ BIS (2011) "Small Business Survey 2010"

³⁷ BDRG Continental (2011) "SME Finance Monitor"

³⁸ CBR (2008) "Financing UK SMEs: The 2007 Survey"

³⁹ NESTA (2009) "From Funding Gaps to Thin Markets: UK Government Support for Early Stage Venture Capital"

A number of positive externalities also exist which provide further support for Government policy

There is an under supply of equity finance to young high growth potential businesses due to the divergence of private and social benefits from investing in these businesses.⁴⁰ This is because investing in early stage innovative businesses can lead to a number of positive spill-over effects known as externalities through innovation and knowledge transfers to other parts of the economy, which private investors do not take into account when making their decision to invest in venture capital. This provides further support for Government intervention in venture capital markets.

Ueda and Hirukawa (2008)⁴¹ found that higher venture capital activity is associated with higher patent counts, which is one measure of innovation. However, some other studies have indicated that venture capital investment is not necessarily used to generate patented innovations. Engel and Keilbach (2007)⁴² find that German venture capital funded firms register more patents than comparable firms before receiving venture capital investments, whereas this tendency disappears after the investment is made. The authors conclude that this suggests that the higher innovativeness of venture capital funded firms is due to the selection process of the venture capitalist prior to the funding, and that venture capitalists appear to focus on the commercialization of existing innovations and growth of the firm.

⁴⁰ Investors are primarily concerned with the financial returns from their investment. See BIS (2011) "BIS Equity Finance Schemes: Survey of fund investors" for an overview of investors motivations.

⁴¹ Ueda and Hirukawa (2008) "Venture Capital and Industrial Innovation".

⁴² Engel and Keilbach (2007) "Firm level implications of Early Stage Venture Capital Investment – An Empirical Investigation"

3) Recent trends in finance for SMEs

There has been a decline in bank lending to SMEs

Following a period of sustained growth, the stock⁴³ of bank lending to SMEs peaked in 2009 and has declined in the subsequent years. Corporate lending peaked in 2008, but declined more sharply than SME lending in 2009 due to the credit crunch. Going into the recession, there is no evidence of the SME sector being overleveraged, as SMEs were net depositors of funds. For instance, at the end of 2007, British Banking Association data for small SMEs with less than £1m turnover shows the SME sector deposits exceeded lending by £3.7bn.⁴⁴

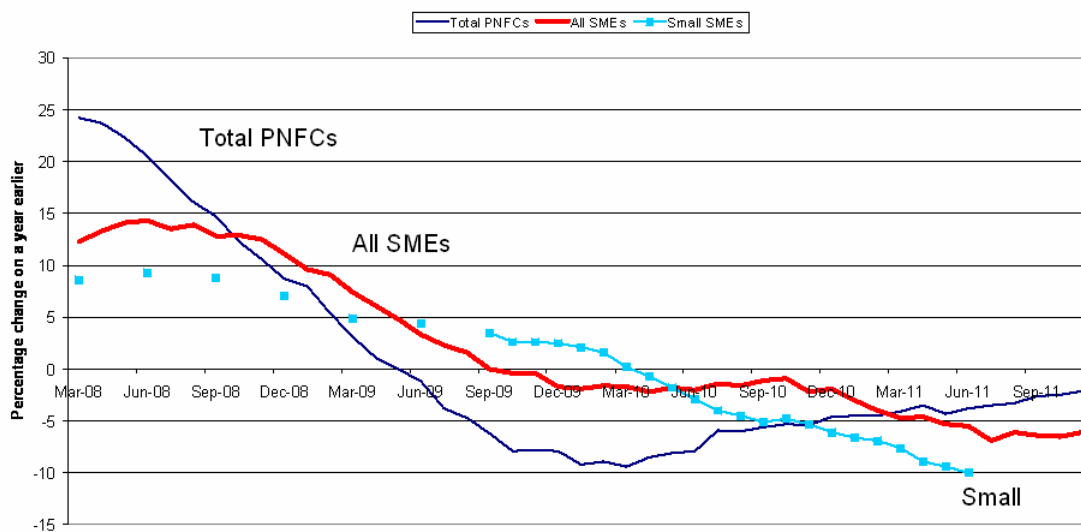
Bank lending to SMEs has not yet shown any recovery. The stock of bank lending in November 2011 declined 6.1% compared to a year ago. The stock of bank lending for smaller SMEs with less than £1m turnover has shown a greater decline.

The decline in the stock of lending is affected by both supply side factors e.g. bank's reduced appetite for risk as well as demand side factors, with evidence indicating that SMEs are themselves deleveraging by repaying existing bank debt, and more generally putting off investment plans in light of strong economic uncertainty.

⁴³ The stock of lending relates to the level of outstanding debt. It is affected by flows of new lending, as well as repayment of existing debt.

⁴⁴ The stock of lending for small SMEs was £50.4bn, whilst the level of deposits was £54.1bn. <http://www.bba.org.uk/download/1253>

Figure 6: Percentage change in the stock of lending to SMEs and corporate businesses (PNFC)⁴⁵



Source: Bank of England Trends in Lending (January 2012)

The decline is caused by reduction in demand...

SMEs demand for bank finance is down with SMEs taking steps to reduce their reliance on external debt. The value of applications by SMEs for new term loan and overdraft facilities in the six months to February 2011 was 19% lower than in the same period a year earlier.⁴⁶ Demand for credit remained muted because SMEs are cautious about business prospects in an uncertain economic environment.⁴⁷ There is strong evidence to show SMEs are repaying existing debt and building up cash deposits. BBA data shows SME's deposits exceeded borrowing by nearly £14bn in June 2011.⁴⁸

Most SMEs that do not seek finance are content that they are not borrowing. However, there is a small but significant proportion of SMEs that are discouraged from applying for finance because they think they will be rejected.⁴⁹ The November

⁴⁵ Private Non Financial Corporation

⁴⁶ Bank of England Trends in Lending

⁴⁷ For instance, see Bank of England (2011) "Agents' summary of business conditions September 2011". The November SME Finance Monitor also shows the "Current economic climate – those that felt this was not the right time to borrow" was mentioned by a quarter of all "would-be seekers", equivalent to around 3% of all SMEs.

⁴⁸ <http://www.bba.org.uk/statistics/article/small-business-support-may-june-201111/small-business/>

⁴⁹ The SME Finance Monitor defines discouragement as "those that have been put off, either directly (they made informal enquiries of the bank and were put off) or indirectly (they thought they would be turned down by the bank so did not ask).

SME Finance Monitor survey estimates around 40% of would be seekers (12%) of all SMEs are discouraged, and this is equivalent to around 5% of all SMEs that are discouraged from applying for external finance.

... As well as a contraction in supply

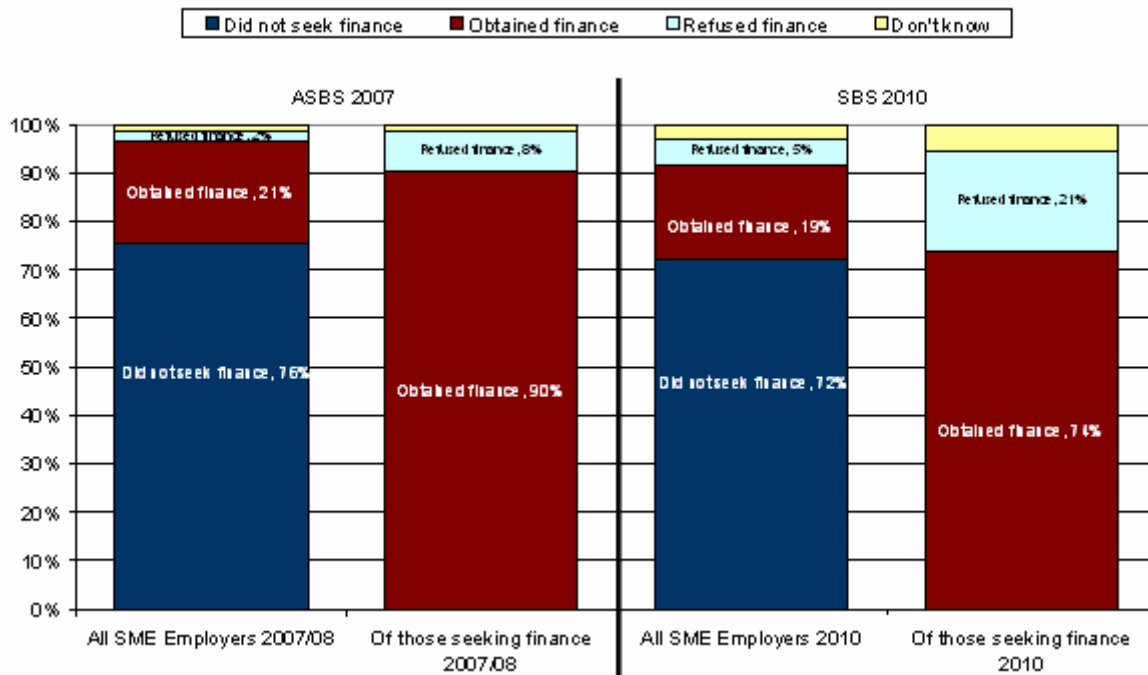
In the immediate years before 2008, the banking market was competitive with banks aggressively pursuing market share by offering loans to 'riskier' businesses, interest rates that did not fully reflect the risk of the loan and often waiving fees & charges.⁵⁰ It is widely acknowledged that an increased sales culture developed within banks, causing bankers to become more sales oriented.

Banks are now more risk averse, both due to the credit crunch and because they are required to be by new financial services regulations (e.g. Basel 3). These new rules require banks to hold more capital against certain types of assets.⁵¹ Although most businesses can obtain the finance they need (74% of those SME employers seeking finance over the previous 12 months managed to obtain some finance), it is now harder to obtain than in 2007/08 when 90% of those seeking finance obtained it. This is equivalent to 21% of SME employers that sought finance being unable to obtain any finance from any source in 2010. This is a significant increase from the 8% seen in the 2007/08 Annual Small Business Survey. This is shown in the graph below, which also shows how many SME employers were affected in the SME employer population.

⁵⁰ This was particularly the case for lending to larger corporate businesses where there was also strong competition from overseas banks. Whilst overseas banks had less involvement in the SME market, an Office of Fair Trading report noted there had been a number of market developments between 2002 and 2007 with several of the smaller banks (HBOS, Alliance & Leicester and Abbey) had increased their market share from around three per cent to nine per cent collectively and there are also signs of increased competition between them. The report also noted while levels of switching remain low, there is evidence that SMEs are now more likely to consider a move to one of the smaller banks, more likely to use more than one finance provider and are more price sensitive than in 2002.

⁵¹ There is currently much debate about the effects of Basel 3 on economic growth, although there has been little assessment of the impact on SME lending. Slovik (2011) estimate the medium-term impact of Basel 3 on GDP growth to be in the range of -0.05 to -0.15 percentage points per annum. This mainly occurs through an increase in bank lending margins as banks pass on the rise in funding costs due to higher capital requirements.

Figure 7: Proportion of SME Employers seeking and obtaining finance (2007-2010 comparison)



Source: Small Business Survey 2010

Current cyclical factors affecting the supply of bank lending to SMEs

It is important to recognise that although banks' lending criteria has tightened, the recession has also increased the underlying credit riskiness of SMEs due to the decline in sales and greater uncertainty. Fraser (2009) shows that the percentage of businesses with a low probability of going out of business in the year ahead (low credit risk businesses) declined from 58% in 2004 to 11.5% in 2008. In addition, the percentage of businesses which did not make unauthorized excesses on their overdraft facility fell from 71.5% in 2003-4 to 63.8% in 2007-8. This may explain some of the increased difficulties businesses are experiencing when raising finance.

The current turmoil in the Euro zone is causing uncertainty in the global economy. Although there is evidence that both the banks and business are more prepared to deal with any economic shock⁵², a default of a large Euro zone country could cause

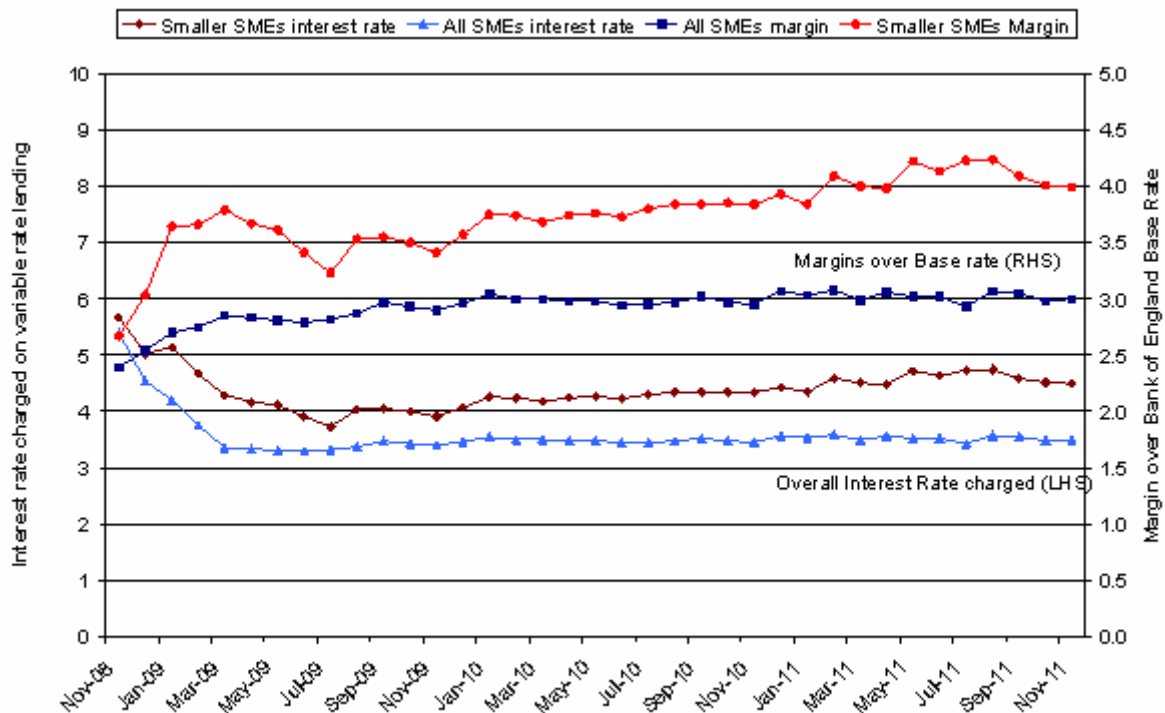
⁵² Banks are better capitalised now than during the previous crisis and have reduced their reliance on wholesale funding. In addition, there are signs that UK businesses are accumulating cash and deleveraging which could act as a buffer to adverse economic conditions.

a major financial crisis due to UK bank's exposure to these markets. The previous financial crisis in 2008 saw a decline in the availability of lending to business, but the impact would also affect UK export markets.

There has been an increase in margins charged but overall cost is lower

There is a widespread perception that businesses are now paying more for finance than previously. Despite an increase in margins charged, most SMEs are now paying less for finance overall due to the decline in the Bank of England Interest rate. For instance, average interest rates on variable rate lending were 5.39% in November 2008 compared to 3.5% in November 2011.⁵³ The increase in margins has been particular pronounced in smaller SMEs with less than £1m turnover.⁵⁴

Figure 8: Indicative interest rates and margins charged on SME variable rate lending



Source: Bank of England Trends in Lending (January 2012)

⁵³ Bank of England Trends in Lending (January 2012)

⁵⁴ As shown on the red line on the graph.

There are a number of reasons for the increase in margins charged including higher bank funding charges, higher risk due to the economy and also less competition amongst banks. Basel 3 regulations may also lead to higher margins.⁵⁵

Although banks are more comprehensive in assessing the credit risk of businesses compared to 2007, there is no evidence that SMEs have to offer significantly more security. The SME Finance monitor survey shows 25% of SMEs needed to offer security on overdrafts in 2011 compared to around 21% in 2007⁵⁶. For loans overall (including secured mortgages), a third were secured in 2011 compared to 56% in 2007.

The venture capital market has been heavily affected by economic conditions

Venture capital is a subset of private equity and relates to the financing of young early stage businesses with the potential for high growth. The term private equity covers the whole industry including Management Buy Outs (MBO) and expansion capital for larger businesses.

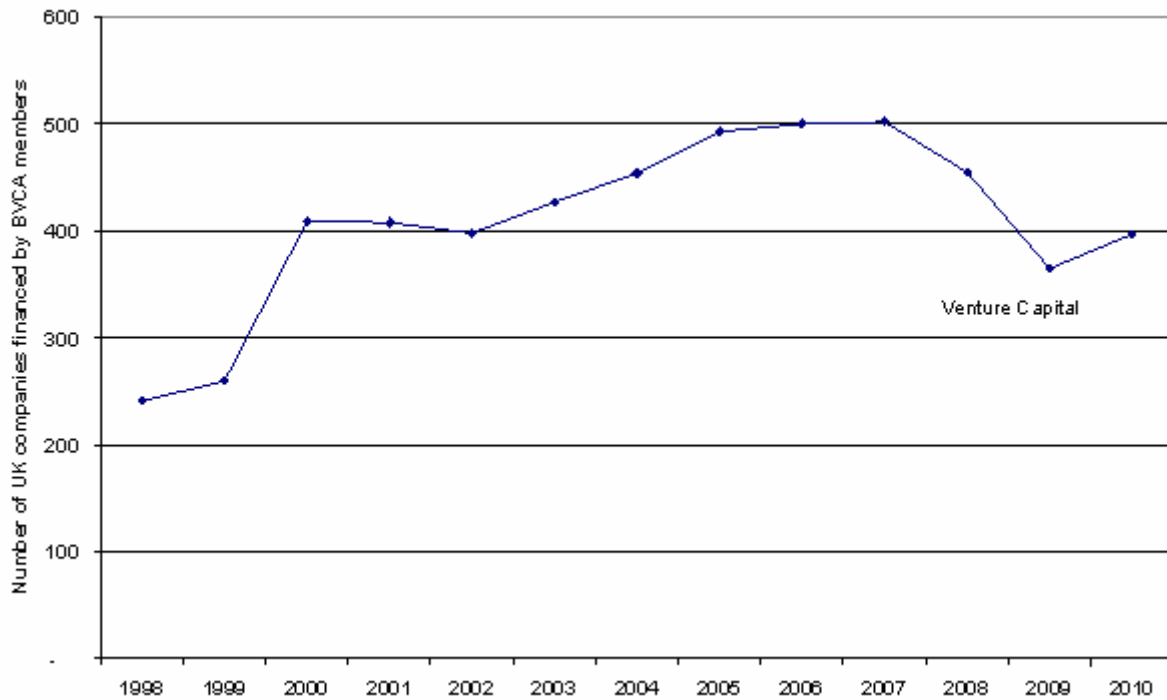
In 2010 BVCA members⁵⁷ invested £313m into 397 UK venture capital stage companies. This is a 31% decrease in the value of investment compared to the previous year but a 9% increase in the number of investments. This suggests the venture capital market is relatively subdued, and has been heavily affected by the Credit Crunch⁵⁸ over the last few years (see figures 9 and 10).

⁵⁵ Slovik, and Cournède (2011), "Macroeconomic Impact of Basel III"

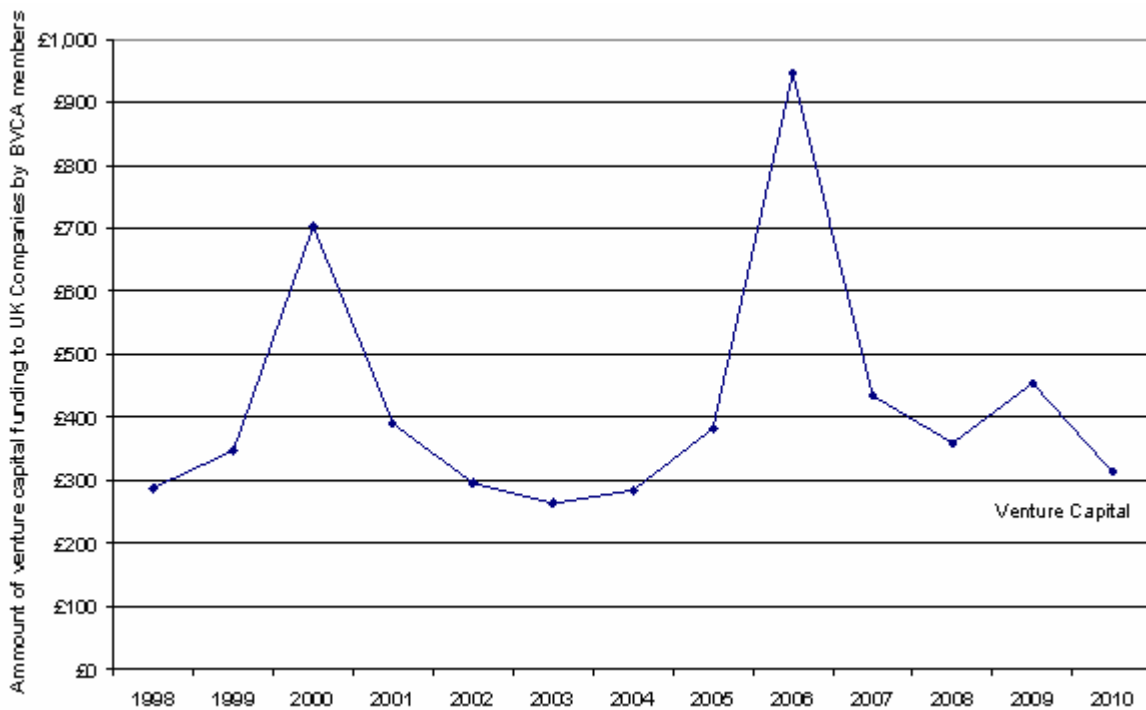
⁵⁶ CBR (2008) "Financing UK SMEs: The 2007 Survey"

⁵⁷ British Venture Capital Association (BVCA) represents venture capital and private equity firms operating investment funds based in the UK. The activity survey covered 97% of BVCA members, which suggests nearly all major UK based private equity firms were included. Although BVCA is the best data source on UK VC investments, it still does not cover the entire market as not all venture capital fund managers are BVCA members.

⁵⁸ 2006 was not a typical year, as fund raising environment for new funds was particularly buoyant.

Figure 9: Number of UK VC companies funded per year by BVCA members

Source: BVCA

Figure 10: Value of UK VC (£m) funded per year by BVCA members

Source: BVCA

However, there has been an increase in private equity, which has increased by 4% by number of investments and 72% by value to £8.2bn invested in 2010. This increase has largely offset the decline in 2009, so that the figures are now similar to 2008 levels.

The strong recovery seen in MBO/MBI may be a future worry if it is at the expense of venture capital financing. In 2010, venture capital formed 48% of the number of private equity deals but only 4% by value, which reflects that venture capital deals are a lot smaller than MBO/MBI deals. Historically, there has been an increase in the number of venture capital deals as a proportion of the wider private equity market, which is encouraging. Over the last decade, venture capital formed 36% of private equity deals by number, so the recent increase is positive.

The latest figures show venture capital only forms 4% of private equity by value, which is lower than the long run 10 year trend of 6%. It appears that increases in the amounts going into private equity, have generally led to larger deal sizes in particular in MBO/MBI, as opposed to increased number of investments. The average private equity deal size reached £10m in 2010 up from £6.1m in 2009. In comparison, the average venture capital deal fell slightly in size from £1.2m in 2009 to £0.8m in 2010. It is not known whether the decrease in venture capital deal size is due to a greater number of smaller investments made in SMEs affected by the equity gap, or companies are receiving smaller investments when they actually require larger amounts of funding, which could then constrain their growth.

It is also important to acknowledge Government venture capital funds that use private sector fund managers (like Enterprise Capital Funds) will be included in the BVCA activity figures. Publicly backed funds have become increasingly important over the past decade. NESTA⁵⁹ analysis of Dow Jones data⁶⁰ for the UK shows in 2002, 20% of all deals involved the public sector but this had doubled to 42% by 2009. This has been driven by both a decline in private sector funding and also increases in government funding. Public funding is particularly prominent in early-stage funding, which peaked at 68 per cent in 2008 but declined to 56 per cent in 2009.

Equity investments have been particularly affected by the credit crunch. The value of venture capital investments has declined due to the general level of uncertainty in the economy affecting expected profitability and risk. In addition, certain exit routes from venture capital like public equity markets or trade sales are only just opening up.⁶¹ As a result, fund managers have concentrated on managing the performance of their

⁵⁹ NESTA (2010) "Venture Capital: Now and After the Dot Com Crash"

⁶⁰ This data source may not be directly comparable to the BVCA data.

⁶¹ These exit routes allow the venture capitalist to sell their equity stake for hopefully a higher value than they paid, enabling them to generate a financial return.

existing portfolio companies rather than making new investments⁶². In addition, the availability of new capital in the economy has been constrained, which has impacted on the ability of fund managers to raise new funds for venture capital.

This is a particular issue for venture capital as the long run financial returns to investing in venture capital have been negative. There is much debate on why this is and many commentators look to the US as a model of an established venture capital market. There is some evidence to suggest the top performing US funds appear to be more successful than the top performing UK funds, which leads to a slightly higher overall average returns figure. However, NESTA research⁶³ suggests since 1998, there has been no difference in fund returns between UK and US once fund characteristics are controlled for. A review of the academic literature⁶⁴ suggests that a number of factors are associated with superior venture capital investment performance including industry specialisation, large fund sizes, strong deal flow, syndication of investments, and experience.

The UK lags the US in terms of venture capital activity but is largely comparable to Europe

The UK has the largest private equity market in Europe, accounting for 31% of the market, followed by France (16%), Germany (11%) and Spain (7%).⁶⁵ However, differences in definitions and data coverage make international comparisons of venture capital very difficult. Looking at the actual number and value of investments also does not take into account differences in the size of the economies and so looking at the value of venture capital investments as a share of GDP is often more informative.

Eurostat data⁶⁶ shows the UK's underperformance against the US is substantial and has persisted over a long period of time. The value of UK Early Stage Venture Capital in 2009 was 0.026% of GDP. In comparison, the value of US Early Stage Venture Capital in 2009 was 0.045% of GDP. However, the series does have some volatility and so it is recommended that an assessment is made over a longer time

⁶² NESTA 2010 "Venture Capital: Now and After the Dot Com Crash" shows the average time to exit from initial investment has increased from 2.32 years in 2001 to 6.19 years in 2008. The increased length of time leads to fund managers' funds being tied up, which can not then be then used to finance new investments.

⁶³ NESTA (2011) "Atlantic Drift: Venture Capital Performance in the UK and US"

⁶⁴ Soderblom (2006) "Factors Determining the Performance of Early Stage high Technology Venture Capital Funds- A Review of the Academic Literature".

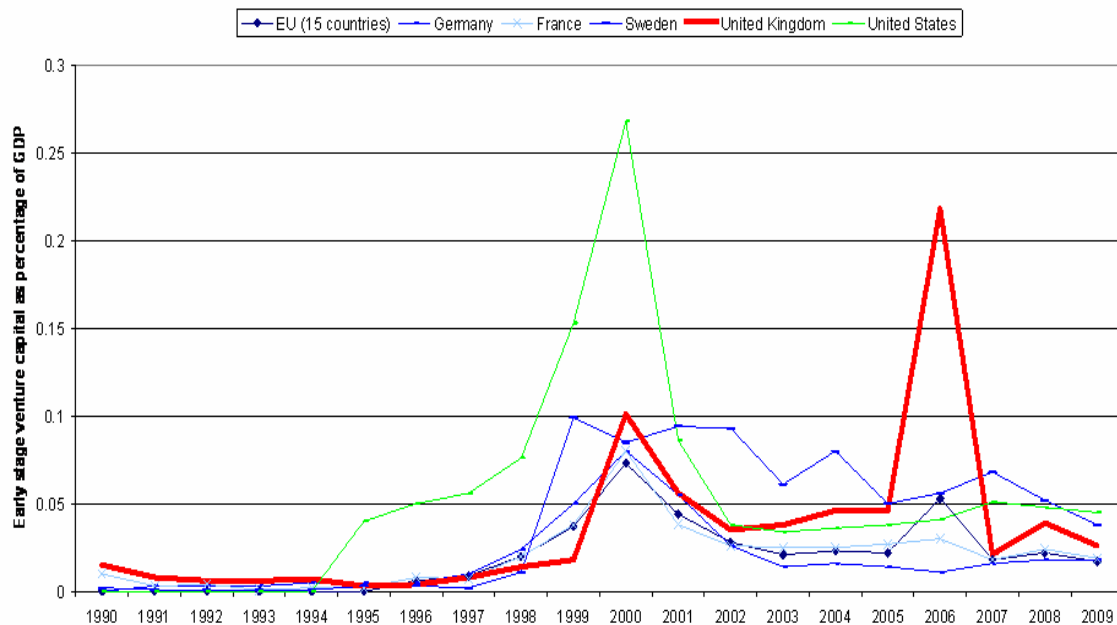
⁶⁵ EVCA. <http://www.evca.eu/knowledgecenter/statistics.aspx?id=410>

⁶⁶

<http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsiir080>

period.⁶⁷ Since 1996, the value of Early Stage Venture Capital in the UK has averaged 0.048% of GDP, well below the US average of 0.073%). The UK also lags Sweden (0.057%) but is at a similar level to Finland (0.047%). The UK performs relatively well in comparison to Germany (0.026%), and France (0.028%). The structure of the French and German economies and their SME finance markets may explain some of the differences.⁶⁸ The importance of public sector venture capital schemes in Scandinavian Countries may also explain why Sweden has a higher proportion of early stage venture capital than the UK.

Figure 11: Early Stage Venture Capital as a proportion of GDP



Source: Eurostat

⁶⁷ For instance, there is a large spike in the UK data in 2006. Although fundraising was more easily available in 2006, there does appear to be an issue with the data for this particular year.

⁶⁸ For instance, German SMEs have a greater use of loans and overdrafts rather than equity finance compared to UK SMEs. This is due to historical and cultural reasons which are reinforced by the tax regime, as well as the structure of the German banking industry with non-commercial banks with public sector involvement having considerable market share and offering subsidised loans and guarantees. (See ACCA (2006) and AXA (2011))

Business angels have become an important source of equity finance to SMEs

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.⁶⁹ It is clear that business angel activity has grown over the last decade, with the number of investments increasing more than threefold between 2001 and 2007.⁷⁰ However, it is difficult to estimate the total size of the business angel market as not every business angel is part of the British Business Angel Association (BBAA) or Linc Scotland. Estimates for the whole market including both visible and non-visible components suggest angel investment activity in the UK in 2009/10 was £318m.⁷¹ This is comparable to the amount invested by BVCA members in venture capital in 2010.

Business angels tend to make smaller investments and so target the lower end of the equity gap not served by venture capitalists. Angels themselves typically invest less than £200,000 per deal, but the total size of a funding round raised through angel networks and syndicates is typically less than £500,000. Only a small proportion of deals are large with less than 10 per cent of deals being in excess of £1m. Investments are predominately in small⁷², early stage companies⁷³ and there is also a strong focus on investments in technology companies.⁷⁴

The use of asset based finance has also increased

Factoring and invoice discounting can improve business cash flow by providing finance secured against unpaid invoices. The lender usually pays the business a percentage of the invoice. When the invoice is paid, the business will receive the balance, minus any charges. The level of finance advanced to an SME therefore varies directly with changes in their order books. For factoring it is the lender, rather than the SME, that collects payments and pursues late payments. For invoice discounting the SME continues to manage its own sales ledger and debt collection.

Over the last few years there has been a significant growth in the amount of finance advanced through factoring and invoice discounting. During Q2 2011 a total of £115

⁶⁹ Mason and Harrison (2011) "Annual Report on the Business Angel Market in the United Kingdom: 2009/10"

⁷⁰ Mason and Pierrakis (2009) "Venture Capital, the regions and public policy: The United Kingdom since the post -2000 technology crash"

⁷¹ Mason and Harrison (2011) "Annual Report on the Business Angel Market in the United Kingdom: 2009/10"

⁷² 78% of BBAA investments are in companies with 10 or less employees

⁷³ 95% of BBAA investments are in early stage

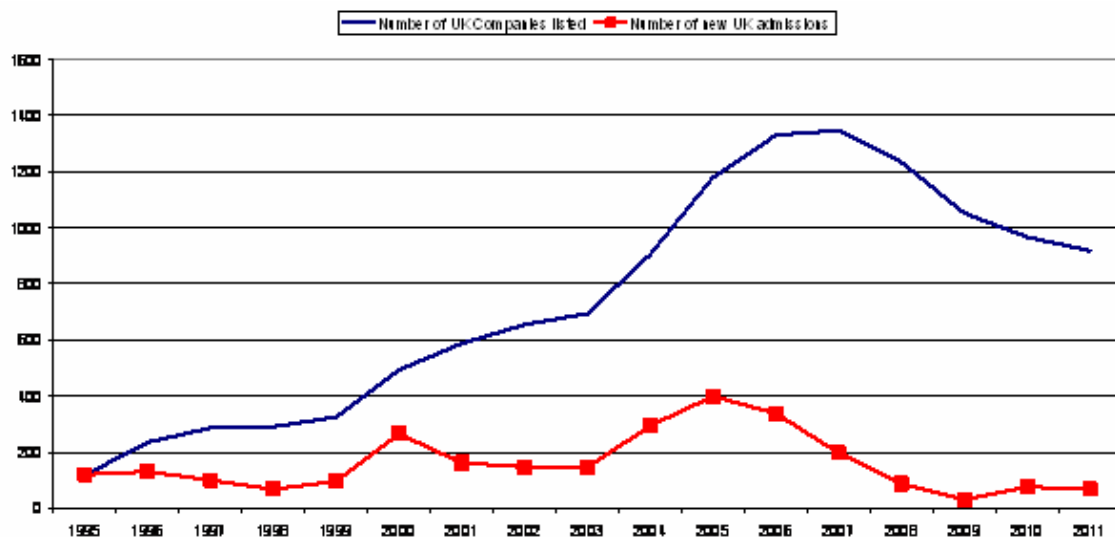
⁷⁴ It is estimated that 63% of investments were in technology companies in 2009/10

billion of clients' invoices were advanced, 14% higher than a year before.⁷⁵ This is largely due to increasing sales as the number of businesses using this type of finance (41,500) has not changed compared to a year ago.

There have been recent improvements to liquidity in SME public equity markets

Alongside trade sales, Initial Public Offerings (IPO) on a public market like AIM (Alternative Investment Market) are a favoured exit route to private equity. Liquidity of AIM was heavily constrained during the credit crunch which severely restricted the trade of listed shares and new admissions. This is also confirmed by the number of new listings on the market which peaked in 2005, before dropping to its lowest level in 2009 with just 30 admissions. The market has shown some recovery in 2010 to 76 UK businesses, a proportion of these will be IPOs from venture capital.⁷⁶

Figure 12: Number of Companies on AIM and new admissions



Source: London Stock Exchange⁷⁷

⁷⁵ Asset Backed Finance Association <http://www.abfa.org.uk/>

⁷⁶ In 2010, 23 companies were divested from BVCA members through an IPO. However, it is not known which public equity market these businesses will have been floated on.

⁷⁷ <http://www.londonstockexchange.com/statistics/markets/aim/aim.htm>

4) Government policies for improving access to finance to SMEs

The Government has a range of policies for addressing the market failures affecting SMEs raising finance. These include the Enterprise Finance Guarantee (EFG), the Enterprise Capital Funds programme and tax based venture capital schemes. This chapter provides a summary of the two main BIS initiatives but a full description of Government interventions can be found on the BIS website www.bis.gov.uk.

There are a number of other Government interventions designed to increase the supply of bank lending to businesses. Via Project Merlin, five major UK banks committed to lend £190 billion in 2011, which is 11% higher than the year before, including £76bn to SMEs. As of the third quarter of 2011, banks have already lent £157bn, including £56bn to SMEs. In addition, the Government announced in autumn 2011 a new National Loan Guarantee Scheme to enable SMEs to access lower cost finance, through Government guarantees of up to £20bn. The Autumn Statement also announced a £1bn Business Finance Partnership, which will invest in smaller and mid-sized businesses in the UK through non-bank channels. Both schemes are scheduled for launch in early 2012.

There are a number of criteria for Government to consider when designing access to finance schemes for SMEs

Targets an identified market failure

Government access to finance schemes should be targeted at correcting an identified market failure, ensuring that the market mechanism in the supply of finance to SMEs is well functioning. The key market failure relates to asymmetric information between the financial institution and SME.⁷⁸ For instance, EFG addresses the need for businesses to provide evidence of track record and/or collateral, whilst ECFs target the equity gap affecting high growth potential SMEs. Interventions should not be used to distort the competitive market mechanism by propping up inefficient businesses.

Maximise impact

Government access to finance schemes should be targeted at where they have most impact. Providing support to businesses that can obtain finance from conventional

⁷⁸ Chapter 2 provides a full description of the market failures affecting some viable SMEs from raising finance.

sources (known as deadweight) ties up Government resources that could be used to support viable businesses that can not obtain finance.

Working with the market

The Government is not in the best position for deciding which individual businesses should or should not obtain finance. Government finance schemes generally use the expertise of private sector financial institutions and investors to make the investment/ lending decision. The specific design of the scheme aligns the private interests of the investor/ lender with the objectives of the Government.

Ensuring schemes are cost effective

At a time of fiscal austerity, Government access to finance schemes need to be cost effective. For instance, small venture capital schemes have high administrative costs, which restrict the cost effectiveness of the schemes. The National Audit Office criticised regional funds for their restrictive investment criteria and small size.⁷⁹ In addition, the level of defaults under EFG is capped to avoid an excessive cost to the tax payer.

Government access to finance schemes appear to be effective, although they need to be flexible enough to adapt to changing economic conditions

Enterprise Finance Guarantee (EFG)

Enterprise Finance Guarantee is a loan guarantee scheme that addresses the market failure of lack of collateral or track record affecting some viable SMEs, enabling the lender to lend when it would otherwise not do so. In the event of a default, the Government provides a guarantee (of 75% of individual outstanding loan amount on loans of up to £1m) up to a specified limit. The scheme was launched in January 2009 in response to the Credit Crunch building on the effectiveness of the previous scheme⁸⁰ by providing assistance to a greater number of SMEs through larger turnover limits and increased number of eligible sectors.

EFG is a targeted measure to be used by lenders on a discretionary basis. It is not designed for the majority of viable businesses to whom banks should lend. As such, EFG forms around 2% of UK bank lending to SMEs with a turnover of up to £25 million.

Overall, since its launch on 14 January 2009, 16,810 SMEs have been offered EFG loans with a total value of £1.70 billion. Of these, 14,750 SMEs have drawn down loans to a value of over £1.47 billion. However, recent evidence suggests a decline

⁷⁹ NAO (2009) "Venture Capital Support to Small Businesses"

⁸⁰ Small Firms Loan Guarantee Scheme

in the use of EFG. Whilst this is partly due to a reduction in demand for bank finance more widely, this issue needs to be investigated further, including an examination of SMEs awareness of the scheme. Survey evidence suggests a lower awareness amongst SMEs now compared to when EFG was launched.⁸¹

Although a formal evaluation is currently underway, an early assessment of EFG undertaken in 2009⁸² indicates a number of positive findings on the effectiveness of the scheme.⁸³ Almost all EFG recipients surveyed felt that they had experienced tangible business benefits (95%) and improved business prospects (94%) stemming from EFG that otherwise would not have been possible. Employment in EFG recipient firms is 38% higher than in the absence of the intervention, which is equivalent to 5.8 jobs saved/ created per firm.

Enterprise Capital Funds (ECF)

Enterprise Capital Funds (ECF) are commercially managed venture capital funds operating in the equity gap that provide equity finance to high growth potential SMEs initially seeking up to £2m of finance. The Government provides around two thirds of the capital, with the remainder being raised from private sector sources. The first fund was established in 2006. To date the scheme is delivered through ten fund managers who have invested in a total of 85 portfolio companies. There have been 3 portfolio exits.

It can take 5-6 years⁸⁴ before the economic impact of venture capital funds begin to emerge and so it is too early to evaluate the effectiveness of the funds. However, an early assessment of the effectiveness of the funds was undertaken in 2010.⁸⁵

This suggested ECFs are targeted at young innovative businesses with potential for high growth. For instance, employment in ECF funded businesses is expected to increase three fold within three years following investment (from around 10 to around

⁸¹ BIS (2011) "SME Barometer Survey August 2011" (IFF Research)

⁸² BIS (2009) "Early Stage Assessment of the Impact of the Enterprise Finance Guarantee (EFG) on Recipient Firms" (Durham Business School)

⁸³ An economic evaluation of the previous scheme, the Small Firms Loan Guarantee Scheme (SFLG) showed even with conservative assumptions, SFLG is found to have a net benefit to the economy over the first two years of businesses receiving an SFLG loan in 2006. For every £1 spent, there is a return of £1.05 to the economy through additional economic output as measured by GVA. The 3,100 SFLG supported businesses in 2006 have created between 3,550-6,340 additional jobs in the two years following receipt of the loan, at a cost of between £5,500-£10,000 per additional job.

⁸⁴ NAO (2009) "Venture Capital Support to Small Businesses"

⁸⁵ BIS (2010) "Early Assessment of BIS Equity Fund Initiatives" (CEEDR)

30 employees per average firm). The majority of businesses expected to grow sales turnover from under £1m to £5m or more within 3-5 years.

ECFs not only provide finance to SMEs but also contribute non-financial benefits like improved corporate management, improved networking to customers and suppliers and also access to further investors.

Recipients generally have an overall positive experience of using ECF funds. Around 90% of respondents rated the value of the funds to their business as “very good”.

However, there are concerns that the current investment limit level of £2m (as specified by State Aid rules) is too low. For instance, consultees⁸⁶ raised concerns that the current investment limit may lead to the business having difficulty raising follow on funding leading to the company’s growth being constrained. The report recommended that the investment limit of public sector funds needs some flexibility to provide additional funding to meet the financing needs of the business, although they still need some mandate to focus on where the equity gap is most acute. This is a view shared by fund managers delivering BIS funds.⁸⁷

⁸⁶ BIS (2010) “The supply of Equity Finance to SMEs: Revisiting the Equity Gap” (SQW Consulting)

⁸⁷ BIS (2010) “Early Assessment of BIS Equity Fund Initiatives” (CEEDR)

Glossary of terms used

- **Basel 3:** Strengthens existing bank capital requirements and introduces new regulatory requirements on bank liquidity and bank leverage by requiring banks to hold 4.5% of common equity and 6% of tier 1 capital of risk weighted assets.
- **Business angel:** 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.
- **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.
- **Credit scoring techniques:** This involves the use of statistical models by lenders to approve loans to SMEs by predicting the probability of default. Information on financial ratios (such as profitability, leverage and liquidity) and information on credit histories/ financial delinquency are used to predict the probability of default. This type of credit assessment by lenders has grown in use for small business lending since the mid 1990s.
- **Deleveraging:** Businesses repaying some or all of its existing debt. Too much debt may increase the risk of default or bankruptcy, and so deleveraging helps to reduce these risks.
- **Factoring:** This type of finance involves a business contracting out its sales ledger and debt collection to an external organisation e.g. bank. The bank will pay the business for its invoices when issued and will then collect payments from its customers and pursue late payers. The business receives the money sooner as it does not have to wait until the invoice date, but pays a fee for using this service.
- **Funding escalator:** The funding escalator model shows the different sources of finance available at different stages of the business life cycle. The escalator is an inter-dependent system, so that any gaps in the provision of particular types of finance will have knock-on effects, restricting the business from reaching the next stage of its development.
- **Invoice discounting:** Invoice discounting involves a business exchanging its invoices for cash. This type of finance is similar to factoring but the business operates its own sales ledger by sending out invoices in its own name. The SME will need to deposit the payments with the finance provider as soon as they have been received from its customers.

- **IPO (Initial Public Offering):** The first time a private owned company sells its shares publicly on a listed stock exchange.
- **LIBOR (London Interbank Offer Rate):** The interest rate banks offer to other banks for loans on the London market. It is used as a reference rate for the pricing of some loans and overdrafts.
- **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 in which the market does not allocate resources efficiently, leading to lower levels of social welfare than is optimal.
- **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.
- **SME (Small and Medium Enterprise):** There is no standard definition of an SME, but frequently used definitions are based on the number of employees (less than 250 employees) or annual turnover (less than £25m annual turnover).
- **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.

References

- ACCA (2006) “Banks, SMEs and Accountants: an International Study of SMEs’ Banking Relationships” Professor Aidan Berry, Brighton Business School
http://www.acca.org.uk/pubs/general/activities/research/research_archive/rr-095-001.pdf
- Aghion, Fally and Scarpetta (2007) “Credit Constraints as a Barrier to the Entry and Post-Entry Growth of Firms” Economic Policy, Vol. 22, No. 52, pp. 731-779,
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1015635####
- AXA (2011) “AXA International Small Business Report: Obstacles to Growth in 2012” <http://newsroom.axa.co.uk/media/76579/axa-international-small-business-report-2011.pdf>
- Bank of England (2011) “Agents’ Summary of Business Conditions September 2011”
<http://www.bankofengland.co.uk/publications/agentssummary/agsum11sep.pdf>
- Bank of England (2012) “Trends in Lending January 2012”
<http://www.bankofengland.co.uk/publications/other/monetary/TrendsJanuary12.pdf>
- BDRG Continental (2011) “SME Finance Monitor: Q3 2011: Developing a deeper understanding” (November 2011) <http://www.bdr-continental.com/EasysiteWeb/getresource.axd?AssetID=4201&servicetype=Attachment>
- BIS (2009) “The Supply of Equity Finance to SMEs: Revisiting the Equity Gap” (SQW Consulting) <http://www.bis.gov.uk/files/file53949.doc>
- BIS (2009) “Early Stage Assessment of the Impact of the Enterprise Finance Guarantee (EFG) on Recipient Firms” (Durham Business School)
<http://www.bis.gov.uk/files/file54076.doc>
- BIS (2010) “Early Assessment of BIS Equity Fund Initiatives” (CEEDR)
<http://www.bis.gov.uk/assets/biscore/enterprise/docs/e/10-1037-early-assessment-bis-equity-fund-initiatives.pdf>
- BIS (2010) “Internationalisation of Innovative and High Growth SMEs” BIS Economics Paper No. 5 <http://www.bis.gov.uk/assets/biscore/economics-and-statistics/docs/10-804-bis-economics-paper-05.pdf>
- BIS (2010) “Economic Evaluation of the Small Firms Loans Guarantee (SFLG) Scheme” (Institute of Employment Studies)
<http://www.bis.gov.uk/files/file54112.doc>

- BIS (2011) “Business Population Estimates for the UK and Regions”
<http://www.bis.gov.uk/assets/biscore/statistics/docs/b/12octoberbusiness%20population%20estimates%20for%20the%20uk%20and%20regions%202011%20edition%20publication%20%20steven%20white%20%20august%202011.pdf>
- BIS (2011) “SME Barometer survey August 2011” (IFF Research)
<http://www.bis.gov.uk/assets/biscore/enterprise/docs/s/11-p75c-sme-business-barometer-august-2011.pdf>
- BIS (2011) “Small Business Survey 2010” (IFF Research)
<http://www.bis.gov.uk/assets/biscore/enterprise/docs/b/11-p74-bis-small-business-survey-2010.pdf>
- BIS (2011) “Job Creation and Destruction in the UK: 1998-2010” (Anaydike-Danes, Bonner and Hart- Aston Business School)
<http://www.berr.gov.uk/assets/biscore/enterprise/docs/j/11-1326-job-creation-and-destruction-uk-1998-2010.pdf>
- BIS (2011) “BIS Equity Finance Schemes: Survey of Fund Investors” (Ekosgen)
<http://www.bis.gov.uk/assets/biscore/enterprise/docs/b/11-984-bis-equity-finance-schemes-survey-fund-investors.pdf>
- Butler, A and Cornaggia, J. (2009) “Does Access to External Finance Improve Productivity? Evidence from a Natural Experiment”
<http://ssrn.com/abstract=1084154>
- BVCA 2010 “Private Equity and Venture Capital Performance Measurement Survey 2010”
http://admin.bvca.co.uk/library/documents/Performance_Measurement_Survey_2010.pdf
- BVCA (2011) “Private Equity and Venture Capital Report on Investment Activity 2010” http://admin.bvca.co.uk/library/documents/RIA_2010.pdf
- CBR (2008) “Financing UK SMEs: The 2007 Survey”
<http://www.cbr.cam.ac.uk/research/policy-evaluation-unit/output13.htm>
- DTI (1999) “Addressing the SME Equity Gap: Support for Regional Venture Capital Funds. Consultation Document”
- Engel, D and Keilbach, M, (2007) “Firm Level Implications of Early Stage Venture Capital Investment - an Empirical Investigation”. ZEW Discussion Paper No. 02-82; Journal of Empirical Finance, Vol. 14, No. 2, pp. 150-167, 2007.
<http://ssrn.com/abstract=392925> or [doi:10.2139/ssrn.392925](https://doi.org/10.2139/ssrn.392925)
- Fraser (2009) “Small Firms in the Credit Crisis: Evidence from the UK Survey of SME Finances”
http://www2.warwick.ac.uk/fac/soc/wbs/research/csme/research/latest/small_firms_in_the_credit_crisis_v3-oct09.pdf.

- HMT (2003) “The Green Book: Appraisal and Evaluation in Central Government”
http://www.hm-treasury.gov.uk/d/green_book_complete.pdf
- HMT (2004) “Graham Review of the Small Firms Loan Guarantee: Recommendations”
<http://webarchive.nationalarchives.gov.uk/20100809171752/webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/media/4/0/6302f406-bcdc-d4b3-1ce017b60a9f5692.pdf>
- HMT and BIS (2010) “Financing a Private Sector Recovery”
<http://www.bis.gov.uk/assets/biscore/corporate/docs/f/10-1081-financing-private-sector-recovery.pdf>
- HMT and SBS (2003) “Bridging the Finance Gap: Next Steps in Improving Access to Growth Capital for Small Businesses”
http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/media//88765/small_business_452.pdf
- Mason and Pierrakis (2009) “Venture Capital, the Regions and Public Policy: The United Kingdom since the Post -2000 Technology Crash” Hunter Centre for Entrepreneurship
http://www.strath.ac.uk/media/departments/huntercentre/WP_Version_VC_regions.pdf
- Mason and Harrison (2011) “Annual Report on the Business Angel Market in the United Kingdom: 2009/10”
<http://www.bis.gov.uk/assets/biscore/enterprise/docs/a/11-p116-annual-report-business-angel-market-uk-2009-10.pdf>
- NAO (2009) “Venture Capital Support to Small Businesses”
http://www.nao.org.uk/publications/0910/venture_capital_support_to_sme.aspx
- NESTA (2009) “Reshaping the UK Economy: The Role of Public Investment in Financing Growth”. <http://www.nesta.org.uk/library/documents/Report%2025%20-%20Reshaping%20the%20UK%20Ec%20v14.pdf>
- NESTA (2010) “Venture Capital: Now and After the Dot Com Crash”
http://www.nesta.org.uk/library/documents/Venture_Capital.pdf
- NESTA (2011) “Atlantic Drift: Venture Capital Performance in the UK and US” (Lerner, Pierrakis, Collins and Bravo Biosca)
http://www.nesta.org.uk/home1/assets/features/atlantic_drift
- NESTA (2011) “Barriers to Growth: The Views of High Growth and Potential High Growth Businesses”
<http://www.nesta.org.uk/library/documents/ResSumBarrierstoGrowth.pdf>
- NESTA/BVCA (2009) “From Funding Gaps to Thin Markets: UK Government Support for Early Stage Venture Capital” (Nightingale, Murray, Cowling, Baden-,

Mason, Siepel, Hopkins and Dannreuther).

[http://admin.bvca.co.uk/library/documents/Thin_Markets_report - Final.pdf](http://admin.bvca.co.uk/library/documents/Thin_Markets_report_-_Final.pdf)

- Office of Fair Trading (2007) “SME Banking: Review of the Undertakings given by Banks following the 2002 Competition Commission”
http://www.offt.gov.uk/shared_offt/reports/financial_products/oft937.pdf
- OXERA (2005) “Innovation Market Failures and State Aid: Developing Criteria” (Report prepared for DG for Enterprise and Industry European Commission)
http://www.pedz.uni-mannheim.de/daten/edzh/gdb/06/innovation_market_failures_and_state_aid.pdf
- Rowlands (2009) “The Provision of Growth Capital to UK Small and Medium Sized Enterprises” <http://www.bis.gov.uk/files/file53698.pdf>
- Slovik, P. and B. Cournède (2011), “Macroeconomic Impact of Basel III”, OECD Economics Department Working Papers, No. 844, OECD Publishing.
<http://dx.doi.org/10.1787/5kghwnhkkjs8-en>
- Stam, E., Garnsey, E. (2008) “Entrepreneurship in the Knowledge Economy”
http://www.dur.ac.uk/resources/dbs/faculty/centre_entrepreneurship/publications/ResearchPaper018.pdf
- Ueda, M and Hirukawa, M, (2008) “Venture Capital and Industrial Innovation”
<http://ssrn.com/abstract=1242693>

BIS Economics Papers

BIS places analysis at the heart of policy-making. As part of this process the Department has decided to make its analysis and evidence base more publicly available through the publication of a series of BIS Economics Papers that set out the thinking underpinning policy development. The BIS Economics series is a continuation of the series of Economics papers, produced by the former Department for Business, Enterprise and Regulatory Reform (BERR) which analysed issues central to business and industry.

The main series is complemented by a series of shorter Occasional papers including literature reviews, appraisal and evaluation guidance, technical papers, economic essays and think pieces. These are listed below:

Main Series

- 15 **Innovation and Research Strategy for Growth**, December 2011
14. **Supporting analysis for the Higher Education White Paper**, June 2011
13. **International Trade and Investment - the Economic Rationale for Government Support**, May 2011
12. **Productivity and the economic cycle**, March 2011
11. **The economic consequences for the UK and the EU of completing the Single Market**, February 2011
- 10B **Manufacturing in the UK: Supplementary analysis**, December 2010
- 10A. **Manufacturing in the UK: An economic analysis of the sector**, December 2010
9. **Economic Growth**, November 2010
8. **UK trade performance: Patterns in UK and global trade growth**, November 2010
7. **Understanding local growth**, October 2010
6. **Learning from some of Britain's successful sectors: An historical analysis of the role of government**, March 2010
5. **Internationalisation of innovative and high growth firms**, March 2010
4. **Supporting analysis for "Skills for Growth: The national skills strategy"**, March 2010

3. **The space economy in the UK: An economic analysis of the sector and the role of policy**, February 2010
2. **Life Sciences in the UK - Economic analysis and evidence for 'life sciences 2010: Delivering the Blueprint'**, January 2010
1. **Towards a low carbon economy – economic analysis and evidence for a low carbon industrial strategy**, July 2009

Occasional Papers

2. **The economic rationale for a national design policy**, August 2010
1. **Research to improve the assessment of additionality**, October 2009

These papers are also available electronically on the BIS Economics website at <http://www.bis.gov.uk/analysis/economics>.

Further information on economic research in BIS can be found at <http://www.bis.gov.uk/analysis/economics/bis-research>. This site includes links to the various specialist research areas within the Department.

Evaluation reports are available on the BIS evaluation website at <http://www.bis.gov.uk/analysis/economics/evaluation>.

The views expressed within BIS Economics Papers are those of the authors and should not be treated as Government policy. We welcome feedback on the issues raised by the BIS Economics Papers, and comments should be sent to bis.economics@bis.gsi.gov.uk.

© Crown copyright 2012

You may re-use this information (not including logos) free of charge in any format or medium, under the terms of the Open Government Licence. Visit www.nationalarchives.gov.uk/doc/open-government-licence, write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email: psi@nationalarchives.gsi.gov.uk.

This publication is also available on our website at <http://www.bis.gov.uk>

Any enquiries regarding this publication should be sent to:

Department for Business, Innovation and Skills
1 Victoria Street
London SW1H 0ET
Tel: 020 7215 5000

If you require this publication in an alternative format, email enquiries@bis.gsi.gov.uk, or call 020 7215 5000.

URN 12/539