

REPORT

EQUITABLE EQUITY

INCREASING AND DIVERSIFYING
FINANCE FOR HIGH-GROWTH
SMEs IN THE UK'S REGIONS

Izzy Hatfield

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Institute for Public Policy Research



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SUMMARY

As providers of jobs, and drivers of economic growth, innovation and productivity, high-growth businesses¹ are critical to addressing the UK's underlying economic weaknesses. Positively for the potential of the UK's regions, these businesses are found in all sectors, and are well-represented across the country.

High-growth businesses need to invest a relatively large amount of money, often at short notice, in new people, premises, products, processes, prototypes and capital equipment. Unfortunately, they are more likely to face difficulty accessing finance because lenders and investors struggle to assess their growth potential. Equity finance is often more suitable for high-growth firms, as it is more resilient than bank finance in a downturn, investors are more likely to take on a higher level of risk and provide support and guidance that helps businesses reach their full potential. Yet the UK's high-growth firms are predominantly financed via banks rather than by investors or through crowdfunding models, meaning some businesses with high-growth potential struggle to access finance.

No region outside of London and the South East has yet seen GDP per capita return to its pre-crisis peak. Improving the supply and demand for finance among high-growth firms in all regions could help to deliver better economic outcomes nationally, and reduce regional inequalities. Our recommendations aim to boost access to finance for high-growth businesses and ensure public money supports this across all regions of the UK.

KEY FINDINGS

- SMEs make up 99.9 per cent of all businesses, but only 24 per cent of them employ any staff, and just five percent are high-growth.
- High-growth businesses, of which there are more than 12,000, are found in all sectors and all regions of the country: in fact, the North East has the highest proportion of high-growth enterprises of all regions, relative to the total number of businesses (figure A.1).
- However, the supply of finance, particularly equity, is extremely regionally imbalanced: the share of equity finance going to businesses in London is more than twice as high as London's share of high-growth businesses.
- Businesses with growth ambitions are more likely to have their applications for bank lending rejected and are more likely to be discouraged from applying for loans in the first place, due to the extra perceived risk they face.
- Equity finance has several advantages for high-growth firms, but just 5 per cent of these businesses use it and the UK market is 10 times smaller than in the US relative to the total size of the economy.

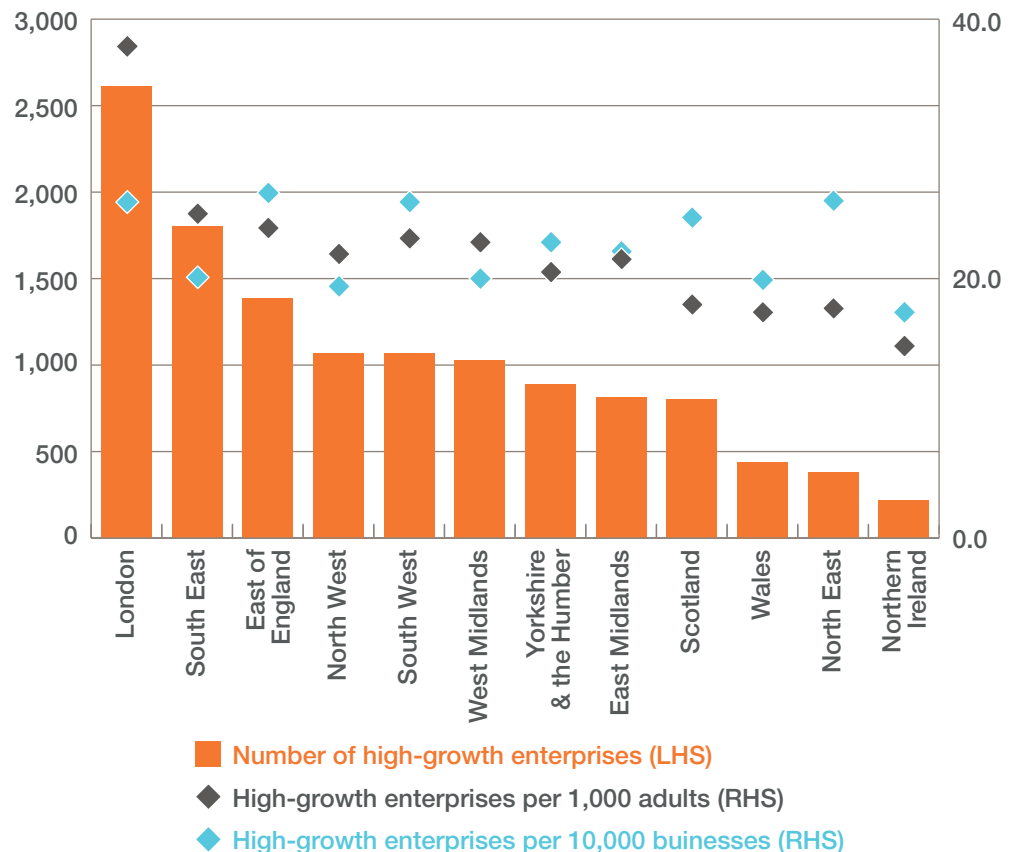
¹ Defined as businesses with more than 10 employees attaining an employee or turnover growth rate of 20 per cent over a period of three years.

- Demand-side constraints include a general lack of awareness of alternatives to bank finance among SMEs, and a preference to retain autonomy. On the supply side, information asymmetries combined with the inelastic cost of due diligence mean investors prefer larger firms.
- Policy on access to finance has largely focused on SMEs in general rather than high-growth businesses in particular, and has done little to increase the supply and demand for equity finance outside of London and ‘high-tech sectors’.
- The crowdfunding market for both debt and equity is growing rapidly, and could help bridge the finance gap for innovative firms with high-growth potential as it is well suited to seed and early-stage businesses.

FIGURE A.1

There are more high-growth businesses per 10,000 businesses in the North East than in any other region of the UK

Number of high-growth enterprises (left-hand axis), and high-growth enterprises per 1,000 adults and 10,000 businesses (right-hand axis) 2013



Source: ONS 2015a and BEIS 2016a

KEY RECOMMENDATIONS

Theresa May has expressed her desire to reduce regional economic disparities, as well as to increase finance for SMEs with growth ambitions. These two issues intersect: there are structural barriers to the supply of SME finance in the regions and demand for finance in the regions is also likely to be weaker than in London.

We recommend that the following measures are taken to help increase and diversify the regional supply and demand for finance.

Regional economic growth policy review

The current local economic policy landscape, coordinated by various actors, including Local Economic Partnerships and Growth Hubs has seen several changes and public spending cuts in the last decade. The development of new and existing regional institutions to support local economic growth, as part of the government's new approach to industrial strategy, should incorporate access to finance initiatives that would support firms with high-growth potential outside of London and the South East.

Recommendation 1: The government should review regional economic growth policy and consider creating and strengthening regional institutions to create networks that can support the diversification of finance outside of London and the South East.

A more explicit regional objective for the British Business Bank

The British Business Bank (BBB) has played an effective role in both supporting private lenders and investors to increase the supply of finance, as well as supporting demand for alternative finance among businesses. The institution is well placed to support the government in its aims to create Northern Powerhouse and Midlands Engine Investment Funds and furthermore should consider place-based outcomes as part of its strategic objectives. While the British Business Bank's activity is well distributed in line with the business population, as equity finance is so concentrated in London, there is a case for greater intervention outside of London. Currently there is very little evidence of the regional impact of many of the government's finance schemes.

Recommendation 2: An additional objective should be added to the British Business Bank's remit which formalises its desire to increase and diversify finance outside of London and the South East.

Recommendation 3: The British Business Bank should review the current suite of SME finance initiatives and attempt to assess the extent to which they unwittingly reinforce concentration of high-growth business finance in London and the South East, and ensure that future evaluations consider regional outcomes.

Evaluation of the Enterprise Investment Scheme and Seed Enterprise Investment Scheme

The EIS and SEIS cost the government £565 million in 2015/16 in income tax and capital gains tax relief, furthermore at least a tenth of this amount is likely to represent deadweight (finance for businesses which would almost certainly have received sufficient funds in the absence of the scheme). The reliefs overwhelmingly benefit businesses in London, which account for just 18 per cent of the business population and 21 per cent of the UK's high-growth enterprises, yet received 46 per cent of all EIS and SEIS funds in 2013/14. These two details are related: the deadweight cost of the policies in their current form are likely to be higher because they don't take account of the relative attraction of different parts of the country to potential investors.

Recommendation 4: HM Treasury should review the Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS) to determine the value of the policies and the extent to which they merely reinforce regional economic disparities. If the evidence suggests the policies have a high deadweight cost, HM Treasury should consider adjusting or even cancelling the two schemes.

1. THE UK'S BUSINESS BASE

1.1 WHICH BUSINESSES SUPPORT EMPLOYMENT, PRODUCTIVITY AND ECONOMIC GROWTH?

Over the last three years the UK's economy has been growing steadily, at more than 2 per cent per year. But the facade of economic success masks some fundamental weaknesses: productivity has stalled and half of households have seen no increase in their disposable income for more than a decade. No region outside of London and the South East has seen GDP per capita returned to its pre-crisis peak (Jacobs et al 2016). As providers of jobs and drivers of economic growth across the regions, the UK's businesses are critical to addressing these underlying economic weaknesses – but a point that is often missed is that some businesses are more critical than others.

There were a record 5.5 million private sector businesses at the start of 2016, following sustained growth in the business population. But not all businesses are drivers of employment, higher wages or productivity growth: for example, only 1.3 million (24 per cent) employed anyone aside from the owner. In fact, the majority of the business population growth, since 2000, has been due to the increase in non-employing businesses (BEIS 2016).

Policies to support businesses are usually targeted, either implicitly or explicitly, at small and medium-sized enterprises (SMEs). In the UK, SMEs – defined according to the European Commission definition² – make up more than 99.9 per cent of all businesses, employ three fifths of the workforce and produce almost half of all business turnover (table 1.1). SMEs are a significant part of the UK economy and successive governments have viewed them as a 'key contributor to economic growth' leading to considerable interest in the role of government in SME finance markets (BIS 2012a).

The theoretical rationale for government intervention in SME finance markets is based on the existence of market failures in debt and equity markets. Information asymmetry between SMEs and potential lenders and investors lead to adverse selection (which refers to a situation where sellers have information that buyers do not, or vice versa, about some aspect of product quality) and moral hazard (which refers to a lack of incentive to guard against risk where one is protected from its consequences).

A lender or investor struggles to identify the 'quality' of an SME, meaning that pricing the specific level of risk appropriately is more challenging than for a larger firm, which is more likely to have an extensive credit history. If the lender or investor offers the same price to all SMEs – regardless of

² SMEs employ fewer than 250 people and have either an annual turnover of less than €50 million or a balance sheet total of less than €43 million

the unobserved level of risk – they are likely to be highly attractive to riskier businesses and projects (adverse selection). Furthermore, high costs to finance may encourage businesses to switch to riskier projects upon receiving finance (moral hazard) (Ramlogan and Rigby 2012).

TABLE 1.1

Nearly all of the UK's businesses are SMEs
Business contributions to employment

Business size by employment	Business share	Employment share	Turnover share
SMEs (0–249)	99.9%	60.0%	47.3%
Non-employing (0)	75.9%	17.3%	6.6%
Micro (0–9)	95.6%	32.5%	18.6%
Small (10–49)	3.7%	15.2%	14.5%
Medium (50–249)	0.6%	12.4%	14.1%
Large (250+)	0.1%	40.0%	52.7%

Source: BEIS 2016a

Given that less than half a per cent of all businesses are *not* SMEs, these initiatives are not well-focused. SMEs are a heterogeneous group and isolating the businesses which are responsible for driving employment and productivity *growth*, rather than simply accounting for a large employment and turnover share, is a challenging task. The OECD attempts to do this by measuring high-growth enterprises, which it defines as enterprises with more than 10 employees attaining an average annualised growth³ rate greater than 20 per cent per year, over a three-year period. Another similar measure, used by Eurostat, sets the threshold growth rate at 10 per cent.

Using the higher threshold of 20 per cent, the UK had 12,495 high-growth enterprises in 2013, equivalent to just over 5 per cent of the business population with more than 10 employees, and just 0.2 per cent of the total business population (ONS 2015a and BEIS 2016a). Under the latter measure (and therefore adopting the lower growth threshold), the UK had 23,685 high-growth enterprises in 2013, employing 2.6 million people.

Separating this out into the economy's three main sector categories – production⁴, services and construction – suggests that high-growth businesses are relatively well-distributed across types of economic activity: 13 per cent of businesses in production are high-growth, 12 per cent of services businesses and 11 per cent of construction firms (OECD 2016). While both measures are of interest, we refer to the first measure unless otherwise stated as there is greater available data using this measure.

Examining the number of high-growth enterprises in each sector of the economy in greater detail provides further evidence that high-growth enterprises are not confined to any particular sector (figure 1.1). The wholesale and retail sector, which employs 15 per cent of the UK workforce (ONS 2016b), has the greatest number of high-growth enterprises, equivalent to 4 per cent of all retail businesses with more

3 Growth is measured either by the number of employees or by business turnover.

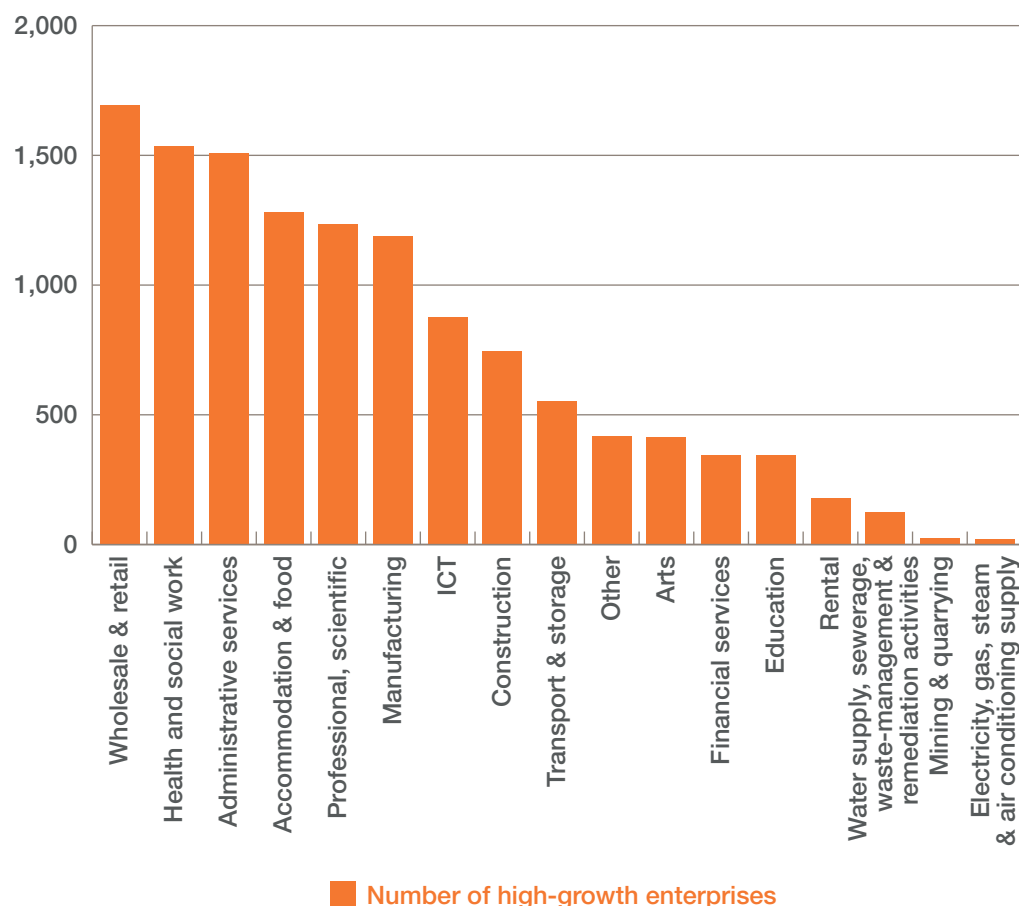
4 Production refers to the following sectors: mining and quarrying; manufacturing; electricity, gas, steam and air conditioning supply; and water supply, sewerage, waste management and remediation activities.

than 10 employees. The health and social work, administrative services, accommodation and food, professional services and manufacturing sectors all registered more than 1000 high-growth enterprises each, which is between 4 and 7.5 per cent of all businesses with more than 10 employees in each respective sector. Research by Nesta confirms that high-growth firms are not exclusive to ‘high-tech’ sectors. In fact, high-growth firms are found in significant numbers in every major sector and are almost equally present in the ‘high-tech’ and ‘low-tech’ sectors (Brown et al 2014).

FIGURE 1.1

The greatest number of high-growth enterprises are found in the wholesale and retail sector

High growth enterprises by sector, 2013



Source: ONS 2015a

Note: High growth enterprises refers to the OECD definition using the 20 per cent growth rate threshold.

High growth firms have been shown to make a strong contribution to productivity (Du et al 2013), strong levels of employment growth (Anyadike-Danes et al 2013) and a positive impact on skills and human capital (Mason et al 2009). Studies exploring what factors contribute to rapid business growth usually emphasise the importance of innovation⁵. Mason et al (2009) finds that innovative firms grow twice as quickly (in terms of both employment and sales) as firms that do not innovate.

⁵ Innovative activities are distinctive new products, processes or forms of work organisation.

For example, their study shows that firms that introduced a product innovation between 2002 and 2004 experienced average employment growth of 4.4 per cent between 2004 and 2007, compared to just 2 per cent in businesses that did not innovate.

The positive spillovers which arise from the difference between private and social returns to investment provide another strong reason for government intervention in SME finance markets (Brown and Lee 2014). Investment in business generates positive externalities, or spillovers, to the rest of the economy in the form of innovation, which refers to new products and processes, and knowledge transfer. This means that innovative firms have the ability to generate significant social benefits. These external benefits are not considered by lenders and investors in their decision meaning that businesses are unable to acquire the socially-optimal level of finance resulting in unrealised social benefits of innovation (Ramlogan and Rigby 2012).

More recently arguments have been put forward to move the debate on from standard market failure theory. Mazzucato and Penna (2015) argues that the state should play a role not only as ‘fixers’ of market failures, but instead as market ‘shapers’. In theory market failures are a ‘necessary but not sufficient condition for governmental intervention’ – that is the benefits of intervention may be outweighed by government failures. In practice, the role of governments in shaping and creating markets enables them to target financial resources to technologies, firms and sectors in order to address societal challenges generating greater economic inclusivity and sustainability.

1.2 THE REGIONAL SPREAD OF BUSINESSES

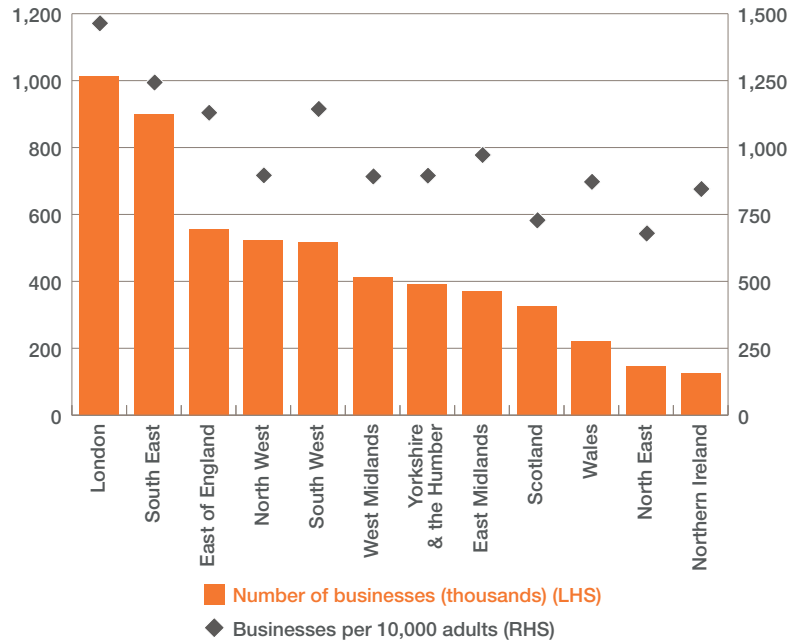
One third of the UK’s businesses are located in London and the South East. These two regions also have the highest business density – that is, the highest number of businesses per 10,000 resident adults. London has more than one million businesses and a business density of nearly 1,500 per 10,000 adults. The North East has the lowest business density, with 679 businesses per 10,000 adults (figure 1.2).

High-growth enterprises are also concentrated in London and the South East, but taking into account the size of the local adult and business populations reduces the degree of concentration (figure 1.3).

The regional density of high-growth enterprises for every thousand resident adults follows a similar pattern to the absolute numbers: London and the South East have the highest business densities per head of adult population, although their lead over the UK’s other regions is less pronounced. Measuring as a proportion of the number of businesses, however, the density of high-growth businesses starts to look much more even across the country. The North West and the North East actually perform better than London by this metric, with 26.5 and 25.9 high-growth enterprises per 10,000 businesses respectively (figure 1.3). Critically, in every region high-growth enterprises are a significant part of the total business population.

FIGURE 1.2:

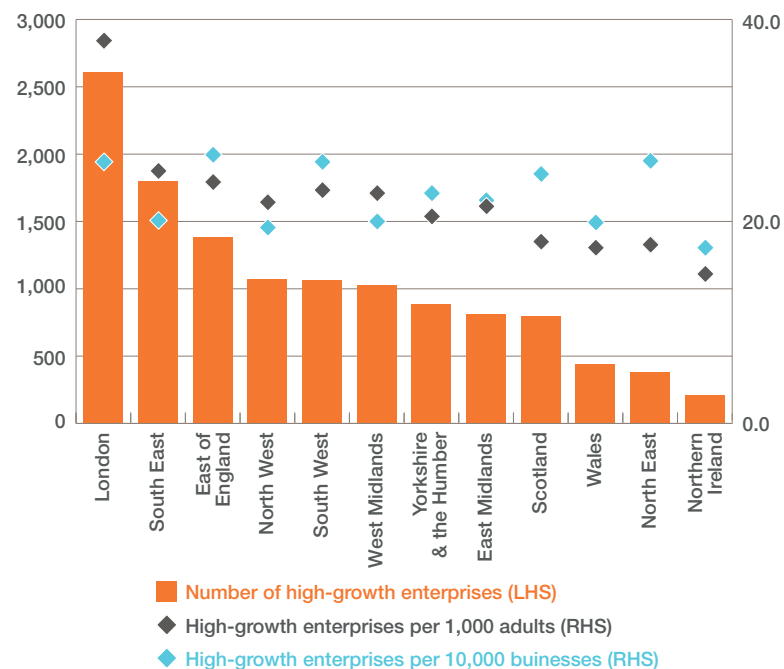
Businesses are concentrated in London and the South East
The regional distribution of businesses, start 2016



Source: BEIS 2016a
 Note: Adults defined as 2015 mid-year population estimates, over 16s.

FIGURE 1.3

Accounting for the business population reduces the apparent density of high-growth enterprises in London
The regional distribution of high-growth enterprises, 2013



Source: ONS 2015a and BEIS 2016a
 Note: High-growth enterprise figures are for 2013, but adults, 2015 and enterprises start 2016

1.3 IMPLICATIONS FOR POLICIES TO BOOST ACCESS TO FINANCE

The overwhelming majority of businesses are SMEs, which means they qualify for a number of government run business finance initiatives. But looking at the diversity of the SME category, it is clear not all SMEs drive of innovation, employment and productivity growth. It is only the high-growth firms, or those with the potential to become high growth do so in practice, and these firms constitute only a small proportion of the business population.

High-growth firms are found in all sectors and are well-represented across the country, relative to the size of the local business base. This suggests there is great potential for innovation, employment and productivity growth in every region of the UK.

In the following chapters we explore the role of a range of financing options – bank lending, equity finance and crowdfunding – in supporting businesses across all regions of the UK. We first consider the role of each type of finance for SMEs and high-growth enterprises. We then explore the regional prevalence of each type of finance. We provide a summary of the policy landscape since 2010 and conclude with recommendations for business finance policy that can help to support the economic recovery outside of London and the South East.

TABLE 1.2

Glossary of types of business and their definition

Type of business	Definition
Small and medium-sized enterprise (SME)	Enterprises which employ fewer than 250 people and have either an annual turnover of less than €50 million or a balance sheet total of less than €43 million.
Of which:	
<i>Non-employing businesses</i>	<i>Enterprises which employ no people.</i>
<i>Micro businesses</i>	<i>Enterprises which employ 1–9 people.</i>
<i>Small businesses</i>	<i>Enterprises which employ 10–49 people.</i>
<i>Medium businesses</i>	<i>Enterprises which employ 50–249 people.</i>
<i>Large businesses</i>	<i>Enterprises which employ 250+ people.</i>
High-growth enterprises (OECD)	Enterprises with more than 10 employees attaining an average annualised growth rate greater than 20 per cent per year, over a three-year period. Growth is measured in terms of either the number of employees or the business turnover.
High-growth enterprises (Eurostat)	Enterprises with more than 10 employees attaining an average annualised growth rate greater than 10 per cent per year, over a three-year period. Growth is measured in terms of either the number of employees or the business turnover.
High-growth firms (Brown and Lee)	Enterprises which have grown at 20% for one year and which predict 20% growth for the next. Growth is measured in terms of employment.
Smaller Businesses (British Business Bank)	SMEs (businesses with fewer than 250 employees) grouped into three market segments as below.
Of which:	<i>SMEs that have been trading for up to five years.</i>
<i>Start-up</i>	
<i>Scale-up</i>	<i>SMEs that have been trading for more than five years, and that have some ambition to grow.</i>
<i>Stay ahead</i>	<i>SMEs that have been trading for more than five years with no ambition to grow.</i>

2. RECENT DEVELOPMENTS IN BANK LENDING

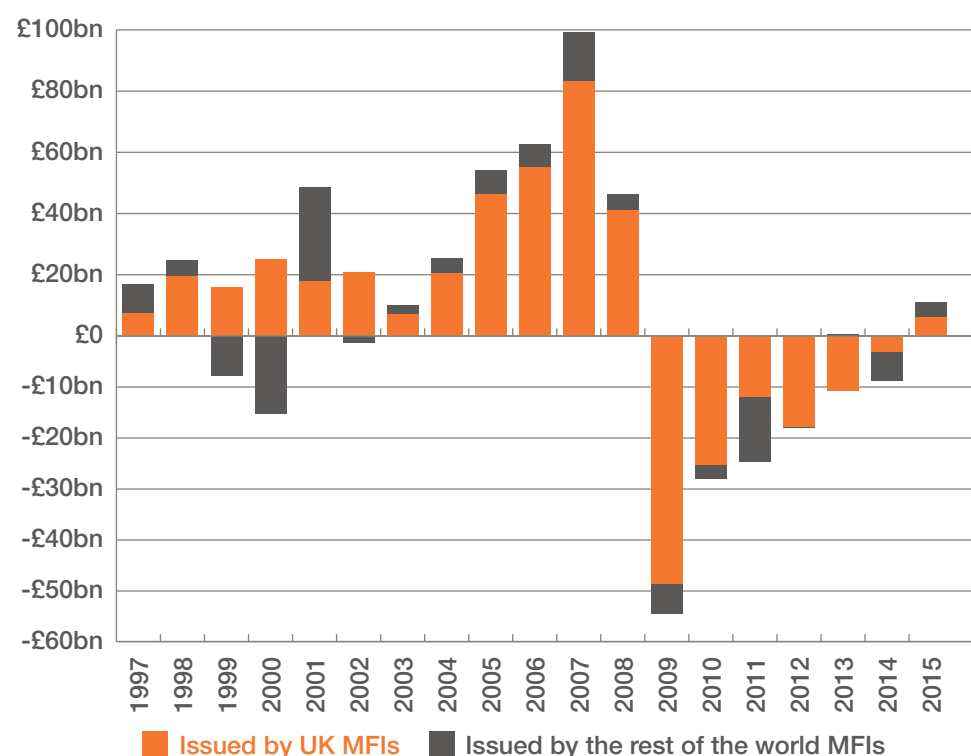
2.1. POST-CRISIS RECOVERY

Where UK businesses have turned to institutions for finance, they have traditionally relied on domestic banks - and therefore debt finance - for both working and growth capital (BIS 2012a). The financial crisis of 2007-08 impacted the financial landscape for businesses significantly. In the years leading up to the financial crisis of 2008, non-financial corporations' net acquisition of bank loans surged (figure 2.1). By 2007, UK businesses were borrowing, from the UK and abroad, £100 billion more than they were making in repayments. As a result, the outstanding stock of loans increased from 30 per cent of GDP in 2004 to 45 per cent in 2008. As the crash hit, bank lending fell sharply and net lending was negative for the next six years.

FIGURE 2.1

Bank lending's post-crisis recovery has been sluggish

Net acquisitions of bank loans (£bn), non-financial corporations, 1997–2015



Source: ONS 2016b

Both supply and demand side factors are likely to have contributed to this result, although the exact balance of the two isn't fully known. On the demand side, firms of all sizes become more 'risk averse' in a low-growth environment (particularly when they anticipate that the slow growth will persist), meaning they postpone or cancel investment and expenditure where they can. This has a direct impact on demand for finance. The UK's slow recovery from the 2009 recession is therefore likely to have limited businesses' demand for external sources of finance (Brown and Lee 2014). The initially large net repayment of loans by non-financial corporations in the years following the financial crisis is consistent with this view. Further, as the economy has improved – particularly over the last two years – net repayments have fallen, suggesting that more firms have sought to acquire loans to finance expansion plans on the back of a more positive economic outlook.

Supply-side issues are also likely to have contributed to the fall in net lending, however. After the financial crisis banks – like businesses – sought to rebuild their balance sheets, 'drastically cutting new lending' and increasing loss-absorbing capital (McCafferty 2015). Banks were more reluctant to lend both while the economy was in recession and in the early stages of recovery, when future growth seemed far from assured. More recently, the recovery of banks' balance sheets, combined with competition from challenger banks, has prompted banks to loosen the supply of credit.

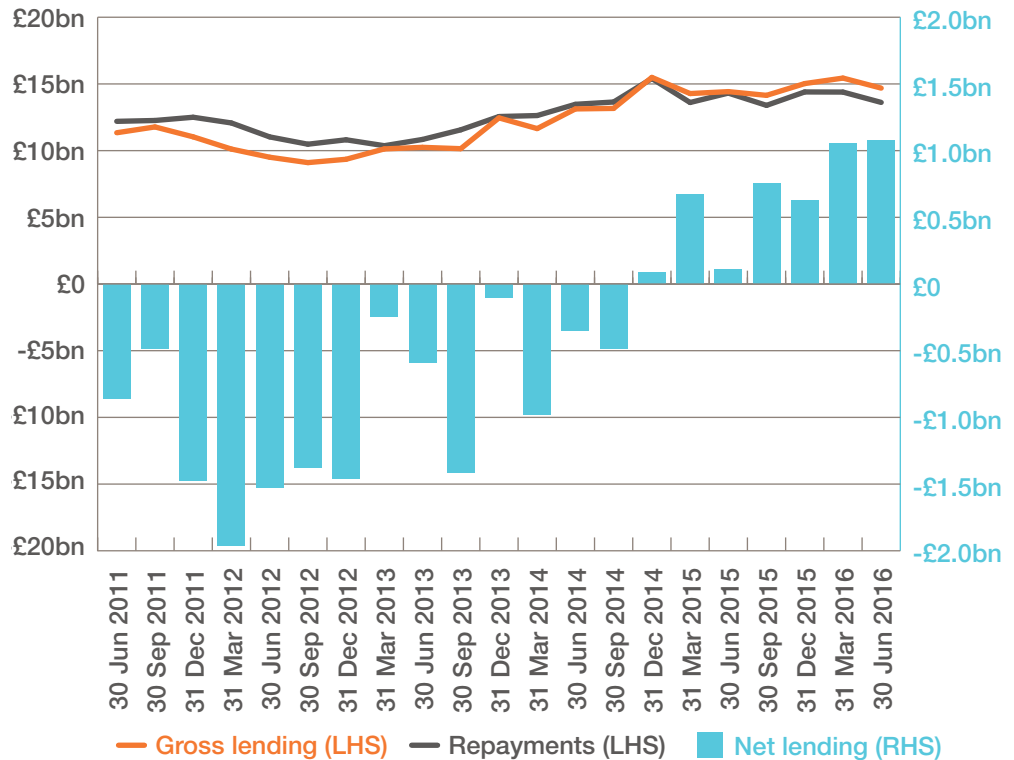
2.2. LENDING TO SMES

Bank lending is the single largest form of finance to smaller businesses (BBB 2016a) and therefore developments in the sector have a significant impact on SMEs' ability to access finance. As figure 2.2 shows, bank lending to SMEs has recovered at broadly the same pace as lending to the business base as a whole, turning positive in the last quarter of 2014 and reaching its post-2011 peak in the second quarter of 2016. Surveys from the Bank of England (BoE) and the Federation of Small Businesses (FSB) confirm that bank credit markets for SMEs improved over 2015 (ibid), signifying that the cyclical effects of the financial crisis and subsequent recession have, for the most part, retreated.

Disaggregating this data into lending to small versus medium-sized businesses suggests that this recovery in net lending to SMEs has been driven overwhelmingly by lending to medium-sized businesses (figure 2.3). Gross quarterly lending to small businesses is yet to pick up and net lending remains negative, as it has been since the third quarter of 2011, the first quarter of available data. Since 2011 there has been very little change in the level of new loans to SMEs and the level of repayments. Repayments have, however, consistently outstripped new loans which accounts for the negative net lending figures. This reflects the structural problem that a proportion of *viable* small businesses are underserved by bank lending, a problem which predates the financial crisis (BBB 2016a). Small businesses are more likely to have a limited track record meaning that they are much more likely to be denied a bank loan or overdraft as the bank struggles to assess their viability and growth potential.

FIGURE 2.2

Net bank lending to SMEs has been positive for the past seven quarters
Quarterly gross and net flows of bank lending to SMEs (£bn), excluding overdrafts, Q2 2011–Q2 2016



Source: BoE 2016a

The British Business Bank’s analysis of new debt applications attempts to measure the number of SME new debt applications (loans and overdrafts) that are rejected each year (BBB 2016a). Their survey evidence suggests that nearly 100,000 SMEs are rejected each year, amounting to £48 billion of unmet demand for debt. Start-ups⁶ are more likely to be unsuccessful in their applications for new debt facilities, compared with scale-up⁷ and stay ahead⁸ firms.

The BBB concedes that many of the rejection decisions made by banks will be legitimate (BBB 2016a). However, it notes a proportion of loans are likely to be declined as a result of structural problems in small business lending markets (ibid). These include:

- Information asymmetries: banks have inadequate information on which to issue a loan where a business lacks a track record (particularly likely when a business is relatively new), or when a business’ future growth potential cannot be determined from its historical performance (in the case of scale-up businesses)

6 SMEs trading up to five years (40 per cent of SMEs in the SME finance monitor data).

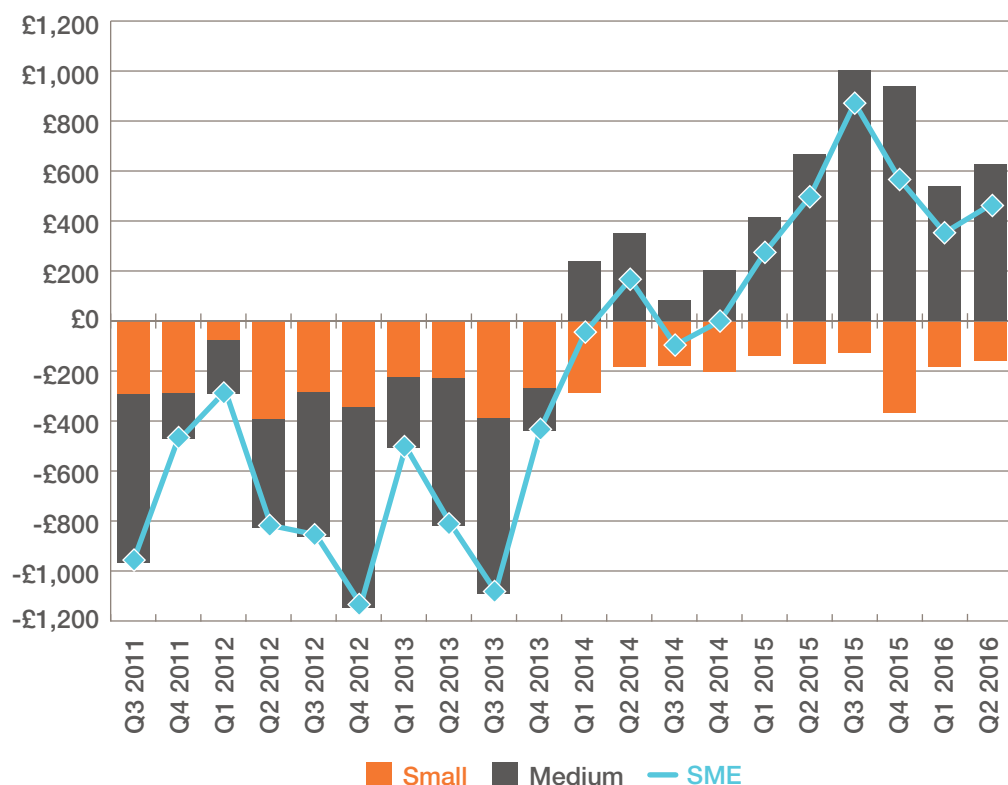
7 SMEs trading for more than 5 years with some ambition to grow (20 per cent).

8 SMEs trading for more than five years with no ambition to grow (40 per cent).

- Positive spillovers: businesses that innovate and grow rapidly generate benefits, in terms of new knowledge being created, that ‘spill over’ to other businesses, as well as to wider society. Neither the bank financing that growth, nor the business doing the innovating, fully captures these benefits, which means that the overall level of bank lending is lower than is optimal for society.

FIGURE 2.3

The improvement in net lending to SMEs is driven by increased lending to medium-sized businesses; lending to small businesses continues to fall
Net lending to small and medium SMEs (£m), Q3 2011–Q2 2016



Source: BBA 2016

Note: This data does not cover the entire SME lending market but is sourced from a panel of lenders: Barclays, HSBC, Lloyds Banking Group, National Australia Bank UK (Clydesdale, including Yorkshire Bank), Royal Bank of Scotland Group (including NatWest), Santander UK and Co-operative Banking Group.

2.3. LENDING TO INNOVATIVE, HIGH-GROWTH BUSINESSES

Access to finance is particularly important for innovative and high-growth businesses, as they are likely to need to invest a relatively large amount of money, at short notice, in new people, premises, products, processes, prototypes and capital equipment (Brown and Lee 2014). In these situations, the information asymmetry between the lender and the borrower described above is exacerbated. Businesses with growth ambitions struggle to show using their previous track record that they will be able to meet the higher debt repayments in the future (even if they have a reasonably long track record) and banks are aware that a large number of

businesses with growth ambitions fail. They also have difficulty determining the likelihood of failure from the information they have available to them.

The balance of empirical evidence looks to support the existence of a structural failure, with the majority of studies concluding that high-growth firms find it more difficult to access finance, in comparison with the SME population as a whole. The UK has a high proportion of start-up businesses (21 per cent), ranking third out of 14 OECD countries. However, it is ranked thirteenth when it comes to the proportion of start-up businesses with one to nine employees that grow to 20 employees or more in three years (BBB 2016a).

The Business, Energy and Industrial Strategy [BEIS] Committee labels access to finance ‘one of the main barriers to scale-up for fast growth SMEs’ (2016). Successive studies have found that businesses aiming to grow, innovative businesses and high-growth businesses are all more likely to experience difficulties raising finance (Nesta 2011; Lee et al 2015). Specifically, Freel (2007) finds that the most innovative firms are less successful in loan markets than their less innovative peers and Lee and Brown (2016) find that innovative firms are more likely to be discouraged from applying for bank finance.

CONCLUSIONS

The latest bank lending data demonstrates that while the cyclical effects of the financial crisis on bank lending to SMEs have largely dissipated, structural barriers remain in the market. The improvement in net lending to SMEs has been overwhelmingly driven by a higher proportion of new loans to medium-sized businesses, while net lending to small businesses remains negative. Banks are well placed to lend to low-growth, stable businesses.

However, studies have shown that lenders struggle to assess the viability of loan applications from small businesses – particularly those with growth ambitions – meaning that these businesses are most likely to have their applications for bank lending rejected. Furthermore, innovative firms, which are most likely to become the high-growth businesses which deliver higher employment, productivity and growth, are more likely to be discouraged from applying for loans and less likely to be successful when they do, than non-innovative peers.

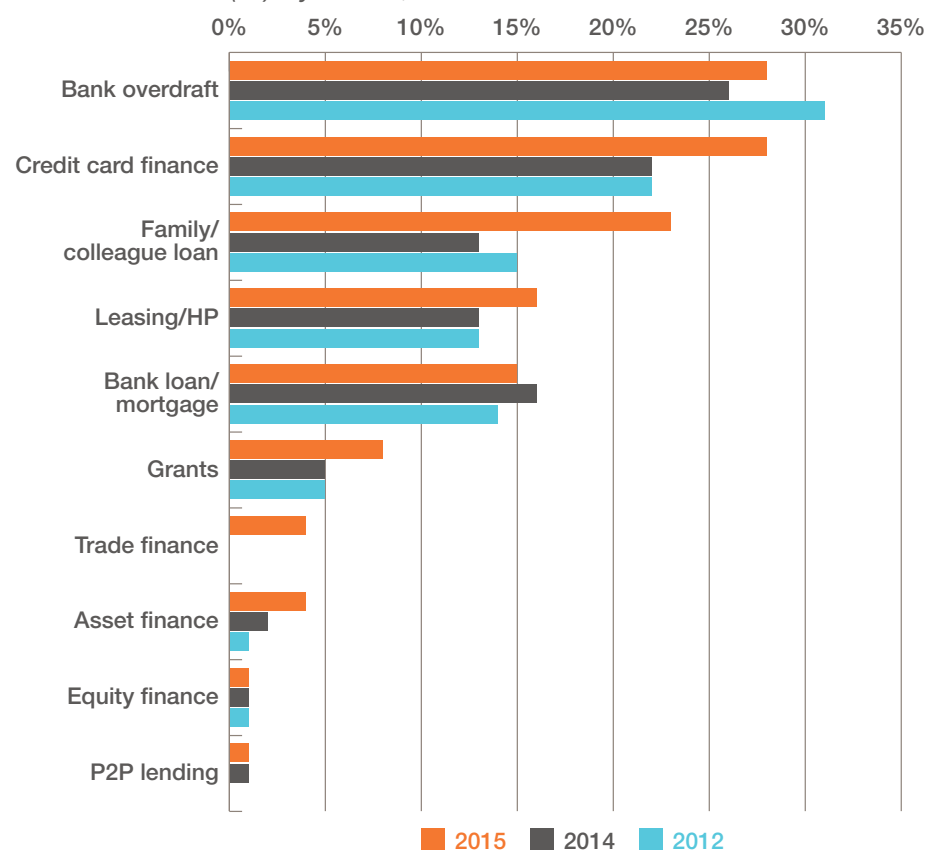
3. THE ROLE OF EQUITY FINANCE

3.1 DEMAND AND SUPPLY OF EQUITY FINANCE

The British Business Bank reports that only one per cent of SMEs have used equity finance over the past three years, with most preferring to use their overdraft facility or a credit card, or to seek funds from family and friends (figure 3.1). Under the ‘pecking order’ theory of funding preferences, firms favour, in descending order, ‘internal equity’ (meaning personal savings, funds from family and friends, or retained earnings), bank finance and then equity sources of finance (Myers and Majluf 1984). Businesses, particularly in their initial stages, are much more likely to use internal equity before they turn to institutional sources, as it allows them to avoid some of the information asymmetries inherent in bank finance, while not sacrificing control through equity finance.

FIGURE 3.1

Only a very small fraction of SMEs use equity finance as a source of funding
Uses of finance (%) by SMEs, 2012–2015



Source: BBB 2016b

As a business grows, it is likely to have to look to external sources of capital, such as business angels (individuals with personal funds to invest in businesses whereas venture capital is invested by firms using other people's money), venture capital markets and finally private equity. The various stages of equity finance, which a business moves through as it grows, have been described as a 'funding escalator' (table 3.2).

TABLE 3.2

Equity funding escalator

Stage of development	Source of finance
Concept/seed	Friends and family
Start-up	Business angels
Early stage	Venture capital
Expansion	Growth market, private equity
Consolidation	Regulated markets, private equity

Source: Freeman 2013

Although the evidence suggests that businesses tend to take on debt before they turn to sources of equity finance, equity is considered to be a particularly appropriate source of finance for innovative businesses with high growth potential (van der Schans 2015). There are a number of reasons for this:

- Equity investors are typically more active than lenders in day-to-day operations, offering advice and support to businesses as they grow.
- Equity investors are more likely to take on the higher levels of risk associated with innovative businesses, meaning a greater chance of being able to access the finance required.
- Equity is more flexible than borrowing, which requires interest and capital repayments to be made according to a fixed schedule.
- Equity is less vulnerable in a financial crisis than debt, which may be difficult to roll on as credit conditions tighten.

There are likely to be both demand and supply issues contributing to the low uptake of equity finance among UK businesses. On the demand side, SMEs often struggle to justify the employment of a dedicated finance professional, leading to a general lack of awareness of alternatives to overdrafts, credit cards and bank loans (BIS 2012a). Even if they are aware of the alternatives to debt, business owners tend to be reluctant to cede control of their businesses (BBB 2015a). They are also likely to consider the higher cost of capital relative to debt finance in their decision.

The supply of equity finance is also a factor, due to the presence of similar information asymmetries to bank finance. Investors attempt to assess the quality of SME proposals and risks by undertaking due diligence. This incurs transaction costs, which do not generally vary with the size of investment. This means that investors are discouraged from financing smaller businesses because due diligence costs are likely to represent a greater proportion of the investment (van der Schans 2015). Furthermore, while equity investors tend to have a higher risk appetite than banks, their appetite is not infinite, and the absence of information

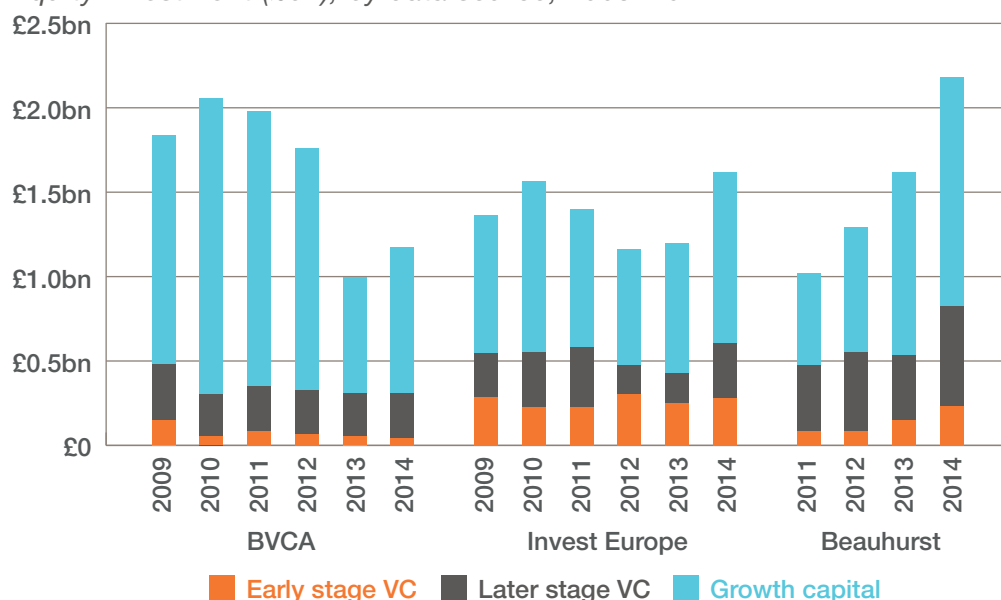
on the likelihood of success of the youngest firms – seed, start-up and early-stage businesses – makes equity valuations extremely difficult.

Combined, these two factors lead to a structural gap where investors in the equity market focus on fewer, larger, more established, lower-risk businesses at the expense of the smaller, younger, riskier businesses (ibid). This has been described as a ‘breakage’ in the funding escalator whereby friends and family, business angels and venture capitalists are unable to supply sufficient funds to potentially high-growth firms (Brown et al 2015).

Nonetheless, there is tentative evidence that the equity market in the UK is growing. There are several different data sources for venture capital investment in the UK, none of which provide a complete picture of venture capital investment activity. As a result of their different coverage of the sector, they suggest different trends in investment between 2009 and 2014. The BVCA and Invest Europe data sets only cover their members - predominantly private equity/venture capital funds – and they show a downward trend in investment. The Beauhurst data, on the other hand, includes equity investors at the lower end of the market - including crowdfunders and business angels - and as a result suggests that the total value of equity investments has maintained a steady upward trend since 2011. Since the smallest businesses are more likely to be funded by these types of investors, this is a positive sign from the perspective of small businesses’ access to finance.

FIGURE 3.2.

Different data sources show different trends in equity investment
Equity investment (£bn), by data source, 2009–2014

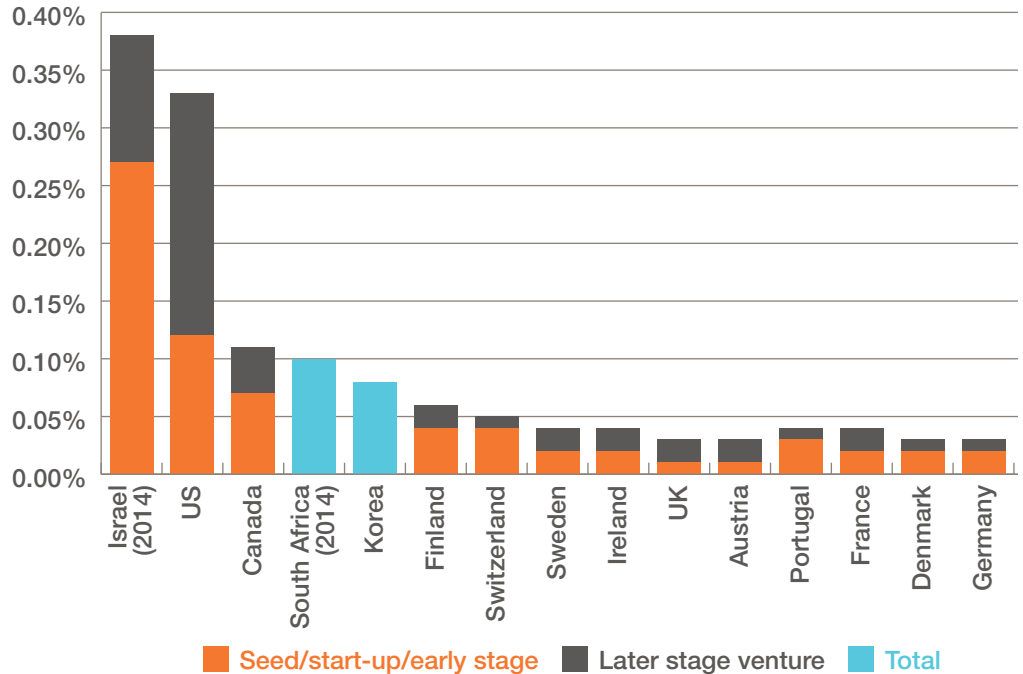


Source: Replicated from BBB 2016a

Notes: BVCA and Invest Europe only cover their members (predominantly private equity/venture capital funds) while Beauhurst includes other equity investors such as crowdfunders and business angels.

FIGURE 3.3

The UK venture capital market lags behind that of the US
Venture capital investments as a percentage of GDP, selected countries, 2015 or latest available year



Source: OECD 2016
Notes: Top 16 OECD countries by size of venture capital market

There is very little internationally-comparable data available on equity finance (BBB 2015a), although it is well established that UK SMEs have considerably less access to capital markets than their US equivalents (McCafferty 2015). We compare total venture capital as a proportion of GDP, which is one of the only internationally comparable measures of equity available. Israel has by far the highest venture capital to GDP ratio having received significant government support to grow its capital markets since the early 1990s (figure 3.4).

The US, and Canada have significantly higher venture capital to GDP ratios than their European competitors, with the UK investing just 0.033 per cent of GDP into venture capital compared to 10 times as much (0.33 per cent) in the US. The UK performs slightly better than its European neighbours France and Germany, although the British Business Bank finds that venture capital as a proportion of GDP fell in all three countries between 2007 and 2013. Further, UK venture capital investments tend to be skewed to mature enterprises (58 per cent), rather than start-ups, more than virtually any other comparator country, excluding the US.

3.2 EQUITY AND INNOVATIVE, HIGH-GROWTH FIRMS

In theory equity finance is the most suitable type of finance for innovative firms of all sizes, with high-growth potential, yet much of the data available focuses on the very large SME group. Brown and Lee (2014) investigate the demand and supply for external finance among

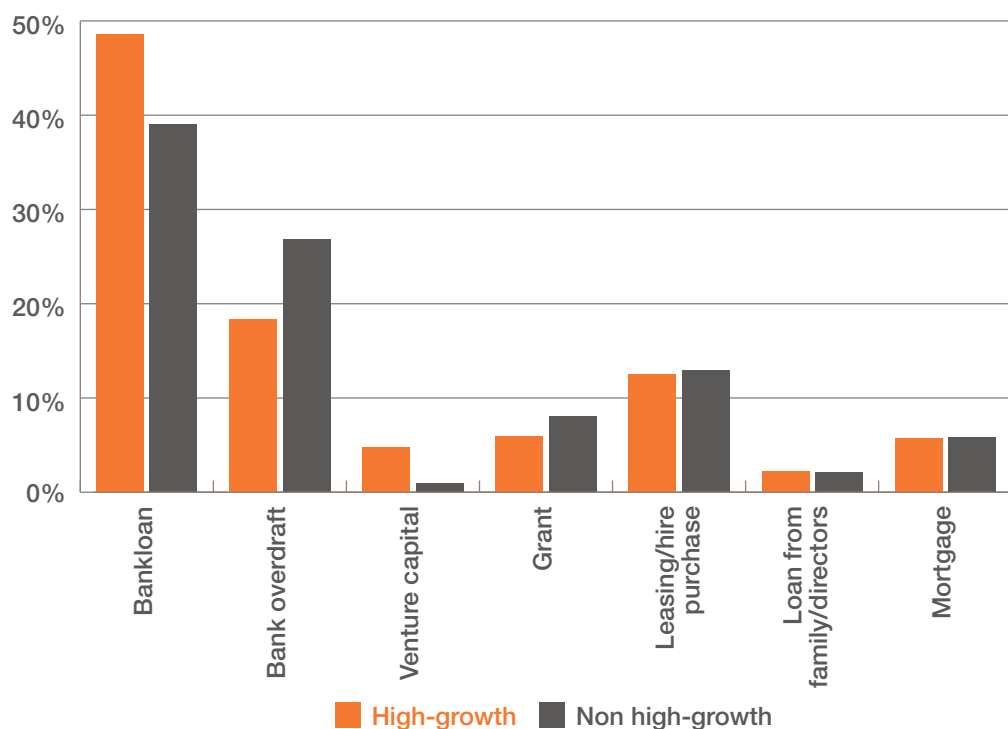
high-growth firms using data combined from the Small Business Survey for 2007/8, 2010 and 2012. Their research shows the different types of finance sought by high-growth and non-high growth SMEs (figure 3.5).

The key finding is that banks are the primary source of finance for both types of SME. Nearly half of all high-growth SMEs (48.6 per cent) in the survey periods⁹ sought a bank loan, 10 percentage points higher than for non-high growth SMEs. Bank overdrafts were less common for high-growth firms while there is little variation between high-growth and non-high growth use of grants, leasing, finance from family and mortgages. A considerably larger proportion of high-growth firms sought equity finance, but the proportion of all high-growth firms is very low at just 4.8 per cent. The authors conclude that while equity is more significant for high-growth SMEs, equity finance is not a dominant source of funding.

FIGURE 3.4

High-growth firms are more likely to seek equity finance than non-high-growth firms

*Type of finance sought (% of total), by type of SME, 2007/8, 2010, 2012**



Source: Brown and Lee 2014

*Note: Data is from the combined Small Business Survey (SBS) for 2007/8, 2010 and 2012.

The authors interviewed a number of high-growth firms to gather the intuition for their results and found that ‘a key issue... evident in all the cases was the strong desire to avoid external sources of funding whenever possible’. The firms interviewed preferred to use internal profits or retained earnings and were particularly keen to remain autonomous and to avoid ‘intrusion from outside’. The low uptake of equity finance

9 The data for the study is from the combined Small Business Survey (SBS) for 2007/8, 2010 and 2012.

is therefore likely to be as much about business demand for this type of finance, as about supply.

CONCLUSIONS

Very few UK SMEs use equity finance, although the market has grown over the past few years. It remains 10 times smaller than in the US (as a proportion of GDP), but is comparable to markets in France and Germany. High-growth firms are more likely to use equity-finance than non-high-growth firms, but it still accounts for just 5 per cent of finance for high-growth businesses. While equity finance has a range of benefits suitable for high-growth firms, businesses are reluctant to use it due to the loss of autonomy implied.

4. THE CROWDFUNDING MARKET

4.1 PEER-TO-PEER LENDING

While still small, the online alternative finance market has grown rapidly since the financial crisis. Online platforms facilitated £3.2 billion of loans, investments and donations in 2015, representing a year-on-year growth rate of more than 80 per cent (Zhang et al 2016). The online alternative finance market, or crowdfunding market, as the Financial Conduct Authority (FCA) terms it, covers both loan-based and equity-based online platforms as well as a number of donation-based models. We focus on the two types of finance which are deemed most relevant to the SME finance market: peer-to-peer lending and equity-based crowdfunding.

Loan-based crowdfunding is widely referred to as peer-to-peer (P2P) lending. Online platforms act as an intermediary between lenders and borrowers, effectively taking the role previously played by a bank. Lenders are able to pool risk across a number of businesses and in some cases this process can even be automated, although at the current state of play there is less regulation to protect consumers than in banks. The first platform, Zopa, was created in the UK in 2005 and connected individual lenders with individuals to finance personal loans. As time has gone on, lending to businesses has expanded and institutional investors have entered the market. P2P business lending amounted to £1.5bn in 2015 (figure 4.1), which for comparative purposes is equivalent to 6 per cent of new loans to SMEs, or 22 per cent of new loans to small businesses¹⁰. The average loan size is £76,280 suggesting that P2P primarily caters to the small business market (Zhang et al 2016).

The growth in P2P business lending has been driven by supply and demand factors. On the supply side, the market may have grown for ideological reasons – some lenders, especially post-financial crisis, like to have control over how their money is invested (Atz and Bholat 2016). A survey conducted by Nesta (Baeck et al 2014) suggests, however, that the main motivation for lenders is financial, with 82 per cent of surveyed lenders citing ‘to make a financial return’ as very important, while only 35 per cent said that it was very important ‘to have control over where my money goes’.

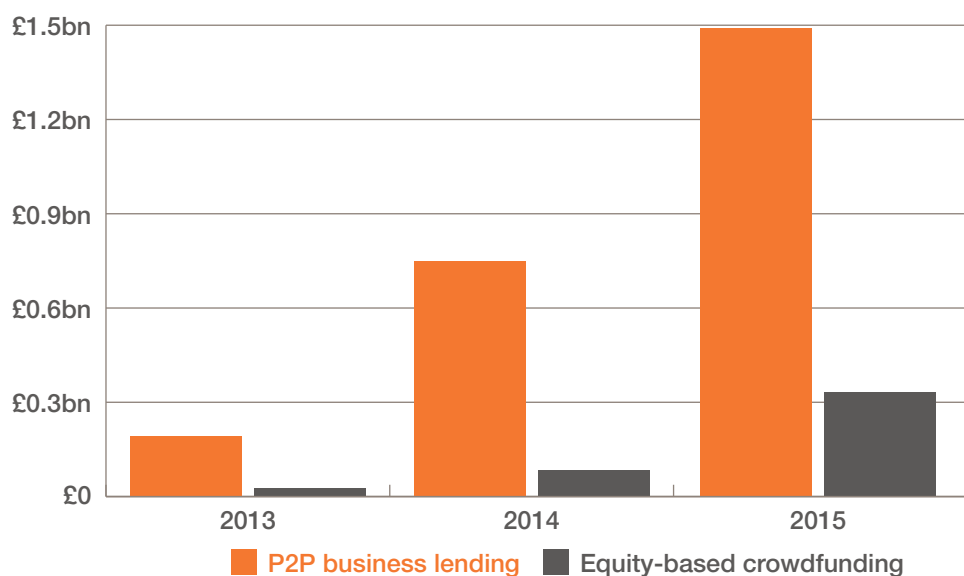
On the demand side, the main business motivation for borrowing via P2P platforms appears to be competitive interest rates, and the speed at which businesses can access funding (ibid). P2P also appears to be meeting a segment of demand for finance that otherwise would go unmet: one third of the businesses raising funds via P2P business lending reported that they would be ‘unlikely’ or ‘very unlikely’ to get funding elsewhere.

10 IPPR calculations using Zhang et al 2016 and BBA 2016

FIGURE 4.1

Peer-to-peer business lending and equity-based crowdfunding have grown rapidly over the past three years

Peer-to-peer business lending and equity-based crowdfunding (£bn), 2013–2015



Source: Zhang et al 2016

Despite recent remarkable growth, Nesta (Baeck et al 2014) found that 76 per cent of SMEs, in a nationally representative survey, were unaware of P2P lending. This lack of awareness may be acting as a constraint on demand.

It is important to note that not all commentators view the growth in the market favourably, with Lord Adair Turner, former chair of the Financial Services Authority, warning that P2P lenders may make significant losses in the future (BBC News 10 February 2016). Due to its status as a new market, with little experience of economic downturn, the exact nature of the P2P business model, and the risks involved in both lending and borrowing via these sites relative to those associated with traditional banks, may not be fully known and understood by P2P customers.

4.2 EQUITY-BASED CROWDFUNDING

Equity-based crowdfunding provides a platform for investors to buy shares in unlisted or small businesses in return for a share of the rewards. The market was worth £332 million in 2015, so is considerably smaller than the P2P business lending market. Nonetheless the market has grown by almost 300 per cent since 2014 (figure 4.1), and the UK has the fastest growing market in Europe by a considerable margin (Wardrop et al 2015).

Crowdcube was the first platform to launch in the UK in 2011, after the market took off in the US in the mid-2000s. Seedrs became the first equity-based crowdfunding platform to be regulated by the Financial Conduct Authority (FCA). In fact, the majority of deals so far have occurred

at the seed-stage (BBB 2015a) suggesting that the online equity-based crowdfunding market provides an alternative to the traditional seed-stage capital sourced from founders, families and friends. The market also covers the start-up and early stages, with some business angels choosing to invest through online platforms. SyndicateRoom in particular targets business angels. For this reason, this type of finance is likely to be more relevant to innovative firms with high-growth potential.

Nesta (Baeck et al 2014) finds that 54 per cent of businesses using equity-based finance sought expansion capital and 46 per cent sought seed or start-up capital. As outlined in section 3.1 under the 'pecking order' theory of funding preferences, firms prefer internal sources of finance (founders, family and friends) before they consider external finance. At this point their first preference would be for a bank loan, after which they would consider equity. It is commonly held that there is a 'breakage' in the funding escalator; in theory equity-based finance has the potential to help bridge this gap.

The 'pecking order' theory does not distinguish between alternative types of equity finance, and equity-based crowdfunding operates very differently from the more established equity market (Brown et al 2015). For instance, many investors on crowdfunding platforms require less information upfront and spend less time negotiating contracts, than in more traditional forms of equity finance (Macht and Weatherston 2014). Furthermore, because the model involves funding from the 'crowd', individual shareholders do not have a big enough stake to exert power over the management team. They may not even be offered voting rights. This is a considerably different model to those operated by venture capital firms and business angels, representing a potentially disruptive change to the way new ventures are funded.

Brown et al (2015) find that many businesses using the platforms were attracted by the ability to obtain finance relatively quickly with little reduction in their ownership stake or autonomy. This weakens one of the main demand side barriers to equity finance discussed in chapter three and shows that equity-based crowdfunding offers the potential to bridge the gap in the equity funding escalator for young, high-growth firms. Nesta (Baeck et al 2014) reports that since securing equity-based finance 70 per cent of businesses have increased turnover and 60 per cent have increased employment.

CONCLUSIONS

The crowdfunding market, including both peer-to-peer lending and equity-based crowdfunding, have grown rapidly over the past few years, but remain a small part of SME finance markets. Peer-to-peer lending is an alternative for bank lending for small businesses and delivers quick access to finance for successful businesses. Equity-based crowdfunding is largely aimed at seed-stage businesses: its 'crowd'-based model may help to bridge the equity gap for small companies with high-growth ambitions, by reducing the likelihood of investor interference in the business.

5. THE REGIONAL SPREAD OF BUSINESS FINANCE

5.1 REGIONAL ECONOMIC PERFORMANCE

London and the South East perform considerably better than the rest of the UK on a number of economic measures. Almost a quarter of all national output is produced in London, with the South East contributing another 15 per cent (Jacobs et al 2016). This trend has intensified over the last 20 years, as the population, productivity and growth of the economy have increasingly concentrated in the south east. The decline in manufacturing, which was largely based in the north of England, Wales and Scotland, combined with a rise in London-based financial services accounts for much of this shift. London's growth as a global financial centre has created spill over effects in private investment (ibid).

High-growth firms, however, are found in all of the UK's sectors, not just technology. They are well-represented in every region, relative to the size of the business base. The regions of the UK, therefore, have significant economic potential for growth. In this chapter we explore the link between business location, potential for growth and access to finance.

5.2 THE REGIONAL SPREAD OF BANK LENDING

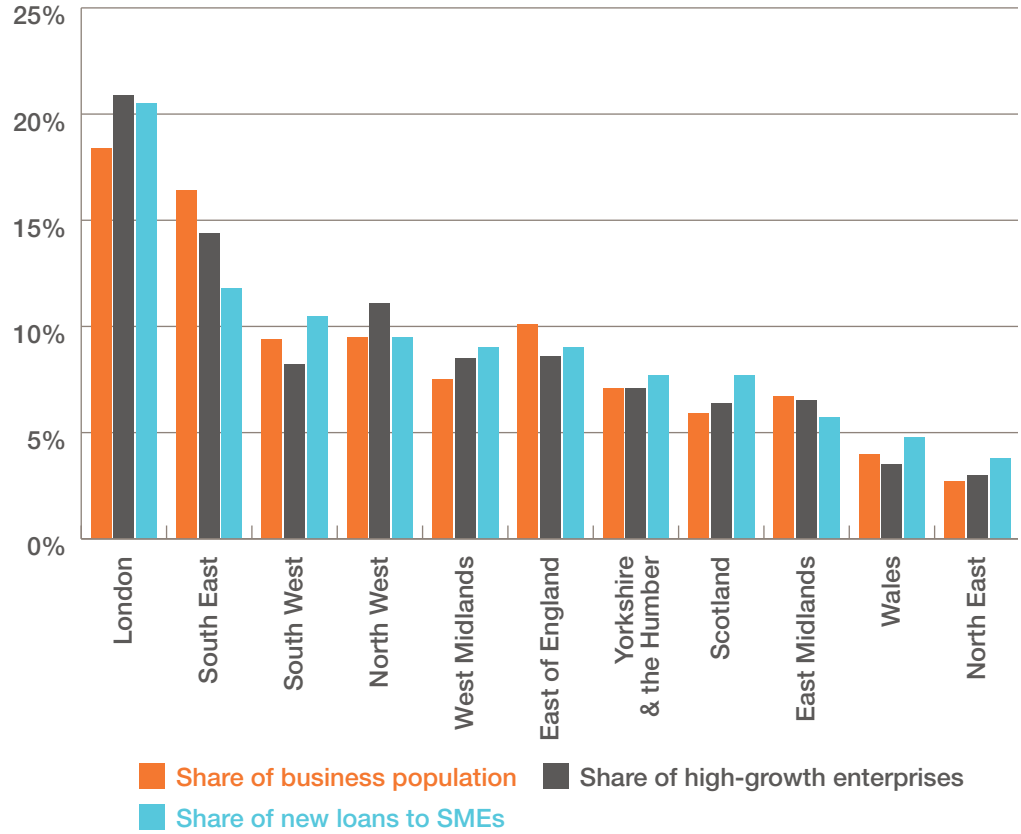
There is some evidence that the increasingly pervasive use of lending technologies and reduced local autonomy in loan decisions have resulted in spatial concentration of bank lending in the UK (Wójcik and MacDonald-Korth 2015). Organisational and technological changes are thought to be reducing the relational proximity between banks and SMEs, and particularly innovative firms. Lee and Brown (2016) consider geographical variation in the demand and supply of bank finance for innovative firms in the UK. They conclude that geography matters in the financing of innovative firms, and firms in peripheral areas may suffer a 'liability of distance', meaning they are less likely to be able to access finance, potentially reinforcing regional disparities. In rural areas, information asymmetries between banks and SMEs are likely to be exacerbated by the greater distance resultant from local bank branch closures (Mason et al 2016).

At a regional level, however, bank lending roughly mirrors the distribution of businesses in the UK, as well as the share of high-growth enterprises. London is the base for 18 per cent of the business population and 21 per cent of all high-growth enterprises. The city received 20 per cent of new bank loans to SMEs in 2015. The share of new loans is slightly below what we might expect given the size of the business population in the south east, but for other regions it is close to business population shares.

FIGURE 5.1

Bank lending to SMEs is largely distributed in line with the business population

Share of new loans to SMEs, business population and high-growth enterprises (%) by region, 2015, per cent



Source: ONS 2015a, BEIS 2016a, BBA 2016

Note: Share of high-growth enterprises data is from 2013. Figure excludes Northern Ireland, as bank lending data is not available.

While innovative firms in peripheral areas¹¹ have a higher demand for bank finance than their contemporaries in urban areas, they are more likely to be discouraged from applying and more likely to have their applications rejected when they do (Lee and Brown 2016). This may be caused by the pecking order hypothesis: they are forced to seek bank loans and overdrafts because they have less access to internal capital than their peers in non-peripheral areas (for example because property prices are lower in peripheral areas).

While this does not necessarily mean that the share of new loans to SMEs is particularly low in regions outside of London and the South East – Manchester and Birmingham are not defined as periphery – it does suggest that businesses far from cities with strong financial infrastructure are likely to face greater barriers to accessing bank finance.

¹¹ Which are defined according to their proximity to urban areas (areas near London score particularly highly).

5.3 THE REGIONAL SPREAD OF EQUITY FINANCE

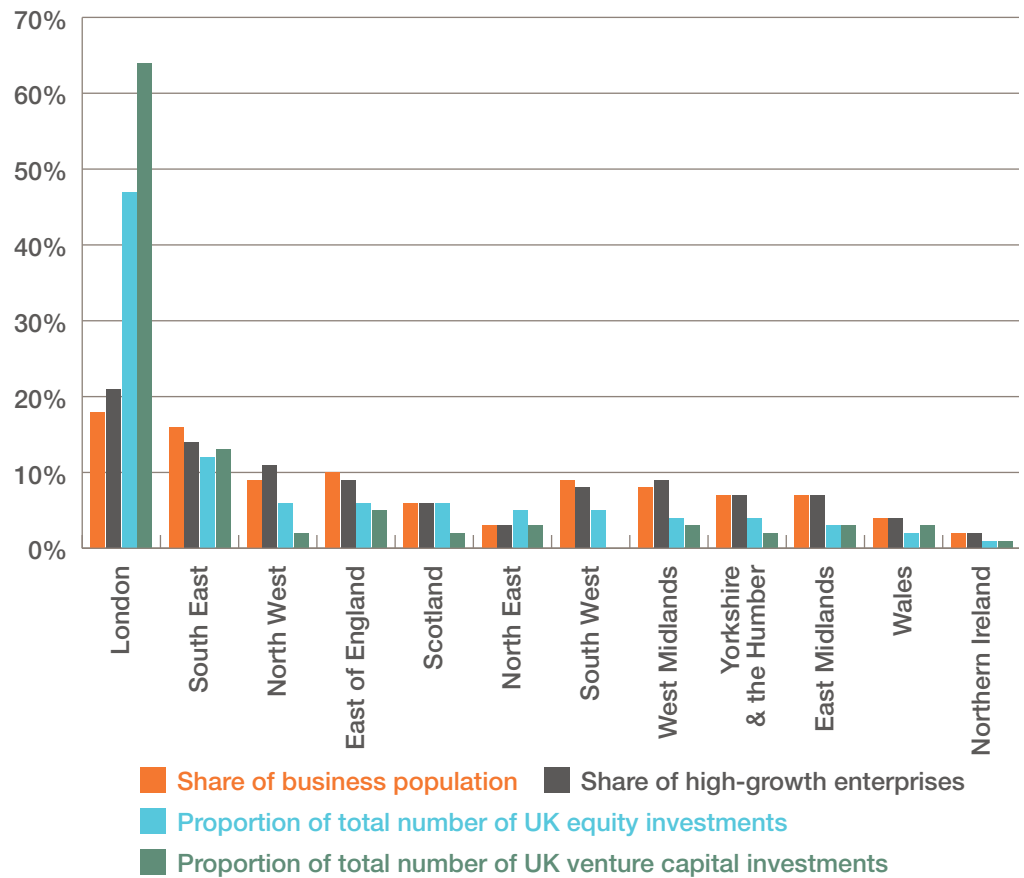
While bank lending is broadly distributed across the UK regions in line with the business population (figure 5.1), equity investment is heavily skewed to London. Using the broad definition applied by Beauhurst, 47 per cent of equity deals were conducted in London in 2015, representing 58 per cent of total investment in the capital (table 5.2).

The BVCA data – which as discussed, includes only relatively high-value venture capital investment – suggests that regional investment disparities are even starker. 64 per cent of all equity investments – excluding business angels and crowdfunding – occur in London, more than three times the share of high-growth enterprises. The comparison between the Beauhurst and BVCA data perhaps suggests that business angels and crowdfunders (absent from the BVCA data) are less concentrated in London than larger-scale private equity investors.

FIGURE 5.2

Equity investment is heavily concentrated in London, where nearly half of all investment occurs

Share of equity deals, high growth businesses and business population by region, 2015, per cent



Source: Replicated from BBB 2016c and BVCA data on request

A number of factors might explain the concentration of equity in London. In general investors prefer to invest in local businesses (see for example Cumming and Dai 2010) as information asymmetries between business and investor are amplified by distance (Mason et al 2012). There is a greater wealth in London, including the majority of venture capital firms, meaning a larger pool of potential investors.

Proximity helps VC firms and business angels to maintain close working relationships with their investee businesses. Surveys suggest that even when a significant proportion of respondents express no preference over geographical location, there is little evidence of more investments being made further afield (Mason 2007). Awareness of potential investment opportunities is positively correlated with proximity: ‘the likelihood of an investment opportunity coming to an individual’s attention increases, probably exponentially, the shorter the distance between the two parties’ (Wetzel 1983). Venture capitalists and business angels largely operate through informal networks of trusted friends and business associates, meaning they are unlikely to find out about investment opportunities in different regions without extensive searching or the existence of a systematic channel of communication between investor and entrepreneur (Mason 2007).

There are also likely to be demand-side causes of the concentration. Particular sectors cluster in different regions and London is well known for its high-tech sectors (including social media, life sciences and software). While we have shown that high-growth enterprises exist in all parts of the economy, there is a long held association between tech businesses and growth expectations. London’s reputation as the UK’s tech-hub is likely to contribute to business decisions to locate and aspire to growth.

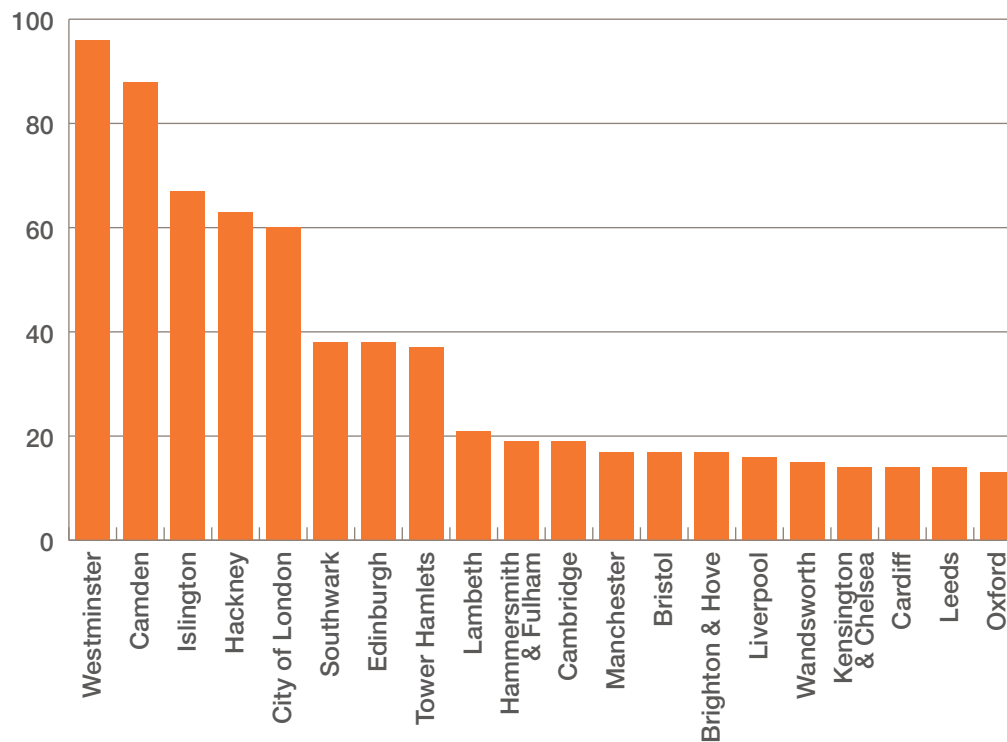
Businesses in these sectors are also likely to have very high capital requirements in the seed, start-up and early stages of growth, meaning that they face greater difficulty acquiring sufficient capital from other sources than businesses in more traditional sectors. Higher costs in London (for staff or premises, for example) are also likely to contribute to the higher demand. Business demand for equity is also likely to be higher due to the impact of network effects – businesses who have used equity successfully for growth are likely to share this information with their peers.

Nonetheless, given that only 21 per cent of high-growth businesses and just 18 per cent of the total business population, are to be found in London, there is scope to develop regional equity finance markets.

Looking at the distribution of equity deals by local authority area (figure 5.3) reveals that, although a few cities outside of London do have equity finance markets, the majority of activity takes place within inner London (BBB 2016c). Outside of London, Edinburgh had the highest number of deals at 38, followed by Cambridge (19), Manchester (17), Bristol (17) and Brighton and Hove (17).

FIGURE 5.3

The majority of equity deals take place in inner London
Number of equity deals by local authority, 2015



Source: BBB 2016c

5.4 THE REGIONAL SPREAD OF CROWDFUNDING

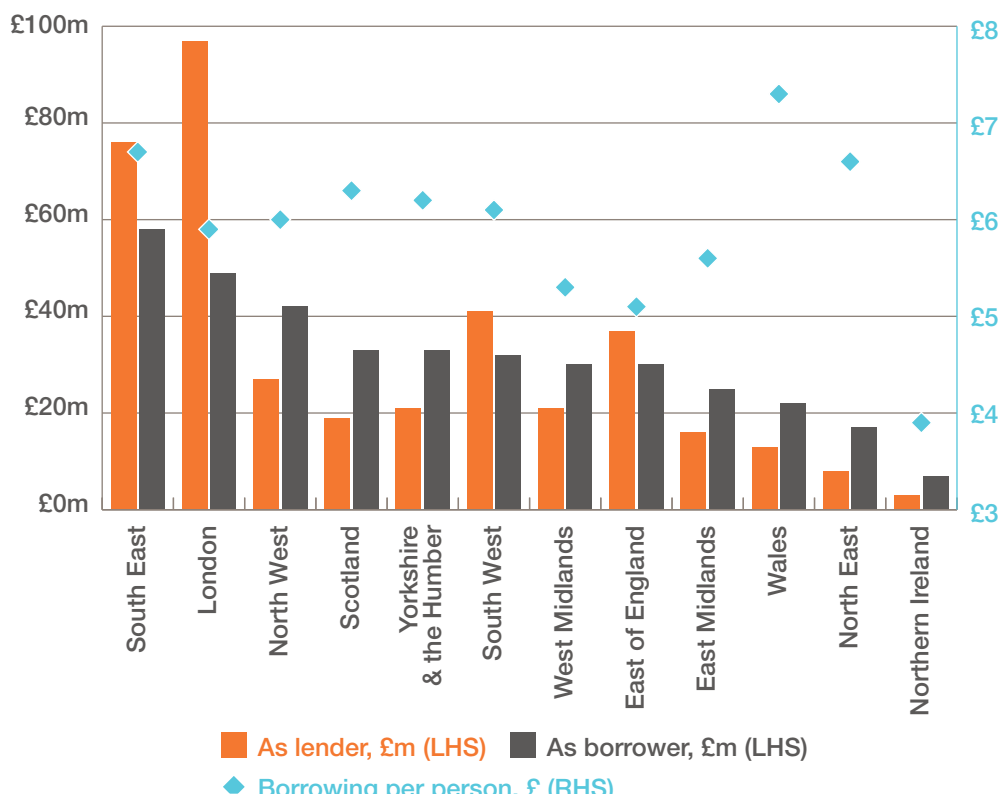
Many peer-to-peer platforms publish their loan books, meaning there is a reasonable amount of data presenting the regional location of both lenders as well as the businesses receiving the finance. Individuals and businesses in the South East and London receive the highest proportion of P2P lending, by some margin (figure 5.4). The pattern of lending is similar to other types of business finance, with Wales and the North East recording some of the lowest total loan amounts. Accounting for the variation in regional population shows, however, that businesses and individuals in these areas have among the highest levels of P2P lending per head.

Figure 5.4 demonstrates that while borrowers are reasonably well distributed across the regions, there are substantially more lenders active in London and the South East. Atz and Bholat (2016) note that the regional allocation of funds on these sites is not a deliberate decision made by lenders. In the case of RateSetter for example, investors do not know which individuals or businesses they are investing in. This suggests the platforms may offer scope for lenders on peer-to-peer sites and investors on equity-based crowdfunding platforms to lend further afield than their traditional bank and equity rivals would consider, without the need for a strong regional presence.

FIGURE 5.4

Wales and north east England, as well as the South East, have the highest levels of P2P lending per head

Peer-to-peer lending and borrowing by region/nation (£m, left-hand axis) and borrowing per person (£, right-hand axis), October 2010–May 2013



Source: Atz and Bholat 2016

Note: Lending data includes peer-to-peer lending to individuals (consumer credit) and to businesses: containing all loans intermediated by Zopa, Funding Circle and RateSetter over 32 months.

Similar to more traditional equity investment, equity-based crowdfunding is skewed towards London (businesses there receive more than 40 per cent of all investment). The British Business Bank states that the gap between London and the other regions has widened significantly since 2013 (BBB 2015a). The South West region comes in second to London, which has been attributed to the presence of Crowdcube in the region (ibid).

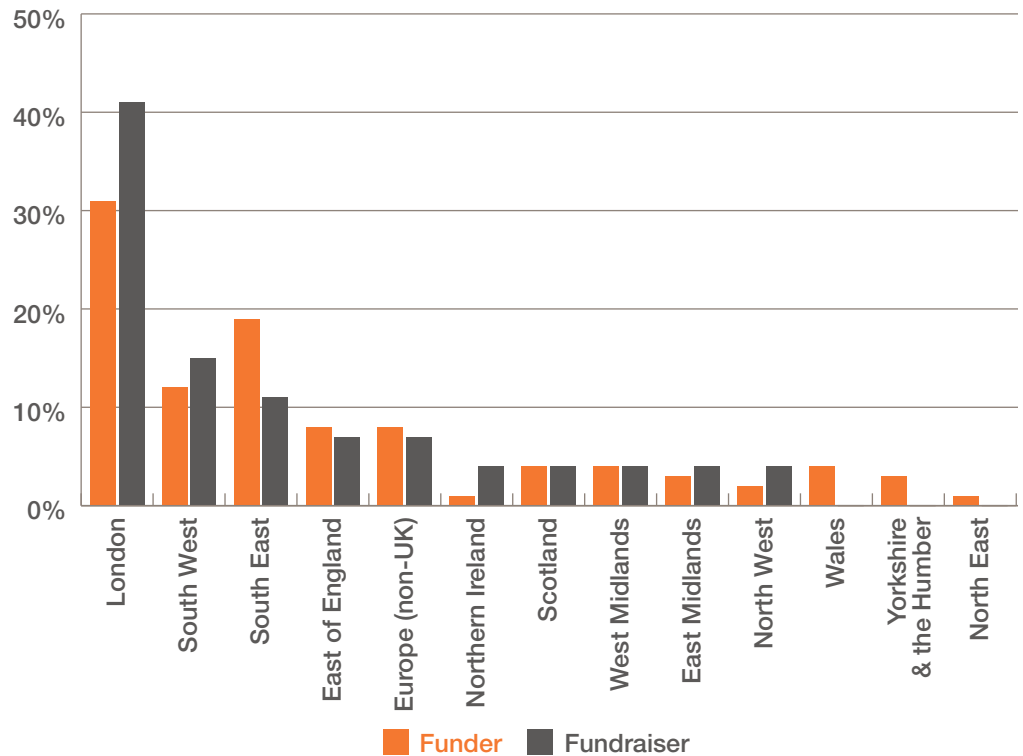
5.2. First the technology enables investors to overcome the informational barrier to awareness of investment opportunities outside of their region. Secondly the lower expectation of investor involvement in the day-to-day running of the business and the ability to spread investments across a high number of businesses easily, means that business location is a less important consideration in investor decisions. There is, however, potential for demand-side barriers such as low business awareness, to be exacerbated at a regional level.

There are two reasons why equity-based crowdfunding platforms may be able to overcome the traditional supply side barriers to equity investment relating to investors' preference for local businesses outline in section.

FIGURE 5.5

Equity-based crowdfunding is skewed towards London

Equity-based crowdfunding by funder, fundraiser and region/nation (%), 2014



Source: Baeck et al 2014

CONCLUSIONS

There are considerable regional imbalances in the spread of finance across UK regions, which is likely to have implications on business access to finance, particularly for innovative or high-growth firms, which we showed in chapter one are distributed in all sectors and regions of the economy relative to the business base. Bank lending to SMEs is quite well distributed in comparison to high-growth businesses, but the share of equity finance in London is more than twice as high as the share of high-growth businesses in London. Peer-to-peer finance is relatively well distributed across the regions, but again equity-based crowdfunding is concentrated in London.

TABLE 5.5

Summary table: finance options, advantages and disadvantages

Type of finance	Suitable for which type of business	Suitable for which type of capital	Advantages	Disadvantages
Bank lending	Large businesses SMES with no growth ambitions	Mostly working capital for day-to-day operations	<ul style="list-style-type: none"> • Low cost of capital • High business awareness • High regional representation 	<ul style="list-style-type: none"> • Start-ups and scale-ups likely to be rejected • Do not provide long-term debt finance for high growth firms
Equity investment	<ul style="list-style-type: none"> • SMEs with growth ambitions • Seed • Start-up • Early stage 	Growth capital for innovation and investment	<ul style="list-style-type: none"> • Investor involvement in operations • Higher risk appetite • More flexible • Less vulnerable to economic shocks 	<ul style="list-style-type: none"> • Lower business awareness • High cost of capital • High due diligence costs do not vary by size • Loss of autonomy • Poor regional coverage
Peer-to-peer lending	Small businesses	Mostly working capital for day-to-day operations	<ul style="list-style-type: none"> • Speed • Online access • May serve businesses that banks have turned down • Potential to overcome regional barriers 	<ul style="list-style-type: none"> • Low business awareness • In general, cannot offer sector or firm based expertise
Equity crowdfunding	Mainly seed-stage businesses, but some start-up and early stage	Growth capital	<ul style="list-style-type: none"> • Speed • Online access • Less company dilution • Potential to overcome regional barriers 	<ul style="list-style-type: none"> • Low business awareness • In general, cannot offer sector or firm based expertise

6. EFFORTS TO BOOST BANK-LENDING, EQUITY FINANCE AND CROWDFUNDING

6.1 THE GOVERNMENT'S AIMS

Successive governments, over the past 30 years, have introduced policies with the 'broad intention of creating an 'entrepreneurial society' (Arshed and Carter 2012). These have included a range of fiscal, regulatory and business support initiatives designed to support the SME sector, and have consistently emphasised the importance of access to finance. The rationale for intervention has been the size of the SME sector, in terms of both the sheer number of businesses and employment, as well as recognition of the failures in business finance markets, which are particularly acute for smaller businesses.

Following the 2007-08 financial crisis, the government recognised that the future availability of credit would be crucial to help support businesses to harness opportunities and drive forward growth in the wider economy (BIS 2012a). The government identified a number of market failures in the supply of finance to SMEs and argued that there were risks associated with a heavy reliance on bank lending. In response the coalition government introduced a number of measures designed to increase the supply of finance to SMEs, as well as to diversify the sources of that finance. Much of the literature still focused on SMEs, although there was recognition that this group was not entirely homogenous and the British Business Bank identified SMEs with growth ambitions using the terms 'start-ups' and 'scale-ups'.

In November 2016 Theresa May signalled her interest in this latter group of SMEs, stating in her speech to the Confederation of British Industry (CBI) that 'while the UK ranks third in the OECD for the number of start-ups we create, we are only 13th for the number that go on to become scale-up businesses' (May 2016). This chapter provides a summary of successive governments' main initiatives directed at improving SME access to finance since 2010.

6.2 THE BRITISH BUSINESS BANK

The British Business Bank (BBB) was established in November 2014 with the goal of changing 'the structure of finance markets for smaller businesses, so these markets work more effectively and dynamically'

(BBB 2014). The Bank has four core objectives against which it measures its performance (BBB 2016d):

1. Increasing the supply of finance to smaller businesses where markets do not work well.
2. Helping to create a more diverse finance market for smaller businesses, with greater choice of options and provider.
3. Promoting better information in the market, building confidence among SMEs in their understanding of the finance options available to them.
4. Achieving this while managing taxpayers' money effectively and within a robust risk management framework.

The BBB describes itself as a national economic development bank although it doesn't lend or invest directly in finance markets, but instead through over 80 partners such as banks, leasing companies, venture capital funds and web-based platforms. It is government-owned but independently managed and is responsible for a number of schemes which, alongside the Funding for Lending Scheme (introduced by the Bank of England) and some tax reliefs, compose the government's main efforts to boost finance for SMEs.

6.3 BANK LENDING

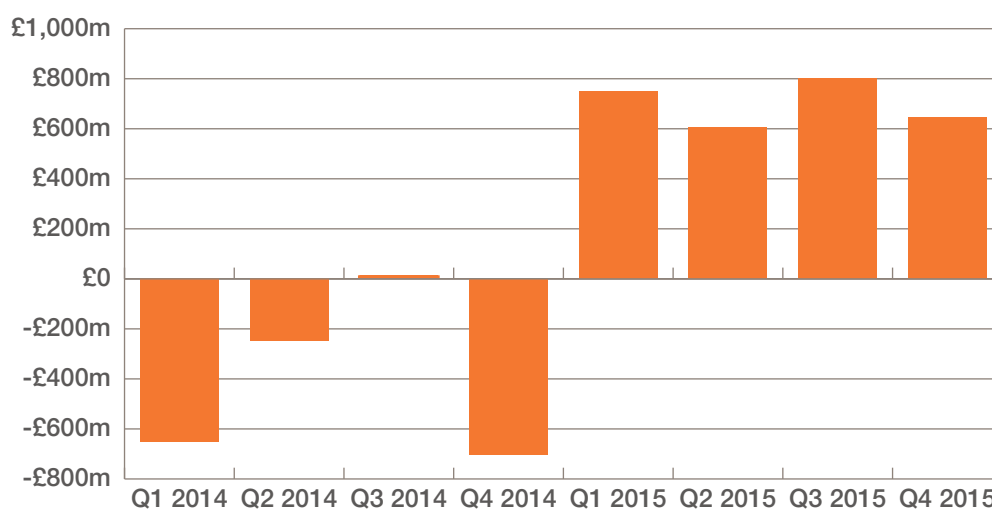
Funding for Lending Scheme

The Funding for Lending Scheme was launched by the Bank of England in July 2012 and aimed to increase the volume of business loans by allowing banks to borrow at sub-market rates (BIS 2013a). Although initially broader in scope, covering lending to households and businesses, when the scheme was extended in 2014 it was announced that it would focus on lending to SMEs only. Early critics suggested that the scheme was a failure because even in 2014, two years after its introduction, bank lending to businesses continued to contract (figure 6.1).

FIGURE 6.1

The Funding for Lending Scheme

Net lending flows to SMEs (£m) in the Funding for Lending Scheme, Q1 2014–Q4 2015



Source: BoE 2016b

Net lending to small and medium-sized firms by participants in the Funding for Lending Scheme did indeed contract in three out of four quarters of 2014 (figure 6.1), despite banks and building societies drawing down £15.6 billion in cheap loans. (Lending to large firms also contracted.) The scheme may, however, have prevented even bigger falls (BoE 2014). In 2015, when banks drew down a further £16.9 billion through the scheme, net lending to SMEs increased by £2.7 billion. In November 2015 the Bank of England announced a two-year extension to the scheme to support further improvements in credit conditions for SMEs and to allow for it to be gradually phased out, by reducing borrowing allowances over time, thereby minimising risks to economic recovery (BoE 2015).

Enterprise Finance Guarantee

The Enterprise Finance Guarantee (EFG) is a loan guarantee scheme, which was started in 2009 for small businesses unable to access conventional bank loans due to lack of collateral or track record (BIS 2013a). It is open to SMEs with an annual turnover of less than £41 million seeking loans of between £1000 and £1 million. The government provides the lender with a 75 per cent guarantee for each individual facility (term loans, overdrafts, invoice finance, trade credit).

An independent evaluation of the scheme examined the impact of the loan on the 2009 cohort of EFG users between 2009 and 2012 (BIS 2013b). In 2009 there was a total of 7,414 loan offers made by lenders, worth a total of £759 million. The authors conclude that the EFG created additional economic output and employment. After accounting for deadweight and displacement, the authors estimate that over the time period the scheme created 6,500 additional jobs. Businesses who obtained an EFG loan in 2009 generated £1.2 billion of additional GVA, representing a net benefit to the economy of £1.1 billion. The authors expect the net economic benefit to be even larger in future years as the costs of running the scheme were front loaded (with the majority of defaults occurring in the first few years) while the economic benefits continue over many years.

Business Finance Partnership

The Business Finance Partnership (BFP), launched in 2012, aims to increase the supply of capital through non-bank lending channels by co-investing to help create and support new sources of lending for SMEs (BIS 2013a). The scheme has two strands, the first of which lends to the medium-sized business market with turnover up to £500 million, using six funds. As of 2013 the £863 million of government money had been committed to the funds but only £159 million had been drawn down alongside £668 million from private sector investors (HM Treasury 2013). The second strand is aimed at small businesses with a turnover of up to £75 million and uses seven lenders including online platforms such as Funding Circle.

Start-up Loans

The Start-up Loans programme, introduced in 2012, offers small loans to individuals looking to start a business, or to develop a new business, alongside business support and mentoring (BIS 2013a). By the end of January 2016 the programme had lent over £185 million to over 30,000 people at an average value of £6,100 (BBB 2016e). Self-reported evidence

suggests that more businesses have been created than would be the case in the absence of intervention, with around one third of respondents that have started a business stating that they would not have done so without support from the programme. Econometric evidence indicated that the programme had a positive and significant effect on the start-up rate (ibid).

6.4 EQUITY FINANCE

Enterprise Investment Scheme and Seed Enterprise Investment Scheme

The Enterprise Investment Scheme (EIS), first introduced in 1994, is designed to help small, higher risk businesses to raise finance, by offering a range of tax reliefs to investors who purchase shares in those businesses (BIS 2013a). The tax reliefs include: 30 per cent relief on income tax liability, any gains free from capital gains tax and any losses offset against income tax. The scheme applies to individuals investing in businesses with less than 250 employees and assets of fewer than £15 million. Data for 2013/14 shows that 2,795 companies raised a total of £1,563 million under the EIS scheme.

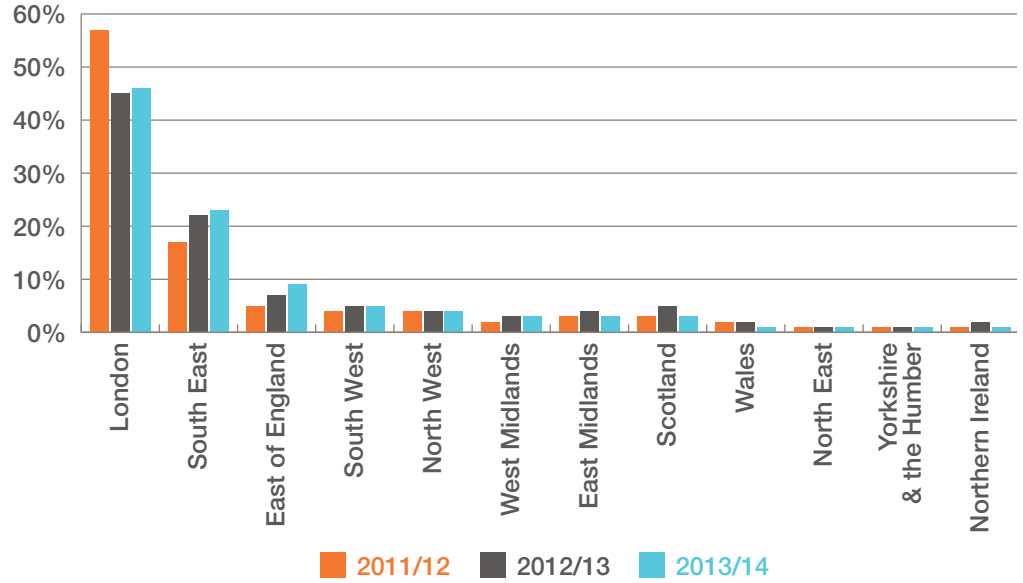
The EIS is one of the few interventions for which it is possible to analyse the impact at a regional level. Table 6.2 shows the distribution of EIS funds raised by region, demonstrating that the highest concentration of tax relief is given to businesses registered in London (46 per cent in 2013/14). This may in part reflect the fact that many businesses are head-quartered in London, even if the investment took place in a different region. Nonetheless, the scheme does nothing to rebalance - and perhaps exacerbates - the high concentration of equity investment in London.

The Seed Enterprise Investment Scheme (SEIS) is a derivative of EIS, started in 2012, which offers even greater tax relief for investors who purchase shares in businesses with fewer than 25 employees and assets of less than £200,000 (BIS 2013a). In 2013/14 £168 million was invested in 2030 businesses through the scheme (HMRC 2015). The scheme was initially intended as a temporary measure but in 2014 the chancellor announced that the scheme would be made permanent.

Early research based on interviews with agents (typically accountancy and financial services firms) and participating enterprises finds that SEIS enterprises had become more favourably inclined to equity funding via business angels and small investors as a result of SEIS (PACEC 2013). SEIS enterprises preferred equity as, unlike debt, it did not have to be repaid or serviced through interest payments. Businesses also benefitted from the advice given by investors, especially if they had experience of the sector.

FIGURE 6.2

The greatest share of EIS funds go to businesses in London
Share of EIS funds raised (%) by region, 2011–2014

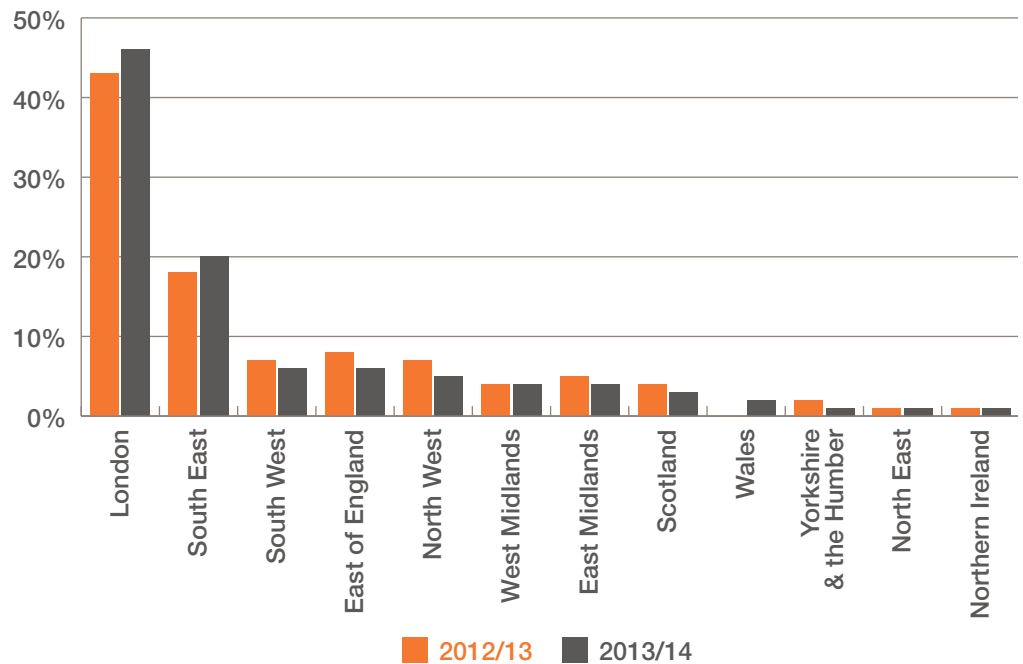


Source: HMRC 2015

Note: The regional breakdown is based on the registered address of the company, which may differ from the region in which the investment took place.

FIGURE 6.3

The greatest share of SEIS funds goes to businesses in London
Share of SEIS funds raised (%) by region, 2012/13 and 2013/14



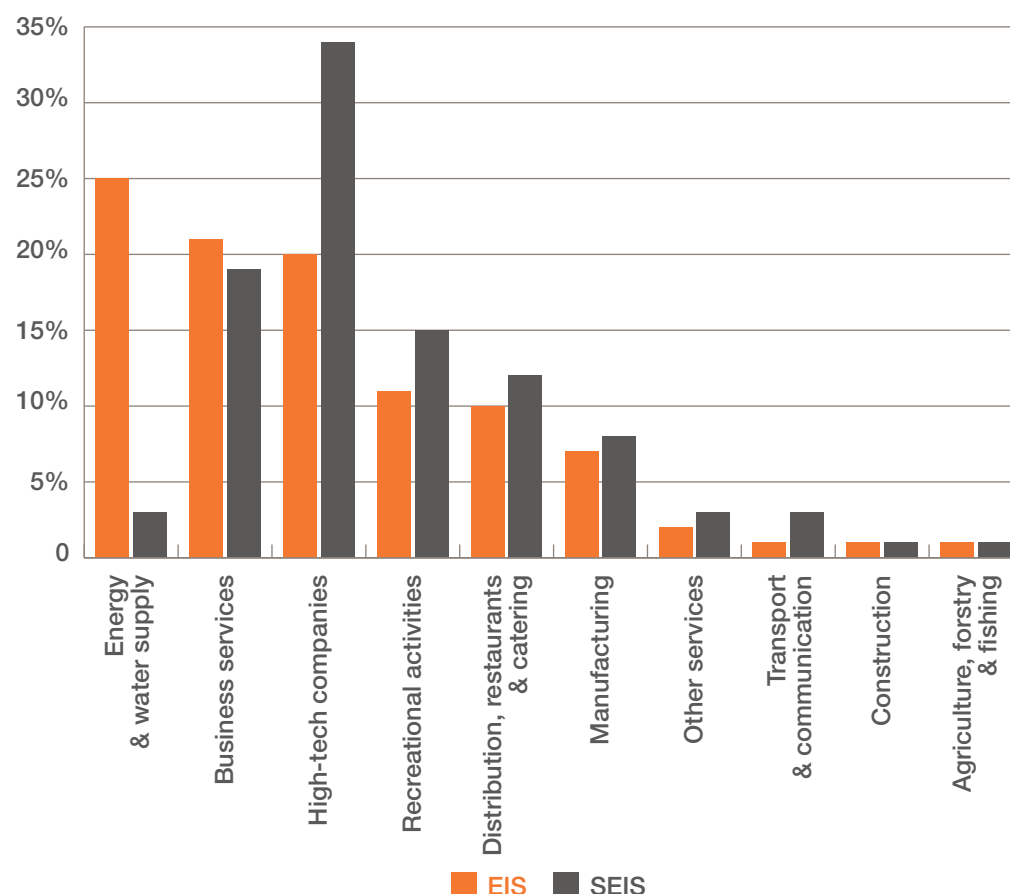
Source: HMRC 2013

Similar to the EIS scheme, the largest proportion of SEIS funding goes to businesses in London (46 per cent). The SEIS scheme is particularly likely to benefit businesses in high-tech sectors, which received 36 per cent of all SEIS funds in 2013/14 (figure 6.3). EIS funds are slightly differently shared between sectors, with the highest proportion of EIS funds going to businesses in the energy and water supply sectors and business services, followed by high-tech sectors. IPPR research has previously shown that diesel generators, the dirtiest form of energy generation available, were eligible for finance through the EIS tax relief until the 2015 Autumn Statement removed the option (Aldridge 2015). This accounts for the high share of EIS finance going to the energy and water sector.

FIGURE 6.4

SEIS funds are concentrated in high-tech companies, but the majority of EIS funds go to the energy and water supply sector

Share of EIS and SEIS funds raised (%) by sector, 2013/14



Source: HMRC 2015

Notes: High-tech companies includes selected companies from other industry groups involved in activities such as research and development, chemicals and computer consultancy.

Indeed, the total amount of tax expenditure on EIS firms, via income tax and capital gains tax relief has fallen in the year from 2014/15 by £115 million (table 6.1). Nonetheless the EIS and SEIS are a big cost to the exchequer in comparison to other government finance schemes: in 2015/16 the combined tax relief amounted to £565 million.

TABLE 6.1**Tax expenditures on the EIS and SEIS (£m), 2012/13–2015/16**

	2012/13	2013/14	2014/15	2015/16
Income tax				
Enterprise Investment Scheme	£315m	£445m	£475m	£395m
Seed Enterprise Investment Scheme	£40m	£80m	£85m	£80m
Capital gains tax				
Enterprise Investment Scheme	£65m	£110m	£120m	£85m
Seed Enterprise Investment Scheme	£10m	£5m	£5m	£5m
Total	£430m	£640m	£685m	£565m

Source: HMRC 2016

Both schemes are likely to fund some deadweight – that is financing companies which would have met their investment requirements without the schemes. Colahan et al (2016) find 11 per cent of EIS firms¹² felt that their proposed investment would definitely have gone ahead without the schemes and the proportion increased alongside company size: the smaller the firm the more likely it was that the scheme enabled them to secure investment they would not otherwise have received.

Venture Capital Trust Scheme

The Venture Capital Trust (VCT) scheme encourages individuals, via tax reliefs, to invest in small, unlisted companies indirectly through the acquisition of shares in a trust approved by HMRC (BIS 2013a). Investments can be made in businesses with up to 250 employees and gross assets of up to £15 million (BBB 2015a). VCTs offer similar tax reliefs to the EIS and SEIS schemes but apply to individuals investing indirectly in eligible companies which are more likely to be at the medium end of the SME spectrum (Colahan et al 2016).

Business Angel Co-Investment Fund

The Business Angel Co-Investment Fund (also known as Angel Co-Fund) aims to support business angel investments into early stage SMEs with high-growth potential (BIS 2013a). The co-fund is able to make initial equity investments of between £100,000 and £1 million in to SMEs alongside syndicates of business angels, with final investment decisions being determined by the independent investment committee of the co-fund.

In an early evaluation undertaken by the BBB in 2014 the Angel Co-Investment Fund was found to be ‘providing finance to young, innovative businesses expecting rapid growth, and was enabling firms to progress with their plans quicker or on a larger scale’ (BEIS Committee 2016). The fund had supported 57 smaller businesses with £113 million between opening in 2011 and the end of September 2015 (ibid).

12 Random-probability telephone surveys were undertaken from 5 August to 5 September 2014 with 628 investee companies and 546 investors, covering both EIS and VCT schemes.

Enterprise Capital Fund Programme

The Enterprise Capital Fund (ECF) programme attempts to bridge the gap in the equity funding escalator caused by the relatively high costs of due diligence in relation to equity deal size (BIS 2013a). The programme uses government funding alongside private sector investment to create funds which can invest up to £2 million in an SME.

The ECF programme has facilitated over £227 million investments in 167 smaller businesses between 2011 and 2015. BBB analysis shows that ECF recipients saw turnover increase by 170 per cent post investment, with employment almost doubling. Businesses were highly innovative and export focused, while 92 per cent stated that involving fund managers had improved their management processes (ibid).

UK Innovation Investment Fund

The UK Innovation Investment Fund (UKIIF), established in 2009, is a venture capital fund of funds that aims to drive economic growth and create highly skilled jobs by investing in innovative businesses where there are significant growth opportunities (BIS 2013a). The underlying funds invest in technology based businesses in strategically important sectors to the UK including digital technologies, life sciences, clean technology and advanced manufacturing. In 2012-2013 the scheme helped 111 SMEs but only 44 of these were based in the UK (NAO 2013). There is very little data available on the take-up of these funds and the government has stated that a full evaluation of the fund will only be possible 'as the fund closes' which could be in 10 to 12 years (Tyler and Rhodes 2014). An early assessment of the fund in 2012 showed £150 million of government money had been invested alongside £180 million from private investors (BIS 2012b).

Midlands Engine Investment Fund and Northern Powerhouse Investment Fund

In his final budget in March 2016, George Osborne announces two new funds designed to increase investment in the Northern Powerhouse, and Midlands Engine regions. The two funds, to be launched in 2017, will bring together legacy funding from existing programmes, new funding from the British Business Bank and new European funding to be managed by the British Business Bank in partnership with Local Enterprise Partnerships in the respective regions.

6.5 CROWDFUNDING

Business Finance Partnership: Small Business Tranche

The second strand of the Business Finance Partnership aims to invest through non-traditional lending channels that lend directly to small businesses. These channels include mezzanine finance funds, supply chain finance schemes and peer-to-peer lenders.

Bank Referral Scheme

The bank referral scheme, which launched on 1 November 2016, requires businesses to refer unsuccessful applicants to one of three finance platforms including Funding Options, which help businesses to find an alternative source of finance, such as a peer-to-peer loan.

Credit Reference Agencies

Designated banks are required to share information about their SME customers with alternative finance providers through designated Credit Reference Agencies to help them make informed decisions about small business finance applications

Government support for crowdfunding platforms

British Business Bank Investments Ltd, the trading arm of the British Business Bank, invests money to UK small businesses through the peer-to-peer lending platform Funding Circle, announcing a further £40 million of investment in January 2017 (source). Many local authorities also have partnerships with Funding Circle allowing them to invest council funds into local businesses via the platform.

6.6 AWARENESS OF FINANCE INITIATIVES

Despite the government's efforts there is evidence that many SMEs are not aware of many of these initiatives. Table 6.2 reports the proportion of SMEs that were aware, when prompted, of various funding initiatives discussed above (BDRC Continental 2016).

TABLE 6.2.

Only 9 per cent of all SMEs were aware of the British Business Bank when prompted

Prompted awareness of specific funding initiatives, Q2 2016, by business size

	Total	0	1-9	10-49	50-249
Unweighted base	4,500	900	1,450	1,450	70
Start-up Loans	40%	39%	42%	43%	42%
Funding for Lending	26%	24%	32%	35%	35%
Enterprise Finance Guarantee Scheme	18%	17%	20%	23%	25%
British Business Bank	9%	8%	13%	15%	23%
Any of these	52%	50%	58%	60%	65%
None of these	48%	50%	42%	40%	35%

Source: BDRC Continental 2016

Of the entire sample, just nine per cent of SMEs were aware of the BBB, rising to 23 per cent of medium-sized businesses. More promisingly, 40 per cent of SMEs are aware of the Start-up Loans initiative – but far fewer had heard of the Funding for Lending or Enterprise Finance Guarantee suggesting that there is considerable space for more efforts to raise business awareness.

6.7 EUROPEAN FINANCE

The European Investment Fund (EIF) has been an important investor in British private equity and venture capital. Established in 1994 and headquartered in Luxembourg the EIF was tasked with providing finance to SMEs in Europe. It is majority owned by the European Investment Bank, which in turn is owned by the member states of the European Union. Between 2011 and 2015 the EIF committed 2.3 billion euros to

144 UK based venture capital firms and 27,700 SMEs, representing 37 per cent of all VC funding in the UK during those years (EIF 2016).

The outcome of the UK referendum on its membership of the European Union in June 2016 puts this funding at risk. In June 2016 the EIF confirmed 'it won't [at present] change its approach to operations in the UK' (Shubber 2016). However, there is concern among venture capitalists that when we exit the EU the UK will no longer receive EIF funding, at least in such large amounts. Beyond its substantial investments, the EIF has been important to the sector as it has often acted as the cornerstone of funds, providing not only finance, but government-backed credibility.

6.8 THE 2016 AUTUMN STATEMENT

The chancellor, Philip Hammond made a number of announcements which pertain to business finance in the 2016 autumn statement (Hammond 2016). These were:

- launching a Patient Capital Review
- investing an additional £400 million into Venture Capital Funds to help unlock £1 billion of new investment for innovative firms planning to scale up
- £500,000 a year for FinTech specialists
- state of FinTech report on key metrics for investors
- launch a network of regional FinTech envoys.

The details of these policy proposals are still to come, but are a promising indication that the chancellor will focus on alternatives to traditional bank lending, including equity finance and crowdfunding, although the network of regional FinTech envoys is the only nod to making sure these policies are not solely to the benefit of London and the South East.

CONCLUSIONS

There have been considerable efforts to increase and diversify the supply and demand of finance to SMEs since 2010. It's difficult to gauge the effectiveness of all of these measures, but we have provided tentative evidence that many of the BBB's efforts have increased the amount of finance going to small, and sometimes innovative or high-growth businesses. Many initiatives however are not backed by particularly large sums of money, and have often only helped a relatively small number of firms often concentrated in certain sectors and regions of the economy.

While the British Business Bank, and more recently Theresa May, have recognised that SMEs are not a homogenous group, very few initiatives are specifically tailored to the small proportion of SMEs that are thought to deliver the majority of productivity, employment and growth gains: high-growth enterprises. Even fewer policies explicitly attempt to address the regional provision of finance to these businesses although the BBB is attempting to address 'the structurally-driven regional disparities in access to finance in the immediate term by executing the Northern Powerhouse Investment Fund and Midlands Investment Fund subject to confirmation of EU funding commitments' (BBB 2016d).

Often the implicit assumption of SME finance policy has been to assume that where targeted policies are required, they should be aimed at ‘high-tech’ sectors, which are popularly associated with high innovation and growth. This is typical of spatially blind policies that ‘build on success’. Our research shows that high-growth firms are found in all sectors, and well-represented across the country, meaning that this represents a gap in the policy landscape.

7. CONCLUSIONS AND RECOMMENDATIONS

As providers of jobs and drivers of economic growth, the UK's businesses are critical to addressing many of the underlying weaknesses of our economy. Productivity has stalled; incomes are stagnating and the UK has a high degree of regional inequality (Jacobs et al 2016). Access to finance is vital in enabling businesses across the country to reach their full potential.

Not all businesses need policymakers' attention however: SMEs account for 99.9 per cent of the business population, but they are not all drivers of innovation or productivity growth. In fact, just five per cent of SMEs with more than 10 employees achieved high growth over the three-year period to 2013. The good news, in terms of regional inequality, is that these businesses are well distributed between the UK's sectors and regions, and not concentrated in the tech sectors of London, as is often imagined.

Different types of finance are suitable for different types of business and present different advantages and disadvantages for both businesses and the economy. Bank lending is usually the most suitable finance option for larger businesses, or those SMEs with a long track record and no growth ambitions. Equity finance is usually more appropriate for SMEs with growth ambitions and offers a range of benefits to these businesses including the likelihood that an investor will offer sector specific business advice as part of their role. New forms of finance, such as crowdfunding, are disrupting the market particularly for small and seed-stage businesses.

Over the past decade, the government has made considerable efforts to increase and diversify the supply of finance to SMEs, as a result of perceived market failures in SME finance markets. Several initiatives have attempted to kick-start the UK equity market, however, many of these policies are spatially blind, or focus on tech activity which tends to be over-represented in London. In fact, while high-growth firms are well represented across the UK, the supply of equity finance (both traditional and equity-based crowdfunding) is highly concentrated in London.

In her first seven months as prime minister Theresa May has expressed her desire to reduce regional economic disparities, as well as to increase finance for SMEs with growth ambitions. As this report shows these two issues intersect: there are structural barriers to the supply of SME finance in the regions and demand for finance in the regions is also likely to be weaker than in London. We recommend that the following measures are taken to help increase and diversify the regional supply and demand for finance.

REGIONAL ECONOMIC GROWTH POLICY REVIEW

The current local economic policy landscape, including Local Economic Partnerships, Growth Hubs, the British Business Bank, Chambers of Commerce and other private providers, is complex, and has seen several changes and public spending cuts in the last decade. The development of new and existing regional institutions to support local economic growth, as part of the government's new approach to industrial strategy, should incorporate access to finance initiatives that would support firms with high-growth potential outside of London and the South East.

Recommendation one: The government should review regional economic growth policy and consider creating and strengthening regional institutions to create networks that can support the diversification of finance outside of London and the South East.

A MORE EXPLICIT REGIONAL OBJECTIVE FOR THE BRITISH BUSINESS BANK

The BBB has played an effective role in both supporting private lenders and investors to increase the supply of finance, as well as supporting demand for alternative finance among businesses. The institution is well placed to support the government in its aims to create Northern Powerhouse and Midlands Engine Investment Funds and furthermore should consider place-based outcomes as part of its strategic objectives. While it is well distributed in line with the business population, as equity finance is so concentrated in London, there is a case for greater intervention outside of London. Currently there is very little evidence of the regional impact of many of the government's finance schemes.

Recommendation 2: An additional objective should be added to the BBB's remit which formalises its desire to increase and diversify finance outside of London and the South East.

Recommendation 3: The British Business Bank should review the current suite of SME finance initiatives and attempt to assess the extent to which they unwittingly reinforce concentration of high-growth business finance in London and the South East, and ensure that future evaluations consider regional outcomes.

EVALUATION OF THE ENTERPRISE INVESTMENT SCHEME AND SEED ENTERPRISE INVESTMENT SCHEME

The EIS and SEIS cost the government £565 million in 2015/16 in income tax and capital gains tax relief, furthermore at least a tenth of this amount is likely to represent deadweight (finance for businesses which would almost certainly have received sufficient funds in the absence of the scheme). The reliefs overwhelmingly benefit businesses in London, which account for just 18 per cent of the business population and 21 per cent of the UK's high-growth enterprises, yet received 46 per cent of all EIS and SEIS funds in 2013/14. These two details are related: the deadweight cost of the policies in their current form are likely to be higher because

they don't take account of the relative attraction of different parts of the country to potential investors.

Recommendation 4: HM Treasury should review the Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS) to determine the value of the policies and the extent to which they merely reinforce regional economic disparities. If the evidence suggests the policies have a high deadweight cost, HM Treasury should consider adjusting or even cancelling the two schemes.

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