EQUITABLE EQUITY

Increasing and diversifying finance for high-growth SMEs in the UK's regions

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60-SECOND SUMMARY

As providers of jobs, and drivers of economic growth, innovation and productivity, high-growth businesses 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.
- 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.

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.*

For the full report, including all references, data sources and notes on methodology, see:
http://www.ippr.org/publications/equitable-equity

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