UK Government action to support SME access to finance
How businesses finance themselves

Money Invested

£10m

£5m

£1m

£250,000

Start-up

Early Stage

Growth

Maturity

Trade sale or flotation to raise funds on public markets (AIM/PLUS)

High growth firms continue to need equity from Private Equity funds. Others making sufficient profits turn to banks for debt funding for investment; most will use banks for working capital such as overdrafts.

Many firms still need equity, from venture capital funds or mezzanine finance; begin to see some bank debt coming in to leverage equity for those firms making sufficient profit.

Equity from Business Angels and early-stage venture capital funds.

Seed finance – ‘friends, fools, family’, grants, credit cards, personal loan/mortgage, or private investment (business angels).
Four longstanding access to finance challenges:

- 'Investment readiness' (SME understanding of and access to various financing options)
- The 'equity gap' (risk capital for innovative, high growth potential SMEs) £250k - £2m and beyond. Credit crunch /recession: this gap is increasing.
- Growth capital (for established SMEs seeking £2-10m to invest for growth)
- Bank lending to viable firms who lack collateral or financial track record

• Two current issues:
- Continuing adjustment to banks' risk models post-credit crunch.
- Risk that for 2 – 5 years, bank lending to SMEs will be constrained due to impact of banking regulations on availability and price of finance
Debt / bank lending:

- issues
- government interventions
Situation post credit crunch

- Concern is that banks have shifted too far in reaction to the credit crunch, possibly delaying recovery. Further risks:
  - **Regulatory changes**: banks could react to new regulations on capital and liquidity by restricting lending which is capital intensive and increasing price.
  - **Possible disproportionate effects**: size of firms – SMEs more affected as banks restrict lending; sectors – all firms in risky sectors find it difficult to get finance.

20% of SMEs seeking finance are unsuccessful.
Lending to SMEs has been decreasing since 2009

- The amount of new term lending continues to decline
- Demand remains historically low; there has been little change in approval rates
- Repayments are still at historically high levels

Fig 1. New Term Lending (£m) to Small Businesses
Indicative median interest rates on new SME variable-rate facilities

- Overall increase in spreads of 1-2% [reflects higher costs of funding for the banks?]
- Sharper increase for riskier businesses where the 10% most risky are seeing a sharp increase
- Increase in price since 2009 but still lower than 2007

Sources: BIS and Bank calculations.
• An agreement between the UK Government and major high-street banks to make £76bn of credit available to SMEs in 2011 (a 15% increase on 2010)

• UK banks made additional commitments on:
  - customer complaints
  - mentoring customers
  - improving information and understanding
  - improving customer relations

• The UK’s largest banks are also funding a £2.5bn Business Growth Fund: offering £2 - 10m to established companies with strong growth potential, in return for an equity stake
Enterprise Finance Guarantee

- Target = viable businesses who lack collateral or a track record.

- UK Government provides banks with guarantee for 75% of the loan.

- UK Government charges borrowers a premium which partially covers the cost of the guarantee.

- Since January 2009, almost 13,000 SMEs have drawn loans totalling £1.27bn

- Employment in Enterprise Finance Guarantee recipient firms is 38% higher than in other firms = 5.7 jobs saved/created per firm.

- Enterprise Finance Guarantee scheme for exporters, designed to be self-financing, has just been launched.
Equity finance:

- issues
- government interventions
Tax incentives

- **Enterprise Investment Scheme**: incentivises individuals to make **direct** investments in SMEs (£692m 2007).

- **Venture Capital Trust**: benefits those who provide **indirect** finance for high-risk firms through a managed VCT fund. (£340m, 2009/10)

Venture Capital Funds

- **Enterprise Capital Funds** programme (£156m already invested, and providing up to £300m of investment over next 4 years).

- **UK Innovation Investment Fund** of funds (£325m)

Business angels

- Tax incentives plus

- £50m co-investment fund
Enterprise Capital Funds

- Invests in promising fund management teams

- Incentivises private investors by offering leverage:
  - UK Government provides up to 2/3 of capital for each fund
  - UK Government takes prioritised return of 4.5% (Government takes least risk)
  - Private investors take majority of profit share (Government takes least return)

- Investments of up to £2m in each firm (can go higher if necessary to avoid dilution, up to 10% of fund size)

- 10 funds since 2006 (£275m), more in pipeline

- Rolling programme: portfolio of different vintages

- Designed to be cost neutral over the medium term

- Decisions are commercial / arms length from UK Government
UK Innovation Investment Fund

- Designed to provide equity investment for high-growth, high-tech businesses.
- Operates on a fund of funds principle.
- The UK Government has committed £150m, with the aim of attracting further investment from the private sector.
- Hermes Environmental Innovation Fund – Hermes is investing £75m alongside £50m from UK Government. **Total: £125m**
- EIF UK Future Technologies Fund – EIF investing up to £100m alongside £100m from UK Government. **Total: £200m**
- Govt is investing on an equal basis – sharing the risks & returns with private investors. Govt will have no role in fund managers’ investment decisions.
- It has the flexibility to make investments larger than £2m.
SME finance skills:

- issues
- government interventions
• Both equity and debt investors have noted that a number of businesses have strong deficiencies in management, finance and marketing skills.

• 35% of SMEs do not use external advice when seeking finance.

• Accountants are the most commonly used external source, used by 31% of SMEs, followed by bank managers (11%) and friends/business associates (9%).

• Just 25% of SMEs have a formally qualified financial manager, though this increases with the size of the business - 66% of medium-sized businesses have such a resource.
• Bank initiatives and mentoring

• Website Advice

• Coaching of SMEs with high-growth potential
Challenges and actions:

'Investment readiness': mentoring, web advice, accountants, media, coaching

The 'equity gap': business angels, tax incentives, government investment in funds

Growth capital: banks' Business Growth Fund

Bank lending: Enterprise Finance Guarantee, bank commitments, competition, monitoring and scrutiny
Summary

- Long standing issues: marginal bank lending, finance skills, equity gap.
- All exacerbated by financial crisis and recession. Over-correction of property and debt bubble. Bank and SME adjustment to new world.
- Long term: demonstrating to global investors the venture capital opportunities in Europe.
- No ‘silver bullet’: variety of actions by government, financial institutions and SMEs and their representatives and advisers.