GOING FOR GROWTH

HELPING SMALL FIRMS FLOURISH THROUGH ACCESS TO FINANCE

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WHO WE ARE

The Federation of Small Businesses (FSB) is the UK's leading business organisation. Established over 40 years ago to help our members succeed in business, we are a non-profit making and non-party political organisation that's led by our members, for our members. Our mission is to help smaller businesses achieve their ambitions. As experts in business, we offer our members a wide range of vital business services, including legal advice, financial expertise, access to finance, support, and a powerful voice in government.

FSB is the UK's leading business campaigner, focused on delivering change which supports smaller businesses to grow and succeed. Our lobbying arm starts with the work of our team in Westminster, which focuses on UK and English policy issues. Further to this, our expert teams in Glasgow, Cardiff and Belfast work with governments, elected members and decision-makers in Scotland, Wales and Northern Ireland.

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FOREWORD

Many small businesses want to grow. Although many do not grow at a rate that would categorise them as a 'scale-up' (as defined by the OECD), those businesses that display, or aspire to, moderate growth remain hugely important to the UK economy and should not be underestimated.

Following the 2008 financial crisis, there has been a material reduction in the proportion of smaller businesses seeking external finance. Trust, once lost, is hard to win back. The latest data from the British Business Bank (BBB) suggests that 70% of smaller businesses would rather accept slower growth than seek to maintain or increase growth by attempting to access external finance. So, much more needs to be done to rebuild trust and tackle both latent as well as discouraged demand.

Smaller businesses that do wish to access external finance face a number of challenges. Security requirements, based on the probability of default, can rule out many younger businesses from accessing traditional debt finance. The Enterprise Funding Guarantee is an important intervention aimed at tackling this issue. However, there are wider systemic factors in relation to both the supply and demand of external finance – including growth finance – that need to be addressed.

Positively, there has been an overall uptick in the proportion of smaller businesses seeking external finance, from a low point in 2014. However, levels remain below those seen before the financial crisis. Some progress has been made through initiatives such as The Treasury and BBB's Bank Referral Scheme, the Business Finance Guide, as well as expansions in the coverage of the Enterprise Finance Guarantee and ENABLE. We also welcome the announcement of a Government Review of the challenges women face when starting and growing their enterprises. This must have a strong focus on access to external finance.

However, much more needs to be done, particularly because FSB evidence suggests that smaller businesses seeking funding to grow are likely to be exploring different forms of finance, other than just traditional debt finance. Now is the time for action to support smaller businesses so they can continue to be the engine of the UK economy post-Brexit.

Peter Cowley
Associate FSB member and Angel Investor

EXECUTIVE SUMMARY

A lot of smaller firms rely on external finance to help them to grow.

The financial crisis of 2008 created a very different climate for smaller businesses seeking to borrow. Today, the process of searching for suitable finance has become more complex and varied. There is evidence that the poor conditions for lending at a macro-economic level are being exacerbated at a local level in some parts of the country by bank branch closures.[1]

Many smaller businesses believe credit is relatively scarce. According to FSB's most recent Small Business Index (SBI) data, 42 per cent of small business owners say credit availability is very poor (19%) or quite poor (23%). Just 24 per cent feel credit is readily available. These numbers improved between 2012 and 2016, but have weakened in the past two years.

Traditional bank lending (debt finance) has become less accessible to small firms – particularly those seeking early stage funding – with banks less likely to take on riskier propositions. However, alternatives are available for those that know where to look. For example, challenger banks have started to step into the space vacated by more established institutions. And new options, such as crowdfunding, have also provided a solution for some small businesses seeking external finance. In fact, there are a variety of alternative finance options available, such as equity finance (including angel and venture capital finance) and peer-to-peer finance. However, despite increasing awareness among smaller firms, these alternatives still exist on the margins of small business finance markets.

The reality is that most small firms fail to look beyond traditional banks (usually the bank they use in a personal capacity) when attempting to secure a loan. Large banks remain the dominant force in small business finance markets.

In the last ten years, the supply of external finance has improved, although many small business owners would argue that this does not reflect their personal experience. The perception that credit is not available may, in itself, dampen demand. According to FSB's SBI data, only 13 per cent of small businesses say they have applied for new credit in the past quarter. However, of those that did, 58 per cent have had their credit application approved, and a further 12 per cent say they are awaiting a decision.

So more needs to be done to ensure there is continued improvement in the supply of finance, but also in the signposting of appropriate types of finance for different business purposes. If we are to solve the UK's productivity puzzle, businesses need to be encouraged to take risks and to invest to grow. External finance plays an important role in facilitating this.

1 Move your Money; Abandoned Communities: the crisis of UK bank branch closures and their impact on local communities; July 2016, available at: https://gallery.mailchimp.com/c9b157c9d89ca0bdb156c5128/files/Abandoned_Communities_V2.1.pdf#page=4

RECOMMENDATIONS

1. **The UK Government must ensure the success of open banking, which will be a critical tool for empowering small businesses seeking external finance and other services.**

   Open banking has the potential to improve the flow of information in finance markets and facilitate innovative new products and services. Funding platforms have already started setting the foundations for effective matchmaking systems, linking those seeking to invest with those seeking to borrow. There are, however, still competing ideas about what technology will be necessary to enable the full benefits of open banking while keeping data safe. While this is for the industry to work out, possible unintended impacts on customers must be constantly anticipated and assessed. It is important that industry works closely with smaller businesses and their representatives on the design and implementation of technologies seeking to harness open banking.

   On the demand side, the UK Government, in partnership with banks, should launch a targeted communications strategy, utilising the latest thinking from behavioural economics to communicate the benefits of open banking to small business owners. This strategy must address specific concerns related to the sharing of sensitive personal data. The ability for challenger banks and alternative finance providers to effectively engage with potential customers depends on the willingness of customers to allow banks to share their personal data. It is key that engagement with smaller businesses happens at the right time, and by the right people. Communication that makes the benefits of open banking clear will encourage business owners to share sensitive personal data in a secure way.

   On the supply side, it is important to develop a healthy provider market and prevent domination by a small group of firms. Therefore, the data that prospective clients need to provide should be proportionate. Excessive data sharing requirements (e.g. many years of bank account statements) might benefit larger firms with more advanced forms of AI and Machine learning that are capable of digesting this data, at the expense of smaller providers that may not have access to such advanced technology but want to harness the power of open banking. Limiting the amount of mandatory data sharing should also help to increase the trust of clients in this new and evolving market.

   It is also important that the solutions developed by the winners of the NESTA challenge prize for open banking are incorporated into the evolution of open banking policy.

2. **The UK Government should encourage banks to refer a greater proportion of their unsuccessful loan applicants to alternative finance providers. They should explore the benefits of a *de minimis* target for referrals to alternative finance platforms.**

   In the short-term, the Government's Bank Referral Scheme must be as effective as possible. Progress has been made over the past year, but there is still a dramatic drop-out rate, with too few referred businesses going on to be successful in their applications. Currently, just over 50 per cent[2] of those referred make contact with one of the Government-designated finance platforms and, of those that do, the quarterly conversion rate is just over 10 per cent.[3]

   As part of its current review of the referral scheme, the Treasury should consider:

   - Requiring banks to publish additional data regarding referrals, such as the purpose for which external finance is being sought.
   - Setting banks indicative targets for the proportion of rejected applicants they successfully refer to alternative providers, either through their own dedicated schemes or via the Government's Bank Referral Scheme.
   - Developing a better understanding of the customer journey of individuals who agree to be referred via the referral scheme, including the administrative and data sharing burdens that come with this, and the reasons why clients drop out of the system after they have agreed to be referred via the platforms.

2 HM Treasury, Bank Referral Scheme: Official Statistics, 31 August 2018, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/737136/Bank_Referral_Scheme_Official_Statistics_Publication_-_August_2018.pdf

3 2827 referrals in Q2 2018 compared to 1453 contacts.

3. **The British Business Bank (BBB) should play a key role in improving the quality and reach of equity finance – including angel finance – in UK regions outside of London and the Southeast.**

   The strong focus on the supply of equity finance outside of London, through both the Northern Powerhouse Investment Fund and the Midlands Engine Investment Fund, is welcome. BBB regional advisors should utilise cluster theory to support the development of angel clusters across the UK, working closely with wider private sector institutions and LEPs in England (and their equivalents in Scotland, Wales and Northern Ireland).

   The skills base of investors could also be further developed through a programme of knowledge sharing between well-established angel networks and areas that otherwise lack a strong angel pool. The BBB's recently launched 'request for proposals' (seeking new ideas from the market on how, for example, to innovate and develop angel clusters) is a welcome step forward and needs to be built upon. The Angel Co Fund model could also be expanded.

4. **The UK Government must not lose sight of the objective of making investor tax reliefs, like the Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS), more effective after Brexit, particularly for innovative businesses.**

   The experiences of FSB members underscores the importance of SEIS and EIS for equity investors. Many small firms find the current system too administratively arduous and slow. For relatively small initial investments (e.g. such as those that may be needed for knowledge intensive firms at the very start of their life cycles) it is possible that the complexity of the relief schemes presents a barrier.

   The UK Government should expedite efforts to digitise the advance assurance process in order to make both EIS and SEIS more attractive for investors and easier for businesses to use.

5. **After Brexit, the UK Government must ensure there is no diminution in the amount of funding provided for small business access to finance purposes, compared to what is currently provided, for example through the European Investment Fund (EIF) and European Regional Development Fund (ERDF).**

   Brexit means that EU funding – at least in its present format – will soon come to an end. This will have significant implications for smaller businesses, particularly in relation to their ability to access finance. Post-Brexit, the way that access to finance funding is distributed throughout the UK will also change, potentially via the Shared Prosperity Fund and potentially with a greater role for the BBB as a key managing agent or fund of funds manager.

   By managing and consolidating a number of funding sources, the BBB has already demonstrated success in leveraging funding for access to finance at a pan-regional/pan-LEP level through both the Northern Powerhouse Investment Fund and Midlands Engine Investment Fund. In future, there may be further opportunities to replicate these kinds of projects across the UK in areas where there is a recognised clear market failure, with the BBB facilitating the distribution of new, post-Brexit sources of funding. This would enable local areas or regions to draw on the commercial expertise of the BBB, which may be particularly important if there is a shift away from the provision of grants and towards the provision of loans. This approach also increases the 'size of the prize' by empowering regional bodies to access multiple funding pots.

   More broadly, there must be a debate on the future role of the BBB, and the extent to which it intervenes directly in finance markets, perhaps through a development bank model (like the Development Bank of Wales). As an example of success, the UK Government should look to the German development bank, KfW, which has been instrumental in creating world-leading SMEs.

   To date, one of the few ways in which the BBB has intervened directly in finance markets is through one of its subsidiaries, the Start Up Loans Company. This provides a vital service to around 10,000 new businesses a year. FSB welcomes the Chancellor's Budget announcement that funding for the Start-up Loans Company will be extended a year to 2021. A program that continues the SULC's good work past this date should be considered as soon as possible.

6. **The UK Government must invest in building entrepreneurial skills.**

   Providing business owners with the tools to run their firms more efficiently frees up their time to think strategically about their growth and development. General business support, therefore, has a key role to play in promoting growth.

   Most start-ups require external funding to function in their first year. In fact, many start-ups are unlikely to break even until their second or third year, making them unattractive to many traditional banks. Start-up owners must be directed towards appropriate sources of external funding at the earliest possible stage. This is vital to ensuring they fulfil their later growth potential and will decrease the likelihood that they are subsequently hindered or upended by avoidable pit falls.

   One means of assisting with this is by looking at best in class international practice. For example, in Estonia, all start-ups are provided with a comprehensive guide on where to find further information and advice on a range of business topics, including accessing finance. Estonia has one of the most digitised and joined-up offerings for start-ups, with relevant information and guidance all in one digital place.

   Training in entrepreneurship must start early. Financial skills should be taught at school, and entrepreneurship should be promoted as a legitimate career path. Embedding enterprise education into the national curriculum and throughout the education system is vital to preparing young people with the skills, capabilities and inspiration to consider entrepreneurship as a career choice.

7. **The UK Government must provide bespoke solutions for groups and individuals within the small business community that particularly struggle to access external finance.**

   The recently announced Government review into the barriers women face in starting up their own businesses must address the challenges they face when trying to access external finance.

   Elsewhere, there is evidence that business owners from black and minority ethnic (BAME) backgrounds find it harder than others to access credit and have a higher expectation of rejection.

   Alongside awareness-raising, a dedicated scheme – similar to the Aspire Fund – would help more women and BAME-led businesses access the finance they need to grow.

   More broadly, the UK Government must recognise the importance of ongoing business support throughout business lifecycles. More businesses need access to formal training programmes, such as the London Stock Exchange's ELITE programme and the Goldman Sachs 10,000 Small Businesses programme.

INTRODUCTION

External finance plays a key role in ensuring small businesses have the necessary resources to start up, employ staff, invest, innovate, and grow to scale. External finance is a broad term. It also includes funding that fills cash-flow gaps without being used for growth.

Growth finance, however, is used by businesses to fulfil growth ambitions. Businesses achieve this through a variety of products. Growth finance includes core debt funding (loans, overdrafts and credit cards). It also encompasses 'alternative finance', such as peer-to-peer lending, equity finance (ranging from angel funding all the way through to venture capital), asset-based finance, and private debt funding.

Access to external finance is important for growth in businesses of all sizes, from start-ups, to scale-ups, to long-established businesses. However, demand for external finance by UK smaller businesses has declined since the 2008 financial crisis.

This report looks at both smaller business demand for external finance, and the supply of viable external finance options, for the purposes of growth. Clearly, external finance is only one potential solution and, in some cases, other forms of funding may be more conducive, depending on individual circumstances.

For some, the use of traditional debt finance (loans, overdrafts and credit cards) may be inappropriate for growth purposes. Start-ups, in particular, may face challenges accessing core debt products because they do not have a long record of accounts and will likely have fewer assets against which to borrow.

In some cases, alternative arrangements, like equity finance, may be suitable for smaller businesses that are looking to grow, particularly those that have the potential for high growth. Equity finance may also work for early-stage businesses that are unlikely to be successful in securing core debt products because of their risk profile (including their probability of default). This may be because they have unstable or frequently non-existent cash flows, or an inability to provide sufficient security against which to borrow because of limited assets.

However, it remains the case that many smaller businesses rely on core debt products to enable growth, as opposed to using it to cover a short-term gap in working capital or provide a financial safety net.

This report focuses on how best to tackle the challenges of both 'dormant' and 'discouraged' demand for external finance for the purposes of growth. Dormant demand can result from a lack of awareness of external finance options by smaller businesses.

Discouraged demand can arise as a consequence of an expectation of failure by those seeking finance. This reduces the likelihood that smaller businesses will try to access external finance, or make it more likely that they will give up after one failed attempt to secure it. The BBB estimates that 9% of smaller businesses are discouraged or deterred from applying for finance, despite identifying the need for it.[4]

A range of organisations and resources play a key role in supporting smaller businesses to overcome information asymmetries and select the most appropriate type of external finance to support their growth. These include the Business Finance Guide, LEPs/Local Growth Hubs in England (and their equivalents in Scotland, Wales and Northern Ireland), and the wider formal and informal public and private business support infrastructure.

However, even the most informed smaller business is likely to face a number of supply-side market failures. For example, there remain challenges in relation to the distribution of angel funding across all the regions and nations of the UK, given its current concentration in London and the South East.

There is also a specific issue of access to growth capital for mature, often mid-sized, companies. For example, the fixed costs of due diligence – often not proportionate to the size of the finance deal itself – mean that the cost-effectiveness of smaller finance deals is reduced, and so investors may be hard to attract.

4 Enterprise Research Centre, November 2016, Dr Robyn Owen, Exploring the success and barriers to SME access to finance and its potential role in achieving growth.

As important as equity funding is, it is part of a wider range of alternative external finance options. These include peer-to-peer debt funding, asset and asset-based funding, as well as private debt funds. In this regard, it is encouraging to see the BBB open up schemes such as ENABLE to peer-to-peer lenders, asset finance lenders and challenger banks, and so providing them with more efficient access to capital markets. The BBB's investment programme is also important in this regard.

Supporting private debt options for smaller scale loans is a priority. The implications of the loss of EU funding post-Brexit could also have severe ramifications for the provision of micro finance.

SMALL BUSINESS DEMAND FOR CREDIT

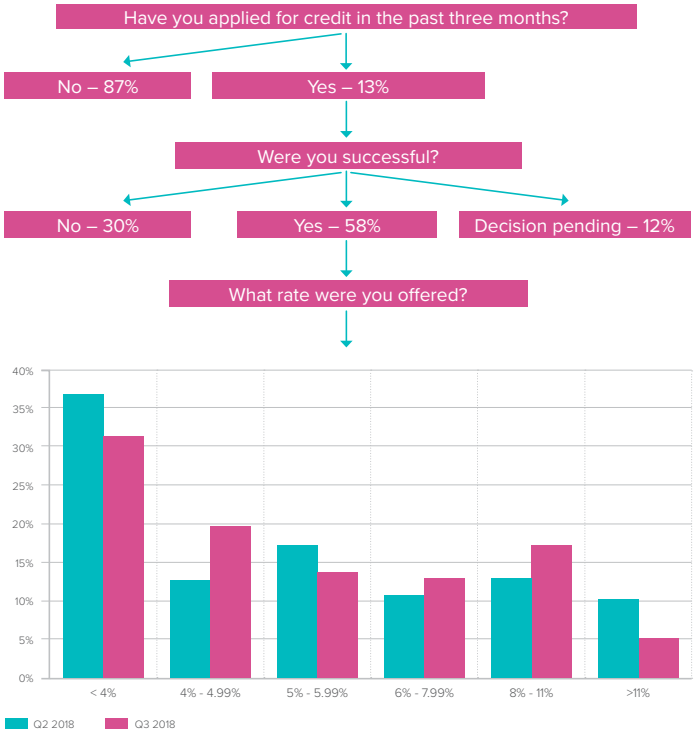
Many small businesses still believe credit is scarce. According to the most recent SBI data, 42 per cent of small businesses say credit availability is very poor (19%) or quite poor (23%). Just 24 per cent feel credit is readily available. The view that credit is not available may dampen demand (Figure 1). Only 13 per cent of small businesses say they have applied for new credit in the past quarter but, of those that did, 58 per cent have had their credit application approved, and a further 12 per cent say they are awaiting a decision.

Figure 1: Small business views on credit availability
Source: FSB Small Business Index, Q3 2018

How do you rate the overall availability of new credit for small businesses?		
Very good	4%	**NET GOOD: 24%**
Quite good	20%	
Neither good nor poor	33%	
Quite poor	23%	**NET POOR: 42%**
Very poor	19%	

Figure 2 shows that, based on small business experience, credit availability has fallen in the last few years.

Figure 2: Small business experience of credit availability
Source: FSB Small Business Index, Q3 2018



FSB has an in-house funding platform which is provided by Finpoint. Recent data from the platform shows that most external finance sought by smaller businesses was for growth purposes (62%). These include buying and developing property (24%), investing in equipment or machinery (22%) and seeking investment (16%).

Less than a quarter (23%) of applicants were looking for funding to improve cash flow.

Figure 3: Small business applications to FSB's funding platform
Source: FSB Funding Platform in Association with Finpoint, Q1 2018 data

Main reason for application	Proportion	
Buy or develop property	***24%***	**GROWTH 62%**
Improve cash-flow	23%	
Invest in equipment or machinery	***22%***	
Seeking investment	***16%***	
Refinancing	8%	
Buy or refinance vehicle(s)	5%	
Help with grants, tax credits and pension finance	3%	

External finance for small businesses

Small businesses seek finance from a range of different sources, and for a variety of different reasons. This report looks at instances where external finance is being sought to fund new capital investment (such as machinery) or investment in intangibles (such as patents or upskilling to encourage further R&D).

Traditional Debt Finance

As discussed above, many smaller firms see debt finance as the obvious and most straightforward way of accessing additional capital, particularly in relation to their core 'business-as-usual' working capital requirements. However, more businesses are seeing the benefits of alternative finance in supporting growth.

When seeking finance, most small business owners – having opened a business account with whichever bank they already use for personal purposes – seek external funding from their current bank.

Eighty-one per cent of the business loan market is currently covered by the four largest UK banks: RBS, Barclays, Lloyds Banking Group and HSBC.[5] FSB has consistently raised concerns about the concentration of the banking market and the anti-competitive nature of mergers within it.

However, recent BBB data suggests the proportion of smaller businesses that only approached the four major banks for external finance dropped by 7 percentage points to 43% in 2017/18, compared to 50% in the previous year. This suggests that small businesses are starting to expand their finance horizons.

5 British Business Bank, Small Business Finance Markets 2015/16, available at: https://british-business-bank.co.uk/wp-content/uploads/2016/02/British-Business-Bank-Small-Business-Finance-Markets-Report-2015-16.pdf

Small business decision-making around where to seek external finance does still seem to be heavily driven by trust, based on past relationships or recognition of a particular brand. Those small businesses that are attempting to grow often assume that their own bank knows them best and is the most likely to reward them for their loyalty. They believe other banks and financiers are less likely to provide the funds they are seeking. If their finance application is rejected by their bank, few businesses then search elsewhere.[6]

Recent BBB research has identified that younger businesses have found it harder than more established firms to obtain new debt finance.[7] Even for those that can access traditional debt services, the addition of debt servicing costs to outgoings at an early stage may stifle potential, particularly among those that are not immediately ready to generate revenue. This could include start-ups that need to develop intellectual property or make an initial investment in expensive plant and machinery in order to succeed.

These types of pre-revenue businesses are unattractive to banks as they are unlikely to be able to service debt immediately and are seen as more risky investments because of the difficulty in predicting their likelihood of default.[8]

For this reason programmes such as the Start Up Loans Company play a vital role in the health of the small business sector. Ensuring this company remains well-funded and resourced should be a priority.

British Business Bank initiatives to encourage lending to smaller firms

Enterprise Finance Guarantee (EFG)

The Enterprise Finance Guarantee (EFG) supports the provision of finance to smaller businesses that are viable but unable to obtain finance from lenders due to having insufficient security to meet lender requirements.

The EFG provides lenders with a government-backed 75 per cent guarantee against outstanding facility balances for such businesses. Since its launch in 2009, EFG has supported the provision of over 28,000 business loans with a total value of over £3bn (as at end of September 2017).

ENABLE Guarantee Programme

The ENABLE Guarantee programme is designed to encourage additional lending to smaller businesses.

The Capital Requirements Directive requires all banks and building societies of all sizes to comply with the Basel standards. Challenger banks often argue that the requirement to comply with the internal ratings based approach means they hold far more capital against small business lending than larger institutions.

Challenger banks that participate in the scheme are able to lend more to smaller businesses as it reduces the capital they need to hold against SME portfolios.

Start-Up Loans Company

The Start Up Loans Company is a subsidiary of the British Business Bank. It delivers the Government's Start-Up Loans programme, providing finance and support for businesses that otherwise struggle to access finance. The scheme has backed over 51,000 businesses and has lent nearly £360m, with an average loan size of £6,500.

6 HM Treasury, Bank Referral Scheme: Official Statistics, 31 August 2018, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/737136/Bank_Referral_Scheme_Official_Statistics_Publication_-_August_2018.pdf

7 British Business Bank, Small Business Finance Markets 2017/18, available at: https://british-business-bank.co.uk/wp-content/uploads/2018/02/364-Small-Business-Finance-Reportweb.pdf

8 KPMG, Rise of Challenger Banks, available at: https://home.kpmg.com/xx/en/home/insights/2018/02/rise-of-challenger-banks-fs.html

Challenger banks

For smaller businesses seeking external finance, challenger banks offer a variety of core products which differentiate them from the traditional market. However, many smaller firms are unaware of the different finance options available from challenger banks, in part due to their small market share. Challenger banks still currently hold a small minority of business bank accounts and loans. According to data from Business Banking Insight – which is generated through interviewing tens of thousands of small business owners – the Big Five banks have an 88 per cent share of the market for businesses turning over £100,000 per annum or less, and a 90 per cent share of the market for those turning over between £100,000 and £25 million per annum.

In fact, smaller businesses may be more open to looking beyond debt finance than is generally perceived. Debt finance is still the predominant source of external finance for small firms, but there are some signs that alternative providers are breaking up the traditional debt finance hegemony. Data from the BDRC's SME Finance Monitor shows that, in 2012, 11 per cent of smaller businesses reported an application for new or renewed loans or overdrafts.[9] This fell to seven per cent in 2015, dropping to four per cent in 2016, before rising back to seven per cent by the middle of 2018 (across all business size bands).

In the same period, the volume of cash reserves held by smaller firms has risen. In 2012, 16 per cent of SMEs reported holding more than £10,000 in credit balances, with an average balance of £25,000. These figures rose by 2016, with 22 per cent of SMEs reporting more than £10,000 in credit balances, with an average balance of £30,000. And by 2017, 25 per cent reported credit balances of more that £10,000, with an average balance of £37,000 (Figure 4). This could reflect ongoing economic uncertainty, with many businesses preferring to hold back investment and sit on their cash.

Figure 4: Average credit balance of UK SMEs
Source: SME Finance Monitor, Q2 2018

Year	Average credit balance	Proportion of SMEs holding more than £10,000 in credit balances
2012	£25,000	16%
2013	£24,000	17%
2014	£31,000	20%
2015	£39,000	24%
2016	£30,000	22%
2017	£37,000	25%
2018*	£37,000	22%

**partial year data*

So, despite the importance of debt finance, it is not always the most appropriate option for smaller businesses seeking to grow. Some may seek debt finance simply because they are unaware of other external finance options which may better suit their businesses. Smaller businesses need greater support in identifying the full range of growth finance options.

9 SME Finance Monitor Q2 2018, An independent report by BDRC, September 2018, available at: http://www.bva-bdrc.com/wp-content/uploads/2018/10/BDRC_SME_Finance_Monitor_Q2_2018_Final.pdf

ALTERNATIVE FINANCE

Despite a low baseline of familiarity, non-bank financing has continued to grow in importance for smaller businesses. Despite their current high dependence on traditional debt finance, there is evidence that smaller businesses are more confident in assessing different finance options than has been the case previously. But there is still further to go.

Equity finance

Equity finance (raising capital through the sale of shares) is an important source of external finance for growth, particularly for fast-growing companies.

Angel funding is the main source of pure growth finance for small businesses. This is the riskiest type of business investment, targeting small businesses that are seeking to grow rapidly. Most often these are start-ups but they can also be firms seeking to scale-up from a low level of revenue/turnover.

Equity crowd funding has provided a boon in liquidity to equity markets. This liquidity has been transferred effectively toward small businesses, particularly start-ups. Equity crowd funding platforms are not flawless, however. The platforms rarely provide businesses with the expertise of traditional angel investors. Also, these platforms may not be the most selective when it comes to the businesses that they fund.

There is a lack of small business awareness about equity finance. According to FSB's latest SBI data, only a small proportion (9%) of smaller businesses have reported seeking equity finance. BDRC's annual data is even more pronounced. In 2017, 62 per cent of SMEs said that they did not know anything about equity finance, increasing to 68 per cent in the first half of 2018.

Awareness varies from region to region, possibly related to the differing supply of equity finance and quality of investors across different regions. For example, small business owners in the North and North East are far more likely to say they 'Don't know anything about' equity finance (74%) than their counterparts in London (58%).

There has been a material improvement in the awareness of crowdfunding platforms, however. In 2014 just 27 per cent of businesses reported awareness of crowdfunding. That figure is now 40 per cent UK-wide.[10]

The later-stage funding gap

Later-stage equity funding has been identified as hard to come by. Many UK based businesses, once established, fail to access the funds necessary to scale-up. Such funding seems to be less available in the UK than the US.

At the scale-up stage, many UK businesses are bought out by foreign firms as the funding for scaling-up is not readily available. Evidence of this can be found in the British Business Bank's SME Finance Market report, backed up by reports from many business owners themselves.

CASE STUDY: Equity Finance

"I knew that we needed to expand quickly if the business was going to stay competitive. Up until that point, we had been able to self-fund the business using our own money, reinvesting all our profits and bootstrapping everything we did.

By participating in the Goldman Sachs 10,000 Small Businesses programme, I got access to the knowledge and resources required to plan what we needed to do to grow faster. However, even though we had a working business model that was profitable, it became apparent that scale-up finance was very difficult to access and that the only way to raise the funds we needed was through a significant equity investment. The challenges of going through this process almost led us to sell the business instead. The paradox is that it would have been easier for us to raise early stage finance as a start-up without a track record."

FSB small business, London

10 SME Finance Monitor Q2 2018, An independent report by BDRC, September 2018, available at: http://www.bva-bdrc.com/wp-content/uploads/2018/10/BDRC_SME_Finance_Monitor_Q2_2018_Final.pdf

CASE STUDY: Equity Finance

"Our business stared from a small site on the south side of Edinburgh in 2008. Three years later, when we opened a second store in the heart of the city centre, we were thrown into financial difficulty after our bank suddenly withdrew our agreed overdraft. Up until that point, we had always enjoyed a good relationship with the bank and, on the strength of the existing business, had agreed a £25,000 overdraft facility to help fund the opening of the new store. On the eve of opening, our bank withdrew the overdraft facility, refusing to honour the agreement, despite having previously used our business as a model case study. Thankfully, we managed to switch to another major high street bank.

However, our bad experience led to a loss of trust. So when it came to seeking capital to open a new branch – this time in Hong Kong – we felt we couldn't take the risk of being let down by a traditional lender for a second time. Instead we turned to private investors to fund expansion, through a mix of debt and equity funding. This time the process was smooth and fast, taking only four weeks from beginning to end to conclude the deal.

Since securing private finance the business had continued to grow from strength to strength, trading successfully at a number of key locations and providing training and employment for many."

FSB small business, Edinburgh

In relation to boosting the provision of later-stage equity finance, work has already begun via the establishment of the Patient Capital Review.

The UK Government's Patient Capital Review[11]

- In the 2017 Budget, the Government announced an action plan to unlock over £20 billion of patient capital investment to finance growth in innovative firms over 10 years by:
- Establishing a new £2.5 billion Investment Fund incubated in the British Business Bank with the intention to float or sell once it has established a good track record. The ambition is to unlock a total of £7.5 billion of investment by co-investing with the private sector.
- Doubling the annual allowance for people investing in knowledge-intensive companies through the Enterprise Investment Scheme (EIS) and the annual investment these companies can receive through EIS and the Venture Capital Trust scheme. Additionally, introducing a new test aimed at reducing the scope for low-risk investment through these schemes and redirecting it elsewhere. Taken together, these measures could unlock over £7 billion of growth investment.
- Investing in a series of private sector fund of funds. The British Business Bank will seed the first wave of investment with up to £500 million, unlocking double its investment in private capital. Up to three waves will be launched, supporting a total of up to £4 billion worth of investment.
- Backing new and emerging fund managers through the BBB's established Enterprise Capital Fund programme, unlocking at least £1.5 billion of new investment.
- Backing overseas investment in UK venture capital through the Department for International Trade, expected to unlock £1 billion of investment.

FSB believes investment through funds should be the predominant means of channelling patient capital. This is because it can be better directed in a more focused way, addressing specific issues in different regions, or channelling investment to specific types of business.

11 Financing growth in innovative firms: consultation response, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661398/Patient_Capital_Review_Consultation_response_web.pdf

Peer-to-peer lending

The rise of online marketplaces has been a defining feature of small business finance markets since the financial crisis.

According to FSB's SBI data, the share of small businesses applying for peer-to-peer credit rose from four per cent to nine per cent between Q3 2015 and Q2 2016[12]. However, while peer-to-peer lending is increasing, it still represents a small proportion of overall lending to SMEs, (around four per cent of new lending in Q3 2018 according to SBI data).[13] Smaller businesses still tend to put more trust in traditional finance products.[14] In 2017, peer-to-peer loans became eligible for inclusion in Innovative Finance ISAs. However, eligible platforms are required to obtain FCA approval, which can be a cumbersome process.

CASE STUDY: Peer-to-Peer Lending

"We are a digital/IT company and, in 2012 we won two really big contracts which required substantial investment in the growth of our business and the skills of our workforce. We also wanted to use these contracts as a springboard for taking on more ambitious projects in the future and marketing ourselves to a wider audience.

Unfortunately, back then, we were in leased premises with very little in the way of assets. So when we went looking for a traditional bank loan, our application was declined by our own bank, and by another well-known high street bank which we subsequently approached.

It was during an FSB networking event that another small business recommended we should look into peer-to-peer lending. After taking their advice, we managed to very quickly secure the £30,000 we needed.

Three years later, we moved offices and made some major changes to the way our business operated. We required finance to cover renovation and fittings of our new premises, and also took the opportunity to consolidate our debt. We didn't even bother with banks this time.

Again, we approached a peer-to-peer lending platform and managed to secure £45,000 to cover our office renovation and, separately, £17,000 to consolidate our debt. It was even easier this time round. We received confirmation that our application was successful just five days after submitting it.

In hindsight, I don't know why we approached the bank first time round. It's just what you do, isn't it. We didn't know any better back then. We didn't even have a very good relationship with them. In contrast, the peer-to-peer lending platform was great. They are keen to invest in IT companies and offered really flexible terms for repayment."

FSB small business, Leamington Spa

12 FSB Voice of Small Business Index, Quarter 2, 2016, available at: https://www.fsb.org.uk/docs/default-source/fsb-org-uk/fsb-small-business-index-q2-2016.pdf?sfvrsn=1

13 FSB Voice of Small Business Index, Quarter 3, 2018, available at: https://www.fsb.org.uk/docs/default-source/fsb-org-uk/fsb-sbi-q3-2018-v02-(003).pdf?sfvrsn=0

14 8 in 10 SMEs still prefer traditional bank loans over alternative finance, available at: http://www.growthbusiness.co.uk/8-10-smes-still-prefer-traditional-bank-loans-alternative-finance-2553508/

Asset and asset-based finance

Asset funding through leasing and hire purchase agreements enables smaller businesses to utilise plant and machinery without owning it, as well as giving them the option to purchase it in due course.

Asset-based funding enables smaller businesses to borrow against the value of their assets be that accounts receivable, inventory, plant and machinery, property, intellectual property and brands. This includes factoring and invoice finance.

CASE STUDY: Asset Finance

"Our business relies on a number of heavy machines, each costing £25,000 to £30,000. On several occasions we have taken the decision to invest in new equipment, either to upgrade or diversify our machinery. We simply don't have this liquid capital available to fund these investments, so we have always opted for lease-purchase agreements, whereby we buy the new machine over a period of 4 to 5 years, eventually taking full ownership.

"Asset finance may be a little bit more costly than traditional debt finance, but it has worked extremely well for us. It's relatively straight-forward, and the rules around repayment are clear and fixed.

"We haven't had good experiences of banks in the past. Their costs keep going up and they keep changing the rules. And, unlike asset finance offers, banks don't tend to guarantee the loan rate until the asset was delivered, which in our line of work can be many months after we've placed the order. We've been stung by that in the past.

"We've got quite a lot of experience of asset finance now, but for those that don't, there's more that asset finance lenders could do to encourage small businesses, particularly in terms of marketing, clarifying the basis on which they agree to lend, and advice around how to maximise the success of applications."

FSB small business, Burton-on-Trent

FSB's latest SBI data shows that the share of smaller businesses seeking asset-based finance rose from 12.5% to 16.9% in Q2 2016.[15] Asset and asset based finance are not traditionally seen as growth finance options for smaller firms as, particularly with asset finance, there is relatively little risk for the investor who has the asset as security. However, it is the purchase of the asset that allows for expansion. Similarly, asset-based financing is normally used as a means to support working capital, rather than expanding a business. However, if this is used to support a new line of business it also becomes essential for that firm's growth in a given time period. SBI data analysis suggests that asset and asset based finance is being used by smaller businesses to finance growth.

The most appropriate finance option for an individual business depends on its specific nature and circumstances. All types of financial products can drive growth in certain circumstances. Therefore, rather than framing the debate around access to finance in terms of core debt products versus equity finance, FSB wants to see a far more nuanced discussion based on identifying the right external financing vehicle for each individual smaller businesses. How we look at external finance needs to reflect the nuanced reality in which small businesses exist.

15 FSB Voice of Small Business Index, Quarter 2, 2016, available at: https://www.fsb.org.uk/docs/default-source/fsb-org-uk/fsb-small-business-index-q2-2016.pdf?sfvrsn=1

CASE STUDY: Asset-based Finance

"I've used asset-based finance a lot, rather than debt finance. It just makes good business sense and means that my overdraft can be kept clear for every-day working capital. And, obviously, an overdraft can be withdrawn by a bank with little or no notice, so I wouldn't want to rely on it. I think it's really important for business to diversify their borrowing. But a lot of businesses don't seem to have the confidence to do it.

As an example, I recently agreed a new contract to install around 300 micro-computers into a client's offices. I agreed an asset-based finance deal whereby the lender provided around 30 per cent of the cost of each computer. I didn't need to buy them all up-front. Instead, I would buy, say, ten at a time, send the serial numbers to the lender, and they would pay me the agreed amount each time. It's really straight-forward. The amount you can borrow obviously depends on how easy it would be for the lender to recoup the assets – you can borrow up to 90 per cent for a car. But in this particular case, the computers were embedded in clients' offices and wouldn't have been easy to repossess if I'd stopped repayments. So 30 per cent was probably a fair balance.

Before the financial crisis, asset-based finance was being flogged left right and centre. It was hard to avoid it. Since then, asset-based lenders are much more picky about what they lend money for and they're much more risk averse. But, again, there's still plenty of availability out there, albeit with more scrutiny these days.

I'm an engineer by training so I never had an amazing grasp of finance, but I learned pretty early on to surround myself with people who knew more than me. I think networking with other businesses is incredibly important. Early on in my business career, I joined Entrepreneurs Forum up in the north east, which gave me amazing access to different businesses with different skill sets, and provided other opportunities like access to equity finance. And, later, I joined FSB which, again, gave me access to loads of different businesses and advice."

FSB small business, County Durham

USE OF EXTERNAL FINANCE TO SUPPORT SMALL BUSINESS GROWTH AMBITIONS

Growth aspiration drives the demand for growth finance among smaller businesses.

According to FSB's latest SBI data, half of small business owners believe they will experience growth to some degree in the 12 months. Of these, eight per cent believe their turnover will grow by more than 20 per cent, while 41 per cent believe they will experience a moderate (up to 20%) growth in turnover.

Growth ambitions have a significant impact on the type of finance that a business owner seeks. Furthermore, firms that have growth ambitions tend to use different types of finance compared to the general population of finance-seeking businesses.

Small businesses are most likely to seek traditional forms of debt finance in the first instance. According to FSB's most recent SBI data, more than two thirds of small business finance applicants sought an overdraft (32%) and/or a bank loan (38%) in the last three months. However, small businesses with growth expectations were much less likely to make applications for overdrafts or seek debt finance, compared to the overall smaller business population. This suggests that smaller businesses with growth ambitions may be more likely to look for finance from alternative, non-traditional sources, compared to those that seek finance for cash flow purposes.

Although awareness and availability of non-traditional finance options is increasing year-on-year, small businesses are, generally speaking, still far less likely to opt for these forms of credit.

Asset-based finance is also quite a popular option for smaller businesses, with 28 per cent of respondents saying they have applied for this kind of finance.[16] Nearly three-quarters of the businesses that sought asset or invoice finance are also planning to grow within a year. Asset-based finance is potentially a key – but often overlooked – element of the growth finance picture.

SBI data also shows that export/import finance, which is normally provided by a bank, accounted for just two per cent of small business finance applications. Angel finance and venture finance totalled eight per cent of applications, with three quarters seeking angel investment. All of these applications for angel and venture investment came from businesses that are planning to grow. These are external finance sources that are secured by demonstrating the potential for growth and a return on investment.

Peer-to-peer finance accounted for eight per cent of small business applications, while crowdfunding platforms accounted for another five per cent.

16 FSB Voice of Small Business Index, Quarter 3, 2018, available at: https://www.fsb.org.uk/docs/default-source/fsb-org-uk/fsb-sbi-q3-2018-v02-(003).pdf?sfvrsn=0

THE IMPACT OF BREXIT ON SMALL BUSINESS FINANCE MARKETS

Brexit means that EU funding – at least in its present format – will soon come to an end. It is critical, therefore, that the Government sets out its proposals for how future support will be provided for small businesses seeking to access external finance for growth.

EU funding programmes have generally been successful. Recent FSB research shows that among small businesses that have successfully applied for EU funds, 68 per cent thought that doing so had a positive impact on their firm.[17] A similar proportion (64%) thought that such funds have benefited their local area.

EU funding has been used to support the provision of a wider range of alternative finance options. Between 2006 and 2016 the European Investment Bank provided more than £3bn to the UK small business finance market.

In June 2016, immediately before the EU referendum, the European Investment Bank agreed a £100 million investment in loans to UK small businesses through Funding Circle. This investment, alongside £25 million from the Funding Circle SME Income Fund, is set to enable over £200 million of new loans to UK small businesses by 2023.[18]

The European Investment Fund has continued to provide support to small businesses through Funding Circle since the Brexit vote. Working alongside the German development bank KfW in May 2018, the EIF securitised 4,007 loans made through Funding Circle in six tranches worth a combined £206.5 million.

It is vital that the UK Government ensures this level of funding continues when the UK leaves the EU. The Government must ensure there is no diminution in the amount of funding for small business finance markets as a result of lost access to the EIF. Replacement funds could be better targeted by, for example, being steered towards investments of under £10 million and be inclusive of venture debt.

Just as importantly, EU funding also facilitates micro-finance, growth loans and other types of funding (beyond equity finance).

The JEREMIE Funds[19]

The JEREMIE Funds (Joint European Resources for Micro to Medium Enterprises) operate in the North of England. The fund management companies receive and invest large volumes of capital from European Regional Development Funds (ERDF), as well as finance from central government and the European Investment Bank (EIB), targeting it at SMEs.[20] The funds are set to provide financial support for more than 600 businesses, creating around 3,500 jobs over the life of the fund, and deliver a legacy fund of up to £80m for further investment in the region over the next decade.[21]

The JESSICA Fund

JESSICA stands for Joint European Support for Sustainable Investment in City Areas. This initiative is being developed by the European Commission and the European Investment Bank (EIB), in collaboration with the Council of Europe Development Bank (CEB).

17 Reformed EU Funding – Brexit series FBS (2016)

18 Funding Circle Blog, European Investment Bank and Funding Circle announce ground-breaking £100 million investment into UK small businesses, 21 June 2016, availabale at: https://www.fundingcircle.com/blog/press-release/european-investment-bank-and-funding-circle-announce-groundbreaking-100-million-investment-into-uk-small-businesses/

19 Both JEREMIE and JESSICA also operate in Wales through the Development Bank for Wales, but these related to the previous tranche of funding, pre-2014.

20 British Business Bank, JEREMIE Funds, available at: https://www.british-business-bank.co.uk/ourpartners/managing-other-schemes-on-behalf-of-the-taxpayer/jeremie-funds/

21 £120m boost for North East as EU Jeremie fund set to go live following Brexit delay, available at: https://www.chroniclelive.co.uk/business/business-news/120m-boost-north-east-eu-14068219

Under new procedures, Member States are being given the option of using some of their EU grant funding, their so-called Structural Funds, to make repayable investments in projects forming part of an integrated plan for sustainable urban development. These investments, which may take the form of equity, loans and/or guarantees, are delivered to projects via Urban Development Funds and, if required, Holding Funds.[22]

COSME Funding

COSME is a joint EC/EIF operated scheme which channels debt finance, equity finance, and guarantees through financial instruments that have been available since August 2014. With an overall budget of over £1.1 billion, COSME looks to fund small businesses where market gaps have been identified across the EU. As with other EU funding schemes, COSME's financial instruments in the UK are managed by the EIF in cooperation with the British Business Bank (BBB).

22 Jessica: A new way of using EU funding to promote sustainable investments and growth in urban areas, available at: http://www.eib.org/en/infocentre/publications/all/jessica.htm

BOOSTING THE SMALL BUSINESS FINANCE MARKET

Open banking

New regulations, which will come into force from March 2019, require banks to disclose performance and fee data in electronic format. The intention is to make it easier for customers to compare the offerings of different financial providers.

The new regulations also require banks to use open application programming interfaces (APIs) which will allow different software to communicate with each other repeatedly over time based on the permission obtained from the user of the software. Information is made available in a standardised way that allows external applications that have permission to access that information to interpret and use that information for their own purposes.

Through this 'open-banking' mechanism customers can readily share their financial information with other providers, if they choose to do so. Open APIs will also make it much easier for customers of big banks to transfer their accounts, manage payments, and conduct transactions through other banks and non-banks, thus reducing barriers to switching.

The UK Government must ensure the success of open banking, which will be a critical tool for empowering those small businesses seeking external finance and other services.

Open banking has the potential to improve the flow of information in financial markets and enable innovative new products and services. Funding platforms have already started setting the foundations for effective matchmaking systems, linking those seeking to invest with those seeking to borrow. There are, however, still competing ideas about what technology will be necessary enable the full benefits of open banking and while keeping data safe. While this is for the industry to work out, possible unintended impacts on customers must be constantly anticipated and assessed. It is important that industry works closely with smaller businesses and their representatives on the design of technologies seeking to harness open banking.

On the demand side, the UK Government, in partnership with banks, should launch a targeted engagement strategy, utilising the latest thinking from behavioural economics to communicate the benefits of open banking to small business owners. This strategy must address specific concerns related to the sharing of sensitive personal data. The ability for challenger banks and alternative finance providers to effectively engage with potential customers depends on the willingness of customers to allow banks to share their personal data. It is key that this engagement with smaller businesses happens at the right time and by the right people. Communication that makes the benefits of open banking clear will encourage business owners to share sensitive personal data in a secure way.

On the supply side, it is important to develop a healthy provider market and prevent domination by a small group of firms. Therefore, the data that prospective clients need to provide should be proportionate. Excessive data sharing requirements (e.g. many years of bank account statements) might benefit larger firms with more advanced forms of AI and machine learning that are capable of digesting this data, at the expense of smaller providers that may not have access to such advanced technology but want to harness the power of open banking. Limiting the amount of mandatory data sharing should also help to increase the trust of clients in this new and evolving market.

It is also important that the solutions developed by the winners of the NESTA challenge prize for open banking are incorporated into the evolution of open banking policy design.

Improving referrals

When seeking a loan, some small businesses run into problems because they may be applying for inappropriate sources of finance, particularly if – like most businesses – they have applied to a traditional bank. At the point at which a business's application is first refused by their bank, they should be directed to information about a wide range of finance options. Where businesses are deemed too risky or underprepared for a traditional bank product, feedback outlining why this is the case should be provided alongside advice for making future applications.

The UK Government should encourage banks to refer a greater proportion of their unsuccessful loan applicants to alternative finance providers. They should explore the benefits of a *de minimis* target for referrals to alternative finance platforms, as designated by the British Business Bank.

In the short-term, the Government's Bank Referral Scheme must be as effective as possible. Progress has been made over the past year, but there is still a dramatic drop-out rate, with too few referred businesses going on to be successful in their applications. Currently, just over 50 per cent[23] of those referred make contact with one of the Government designated finance platforms and, of those that do, the quarterly conversion rate is just over 10 per cent.[24]

As part of its current review of the referral scheme, HMT should consider:

- Requiring banks to publish additional data regarding referrals, such as the purpose for which external finance is being sought.
- Setting banks indicative targets for the proportion of rejected applicants they successfully refer to alternative providers, either through their own dedicated schemes or via the Government's Bank Referral Scheme.
- Developing a better understanding of the customer journey of individuals who agree to be referred via the referral scheme, including the administrative and data sharing burdens that come with this, and the reasons why clients drop out of the system after they have agreed to be referred via the platforms.

The Business Finance Guide

The Business Finance Guide has been devised for businesses and advisors by the British Business Bank and the ICAEW Corporate Finance Faculty, supported by a further 21 major professional, membership and representative organisations.

It sets out the main elements to consider when making an application and the finance options available to businesses – ranging from start-ups to growing mid-sized companies.

The Business Finance Guide draws on the considerable expertise of its many contributors, who together represent more than a million individuals across businesses, finance providers, advisory firms and wider organisations.[25]

23 HM Treasury, Bank Referral Scheme: Official Statistics, 31 August 2018, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/737136/Bank_Referral_Scheme_Official_Statistics_Publication_-_August_2018.pdf

24 2827 referrals in Q2 2018 compared to 1453 contacts.

25 The Business Finance Guide, available at: www.businessfinanceguide.co.uk

Improving the quality and reach of equity finance

The British Business Bank (BBB) should play a key role in improving the quality and reach of equity finance – including angel finance – in UK regions outside of London and the Southeast.

The strong focus on the supply of equity finance outside of London through both the Northern Powerhouse Investment Fund and the Midlands Engine Investment Fund is welcome. BBB regional advisors should utilise cluster theory to support the development of angel clusters across the UK, working closely with wider private sector institutions and LEPs in England (and their equivalents in Scotland, Wales and Northern Ireland). The skills base of investors could also be further developed through a programme of knowledge sharing between well-established angel networks and areas that otherwise lack a strong angel pool. The BBB's recently launched 'request for proposals' (seeking new ideas from the market on how, for example, to innovate and develop angel clusters) is a welcome step forward and needs to be built upon.[26]

By contrast, there are some areas in the country that have little or no external equity investment activity. Knowledge-intensive businesses in regions outside of the Southeast, in one of the many underdeveloped finance ecosystems, will find accessing equity finance a struggle. In many regions there are a lack of angels, super-angels and venture funds.

There are similar problems when it comes to equity crowdfunding. According to the British Business Bank, crowdfunding platforms appear to focus even more on the 'south' than equity investors more generally[27].

The skills base of investors could be further developed through a programme of knowledge sharing between well-established angel networks and areas that otherwise lack an angel pool.

Good investors are described by business owners as knowledgeable and patient. They are available when business owners need them, but not too intrusive. The relationships they foster with entrepreneurs should be based upon honesty and transparency. They are what angel investor Peter Cowley describes as "invested investors". Spreading this approach across the country should be the aim of any programme which shares investor best practice.

It is also important that investors have the right intentions and temperament. However, some small business owners have reported that their investors' objectives do not always align with their own.

While some of the desirable investor skills and qualities are not tangible, best practice from the UK's strongest ecosystems should be shared across different regions so that good investor behaviour is practiced throughout the UK. However, exporting investor skills and experience from one area to another presents a challenge. A strong investor ecosystem tends to be created organically, over a long period of time, and is shaped by factors that are unique to the area. Cambridgeshire is one such example, with a world leading university generating elite intellectual property and a set of well-informed, well-connected angels that started investing in IP based businesses decades ago.

26 British Business Bank, Small Business Equity Tracker 2017, available at: https://www.british-business-bank.co.uk/small-business-equity-tracker-2017/

27 Equity Crowdfunding in the UK: Evidence from the Equity Tracker, available at: https://british-business-bank.co.uk/wp-content/uploads/2015/03/230315-Equity-crowdfunding-report-final.pdf

CASE STUDY: Angel Finance

"In the decade since I started angel investing (after three decades as an entrepreneur) the access to and usage of early stage investment from angels and VCs has improved significantly, although with a bias to the South East. Becoming an entrepreneur has almost become a career choice after school or university. But with most things in life, experience makes a big difference to successful outcomes, so that equity cash with help – so called smart money – is very important and sometimes crucial to entrepreneurs, particularly those under 30.

"This smartness is best provided by investors who have been entrepreneurs, as they have experienced the many highs and lows of building a business, but that shouldn't and doesn't exclude anyone who has experienced commercial life and has the time and cash to help. I am hoping that my Invested Investor project will help entrepreneurs and angels to work better together to build even more successful businesses."

Peter Cowley (Angel Investor)

"Good investors are there when you need them but are not too intrusive. That balance is very important.

"Unfortunately, some investors offer very little other than money. In some instances investors actually end up doing more harm than good. This is referred to as 'toxic money' and is mainly when the investor does not share the vision of the business owners and therefore causes friction.

"The best investors have expertise, are able to offer advice, trust the founders and have a strong network they are willing to share."

FSB small business, Cambridgeshire

The BBB has a role to play in helping to facilitate the sharing of investor knowledge. They have announced a regional angel programme to help spread the distribution of quality investors. In the 2017 Autumn Budget, the Chancellor announced that the BBB will shortly launch a commercial investment programme to support developing clusters of business angels outside of London.

The creation of the Northern Powerhouse Investment Fund and the Midlands Investment Fund – where 40% of the distributed funds are private equity – are both important steps in the right direction. The investment in the regional infrastructure of the BBB, through the creation of a BBB regional banking structure, should further improve the BBB's impact.

Increasing liquidity through tax incentives

Tax incentives can support the use of equity finance, and they should be aimed at those that take the risk of reinvesting their capital as well as their labour into growing businesses.

The UK Government must not lose sight of the objective of making investor tax reliefs, like the Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS), more effective after Brexit, particularly for innovative businesses.

Both the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) have proven a success. FSB supported recent attempts to expand EIS relief for those who invested in knowledge-based firms. Three in four of the small businesses interviewed for this report said that the reliefs drove significant extra liquidity into the market.

CASE STUDY: EIS/SEIS

"EIS and SEIS were very good incentives for investors and were used in every round of financing. Both were used in the first round and we were able to draw in £450k, which enabled us to grow from 3 employees to 7. The subsequent round of funding, of £1.2m, was supported by EIS. Since then we have grown to employ 22 employees."

FSB small business, Cambridgeshire

Recent estimates suggest that 90% of visible angels are using the SEIS/EIS schemes for 79% of their deals.[28]

HMRC data shows that, in 2016-17, 3,470 companies raised a total of £1.797 million of funds under the EIS scheme. In 2015-16, 3,545 companies raised £1.954 million of funds. 2,260 companies received investment through the SEIS and £175 million of funds were raised, down from 2,405 and £182m in 2015-16.

The Government recently consulted on expanding EIS relief for knowledge-based firms. The annual relief limit was raised from £5m to £10m for a knowledge-intensive company for shares issued on or after 6 April 2018. FSB is supportive of this change but it is currently subject to EU approval under its state aid rules.

CASE STUDY: Tax Reliefs

"The tax reliefs for angel investors in early stage businesses were introduced in the early 1980s and have provided an unparalleled benefit to start-ups in the UK. It is said that over half of all European early stage investing happens in the UK. Other factors driving this inward investment include our English language, which is critical for expansion into the USA and many other countries in the world, as well as the UK's early adoption of digital technology and the cosmopolitan lifestyle on our islands.

"Other countries are surprised that the UK gives tax reliefs to people with wealth (which applies to all angels to varying degrees), a proportion of which may be lost as the failure rate of start-ups is considerably above zero. But this has led to entrepreneurs taking more risks and, for some, great successes. And after a failure, many entrepreneurs have learnt and go on to succeed a second and third time. Having 'invested investors' providing capital will reduce the failure rate."

Peter Cowley - Angel Investor

The experiences of FSB members underscores the importance of SEIS and EIS for equity investors. However, improvements can still be made to the EIS and SEIS application processes to help attract more investors. Many find the current system too administratively arduous and slow. For relatively small initial investments (such as those that may be needed for knowledge intensive firms at the very start of their life cycles) it is possible that the complexity of the relief schemes presents a barrier.

Even the current SEIS, for investments of up to £150k per company (£100k per investor) is described by the likes of PwC as "very complex".[29] Smaller professional advisers often used by small businesses tend to be unfamiliar with the intricacies of the SEIS rules and therefore do not necessarily guide companies towards using the scheme. Companies considering using the SEIS have to budget for this extra layer of professional fees. This means the SEIS cannot be used without proper ongoing tax advice for the investor and company alike, creating transaction costs that use up part of the investment funds.

28 Enterprise Research Centre, A Nation of Angels: Assessing the impact of angel investment in the UK, 2015, available at https://www.enterpriseresearch.ac.uk/wp-content/uploads/2015/01/ERC-Angels-Report..pdf

29 PwC Budget Briefing and Predictions, Supporting SMEs, Rebecca Reading, tax director at PwC, 2017, https://www.pwc.co.uk/press-room/press-releases/Handcuffed-Chancellor-needs-to-box-clever-PwC-Budget-briefing-and-predictions.html

FSB has welcomed HMRC's advance assurance scheme, whereby those seeking venture capital can ask HMRC if they agree that an investment would meet the conditions of a scheme before they apply. Small businesses can then use this to show potential investors that their proposed investment may qualify for a scheme. Advance assurance will not tell you if an investor would meet the conditions of the scheme.[30]

The UK Government should expedite efforts to digitise the advance assurance process in order to make both EIS and SEIS more attractive for investors and easier to use for businesses.

CASE STUDY: Advance Assurance

"The process of getting advanced assurance is understandably not entirely easy as HMRC has to ensure that the relief is being used for the right reasons. It is still an unnecessarily long process and desperately needs to be smoothed."

FSB small business, Wales

A fair distribution of funding, post-Brexit

After Brexit, the UK Government must ensure there is no diminution in the amount of funding provided for small business access to finance purposes, compared to what is currently provided, for example through the European Investment Fund (EIF) and European Regional Development Fund (ERDF).

Brexit means that EU funding – at least in its present format – will soon come to an end. This will have significant implications for smaller businesses, particularly in relation to their ability to access finance. Post-Brexit, the way that access to finance funding is distributed throughout the UK will also change, potentially via the Shared Prosperity Fund and potentially with a greater role for the BBB as a key managing agent or fund of funds manager.

By managing and consolidating a number of funding sources, the BBB has already demonstrated success in leveraging funding for access to finance at a pan-regional/pan-LEP level, through both the Northern Powerhouse Investment Fund and Midlands Engine Investment Fund. In future, there may be further opportunities to replicate these kinds of projects across the UK in areas where there is a recognised clear market failure, with the BBB facilitating the distribution of new, post-Brexit sources of funding. This would enable local areas or regions to draw on the commercial expertise of the BBB, which may be particularly important if there is a shift away from the provision of grants and towards the provision of loans. This approach also increases the 'size of the prize' by empowering regional bodies to access multiple funding pots.

More broadly, there must be a debate on the future role of the BBB, and the extent to which it intervenes directly in finance markets, perhaps through a development bank model (like the Development Bank of Wales). As an example of success, UK Government should look to the German development bank, KfW, which has been instrumental in creating world leading SMEs.

The Development Bank of Wales was launched in October 2017 with £440m of funding to support the growth of Welsh businesses. Most of its funding (with the exception of the Micro-Business Loan Fund) is ERDF backed. The funding included a £100m Flexible Investment Fund. This is being lent to firms for up to ten years with interest rates between 4 and 12% per annum. Like the Finance Wales investment bank it replaced, the Development Bank is focused on ambitious SMEs. It aims to support around 1,200 businesses, arranging co-investment from other institutions and investors.

The Development Bank of Wales has a £1bn impact target within five years and it seems they have made a good start toward this, with a number of success to tell less than a year after it was set up. The Development Bank's data shows that £15 million was invested into 65 North Wales-based businesses in 2017. This was three times the amount invested by Finance Wales, the bank's predecessor, in 2016. A large proportion of the funds they have provided smaller businesses have been in the form of loans.

30 Government guidance on applying for advance assurance on a venture capital scheme, available at: https://www.gov.uk/guidance/venture-capital-schemes-apply-for-advance-assurance

Similarly, efforts are underway to set up a Scottish National Investment Bank by 2020, with the aim of making £2 billion worth of investment available to smaller firms over ten years. Thus far, three broad targets have been identified for the bank: support for early stage SME investment; scaling-up SME investment; and mission-led, patient long-term investment.[31] Currently, ERDF funding is distributed in Scotland via platforms such as the Scottish micro-finance scheme and Business Loans Scotland.

Extending the Start-Up Loans programme

To date, one of the few ways in which the BBB has intervened directly in finance markets is through one of its subsidiaries, the Start Up Loans Company. This provides a vital service to around 10,000 new businesses a year, disproportionately benefitting women business owners and those setting up in business from BAME communities.

In the recent budget the Chancellor announced that funding for the Start-Up Loans Company will be extended by a year to 2021. While FSB welcomes this announcement, more should be done. The UK Government should now be planning to put in place a programme that continues for another five years, building on the strengths of the SULC. It should maintain the target of helping around 10,000 businesses every year, evidencing the Government's commitment to supporting entrepreneurs.

Developing entrepreneurial knowledge and skills

Providing business owners with the tools to run their firms more efficiently frees up their time to think strategically about their growth and development. General business support, therefore, has a key role to play in promoting growth.

The UK Government must invest in building entrepreneurial skills

Business owners need support to understand the different finance options available to them. Improving business owners' knowledge of the options available to them will enable them to make better choices and capitalise on greater competition among providers.

It is critical that small business owners are well-informed about their potential finance options at start-up stage. Many start–ups begin as experts in their field, but with very little general business knowledge.

Knowledge 'touch points'

Start-up owners must be directed towards appropriate sources of external funding at the earliest possible stage. This is vital for their later potential and will decrease the likelihood that they are subsequently hindered or upended by avoidable pit falls. There are a number of obvious 'touch points' where start-ups may receive such advice.

Most start-ups require external funding to function in their first year which, according to a recent study by online business service Geniac requires an average outlay of nearly £22,000.[32] In fact, many start-ups are unlikely to break even until their second or third year, making them unattractive to many traditional banks. So knowledge about the broader finance market and understanding about the most appropriate external finance options is vital during these early stages.

One means of assisting with this is by looking at best in class international practice. For example, in Estonia all start-ups are provided with a comprehensive guide on where to find further information and advice on a range of business topics, including accessing finance. Estonia has one of the most digitised and joined-up offerings for starts-up, with relevant information and guidance all in one digital place.[33]

31 Scottish National Investment Bank: implementation plan, available at: https://beta.gov.scot/publications/scottish-national-investment-bank-implementation-plan/
32 How much money does your start-up need to survive the first year?, available at: https://www.telegraph.co.uk/business/sme-home/start-up-costs/
33 Startup Estonia just got #started!, Start Up Estonia, September 2015, available at: http://www.startupestonia.ee/blog/startup-estonia-just-got-started

Start-up Estonia

Start-up Estonia is a governmental initiative aimed at supercharging the Estonian start-up ecosystem in order to make it the birthplace of many more start-up success stories. It seeks to collaborate with and unite the best start-ups, incubators and accelerators across both the private and public sector.

The organisation also carries out training programs for start-ups, works on eliminating regulative issues and barriers, educates local investors to help them invest more, kick starts new accelerator funds and helps attract foreign investors to Estonia.

SEIS and EIS both present other key touch points for small businesses. During the application process small businesses should be made aware of Research and Development tax credits and other tax incentives that they might benefit from. In particular R&D tax credits are likely to be relevant to the types of businesses that seek and benefit most from equity investment.

FSB believes that every new small business in the UK should receive robust financial guidance. Making Tax Digital provides one route through which to reach smaller businesses and achieve this. By using their data, HMRC should be seeking to inform firms about the reliefs and assistance that might be available to them.

Additionally, accountants, who will hopefully be less burdened with manual admin once MTD is fully operational, might also be well-positioned to offer broad information and guidance. The result of this could be more resources like ICAEW's Business Advice Service – which offers start-ups and SMEs free consultations with chartered accountants to help them with their next steps in financial planning and investment.[34]

The aim of these initiatives should be to direct entrepreneurs to tools such as the Business Finance Guide and other sources of advice on finance and other common issues for small businesses. A clear understanding of where to find reliable guidance on these issues will be invaluable to many new entrepreneurs who will only be able to otherwise learn through trial and error.

Entrepreneurial skills are important to small business performance. Research suggests a positive association between entrepreneurial skills and some measures of business success.[35] However, a significant number of small businesses in the UK have relatively underdeveloped entrepreneurial skills.[36] FSB research shows that a quarter (27%) of business owners have not provided any training for themselves in the last year. Issues related to time, resource and cost are the most common barriers to training.[37]

Established business owners can be supported by existing business support networks. While signposting could be improved, generally the work done by LEPs and Growth Hubs – and indeed Business Link which proceeded these institutions – has been beneficial.[38] The development of entrepreneurial skills should be covered by the new Skills Advisory Panels which will work with LEPs and combined authorities to identify local skill shortages and priority areas while feeding into Local Industrial Strategies.[39]

Training in entrepreneurship must start early. Financial skills should be taught at school, and entrepreneurship should be promoted as a legitimate career path. Embedding enterprise education into the national curriculum and throughout the education system is vital to preparing young people with the skills, capabilities and inspiration to consider entrepreneurship as a career choice. The future

34 What is the ICAEW Business Advice Service?, ICAEW, available at: https://www.icaew.com/membership/offers-discounts-and-services/business-offers-discounts-services/promoting-your-practice/business-advice-service/what-is-the-icaew-business-advice-service

35 Andy Lockett, James Hayton, Deniz Ucbasaran, Kevin Mole & Gerard P Hodgkinson (2013), Enterprise Research Centre and Warwick Business School, University of Warwick, Entrepreneurial Leadership, Capabilities and Growth, available at: https://www.enterpriseresearch.ac.uk/wp-content/uploads/2013/12/ERC-White-Paper-No_2-E-Leadership-final1.pdf

36 Department for Business, Innovation and Skills (2015). Entrepreneurship Skills: literature and policy review, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/457533/BIS-15-456-entrepreneurship-skills-literature-and-policy-review.pdf

37 FSB (2017), Learning the Ropes: Skills and Training in Small Businesses, available at: https://www.fsb.org.uk/docs/default-source/fsb-org-uk/skills-and-training-report.pdf?sfvrsn=0

38 BusinessLink RIP - where do businesses go for help now?, available at: https://www.simplybusiness.co.uk/knowledge/articles/2011/03/2011-03-22-businesslink-rip-where-do-businesses-go-for-help-now/

39 Ministry of Housing, Communities and Local Government (2018), Strengthened Local Enterprise Partnerships, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/728058/Strengthened_Local_Enterprise_Partnerships.pdf

generation of entrepreneurs need to be taught financial management and other essential business skills from an early stage 'when children are open to the ideas and influences which will shape their futures'.[40]

The Government's Careers Strategy tasks schools and colleges with offering young people at least seven encounters with employers and at least two experiences of the workplace before they leave full-time education, supported by the Careers & Enterprise Company (CEC)'s network of Enterprise Coordinators and Advisers[41]. While these encounters are important, providing enterprise education embedded within the curriculum and supported by Ofsted school inspections would place a greater emphasis on enterprise education and entrepreneurship skills and help develop the next generation of entrepreneurs.

CASE STUDY: Skills Development

"Awareness of the options and who and where to look has been vital to our success in gaining investment.

"Confidence is also key. An entrepreneurial education is vital to the business owner. Being accustomed to presenting is invaluable – children need to be taught these skills at school."

FSB small business, Cambridgeshire

"One of the biggest challenges for an entrepreneur is finding the time to develop your own skills. There never seems enough time in the day to do deal with the day-to-day issues, let alone anything else. It was only by taking part in formalised training programmes that I've been able to do this, most recently as part of the London Stock Exchange's ELITE programme.

The value of classroom learning, personal study and peer-to-peer support was invaluable to my professional development and the growth of the business that followed as a result. In particular, learning alongside other entrepreneurs with similar experiences and issues, created a 'trusted network' that has lasted long after the programme finished and continues to be an invaluable reference point and support system."

FSB small business, London

40 Lord Young (2014). Enterprise for all. The Relevance of Enterprise in Education, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/338749/EnterpriseforAll-lowres-200614.pdf

41 Department for Education (2017). Careers Strategy: Making the Most of Everyone's Skills and Talents, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/664319/Careers_strategy.pdf

Supporting small business diversity

The UK Government must provide bespoke solutions for groups and individuals within the small business community that particularly struggle to access external finance.

Awareness and take-up of alternative finance is lower among majority women-led firms.[42] On average, women start their businesses with a third less capital than their male counterparts. Women are more likely to apply for loans from banks or loans/grants from government-backed enterprise schemes, rather than applying for alternative forms of finance.[43] The recently announced Government review into the barriers women face in starting-up their own businesses must address the challenges they face when trying to access external finance.

Elsewhere, there is evidence that business owners from BAME backgrounds find it harder than others to access credit and have a higher expectation of rejection.[44]

Alongside awareness-raising, a dedicated scheme – similar to the Aspire Fund[45] – would help more women and BAME-led businesses access the finance they need to grow.

More broadly, the UK Government must recognise the importance of ongoing business support throughout business lifecycles. More businesses need access to formal training programmes, such as the London Stock Exchange's ELITE programme and the Goldman Sachs 10,000 Small Businesses programme.

Ex-Forces

Service leavers that would like to start or scale-up their own businesses can similarly struggle to access risk capital. Intermediaries that bring specialist knowledge of the ex-armed forces community and their circumstances can play an important role in helping to identify and match finance with appropriate commercial propositions from entrepreneurs in the service leaver community. Organisations such as X Forces with their extensive support for service leaver businesses, which includes facilitating access to external capital alongside a range of other support measures such as mentoring, are a good example of a highly effective organisation playing this coordinating role i.e. bringing together the commercial ambitions and viable business ideas of service leavers and the risk finance needed to ensure they come to fruition.

42 Roper, S. Driffield, N. Sena, V., Higon, D.A. and Scott, J. (2006), Exploring Gender Differentials in Access to Business Finance – An Econometric Analysis of Survey Data, via https://www.enterpriseresearch.ac.uk/wp-content/uploads/2013/12/ERC-White-Paper-No_3-Diversity-final.pdf

43 Carter, S., Ram, M., Trehan, K., and Jones, T. (2013), Diversity and SMEs, ERC White Paper No 3, available at: https://www.enterpriseresearch.ac.uk/wp-content/uploads/2013/12/ERC-White-Paper-No_3-Diversity-final.pdf

44 Ram, M., Smallbone, D. and Deakins, D. (2002) The Finance and Business Support Needs of Ethnic Minority Firms in Britain, British Bankers Association Research Report. Fraser, S. (2009), via https://www.enterpriseresearch.ac.uk/wp-content/uploads/2013/12/ERC-White-Paper-No_3-Diversity-final.pdf

45 The Aspire Fund, which is no longer considering new investments, was created to support women-led businesses across the UK and to help those with real potential to access growth capital, available via: https://www.british-business-bank.co.uk/ourpartners/aspire-fund/

METHODOLOGY

This report is based on the experiences of small business owners who have sought finance for growth purposes. In July and August 2018 FSB undertook a series of semi-structured interviews with such business owners, many of whom are FSB members. All interviews were conducted over the telephone and lasted approximately 30 to 40 minutes each. This report also drew upon survey data from FSB's Small Business Index, Quarter 3, 2018.

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