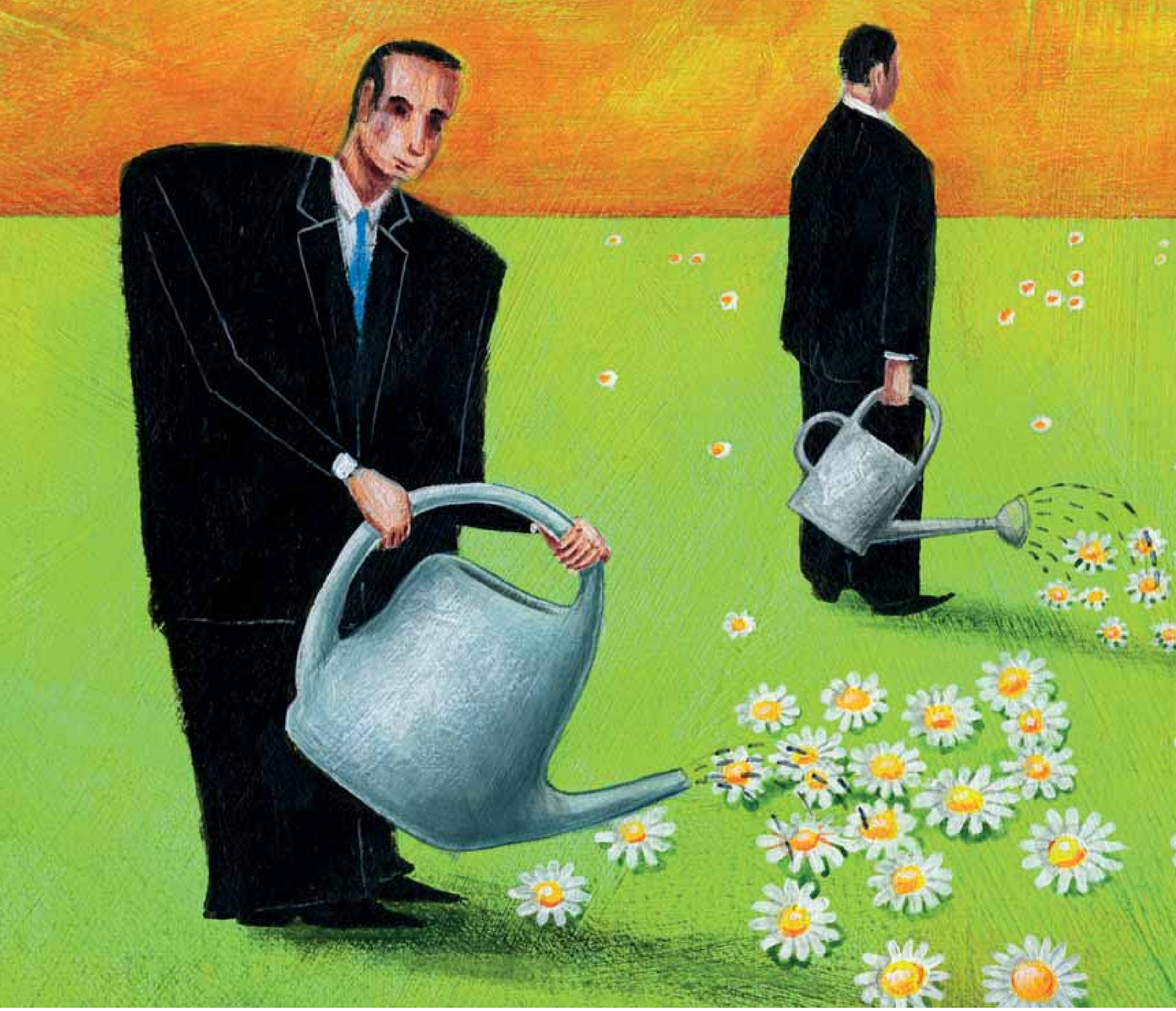

GROWING PAINS

Barriers to funding are holding back SMEs, research commissioned by ICAS has discovered. So what can be done to unlock growth? **Ian Harper** reports

SMALL AND medium enterprises, especially high-growth ones, are considered crucial to boosting UK productivity and enhancing wealth creation. However, a research report just published, and commissioned by ICAS, shows that banks' lending practices are either forcing many SMEs to downgrade growth targets or put them off borrowing altogether.

According to the report's joint author, Dr Ross Brown of the School of Management at the University of St Andrews: "More than half the companies interviewed claimed that problems accessing finance reduced their overall rate of growth. It therefore appears that funding could be an inhibiting factor, reducing their growth."

The report also found that "discouraged borrowers" (SMEs that fear they'll be rejected for a loan, so don't even apply) probably do sacrifice growth rather than seek external finance. Brown says recent research suggests there are 30,000

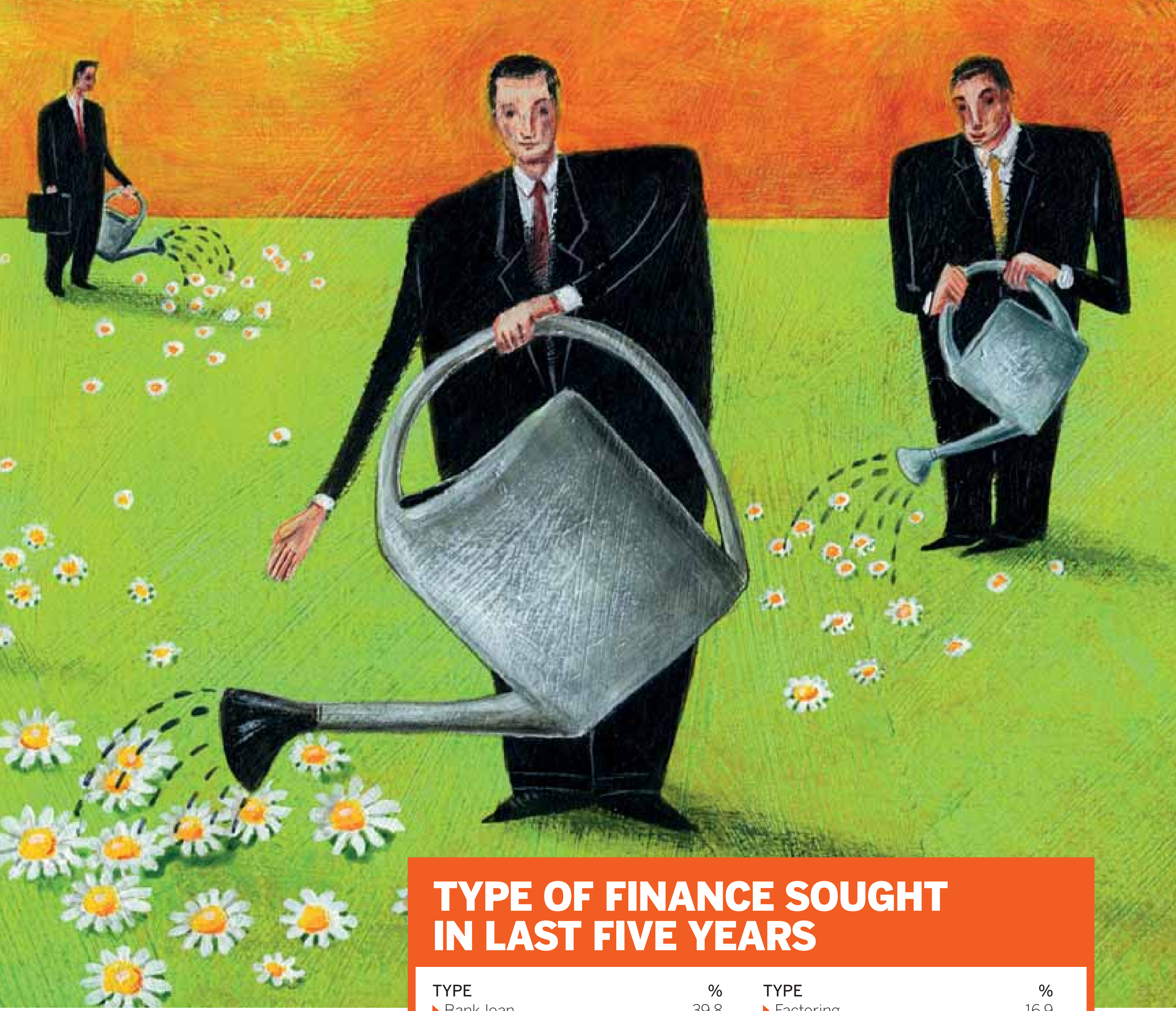

ILLUSTRATION BY HENDRIK JONAS / IKON IMAGES

TYPE OF FINANCE SOUGHT IN LAST FIVE YEARS

TYPE	%	TYPE	%
Bank loan	39.8	Factoring	16.9
Bank overdraft	33.7	Grants	16.9
Supplier credit	16.9	Credit card	15.7
Retained earnings	27.7	None	12.0
Hire purchase	24.1	Equity from venture capital	12.0
Equity from family	22.9	Peer to peer	2.4
Loans from family	20.5	Crowdfunding	0.0

discouraged borrowers in the UK and that up to a third would have obtained funding if they'd applied. "This reluctance to borrow could be generating a growth shortfall within the UK economy," he warns.

So what are the key issues confronting SMEs in their quest for success which make them reluctant to seek funding? We asked the experts.

THE BANKS DOMINATE

While it is generally acknowledged that high-growth SMEs have better access to equity investment than their more slowly growing counterparts, the ICAS research clearly identifies the main banks as the major source of all SME finance over the last five years – either by way of a loan (40 per cent) or an overdraft (34 per cent). Overall, it is estimated that the four main banks account for 80 per cent of all SME lending.

So what is it that makes a large number of SMEs reluctant to borrow and hobble their growth prospects? When it comes to the banks the key issues are "transactional lending", personal guarantees and a lack of trust. When it comes to the alternatives the key issue is lack of awareness. On top of this there may even be a regional lending bias.

PERSONAL GUARANTEES

According to Brown: "It appears from our own work that personal guarantees required as collateral substantively affect the ability of SMEs to obtain credit, with 70 per cent of SMEs identifying this as a barrier to borrowing. This is one of the main reasons that many governments across the world offer credit guarantee schemes to help alleviate the need for personal guarantees."

Manchester-based OakNorth Bank is a specialist lender with a hard SME focus. Joel Perlman, co-founder and chief strategy officer, says personal guarantees are definitely an impediment to SMEs: "Entrepreneurs have typically been required to offer property as collateral – an approach that simply isn't fit for purpose in this age of falling homeownership and new industries where property assets aren't required, such as technology. Many of the entrepreneurs we come across are in their late 20s or early 30s which means they may not yet be on the property ladder." »

However, Stuart McCallum, partner at RSM UK, takes a different tack: "Ultimately, if the lend is correctly assessed and structured then a personal guarantee should not be required. However, if a company seeks funds with no assets or cash flow then some form of security needs to be considered to protect the borrower. Conditions can be complicated, so understanding why the requirement is needed and what the consequences are is important to establish from the beginning."

TRANSACTIONAL LENDING

This is the process, says Perlman, where "over the course of the last few decades banks have increasingly focused their relationship managers on large companies, while centralising and automating underwriting processes for smaller loans".

Such an approach has helped create a situation where the banks can't relate to SMEs, probably because they don't fall into these funding categories, but also because the high-growth ones may be perceived to be too risky.

Gareth Magee CA, a partner with Scott-Moncrieff, says: "I think a big part of [the banks'] inability to lend again lies in the loss of a generation of valuable banking relationships. The last 10 years have seen the banks lose individuals, knowledge and connections with both SMEs and intermediaries. These valuable connections will take a long time to be re-established."

Perlman says it has also created a 'funding gap'. "In 2013, the National Audit Office reported that there was an estimated 'funding gap' of between £10bn and £11bn in the UK," he explains. "They said that by 2017 this figure [the demand for loans that the market is unwilling to supply] may rise to about £22bn. In our experience this gap relates to a very specific portion of the SME market as big banks in the UK tend to focus on either small loans (in the tens or hundreds of thousands) or large loans (typically above £20m), neglecting the 'middle child' of loans between £500k and £20m."

"Big banks in the UK tend to focus on either small loans or large loans, neglecting those of £500k to £20m'

Joel Perlman

TRUST IS GONE

According to Brown, while trust is a hugely important factor in borrower-lender relationships, "I think the levels of trust were seriously eroded during the global financial crisis".

Alistair Dickson, a partner at RSM UK, agrees: "Trust is an issue. The business practices that were uncovered following the financial crash in 2008 have made businesses warier. In addition, increased regulation and a more restricted appetite to risk create more barriers to lending and can be perceived as a lack of support, particular within some sectors."

For Bruce Davis, a joint founder of alternative lender Abundance, the issue is less to do with trust. "It is more about being able to deal with someone who really understands your business and isn't driven by a computer decision at head office," he says.

Kevin Vendel, senior partnership manager at Spotcap UK, a specialist in lending to SMEs, believes there's an opportunity here the banks should grasp. He says: "Alternative lenders use innovative technology to manage the demands and needs of consumers, with a focus and efficiency previously unseen. They are particularly suitable as partners for banks as they are a delivery system for continued quality and innovation. In addition, they have the potential to help banks innovate, build trust and create new user experiences."

He adds: "Improving customer service is another important part and some banks have recently started collaborating with alternative lenders to improve their user experience and address client demand. This willingness to change is an important aspect of rebuilding trust."

IMPORTANCE OF LOAN GUARANTEES AND COVENANTS

Importance	How important is the issue of personal guarantees when seeking external finance?	How important is the nature of loan covenants when seeking external finance?
Not at all important	7.2%	20%
Neither important nor unimportant	21%	60%
Very important or extremely important	70.8%	20%

WHAT REGIONAL BIAS?

Much has been said about a regional funding bias, but our experts feel this may affect borrowing less than equity finance.

Dickson says: "There could be a sense of money following money, and as the majority of GDP is created in the south-east [of England] there could be a north/south bias regarding appetite to grow or to take on risk. However, the regional business profile, affluence and opportunities in the area will come into play so lenders outside the south-east may take a more conservative approach to lending."

Perlman agrees: "When it comes to debt finance there doesn't appear to be a north/south bias as bank lending tends to mirror the distribution of businesses across the UK."

However, when it comes to equity finance, he says: "There's definitely a north/south bias. In its research published earlier this year the Institute for Public Policy Research found that 47 per cent of all equity deals were conducted in London in 2015. Additionally, businesses in London have received 46 per cent of all Enterprise Investment Scheme and Seed Enterprise Investment Scheme funds, and when you include the south-east this figure rises to 65 per cent."

POLICY RECOMMENDATIONS

A key recommendation of the ICAS report relates to the British Business Bank's (BBB's) enterprise finance guarantee scheme (EFG) (see "Oiling the Wheels", The CA, March 2017).

EFG underwrites 75 per cent of each loan made to an SME by a participating bank, subject to an overall 'cap' on the percentage guaranteed of all EFG-related loans by value in the portfolio which, for one reason or another, SMEs can't repay. This cap or maximum 'default rate' is currently set at 15 per cent and the ICAS report recommends raising it.

Judith Hartley, MD lending solutions at the BBB, told us: "Actual loss rates for EFG vary between lenders but in aggregate are running well below the 15 per cent maximum claim limit discussed above, and are forecast to remain below the 15 per cent."

This indicates lender conservatism, implying many more SMEs could benefit from the EFG than at present – and so overcome the issue of personal guarantees.

Brown says: "Academic evidence has shown this to be a very effective means of improving access to finance in SMEs. However, the manner in which it operates by the UK's main banks may be undermining its effectiveness."

Brown points to anecdotal evidence which suggests some of the banks still require personal guarantees in addition to the guarantees provided under the EFG scheme. He also points out that it appears that the low level of defaults within the portfolio of SMEs supported by the scheme is being underutilised.

The EFG has its critics, including Magee: "There are five million SMEs in the UK which are the backbone of the economy. Less than 1 per cent have received EFG – the scheme specifically designed to support SMEs. The shocking statistics show that it simply isn't working."

KNOW THE ALTERNATIVES

Vendel says: "Many SMEs are not aware of all the funding options available to them so education is key." He adds: "What's more, many intermediaries, such as accountants, trusted advisers or corporate finance advisers, are not aware of those new offerings either and it is crucial that they understand the need to educate themselves and be up to date about new players."

According to Tim Wright, director of crowdfunding consultancy twintangibles: "I would incorporate building awareness and understanding of the alternative finance sector and the distinctive characteristics of the crowd economy into the CPD of professional bodies as I have met very few accountants, lawyers or IFAs who really do 'get it' in any meaningful way. The same applies to all business support services – like Business Gateway etc."

The latest Business Barometer survey from Close Brothers Asset Finance found that 59 per cent of UK businesses are unaware that funding can come from a large number of alternative lenders. Colin Swanston, MD of the transport division of Close Brothers Asset Finance, says: "The survey shows that 39 per cent of SMEs reach out to traditional high-street banks to raise capital, in spite of continuing hesitancy from banks to lend to small businesses. In 2016 business bank overdrafts decreased by 2 per cent, and net loans from the largest UK banks fell significantly, according to the latest figures issued by the Bank of England."

"Many SMEs are not aware of all the funding options available to them so education is key"

Kevin Vendel

BREXIT AGAIN

Meanwhile, Brexit looms. While "hard Brexit" may be giving way to "soft Brexit", one must wonder what will replace the European Investment Bank (EIB) as a source of SME funds.

According to Mike Cherry, FSB national chairman: "The EIB has supported more than 27,700 UK small businesses since its inception and the European Investment Fund (EIF) contributed almost £2bn to UK small business finance markets in the period 2011-15. An end to these funding streams once we leave the EU risks a serious shock to the availability of credit for small firms. That's why we're calling on the next government to ready the British Business Bank to replicate the work of the EIB post-Brexit. The £400m promised to the BBB in last year's autumn statement was a start but more resources will be needed if we're to see small business access to finance improve." CA

Reluctant borrowers? Examining the demand and supply of finance for high-growth SMEs in the UK (Ross Brown and Neil Lee) can be downloaded at icas.com/research. This study was funded by the ICAS Foundation (previously known as SATER)