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ERC *Insights*

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FINANCING GROWTH

Recent ERC research provides new insights into bank borrowing among UK SMEs and emphasises the potential value of effective company boards in helping firms to access appropriate finance. The evidence suggests that only around 1 in 7 small businesses in the UK seek bank funding. Yet we know that firms which do utilise external finance grow more rapidly. As the upswing takes hold what can be done to encourage more small firms to seek external finance to support their growth? Recent ERC research provides some of the answers and highlights other 'known unknowns'.

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Introduction

There is increasing optimism about the sustainability of the UK's economic recovery. Yet only around 1 in 7 small businesses are currently seeking bank funding which remains the main source of external finance for SMEs. One reason for this low demand is an overly pessimistic perception among smaller businesses about the availability of bank funding. Here, we outline ERC research which indicates that improving the quality of financial relationships - re-building SMEs' trust in the banks - is an important step to improving these perceptions and encouraging more small businesses to seek bank funding. At the same time various cognitive barriers may affect entrepreneurs' decisions to seek non-bank funding which, in some cases, may be more appropriate. What are these barriers?

The UK's SME funding landscape

Bank of England lending data provides clear evidence that bank funding remains the dominant element of SME funding in the UK. Despite attracting significant attention, flows of venture capital/crowd-funding are equivalent to less than 1% of bank lending and angel finance is not much greater. One omission from the Bank of England figures, however, is trade credit, a potentially important source of funding particularly for smaller firms. In fact, ERC analysis of company balance sheets shows that outstanding trade credit is 1.2 times the total amount of credit from financial institutions. Smaller firms themselves supply more than £80bn in trade credit and receive more than £130bn and were therefore net recipients of around £50bn of trade credit in 2012. Smaller firms are also more likely to utilise trade credit as they come out of recession and where bank credit is in relatively short supply.

The sources of finance used by individual firms at any point in time depend on a wide range of factors including the amount sought, purpose, the availability of finance and its cost. Traditional economic explanations of the supply of finance centre on the role of information costs in the supply of finance: in instances where the costs of gathering information are higher (e.g. in smaller, younger firms) finance will be less readily available. Developments in small business credit scoring have helped reduce information costs for bank finance, and some studies suggest this has helped to increase the availability of bank finance since the mid-1990s.[1] Equally, rising property prices fuelled increased (asset-based) lending during the credit boom of the mid-2000s as the availability of collateral reduces risk and information costs.

Alongside these supply-side explanations of the availability of SME finance we also need to consider the demand side of SME financing. Here, the growth ambitions of entrepreneurs, an aversion to sharing control of a business and risk perceptions are all potentially important and yet, with few exceptions, have been largely ignored in previous research.

Equity is the main alternative to debt finance for most small firms. However, information costs for equity financiers are higher than those for providers of debt finance as they must engage in extensive due diligence and monitoring due to the riskier nature of equity investments and the types of venture which seek equity finance. Often these are high-tech or knowledge-based businesses which lack a market track record and/or collateral. But they also involve management buy-outs and buy-ins of businesses with high growth potential but which has yet to be realized, either because the previous owners frustrated managers from pursuing new opportunities or because the business needs to be turned around. ERC/CMBOR research shows that, despite the huge attention given to a few large private equity backed deals, most management buyouts and buy-ins like Goodfish show significant growth after the change in ownership.[2] This may result in so-called ‘equity gaps’ where the high fixed costs of gathering information mean that small scale investments are unprofitable for many venture capital and private equity firms.

Can the increasing availability of alternative finance help fill these equity gaps? Recent developments including supply chain finance (reverse factoring), peer-to-peer lending and crowd-funding will play a more important role in funding small firms in the recovery. However, these sources of finance are currently used by a tiny minority of small businesses. In part this is due to a lack of availability. It also reflects small firms’ awareness of these products (e.g. only 18% of SMEs are aware of crowd-funding, though this is probably changing rapidly), a lack of financial expertise and a lack of confidence in being able to obtain these sources of funding.

In summary, there are various supply-side and demand-side reasons for the dominance of bank lending in the SME finance arena: the high cost of equity finance; control aversion on the part of entrepreneurs; the absence of (high) growth objectives; a lack of financial sophistication/expertise; and, a low awareness of alternative sources of finance. It would be wrong to characterise the typical small business as a ‘debt junkie’. The stock of SME lending has been contracting since late 2009[3] and only around 1 in 7 businesses currently seek bank funding (compared to around 1 in 4 before the financial crisis). What factors may be affecting businesses decisions not to seek bank funding? This question was at the core of recent research carried out by ERC[4].

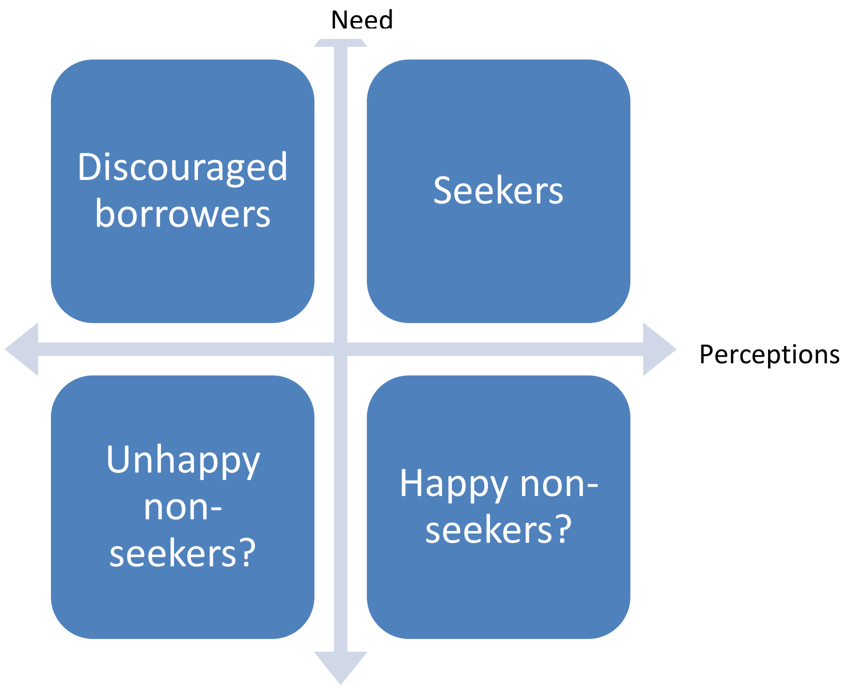
Explaining SME financing decisions

A recent ERC research project investigated the factors that affect firms’ decisions to seek (or not to seek) bank funding. The aim was to understand how we might encourage creditworthy businesses which had been discouraged from seeking bank lending to re-engage with potential lenders. The research was based on a new framework in which firms’ decisions to seek external funding depend on:

i) whether the business has external funding needs (vertical axis) which relates to the ambition of the entrepreneur[5]: more ambitious entrepreneurs, are more likely to seek external funding; and,

ii) the entrepreneur’s perceptions of whether a funding application will be successful (horizontal axis).

Figure 1: Needs, perceptions and UK SME borrowing behaviour



The financing 'needs' and 'perceptions' of SMEs divide the population of small firms into four groups (Figure 1). Three of these groups of firms have been identified in other research. These are:

- **Seekers** - with high funding needs and high perceptions of obtaining funding account for about 1 in 7 businesses (c. 600,000 firms), and which tend to be larger and older businesses with more wealthy and experienced owners. About 7 in 10 seekers obtain all of the funding for which they are looking.
- **'Happy' non-seekers** have low funding needs and therefore do not seek external finance. This large group accounts for around 4 in 5 small businesses (c. 4m firms) and are generally smaller than Seekers.
- **Discouraged borrowers** have high funding needs and low perceptions of obtaining funding. They account for about 1 in 25 businesses (c. 200,000 firms) and tend to be smaller and younger businesses compared to the other groups with less wealthy and less experienced owners.

A new group of firms identified in this research are the '**unhappy' non-seekers**. Discouragement has become so entrenched for these businesses that their growth ambition is also curtailed; a deeper malaise than 'normal' discouragement (where ambition is retained). However, an improvement in perceptions might help to rekindle their ambition. In future ERC research we plan to investigate further this newly identified group of firms.

Getting back to borrowing

A key finding of the research is that, since the financial crisis, businesses perceptions of successfully seeking bank finance have been excessively low, i.e., firms have tended to under-estimate their chances of obtaining funding. By implication more businesses would have sought funding if they had greater confidence in the outcome of their applications. Why have firms been so pessimistic? Whilst the economic climate is one factor, the main issue seems to relate to poor relationships between the main lenders and firms. This is illustrated by the comment of one entrepreneur we interviewed:

> *"At the time, I kept on phoning but they wouldn't even agree to meet me. They just asked us to email over our records and said they'd look at it, then they'd email me back with a 'no', because we'd already got a loan. It was heart-breaking to be honest - we were only asking for £10,000 and have never defaulted on any payments."*
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> *Haulage firm, East Anglia*

On a positive note the ERC research also showed that lending support initiatives, principally the Lending Code/Principles and the Independent Appeals Process, are effective in encouraging businesses to seek funding. Another firm commented:

> *"It gives you a bit of hope and encouragement. Maybe they can give you a bit of advice, because you may have missed things."*
>
> *Estate Agent, West Midlands*

But here the issue is that fewer than 1 in 5 businesses are aware of this support. So the ERC research suggests the value of raising awareness of these support initiatives and to improve financial relationships to encourage more creditworthy businesses to seek bank funding. The research also highlights the need for better signposting to alternative sources of funding where this is more appropriate.

Into the unknown…

Finance for SMEs has attracted much media attention during the recession. Research in this area remains surprisingly limited, however, and often fails to take into account the diversity of the SME population, the role of governance in shaping firms' financial decisions and the diversity of potential sources of finance. For example, discouragement may be a broader and deeper issue than we currently think relating both to 'unhappy' non-seekers and non-bank sources of finance. More research is also required to understand the wider role of entrepreneurial cognition in constraining firms' decisions to seek and use alternative funding sources.

Another issue that we do not fully understand is the impact of funding gaps – in both bank and non-bank funding - on SME growth. These funding gaps may arise: because of constraints in the supply of funding; because the business feels discouraged from seeking funding in the first place; or, due to other cognitive barriers that limit the range of finances sought by the business.

How can SMEs overcome these cognitive barriers, improving their awareness and understanding of alternative sources of finance? Recent ERC research here highlights the potential value of appointing outside directors and building boards with the right skills, commitment, networks, diversity and track records of success. Without such support, entrepreneurs may not be able to identify and seek the best sources of funding, nor to make the best use of the finance when they get it. This challenge places a key emphasis on the need to build boards in SMEs that can help entrepreneurs develop and implement growth strategies with the finance they need.

Now may be a critical time for some firms. Funding gaps can become more significant as we move out of recession, as the risk climate changes, and firms need more funding as they recover their trading activities and seek to grow. Perceptions of difficulties in accessing bank credit may also constrain the activities of entrepreneurs who see opportunities for buying into existing SMEs (such as in Goodfish) that need restructuring but which may present less risky growth opportunities than new start-ups. Such perceptions may also exacerbate the problems of increasing trade credit alluded to earlier, raising the spectre of vulnerability to over-trading. Crowd-funding and peer-to-peer lending may help to fill any such funding gaps, of course. And, they are increasingly recognized by entrepreneurs as potential substitutes for traditional bank finance. More research is needed, however, to understand the impact of these funding sources on business growth both in the short and medium-term.

[1] More generally banks tend to have an information advantage over other financiers through having a pre-existing relationship with the business and being able to observe over time how well the business manages its financial affairs.

[2] CMBOR (2014), UK Buy-outs Report First Quarter 2014 Private Equity Backed Data Supplement, CMBOR: Imperial College Business School; Wilson, N. and Wright, M. (2014), A Convenient Truth: Private Equity and Portfolio Company Growth, working paper.

[3] Bank of England (2012), *Trends in Lending – April 2012*. London: Bank of England.

[4] Fraser, S. (2014), Back to Borrowing? Perspectives on the Arc of Discouragement. ERC White Paper

[5] Specifically 'need' is positively related to ambition/productivity and negatively related to the cost of capital and the amount of capital already invested (under diminishing returns).