Secondary research into the availability of business finance

NESTA

The National Endowment for Science, Technology and the Arts (NESTA) is an independent body with a mission to make the UK more innovative. Research conducted by NESTA shows that just 6 percent of UK businesses with the highest growth rates generated half of the new jobs created by existing businesses between 2002 and 2008. So, the work of NESTA shows that supporting the relatively few firms with high growth rates will produce maximum benefits in terms of job creation.

However, NESTA's research also suggests that growth firms are currently not accessing the finance they need to expand and explore their full potential. Indeed NESTA suggest that, "Access to finance continues to be a major barrier to business growth, and the tightening of financial regulation risks restricting it further in the short term," a view that is also supported by the Financial Stability Board and the Basel Committee on Banking Supervision (FSB-BCBS). NESTA argue that there is a need to make sure the UK's new financial architecture is geared to supporting high growth firms, with the availability of multiple pools of capital and a supportive and competitive financial sector.

- **Finance acting as a barrier to growth**

While previous research by NESTA has shown that relatively few high growth companies are the key to future job creation, recent research has highlighted that obtaining finance is a particular problem for high growth firms. In a recent consultation exercise, around a third of high growth firms said obtaining finance is a significant obstacle to the success of their business, while 5.2 percent of high growth firms said that access to finance is the most important obstacle they face. It is therefore thought that for some firms with high growth potential, a lack of finance is stopping them achieving their aims.

Cash flow is also shown to be a significant obstacle for high growth firms, particularly for firms that are established and require cash to expand and fund ongoing activities. This view is also supported by other research suggesting that the UK banking system is currently ill-configured to support small and medium enterprises undergoing rapid growth (Davis, 2011; Hutton & Nightingale, 2011).

Bank lending is the source of finance for the majority of companies and it is argued that more effective provision of corporate credit needs to be encouraged. It is thought that there is a strong case that more competition in business banking, and in particular the arrival of new entrants, would improve small business finance by encouraging innovative ways of meeting borrowers' needs.

- **Venture capital**

Evidence suggests that venture capital significantly promotes innovation and business growth and creates significant spill-over effects. Venture Capital (VC) backed firms are believed to introduce more radical innovations and pursue more aggressive market strategies compared to other start-ups. There are currently between 800 and 1,100 venture capital-backed businesses in the UK and it is argued that these companies high growth potential makes them vital to our economic future.

NESTA's research highlights that the current crisis appears to have compounded issues that the venture capital industry was already facing following the dotcom crash. Of particular concern is the fact that the number of new venture capital funds established in 2009 was the lowest seen in the previous decade. However, the UK is shown to still boast the second largest venture capital market in Europe, although the UK does not perform so well in terms of early-stage investments.

Between 2007 and 2009, the number of companies receiving venture capital finance decreased by 38 percent while the total amount invested fell by 37 percent. Unfortunately we do not know if these trends have continued, but it does suggest that access to venture capital may be an issue.

- **Business angels**

After entrepreneurs develop an opportunity, and use up their own resources, they often turn to investors for early investment to keep the venture growing. Investors at this point have increasingly become known as 'business angels'. NESTA research shows that angel finance plays an increasingly pivotal role in financing growth businesses. The economics of angel investments means they can back high growth businesses smaller than those in which VC firms invest and can focus on particular regions. The best estimate for angel investment in the UK suggests they make over 3,000 investments annually with a total value of over £1billion per year. NESTA argue that expanding angel activity will provide a substantial source of finance to promising companies. Tax incentives are shown to be a major reason behind business angel investment, while the recently announced Seed Enterprise Investment Scheme (SEIS)[1] is expected to increase this type of investment.

NESTA's research focused on a sample of 158 angel investors in the UK who had cumulatively invested £134 million into 1,080 angel investments. On average, the investment into each business totalled £42,000, with 90 percent of investments being for less then £100,000. These investments typically acquired eight percent of the company, with only 10 percent of the investments acquiring 20 per cent or more of the ownership of a company

Federation of Small Businesses (FSB)

The FSB, in partnership with ICM Research, carried out a consultation exercise between September and October 2009, asking businesses in part about finance issues. The consultation received nearly 10,000 responses, and provides a useful insight into the views of businesses on finance related issues. The following information picks out the most interesting results from the survey related to businesses being able to access finance.

Figure 6 shows the sources finance sources that businesses had used in the previous 12 months, and whether they considered them to be a major or minor financial source.

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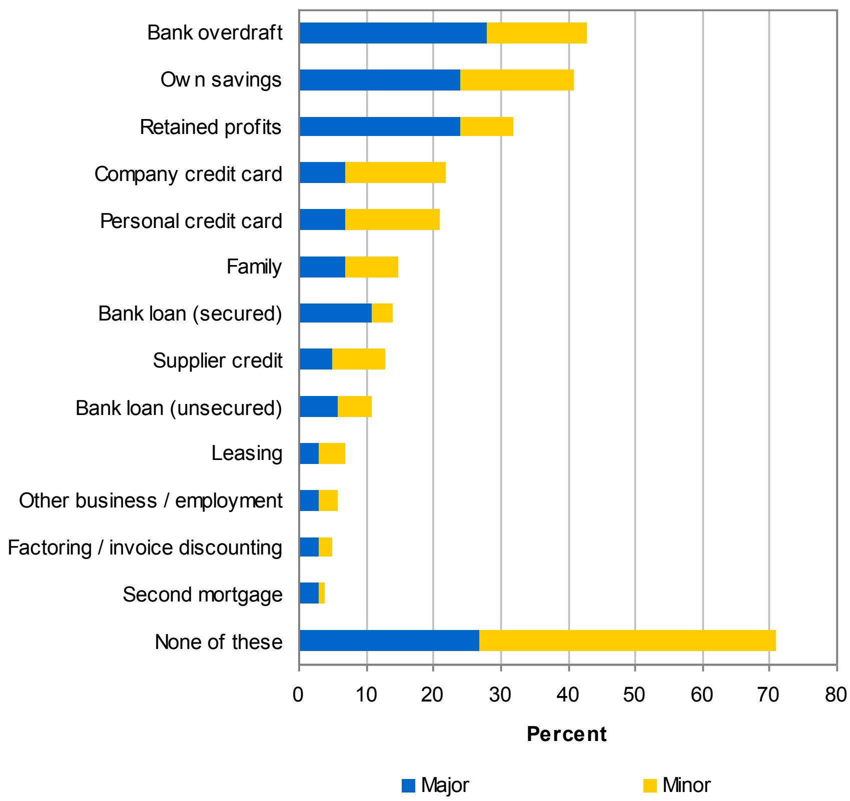
[1] Autumn Statement, HM Treasury, November 2011, http://cdn.hm-treasury.gov.uk/autumn_statement.pdf

Figure 6 - Which of the following sources have you used to finance the business in the last 12 months?

Please indicate whether you regard them as a major financial source (e.g. long-term capital provider), or minor financial source (e.g. small amounts of short-term finance).

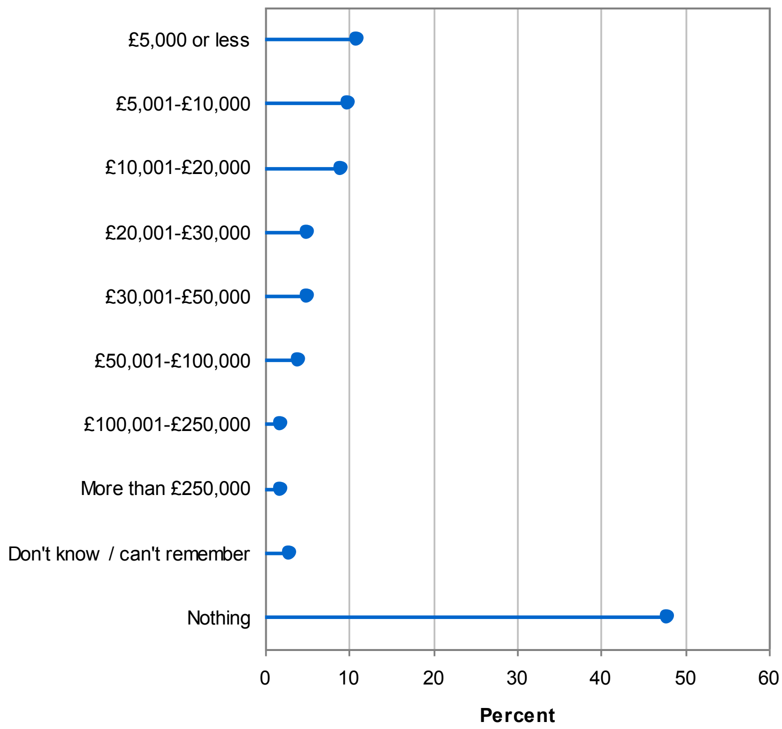


Source: FSB-ICM Voice of Small Business Survey 2009

The most common source of business finance is shown to be bank overdrafts, with 28 percent of respondents having used them as a major source of finance in the previous 12 months. Savings and retained profits are also shown to be have been used as sources of finance, particularly major sources of finance, in the previous 12 months.

Figure 7 shows how much the respondent's main business borrowed in loans from all sources in the previous 12 months.

Figure 7 - Over the last 12 months, approximately how much has your main business borrowed in loans from all sources?



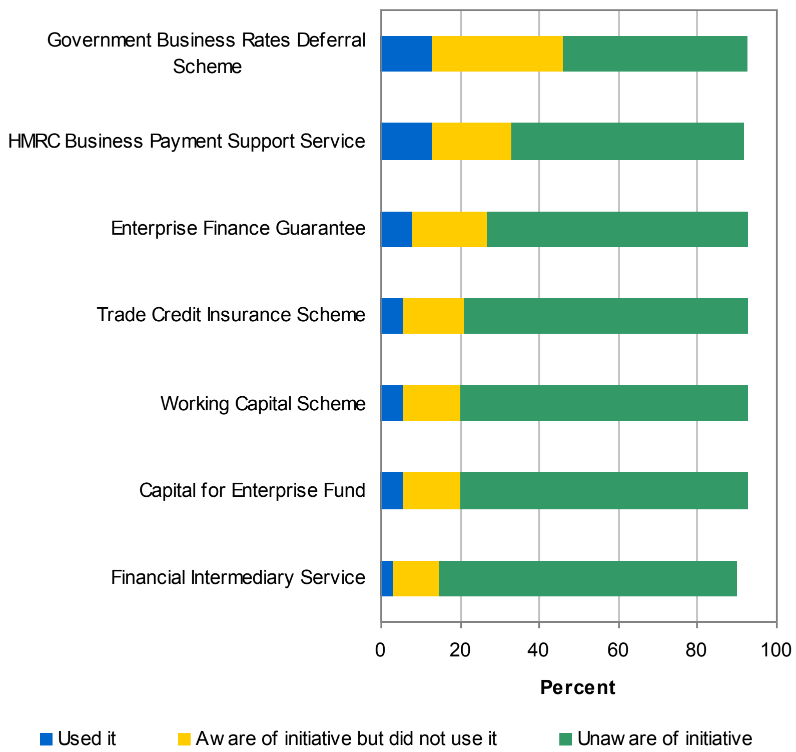
Source: FSB-ICM Voice of Small Business Survey 2009

Around half of all respondents had not borrowed any money in the previous 12 months. Looking at the amounts borrowed by those businesses that needed loans, the majority of firms had borrowed less than £20,000, with just 18 percent of businesses borrowing more than £20,000. The mean amount borrowed by all respondents in the previous year was around £25,000.

Figure 8 highlights businesses awareness of some key Government business support initiatives. Due to the survey being conducted in 2009, not all of these initiatives are now relevant, although the figure does highlight the real issue of businesses lack of awareness of potential support. What is of particular interest is the Enterprise Finance Guarantee, which has recently been extended to include businesses with higher levels of turnover[2].

[2] [2] Autumn Statement, HM Treasury, November 2011, http://cdn.hm-treasury.gov.uk/autumn_statement.pdf

Figure 8 - How helpful have each of the following Government initiatives under the 'Real help for Business' banner been for your business during the last year?

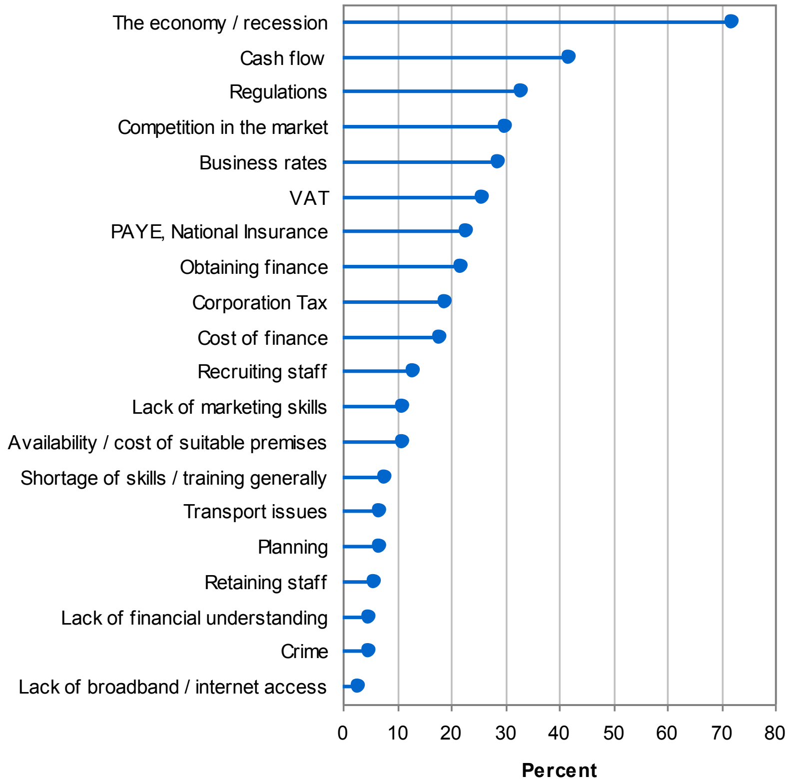


Source: FSB-ICM Voice of Small Business Survey 2009

Although the Enterprise Finance Guarantee is shown to be one of the most commonly-used and well-known Government initiatives, around two-thirds of respondents were shown to be unaware of this initiative. The high level of businesses that were unaware of major Government schemes does suggest that a great deal of businesses lack the knowledge of what support, including finance opportunities, are available to them.

Figure 9 highlights what respondents consider to be the main obstacles to the success of their business.

Figure 9 - What would you say are the main obstacles to the success of your business in general?

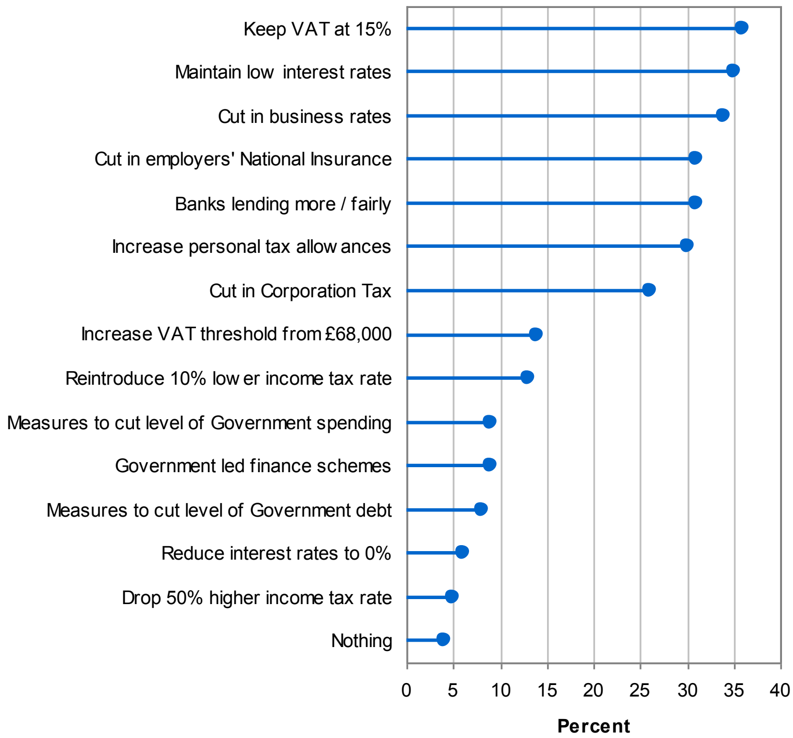


Source: FSB-ICM Voice of Small Business Survey 2009

Given the period when the consultation was conducted, it is no surprise that the vast majority of respondents perceived the economy to be a major obstacle to the success of their business. However, figure 9 reinforces the view that finance is a major concern to a lot of businesses. Cash flow is shown to be a concern for around 42 percent of businesses, a major problem for businesses with the potential for rapid expansion. Overall, 29% of respondents stated that both the cost and availability of finance are obstacles to the success of their business.

Figure 10 highlights what respondents perceive would most improve the economic prospects of their business.

Figure 10 - Which 3 of the following options in your view would most improve your business' economic prospects?



Source: FSB-ICM Voice of Small Business Survey 2009

Almost a third of all respondents stated that banks lending more and being fairer in their lending would most improve their business' economic prospects. Overall, access to finance is a key issue that is mentioned repeatedly throughout the FSB survey results. However, it should also be remembered that this survey was conducted during the economic downturn and the results may be influenced by that fact.

Academic Research

As well as research conducted by bodies with a direct interest in businesses access to finance, academics have also contributed to the business finance debate. Research conducted by YFM Equity Partners (2011) suggests that there is currently a lack of availability of debt finance, resulting in a shift in small and medium sized enterprises now seeking equity finance provided by venture capital investors and business angels. According to Harding (2000), venture capitalists usually favour high growth companies as these companies promise the highest returns, and due to the majority of firms not being high growth (as reaffirmed by the work of NESTA), a large proportion of businesses may now struggle to access funding. Rowlands et al (2009) confirm this, suggesting that a lack of data around business performance and a lack of investment readiness restrict most businesses ability to access equity finance.

Harding (2000) also suggests that there may be a lack of understanding of the nature of venture capital by the potential investees. This suggests that while venture capital may be a potential funding source for businesses, they lack the knowledge needed for this to be a viable option. Increasing awareness of such funding sources may open up finance possibilities for a large proportion of businesses.

In terms of business angels, research conducted by Mason and Harrison (2002) suggests that many business angels struggle to find suitable investees. It is thought that most business angels have defined criteria for investments, and their activity is often geographically constrained, again reaffirmed by the work of NESTA. The research also shows that 81 percent of business angels believe that inadequate quality of the business and failure to negotiate are impeding factors to investment.

Research by Bohm et al (2011) also suggests that businesses are increasingly challenged to obtain bank finance and are therefore moving towards equity, while it is also shown that certain sectors particularly struggle to access bank finance as the required investment is too high or too risky. It is also argued that while finance may be easy to access for some businesses, capital flows are drying up for the less “fashionable” established businesses.

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