

## 1.2

# Financial Market and Business Conditions for SMEs

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In the present economic conditions of the last quarter of 2001 both the financial market and business outlook for SMEs are in a state of uncertainty. Even before the terrorist outrages of September 11, it was evident that the brave assertions made at the beginning of year by the European Central Bank (ECB) and finance ministers of leading Eurozone member countries that the EU economies would be little affected by a prolonged US downturn had proved to be overconfident. The economists' axiom that 'when America sneezes, the rest of the world catches a cold' has been revalidated. It remains to be seen whether September 11 and the continuing threat of terrorism or worse will cause the 'cold' to develop into a more severe attack of economic 'influenza'.

At first sight, economic indicators suggest that business in the United Kingdom is holding up rather well. Real GDP year over year growth has declined from 2.8 per cent in the third quarter (Q3) of 2000 to 2.2 per cent for Q3 (2001), while the retail price index (January 1987=100) rose from 170.9 to 174.0 over the same 12-month period. The unemployment rate continued to fall from 3.5 per cent in Q3 (2000) to 3.1 per cent for Q3 (2001), but rose marginally in October. However, the most recent reports of the Purchasing Managers Institute (PMI) released in the first week of November provide gloomier reading.

For manufacturing, although there was a surprise increase of 1.4 per cent in output in August, the year on year growth rate remained negative at -2.0 per cent with further declines in output signalled. In October, new orders weakened for the sixth month running and export orders fell back sharply for the second month in succession to the lowest level for nearly three years. In its latest quarterly survey, the Confederation of British Industry (CBI) reported export optimism at a 20-year low.

For service-sector companies, the PMI reported that business activity contracted in September 2001 for the first time since February 1999. New orders have weakened across all sectors, with many companies deferring the placement of new contracts while the hotels and restaurants and transport sectors all reported widespread cancellations of new business. No doubt the Bank of England's Monetary Policy Committee will be closely monitoring how effective the interest rate cuts since September 11 will be in restoring confidence.

These weakening international and domestic conditions are reflected in mergers and acquisitions (M&A) activity in 2001 involving UK companies. The *Thomson Financial Datastream* third-quarter data released on 6 November ([www.ntc-research.com](http://www.ntc-research.com)) clearly shows the depressed condition of financial markets. In 2000, UK companies made 587 acquisitions of other UK companies worth almost £107 billion, but this activity dropped to 221 transactions during the first half of 2001. In 2000, there were 557 overseas acquisitions by UK companies worth more than £18 billion, but overseas acquisitions in the first six months of 2001 fell to 170 transactions worth £26.5 billion. Similarly, acquisitions in the United Kingdom by foreign companies fell from 227 worth £64.6 billion in 2000 to only 79 transactions worth £15.7 billion in the first half of 2001.

The implications of all these trends and indicators for SMEs are hardly encouraging. In the absence of further traumatic events, the most likely outlook is that consumers and businesses will continue to cut their debts and, in the case of the latter, strengthen their balance sheets.

### **Types of corporate finance available to SMEs**

#### ***Debt finance***

In the eighth edition of its report, *Finance for Small Firms* (March 2001), the Bank of England points out that, in total, SMEs have become markedly less reliant on external finance in recent years. For those that do raise external finance, traditional bank loans and overdrafts remain

the primary source of funding. Bank lending to SMEs rose rapidly in 2000 after several years of decline, with term loans accounting for 72 per cent of lending as at the end of September 2000 and the maturity profile remaining stable. A slight shift towards variable rate loans (nearly 70 per cent of total bank lending at 30 June 2000) was discernible, while asset-based and receivable finance remains significant (see Chapter 2.2).

The Bank of England's report reveals that at mid-year 2000, approximately 37 per cent of SMEs throughout Britain had loans of less than five years outstanding totalling £39,400 million, of which £28,100 million was in term borrowing. The banks were operating on a nationwide average lending margin of 2.7 per cent. The total stock of lending to SMEs reached a record high of £42.5 billion in September 2000, an increase of more than 14 per cent year over year.

The specific financing issues that technology-based small firms (TBSFs) encounter are described in Chapter 1.4, but another category of small firms with special needs is that of businesses in deprived communities. The reasons why these firms are disadvantaged are easy to understand:

- The availability of external finance is crucial because those who set up businesses in deprived areas are less likely to be able to draw on internal funds than those in more affluent areas.
- Businesses in deprived areas tend to lack business experience as well as collateral and personal equity.
- Business tends to be concentrated in sectors subject to higher failure rates; they suffer from remoteness, small and localised markets and high crime rates.

Data collected by the Bank of England indicated that the major UK banks currently lend some £1.5 billion to small businesses in some of the most deprived areas, but that the proportions of overdrafts to term loans and fixed to variable rate loans are almost the same as for the country as a whole. However, the average lending margin charged to SMEs in deprived areas is significantly greater at 4.1 per cent, which is attributable to the increased lending risk. From the data available, the default rates of small businesses in deprived areas may be over three times as high as the nationwide average.

### **Equity finance**

Although the UK venture capital industry is the largest and most developed in Europe, it currently invests little more than 5 per cent of

funds in start-ups and early-stage finance, compared with 20 per cent in expansion capital and as much as 75 per cent in management buy-outs/management buy-ins (MBOs/MBIs). Moreover, the figures for average deal sizes suggest that the opportunities for SMEs, including TBSFs, to raise formal venture capital of under £500,000 are fairly limited.

Research shows that the majority of SMEs have never accessed either private equity or public equity finance. Private equity finance comprises the two distinct markets of formal and informal equity. Formal private equity is sourced from banks, special investment schemes (some of which are described in Chapter 1.3) and private equity and venture capital firms. The term 'private equity' is commonly used in the United Kingdom in place of 'venture capital', which is reserved for a subset of private equity involving the smaller, earlier-stage and often more risky deals. The British Venture Capital Association (BVCA) has acknowledged this tighter definition by extending its logo to include 'Representing British Venture Capital and Private Equity'. The comments that follow on SME financing reflect the narrower definition of venture capital.

Essentially, venture capital involves the long-term commitment of external equity to enable businesses not listed on any public stock exchange to grow and prosper. In becoming an equity partner, the venture capitalist will place more emphasis on realising the final capital gain than regular cash flows. Typically, investments last for three to seven years, although exits are generally anticipated within five years. Typically, the venture capitalist will also provide expertise, experience and contacts to help nurture the business and the capital gain will be realised either as the result of an independent public offering (IPO) or through a trade sale.

### **Alternative sources of venture capital**

In addition to formal venture capital described above and elsewhere in this book, there are other sources of financing that play their several parts in funding the development of SMEs.

#### ***Bank equity products***

The main clearing banks, which also promote reputable 'business angels', have designed and offer a range of equity products for smaller companies. Prominent among the funds on offer from the clearing

banks are the nine HSBC Enterprise Funds, operated by HSBC, which provide investments from £5,000 to £250,000 specifically orientated to start-ups and small businesses. HSBC has committed £18.75 million to these funds since 1992. HSBC has also leveraged in money from other sources (including the European Investment Bank (EIB)), which have committed over £45 million to the Enterprise funds and a separate fund for technology-based companies, of which some £27 million has already been invested in 203 companies. The average investment value is just £133,000. In addition, HSBC Ventures, the bank's venture capital arm, specialises in investing equity sums of between £250,000 and £2 million.

Separately, the Bank of Scotland contributes to a number of Scottish-orientated funds, such as the Dumbartonshire Fund and the West Lothian Venture Fund; the Bank also participates with other clearers as an investor in the Scottish Equity Partnership. Barclays, HSBC, Lloyds TSB, and RBS-NatWest together support the National Business Angel Network (NBAN), which relies on a regional presence to match business angels with appropriate investment opportunities.

### ***Informal venture capital***

This market consists of high-net-worth individuals – 'business angels' – willing to invest risk capital in small unquoted companies. In addition to capital, business angels are able to provide expertise and advice to assist the investee company in return for their equity stake. They play an important role in filling the gap between debt finance and the formal venture capitalists whose attention is focused on larger deals. With a lower cost base and different objectives, business angels are more comfortable investing smaller amounts and are more orientated towards start-up or early-stage funding.

With its comparatively low visibility, business angels' activity is probably underestimated. The 1999–2000 edition of the BVCA directory lists 48 business angel networks and research by Southampton University,<sup>1</sup> which the BVCA commissioned, concluded that 280 registered business angels invested £20 million in 1998–99 through 192 investments in 185 companies. Based on the limited sample of BVCA registered angel networks, the same survey found that 51 per cent of business angel investments were for amounts of less than £50,000 and only 24 per cent of investments were over £100,000,

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1 BVCA, *Sources of Business Angel Capital 1999/2000* (2000).

compared with 86 per cent of formal venture capital investments. Some 60 per cent of the business angel network investments were focused on start-ups and early-stage financing and only 11 per cent on MBO/MBI investments. It was estimated in 1999 that the United Kingdom had approximately 18,000 business angels and that they invest about £500 million annually.<sup>2</sup> If this is true, the informal market would appear to provide some £300 million each year to start-up and early-stage finance, which puts it on an equal footing with the formal market in the provision of such funds.

Business angels bring other benefits to the businesses in which they invest. In particular, they can generate additional financing; banks are said to contribute to 86 per cent of businesses receiving finance packages from business angels, and venture capitalists to 25 per cent. Business angels that play an active part in advising or managing the companies in which they invest tend to act as magnets to more formal investors and give credibility to an enterprise among its customers and suppliers. Indeed, through the media of the banks and the Small Business Service (SBS), encouragement is being given to business angels and formal venture capital funds to co-invest in SMEs.

### **Overview of external finance sources for SMEs**

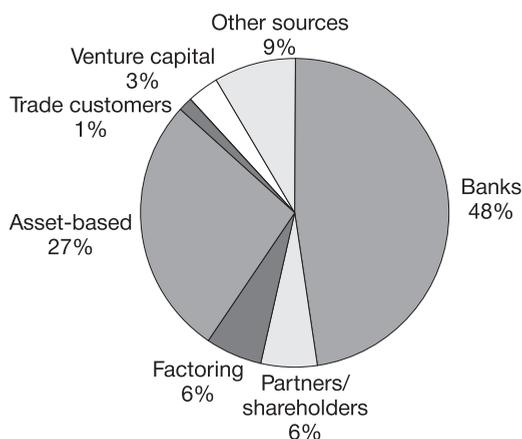
The different forms of debt and equity finance up to public flotation are discussed in detail in Parts Two and Three of this book, but Charts 1.2.1 and 1.2.2 help to put into perspective the relative contributions which each make to the provision of external finance for SMEs.

Perhaps the most striking conclusion from a first glance at the charts is the very small contribution that formal venture capital makes to the overall financing requirements of SMEs. Given the present economic environment and confidence levels, it seems unlikely that this contribution will be raised from the 1997–99 level of 1 per cent in the foreseeable future.

The second significant point is that the proportion of SME external finance provided by the banks rose from 48 per cent over the period 1995–97 to 61 per cent in the period 1997–99, and, as the absolute value for bank lending in September 2000 indicates, appears to be rising

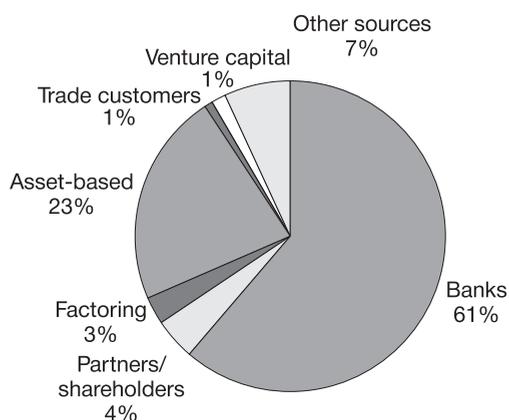
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2 Mason, C and Harrison, R.: 'Public Policy and the Development of the Informal Venture Capital Market: UK Experience and Lessons for Europe', in K. Cowling (ed), *Industrial Policy in Europe* (1999).



**Figure I.2.1** Sources of external finance for SMEs 1995–97

Source: ESRC Centre for Business Research Cambridge



**Figure I.2.2** Sources of external finance for SMEs 1997–99

Source: ESRC Centre for Business Research Cambridge

further. However, it is possible that the survey on which the charts are based has magnified the extent of any recent shift to traditional bank finance, because the database contained a disproportionately high element of expanding firms seeking finance and fewer sole traders and partnerships.

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