British Business Bank

Small Business Finance Markets 2021/22

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Foreword

Through its programmes, the British Business Bank sees daily examples of external finance helping businesses to start up, to grow and to manage the challenges of trading towards recovery. At the same time, we are committed to breaking down the barriers that some businesses face in accessing finance, to championing sustainable growth, and to backing increased investment in innovation through improved financial support.

In this, our eighth annual Small Business Finance Markets report, we use our unique position at the intersection of government and financial markets to survey the smaller business finance landscape. Our analysis provides an independent and comprehensive assessment of how finance was used in 2021, the outlook for 2022 and the challenges and opportunities further ahead.

2021 clearly bore the marks of the year that preceded it. Bank lending fell by 45% year-on-year, with just under £60bn lent, broadly in line with pre-pandemic levels. The fact that such a sharp fall could merely bring lending back to historic averages shows just how unique 2020 was and, equally, the important role the government's Covid-19 emergency finance schemes played in helping sustain many thousands of UK businesses throughout.

The British Business Bank has always been a champion of greater diversity in finance markets. It is therefore particularly encouraging to see many forms of alternative debt finance showing signs of recovery in 2021, including challenger and specialist banks' share of the market rising sharply to a record high. Equity finance also provided grounds for optimism last year, with smaller businesses in the UK on course to raise double the amount of equity capital seen in 2020.

Looking to the year ahead, the anticipated economic recovery should create many growth opportunities that smaller businesses can seize using external finance. Forecasters expect strong growth during the year, particularly in business investment, and this should help to grow demand for finance still further.

The past two years have, however, meant smaller business leaders are increasingly attuned to economic uncertainty. As recently as winter 2021, the emergence of the Omicron variant triggered another wave of contingency planning and businesses are now likely to be taking into account developments in the wider economy.

Many businesses will also be mindful of having altered balance sheets following the pandemic. All sectors of the economy saw increases in debt use and, while data on several measures of debt sustainability have moved in the right direction during the year, debt positions may weigh down on flows of finance, particularly in the sectors most affected by the pandemic.

Each individual business will, of course, make finance decisions based on their own particular context. We know from past research and from our role as a market participant that business characteristics can influence finance flows but, in this year's report, we have also examined how the characteristics of business leaders and the locations in which they operate can play a role.

Finance outcomes show significant variation from place to place. This is something we analysed in depth in our Regions and Nations Tracker last year, and shows the importance of the aims of the Levelling Up agenda in helping entrepreneurs and businesses across the UK to draw fully on the opportunities afforded by greater access to finance.

Breaking down the barriers faced by businesses operating in less well served local finance markets offers the prospect of not just economic gains, but environmental improvements too. Businesses in all parts of the UK are involved in eco-innovation and all businesses, wherever they are based, will need to take action on their own carbon emissions if the UK is to reach net zero.

Given the role of finance in driving both economic growth and environmental improvement, it is vitally important that business leaders of all backgrounds have equal opportunities for access. This year's report finds that Ethnic Minority-led businesses are more open to using finance and have greater ambitions for growth, but experience higher rates of discouragement and rejection. Female-led businesses are also more likely to be discouraged from applying, citing issues such as uncertainty over where to find finance and concern over the application process being too burdensome.

Creating more opportunities by breaking down barriers in access to finance for businesses led by people of all backgrounds and in all locations, championing sustainable growth and backing innovation are all core to the British Business Bank's strategic objectives. The Government's 2021 Spending Review will enable us to meet these more fully, with funding for 33,000 Start Up Loans over the next three years, expansion of our Regional Angels Programme, and four new and two extended Regional Funds.

These programmes play an important role in breaking down barriers. Start Up Loans has consistently enabled more female and Ethnic Minority entrepreneurs to establish and grow their businesses, while our regional programmes are specifically designed to provide additional finance options for smaller businesses operating in places with less well served finance markets.

Across our range of programmes, the Spending Review will enable us to make a further £4.9bn of financial commitments and loans. As we do this, retaining a deep understanding of the markets through which these funds will be deployed, and strengthening our relationships with market participants, remains vital. We know there are huge opportunities that will come from improving access to smaller business finance and hope that this report acts as a source of insight and inspiration for all those with an interest in helping deliver these opportunities.

Catherine Lewis La Torre
CEO, British Business Bank

Executive summary

External finance has played an important role in helping smaller businesses navigate the Covid-19 pandemic. As we move further into our economic recovery, smaller businesses will be greeted by new opportunities and challenges where finance can make an impact.

Finance can help smaller businesses to grow and transform. It can help them manage the fluctuations of their trading environment and can even support them in contributing to environmental or societal change.

In this year's Small Business Finance Markets report we examine how businesses have used finance for each of these purposes in 2021. We analyse the outlook for 2022 and we investigate the challenges and opportunities further ahead.

1

2021 was a year of contrast between debt and equity smaller business finance markets

Lending to smaller businesses by UK banks returned to pre-pandemic levels after a record £104.8bn was lent in 2020. The mix of providers also reverted to pre-Covid patterns, with challenger and specialist banks accounting for 51% of lending, up from just 32% in 2020 and broadly in line with 2018 and 2019.

Other forms of debt finance also saw pandemic-related trends begin to ease away. Alternative finance markets such as private debt, asset finance, and invoice finance and asset-based lending all saw rebounding levels of activity after a difficult 2020.

The year also featured continued innovation and structural change. For many lending types, changes were positive including the award of banking licences to three new lenders that will serve smaller businesses.

In the private debt space, however, the continued shift towards larger and larger funds meant just 3% of 2021 fundraising went to the sub-£250m funds who typically cater for smaller businesses.

Equity markets for smaller businesses have seen growth across the board in 2021. In the first three quarters alone, £14.0bn of investment was recorded which already exceeds the £8.7bn invested in 2020.

Investment records were set at all deal stages in the first three quarters and there was also strong growth in deal volumes which, at 1,811, are 20% up on the equivalent period in 2020. Competition for deals has played a big part in driving investment levels through its effect on deal sizes which rose to an average of £8.4m.

2021 was also a strong year for equity exits, financial returns and fundraising. The 258 exits during the year released value of more than £35bn contributing to increases in several measures of financial returns. Fundraising of £4.0bn during the year was spread across the fund size spectrum and left dry powder at record levels.

2

Output and investment growth in 2022 should create demand for finance but notes of caution remain, particularly in sectors most hit by Covid-19

The Bank of England (BoE), the Office for Budget Responsibility (OBR) and a range of independent forecasters all expect strong growth in 2022. GDP is expected to increase by between four and six per cent and business investment by between 14% and 16%.

Growth at these levels should generate significant demand for finance in 2022 but there are some potentially countervailing forces. High inflation raises the prospect of further interest rate increases beyond the 40 basis point uplift the BoE has enacted already.

Another headwind comes from increased debt levels among some smaller businesses. Finance use increased in all sectors following the pandemic with an estimated 600,000 smaller businesses borrowing for the first time and many more returning to finance use or taking larger facilities.

Prospects for further demand among this group of new and existing borrowers will be influenced by how their debt positions evolve over the coming year. Survey data collected in late 2021 show that less than half of the smaller businesses that took out finance in the wake of the pandemic had spent all of their facility. This echoes data on smaller business deposits which reached a record high in 2021 and suggests that for many businesses, increases in current liabilities were offset by increases in current assets.

Data on other indicators such as repayments relative to turnover, self-reported insolvency risk and credit ratings also paint a relatively improved picture. There are, however, important sectoral differences with smaller businesses in sectors that were hardest hit by the pandemic, such as hospitality and transport, typically reporting the highest levels of concern over debt repayments.

Lenders understandably also appear to be most concerned about this group. BoE Agents report lender caution over-extending further credit to these borrowers which is likely to have played a part in falling approval rates. Sixty-five per cent of smaller business debt facilities were approved by the largest seven lenders in 2021, 30 percentage points down on the peak in 2020 and around 15 percentage points below pre-pandemic levels.

3

In the longer-term, finance can unlock sustainable growth, but female-led and Ethnic Minority-led businesses are missing out

Evidence from the Bank's programmes and beyond shows the transformative impact of external finance. There are business leaders from all backgrounds that recognise this impact but those from an Ethnic Minority background are most likely to be open to using finance in their business.

Half of Ethnic Minority-led businesses are open to using finance for growth compared to 32% of White-led businesses. Though Ethnic Minority-led businesses are more open to using finance, they are also more likely to be discouraged from doing so. In 2021, 20% of Ethnic Minority-led businesses wanted to apply for finance but were stopped by something compared to just 8% of White-led businesses.

Key reasons for discouragement include fear of rejection, not knowing where to find appropriate finance and concerns over the decision taking too long or being too much hassle. Female-led businesses are also more likely to be discouraged than male-led businesses and typically cite similar factors.

Ethnic Minority-led businesses that do apply for finance face notably higher rejection rates. Between 2018 and mid-2020, 52% of Ethnic Minority-led businesses that applied for finance were turned down compared to just 22% of White-led businesses. Rejection rates dropped markedly for all businesses from Q3 2020, following the introduction of the Bounce Back Loan Scheme. However, the 18% rejection rate among Ethnic Minority-led businesses after Q3 2020 was still eight percentage points above that for White-led businesses.

In addition to patterns of discouragement, representation among finance providers can also influence finance outcomes. This is particularly true in the equity space where networks and warm introductions are important. Consequently, the underrepresentation of both women and people from Ethnic Minority backgrounds in investing teams is likely to contribute to the stark underrepresentation of female-led and Ethnic Minority-led businesses receiving equity investments.

4

Businesses operating in places with thinner finance markets miss out too

It is not only Ethnic Minority and female-led businesses that face barriers to accessing finance, businesses operating in places with thinner finance markets face additional challenges too. On the demand side, smaller businesses outside of London are less likely to be open to using finance, have lower awareness levels of certain finance forms and are less likely to have finance experts in their business.

On the supply-side, entrepreneurs in less affluent areas may be less able to provide collateral to unlock lending while those operating outside of London will also have fewer equity and private debt providers nearby. Distance matters for these complex and flexible forms of finance and while investor presence has improved outside of London, the capital's status as a globally-leading finance ecosystem means gaps in investor presence in the UK have actually widened.

These gaps mean that equity, in particular, continues to be concentrated in the capital. London companies received 70% of equity investment in 2021 to date with companies in central London EC postcodes alone taking in 27% of the national total.

5

Breaking down barriers to smaller business finance and accelerating finance use are vital to achieving net zero

In addition to the economic opportunity from breaking down barriers to finance use, there is also an environmental opportunity. This goes beyond just those that face specific barriers and includes all businesses, each of which have a role to play in reaching net zero, whether as an eco-innovator or an eco-adopter.

Eco-innovators devise the technologies and processes that help others reduce their environmental impact. Developing new technologies in often untested markets means equity finance typically suits their risk profile.

2021 was a good year for these companies who are often badged as clean tech reflecting that they use technologies, materials, or processes to reduce harmful environmental impacts and promote the sustainable use of resources. Clean tech companies attracted £572m of equity investment across 147 deals spanning 46 different sectors in the first three quarters of 2021.

This investment is increasingly coming from investors that do not have an explicitly environmental or social impact focus, reflecting that considering these factors is increasingly mainstream. Eighty-three per cent of fund managers who responded to our 2021 survey considered environmental factors in investment decisions with 52% considering these factors significant or integral to investing.

With more investors supporting a broader set of eco-innovators to progress their offerings, eco-adopters look set to have more options for lessening their environmental impact. Using finance can help smaller businesses take up these options but currently only 11% of smaller businesses have used finance to reduce their environmental impact.

Given that all businesses will need to reduce their carbon emissions, the finance needs of future eco-adopters are incredibly diverse. Debt products such as bank loans and asset finance are likely to feature prominently, but all finance forms will have their niche and the finance system as a whole will need to continue to reorient itself toward environmental goals.

The Bank, with our mission to drive sustainable growth and prosperity across the UK, and to enable the transition to a net zero economy, by supporting access to finance for smaller businesses, is uniquely placed to help drive this continued reorientation over the medium-term and to further break down barriers to accessing finance. Last year's Spending Review gave us the funding to make over £4.9bn of financial commitments and loans, expanding our programme of activity to help us, and the partners we work with, achieve an even greater impact.

Introduction

This is the eighth annual British Business Bank Small Business Finance Markets report, analysing the latest developments in smaller business finance markets and assessing the outlook for the period ahead.

Our understanding of smaller business finance markets, both in terms of the latest available data, and the intelligence we obtain as an active participant in finance markets, is central to delivering on our objective to be the centre of expertise on these markets for government. It is also used to shape our business plan and in the design of our programmes and products.

New evidence and analysis

The British Business Bank has continued to develop evidence and analysis to deepen our understanding of smaller business finance markets. In particular:

– We have refreshed our Business Finance Survey to keep the topics covered up to date.

– We have continued to evolve Part B of the report to give more insight into smaller business finance markets. For example, this year we have analysed data provided by the National Association of Commercial Finance Brokers and from the Bank's UK Network survey of finance intermediaries.

– We have made continued use of the Bank's management information and market contacts.

This report also references a wide range of evidence drawn from academic, government and market research. We are keen to further increase the range of researchers we work with.

Structure of the report

As usual the report is split into two sections to allow both consideration of broader trends and issues in smaller business finance markets, and to explore specific segments of the market in detail.

Part A of this year's report is dedicated to exploring the role of finance in sustainable growth. The three main sections in Part A cover the challenges and opportunities of financing the UK's diverse entrepreneurs, financing smaller businesses in all parts of the UK and financing smaller businesses' net zero journeys.

Part B examines developments in the macroeconomy, smaller businesses' debt positions and the smaller business population. It then considers in more depth the markets for different types of debt and equity finance most widely used by smaller businesses, identifying the drivers of the latest trends.

Aggregate flow and stock of smaller business finance

– Bank lending returned to pre-pandemic levels in 2021 from a record high in 2020
– There were increases in asset finance and marketplace lending
– 2021 was an exceptional year for equity finance, with investment on course to double its 2020 record level

This section brings together the latest data from a range of sources on the volume and value of various types of external finance provided to smaller businesses. Consistent and comprehensive data outlining the value of the aggregate stocks and flows of all forms of external finance is not readily available. However, the summary table below provides a reasonable snapshot. While flows of different types of finance are not directly comparable, the data shows that bank lending remains the single largest form of external finance for smaller businesses.

Figure 1:

Estimates of the flow and stock of external finance for UK SMEs (£ billions) (a)

		2016	2017	2018	2019	2020	2021
Bank lending stock Source: Bank of England	Outstanding Amount (b)	166	165	166	168	213	**209**
Bank lending flows Source: Bank of England	Net flows (c)	3.3	0.7	0.6	2.1	46.6	**-8.0**
Other gross flows of SME Finance	Gross flows (d)	59.2	57.3	57.8	56.9	104.9	**57.7**
Private external equity investments		3.9	6.8	7.1	8.1	8.7	**14.0** (Q1-Q3)
Source: Beauhurst (e)	Number of announced deals	1588	1825	1846	1941	2032	**1811** (Q1-Q3)
Asset finance flows Source: FLA (f)		17.0	19.0	19.5	20.2	16.0	**19.9**
Marketplace lending flows Source: British Business Bank analysis of finance provider submissions and public filings (h)	Business lending and commercial/business property lending (g)	2.1	2.9	3.4	4.0	4.0	**4.1**

(a) The information contained in this table should be viewed as indicative as data and definitions are not directly comparable across different sources. There can be some double counting across estimates in different parts of the table. Flows data are cumulative totals for the year or to the date stated. Non-seasonally adjusted. All numbers are in billions, except number of reported equity deals, and have been rounded appropriately.
(b) Movements in amounts outstanding can reflect breaks in data series as well as underlying flows.
(c) Net flows does not always reconcile with change in stock due to differences in statistical reporting. The reported stock can include other adjustments made by banks but not detailed when reported, whereas flows data does not include these adjustments.
(d) Data exclude overdrafts and covers loans in both sterling and foreign currency, expressed in sterling. The total may not equal the sum of its components due to rounding.
(e) Beauhurst is a market data provider that records visible equity deals including crowdfunding deals (2021 data for Q1-Q3 only).
(f) The Finance & Leasing Association (FLA) whose members make up 90-95% of the market.
(g) Commercial/business property lending data does not include residential mortgages.
(h) 2021 data is only partial, several finance providers are yet to publish 2021 full year data.

Bank lending returned to pre-pandemic levels in 2021 from a record high in 2020

Gross lending (excluding overdrafts) to SMEs by all UK banks in 2021 was £57.7bn, according to the data from the Bank of England. This was up 1% from £56.9bn in 2019, before Covid-19. However, 2021 lending was 45% down from 2020, when a record £104.8bn was recorded.

The fall in gross lending in 2021 was driven by lower drawdowns of government loans. The Coronavirus Business Interruption Loan Scheme (CBILS) and the Bounce Back Loan Scheme (BBLS) closed to new applications in March 2021 with the Recovery Loan Scheme (RLS) opening immediately after.

According to British Business Bank data, the total value of the CBILS, BBLS and RLS facilities drawn down from banks in 2021 was £8.0bn. This was down significantly from the £56.7bn drawn down from CBILS and BBLS in 2020.

There were increases in asset finance and marketplace lending

The SME asset finance market reported an increase in new business of 25% in 2021 to £19.9 billion following a fall of 21% in 2020 to £16.0 billion. The recovery by this market during 2021 meant the annual new business level was only 1% below 2019, the pre-Covid peak.

Gross flows of lending to businesses via marketplace lending were £4.1bn in 2021, marginally up on 2020 when £4.0bn was lent. The increase in lending during the year comes despite the closure of BBLS and CBILS which were key to supporting volumes in 2020. This suggests activity during the year has shifted back towards more market-based lending.

2021 was an exceptional year for equity finance, with investment on course to double its 2020 record level

£14bn was invested over the first three quarters of 2021, a 130% increase on the £6.1bn invested over the same quarters in 2020. With one quarter still to go, investment has already exceeded the £8.7bn invested in the whole of 2020, itself a record at the time.

Key drivers for this are larger deal sizes and higher valuations, especially at the later stages. There are also indications of fund managers increasingly competing for deals. Alongside greater investment levels, deal volumes have increased too. Over the first three quarters of 2021, 1,811 equity deals were completed in UK SMEs, a 20% increase on the same quarters in 2020.

Part A

Finance and sustainable growth

Part A of this year's Small Business Finance Markets report is dedicated to exploring the role of finance in sustainable growth.

The three main sections cover the challenges and opportunities of financing the UK's diverse entrepreneurs, financing smaller businesses in all parts of the UK and financing smaller businesses' net zero journeys.

1.1

Financing sustainable growth

- The UK's 5.6 million smaller businesses generate £2.3 trillion of turnover, employ more than 16 million people but are responsible for emissions of more than 120 million tonnes of carbon dioxide equivalent per year
- External finance can help smaller businesses contribute to economic growth while reducing environmental impacts
- Finance-fuelled growth needs to be widely spread and efforts to reduce environmental impacts need to be accelerated

The British Business Bank has a mission to drive sustainable growth and prosperity across the UK, and to enable the transition to a net zero economy, by supporting access to finance for smaller businesses.

The UK's 5.6 million smaller businesses generate £2.3 trillion of turnover, employ more than 16 million people but are responsible for emissions of more than 120 million tonnes of carbon dioxide equivalent per year

Small and medium-sized enterprises make up 99.9% of the UK business population and also account for large shares of employment and turnover. The 16.3 million employee positions within smaller businesses make up 61% of the total while the £2.3 trillion of turnover they generate represents just over half (52%) of the private sector total.

Understandably, given their large share in economic activity, smaller businesses also have a sizeable environmental footprint. Research by the Bank last year quantified one aspect of this, estimating that smaller businesses accounted for around half of UK business-driven greenhouse gas emissions. This share is in-line with smaller businesses' contribution to private sector turnover but still means these businesses drive emissions of approximately 120 to 150 million tonnes of carbon dioxide equivalent per year.

External finance can help smaller businesses contribute to economic growth while reducing environmental impacts

Maintaining or increasing sales is the most common ambition for smaller businesses with more than seven in 10 rating this as a high priority. Reducing carbon emissions, environmental impacts and waste is not too far behind, however, and is a high priority among five in 10 businesses.

External finance can help with both of these ambitions and, encouragingly, sizeable shares of smaller businesses are already open to the prospect of using external finance to fuel growth or to benefit the environment. More than one in three smaller businesses are happy to use finance to fuel growth while around one in five are currently open to using finance for environmental actions (Figure A.1).

In many circumstances businesses will be able to improve environmental outcomes and their bottom line through the same actions. This will often involve adopting more efficient technologies or processes but there is also a group of innovative smaller businesses whose revenues derive from creating environmentally friendly products and services for others to adopt.

Evidence from the Enterprise Research Centre suggests this group of businesses who are using innovation to make their core product and service offering less carbon intensive could be quite large. In 2020, their Business Futures survey found that 25% of respondents had introduced new low carbon products or services to the market in the past year.[1]

Finance-fuelled growth needs to be widely spread and efforts to reduce environmental impacts need to be accelerated

It is encouraging that sizeable proportions of smaller businesses are already open to using finance to grow their company, help reduce their environmental impact or achieve both these aims. We know, however, that there are barriers which inhibit finance demand, discourage finance supply and confuse the finance landscape.

Without breaking down these barriers, the benefits of smaller business growth will continue to be spread unevenly across different parts of the UK and between entrepreneurs with different background characteristics. Equally importantly, without enhancing the role finance can play in net zero innovation and adoption, the powerful contribution smaller businesses can make toward environmental goals will remain underexploited.

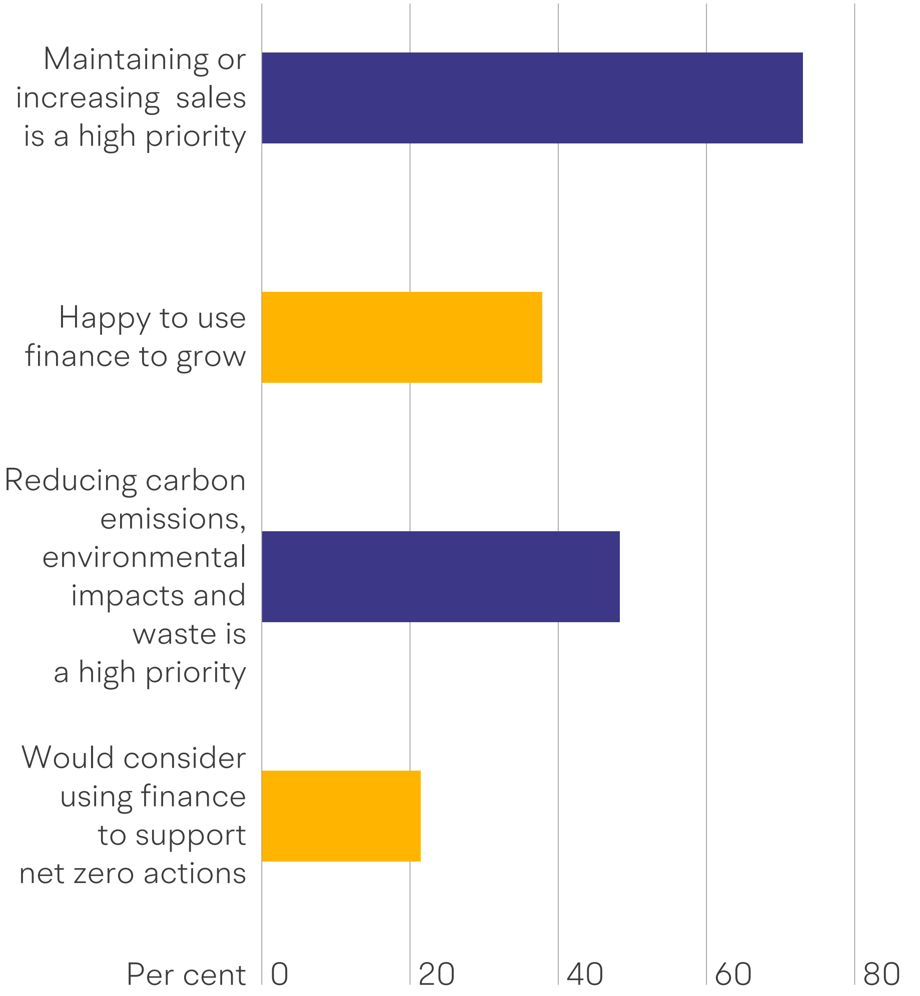
Given these challenges, we have dedicated Part A of this year's small business finance markets report to setting out some of the evidence on the barriers we want to break down and on the ways in which we want smaller business finance to help tackle climate change.

In sections 1.2 and 1.3 we set out how smaller business leaders' personal diversity characteristics and geographical locations can influence the finance landscape they face. We follow this in section 1.4 with an examination of the role finance can play in progressing towards net zero. Taken together, these three chapters will shed light on the challenges the Bank and others need to face to drive sustainable growth and prosperity across the UK, and to enable the transition to a net zero economy.

Figure A.1

Smaller business priorities and openness to external finance

Source: British Business Bank Net Zero Survey 2021, n=877 and BVA BDRC SME Finance Monitor H1 2021, n=8,513



1.2

Financing the UK's diverse entrepreneurs

- Ethnic Minority-led businesses are more open to using finance but, along with female-led firms, face barriers to getting it
- Ethnic Minority-led and female-led businesses are less likely to get finance, leading to negative impacts on their business
- Covid-19 has disproportionately impacted underrepresented groups, increasing their need for finance
- Despite increased availability of finance through government-backed schemes, barriers remain
- Bank programmes continue to provide finance for underrepresented groups and we are working with partners to improve data collection and reporting on diversity

The UK's diverse entrepreneurs face barriers in accessing the finance they need to help their businesses survive and grow. Not only can these barriers prevent businesses from achieving their growth potential, they can also stop some entrepreneurs from launching their business in the first place.[2] We draw on a range of survey data to compare access to finance for Ethnic Minority-led and female-led smaller businesses to their White or male-led counterparts.[3,4]

We have followed definitions adopted within our source survey data to ensure consistency and to aid comparison within and between datasets. As a result, the group of Ethnic Minority-led businesses in this analysis excludes those led by White Minorities which are included within the White-led group. We recognise the imperfect nature of grouping diverse entrepreneurs and businesses along these lines and welcome further engagement on data collection to reflect this diversity.

The challenges faced by all businesses and their leaders can be caused and/or exacerbated by a range of factors beyond ethnicity and gender. Age, social background, place, disability, education, income, working hours and caring responsibilities are among the examples. Firm characteristics like size, location, sector, business age and risk profile influence access to finance too.[5] We also recognise the compounded challenges faced by female entrepreneurs from Ethnic Minority backgrounds, highlighted by previous Bank research, and where possible include results for this group. We highlight where these differences exist with the aim of identifying further areas for research and exploration.

Around 7% of smaller businesses are led by an individual or team identifying as being from an Ethnic Minority background and around 24% of the UK's business population is female-led. Ethnic Minority-led businesses are more likely to be in wholesale/retail, transport, storage and communication, with fewer in production industries.

Ethnic Minority-led businesses are also more likely to be younger businesses (less than five years old) and based in London (50% compared to 15% of White-led firms). Female-led businesses are more likely to be in hotels and restaurants, health and social work and other community, social and personal care services.[6]

The scale of entrepreneurship amongst Ethnic Minorities and females is likely to be higher than reported by business surveys: around 12% of the UK's self-employed workforce identify as being from an ethnic group other than White and 35% of all self-employed are women.[7] According to the Global Entrepreneurship Monitor, one in three growth-oriented entrepreneurs are women.[8] Research has also highlighted the entrepreneurial contribution of other underrepresented groups, such as migrants and young people.[9]

Ensuring all entrepreneurs have equal opportunity to access finance regardless of personal characteristics and background will help support job creation and growth.

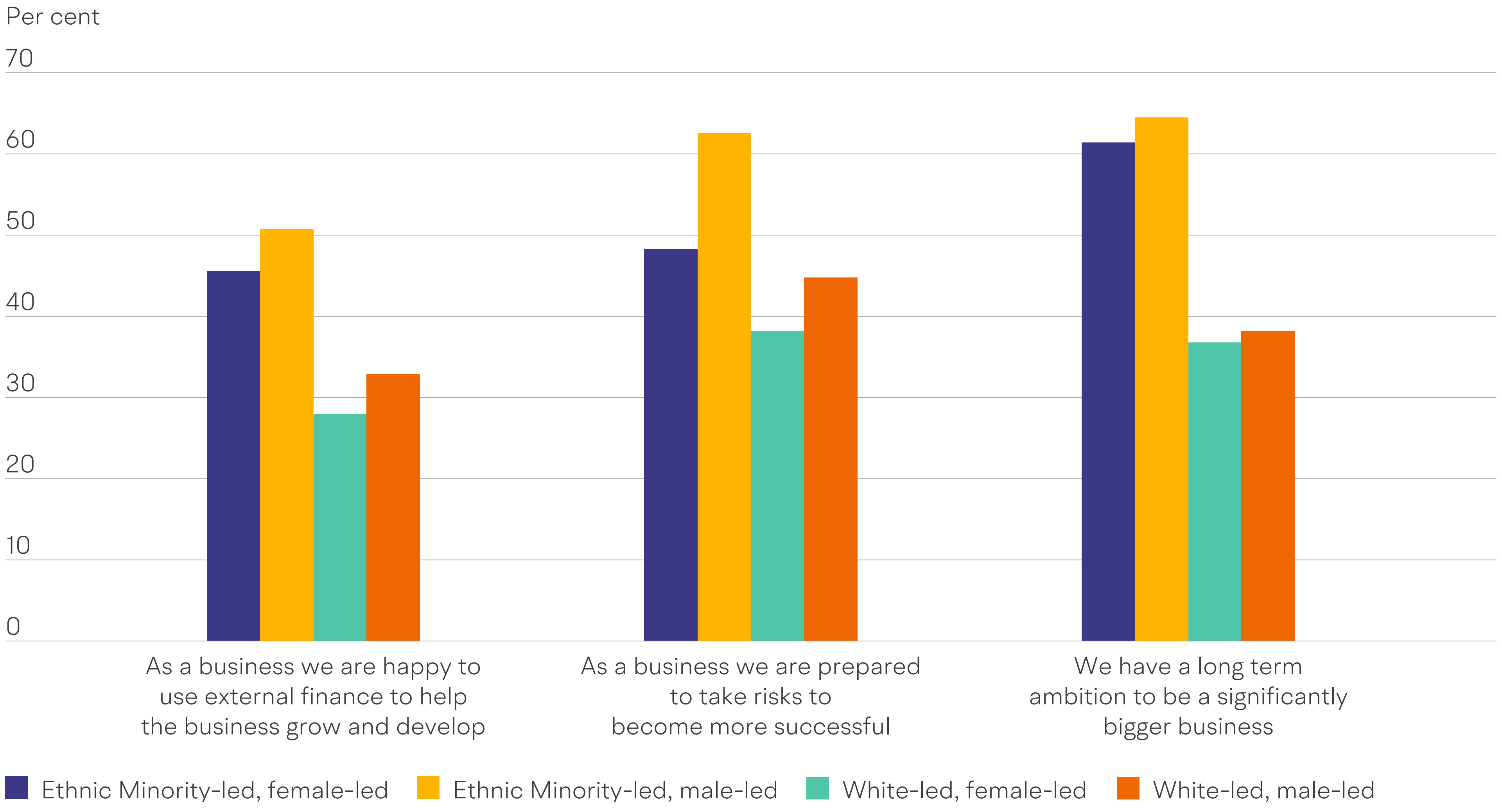
Ethnic Minority-led businesses are more open to using finance but, along with female-led firms, face barriers to getting it

Ethnic Minority-led businesses are more open to using finance and have stronger growth ambitions than White-led firms (Figure A.2). Ethnic Minority-led firms are also less likely to say they never think about using more finance, their plans are based on not taking on additional external finance and they would accept slower growth (rather than borrowing to grow) than their White-led counterparts.[10] Research has pointed to a consistent correlation between Ethnic Minority-led businesses, growth ambitions and willingness to take risks, central to entrepreneurship.[11,12]

Figure A.2

Willingness to use finance to grow and develop, willing to take risks and aspiring to grow, by ethnicity and gender of business owner/partner(s)

Source: BVA BDRC SME Finance Monitor, 10 quarters to Q2 2021



Female-led businesses tend to show more caution with risk-taking and finance use than their male counterparts, although this varies by ethnicity. Appetite for using finance has significantly increased amongst female-led businesses (31% in Q2 2020-Q2 2021, up from 26% in Q1 2019-Q1 2020), but remains lower than for male-led businesses at 39%.

Despite greater willingness to use finance, Ethnic Minority-led firms were around twice as likely to see access to finance as an obstacle to running their business (Figure A.3). Over half (53%) of Ethnic Minority-led businesses thought it would be difficult for them to get finance over Q2 2020-Q2 2021, compared to 38% of White-led businesses, despite increased availability of finance following the launch of the Bank's Coronavirus Business Interruption Loan Schemes.

Perceived finance constraints can discourage businesses that need finance from applying as they expect to be rejected.[13] Personal characteristics influence this discouragement. Coming from an Ethnic Minority background, being female or having a lower income have all been associated with higher rates and intensity of borrower discouragement.[14,15]

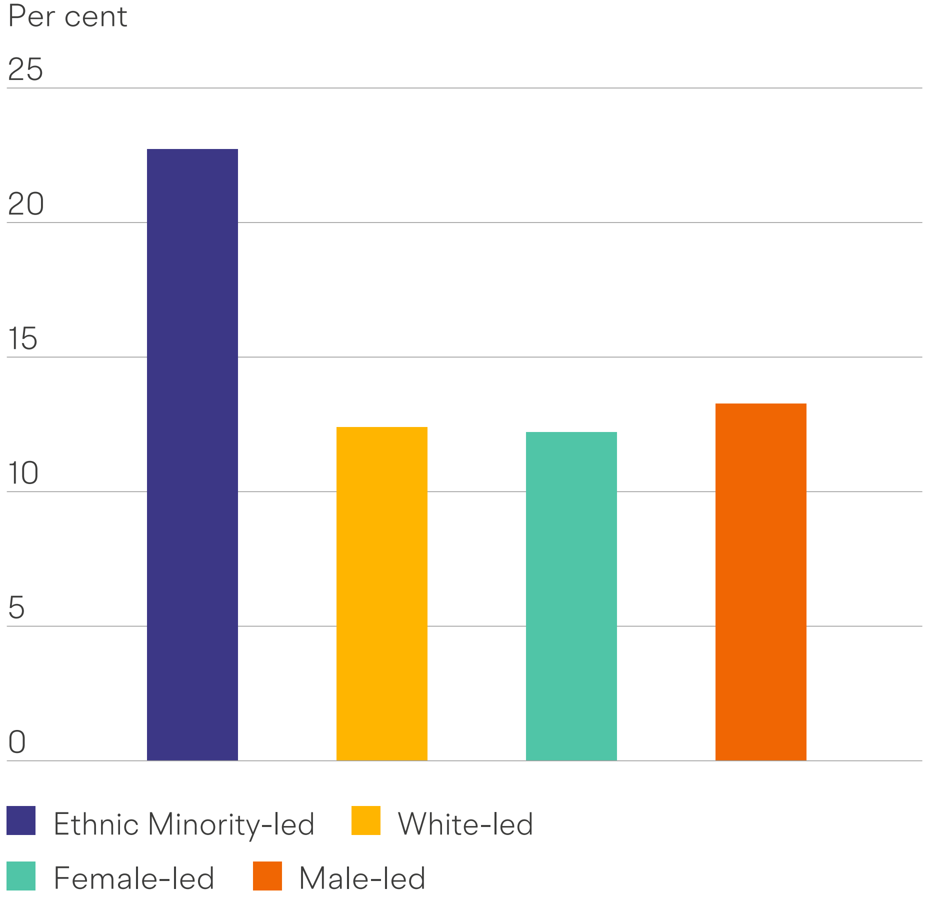
Ethnic Minority-led businesses were more than twice as likely to say they wanted to apply but something stopped them than their White counterparts in 2021 (20% compared to 8%).[16] Previous research has linked discouragement to perceptions of discrimination in capital markets, with higher levels of discouragement among Black Caribbean-led firms and Indian-led firms present even when other explanatory factors were controlled for.[17]

Female entrepreneurs could be up to twice as likely to be discouraged relative to their male counterparts.[18] Our Business Finance Survey showed no significant difference in discouragement between male and female-led firms in 2021, but SME Finance Monitor data suggests female-led firms were more than twice as likely to say they needed finance but something stopped them from applying (5% compared to 2%) over Q2 2020-Q2 2021.[19] A similar gap was observed in 2020.[20]

Figure A.3

Access to finance is an obstacle to running the business as they would want over the next 12 months, by ethnicity or gender of business owner/partner(s)

Source: BVA BDRC SME Finance Monitor, 10 quarters to Q2 2021, % share that answered 6-10 on a scale of 1-10 where 1 means not an obstacle at all and 10 is a major obstacle



There are common reasons for discouragement among the 26% of Ethnic Minority-led and 13% of female-led zero employee firms that needed finance but didn't apply. The BEIS Small Business Survey suggests these include fear of rejection, not knowing where to find appropriate finance and concerns over the decision taking too long/too much hassle (Figure A.4).

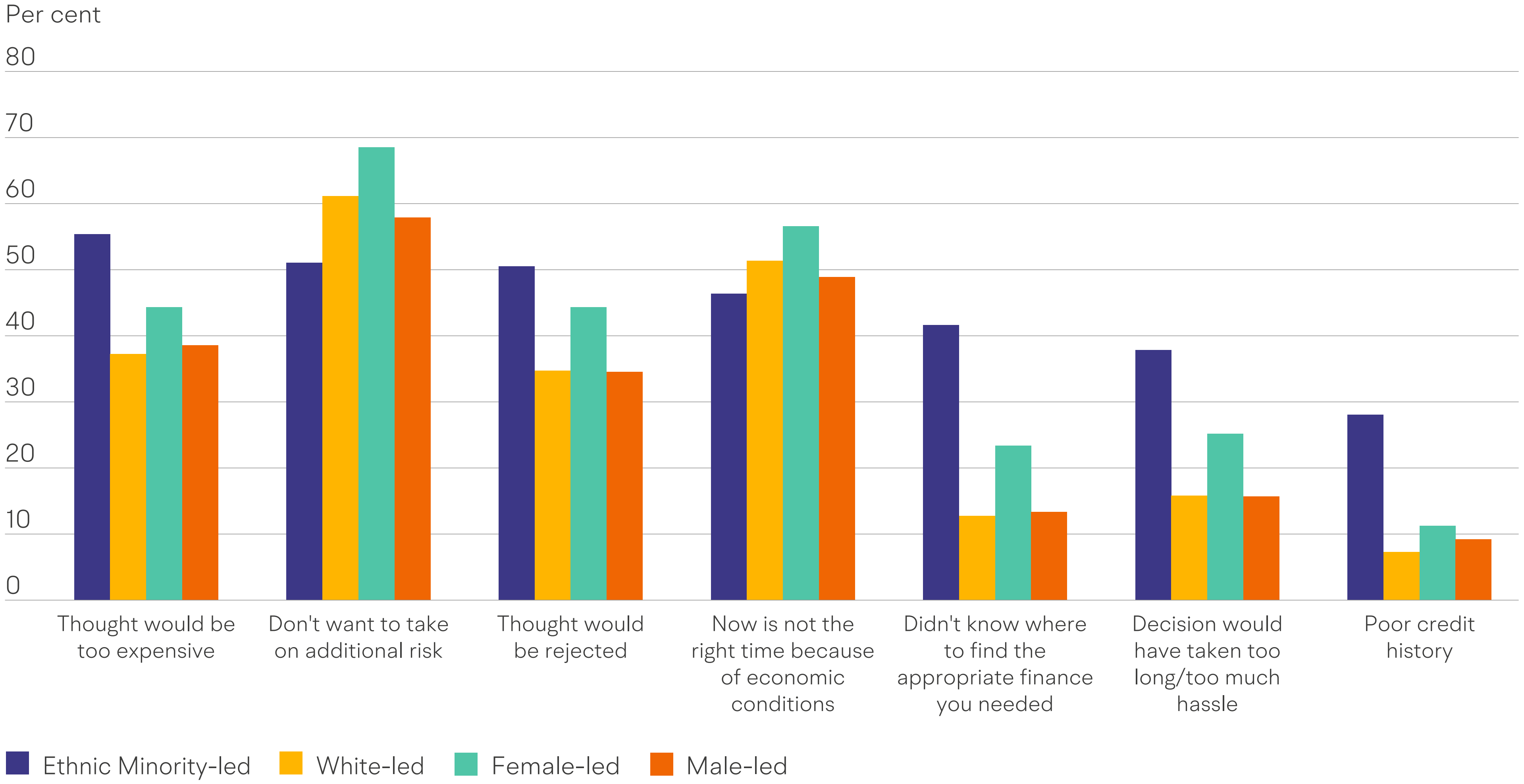
Fear of rejection could reflect previous experience, whether personal or from a business leader's wider network, perceptions of financial markets or other factors. Previous research suggests media reports, hearsay and self-diagnosis can all discourage borrowing.[21] Our Business Finance Survey found that Ethnic Minority-led and female-led firms were more likely to say they weren't confident of where to find information on the types of finance and providers available.[22]

In some instances, discouragement prevents businesses from taking on finance that may not be appropriate for them. However, information asymmetries can prevent "good borrowers" from accessing finance that could help their business grow.[23,24]

Figure A.4

Reasons for discouragement amongst zero employee businesses that needed finance but didn't apply, by ethnicity or gender of business owner/partner(s)

Source: BEIS Longitudinal Small Business Survey, 2020, nb. low base sizes, n=63 for Ethnic Minority-led, n=474 for White-led, n=364 for male-led, n=164 for female-led



Ethnic Minority-led and female-led businesses are less likely to get finance, leading to negative impacts on their business

Finance rejection rates are significantly higher for Ethnic Minority-led businesses than for White-led businesses. While rejection rates have declined in recent quarters, likely reflecting the impact of government-backed schemes, a significant gap remains (Figure A.5).

Past research has suggested that business characteristics don't always explain this gap and reported reasons for rejection don't provide a clear explanation either. [25,26] There were no significant differences in reported reasons for being turned down over the past 10 quarters (reflecting very low base sizes) but 29% of Ethnic Minority-led firms reported not being given a reason (compared to 2% of White-led businesses).[27]

Rejection rates have historically been higher for female-led businesses, reflecting a higher share of applications made in the applicant's personal name, but are now in line with those for male-led businesses.[28]

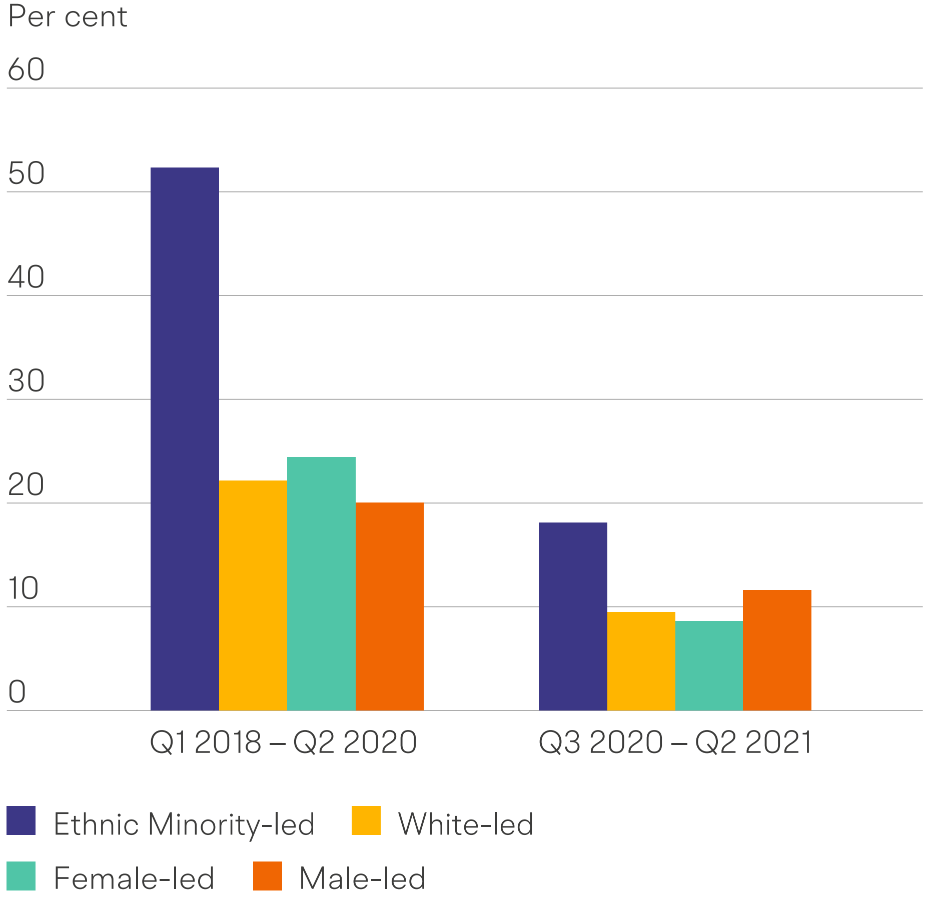
Among the factors that are likely to contribute to these differences in rejection rates, past research has highlighted the importance of risk indicators, such as age of business and track record.[29] For example, Ethnic Minority-led firms tend to be younger and less profitable, with female entrepreneurs and those from Ethnic Minority backgrounds more likely to be on lower incomes.[30] These characteristics can increase the chances of being turned down due to lack of track record, credit risk or collateral respectively.

The fact that risk indicators can help explain some of these patterns suggests gender-based and/or ethnicity-based discrimination aren't driving differences in application outcomes. Other potentially influential factors such as the presentation of applications and banks' willingness to lend aren't captured in the key survey sources used for this analysis. This, coupled with low base sizes for applications in recent years, limits analysis and means further work is necessary to understand why differences in outcomes persist.

Figure A.5

Turned down for finance by ethnicity or gender of business owner/partner(s), as a share of all reported applications with known outcomes

Source: BVA BDRC SME Finance Monitor, n=115 and n=172 for Ethnic Minority-led, n=2,859 and n=2,281 for White-led, n=484 and n=588 for female-led, n=2,149 and n=1,830 for male-led



These persistent differences in outcomes understandably feed into differences in levels of satisfaction. Ethnic Minority-led businesses were significantly more likely to say they were not satisfied with the outcome of their application (33% of applicants compared to 13% of White-led applicants). Of those who were only 'fairly' satisfied or not satisfied with the application outcome, Ethnic Minority-led businesses were significantly more likely to say this had a negative impact on their business (Figure A.6).

Lack of finance was the reason why 39% of Black entrepreneurs and 49% of entrepreneurs from Asian or Other Ethnic Minority backgrounds had to stop working on their idea (compared to 25% of White British entrepreneurs), illustrating the impact of gaps in access to small business finance markets.[31]

Gaps in access to finance matter for all finance forms but given the role equity finance plays in supporting the growth of the most innovative and ambitious smaller businesses, gaps in equity provision can have out-sized economic implications. Encouragingly, growth in the number and value of equity deals into companies with at least one female founder outpaced investment into all male founding teams in 2020. However, investment in these companies and those with all female founders remains substantially below the share of deals and investment value received by all male teams. Female founders receive lower value deals on average, reflecting overrepresentation at seed stage and possibly indicating a pipeline of high-growth female-led companies going forward.[32]

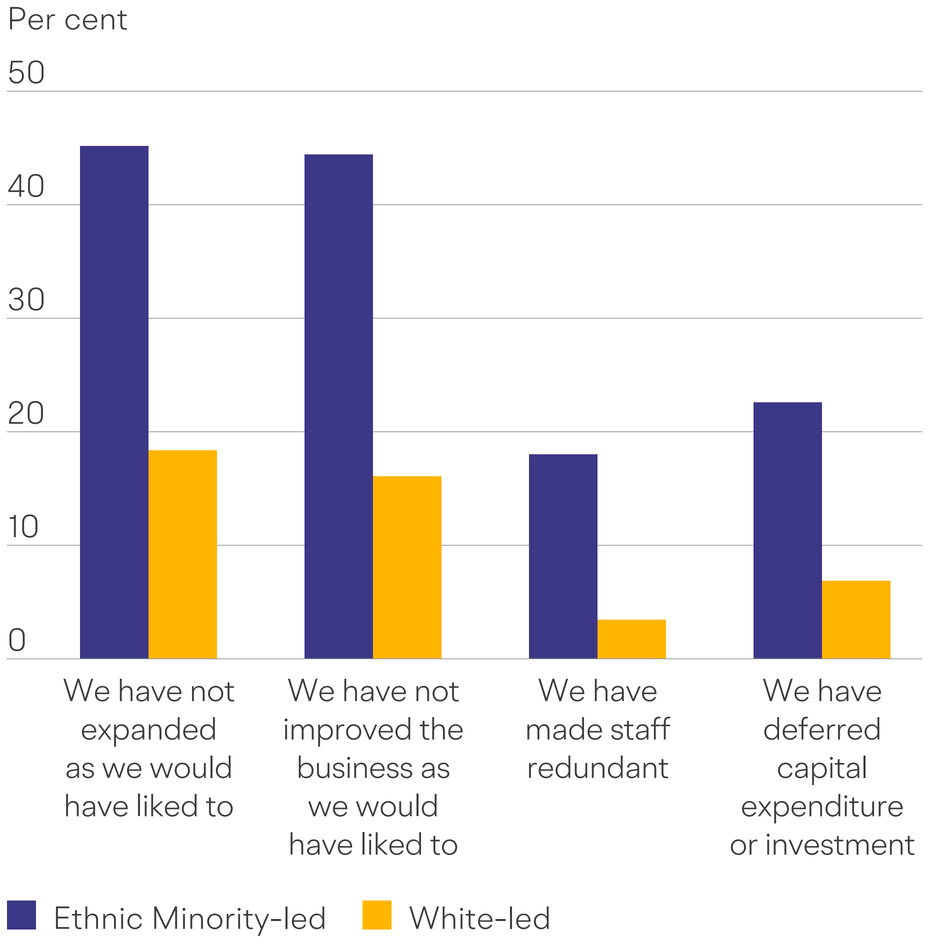
Founders from Ethnic Minority backgrounds have also struggled to access equity, with Black entrepreneurs receiving a particularly low share of investment between 2009 to 2019 at just 0.2%. Ethnicity and gender compound investment gaps. Male founders from Ethnic Minority backgrounds have received over five times the investment their female counterparts did.[33] Despite being 'VC-eligible', female founders from Ethnic Minority backgrounds don't receive corresponding levels of funding.[34]

Black female entrepreneurs received just 0.02% of VC investment over the past decade and nothing at later stage investment phases.[35] Limited access to early stage capital for female entrepreneurs and those from Ethnic Minority backgrounds can also hinder "investment-readiness" for growth capital.[36] The Bank's Alone Together research highlighted that outcomes are

Figure A.6

Impact on business, as a share of those dissatisfied or fairly satisfied with outcome of application, by ethnicity of business owner/partner(s)

Source: BVA BDRC SME Finance Monitor, 10 quarters to Q2 2021, n=75 for Ethnic Minority-led, n=815 for White-led



worst for female entrepreneurs from Ethnic Minority backgrounds, who face systemic disadvantage.[37]

Lower levels of equity investment may reflect demand side barriers. Awareness of equity and venture capital is lower for both female-led and Ethnic Minority-led businesses relative to their male-led and White-led counterparts (Figure A.7). This could result in potentially investable businesses not seeking venture capital funding.

Imperfect information also plays a role on the supply side. A lack of objective and measurable information on the track record and prospects for success of individuals with innovative ideas and early stage companies increases the possibility of unconscious investor bias. This issue is particularly relevant for female and Ethnic Minority-led businesses given women and individuals from Ethnic Minority groups are under-represented among the investor population.

Of 29 fund managers the Bank surveyed in 2021, 20% of investment committee members were women, comparable to the 21% reported by the Investing in Women Code signatories.[38,39] A third (33%) of funds had no women on their investment committees.

This under-representation is problematic as data suggests that VC firms with female investment partners are four times more likely to invest in female CEOs. The importance of representation is further emphasised in The Black Report which found that over a third (38%) of investors with a stake in Black founders' businesses were from Ethnic Minority backgrounds.[40]

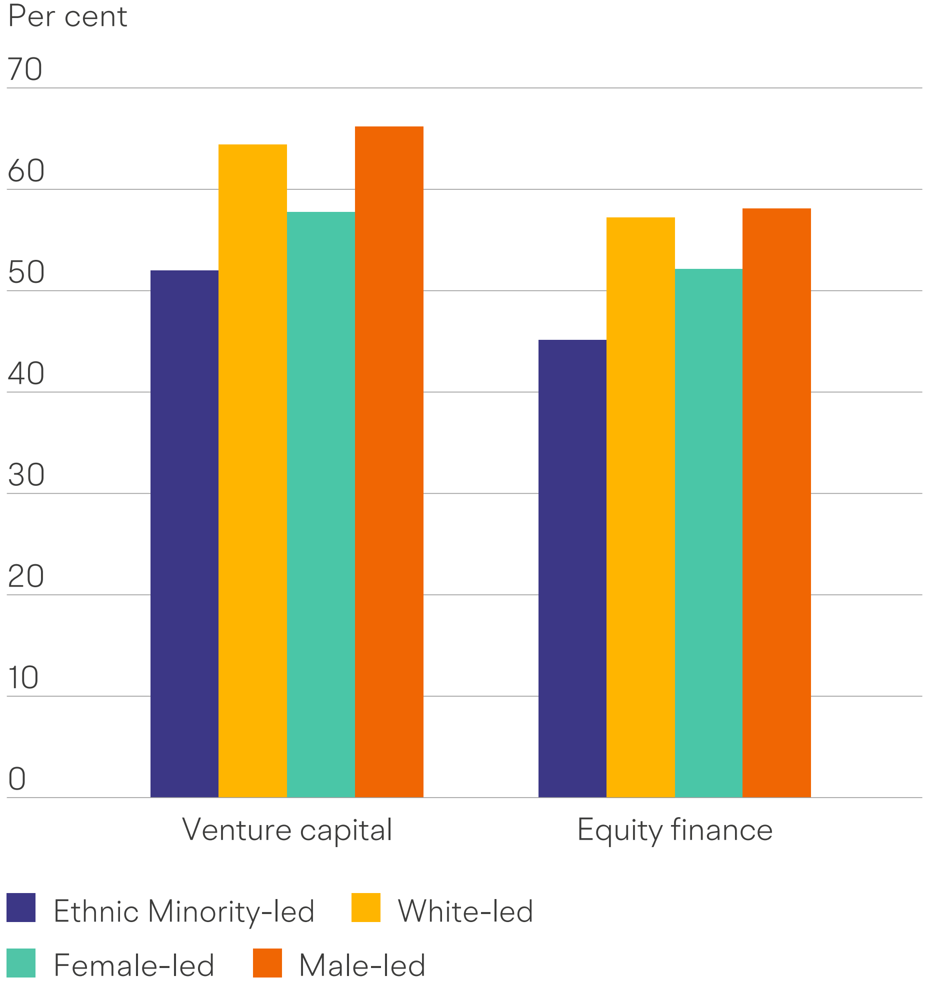
Research shows that access to networks and the warm introductions that network contacts can bring, increases the chance of securing investment.[41,42] There are also benefits post-investment as further research suggests that social proximity between VCs and start-ups leads to improved communication, coordination, and investment performance.[43]

Diversity focused VCs and angel networks are helping solve this problem by increasing representation and investing in underrepresented founders. This activity is vital, not only for diversity focused investors but also for the wider market, in order to ensure that the brightest business prospects can get funded, whatever the characteristics of their founding team.

Figure A.7

Awareness of venture capital and equity finance, by ethnicity or gender of business owner/partner(s)

Source: British Business Bank Business Finance Survey - Ipsos Mori, 2021, n=2,804



Covid-19 has disproportionately impacted underrepresented groups, increasing their need for finance

The pandemic increased gaps in entrepreneurship, with entrepreneurs from underrepresented and disadvantaged backgrounds more likely to work reduced hours or close their business.[44] Women and Ethnic Minority-led businesses are also more likely to be in those sectors most affected by Covid-19 restrictions. 43% of female-led businesses closed temporarily during lockdown in 2020, compared to 29% of male-led businesses.[45] Female entrepreneurs also tackled a disproportionate share of caring responsibilities during the pandemic, restricting available time for their business.[46]

Ethnic Minority-led businesses were also disproportionately hit by the pandemic. 45% said the pandemic had a very negative impact on their business compared to 34% of White-led businesses.[47] Affected entrepreneurs expected some of these adverse impacts to persist, with Ethnic Minority-led and female-led businesses significantly less likely to expect their revenues to stabilise over the next few months compared to their White-led and male-led counterparts.[48]

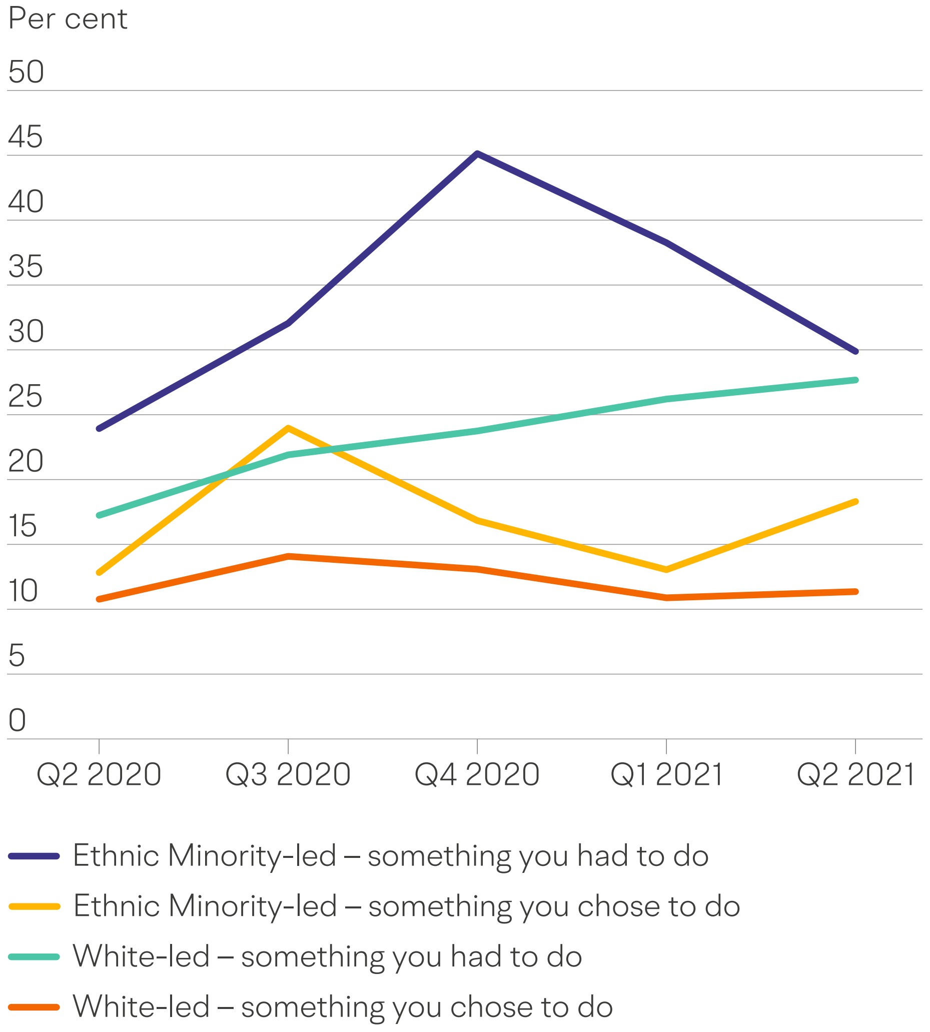
Previous Bank research found that Black business owners, along with Asian and Other Ethnic Minority groups, experienced the most severe impacts even when controlling for other factors.[49] Half (51%) of Ethnic Minority-led businesses put personal funds into their business following the onset of the pandemic (Q2 2020 onwards) compared with 35% of White-led businesses. Most felt they had to inject their own money (Figure A.8).

Female-led businesses are also significantly more likely to say they are using personal funds (16% compared to 13% of male-led firms in Q2 2020-Q2 2021). Increased reliance on personal funds amongst underrepresented groups coupled with lower income and/or wealth can contribute to difficulties for such businesses. There was some evidence of this happening in late 2020 and early 2021 with almost half (48%) of Ethnic Minority-led businesses reporting that they were worried about whether they had enough funding for the next six months, compared to 26% of White-led businesses.[50] This concern was reflected in reported funding needs as Ethnic Minority-led businesses were almost twice as likely to report a need for finance over Q2 2020-Q2 2021 than White-led businesses (22% compared to 12%).[51]

Figure A.8

Reason for injecting personal funds into business, by ethnicity of business owner/partner(s)

Source: BVA BDRC SME Finance Monitor



Despite increased availability of finance through government-backed schemes, barriers remain

Prior to the pandemic, demand for finance from Ethnic Minority-led businesses was similar to that of White-led firms. Applications increased significantly amongst all smaller businesses in Q2 2020-Q2 2021, but the increase was far greater amongst Ethnic Minority-led businesses (Figure A.9).

There was also an increase in use of finance with around half (51%) of Ethnic Minority-led businesses using finance in Q2 2020-Q2 2021, significantly above White-led businesses' use (Figure A.10). Male and female-led businesses' use of finance is similar across surveys.[52]

Increased use of finance has been driven by increased take up of loans, particularly government-backed loan schemes. In 2021, Ethnic Minority-led businesses were significantly more likely to be using a Bounce Back Loan than their White-led counterparts (34% compared to 22% respectively) (Figure A.11).

Figure A.9

Had a borrowing event relating to finance need, by ethnicity or gender of business owner/partner(s)

Source: BVA BDRC SME Finance Monitor

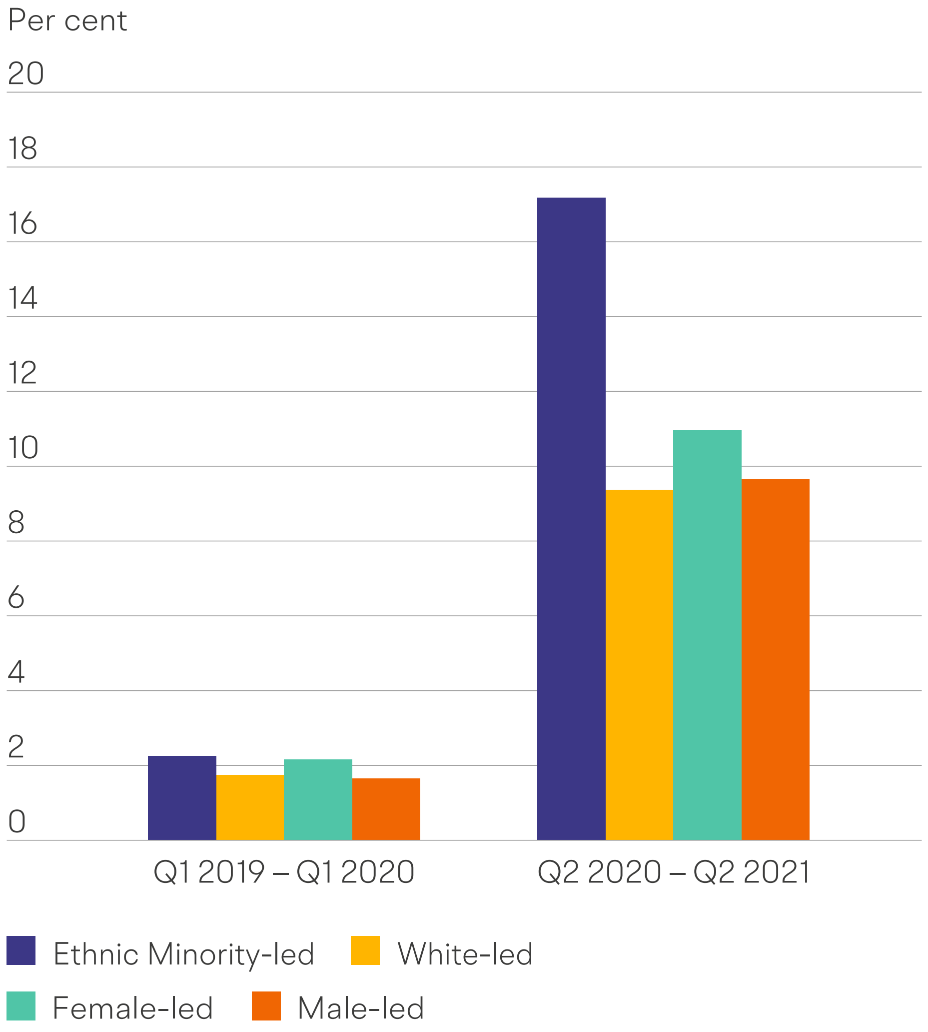
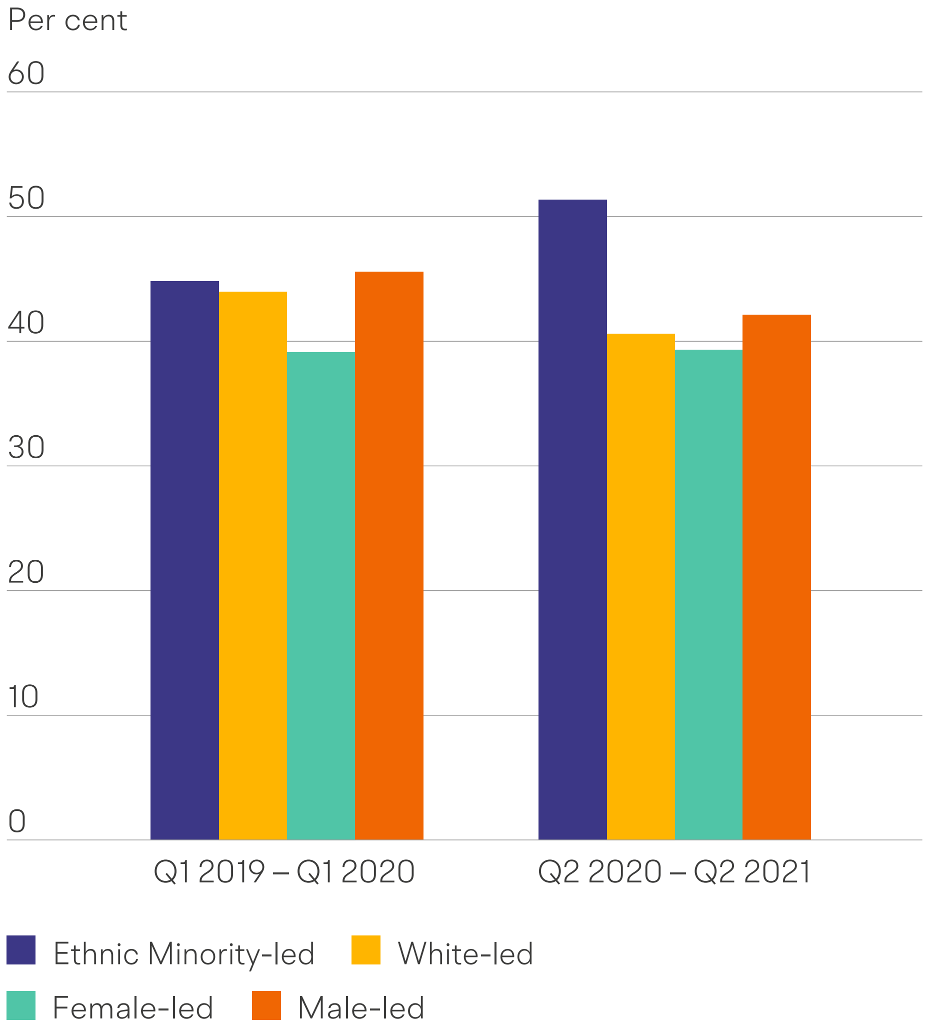


Figure A.10

Use of any external finance, by ethnicity or gender of business owner/partner(s)

Source: BVA BDRC SME Finance Monitor



Female-led businesses were significantly more likely to be using grants than their male counterparts in 2021 (Figure A.11), with some estimates suggesting up to 40% of female-led firms were using grants in 2020.[53,54] Around 18% of female-led firms were using government-backed finance or grants only, compared to 11% of male-led firms.

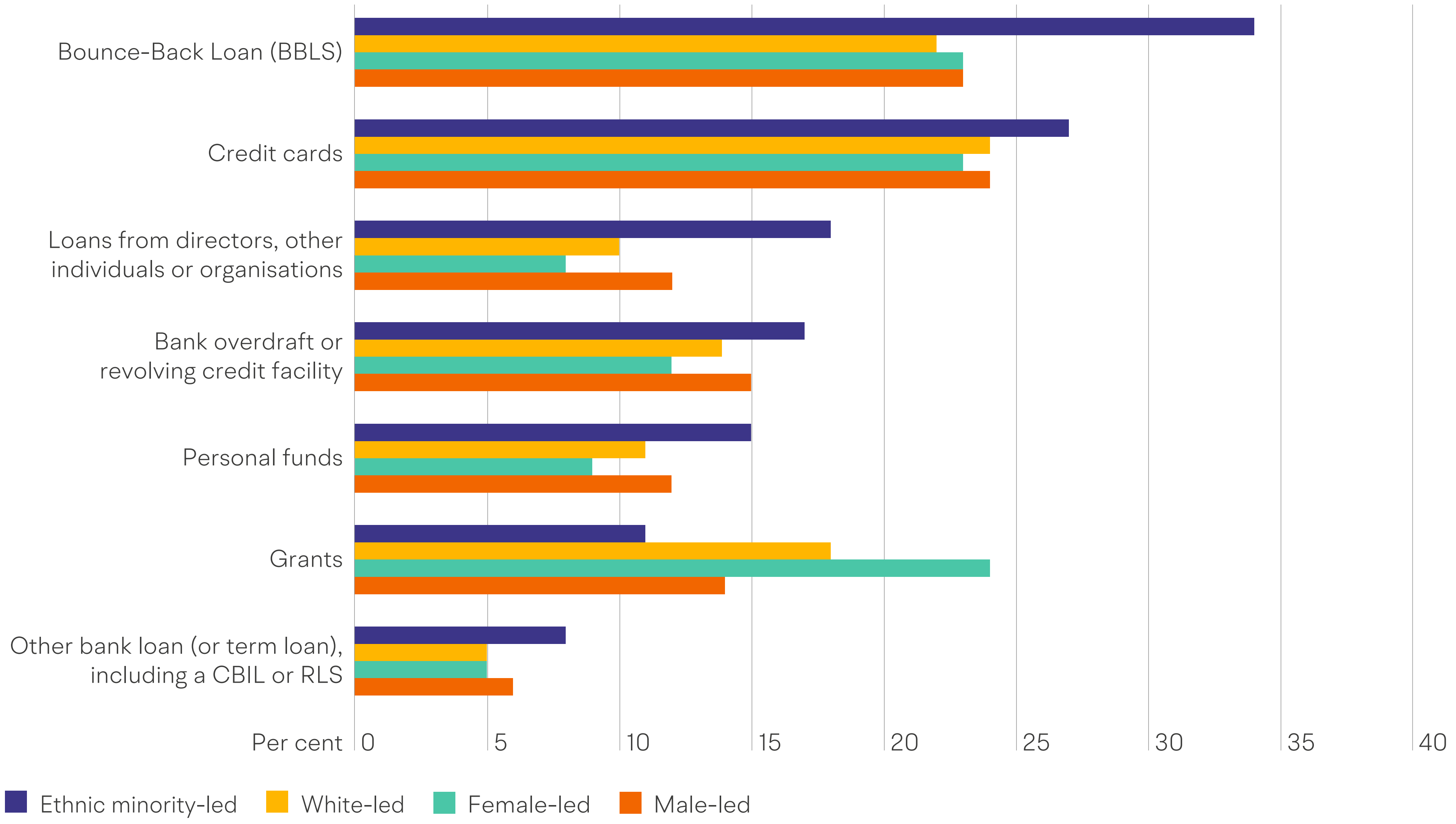
Both Ethnic Minority-led and female-led firms also made use of Future Fund, the Bank's scheme to support previously equity-backed companies through the pandemic. Over half (56%) of the funding from the Bank's Future Fund scheme went to businesses with management teams with one or more team members from Black, Asian or Other Ethnic Minority backgrounds. Over three quarters (78%) went to mixed gender senior management teams.[55]

Networks have also been an important source of finance for Ethnic Minority-led businesses in recent years, with almost one in five (18%) using loans from directors, other individuals or organisations in 2021, compared to 10% of White-led firms.[56]

Figure A.11

Use of finance types, by ethnicity or gender of business owner/partner(s)

Source: British Business Bank Business Finance Survey - Ipsos MORI, 2021, n=2,804



Between September 2021 and January 2022, most (57%) Ethnic Minority-led businesses anticipated a need to finance their business in the next three months compared to 43% of White-led firms. 30% plan to inject personal cash reserves, significantly above the 21% of White-led businesses planning to do the same.[57] This could act as a growth constraint if businesses need finance but can't afford to self-fund as many desire.

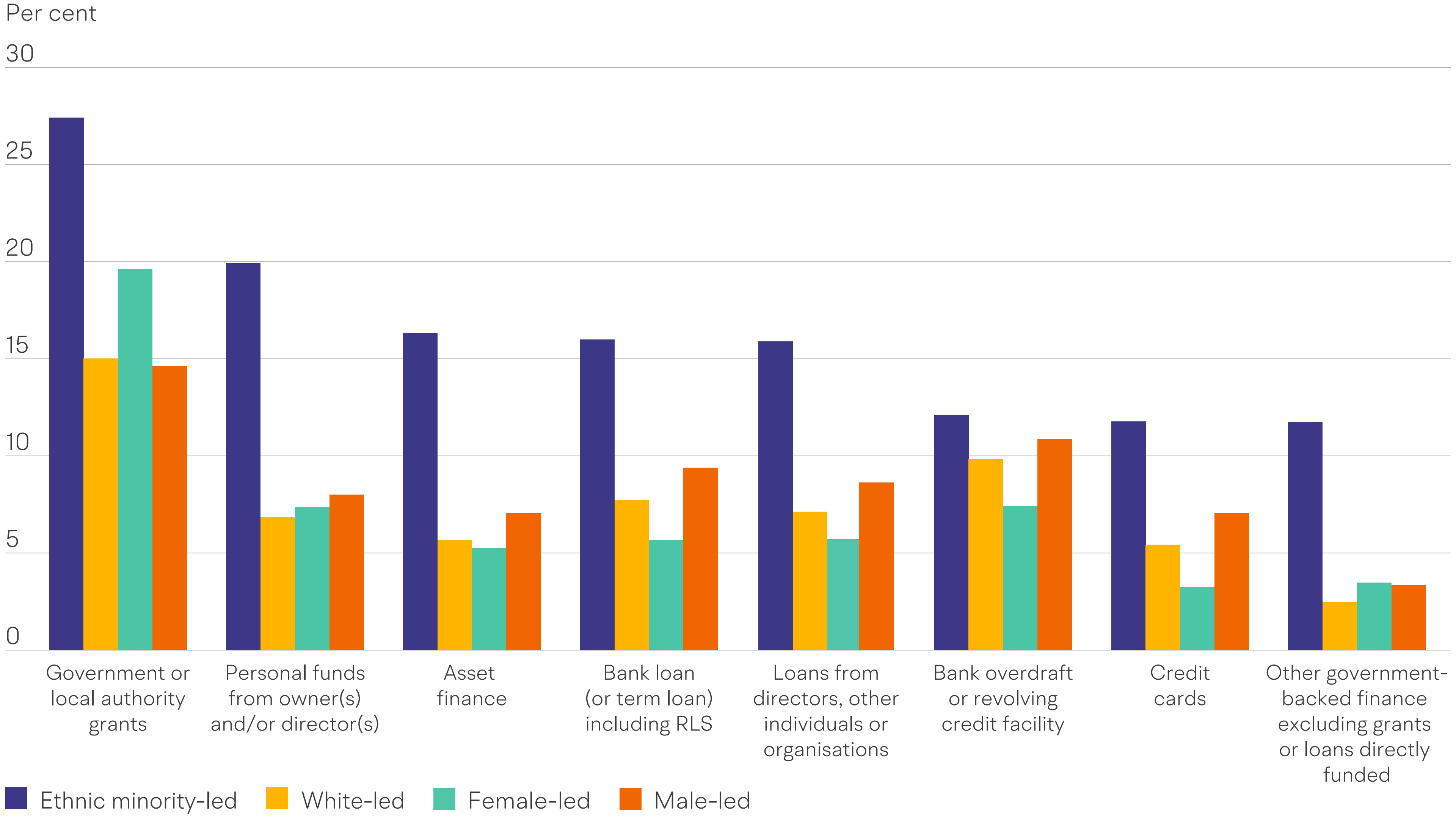
Demand for finance over the next 12 months is significantly higher amongst Ethnic Minority-led businesses, with half (49%) planning to apply for one or more forms of external finance, compared to 33% of White-led businesses (Figure A.12).[58] Ethnic Minority-led firms are more open to applying for most finance products including alternative finance, for example asset finance and marketplace lending (6% compared to 1% of White-led firms, nb. very low base sizes).

Female-led firms are significantly more likely to consider applying for further grant funding. This could reflect higher willingness to use finance amongst this group and/or increased expected need.

Figure A.12

Forms of finance considering applying for in next 12 months, by ethnicity or gender of business owner/partner(s)

Source: British Business Bank Business Finance Survey - Ipsos MORI, 2021, n=2,804



Despite higher levels of demand, perceived barriers remain for future finance seekers. According to SME Finance Monitor data, of the 26% of Ethnic Minority-led businesses planning to apply or renew their finance over the next three months, just 27% were confident their bank would say yes (compared to 42% of White-led counterparts). Even amongst current users of finance, disparities in concern over getting additional finance persist. Most (56%) Ethnic Minority-led finance users agreed they thought it would be difficult for them to get finance, compared to 42% of White-led finance users.[59]

Increased use of finance over the pandemic has closed the gap between those willing to use finance and those who go on to apply and use finance, but structural issues remain.

Bank programmes continue to provide finance for underrepresented groups and we are working with partners to improve data collection and reporting

The Bank values the important role already played by entrepreneurs from all backgrounds but equally we recognise this role can become even bigger if we help break down the barriers that affect their use of finance. The Bank has a number of actions underway to continue to support this:

1

The Bank's **Start Up Loans** (SUL) programme is building on its track record of lending and providing mentoring support to entrepreneurs who struggle to access finance. Continued funding for a further 33,000 loans over the next three years was announced in the Government's 2021 Spending Review. This will ensure even more transformational finance and support will reach underrepresented entrepreneurs all over the UK.

- Around 36,000 (40%) of loans have gone to female entrepreneurs and around 18,000 (21%) to entrepreneurs from Black, Asian or Other Ethnic Minority backgrounds. Almost 8,000 (9%) have gone to female entrepreneurs from Ethnic Minority backgrounds.[60]
- SUL has made Sharia investments since 2014/15, ensuring entrepreneurs who live according to Islamic values can access funding to start and grow their business.
- 15% of loans went to entrepreneurs aged between 18 and 24, with 35% of those recipients not in employment, education, or training at the time of application. More widely, 29% of all recipients were unemployed before receiving their loan.
- The Bank has launched a partnership with the Royal National Institute of Blind People to improve the accessibility of SUL further by ensuring that entrepreneurs with sight loss can access information on the programme and apply.

2

The Bank is working with delivery partners to encourage collection of diversity and inclusion information as part of due diligence processes and to encourage participation in the **Investing in Women Code**.[61] The Bank's fund managers' survey found that just over half (52%) of respondents collected information on the gender composition of founding teams in their portfolio, suggesting progress is being made.[62] Less is known about other aspects of founder diversity like ethnicity or socio-economic background. The Bank is working with BEIS, BVCA and UKBAA to pilot an extension to the Investing in Women Code that will report on ethnicity data for equity investments, increasing market transparency and sharing best practice.

3

The Bank's previous research into entrepreneurship and diversity has led to the formation of public-private intermediary working groups at a local level, demonstrating the Bank's role as a centre of expertise. Facilitated by the Bank's **UK Network**, these working groups collaborate on ways to improve diversity and inclusion within their local ecosystems and communities, recognising the importance of place in influencing the experience of underrepresented entrepreneurs.

1.3

Financing smaller businesses in all parts of the UK

– There is a huge economic opportunity from breaking down regional barriers to finance
– Both demand and supply-side factors contribute to geographic imbalances in finance flows
– Finance imbalances exist at regional and sub-regional level but are most stark for important forms of growth finance
– These imbalances have contributed to the UK’s uneven economic landscape
– The Bank is determined to create greater demand and more opportunities to access finance in every region and Nation of the UK

The UK's 5.6 million businesses operate from all kinds of locations. From bedroom to boardroom, from countryside to city and from St Agnes to Haroldswick. Each of these businesses have their own ambitions and challenges. For every one of our existing businesses and for those still to come, external finance can be an important tool to overcome challenges and meet ambitions.

There is a huge economic opportunity from breaking down regional barriers to finance

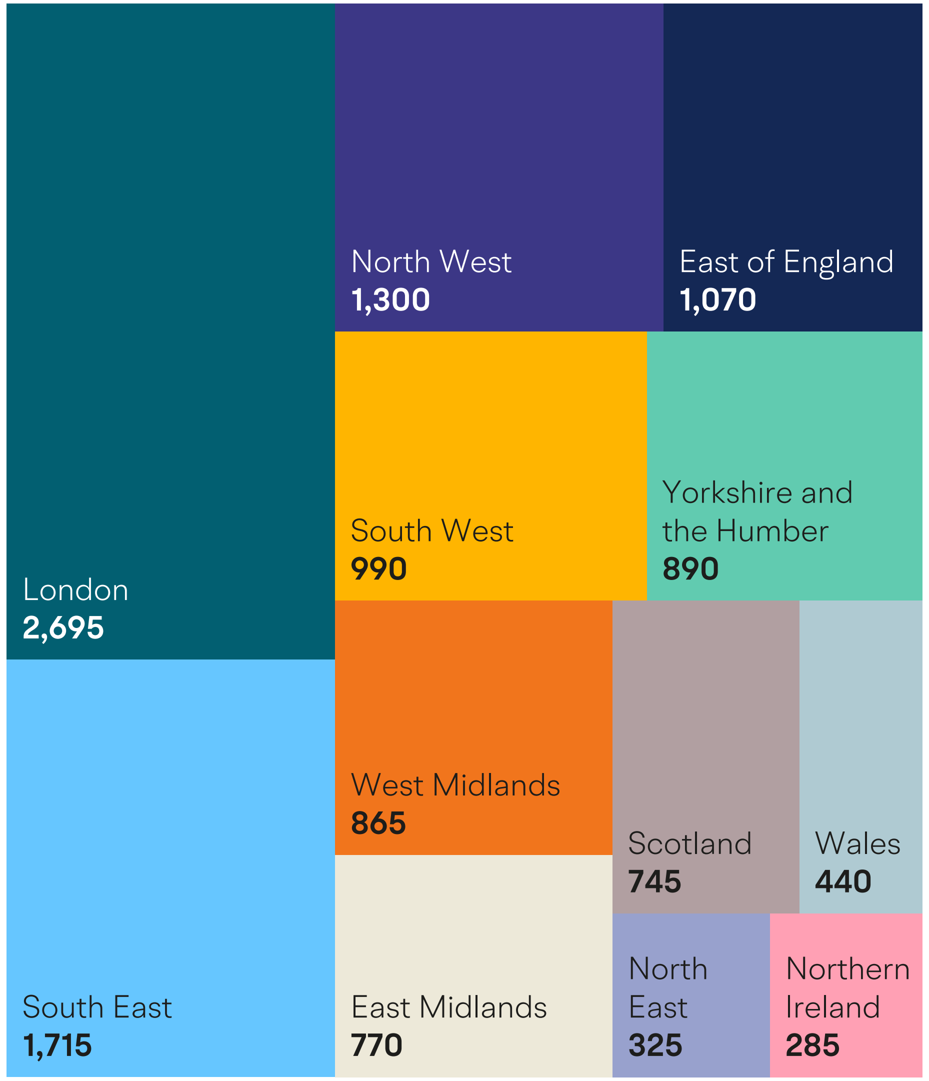
In each part of the UK, there are already large numbers of businesses growing rapidly, even in the incredibly challenging conditions created by the Covid-19 pandemic. In 2020, there were more than 12,000 high growth businesses across the UK. To attain this status, a business needs to expand its employment by at least 20% each year for three years. The definition only applies to businesses with at least 10 employees before their period of rapid growth which means the 12,000 who attained high growth status in 2020 represent 4.3% of the total stock of businesses of at least this size.

The number of high growth businesses recorded in 2020 is unfortunately the lowest since 2012 but the latest cohort does remain well spread out across the UK (Figure A.13). London had the highest rate of high growth businesses in 2020 with the 2,695 recorded representing 5.5% of businesses with more than 10 employees in the capital. At the other end of the scale, Scotland's total of 745 high growth businesses means that only 3.7% of eligible Scottish firms attained high growth status.

Figure A.13

High growth businesses in 2020

Source: ONS



Meeting the technical definition of a high growth firm is clearly a positive indicator for a firm but growth across the whole of the spectrum matters too. Although only a small minority of businesses ever reach high growth status, large shares of smaller businesses experience growth each year and an even larger share have ambitions for growth in the future. While the pandemic dented both achieved and desired growth, there are clear signs that large shares of businesses are beginning to aim for expansion once more (Figure A.14).

With large proportions of firms once again targeting growth, empowering these firms with external finance has the potential to boost the UK's recovery in all locations. Evidence from the Bank's own programmes demonstrates just how this can happen.

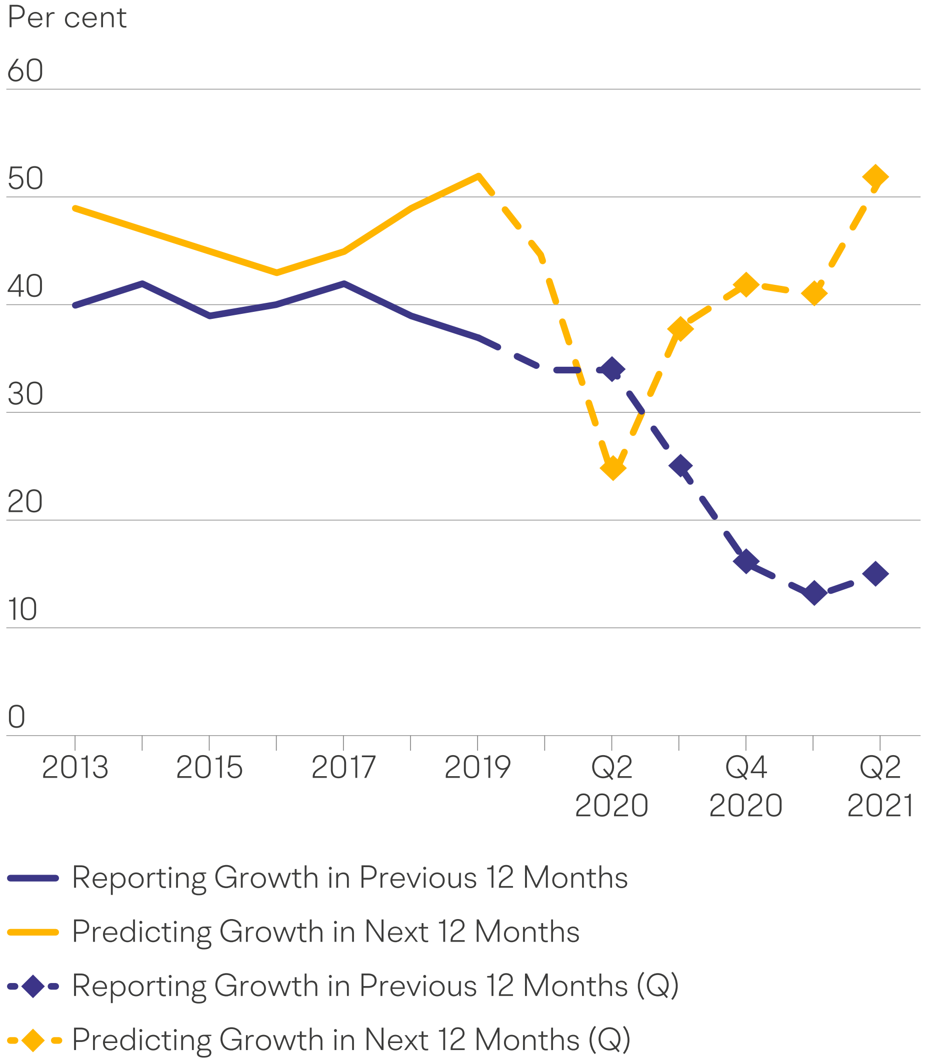
At the smaller end of the scale, our Start Up Loans evaluation shows how small debt facilities not only encouraged the formation of new businesses but also boosted the turnover levels of existing businesses that received loans.[63] We have also seen the positive impacts of debt and equity finance provided by the Bank's Regional Funds.[64] Early evidence for the Northern Powerhouse Investment Fund (NPIF), the Midlands Engine Investment Fund (MEIF) and the Cornwall and Isles of Scilly Investment Fund (CIOSIF) has shown that finance obtained through all three funds was already enabling businesses to innovate, improve their processes and upskill staff.

For NPIF, the longest established of the funds, the Bank also has longer-term evidence that factors in almost five years of performance. This evidence demonstrates that NPIF beneficiaries grew their employment and turnover at notably faster rates than comparable companies that did not utilise NPIF finance. Our longer-term evidence also shows a continued impact on skills, innovation and other aspects of business performance.[65]

Figure A.14

Growth rates and growth ambitions

Source: BVA BDRC SME Finance Monitor



Another recent, and powerful, demonstration of the transformative impacts of external finance comes from the Enterprise Capital Funds (ECF) programme. The ECF programme backs emerging venture capital fund managers, boosting their investment capacity and enabling them to support more smaller businesses with greater funding amounts. Our recent evaluation looked at smaller businesses backed by ECF fund managers between 2011 and 2019 and was able to establish that their annual employment growth was a rapid 48% and their turnover growth was even higher at 76% per year.[66]

Both demand and supply-side factors contribute to geographic imbalances in finance flows

Despite clear evidence on the benefits of external finance, both from the Bank's programmes and beyond, businesses that are happy to use finance to grow remain in the minority. In the first half of 2021, 37% of businesses reported that they were happy to use finance to grow and although this is four percentage points up from 2020 and eight percentage points up from 2019, it still leaves 63% who are not happy to use finance for growth.[67]

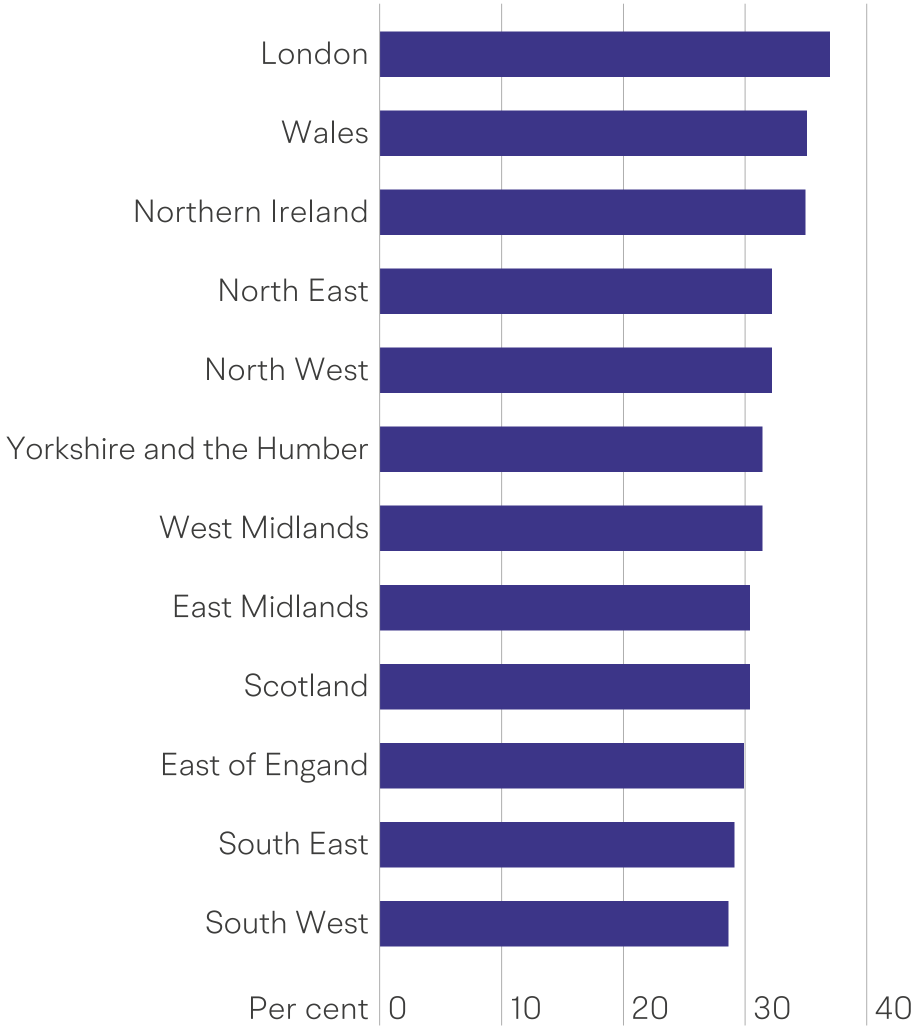
The extent to which smaller businesses are open to using finance for growth does appear to vary between the different regions and Nations of the UK. London businesses have typically been most open to using finance for growth with 37% happy to do so in the 10 quarters to Q2 2021, while most other parts of the UK are clustered below this level at between 29% and 32% (Figure A.15).

The relatively high levels of happiness in using finance for growth are broadly spread among London firms. Firms in the capital come top or second in the rankings for openness to finance in seven of the nine broad sectors covered in the SME Finance Monitor.[68] This openness to finance is expected to bear out in 2022 with all but one of the 20 London-based finance intermediaries surveyed by the Bank's UK Network in winter 2021 expecting at least a quarter of their client base to explore finance for growth in the year ahead. Half of our contacts in London actually expect demand for growth finance from the majority of their client base in 2022.

Figure A.15

Proportion of smaller businesses happy to use finance to grow

Source: BVA BDRC SME Finance Monitor, 10 quarters to Q2 2021



It is not just openness to finance where London-based firms are slightly ahead of the rest of the UK, they also top the rankings for the proportion of firms with a formal written business plan and with a financial decision maker who is trained or formally qualified in finance.[69] There is a similar picture on certain measures of awareness too. For example, 72% of London businesses are aware of venture capital as a form of finance compared to 62% in the rest of the UK and there is a similar gap in awareness of business angels where the proportions are 48% and 38% respectively.[70]

Demand-side issues, such as varying levels of financial openness, awareness and capability are important and will influence finance flows across multiple forms of finance. The supply-side matters greatly too of course, and also exhibits some meaningful geographic variations.

One common supply-side issue that affects smaller business finance is that the potential finance provider generally knows less about the prospects of the finance seeking business than the business itself. This can make assessing the level of risk and consequently agreeing the terms of the finance difficult. This problem is often overcome through the provision of security or collateral which not only gives the provider some recourse if the business fails but also signals the finance seeker's confidence in their own prospects.

The provision of security is fairly common in debt finance with the latest SME Finance Monitor data reporting that 15% of successful finance applications required security.[71] Though usage of security is relatively common, the ability to provide it will vary. For example, businesses in capital intensive sectors may own valuable machinery that can be used for collateral while for other businesses the most suitable asset may be a personal property owned by a director. It is this latter scenario where place-to-place differences can emerge given the wide variations in property values across the UK.

The relevance of this property price channel on business borrowing is evidenced both through external research[72] and through the Bank's former Enterprise Finance Guarantee (EFG) scheme. The EFG scheme was designed to support lending to viable businesses with insufficient collateral and was used more heavily in locations with lower house prices[73] demonstrating that geographical variations in asset prices can influence finance outcomes.

The location of finance providers can influence finance outcomes too. On the equity front, data covering the EIS and SEIS schemes that are commonly used by angel investors show significant geographic concentration. 32% of the investors benefitting from EIS or SEIS in 2019/20 were in London with another 26% in the South East.[74]

The concentration is even more stark for venture capital where London hosts 581 non-government investors with venture capital as their primary investment strategy, compared to just 47 in the East of England, the next most well-stocked region. The number of unique VC investors in London has increased by 275 since 2017 reflecting the fact that new fund managers can benefit from knowledge spillovers and other benefits that derive from locating near the existing hub.[75]

These cluster forces mean that London has a much greater VC presence relative to its business stock than the rest of the UK. Although investor presence has improved in other parts of the UK since 2017, growth in the capital has been much faster so the gap in non-government investor presence has actually widened (Figure A.16).

This concentration of investors is important as distance matters. In the Bank's first Regions and Nations Tracker we showed that 82% of equity investment stakes in UK SMEs are between investors and SMEs located within two hours of each other.[76] While long-distance investment does take place, parts of the UK where the local investor-base is relatively strong tend to have more equity activity relative to their economic scale than regions with a strong dependency on more distant backers.

There are lots of driving forces for this pattern. Equity investments aren't off-the-shelf transactions and the parties involved benefit from forming close relationships that both support the initial deal and the ongoing guidance that is a feature of many equity stakes. Building these relationships can be much easier where travel times between parties are short enough to allow face-to-face interaction. Proximity can also make the due diligence process easier given this often involves site visits and is also likely to play a part in deal sourcing given the importance of warm introductions in equity investment.[77]

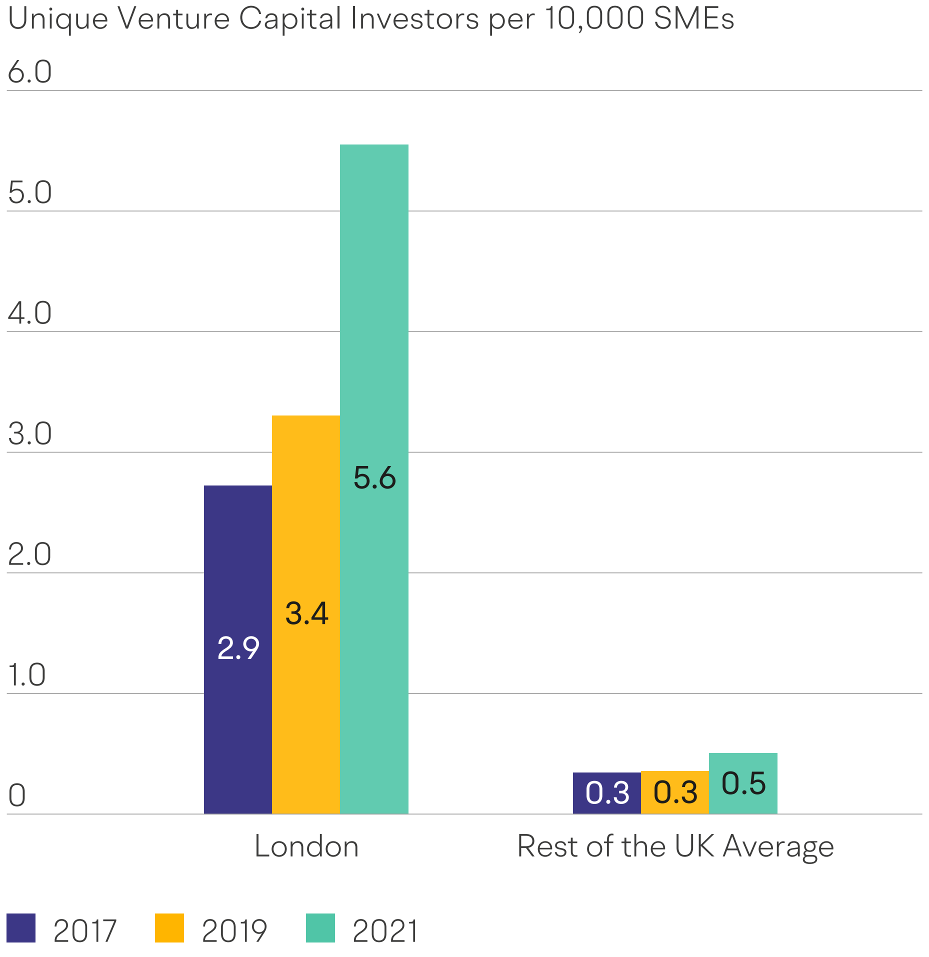
Much like equity, private debt is also not an off-the-shelf product. Given that funders in this space differentiate themselves from bank lending by offering bespoke funding structures, often to companies looking to implement step-change growth plans, there are again benefits from having a strong relationship between the parties to a deal. With more than three quarters of the fund managers that participated in our 2020 private debt data collection activity operating from registered offices in London, it is again clear that London has a stronger provider base than elsewhere.[78]

London does not, however, stand out when we look at the distribution of mainstream banks and building societies. Bank and building society branches, which provide a route into business banking divisions, are relatively closely aligned with the business population across the regions and Nations of the UK. London in fact is marginally underweight hosting 16% of branches compared to its 19% of the smaller business population.[79]

Figure A.16

Venture capital investors relative to the business population

Source: British Business Bank analysis of user defined PitchBook search and ONS data. Results may differ from PitchBook's own published figures.



Finance imbalances exist at regional and sub-regional level but are most stark for important forms of growth finance

The thinner provider base outside of London and the gaps in demand observed can reinforce each other and feed into some markedly different finance outcomes. Where demand is weak and financial capability is low existing providers may not see the level of deal flow required to sustain their activities. Conversely, where pockets of demand do exist in areas of thin supply, the potential finance user may not be able to find the right form of finance or the right level of funding.

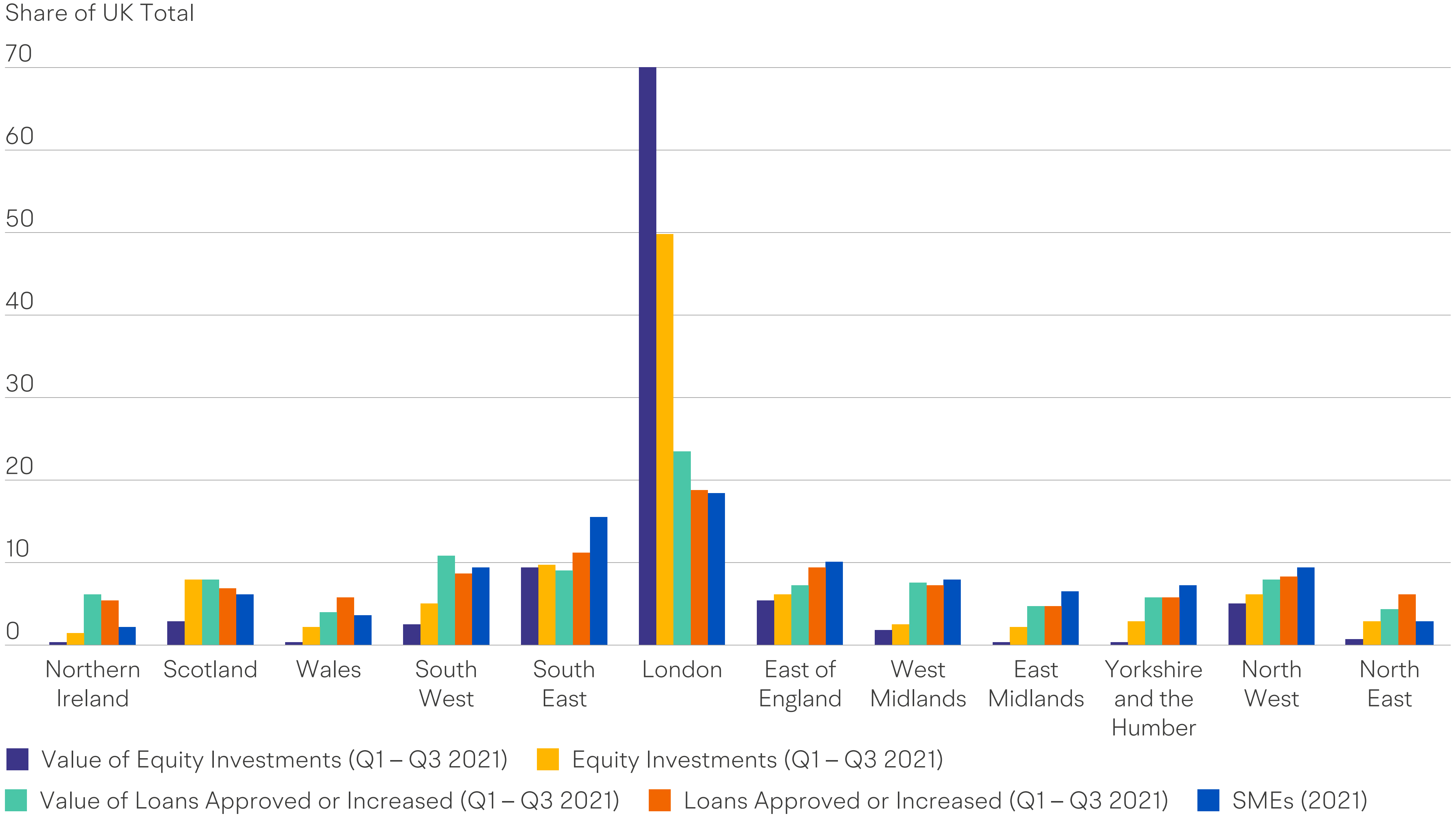
Thin markets also mean the few providers who are active have limited opportunities for syndication or collaboration on deals. This can lead to under-funding or mean that potentially viable deals simply don't get off the ground as the interested investors or lenders want to share the deal risk or the burden of due diligence.

The interaction of supply and demand factors plays out differently for different forms of finance. For mainstream bank lending the resulting activity is fairly closely aligned with the business population at regional level (Figure A.17).

Figure A.17

Bank lending, equity investment and the smaller business population

Source: British Business Bank analysis of UK Finance, Beauhurst and ONS data



This is unsurprising given the wide geographic footprint of the provider-base and the lack of geographic variations in awareness of this finance form.

For equity activity, however, the picture is very different, and we see a high degree of concentration in London whether judged by deal volumes or values (Figure A.17). This too is unsurprising given the complex nature of equity deals means the majority take place between parties that can easily meet face-to-face and that the investor population is clustered in London. Added to this are the demand-side differences already mentioned with awareness of VC and angel investors lower among non-London firms which on average are also less likely to have a trained financial decision maker.

We don't have geographically disaggregated 2021 figures for private debt but data for previous years shows London firms were receiving the largest share of investment. Across 2018 and 2019, 35% of investment undertaken by fund managers that participated in our data collection activity was for London firms. As with equity, the concentration of the provider base is likely to play a part here too.

Given these patterns of concentration, it is clear that when we look across the UK's 12 regions and Nations, businesses in London achieve the best finance outcomes. This is not the end of the story, however, as there are also variations at sub-regional level.

For equity this sub-regional variation can be quite extreme. For example, between 2011 and 2020 companies in Westminster have had more than 1,000 SME equity deals while 50% of the UK's 374 local authorities have had fewer than 10 during this period and 70% fewer than 20.

Sub-regional concentration has continued to be apparent in 2021 equity activity with companies headquartered in the EC postcode area alone accounting for 27% of investment in the first three quarters of 2021.[80] The £3.7bn invested in SMEs in this postcode area equates to investment of more than £100m for every 1,000 registered SMEs in the area over just the first three quarters of 2021. The equivalent figure for 2021 investment to date in SMEs elsewhere in the UK is much lower, sitting just below £5m for every 1,000 registered SMEs.

As mentioned above we don't have 2021 data for private debt but investment in 2018 and 2019 showed meaningful levels of sub-regional variation. Businesses in Westminster local authority district accounted for 5% of all investment over the period, around £0.9bn, while more than half of the UK's 374 local authority districts had no recorded investment over the two-years covered.

For mainstream bank lending there is no available data on subregional flows of lending. UK Finance do publish data on lending stocks for postcode districts, however, the data are very volatile due to reporting rules designed to protect confidentiality.[81] Averaging recorded stocks over time and aggregating to postcode areas instead of sectors[82] results in a much more stable set of figures that do exhibit some sub-regional variation, but this is much less pronounced than for private debt and equity.[83]

Taken together, the data above show that business populations in different parts of the UK can experience markedly different finance outcomes driven by a mix of supply and demand factors. These outcomes are most different for equity and private debt, both of which are important forms of growth finance, but there is also evidence that place-based factors can influence mainstream lending through the collateral channel.

These imbalances have contributed to the UK's uneven economic landscape

Imbalances in flows of finance have real economic implications. The lower flows of finance, particularly equity and private debt, that we see in certain regions and sub-regions reflect populations of entrepreneurs and businesses operating with fewer choices. Over time, the compromises entailed by a lower choice environment, which can include missing out on finance entirely or compromising on the form or amount of finance accepted, have undoubtedly held back large numbers of businesses.

One way of illustrating the implications of operating in a weaker funding environment is through tracking companies over time. Figures A.18 and A.19 use Beauhurst data to show the fundraising journeys of two cohorts of companies that received their first seed-stage equity investment between 2011 and 2013. The two groups are formed of 183 London-based companies and 325 companies from other parts of the UK, respectively.

The first chart shows the number of equity investments each company received on average over the next seven years while the second chart shows the average

Figure A.18

Cumulative investments in London and non-London seed stage cohorts

Source: British Business Bank analysis of Beauhurst data

Mean cumulative number of deals per company per period, by geography (Cohort – Initial seed round 2011 – 2013)

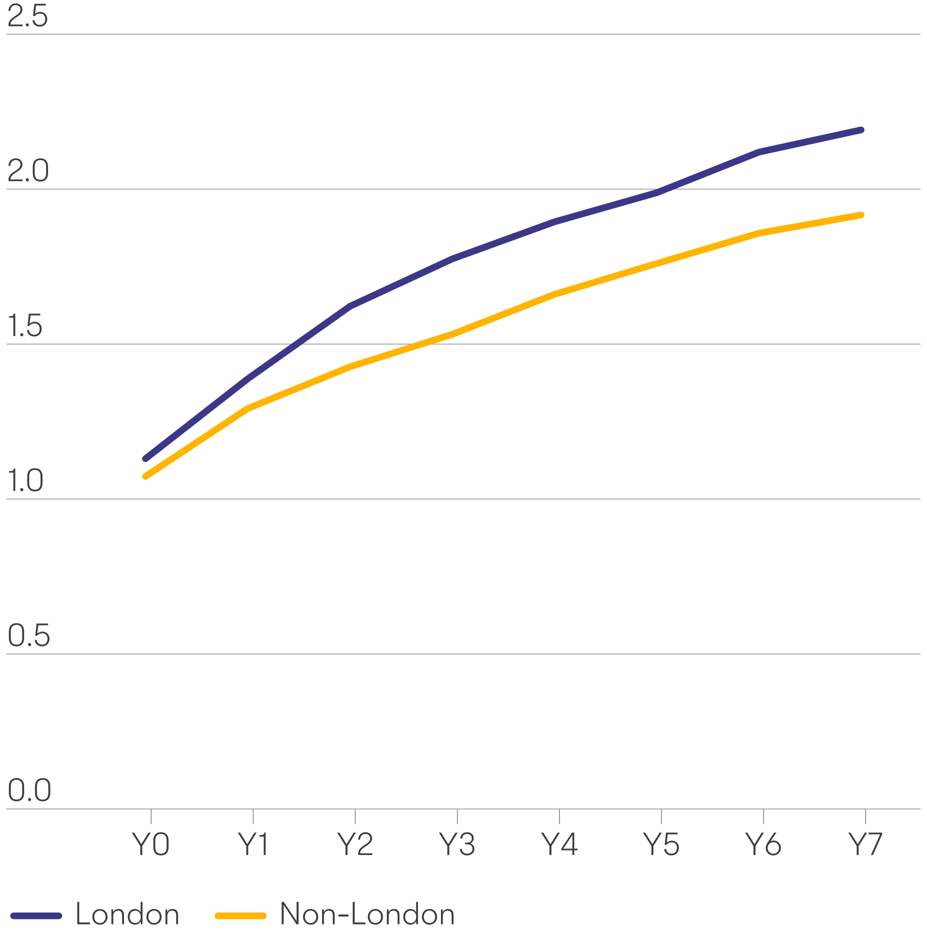
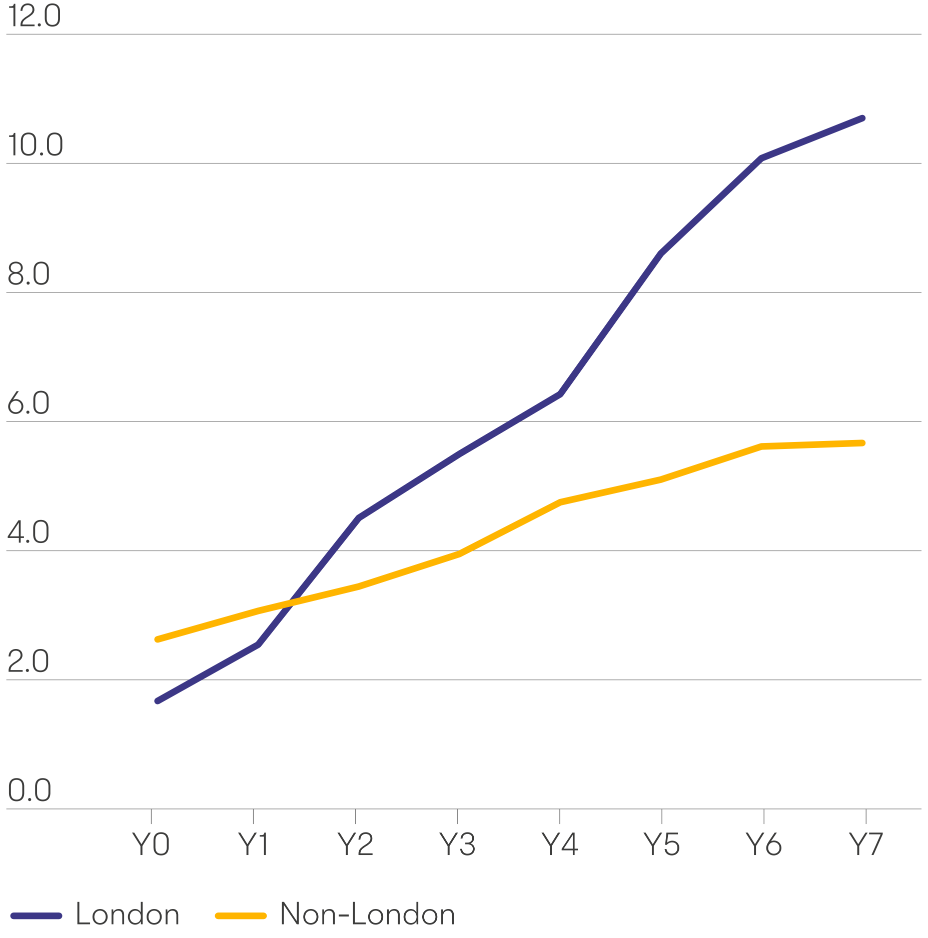


Figure A.19

Cumulative investment amounts in London and non-London seed stage cohorts

Source: British Business Bank analysis of Beauhurst data

Mean cumulative investment (£m) per company per period, by geography (Cohort – Initial seed round 2011 – 2013)



cumulative amount of investment. After seven years, there is relatively little difference in the number of deals per company which sits at around two for both groups, but the amount of investment raised is strikingly different, reflecting the compromises that a weaker fundraising environment will often entail.

The mean amount of total investment per company received by year seven is £10.7m for the London group but just £5.7m for the non-London group. The depth and range of business development opportunities that could be facilitated using an extra £5m of capital will have been markedly different for the London firms, even if we factor in the potential for them to face higher input costs. Over time, this greater scope for activities like research and development, staff recruitment and marketing will have clear implications for the two cohorts and the economies they contribute to.

The outcomes for these cohorts are of course only part of the story as we are comparing between companies that have successfully stepped on to the equity funding escalator. In 2021 there were nine equity deals per 10,000 SMEs in London compared to just two per 10,000 in the rest of the UK. This shows just how much less likely it is, even now, that non-London companies will join this escalator. Consequently, there will be many more firms outside the capital that can only dream of raising £5.7m over seven years, regardless of how this compares to London fundraising experiences.

Another way of illustrating the implications of operating in a lower choice environment comes from listening to the stories of companies helped by our regionally-focused programmes. The Bank has just completed a survey of around 270 beneficiaries of NPIF and the picture painted by these companies of the landscape they would be operating in without NPIF is compelling. Just under half report they would not have been able to get any finance without NPIF while just under a third believe they would have needed to compromise on the amount of funding they sought or to take even more valuable management time away from core operations to secure a facility.[84]

Ensuring that fewer and fewer entrepreneurs face these compromises and barriers in their finance journey is vital if the UK is to move away from its position as the most inter-regionally unequal advanced economy.[85]

The Bank is determined to create greater demand and more opportunities to access finance in every region and Nation of the UK

In the last complete financial year, the Bank's core programmes, which are those not directly related to the Covid-19 pandemic, deployed more than £940m of finance to companies outside of London. This deployment comes from products across the Bank's portfolio, both national and regional, and has continued in calendar year 2021 when an estimated £979m was deployed.

One of the major contributions to the Bank's impact outside of London comes from the Bank's three Regional Funds, which provided a £357m flow of finance in 2020/21. This record flow of finance from the Regional Funds benefitted more than 390 businesses during the year. The Bank's other regionally focused programme, the Regional Angels Programme was also active in 2020/21 contributing an £86m flow of finance outside London.

Both the Regional Funds and the Regional Angels Programme are designed to help tackle exactly the kind of issues discussed in this chapter. For example, part of the model for the Regional Funds is that the private sector fund managers who run the fund operations establish a physical presence in the regions they are supporting. Given the stark geographic imbalances in the distribution of equity and debt fund managers and the importance of distance in the provision of these bespoke and often complex forms of finance, bringing new investors to an area can make a real impact for the companies based there. This physical presence does not just benefit companies in the relatively dense and well-connected urban areas within the fund regions as the oversight and governance processes of the funds draw on local stakeholders to ensure there is outreach to areas with lower business density too.

The Regional Angels Programme is also structured to tackle the challenges to hand. Its model of investing alongside existing angel groups and syndicates to boost the aggregate amount of early-stage equity capital available to smaller businesses directly relates to the supply-side coordination issues discussed above. As a result of adding capital to angel syndicate activity, both through the Bank's direct contribution to deals and through catalysing other investors to participate in deals, the Regional Angels Programme helps willing investors pool their funds more effectively, reducing the risk that companies in the thinner markets it targets end up under-funded.

These are just two examples of how our regional programmes meet the regional finance challenges in the market. We could also reference the demand-side support that is a component of the Regional Funds or the features of the Regional Angels Programme that are designed to boost the profile and professionalism in early-stage equity capital markets across the UK.

This high strategic fit between our regional programmes and the geographic finance challenges seen in the market is why the announcement of additional funding for both the Regional Angels Programme and the Regional Funds at the 2021 Spending Review was so welcome. For the Regional Angels Programme, the £150m provided will allow the programme to continue its impressive pace of committing funding to impactful angel syndicates for another three years.

For the Regional Funds, the additional £1.6bn will be even more transformative. This package of funding not only allows a continuation in the positive work of the Bank's three existing Funds and the Northern Ireland Growth Finance Fund, which the Bank collaborates with Invest NI on, it also allows for a significant geographic expansion of the funds. This expansion will allow NPIF to include the North East of England, will support the creation of a South West Fund, building on CIOSIF and will also establish new funds in Scotland and Wales.

This long-term funding for our regional programmes, coupled with the regional impact of the Bank's complementary national programmes will allow the Bank to continue to break down regional barriers to smaller business finance. Only with such consistent and concerted activity will we succeed in driving sustainable growth and prosperity across the UK.

1.4

Financing smaller businesses' net zero journeys

- Equity finance supports eco-innovators among the smaller business population
- Equity investment in clean tech is increasingly widespread
- Eco-adopters have diverse needs and vary in their openness to finance
- The Bank's programmes are already helping eco-innovators and adopters draw on the transformative impact of external finance

The UK's commitment to achieving net zero by 2050 is one of the most important challenges for the country and is reflected in the Bank's mission. To achieve net zero, the UK will need to draw upon smaller businesses both as eco-innovators and as adopters of emission-reducing practices.

Equity finance supports eco-innovators among the smaller business population

For the UK economy to reach net zero as quickly and efficiently as possible, it is important that no viable technology remains unexplored due to lack of finance. Grants can provide crucial support for the earliest stages of eco-innovation, however, as these innovations move closer to the market, equity finance is often vital to help companies commercialise and achieve scale.

Eco-innovation can be costly, time-consuming, and involve significant risk. These features mean that equity investors, who generally operate with a focus on long-term value, and the investments they make, which do not require regular repayments, are ideally suited to supporting eco-innovation.

There are, however, challenges for eco-innovators looking to raise equity finance. A common issue is that due diligence costs do not vary in line with investment size. That means diligence is relatively more burdensome for the smaller deals needed to make the initial inroads on an eco-innovation, and this can inhibit activity at the lower end of the market.

Levels of knowledge about the underlying technologies among available investors can also be an issue while another specific challenge with eco-innovation is that government subsidies are commonplace in the markets innovators often target.[86,87,88]

This can mean the true level of free-market demand is untested, which adds to the inherently risky proposition of investing in any innovative technology. Consequently, the demand trajectory for clean tech is likely to depend heavily on the evolution of government policy which has the potential to significantly alter the risks and returns to investing in clean tech, and the timescale over which these are realised.

Despite these challenges, UK SMEs have received significant investment to progress eco-innovations over the last decade. Between 2011 and Q3 2021 there were 1,005 publicly announced equity deals in clean tech[89] SMEs amounting to £3.3bn of investment.

The path for deal volumes and funding levels over this period has, however, been somewhat varied. After an early boom between 2006 and 2011, equity investment levels in clean tech dropped, reportedly due to poor returns,[90] before returning to growth in recent years.

Equity investment in clean tech is increasingly widespread

This resurgence reflects growing recognition of the importance of tackling the climate crisis and has resulted in buoyant investment in 2021 to date. In the first three quarters alone 147 clean tech deals for a total of £572m were reported. These 147 deals already surpass the number recorded in 2020, while total investment looks likely to be higher than last year's £679m when full-year figures are available later in the year (Figure A.20).

Another indication of the sector's growing popularity with investors is the appearance of mega-deals of more than £100m. The 12-month period leading up to the United Nations COP-26 conference on climate change in November 2021 saw the first clean tech mega-deals for UK SMEs. Both mega-deal recipients, Flexion Energy and Zenobe, operate in the energy sector, and raised £150m each from private sector investors to finance infrastructure expansion.

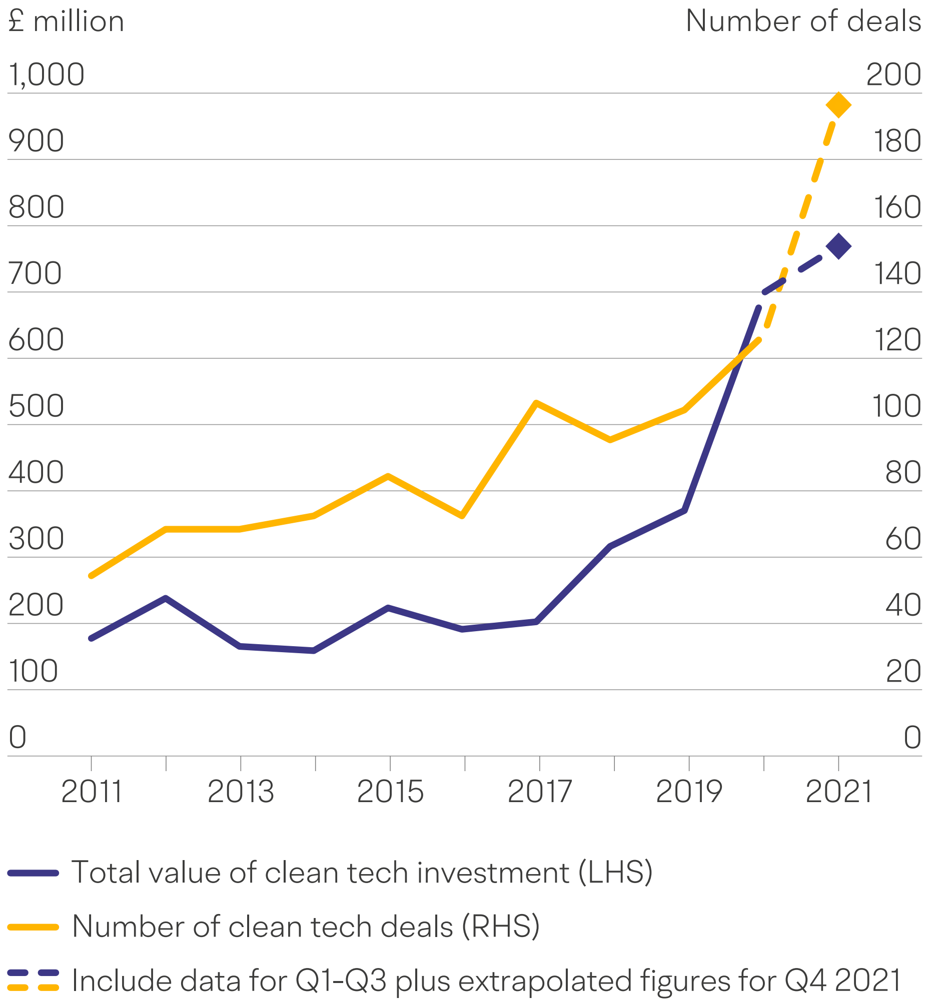
Despite growth in investment and the emergence of the first mega-deals in the sector, clean tech investment hasn't kept pace with the overall UK SME equity market. Clean tech accounted for more than 10% of both deals and investment value in 2011 compared to just 8% of deals and 4% of investment in 2021 Q1-Q3 (Figure A.21). Expectations for the year ahead are, however, strong with several market commentators including Sifted[91] PitchBook[92] and CB Insights[93] suggesting clean tech will see substantial investor interest in 2022.

Investors looking at clean tech in 2022 are likely to come across companies undertaking a wide range of activities. Although there has been some attempt at taxonomy,[94] clean tech in most cases is used as a general term, interchangeable with green tech, climate tech, or environmental tech, to refer to technologies, materials, or processes that reduce harmful environmental impacts and promote the sustainable use of resources.

Figure A.20

Annual clean tech deals and total investment value

Source: British Business Bank analysis of Beauhurst data
Note: Q4 data for 2021 has been extrapolated using the average of Q1-Q3 2021



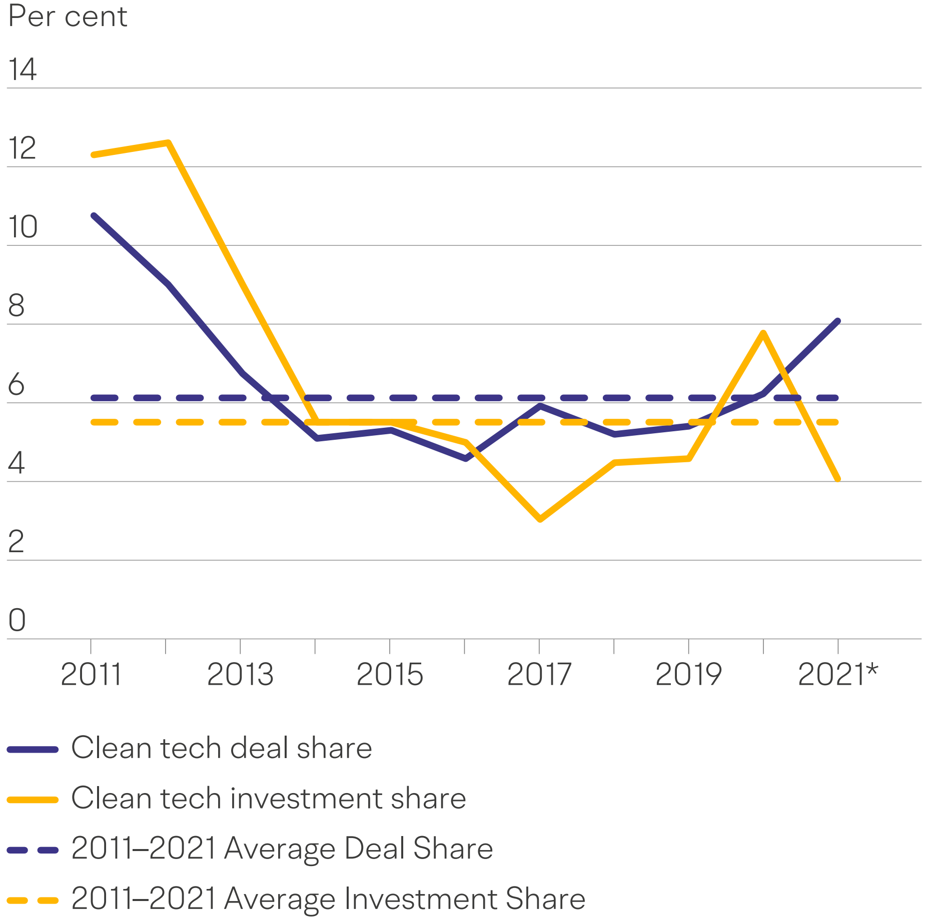
This includes a broad range of products and services, alongside the large infrastructure projects that immediately spring to mind such as wind and solar farms. Clean tech encompasses a wide variety of businesses that are helping to make more sustainable versions of everyday products used by most of the population, such as cars, packaging, and meat, as well as new inventions designed to make homes and businesses more environmentally sustainable.[95] These can include hardware, software, and mobile apps to analyse things like energy usage, emissions, and water pressure.

The breadth of clean tech activity is demonstrated by Beauhurst's comprehensive company characteristics data, which shows that clean tech deals span 73 different sectors. Energy-related sectors account for around 25% of companies that have raised equity and 35% of investment by value.[96] Other important sectors for clean tech include automotive (8% of deals and 11% of investment), waste management (5% of deals and 8% of investment), and other manufacturing and engineering (7% of deals and 4% of investment) (Figure A.22).

Figure A.21

Number of clean tech deals and investment value as a proportion of the total UK SME equity market (2011 - Q3 2021)

Source: British Business Bank analysis of Beauhurst data

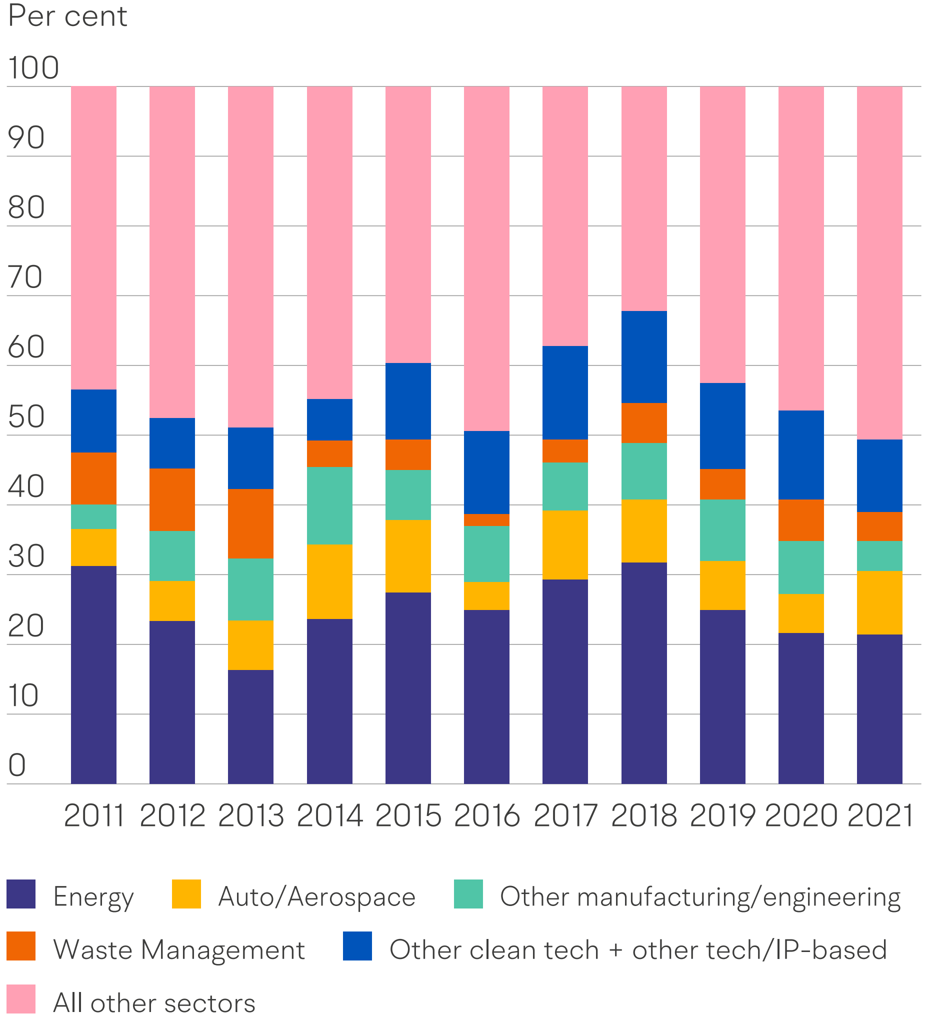


*Note: 2021 is based on Q1 - Q3 data

Figure A.22

Clean tech deal share by sector (%) and year: 2011 – Q3 2021

Source: British Business Bank analysis of Beauhurst data



This breadth of activity appears to have emerged over time as in 2021, companies in 46 different sectors received at least one clean tech equity deal, double the number of sectors represented in 2011. The expanding range of sectors with some clean tech activity is potentially indicative of an ever-widening set of technologies being developed to combat environmental challenges.

These technologies clearly attract a wide range of investor types. Private equity and venture capital funds (PE/VC) are the most active but business angels, government investors, crowd funding platforms and corporates are also frequently involved. Six per cent of the investments made by business angels and crowd funding platforms were in clean tech, which is equal to clean tech's share of the UK SME equity market (by deal count). The number is slightly lower for PE/VC funds, while the opposite is true of corporate and government investors (Figure A.23).

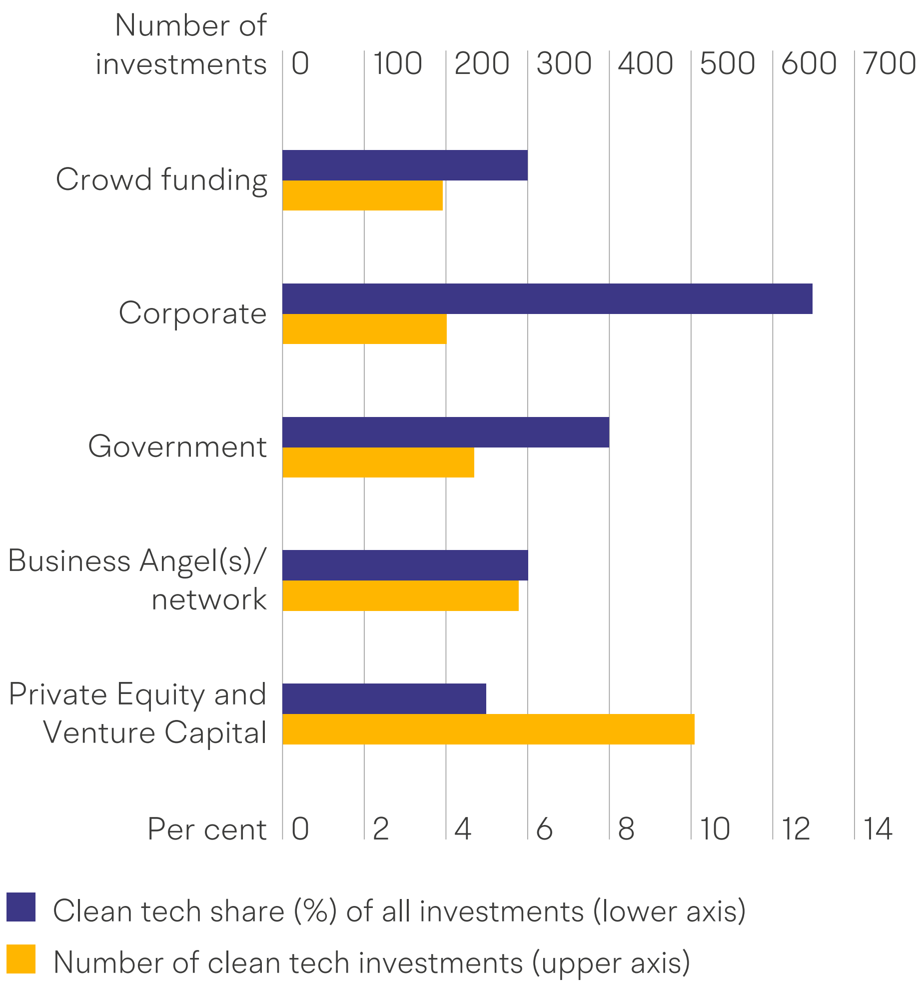
When looking at stated investment strategies across all investor types, there is a clear trend of investors with an explicitly environmental or social impact focus[97] accounting for a decreasing share of investments over time (Figure A.24). This is perhaps indicative of clean tech investment becoming more mainstream, something that evidence from some groups of investors supports.

A clear example of this comes from a survey of UK VC fund managers the Bank undertook in 2021. Eighty-three per cent of fund managers are now considering environmental factors within their investment decisions. Environmental, social and governance (ESG) factors are considered a significant, and in some cases integral, part of the decision-making process by over half (52%) of the responding fund managers.

Figure A.23

Number of clean tech investments and clean tech share of all investments (%) by five main investor types (2011 - Q3 2021)

Source: British Business Bank analysis of Beauhurst data



Environmental factors appear slightly less embedded in reporting as only 31% of fund managers report on portfolio performance against ESG measures. Direct reporting of portfolio carbon emissions is even rarer with only 7% of fund managers doing this (Figure A.25).

Qualitative feedback from the fund managers highlighted some of the challenges in aligning ESG factors within VC firms. These include the lack of a standardised and widely adopted ESG reporting framework as well as the resource and time cost for both fund managers and for their portfolio companies.

Despite these challenges, most also recognise that ESG-aligned investment opportunities can improve profitability too. The majority of fund managers in our survey (59%) expected the returns on investments in companies with strong ESG credentials to be slightly higher (52%) or substantially higher (7%) than for firms with no or limited ESG focus, whilst just 3% reported expecting returns to be worse.

Figure A.24

Number of clean tech investments made by environmental and social/impact funds and as a proportion of total clean tech investments made (%): 2011 - Q3 2021

Source: British Business Bank analysis of Beauhurst data and additional research

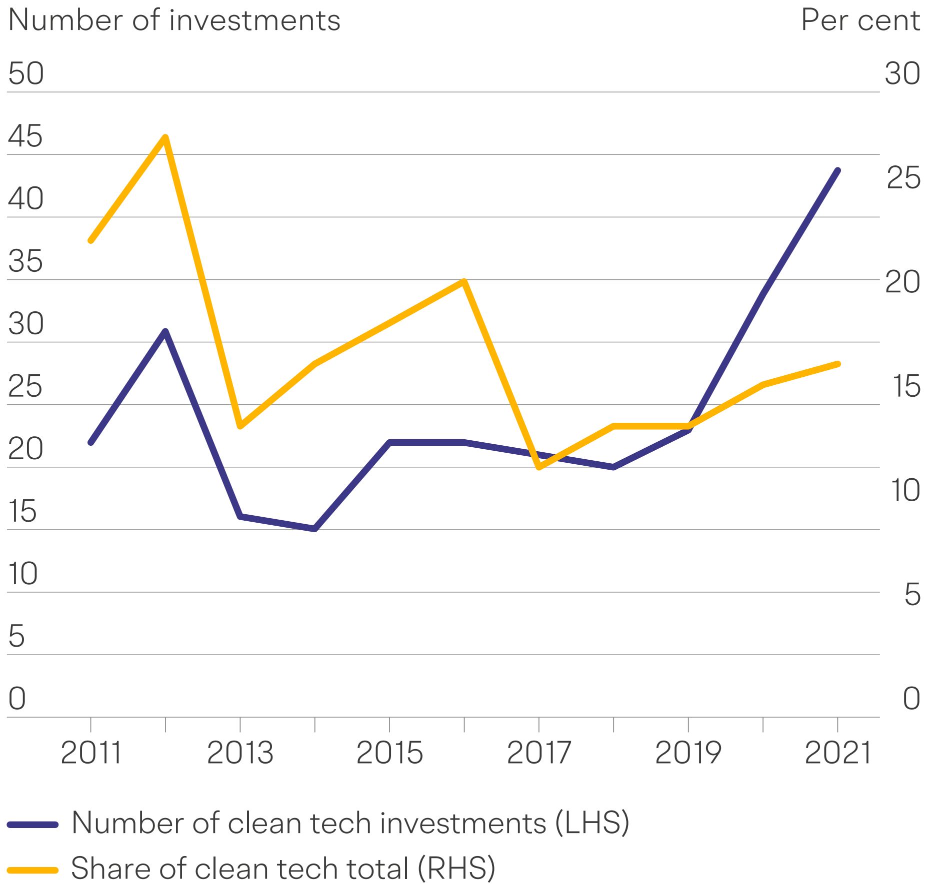
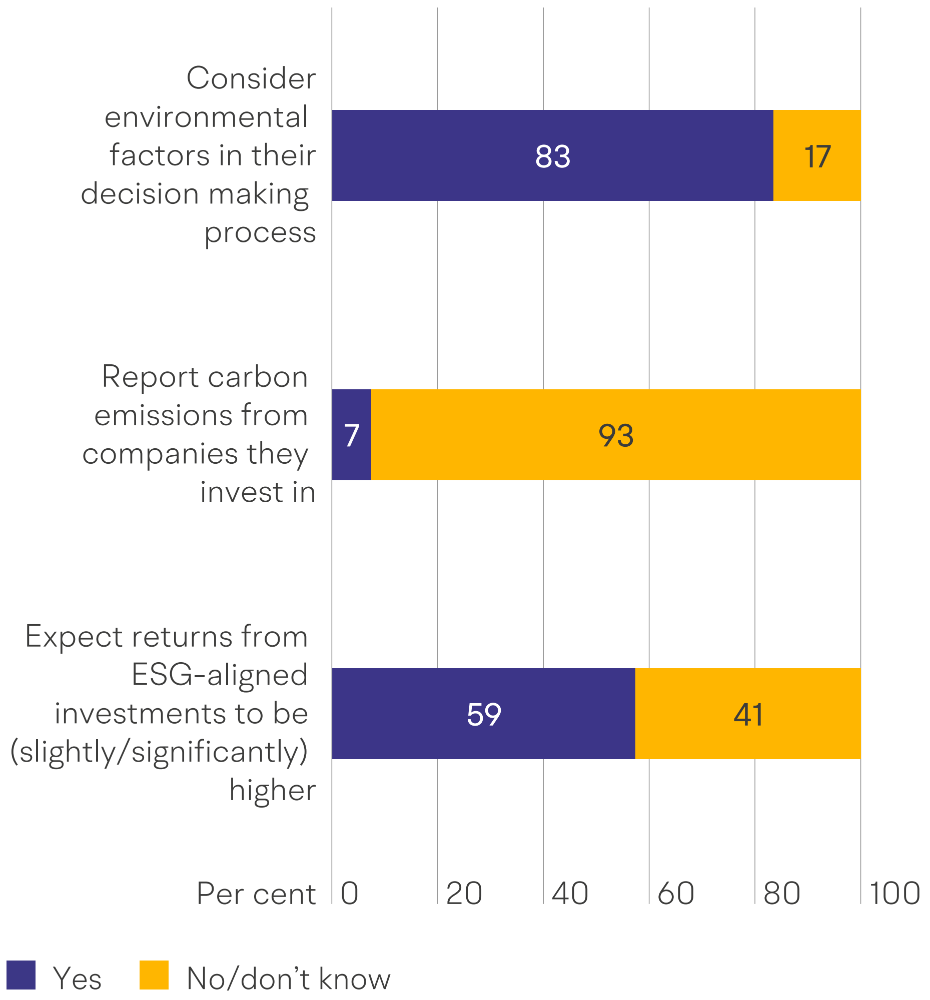


Figure A.25

Fund managers' approaches to ESG/environmental factors in their investment portfolios

Source: British Business Bank Venture Capital Returns survey, 2021, n=29



These expectations reflect the significant evolution of clean tech investment opportunities in recent years. The significant advances made in key clean tech areas (such as battery storage) and the declining costs of renewable energy mean that equity investors have a wider range of ESG-aligned investment opportunities to choose from, often offering higher returns than investments in fossil fuels.[98]

The fact that clean tech investment has returned to growth spurred by increasing recognition of the opportunities it affords is a positive development for smaller businesses' contribution to net zero as eco-innovators. It is important, however, that we also consider what the wider smaller business population can do for the net zero target as adopters of eco-innovations and how external finance can best support that.[99]

Eco-adopters have diverse needs and vary in their openness to finance

The finance needs of businesses looking to adopt emission-reducing practices differ from those of eco-innovators. While eco-innovators will be attracted to equity, eco-adopters are likely to consider a wider range of options. Many of these options will be forms of debt finance such as bank loans or asset finance facilities but equity can also be relevant for some eco-adopters.

This diversity of finance needs stems in part from the diversity of the eco-adopter group which spans all sectors, sizes and locations, since all businesses - even the smallest - will need to take action on their carbon emissions. Another factor that makes eco-adopter needs highly diverse is that there are a wide range of strategies that companies can adopt to reduce their emissions, some of which lend themselves to particular forms of finance.

To add to our understanding of the diverse finance needs of eco-adopters, the Bank carried out a bespoke survey of 1,200 small and medium businesses from across the UK in 2021. The survey gathered detailed information on smaller business attitudes and progress towards net zero.

The survey showed that external finance is already seen by many smaller businesses as a means to transition to net zero. Around 11% of smaller businesses reported that they had used external finance to support the adoption of relevant actions. Among smaller businesses that are planning future net zero-related actions, 22% would consider using finance to support these actions.[100]

Smaller businesses using or considering the use of finance to support net zero actions are clearly in the minority at present, but there are reasons to think these proportions may grow. Feedback from the finance intermediary community, who were surveyed in Winter 2021 by the Bank's UK Network, is one such reason. Forty-five per cent of the 281 finance intermediaries surveyed viewed net zero as an area their smaller business clients would explore finance options for during 2022.[101]

Another encouraging factor is that a relatively high share of firms with experience of using finance view emission reduction as a priority. According to the Bank's 2021 Business Finance Survey, becoming more environmentally sustainable is a more frequent priority among businesses that have sought external finance in the last three years (62%) or are currently using it (61%), than among the overall smaller business population (57%).[102]

Nevertheless, the evolution of demand for net zero-oriented finance in the coming years will be heavily influenced by the attitudes and practices of different types of smaller businesses. These attitudes and characteristics can be grouped into four 'personas' (Figure A.26) that help navigate similarities and differences among smaller businesses in their journey to net zero.

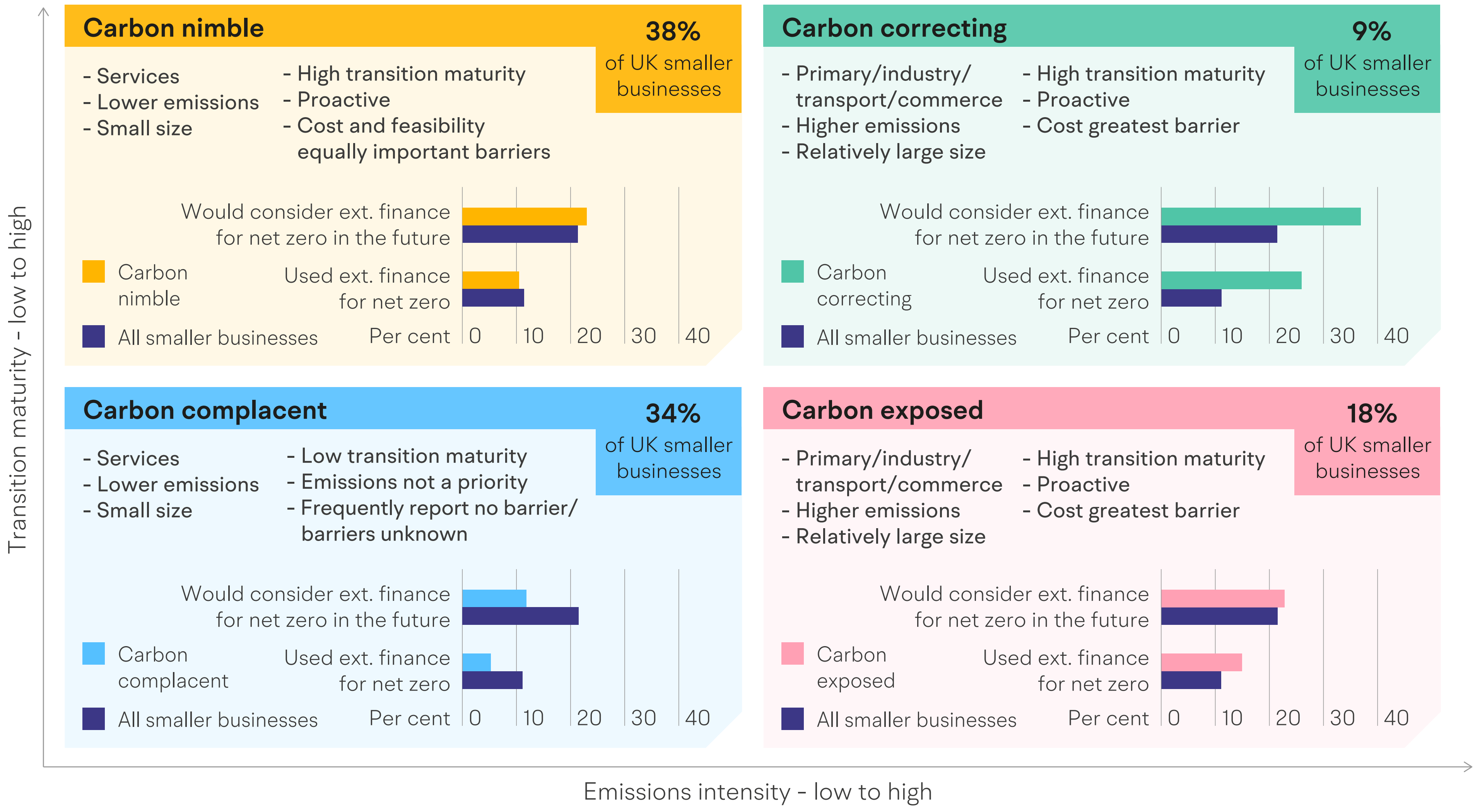
Among these personas, the 'carbon- correcting' group are most open to using finance for net zero actions. This group is characterised by having relatively high emission levels alongside higher transition maturity. High transition maturity means they have greater awareness of net zero impacts on their business, greater progress on implementing actions that reduce their carbon emissions, and greater propensity to take more complex, high-impact actions.

The 'carbon- correcting' group also have a proactive, opportunity-driven approach to decarbonisation and a tendency to identify costs as a significant barrier to implementing net zero in their business. It is therefore relatively easy to see why this group are most open to using finance for net zero actions. However, this group is unfortunately the smallest of the four personas representing just 9% of the business population.

Figure A.26

Key features of the Bank's smaller business personas and their attitudes to finance for net zero actions

Source: British Business Bank Net Zero SME Survey, 2021, n=1,200 for all smaller businesses; n=339-458 for carbon nimble; n=97-111 for carbon correcting; n=227-409 for carbon complacent; n=166-222 for carbon exposed



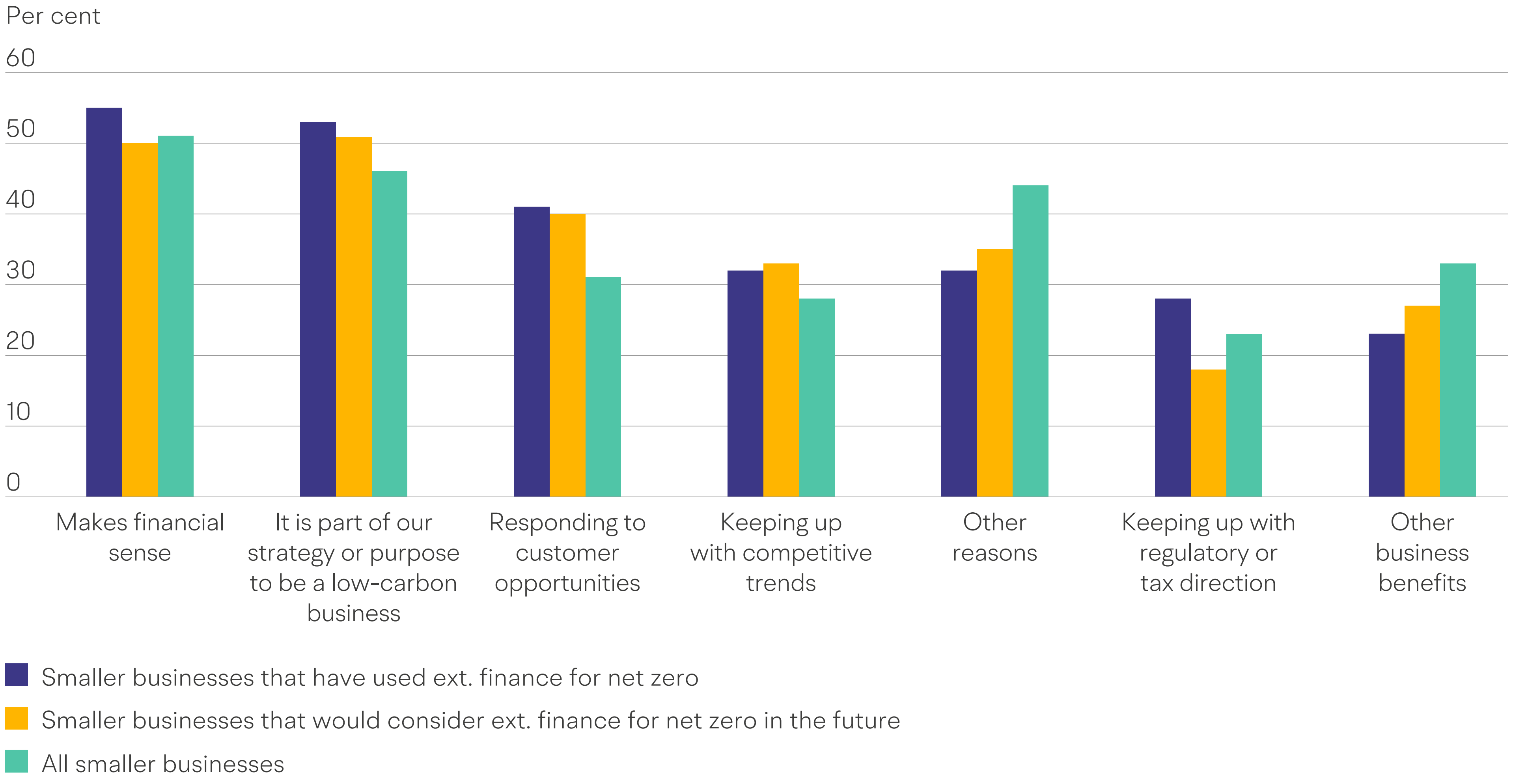
Looking across all four personas, there are three key factors that can help us understand what kind of businesses are open to using external finance for the adoption of net zero practices, and why.

Motivations are one key factor and while the most popular motive is a belief that net zero actions will make financial sense,[103] businesses that are open to using finance for net zero actions also place major emphasis on other factors. In particular, these businesses have a strategic focus on decarbonising their operations and believe both customer demand and competitive pressure supports their actions too (Figure A.27). This is consistent with intermediary views as more than half of those surveyed by the Bank's UK Network rated responding to customer expectations (60%), keeping competitive and enhancing reputation and brand (both 52%) as significant drivers for their smaller business clients.[104]

Figure A.27

Key reasons for taking net zero actions: smaller businesses that have used/would consider using external finance for this purpose

Source: British Business Bank Net Zero SME Survey, 2021, n=1,200 for all smaller businesses; n=134 for smaller businesses that have used ext. finance for net zero; n=179 for smaller businesses that would consider ext. finance for net zero in the future



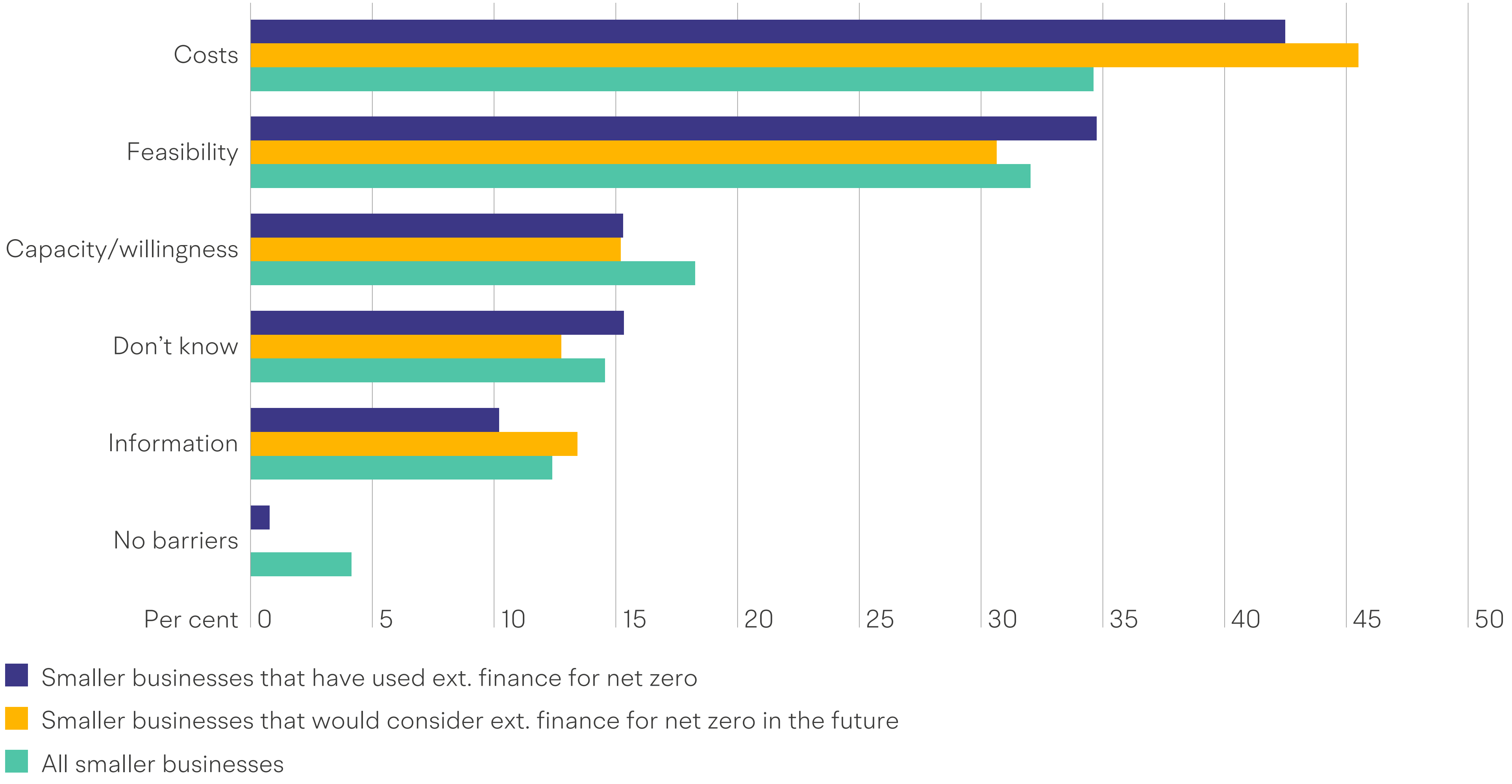
Barriers are a second important factor. Here the key differences are that businesses open to using finance for net zero actions are more likely to mention the cost of actions as a barrier and less likely to mention capacity and willingness as a barrier than other businesses (Figure A.28).

Finally, the actions considered or planned by businesses complete the picture and show the changes businesses want to implement. As above, responses from businesses that are open to finance use show a different pattern with this group of businesses more likely to report an intention to invest in substantive changes such as introducing very-low-emission business vehicles or collaborating with their supply/distribution chain (Figure A.29).

Figure A.28

Key barriers to taking net zero actions: smaller businesses that have used/would consider using external finance for this purpose

Source: British Business Bank Net Zero SME Survey, 2021, n=1,200 for all smaller businesses; n=134 for smaller businesses that have used ext. finance for net zero; n=179 for smaller businesses that would consider ext. finance for net zero in the future



Beyond these three factors that are important for understanding use of finance for net zero actions, there are a handful of further business and entrepreneur characteristics that appear to be correlated with prioritising environmental action.[105] Examples include female-led (70%) and Ethnic Minority-led businesses (60%), which both report environmental sustainability as a priority in greater proportions than male-led (52%) or White-led (57%) businesses.

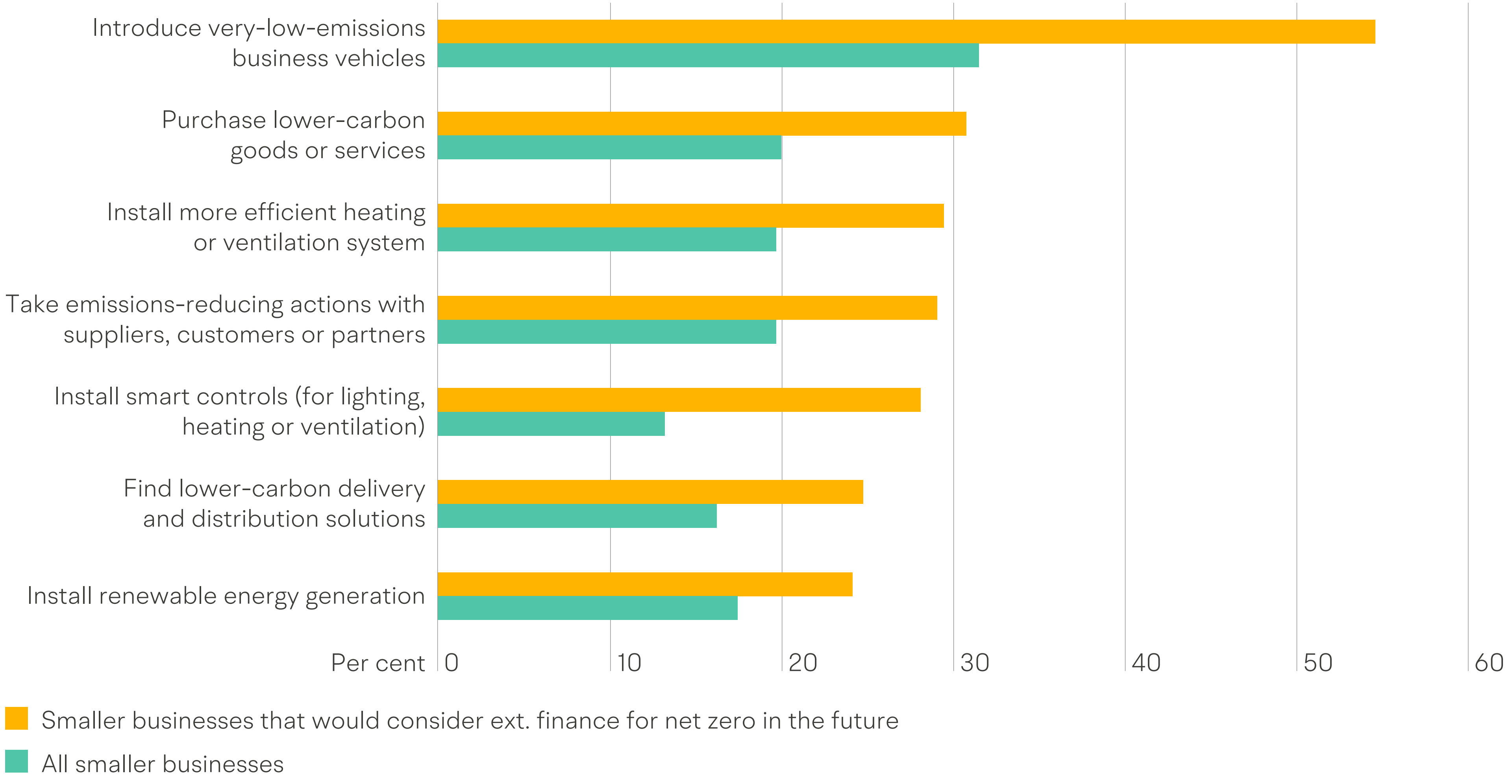
This highlights how breaking down barriers to finance that affect entrepreneurs from different backgrounds will not only help these businesses but can have wider benefits through stimulating net zero actions too. Breaking down place-based barriers to smaller business finance is also vital for net zero. This is because economically weaker regions have the highest per-capita emissions in the UK.[106]

This pattern is partly driven by industrial mix and means that economically weaker regions, which (as outlined in section 1.3) are also the regions that tend to have weaker finance outcomes have the most work to do to transition into low-carbon economies.

Figure A.29

Top net zero actions considered/planned in the future: smaller businesses that would consider external finance for this purpose

Source: British Business Bank Net Zero SME Survey, 2021, n=1,062-1,200 for all smaller businesses; n=168-179 for smaller businesses that would consider ext. finance for net zero in the future



The Bank's programmes are already helping eco-innovators and adopters draw on the transformative impact of external finance

In 2021, the British Business Bank introduced a new climate change objective that commits it to supporting the UK's transition to a net zero economy, alongside joining relevant initiatives such as the United Nations' Race to zero campaign[107] and Business Ambition for 1.5°C.[108] This formalisation of our support for net zero will help us build on the track record we have already assembled in supporting eco-innovation and adoption.

On the eco-innovation front, the Bank's programmes have supported £251m in clean tech investment between Q4 2014 and Q2 2021. The two biggest components of this investment are the UK Innovation Investment Fund and Future Fund, which account for 60% of the total.

As outlined above, eco-innovators are relatively likely to use equity finance while eco-adopters are more likely to use debt. These boundaries are blurred, however, and we see this in our programmes too. Recent evidence on the impacts of the Northern Powerhouse Investment Fund (NPIF), which provides both debt and equity, has highlighted its role in supporting eco-innovation and adoption.

Almost seven in 10 NPIF beneficiaries used their finance to introduce new products and services and just under half of these new products and services were expected to reduce carbon emissions. On the adoption front, more than three in 10 beneficiaries had used their funding to reduce their own environmental impact through adopting low-carbon processes and technologies.[109]

This emphasises how breaking down barriers to finance, in this case the place-based barriers that NPIF is designed to target, can yield benefits for the UK's net zero target. This dynamic does not just apply to place-based barriers, but to those related to personal characteristics and wider financial system barriers too.

This is recognised by the independent Climate Change Committee, who estimate investment needs to rise to about £50bn per year between the late 2020s and 2050 if the UK is to get on track to reaching the net zero target. Investment on this scale will only happen if the UK finance system as a whole becomes better aligned with environmental goals.

This increased alignment of the financial system is the third goal of the Paris Agreement[110] and is a driving force behind the UK government's ambition to make London the world's first net-zero-aligned financial centre.[111] Achieving this alignment will require environmental sustainability considerations to be embedded into finance products for eco-innovators and adopters alike.[112] The Bank is determined to continue to play a part in these efforts, both through our programmes that supply finance and through our role within the finance community.

Part B

Market developments

Small businesses and their use of finance

Finance products

2.1

Macroeconomic developments

- The UK economy broadly returned to pre-crisis output levels in late 2021
- Business investment continued to recover but lagged the UK economy
- The labour market tightened significantly despite the furlough scheme ending
- Inflation rose sharply as businesses passed on higher costs to customers
- Official forecasts predict UK economic growth will start to slow in 2022, and the high inflation will be temporary
- Forecast strong business investment growth in 2022 has the potential to increase the demand of smaller businesses for finance

The UK economy broadly returned to pre-crisis output levels in late 2021

2021 began with two major events. The first was a resurgence in Covid-19 infections that led the UK to enter a third national lockdown. The second was the commencement of rules governing the new relationship between the UK and the European Union following the end of the transition period on 31 December 2020.

By the final quarter of 2021, the level of real GDP in the UK was 0.4% below that in Q4 2019, the last quarter before the start of the Covid-19 pandemic.

The recovery began in mid-2020 but stalled in early 2021 due to the third lockdown, which contributed to a fall in real GDP of around 1% in Q1 compared to the previous quarter. This was the first fall since the record 19% decline in Q2 2020 amid the first lockdown (Figure B.1). The recovery resumed in mid-2021 as most restrictions were lifted, with real GDP rising by around 6% in Q2.

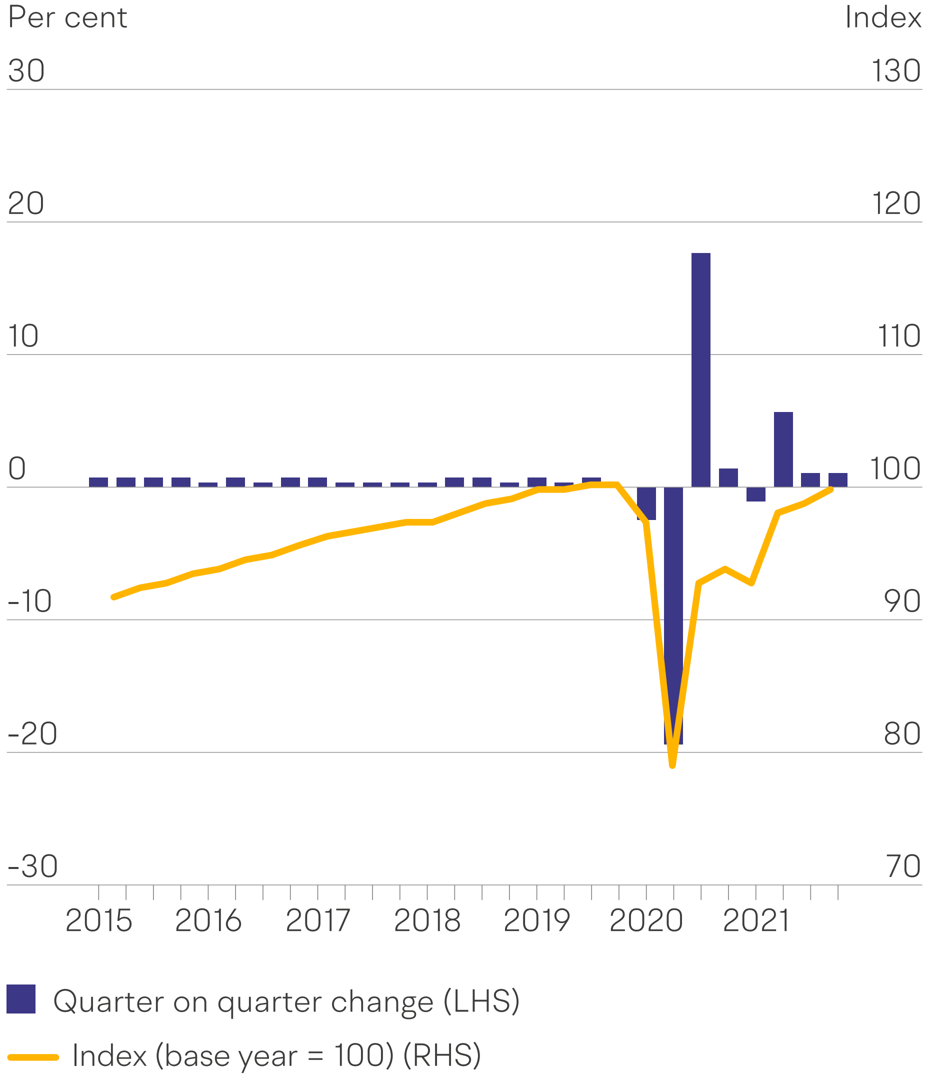
Q3 saw the recovery lose momentum with growth slowing to 1% as disruption to global supply chains dragged on economic activity. By sector, the main drag was from construction with delays in the availability of some construction products and higher input prices a key contributor. Manufacturing also weighed down on growth due to weaker production of transport equipment, which the ONS attributed to a shortage of semi-conductors.

In Q4 the pace of growth was steady relative to Q3.[113] The services sector, particularly human health activities, was the main growth driver. This was largely Covid-19 related, including a large increase in test and trace activities and the extension of the vaccination rollout. However, the Omicron variant weighed on activity in retailing and hospitality as Q4 and 2021 ended.

Figure B.1

UK gross domestic product, seasonally adjusted

Source: ONS



The supply chain disruption experienced in 2021 reflects the impact of both the Covid-19 restrictions and the start of the new trade agreement with the EU. Covid-19 restrictions led demand to exceed supply globally as many factories temporarily or permanently closed. As restrictions were lifted, demand surged while supply remained low as factories had only started to reopen.

The surge in demand also caused congestion at ports, delaying the delivery of consumer goods and business inputs. The new rules for importers and exporters operating between the UK and the EU further contributed to delays in supply chains, particularly in the period immediately after the agreement came into effect. These issues meant the average quarterly value of UK exports in the first three quarters of 2021 remained at around £150bn, unchanged on 2020 but around 13% down on 2019.[114]

Business investment continued to recover but lagged the UK economy

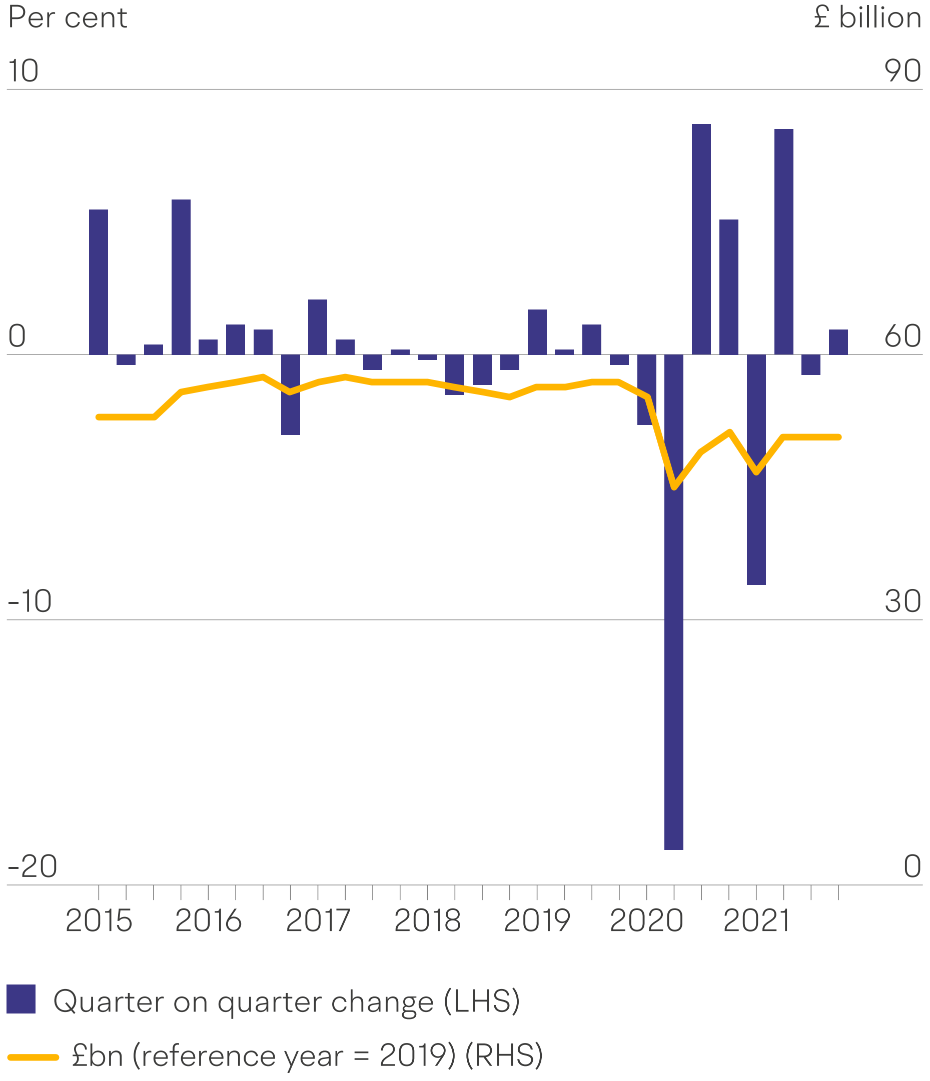
The level of business investment in Q4 was 10.4% below that in Q4 2019, while real GDP was 0.4% below (Figure B.2). The lack of post-pandemic recovery in business investment comes after a couple of decades where business investment growth has been slower than GDP growth and means that investment levels in Q4 are just 18% above 20 years ago while GDP is 35% higher. Business investment is a key driver of economic growth and strong investment activity will be crucial for the UK to meet the net zero target by 2050.[115]

Business confidence was above pre-pandemic levels for much of the year, but this did not translate into a full recovery in investment. Lingering economic uncertainty is one likely explanation for this and is reflected in the bumpy course for confidence during 2021.

Figure B.2

Business investment, seasonally adjusted

Source: ONS



The first three quarters of 2021 were markedly different to the last quarter of 2020 when there was a sharp deterioration in confidence in the lead up to the third lockdown. The FSB Voice of Small Business Index (SBI) Q4 2020 (conducted mid-December) was at -49.3 (Figure B.3). This was down from -32.6 previously and the second lowest (after -143.4 in Q2 2020) since the survey began in 2010.

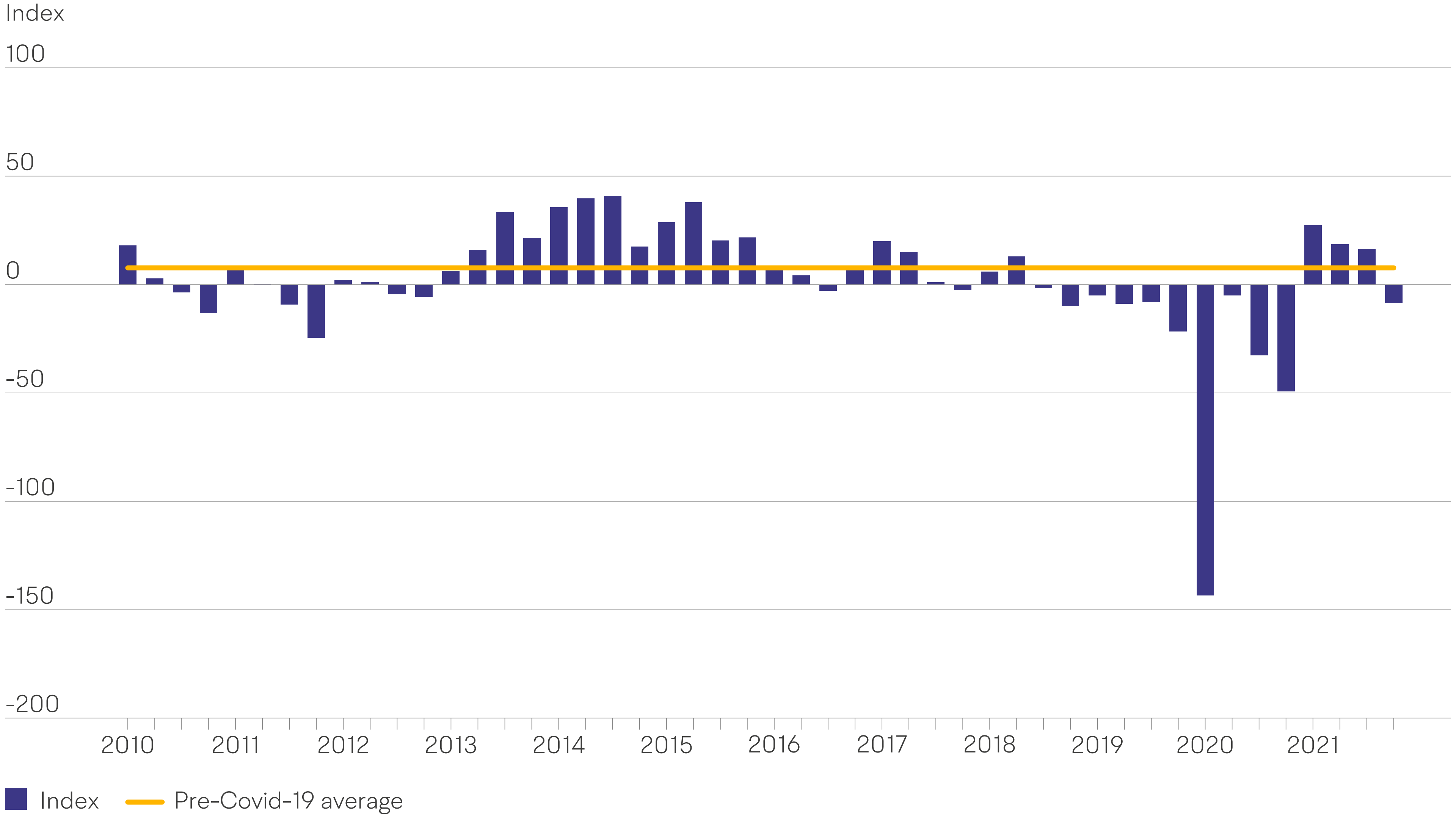
The Government roadmap out of lockdown announced in February 2021 and the successful vaccination rollout enabled businesses to see a way out of the pandemic, leading confidence to improve. The SBI Q1 2021 (conducted mid-March) was at +27.3, back above the pre-Covid-19 average (+7.7). The SBI for Q2 and Q3 were a little lower but remained above the pre-Covid-19 average. However, the SBI Q4 2021 was at -8.5, the first negative in a year,[116] with the emergence of the Omicron variant of Covid-19 a contributing factor.

In addition to many businesses remaining nervous about major investment decisions, the supply chain disruption in 2021 has also slowed the recovery of business investment. The disruptions reduced the availability of some investment assets, particularly transport equipment where supply was limited because the shortage of semiconductors had slowed production.

Figure B.3

Voice of small business confidence index

Source: FSB



The labour market tightened significantly despite the furlough scheme ending

Job vacancies reached a record high in late 2021, signalling that the labour market had tightened significantly. The number of job vacancies in the three months to December 2021 was 1.22m, up 134,000 from the previous equivalent period and the highest since the series started in 2001 (Figure B.4).[117]

The record job vacancies were driven by the surge in demand following the lifting of restrictions, and labour shortages in certain sectors such as agriculture, transport and hospitality following the UK leaving the EU. Also, the ONS noted the number of workers changing jobs (largely driven by resignations rather than dismissals) reached a record high in late 2021.

The unemployment rate trended downward during 2021, which also signalled a tighter labour market. In the three months to November 2021 the unemployment rate for people aged 16-64 was 4.2%, down from 4.5% in the previous equivalent period. This was the lowest in more than a year but remained above that in the three months to December 2019 (3.8%), before the Covid-19 pandemic.

The lower unemployment rate has largely been driven by the employment rate rising. In the three months to November 2021 the employment rate climbed to the highest in over a year but was still below levels seen before the Covid-19 pandemic.[118] There were concerns that the end of the Coronavirus Job Retention Scheme (CJRS) in September 2021 could lead to a large rise in redundancies. However, early indicators such as the number of payrolled employees suggest this has not been the case.

Payrolled employees rose in December for the 11th consecutive month to 29.5m.[119] This was the highest since the series started in 2014 and above the pre-Covid-19 level (29m) for the fourth month in a row.[120] The ONS recently noted it is possible those made redundant at the end of the CJRS will be included in the data on payrolled employees for a few further months while they work out their notice period. However, the ONS also flagged the responses to its business survey suggest the number made redundant was likely to be a small share of those still on furlough at the end of the scheme.

Figure B.4

Number of job vacancies, seasonally adjusted

Source: ONS

Inflation rose sharply as businesses passed on higher costs to customers

The cost of business inputs surged to a record high in late 2021. The producer price index for inputs rose 15.2% in the 12 months to December 2021 (Figure B.5). This was up from 14% in November and the highest since the data series started in 1997.

Higher input prices were driven by multiple factors. Supply chain disruption pushed up the cost of raw materials and intermediate goods while labour market tightness increased wage costs. Businesses also experienced increased prices for energy and fuel.

The higher input costs led businesses to raise their selling prices significantly. The producer price index for outputs rose 9.3% in the year to December 2021. This was down slightly from 9.4% in the previous month, which was the highest since September 2008 (11.9%).

Consumer price inflation also increased sharply to reach the highest level in nearly two decades. The consumer price index rose 5.4% in the 12 months to December 2021. This was the highest since March 1992 (7.1%). It was also well above the Bank of England (BoE) inflation target of 2%.

Figure B.5

Annual rates of input and output PPI and CPI

Source: ONS

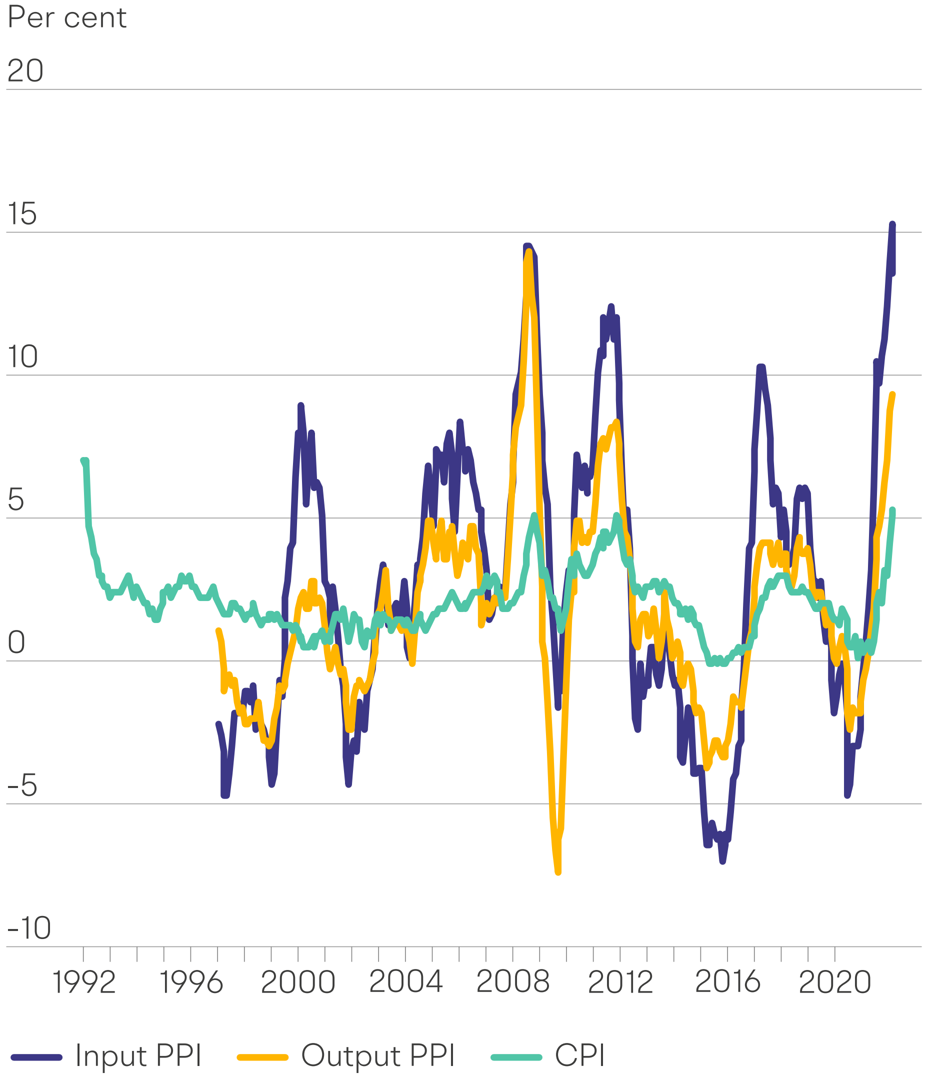
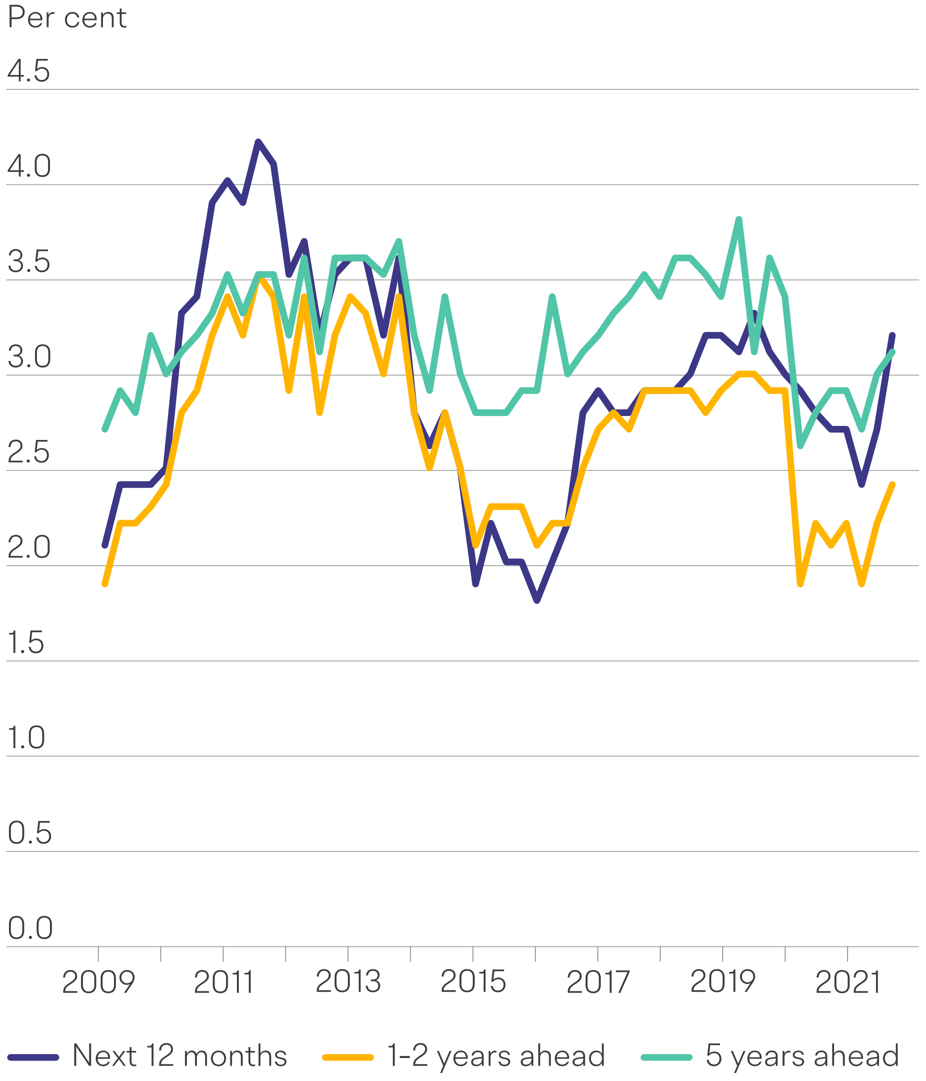


Figure B.6

UK consumer inflation expectations

Source: BoE/Kantar



A key issue for the coming year is whether high inflation will be temporary or longer lasting. The BoE/Kantar quarterly survey of UK consumer inflation expectations provides one evidence point. The latest results from November 2021 indicate inflation expectations have picked up but remain broadly around their long-term average (Figure B.6).[121]

Official forecasts predict UK economic growth will start to slow in 2022, and the high inflation will be temporary

The latest official forecasts for the UK economy, provided by the BoE and the Office for Budget Responsibility (OBR) show the pace of real GDP growth slowing in 2022 to around 4% and 6% respectively. This is a reduction from approximately 7% in 2021 (Figure B.7).[122,123] Both the OBR and BoE expect the main drivers of the slowdown to be the persistence of supply chain bottlenecks and the withdrawal of the fiscal support provided during the pandemic including the CJRS.

The official forecasts show real GDP growth continuing to decelerate in 2023 to around 1%- 2% before stabilising in 2024. The key drivers are expected to be the waning of the boost to the economy from the release of pent-up demand, and again the withdrawal of the fiscal support. However, both the OBR and BoE indicate the UK economic outlook remains highly uncertain.

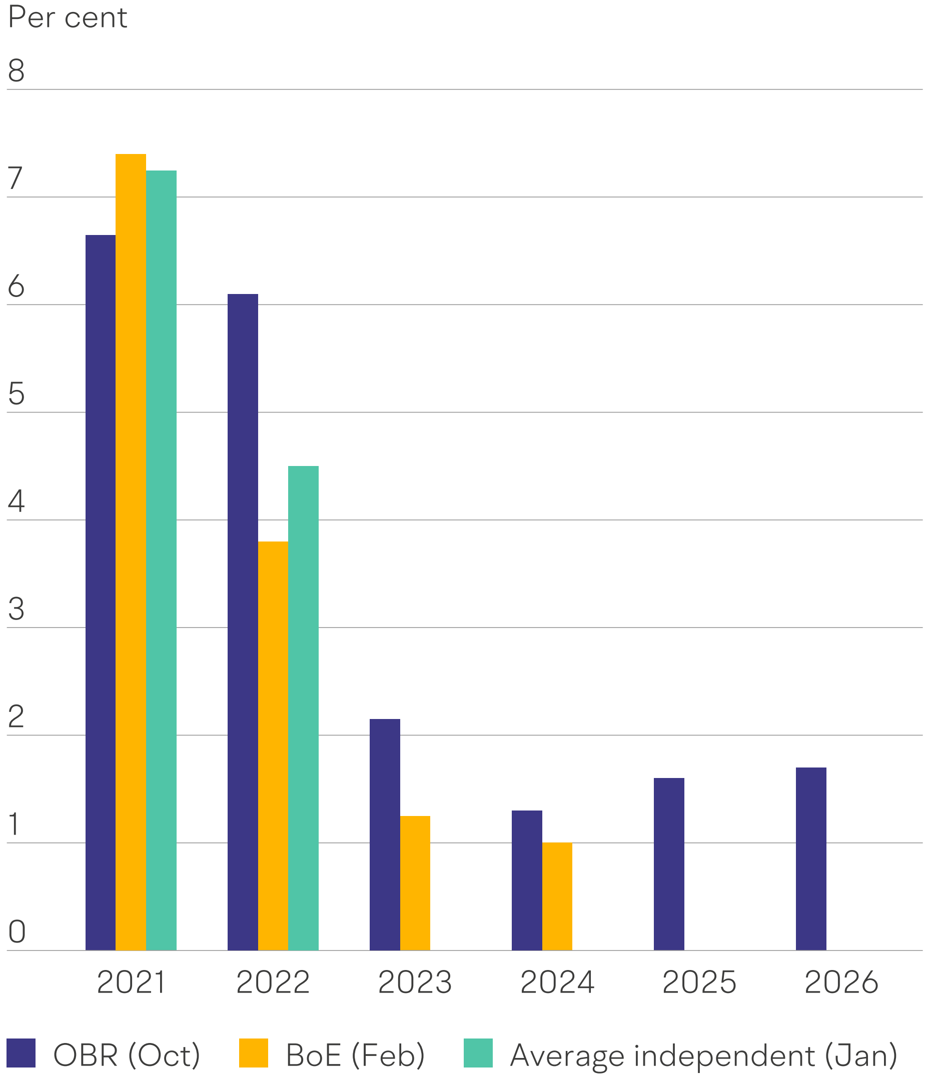
The HM Treasury comparison of independent forecasts provides real GDP growth in 2021 and 2022 only.[124] The average of the independent forecasts for 2022 (4.4%) is broadly in line with that of the BoE but lower than the OBR's.

For business investment, the official forecasts show very strong growth in 2022 before a sharp slowdown. The OBR and BoE expect business investment to rise by around 14% and 16% respectively in 2022. This is based on an expectation that businesses will bring investment forward ahead of the temporary uplift to capital allowances ending in March 2023.[125] The average of the independent forecasts is less optimistic, with business investment growing 7%-8%.

Figure B.7

Official and independent forecasts of GDP growth

Source: OBR, BoE, and HMT comparison of independent forecasts



Both the OBR and BoE expect business investment growth to slow in 2023, to around 5% and 2% respectively. The OBR sees business investment contracting around 1% in 2024, while the BoE forecasts show a fall of around 5%. The end of the temporary uplift to capital allowances is cited as the driver.

Official forecasts predict that elevated levels of consumer price inflation will be temporary. The OBR's most recent forecast in October predicts inflation will peak at 4% in 2022 before falling to less than 3% in 2023 and to around the BoE's 2% target in 2024. The BoE forecast, which is more recent, shows inflation peaking at around 6% this year and then broadly following the same path as the OBR forecast. The lower inflation is driven by supply disruption easing and energy prices stabilising.

Forecast strong business investment growth in 2022 has the potential to increase the demand of smaller businesses for finance

The strong growth in business investment forecast for 2022 has the potential to increase demand among some smaller businesses for finance, particularly asset finance, to invest and grow their business. However, there is a risk the limited availability of transport equipment and other assets due to the supply chain disruption could constrain such investment.

Other potentially countervailing forces include the prospect of further increases in the BoE Bank Rate which would increase the cost of interest payments faced by some smaller businesses, potentially reducing their demand for finance. The Bank Rate rose in December 2021 for the first time in more than three years and there was a further increase in February 2022 to 0.50%. A sharp rise in inflation expectations would increase the likelihood of the high inflation being longer lasting. This has the potential for the BoE to raise the Bank Rate higher than otherwise to prevent high inflation leading to second-round effects.

UK Finance data for September 2021 suggests that changes in the Bank Rate have a greater impact on the interest payments of medium-sized businesses than small businesses. The data showed that for medium-sized businesses, the majority (75%) of existing loans made by the seven largest UK banks were variable rate. In contrast, for small businesses the minority (35%) were variable rate. Changes in the Bank Rate would also affect small and medium-sized businesses that need to refinance, along with those taking on new debt.

Another potential headwind for business investment comes from the increase in debt levels of some smaller businesses. As we move beyond the pandemic the outlook for smaller businesses debt positions is a key factor for future finance demand which we analyse in more detail in section 2.2.

2.2

Smaller businesses and their debt positions

- The Bank's Coronavirus Business Interruption Loan Schemes played an important role in getting businesses through the pandemic
- Smaller businesses' net debt positions are lower than headline borrowing levels
- Repayments of pandemic-prompted debt facilities are already well underway and are creating concern for a decreasing share of borrowers
- Several indicators show positive developments for debt sustainability among smaller businesses
- The strength of economic recovery over the coming years is likely to have the single largest influence on smaller businesses' debt positions

The early impacts of the Covid-19 pandemic and associated policy responses had a profound effect on smaller businesses. British Chamber of Commerce data from around this time showed that 18% of UK businesses had less than a month's worth of cash in reserve, and 44% had only one to three months' worth.[126] In light of this precarious position, the Bank's three Coronavirus Business Interruption Loan Schemes[127] were set up to provide rapid access to low-cost liquidity for businesses particularly exposed to the disruptions brought about by lockdowns and changing consumer behaviour.

The Bank's Coronavirus Business Interruption Loan Schemes played an important role in getting businesses through the pandemic

The key objective across the Bounce Back Loan Scheme, the Coronavirus Business Interruption Loan Scheme, and the Coronavirus Large Business Interruption Loan Scheme was to support business survival during the pandemic. Usage of the three schemes was widespread with more than 1.6m facilities agreed by the time the schemes closed at the end of March 2021. An ongoing consequence of this unprecedented use of finance is that many businesses now have new debt obligations to manage.

Between April 2020 and March 2021, a simple estimate suggests around £47bn of additional finance was taken on by SMEs.[128] This represents an 81% increase on longer term trends and equates to an increase in the stock of SME debt of around 30% from pre-pandemic. Survey data corroborates this increase in finance use with the SME Finance Monitor (SME FM) suggesting 21% of SMEs were using "more finance" relative to pre-pandemic in the second quarter of 2021. This share varies from 17% to 36% for zero employee and 10 - 49 employee businesses respectively.

This group includes SMEs borrowing for the first time, existing borrowers taking on extra finance, and borrowers using more of their existing facilities. New borrowers were the largest contributor with 11% describing themselves as borrowing for the first time during the pandemic including 17% of some of the smallest businesses (1-9 employees). A further 7% were existing borrowers taking on more finance and 3% were existing borrowers using more of their facilities. Note that most SMEs (79%) did not increase their use of finance. The vast majority of this group either used less finance or none at all (86%) with the remainder using the same amount of finance (14%).[129]

Breaking down by industry, three of the top four sectors using more finance were those most affected by the pandemic[130] (Figure B.8). Around a third of Hospitality and Transport SMEs were borrowing more than pre-pandemic with Manufacturing and Wholesale/Retail close behind at around 25%. Amongst these SMEs at least half were borrowing for the first time.

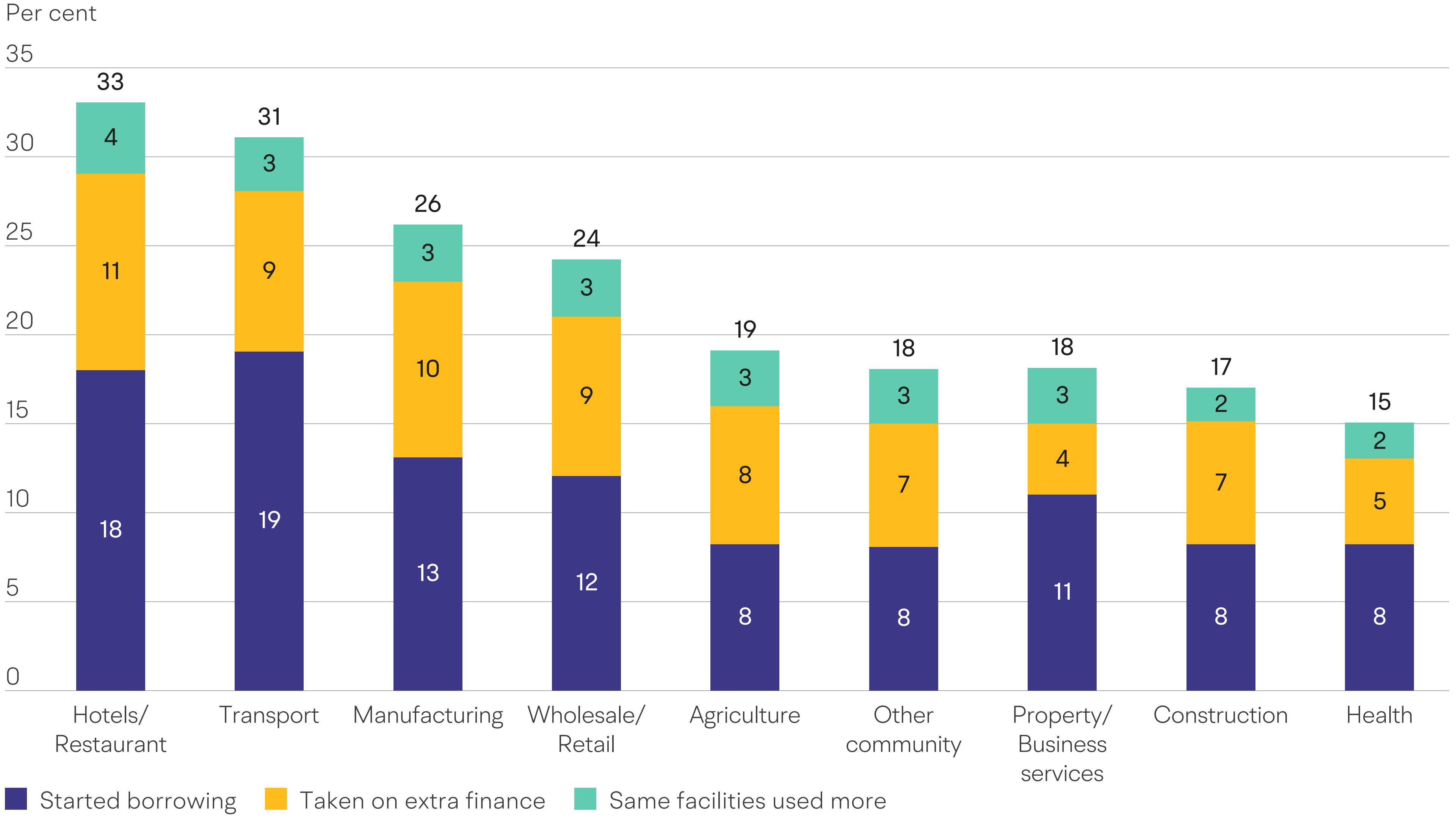
Applying the estimated share of new borrowers per sector to the most recent business population statistics[131] suggests around 0.6m smaller businesses borrowed finance for the first time during the pandemic. Amongst these businesses, just over a third were from the three sectors most exposed to the pandemic.[132]

The relatively higher rates of new borrowers in these sectors suggest that the schemes were used to manage cashflow disruptions - even for businesses with little track record of borrowing. Moving forward these businesses may find themselves at greater risk of the downsides associated with debt burdens (see Box 1) as they have greater sectoral exposure to the pandemic and, as first-time borrowers, they may be unfamiliar with managing regular loan repayments.

Figure B.8

Increased use of finance, sectoral breakdown

Source: BVA BDRC SME Finance Monitor, 2021Q2



Box 1: Debt burden downsides

Businesses are subject to debt burdens when servicing repayments risks their on-going viability. In such situations there are multiple channels through which problems can materialise for the business and the economy as a whole. Some of the key downsides related to high debt burdens are listed below:

1. Rise in business deaths

Business vulnerability caused by unavoidable and high debt repayments can result in a rising number of business deaths. Over the long-term new businesses would be expected to replace failed businesses, but the transitional costs incurred as the economy moves to this new state can be both large and persistent.

2. Restricted access to finance

Businesses with higher exposure to economic shocks present greater risk to lenders. This is especially so when businesses are perceived to be significantly indebted. These businesses may find themselves priced out of external finance needed to manage the peaks and troughs of general business trading. At times of significant uncertainty these downsides may spillover and also be experienced by other businesses (such as those reliant on indebted firms in the supply chain).
This risks disrupting businesses such that it causes lenders to restrict finance to otherwise viable firms. This can reinforce self-fulfilling feedback loops pushing viable businesses into distress, further compounding the rate of business deaths.

3. Debt overhang

When debt repayments make up a significant share of earnings, businesses may struggle to allocate resources to invest and grow. This is likely to negatively impact the rate of productivity growth in the economy which ultimately underpins long run GDP growth. Furthermore, there is evidence that in economic stress where credit is constrained, highly indebted businesses are more likely to cut their investment[133] and employment than less indebted businesses.

Smaller businesses' net debt positions are lower than headline borrowing levels

The net debt position is important to consider when assessing debt burdens. Net debt takes into account both the share of debt that has been spent, as opposed to sitting undrawn, and the amount already repaid. The SME Finance Monitor estimates that in the second quarter of 2021, 45% of those offered Covid-related finance in the previous year had spent all or most of their facilities.[134] This is supported in the recent Business Finance Survey[135] which found that 43% of companies had spent all the external finance they most recently applied for in 2021. The smaller the business the more likely they were to have spent all or most of their Covid-related facilities (up to 48% for 0 employee firms).

Somewhat surprisingly, despite being one of the hardest hit sectors just 35% of hospitality smaller businesses were estimated to have spent all or most of their funding by the first half of 2021. This is ten percentage points down on the SME average and even further below the 60% and 53% of businesses in this position, respectively, in the Agriculture and Transport sectors.

Potential explanations include widespread use of agency staff among hospitality firms which means wage bills are relatively flexible and that hospitality businesses benefited from more extensive use of non-loan Government support schemes.[136,137] There may also be an element of "survivorship bias" where businesses in significant distress cease trading which leaves only the successful surviving businesses in the sample.

Regarding this latter point, across the UK there was a 6.5% decrease in the number of private sector businesses between January 2020 and January 2021 according to BEIS business population estimates. The equivalent drop among accommodation and food service businesses (ie hospitality) was 10% suggesting survivorship bias may be part of the explanation for the relatively favourable unspent facility position of hospitality firms. Regardless of the reason, the reduced rate of facility draw-down may mitigate debt burden risks for hospitality businesses.

Repayments of pandemic-prompted debt facilities are already well underway and are creating concern for a decreasing share of borrowers

In addition to facilities unspent, repayment trends are an important indicator of debt sustainability. In December 2021 the repayment status of each Covid scheme was published online.[138] As at 30th September 2021, 4% of BBLS and CBILS facilities and 6% of the total loan value had already been repaid in full. These repayments have reduced the value of outstanding loans for all businesses, of which SMEs make up the vast majority, by around £4.1bn.

Box 2 develops this analysis further by looking repayment rates split by sector as of December 2021.

Box 2: Repayment rate analysis

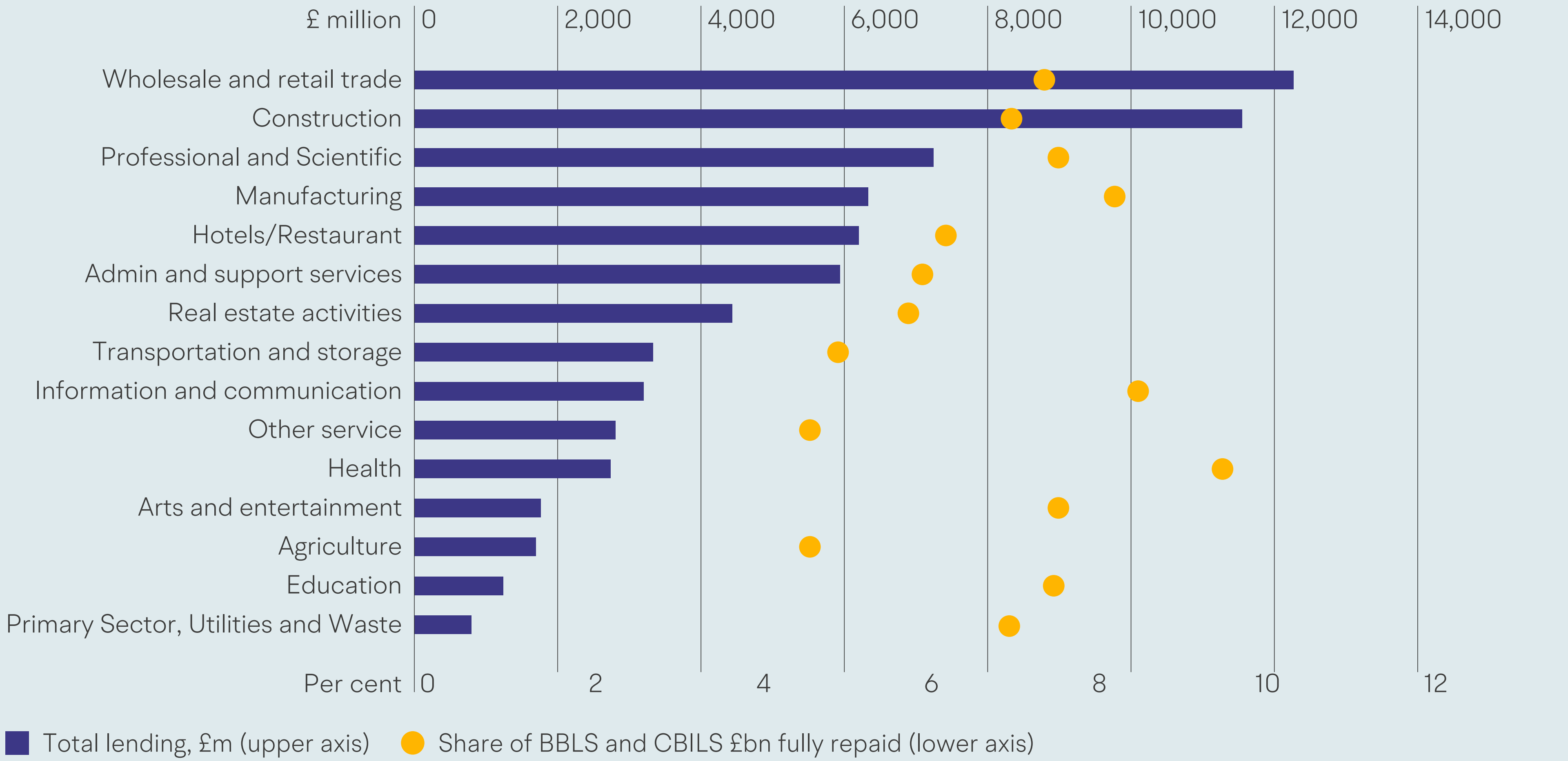
In total £71bn of lending was extended under both BBLS and CBILS to small businesses. Figure 1 demonstrates how both the value of lending and the share fully repaid breaks down by sector as of December 2021.

Whilst it is too early to draw firm conclusions on trends in repayment rates, the data may give an indication of the relative health of different sectors. The share of smaller businesses with fully repaid scheme loans is greatest in the Health (10%), Information and Communication (9%), and Manufacturing (8%) sectors. The lowest rates are found in Agriculture (5%), Other Services (5%), and Transportation and storage (5%).

Figure 1

BBLS and CBILS - value of borrowing and share of debt fully repaid, sectoral breakdown

Source: British Business Bank analysis of Management Information



Looking across all sectors, the highest rates of full repayment are generally found in the sectors where use of the schemes was lowest relative to the economic scale of the sector in question. For example, the Information and communication sector's usage was relatively low accounting for 4.5% of BBLS and CBILS lending compared to the sector's 6.0% estimated share of smaller business turnover.

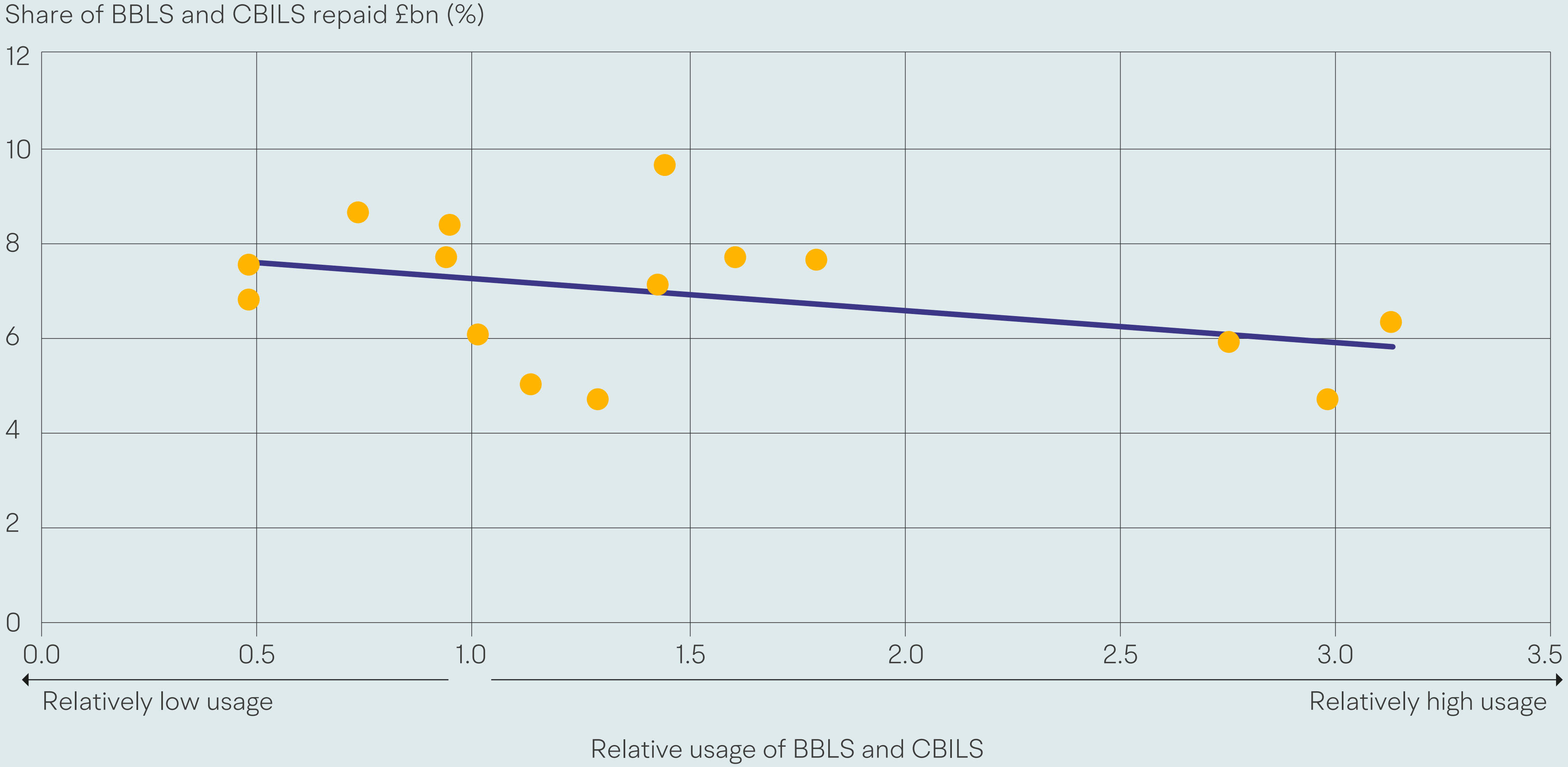
This low scheme usage has been followed by full repayments worth 9% of lending by firms in the sector, notably above the 6% average repayment level to date (Figure 2). Plotting this data for all sectors illustrates a relatively consistent relationship and while it is still too early to draw robust conclusions there are some potentially interesting implications.

In particular, the data could suggest that sectors where scheme usage was relatively high have more finance to manage as they attempt to recover. This would support the finding that sectors affected disproportionately by the pandemic may find themselves more exposed to debt burdens over the coming few years.

Figure 2

Share of BBLS and CBILS fully repaid by levels of usage, sectoral analysis

Source: British Business Bank analysis of Management Information



For businesses that do have debt repayments to make, SME Finance Monitor data from 2021 Q2 estimates that 16% of all SMEs using finance are concerned about their ability to repay finance over the next 12 months.[139] Whilst this is slightly higher than the 14% recorded pre-pandemic (2020 Q1) it is markedly less than the 29% observed in the peak of 2020 Q2. British Business Bank analysis of the underlying data suggests that this reflects around a 150% reduction in the value of finance that SMEs are concerned about repaying.[140,141] This drop in repayment concern is likely driven by higher growth aspirations and the improved economic outlook at the time of reporting.

The smallest SMEs have expressed the most concern consistently over the previous two years - currently at 17% compared to 9% for 50-249 employees. The most concerned SMEs are also found in Manufacturing, Agriculture, Hospitality, and Transport with the latter recognised as two of the most affected sectors by the pandemic. At the same time the biggest falls in concern since 2020 Q2 are seen in Construction, Hospitality, and Other Community services. Again, most of these sectors were the worst affected by the pandemic but also stood the most to gain from restrictions being lifted.

Several indicators show positive developments for debt sustainability among smaller businesses

More debt has undoubtedly increased SME liabilities, but it has also bolstered current assets and liquidity. Prior to the pandemic 23% of SMEs held £10k or more of credit balances, increasing steadily to 34% by Q1 2021 where it has been broadly stable since.

Further evidence for this dynamic comes from analysis of a sample of 2,200 firms[142] who borrowed using BBLS or CBILS during the pandemic. Companies House data from BvD FAME[143] shows that between 2019 and 2021 these firms experienced an 18% increase in current liabilities that was more than offset by an increase in current assets of around 50% (or £53,000, roughly the maximum available to firms under BBLS). The current ratio, which divides current assets by current liabilities, is a key measure of businesses' ability to meet their short term obligations. The average current ratio for the firms analysed increased from 1.3 to 1.6, demonstrating the use of the schemes in helping businesses to 'weather the storm'.

BoE analysis[144] provides further positive signs on smaller businesses' cash positions. 32% of limited company SMEs who have debt in their data set had sufficient cash to repay all debts in full if required.[145] They also found that around 50% of SMEs held at least one month's worth of turnover as cash reserves in May 2021 compared to 39% in the previous year. These higher levels of cash reserves are likely to support SMEs to deal with short term and transitory shocks to revenues despite carrying more debt.

The ONS also produce metrics to help assess debt burden severity.[146] Their data from December 2021 show that the proportion of businesses with debt repayments making up more than 50% of turnover has steadily declined since early 2021 for SMEs of all sizes (Figure B.9) up until the recent Omicron outbreak and imposed Plan B restrictions.

Figure B.9

Share of businesses with debt repayments exceeding 50% of turnover

Source: ONS Business insights and impact on the UK economy

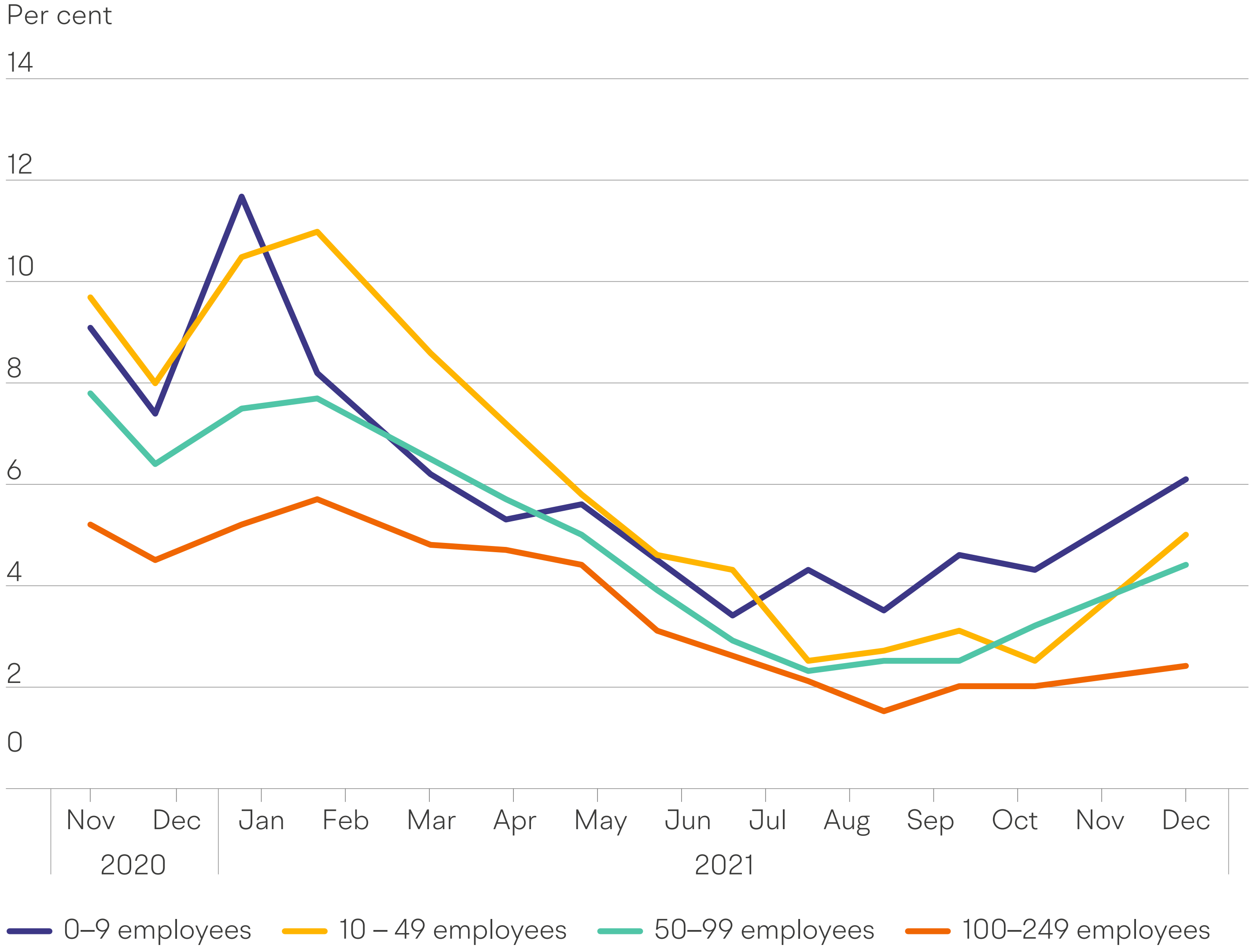
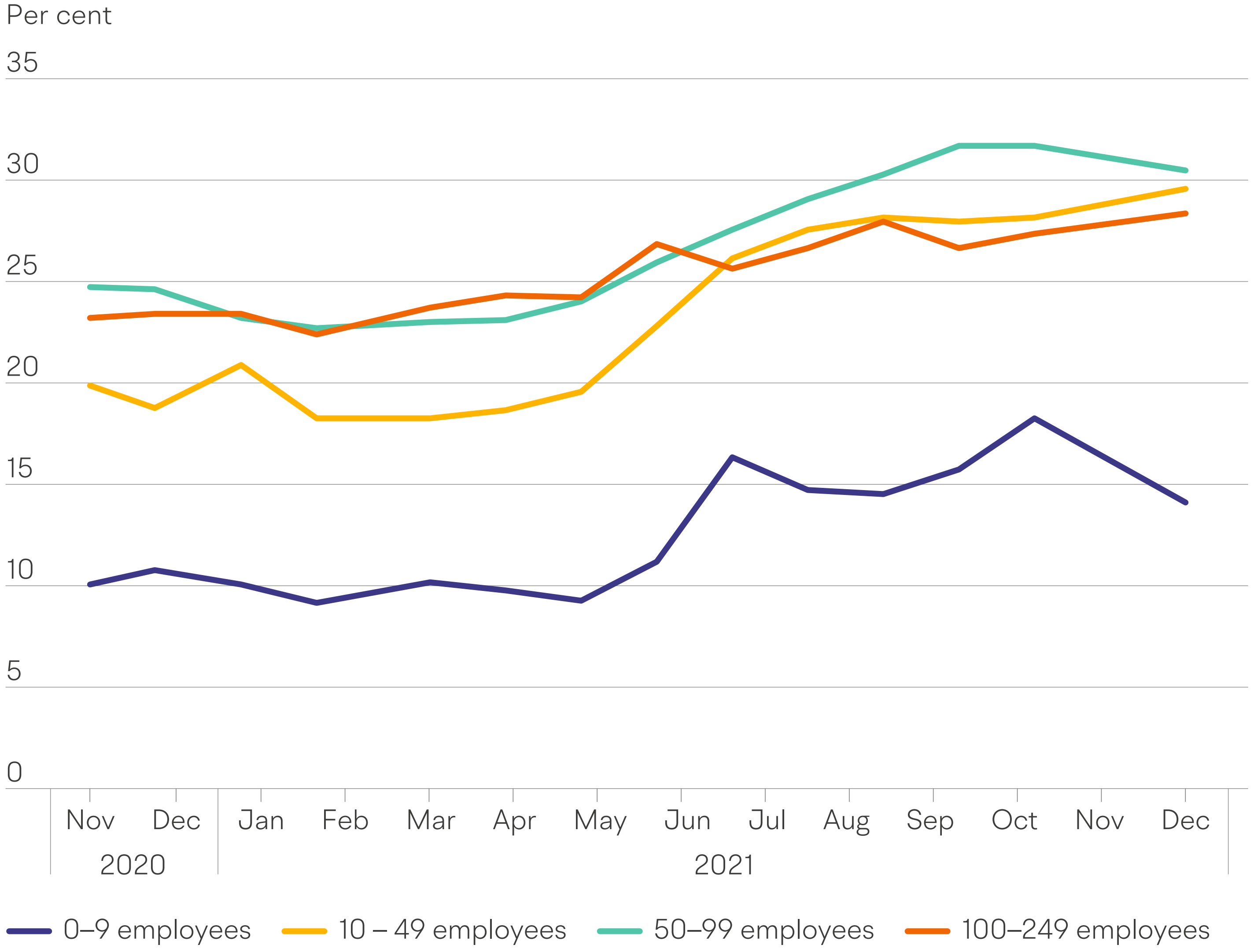


Figure B.10

Share of businesses with debt repayments up to 50% of turnover

Source: ONS Business insights and impact on the UK economy



The smallest businesses, with 0-9 and 10-49 employees, reported a peak of 11% - 12% in late January and early February 2021. By July this share had fallen to 3% but has risen again in recent months, stabilizing at just over 4%. For larger SMEs (100 – 249 emps) just 2.5% report debt repayments above 50% of turnover, down from a peak of around 5.5% in February. The Hospitality sector had the highest share of businesses with debt repayments exceeding 50% of turnover at 34% in late Jan 2021 but this has fallen to around 9% in mid-November.

These improving trends are not a sign that businesses have repaid their debts in full. Instead, they reflect growing turnover levels which make debt repayments less burdensome. Figure B.10 illustrates this point with the increase in share of businesses reporting debt repayments making up 50% of turnover or less since the start of the year. As above, this trend took a slight shock as the impact of Omicron and Plan B restrictions left an impact on business performance. Overall this shows that the potential for widespread debt burdens is on a downward trend.

This is echoed in businesses' self-reported risk of insolvency. ONS data shows that the share of SMEs reporting a moderate or severe risk of insolvency has trended down and narrowed across all firm sizes since the Spring of 2021 to between 5% and 10% (Figure B.11). This improvement mirrors expectations for the state of the economy especially the Government's announcements regarding the roadmap out of restrictions. In late 2021 there appeared to have been a slight uptick in risk, as threats posed by the Omicron variant and policy responses weighed down on business activity.

The higher rate of volatility for smaller businesses is evident in these trends. This is unsurprising given the risks they face compared to larger businesses. It may also suggest that, holding everything else constant, smaller businesses are more exposed to the downsides associated with debt burdens for a given level of borrowing compared to larger firms.

Whilst self-reported responses are useful indicators they may suffer from survivorship bias. Data on actual business insolvencies may be used to mitigate this problem. Section 2.3 provides a thorough analysis on this topic showing that while company dissolutions have picked up in 2021, this is driven by a wide range of factors.

Credit scores are another indicator that can shed light on corporate vulnerability. A recent report by the credit rating agency Experian[147] found that across all businesses in their dataset[148] credit scores dropped from an average of 44 in March 2020 to a low of 40 later in December. This 9.1% fall occurred when restrictions over Christmas were announced followed by a renewed national lockdown. Scores remained low until the Government announced the roadmap out of lockdown and a restriction-free economy with levels returning to the pre-pandemic average of 44 by September 2021 (Figure B.12).

The relatively positive developments seen in SME liquidity, repayments relative to turnover, self-reported insolvency risk and credit ratings are not the end of the story, however. The latest UK Finance data available on SME finance facility approval rates, from Summer 2021, showed approval rates had reduced from 95% at the peak of the pandemic to around 65%. This is lower than the pre-pandemic average of around 80% which could suggest that lenders are increasingly nervous about lending to SMEs following the end of the initial guarantee schemes.

Figure B.11

Share of SMEs reporting a moderate or severe risk of insolvency

Source: ONS Business insights and impact on the UK economy

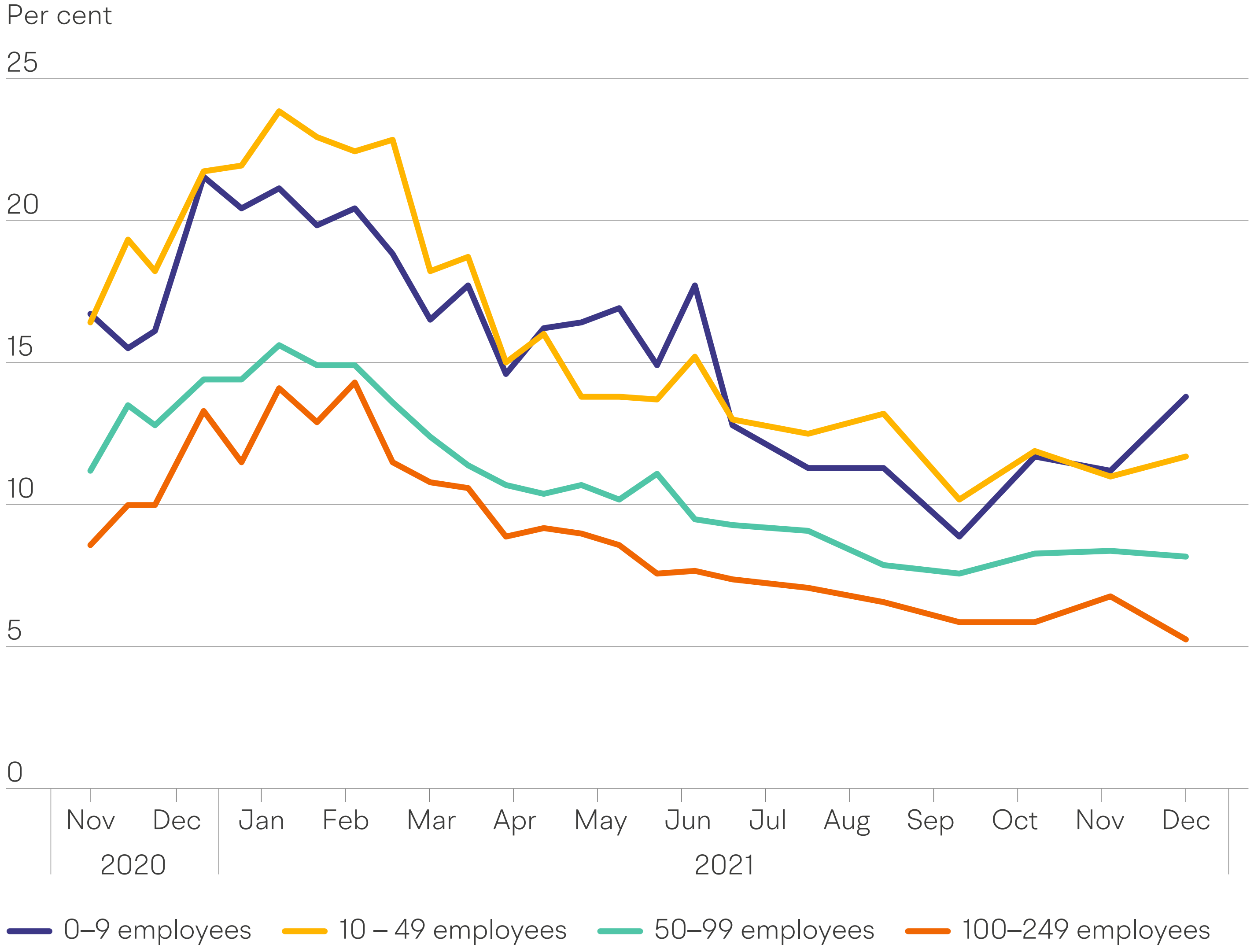


Figure B.12

Evolution of the average business Experian credit score, UK

Source: Experian

This is corroborated in a series of BoE reports. Firstly, the 2021 Q2 credit condition survey found that the proportion of loans approved in the prior three months fell. Lenders expected further falls in the proportion of loan applications from small businesses that are accepted in the following three months.

Secondly, the 2021 Q3 Agents' report found that banks were cautious to increase lending to small companies, particularly those with high levels of existing debt due to economic uncertainty. Credit availability was reported to have improved in the Q4 Agents' report, except for those sectors most affected by the pandemic. Challenger banks were, however, reported to be more willing to lend to these companies.

The strength of economic recovery over the coming years is likely to have the single largest influence on smaller businesses' debt positions

A strong economic recovery is an effective, market-led solution to lifting businesses out of debt burdens. Encouragingly, as outlined in section 2.1, forecasts for GDP growth from the BoE and OBR point to a continued recovery in the coming years. Additionally, the BoE report that market analysts expect company earnings to substantially exceed pre-Covid levels by 2022.

Unsurprisingly, however, earnings weakness may persist for sectors most affected by structural change, precipitated or accelerated by the pandemic. The speed of recovery for smaller businesses in these sectors may be more protracted than the average smaller business. This is likely to make the speed of recovery for smaller businesses in these sectors slower with higher rates of unsustainable debt levels.

For firms not in this position, a continued recovery may actually create opportunities for smaller businesses to use their facilities to invest and grow. As of 2021 Q4, around one in five SMEs had spent no more than 25% of their debt facilities.[149] Many of these businesses may be using Government-guaranteed debt as a precautionary cash buffer but there will also be those who are ready to undertake expansionary projects.

It is important to note that in more normal times taking on debt is not seen as a risky endeavour. For relatively settled businesses, corporate finance research finds that debt is usually the cheapest form of funding, allowing a higher rate of return for business owners. For many firms, therefore, the use of debt should be the preferred financial instrument as it is simple, easy to access and does not require any loss of control or ownership of the firm.

For all smaller firms, whether poised to grasp new opportunities or struggling to bring their earnings back up, the economic outlook remains both vitally important and subject to considerable uncertainty. New Covid variants and policy responses could influence activity again while even if the pandemic continues to abate in the UK, there are other concerns. Businesses are already feeling margin squeezes from higher input and wage costs and supply chain bottlenecks may continue to limit businesses' ability to increase output. It therefore follows that smaller businesses who experience earnings disruptions will face further challenges until a sustained, long-term economic recovery takes place.

2.3

The smaller business population

- The number of UK businesses fell by 6.5% to 5.6 million at the start of 2021 driven by a 12% reduction in unregistered zero employee firms
- The rate of change in the stock of firms across the UK varied substantially by geography and sector, likely impacted by the Covid-19 pandemic
- At the start of 2021 smaller firms had a workforce of 16.3 million, including 4.5 million working proprietors
- Registered business closures tracked above creations in 2021, driving the first annual net reduction in the UK registered business stock since 2010
- Business dissolutions may be substantially outpacing incorporations by year end 2021, signalling further negative impacts beyond 2021

This chapter reviews the current stock of UK businesses and the components of change over time incorporating insights from BEIS business population estimates[150] and ONS business demography.[151]

The number of UK businesses fell by 6.5% to 5.6 million at the start of 2021 driven by a 12% reduction in unregistered zero employee firms

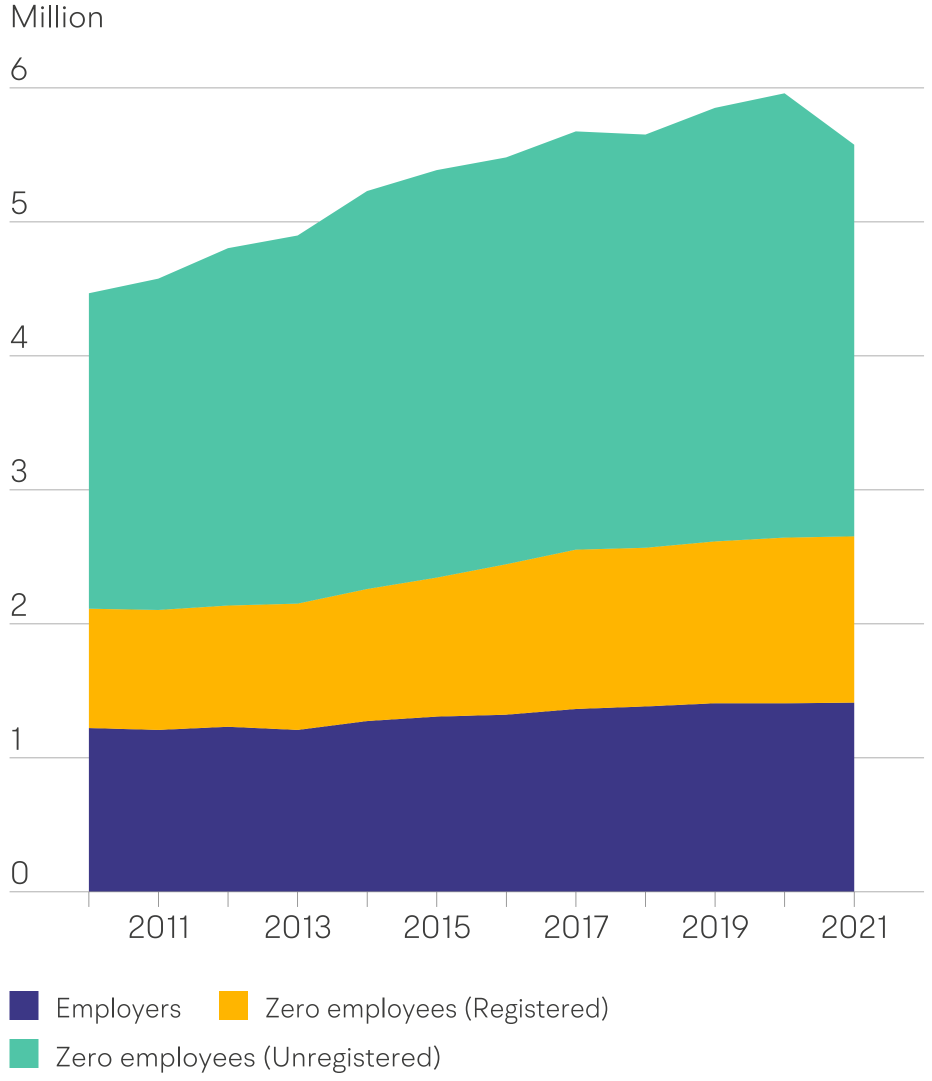
There were an estimated 5.6 million UK private sector businesses at the start of 2021, a 6.5% reduction on the total reported at the start of 2020.[152] This is the first time since the start of 2018 that net annual growth in the UK business population has stalled whilst the scale of the reduction has taken the stock of businesses back to a level last seen at the start of 2016.

Figure B.13 shows these impacts were not evenly distributed by type of firm. There were almost 12% fewer unregistered zero employee firms at the start of 2021 compared to the previous year. Numbers for these unregistered firms[153] are estimated by BEIS and do not feature in the ONS business birth and death rates data covered later in the chapter. In contrast, zero employee registered firms[154] and small and medium sized employers feature in BEIS and ONS data series and showed a small net increase year on year to the start of 2021.

Figure B.13

UK business population, 2010 – 2021

Source: BEIS business population estimates 2021



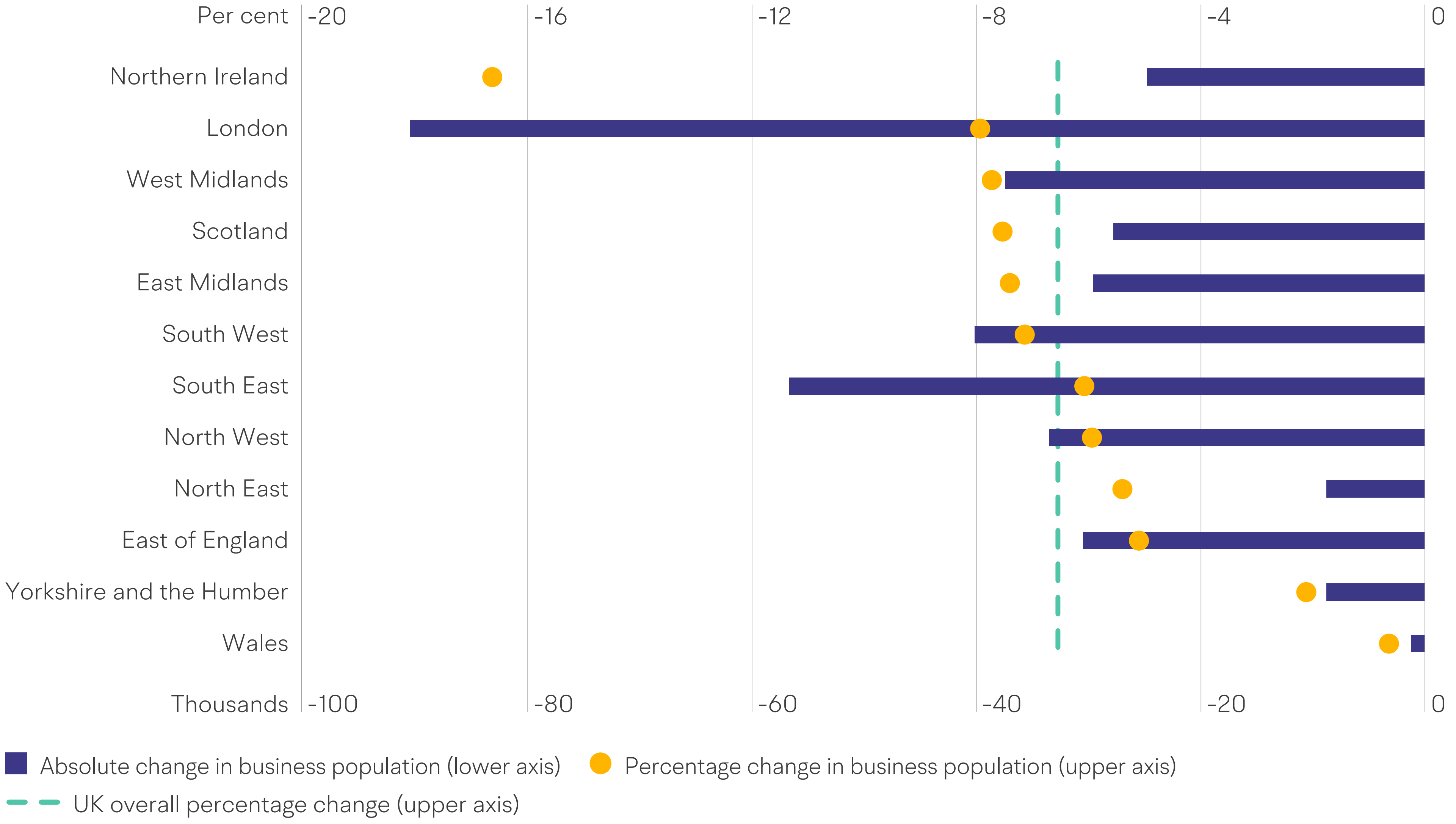
The rate of change in the stock of firms across the UK varied substantially by geography and sector, likely impacted by the Covid-19 pandemic

There was a decline in total business stock in every region and Nation of the UK between 2020 and 2021, however the rate of decline differs substantially. Northern Ireland had the highest decline of any UK region or Nation (16.6%), double that of London, the next highest at 8.0%. Business populations declined least markedly in Wales and Yorkshire and the Humber at 0.7% and 2.1% respectively.

Figure B.14

Change in UK business population by region and Nation, 2020 - 2021

Source: BEIS business population estimates 2021



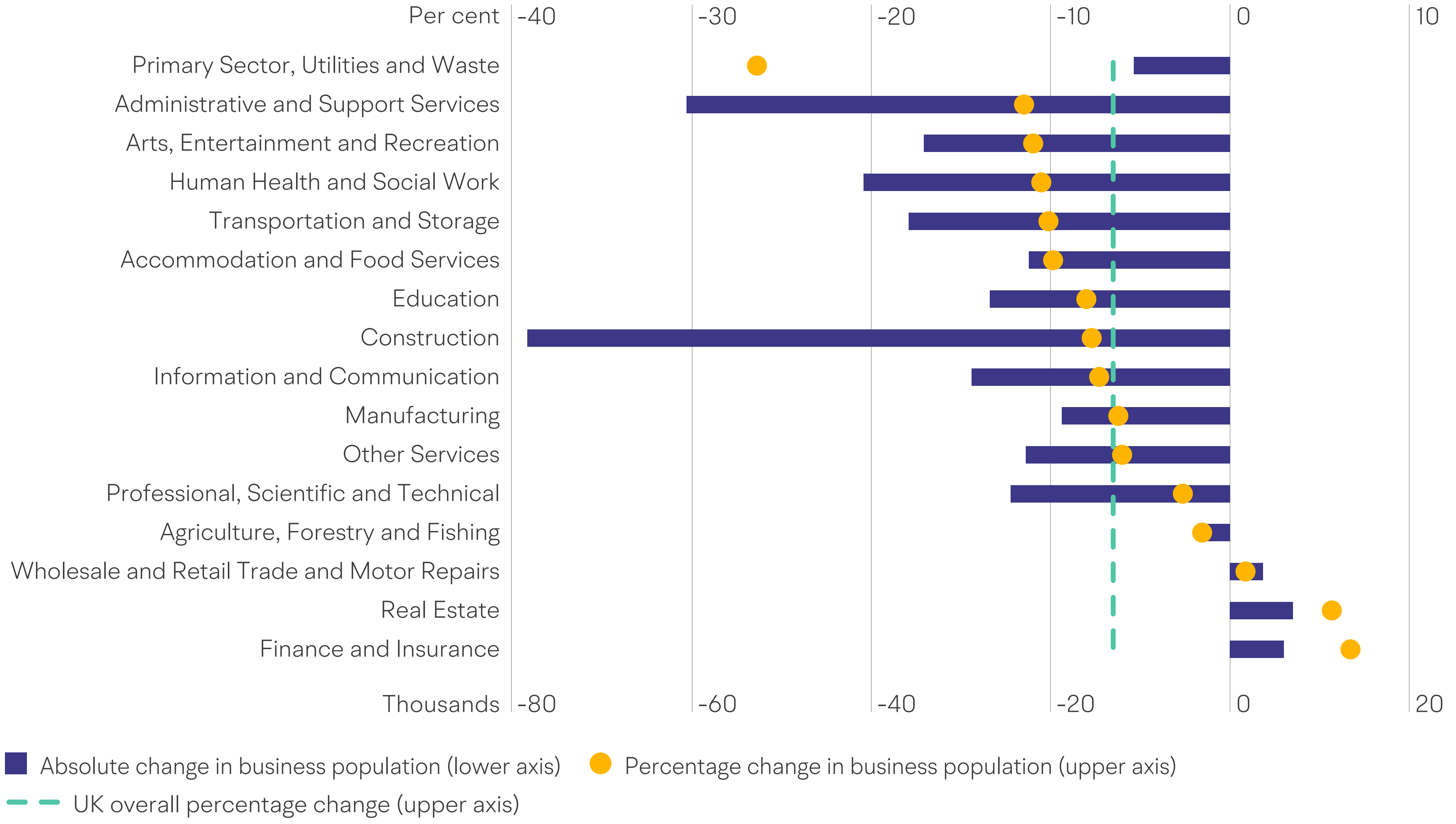
The drivers of these large variations across the UK are not immediately obvious. However, it is clear that the effects of the pandemic and subsequent public health measures have been much more severe in certain sectors. This is confirmed by analysis of the change in business stock by sector where variations are even more substantial than those by geography (Figure B.15).

The business population fell by more than 10% in six sectors. At the other end of the spectrum three sectors saw net increases in the business stock, the largest of which were in Finance and Insurance (6.6%) and Real Estate (5.6%).

Figure B.15

Change in UK business population, by sector, 2020 - 2021

Source: BEIS business population estimates 2021



At the start of 2021 smaller firms had a workforce of 16.3 million, including 4.5 million working proprietors

Despite the scale of the reduction set out above, there were 4.2 million zero employee firms in the UK at the start of 2021 and a further 1.4 million small and medium sized employers (firms with a headcount of between 1 and 249 employees). Collectively, these smaller firms comprised an employed workforce of 16.3 million and contributed £2.3 trillion to UK private sector turnover over the course of 2020.

However, there is a substantial variation in the scale of contribution to turnover by firm headcount. BEIS estimate zero employee firms supported 4.5 million working proprietors at the start of 2021 and contributed just over £300 billion to UK private sector turnover in the previous year. Collectively, micro, small and medium sized employers had an employed workforce of 11.8 million and contributed just over £2 trillion to UK turnover. Whilst there were fewer than 8,000 large private sector firms (with 250 employees or more), they employed a collective headcount of 10.6 million employees and contributed just over £2.1 trillion to UK turnover in the year to 2021.

Registered business closures tracked above creations in 2021, driving the first annual net reduction in the UK registered business stock since 2010

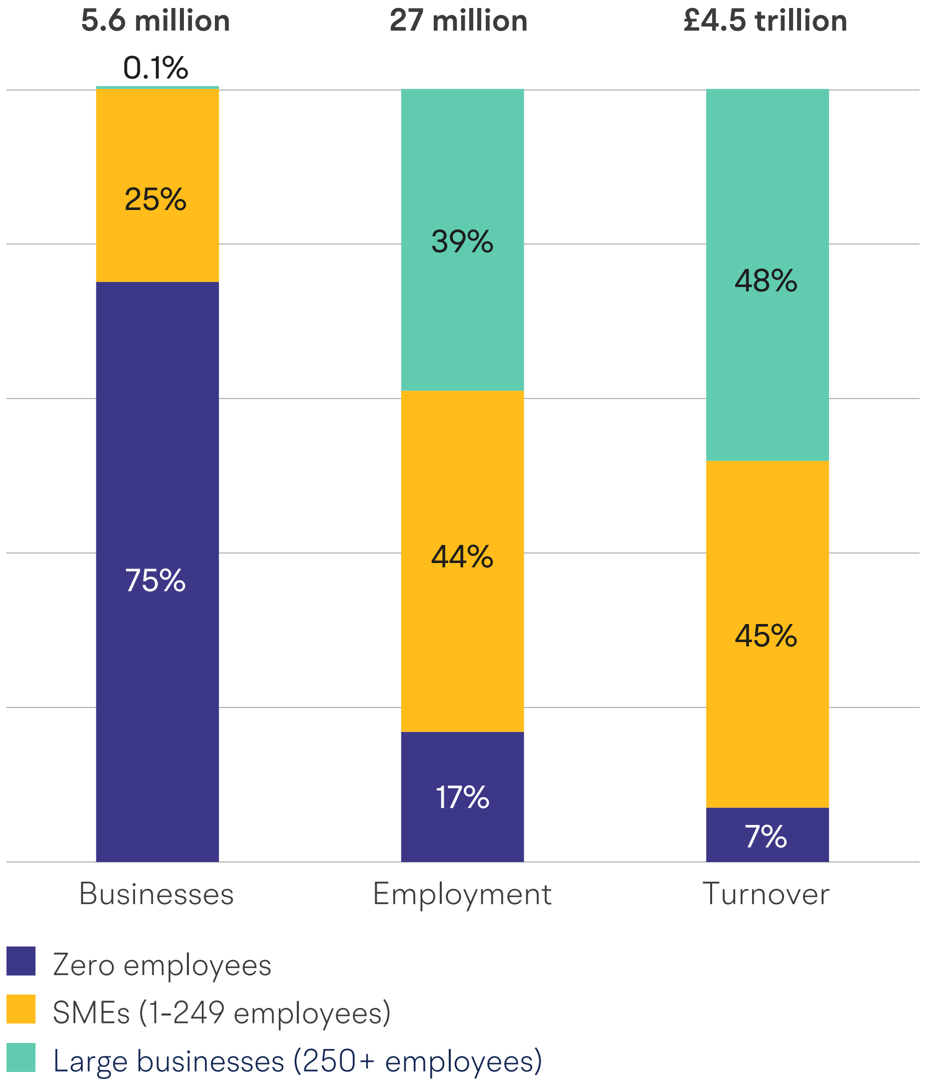
The latest official ONS experimental business demography data permits the tracking of births and deaths for UK registered businesses up to and including Q4 2021.[155] The data[156] show the death rate of registered businesses rose above the birth rate by Q2 2021. The gap widened from Q3 2021 signalling a substantial net reduction by year end. Overall, as figure B.17 shows, there were just over 400,000 business births in 2021 and over 420,000 deaths, leading to a net decrease of around 18,300 UK registered businesses by year end.[157]

It is perhaps unsurprising that the full effects of the pandemic were not realised in the data for 2020. The impacts of lockdown on court proceedings and enforcement activities which were also curtailed by government interventions, mitigated the impacts of the crisis during much of 2020. In addition, many government support schemes implemented in 2020 remained in force into Q1 2021. Furthermore, looking back to the Global Financial Crisis (GFC) in 2007/2008,

Figure B.16

UK businesses, employment and turnover, 2021

Source: BEIS business population estimates 2021



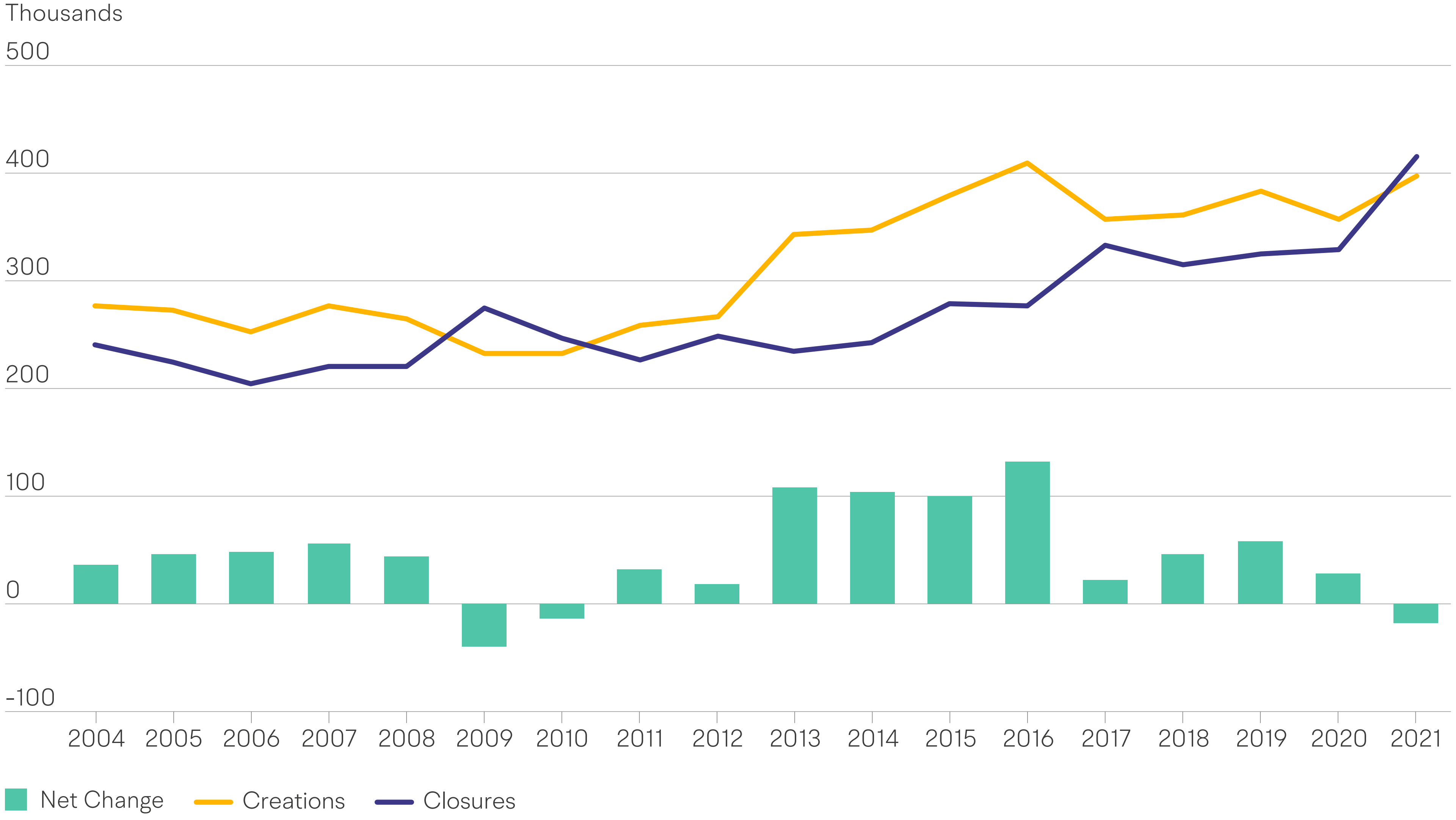
registered business deaths did not outweigh births until 2009 and 2010, before recovering in 2011, suggesting the negative impacts of the present crisis are likely to persist beyond 2021.

Despite the spike in new business creation each year in Q1;[158] a trend that has continued in 2021, the deeper impact of Covid-19 on businesses in this most recent year is clear. ONS data show that, with the exception of Q2 2017, the number of new business creations has outstripped business closures in every quarter until Q4 2020. In addition, ONS report that the average number of employees reported by businesses which have been created since the Covid-19 pandemic is fewer than in those created prior to the pandemic.[159]

Figure B.17

UK business births and deaths, 2004 to 2021

Source: ONS business demography, 2020 and business demography, quarterly experimental statistics, 2021



Business dissolutions may be substantially outpacing incorporations by year end 2021, signalling further negative impacts beyond 2021

A further indication that long term trends of net business growth have stalled is provided in figure B.18 which shows incorporations alongside compulsory and voluntary dissolutions in 2021. Compulsory and voluntary dissolutions are not entirely mutually exclusive as some firms that are undergoing compulsory winding up opt for a voluntary dissolution. However, both voluntary and, more especially, compulsory dissolutions in 2021 are trending above 2020 levels. Moreover, collectively they had risen above the number of incorporations by Q3 2021 with the gap widening to year end.

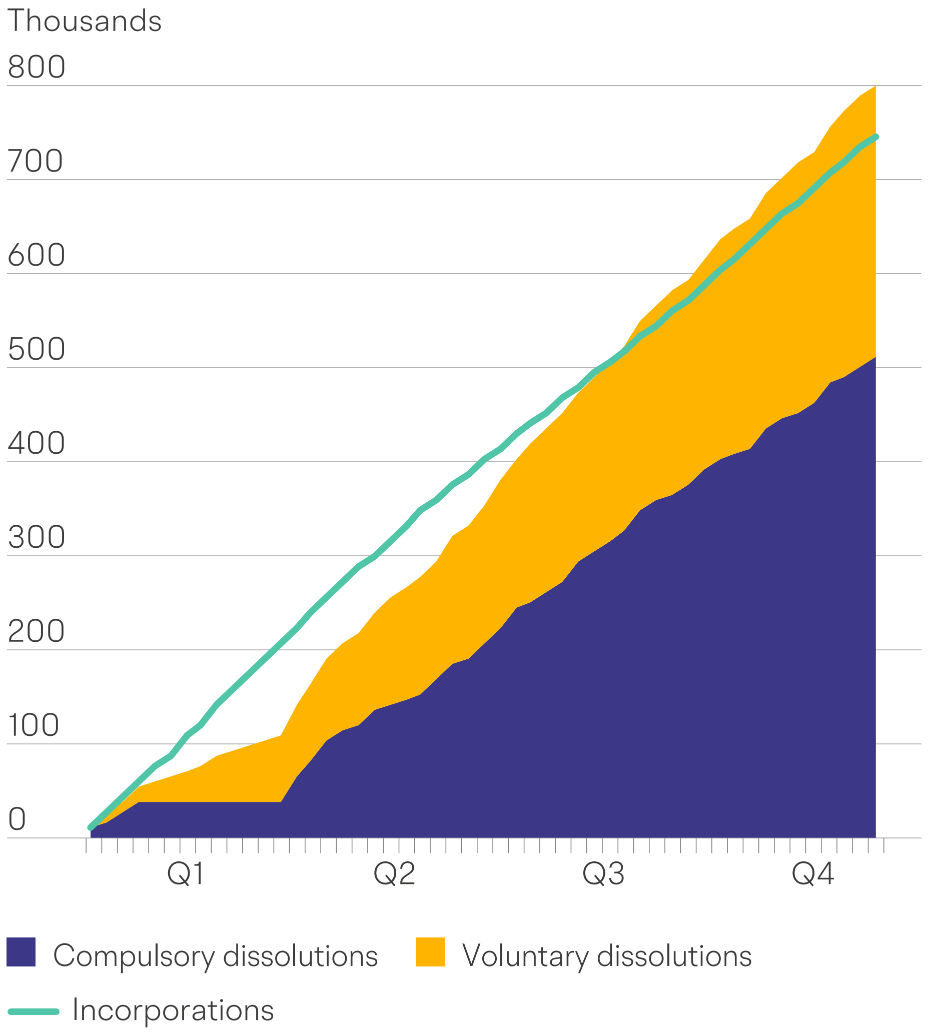
As noted above, compulsory dissolutions were affected by a number of factors in 2020 including court availability and government intervention to prevent compulsory winding up orders. With these issues receding in 2021, dissolutions have picked up. By the end of 2021 there had been over 500,000 compulsory dissolution first gazettes (a notice issued by Companies House indicating their intention to remove a company from the register) and almost 300,000 voluntary dissolutions. This level of dissolutions is notably higher than what was seen in 2019, before the start of the Covid-19 pandemic. Whilst the cumulative level of incorporations was tracking approximately 12% above that of 2019, by Q4 2021, the level of voluntary dissolutions was over 5%, and compulsory dissolutions approximately 33%, higher than the equivalent period in 2019.

This increase in dissolutions mirrors the experience during the GFC during which research from the Global Entrepreneurship Monitor (GEM) suggests there "was a collapse in business start-ups, a rise in business exits and a fall in the number of surviving firms that were growing".[160] Start-up activity fell sharply during the GFC, the recovery driven by "necessity entrepreneurship" together with a slight rise in "entrepreneurial intentions" and a more substantial increase in "perceived opportunities" from 2010. At the same time, "entrepreneurial intentions" followed a similar pattern, signalling future growth in start-ups. From 2011 GEM report a steady rise in the number of business start-ups, up until 2017 when they began to stabilize and exits began to rise possibly related to the 2016 EU referendum.[161] More recent data confirms that during the Covid-19

Figure B.18

UK incorporations, compulsory and voluntary company dissolutions, 2021

Source: ONS, business insights and impact on the UK economy



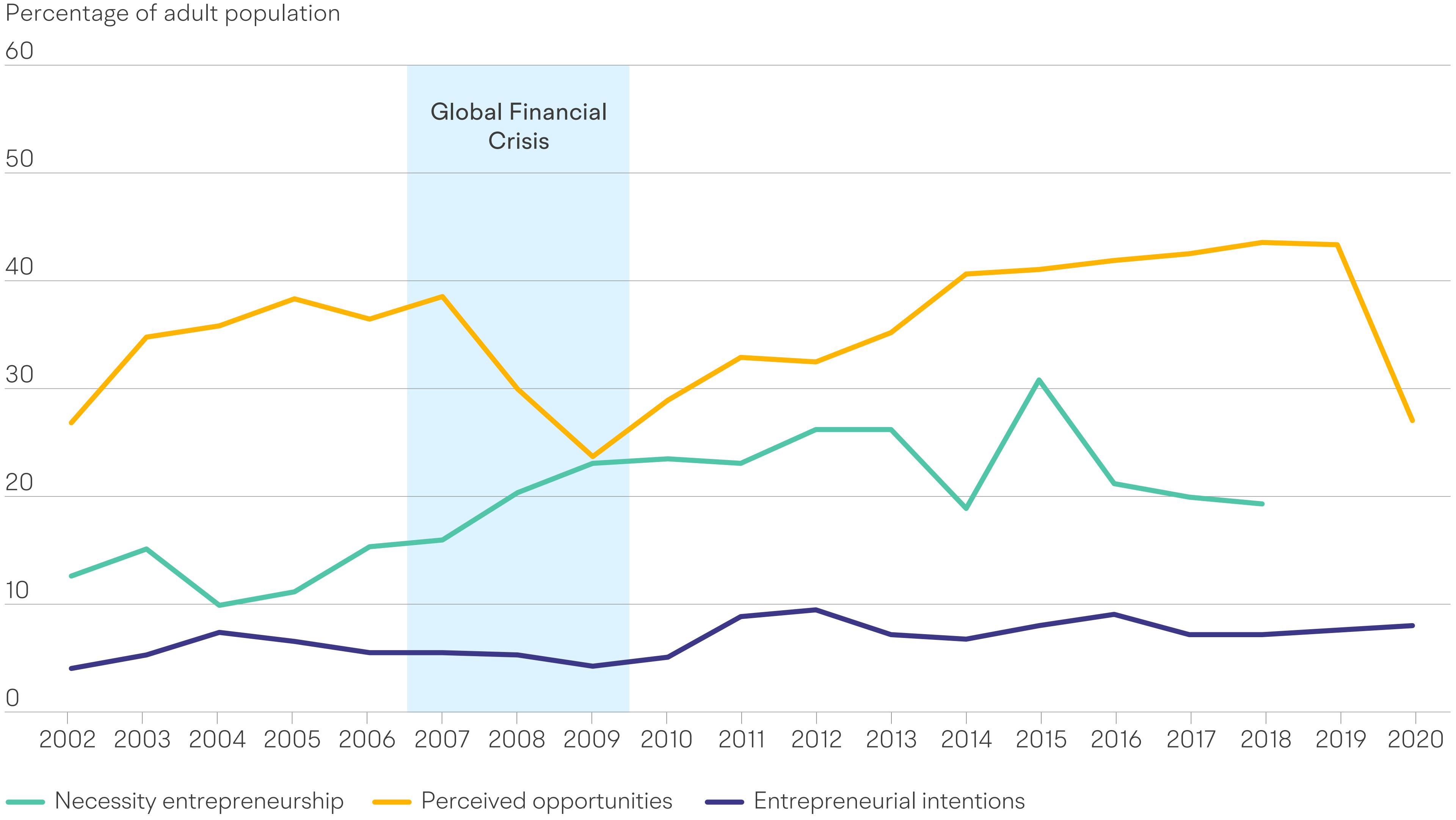
pandemic in 2020, the level of "perceived opportunities" had fallen much more dramatically, than in the previous crisis, whilst the much lower levels of "entrepreneurial intentions" continued on trend.[162]

In conclusion, it is still too early to tell whether there will be a more substantial reversal of the long term growth witnessed in the UK business population since the aftermath of the GFC. The full impacts of the Covid-19 pandemic may yet to be felt, given there was a considerable time lag between the shock of the GFC, the resultant decline in the overall business population and the recovery of entrepreneurial activity. The outlook for 2022 and beyond is likely to involve further reductions in business numbers, as Covid-19 support packages phase out, before previous trends return.

Figure B.19

Global financial crisis and key GEM indicators, 2002 to 2020

Source: Global Entrepreneurship Monitor, 2020



2.4

Use of external finance

- Permanent non-borrowers increased to 44%, the highest level since Q2 2020
- The proportion of SMEs using loans and grants in 2021 was the highest since 2012
- The proportion of SMEs only considering one provider for their finance dropped relative to 2020 but remains above pre-pandemic levels
- Almost four in 10 SMEs currently use trade credit, reducing the need for external finance in some businesses

This section highlights smaller firms' current usage of, and demand for, external finance and reviews their attitudes to finance during the pandemic. It draws on data from BVA BDRC's SME Finance Monitor, the British Business Bank's Business Finance Survey and the Bank of England's Financial Stability Report. For the first time the section also uses data from the Bank's UK Network Intermediary Survey. External finance covers a wide range of debt, equity and grant products.[163] This definition excludes trade credit, which is discussed separately at the end of the chapter.

Permanent non-borrowers increased to 44%, the highest level since Q2 2020

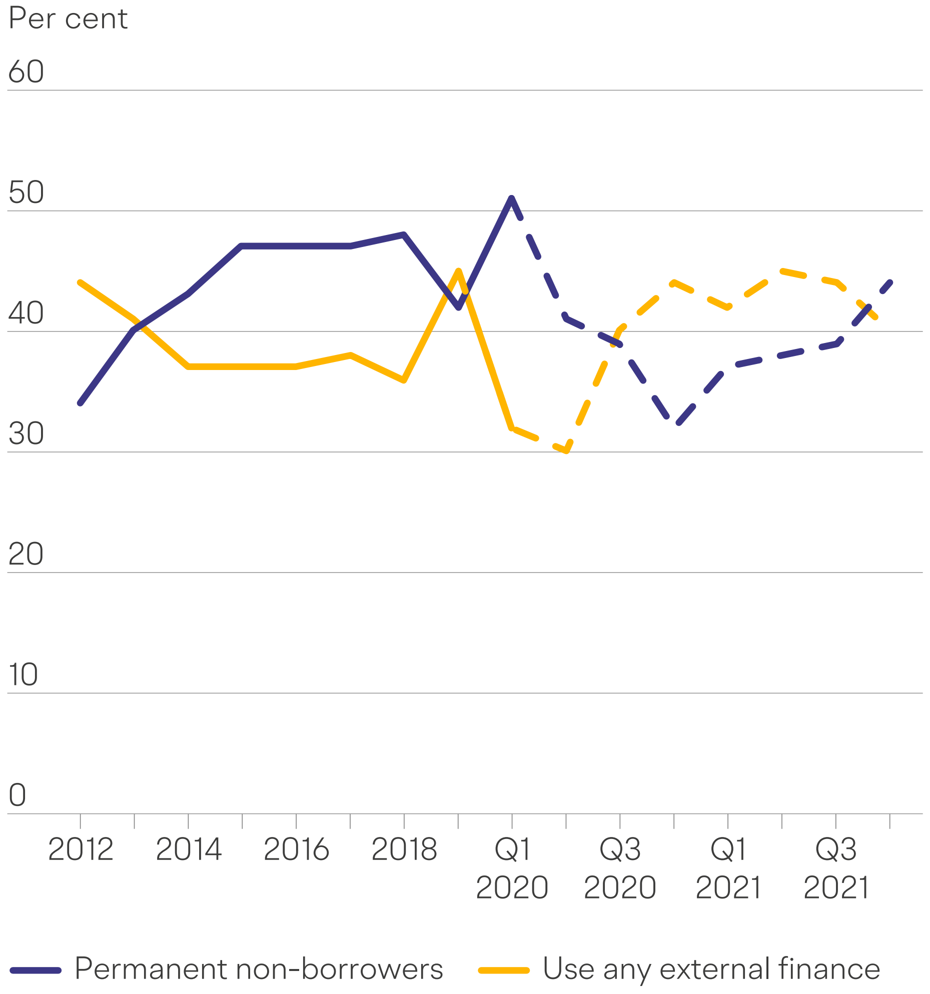
The share of businesses using external finance reached 40% in Q4 2021, a decrease from its peak of 45% in Q2 2021. However, overall use of finance has significantly increased from 30% in Q2 2020, the lowest level since the launch of the SME Finance Monitor survey in 2011. During the same period, the share of 'permanent non-borrowers' (PNBs) first declined from 41% in Q2 2020 to its lowest ever level of 32% in Q4 2020 but then it steadily increased to 44% in Q4 2021. 2021 ends with PNBs overtaking the share of finance users for the first time since Q2 2020, see figure B.20.

The Bank's own survey conducted in the second half of 2021 shows that the proportion of smaller firms using finance fell in comparison to H2 2020, from 67% to 59%. This likely reflects the closure of the Bank's Coronavirus Business Interruption Loan Schemes at the end of March 2021.

Figure B.20

SMEs using external finance and permanent non-borrowers

Source: BVA BDRC SME Finance Monitor, 3 months to December 2021



The increase in use of finance since the start of the pandemic was seen most prominently amongst micro firms (1-9 employees), and small firms (10-49 employees). The latest available data shows that the share of zero employee businesses and those with 1-9 employees using finance rose to 56% and 59% respectively in Q4 2021, from lows of 25% and 45% in Q2 2020.

The pandemic impacted some sectors more than others. The lockdown rules and fear of new Covid-19 variants impacted both Hospitality and Transport in particular. Around six in 10 SMEs in the Hospitality (60%) and Transport (64%) sectors rate the effect of the pandemic as a major barrier to their business, with relatively little change over time. Both sectors were also much less likely to report having made a profit than other sectors. Comparing the pre-pandemic 2019 survey data with Q2 2021, the proportion of firms in the Hospitality sector that reported a profit dropped the most by 30 percentage points to 44% followed by the Transportation sector which fell 27 percentage points to 53%.

Use of finance in Q2 2021 was among the highest in the Hospitality and Transport sectors at 55% and 47% of businesses respectively. These sectors also have the highest proportions of firms reporting concern about being able to repay their loans at 22% in Transport and 25% in Hospitality, respectively. As outlined in section 2.2, levels of concern about repayments have dropped since the middle of 2020 but remain elevated in these sectors relative to the rest of the business population.

Working capital, to cover short-term funding gaps or to help during difficult trading conditions, has been the dominant driver of funding needs since Q2 2020, with many smaller businesses facing heightened cashflow issues because of the Covid-19 pandemic. Of the 15% of SMEs identifying a need for funding, 85% said support for cashflow (including coping with impact of Covid-19)[164] was the reason for requiring funding in first half of 2021, up from 49% in 2019. This can also be seen in the Bank's 2021 Business Finance Survey: almost nine out of ten respondents (87%) said they were seeking finance to help with cashflow as well as to deal with financial issues caused by the Covid-19 pandemic.

This chimes with what the Bank's UK Network Intermediary Survey in 2021 found. External finance for working capital, investment and growth are the most common key areas sought by SMEs as we emerge from the pandemic according to intermediaries.

The proportion of SMEs using loans and grants in 2021 was the highest since 2012

Use of 'core'[165] forms of finance increased four percentage points in Q4 2021 to 29%, after a record low of 25% in Q2 2020. However, this was still lower than the 2019 pre-pandemic average of 39%. The increase was driven by take up of the government guaranteed loan schemes, reflected in an increase in the use of term loans which more than doubled from 9% in 2019 to a record 19% in Q3 2021 before declining to 14% in Q4 of the same year (Figure B.21).

Take up of 'other' forms of finance increased from a historic low of 13% in Q2 2020 to reach a record high in Q2 2021 (27%) but then started to decline in the second half of the same year to 23%. This was an increase mainly driven by use of grants which increased from 4% in Q2 2020 to a peak of 16% in Q2 2021 before declining to 11% later in 2021.[166]

The Bank's Business Finance Survey, undertaken in Q4 2021, provides further colour on the use of external finance. The number of businesses, who were using some form of repayable external finance or grant funding dropped from 67% in 2020 to 59% in 2021. There was a noticeable drop of 15 percentage points to 22% in the proportion of businesses who were using only non-government-backed repayable external finance in 2021. However, the proportion of smaller firms using a combination of government-backed and non-government-backed repayable external finance as well as grant funding increased slightly from 21% to 23%. At the same time, SMEs relying solely on government-backed finance and grants increased from 10% to 13% (Figure B.22).

Figure B.21

SMEs using forms of core finance, leasing/hire purchase products and grants

Source: BVA BDRC SME Finance Monitor, 3 months to December 2021.

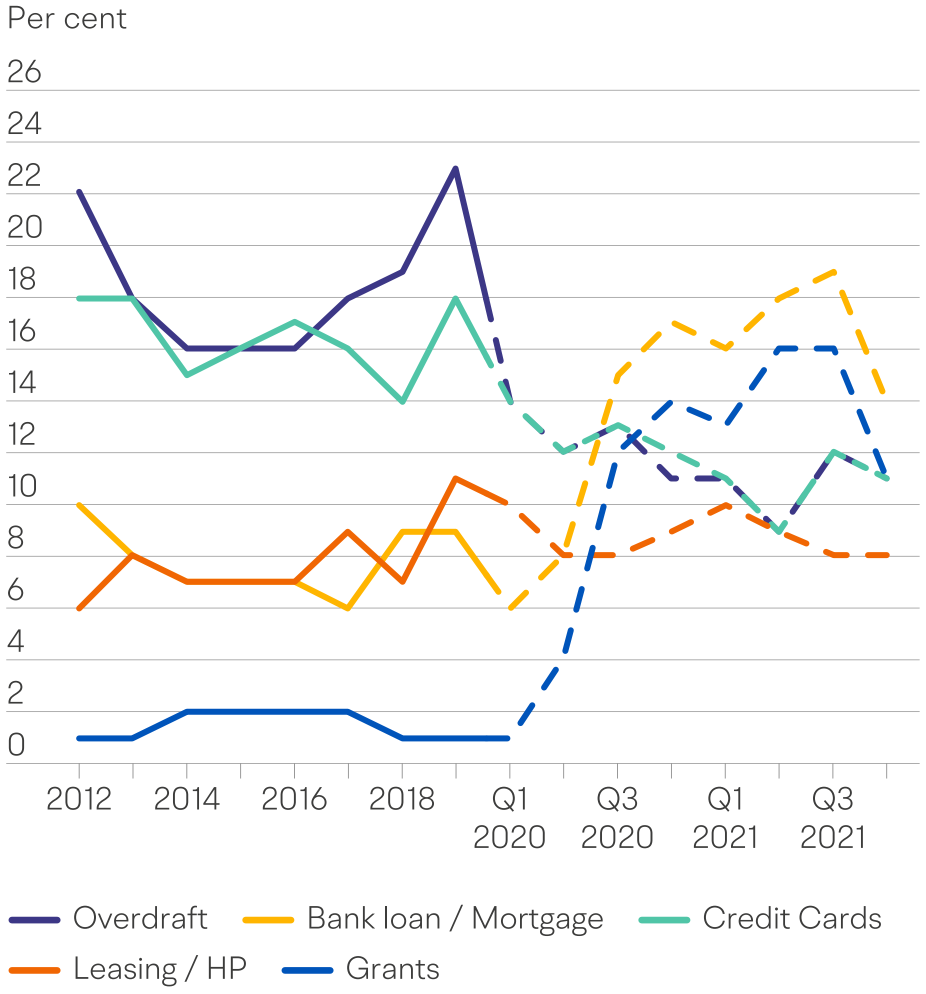
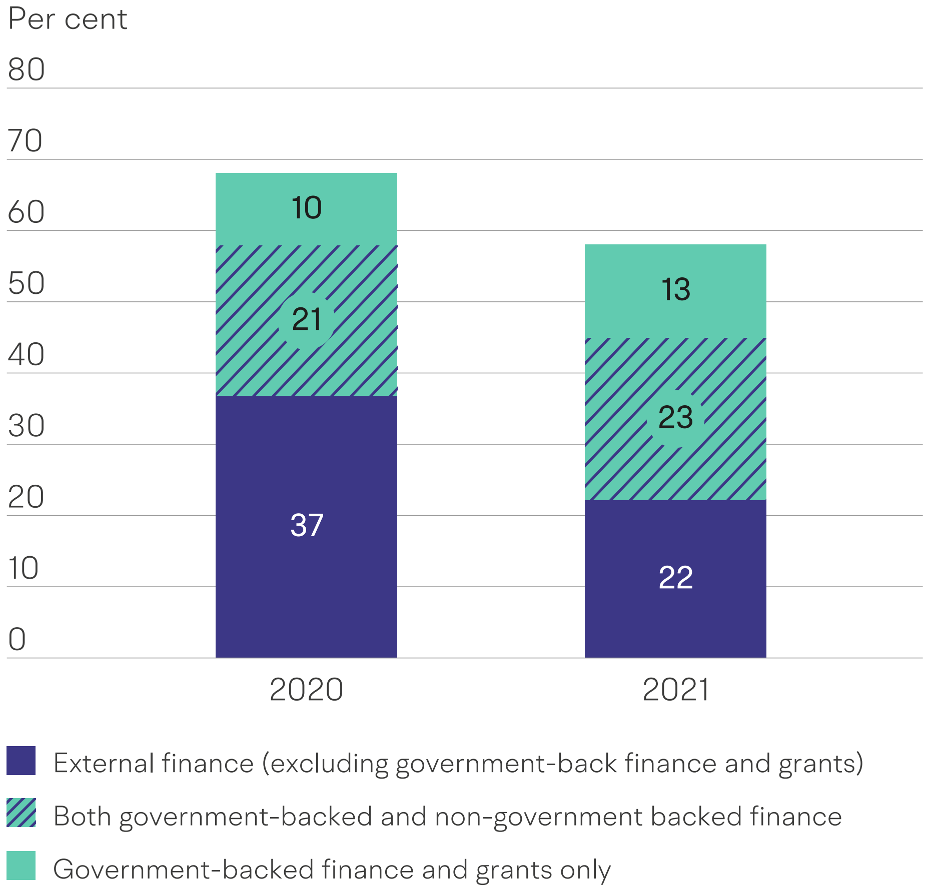


Figure B.22

SMEs use of government-backed finance and grants

Source: British Business Bank Business Finance Survey – Ipsos MORI. Base = all businesses in 2021 (n=2,804) and 2020 (n=4,125), *note: may not sum due to rounding **note: Government grants include government or local government grants, i.e. government funding that is not paid back, and other government-backed finance directly funded by Government

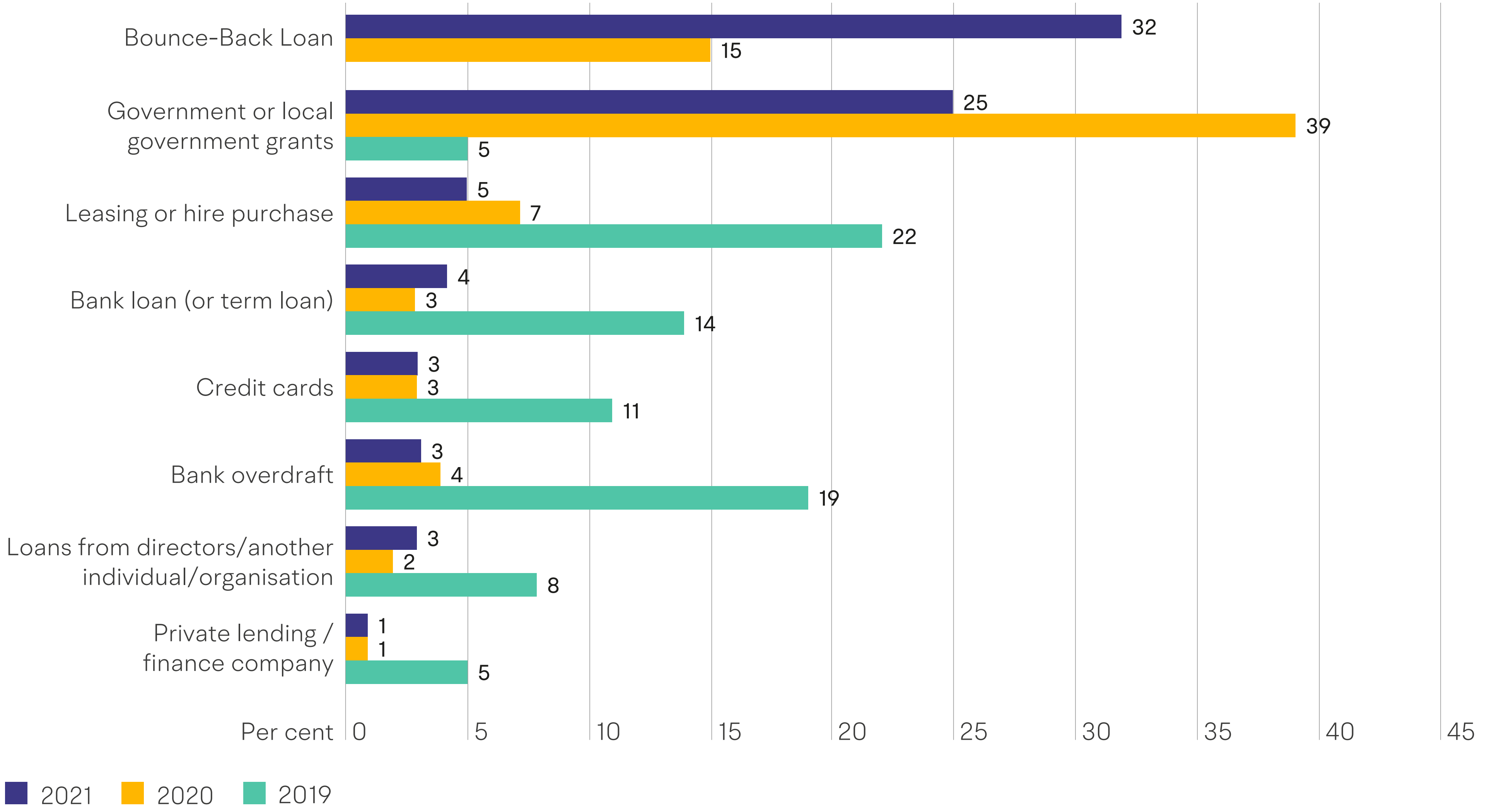


The widespread usage of the Bank's Bounce Back Loan Scheme (BBLS) and pandemic-related grants mean these are now the most common finance forms SMEs applied for in the last three years. 32% of those who sought finance in the last three years applied for BBLS followed by 25% who applied for grant funding. At the same time, the proportions of firms seeking bank loans, bank overdrafts and credit cards as well as leasing or hire purchase have markedly declined from double digit to single digit responses. Leasing or hire purchase dropped from 22% in 2019 to 5% in 2021 and bank overdrafts dropped from 19% to 3% in the same period (see figure B.23).

Figure B.23

SME demand for finance

Source: British Business Bank Business Finance Survey – Ipsos MORI. Base = all businesses who sought finance in the previous three years in 2021 (n=1,813), 2020 (n=2,618) and 2019 (n=1,503)



In addition to these developments in the use of external finance there were two other significant trends. Firstly, the SME Finance Monitor shows that the use of personal funds increased to 40% in Q2 2021, up from 24% pre-pandemic (2019) and almost back to levels last seen in 2012 (43%). This increase was driven by respondents who felt they had to inject funds, rather than those who chose to. The proportion of those forced to inject funds steadily increased from the start of the pandemic in 2020 (12%) and peaked at an historic high of 28% in Q2 2021. This could reflect either an aversion to using external finance or, for some, an inability to access it.

Secondly, there was significant growth in SME cash balances. The Bank of England's Financial Stability report shows that businesses' total cash balances have increased by 29% to £152 billion since end of 2019.[167] Moreover, SME Finance Monitor data shows the share of SMEs with cash balances over £10,000 increased from an average of 23% in 2019 to 31% in Q2 2021. As outlined in section 2.2, unspent BBLS and CBILS facilities are likely to have driven some of the increase in cash but other measures like cost cutting will be relevant too.

The proportion of SMEs only considering one provider for their finance dropped relative to 2020 but remains above pre-pandemic levels

Smaller businesses have typically been less likely to consider a wide set of options when obtaining finance. The cashflow impacts of the pandemic and the availability of the Bank's Coronavirus Business Interruption Loan Schemes appear to have strengthened this trend. The share of smaller firms only considering one provider reached a record high of 75% in 2020 but dropped in 2021 to 65%. This is closer to the pre-pandemic level of 59% in 2019.

Almost a third (32%) of SMEs reported choosing their provider as a result of an established relationship with them. Small (47%) and micro (39%) businesses were most likely to mention this reason. Advice from intermediaries can also influence finance choices with a fifth (21%) of small businesses who applied for finance in the past three years using some form of advice, most commonly accountants (12%).

The Bank's Demand Development Unit (DDU) was established to help businesses understand the types of finance available and help them access those best suited to their needs. In addition, the Bank's UK Network has been established to help build British Business Bank's regional capability, providing the Bank with detailed insights into each part of the UK's characteristics, challenges and priorities from a smaller business finance perspective.

Almost four in 10 SMEs currently use trade credit, reducing the need for external finance in some businesses

Trade credit is an agreement between a buyer and seller, whereby the buyer of the goods or service can delay the payment for an agreed period of time. Trade credit can help the buyer to manage their cashflow but is not included in the SME Finance Monitor definition of external finance.

Trade credit can also help ease the pressure of late payments though levels of concern over late payments and cashflow do appear to have fallen recently. In Q4 2021, 13% of businesses viewed cashflow and late payments as a major obstacle to running their business for the next 12 months, down from 19% in Q2 2020 and in line with 2019.

The use of trade credit increased slightly in the first half of 2021 (37%) compared to 2020 (36%). A quarter (25%) of all SMEs said trade credit reduced their need for finance. However, trade credit and external finance are increasingly being used to complement each other with two out of 10 (20%) smaller businesses using both trade credit and external finance (Figure B.24).[168]

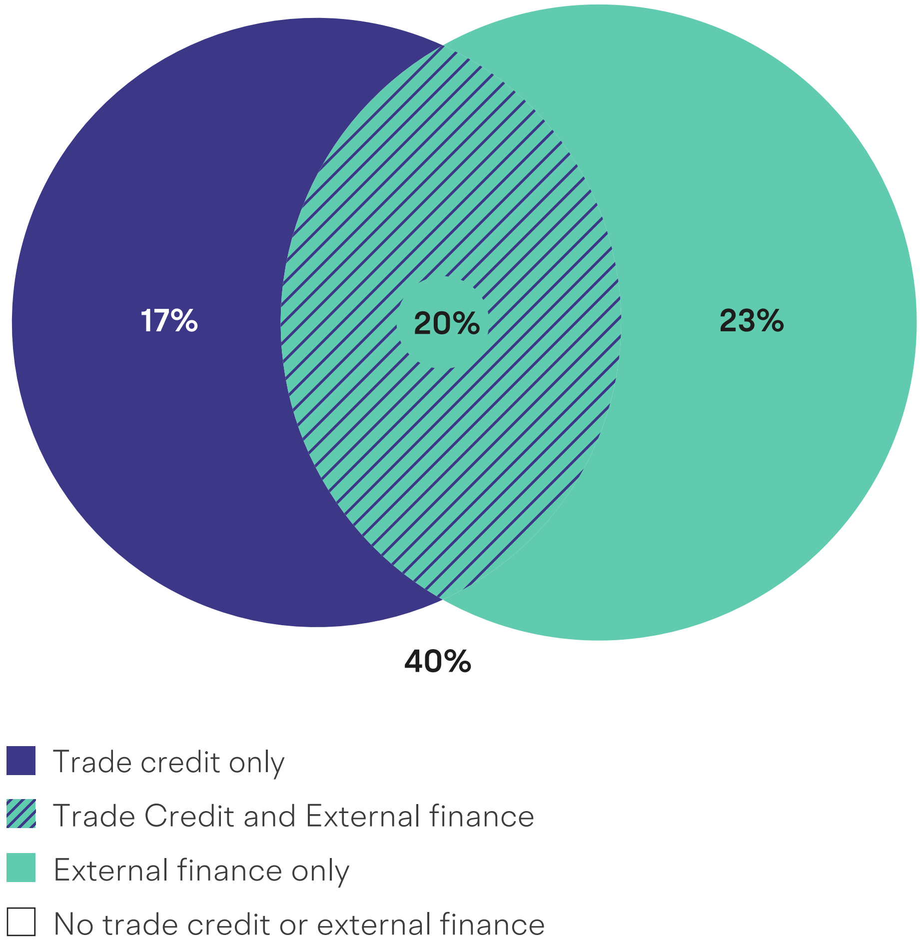
While the SME Finance Monitor showed the use of trade credit overall has remained largely stable, there are variations by size of business. Medium sized firms (50-249 employees) decreased their trade credit usage in Q2 2021 to 56%, from 72% in 2020. In the same period small firms (10-49 employees) increased their trade credit usage markedly by 11 percentage points to 81%, perhaps reflecting the differences in cashflow need.

The Bank of England's Agents' summary of business conditions (based on consultations with companies including SMEs) noted that trade credit insurance cover was expected to become more costly for vulnerable sectors such as Construction, Hospitality and Retail. The SME Finance Monitor also shows that firms in both Retail and Construction sectors were the highest users of trade credit with 61% and 52% respectively. In the access to finance ecosystem trade credit remains an important source of finance for many SMEs as it can act either as a substitute or complement for external finance.

Figure B.24

SMEs receiving trade credit and external finance in H1 of 2021

Source: British Business Bank analysis of SME Finance Monitor, Q2 2021, n=1,185



2.5

Insights from the Bank's UK Network

- The UK Network is one of the Bank’s key sources for regional insight from financial market intermediaries
- Businesses with employees, previous growth, and high turnover are more likely to seek external advice, informing intermediaries’ views on the market
- Intermediaries believe smaller businesses are more likely to seek finance for growth or working capital than for net zero actions in the coming year
- Equity supply is viewed as more of a concern than debt supply among intermediaries
- Working with intermediaries to further strengthen finance ecosystems remains a key focus for the Bank

The UK Network functions as the eyes and ears of the British Business Bank. It gathers regional intelligence about access to finance challenges facing smaller businesses to help the Bank better understand the support needed across the UK. Although smaller businesses face similar challenges in accessing finance, they are part of different local finance ecosystems, which affect not only the nature and scale of the obstacles they face, but also what the solutions might be, and how the Bank can work with stakeholders to achieve them.

The UK Network is one of the Bank's key sources for regional insight from financial market intermediaries

The UK Network builds relationships with intermediaries covering every aspect of finance ecosystems, regularly gathering views from organisations that provide finance, advice, and/or information to smaller businesses. The UK Network then works collaboratively with other teams across the Bank, and the intermediaries themselves, to turn these insights into actions that support smaller businesses to access finance.

In November and December 2021, the UK Network's Regional Team interviewed 281 contacts[169] to help supplement the Small Business Finance Markets Report with intermediaries' views. The survey was designed in collaboration with the Bank's Economics team and gathered mostly qualitative data, through a mixture of one-to-one online meetings and questionnaire forms.

Businesses with employees, previous growth, and high turnover are more likely to seek external advice, informing intermediaries' views on the market

The 2021 Business Finance Survey found that, of the businesses that had considered at least one form of finance in the last three years, only 23% had sought external advice. The proportion is higher for growing firms that sought finance (28%) and even higher for high-growth firms[170] (32%).

Propensity to seek advice is also correlated with other firm characteristics, including age, size, and turnover. Only 3% of businesses started in the last two years reported seeking external advice, compared to 39% of those that were between three and five years old, and 22% of businesses older than that.

Businesses turning over less than £50k were less likely to seek external advice than those turning over between £50k and £1m (19% compared to 25%) and just over half as likely as those turning over £1m or more (37%).

Firms with no employees are less likely to have sought external advice than those with employees (21% compared to 27%). The proportion was particularly high among small (10 to 49 employee) firms (33%), compared to micro (1 to 9) and medium (50 to 250 employee) sized businesses (both 26%).

These differences in the propensity to seek advice are therefore likely to inform an intermediary's views on the market, as certain types of businesses are likely to be over-represented in their client-base. This feature of the data can be valuable if it is properly understood when interpreting the results. High-growth businesses are a good example: while these make up just 4.3% of the business population,[171] 32% of finance-seeking high growth businesses sought advice which suggests they will make up a significantly larger share of intermediaries' client bases.

Intermediaries believe smaller businesses are more likely to seek finance for growth or working capital than for net zero actions in the coming year

Intermediaries were asked what the key areas of support they believed their clients would be looking for emerging from the pandemic.[172] The most popular answers were access to investment or growth finance (87%) and availability of adequate working capital (74%).

There is a large gap between these and the third and fourth-placed answers: ensuring financial security / adequacy of contingency funds (51%) and understanding / financing the move to net zero (45%). As shown in section 1.1, this is in line with the priorities revealed by businesses themselves: the proportion happy to use finance to grow (37%) is well above the proportion stating they are happy to use finance to support net zero actions (22%).[173] These proportions may increase in the future, with one accelerator that responded to the UK Network survey noting that their experience with Bounce Back Loans had resulted in businesses becoming "more open to exploring debt financing options".[174]

Issues around pre-existing debt levels were less of a concern among intermediaries but were mentioned by a sizable minority as a key area of support they expected their clients to look for. Assistance managing debt was the most common (36%), followed by needing to refinance (29%) and needing to restructure (28%).

Several respondents tied this to debt taken on during the pandemic under Government lending schemes. A respondent from a challenger bank noted that this lending "could cause repayment challenges in the near future", with another respondent from a consultancy noting that a number of businesses in certain sectors were relying on a "significant and sustained uptick in business" to support this debt. This echoes the analysis in section 2.2 which highlights the importance of a continued economic recovery for SMEs' debt positions over the coming years.

Equity supply is viewed as more of a concern than debt supply among intermediaries

As a result of the types of businesses that seek out intermediary support, intermediaries are more likely to view access to external finance as an obstacle to businesses in the next 12 months than businesses themselves are. Only 5% of businesses rated access to external finance as a major obstacle in the Business Finance Survey (scoring it eight or more out of 10) compared to 25% of intermediaries.

As outlined in section 1.3, finance imbalances exist at regional and sub-regional level but are most stark for important forms of growth finance like equity. This is echoed in the intermediaries' views. When asked whether the current level of supply met their local market's demand by finance type, the number reporting that the need was not met at all well, or met less well, was just 10% for debt and 13% for working capital, compared to 51% for angel/early-stage equity and 44% for venture capital.

These views of sufficiency vary notably by region. The proportion of London-based intermediaries deeming their local market's demand for venture capital and angel/early-stage equity as not met at all well, or met less well, was just 6% and 18% respectively, while for those based in the East Midlands it is as high as 75% and 88%.

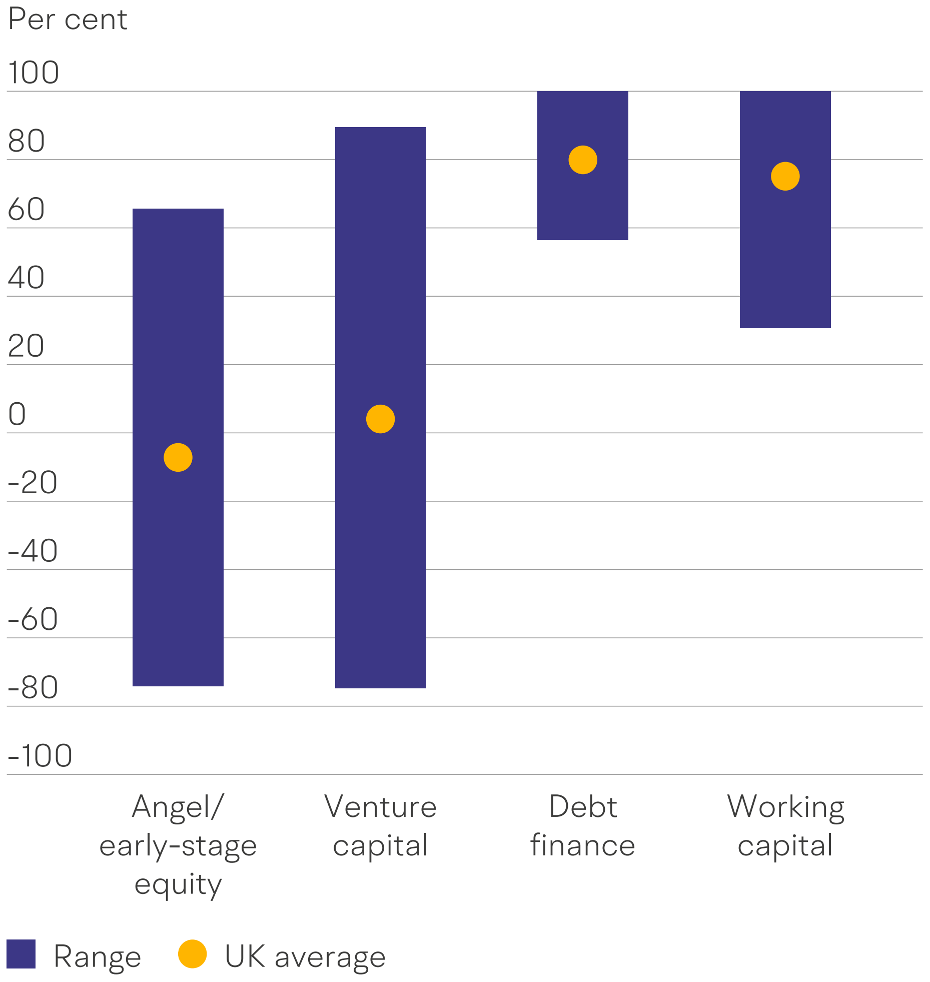
Looking at the balance of positive and negative responses[175] shows a much larger variation between the highest and lowest-scoring regions when it comes to angel/early-stage equity and venture capital than debt finance and working capital (Figure B.25).

The intermediaries' responses also gave some insight into how regional imbalances in equity markets have been affected by the pandemic, and how this may continue to play out in the future. Eighteen respondents including angel investors, accelerators, PE/VC funds, and local authorities highlighted the positive impact of remote working on equity.

Figure B.25

Balance of intermediaries' views by region regarding how well the local finance community met the market's demand for different types of finance

Source: UK Network Intermediary Survey, December 2021, n=281



The widening of networks beyond investors' and founders' immediate geographies was a key driver mentioned. One respondent from an accelerator noted that this offered "fairer access to networks", with another, also from an accelerator, remarking that a "change of mindset" regarding distance has made it "more straightforward" to invest in companies outside of their immediate area, while start-ups were also able to attract funding from outside their region "much more easily".

Another factor viewed as important is that more efficient use of time and technology has increased the speed at which deals can take place, leading to increased deal flow. Time saved travelling to face-to-face appointments can be used to increase the number of meetings held. One respondent from an angel network noted that the volume of investment had gone up as due diligence was being conducted remotely, meaning more people were able to join meetings or watch recordings, thus speeding up the process. Another respondent from a consultancy noted that the efficiency of meeting virtually had led to finance suppliers becoming less "selective" about who they met with.

Leading on from this, suggested by several intermediaries, was the idea that investors had become, in the words of a respondent working at a local authority, "more accessible, but at the same time oversubscribed". How this is managed coming out of the pandemic will be crucial in determining whether these trends continue.

Working with intermediaries to further strengthen finance ecosystems remains a key focus for the Bank

Respondents to the Intermediary Survey made it clear that, while local finance ecosystems displayed resilience throughout the pandemic, there is still room for improvement. Although a small number of intermediaries praised their local finance community for adopting a more collegiate approach following recent major economic events, the number reporting that collaboration had worsened in their view, or continued to be poor, was greater.

The majority of those raising concern about worsening collaboration were from the East Midlands, an area where intermediary insight has traditionally highlighted the disparate nature of the region and its business support community.[176] This highlights the diverse needs of the UK's local finance ecosystems and the benefits of having staff embedded in these ecosystems to understand these needs.

In 2022, the UK Network will continue to leverage its UK-wide physical presence to uncover and report on the needs and challenges of different ecosystems as they arise. The intelligence gathered as part of the Intermediary Survey will generate further activity, as the UK Network works with other parts of the Bank and intermediaries to facilitate a continuous feedback loop. This ensures that where insights are gathered, they are then deployed to strengthen local finance communities.

2.6

Equity finance

- Equity finance is an important funding source for innovative businesses and businesses with the potential for high growth
- 2021 has been an exceptional year for equity finance, with investment on course to double its 2020 record level
- Increased competition for deals has led to larger deal sizes and higher valuations
- Equity investment increased in most Nations and regions in 2021, although London's concentration has also increased
- VC financial returns continue to improve driven by strong exit activity, including several high-profile public listings
- Strong fundraising in 2021 and record levels of dry powder suggests VC funds have sufficient capacity to invest in high growth companies in 2022 and beyond
- British Business Bank programmes have an important role in increasing the availability of equity finance to SMEs

Equity finance is an important funding source for innovative businesses with the potential for high growth

Access to finance is viewed as one of the top three drivers of growth for innovative companies alongside access to talent and new customers.[177] Equity is a particularly important form of finance for innovative businesses and is provided by investors including business angels, venture capital (VC) funds and crowdfunding platforms. Equity investors do not just provide funding but offer expertise and contacts that can benefit innovative companies.

In order to shed light on equity activity during the year, this chapter uses Beauhurst data on announced equity deals from UK SMEs up to end of September (Q3) 2021.[178] Later in the year, our Equity Tracker report will provide a more definitive picture of 2021, as sufficient time will have passed for most deals to be disclosed.

The Beauhurst data used for this analysis covers announced deals only, but Beauhurst also tracks unannounced deals. Deals involving institutional investors are more likely to be announced than equity deals involving some other types of equity investors like business angels. An alternative indicator of the scale of angel activity comes from investments through the EIS and SEIS schemes that are commonly used by angel investors. In 2019/20 6,305 companies raised a total of £2.1bn through the schemes, highlighting the importance of business angels for the early-stage equity ecosystem.[179]

2021 has been an exceptional year for equity finance, with investment on course to double its 2020 record level

Our most recent Equity Tracker[180] report revealed 2020 was a strong year, with record levels of both announced investment into UK SMEs and announced deals, despite the impact of the Covid-19 pandemic increasing uncertainty. Data for 2021 show even greater levels of activity.

£14bn was invested over the first three quarters of 2021, a 130% increase on the £6.1bn invested over the same quarters in 2020 (Figure B.26). With one quarter still to go, investment has already exceeded the £8.7bn invested in the whole of 2020, itself a record at the time.

Key drivers for this are larger deal sizes and higher valuations, especially at the later stages. There are also indications of fund managers increasingly competing for deals. Our 2021 survey of UK VC fund managers[181] found 59% reported high levels of competition for deals in 2021. 59% also reported an increased level of competition compared to 2020. Other surveys confirm this. For example, the Atomico State of European Tech 2021 report[182] found 93% of VC fund managers viewed markets as significantly or somewhat more competitive over the past 12 months.

Alongside greater investment levels, deal volumes have increased too. Over the first three quarters of 2021, 1,811 equity deals were completed in UK SMEs, a 20% increase on the same quarters in 2020.

VC markets are global in nature and consequently are influenced by global as well as national developments. 2021 was a record year in US and European markets too with PitchBook data showing VC investment value up by 85% in the US, and 111% in Europe. PitchBook's figures for the UK show a 113% increase in 2021, higher than both the US and Europe.[183] Deal numbers are up in the US and Europe too, further highlighting the global strength in VC during the year.

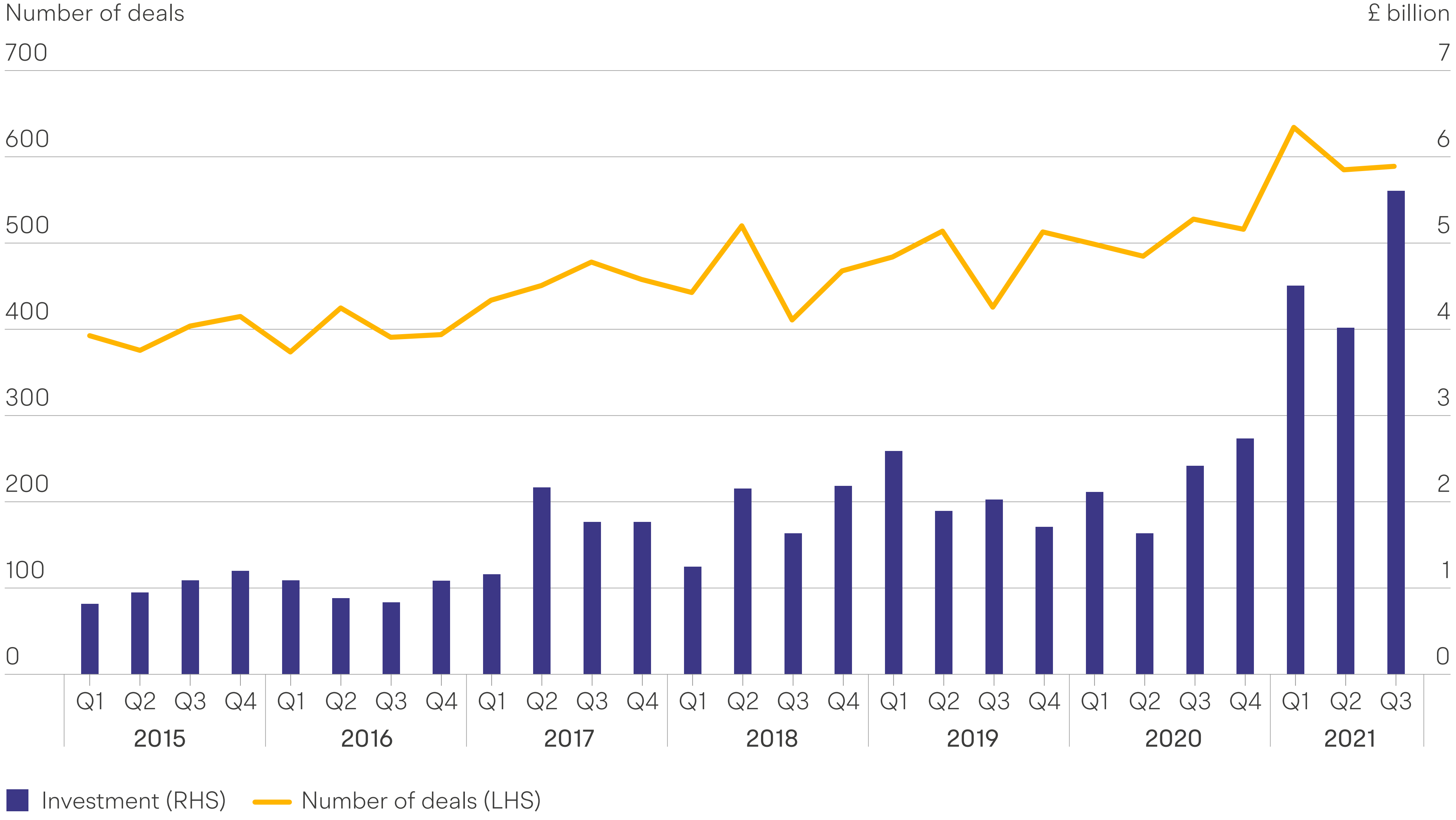
Beauhurst classifies equity deals into four stages; seed, venture, growth and established. These stages reflect product development, commercialisation, sales, and profitability levels in the recipient company. As in previous reports, we combine the growth and established stages for simplicity, which we refer to as the 'growth' stage.

As with the overall market, all three stages have already set annual investment records in just the first three quarters of 2021 (Figure B.27). In recent years, the growth stage has been the main driver of overall investment and has been similarly strong in Q1-Q3 2021. Investment was £8.8bn in the first three quarters of 2021, a 146% increase on the same period in 2020 and already above the £5.0bn invested in the whole of 2020.

Figure B.26

Number and value of announced equity deals per quarter

Source: British Business Bank analysis of Beauhurst data



The value of investment in the venture stage has historically been the most volatile but has also already set a new record with £4.0bn of investment in the first three quarters of 2021, 100% higher than the same period in 2020. A record was set at seed stage too with £1.2bn invested, which is 144% higher than the same period in 2020.

Strength in the seed stage is encouraging as there have been concerns about the early stage of the UK equity ecosystem in recent years. Investment had remained below 2018 levels until this year. There are indications that investors are looking for deals at earlier stages in 2021 than previously to reduce competition for deal flow further down the pipeline and avoid paying increased valuations. This dynamic may continue to support the seed stage though uncertainty remains as we are just three quarters into a rebound.

All three stages have seen increases in deal volumes in the first three quarters of 2021, compared to the equivalent period in 2020. Growth so far has been strongest in growth stage (+30%), followed by venture stage (+28%) and seed stage (+10%). If the current pace of deal activity is sustained in the final quarter of 2021, then there will be record annual deal numbers in 2021 across all three stages (Figure B.27).

Figure B.27

Number and value of announced equity deals by stage

Source: British Business Bank analysis of Beauhurst data

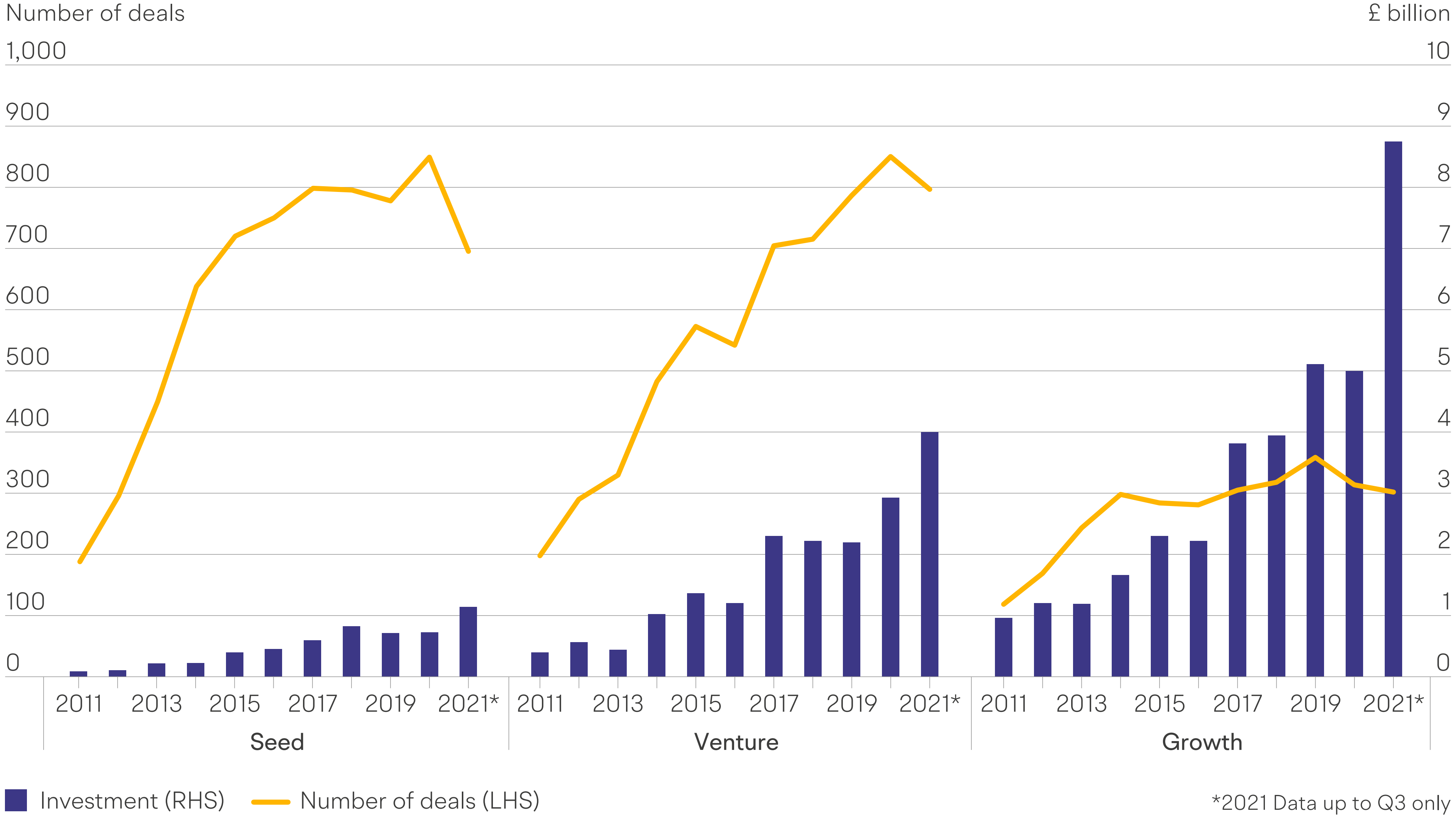
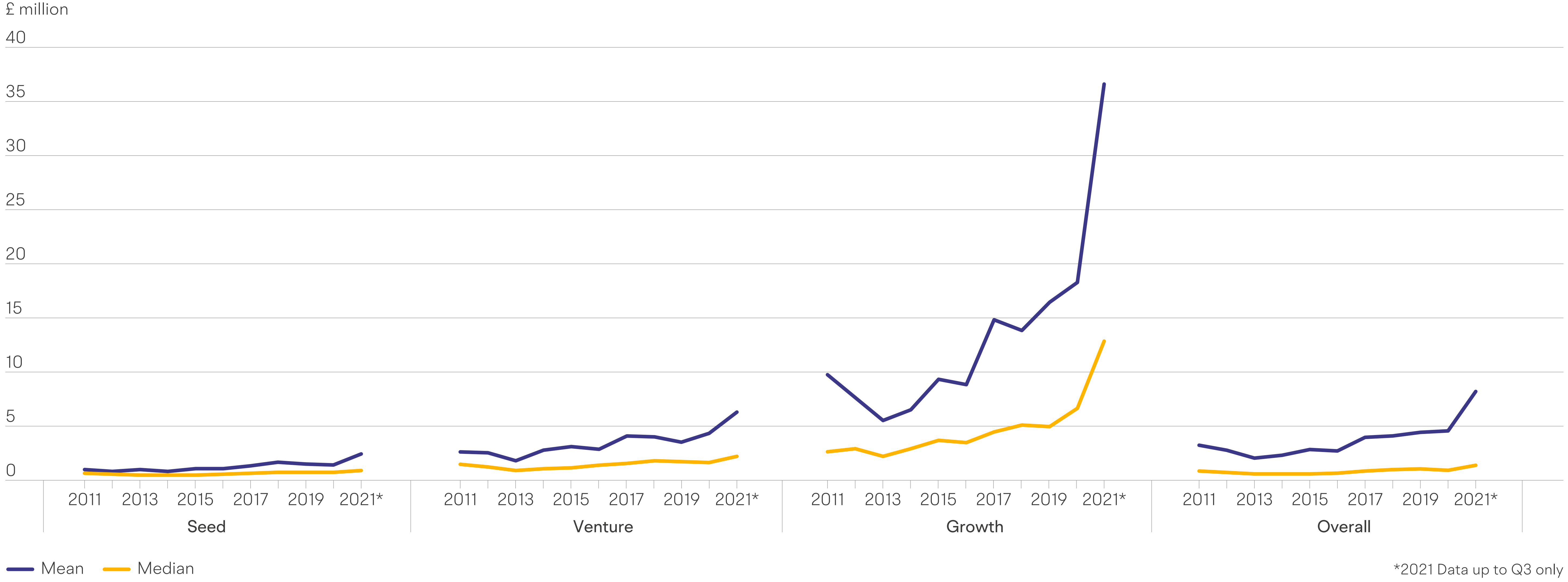


Figure B.28

Mean and median deal size over time by business stage

Source: British Business Bank analysis of Beauhurst data



Increased competition for deals has led to larger deal sizes and higher valuations

Investor appetite increased in 2021, driving competition for deals. Not only are there record levels of UK VC fund dry powder, which sit at £9.8bn,[184] the UK market has also seen increased interest from overseas VCs and non-traditional VC investors including corporate and PE investors. British Business Bank analysis of PitchBook[185] shows that 58% of 2021 VC deals with available series information involved overseas investors, up from 50% in 2020.

Overseas investors were particularly involved in later-stage rounds participating in 88% of known Series B+ rounds. Similarly, DCMS report[186] that 38% of the capital in VC rounds in UK tech companies was provided by US investors, up from 32% in 2020. Higher valuations in US companies appear to be one factor behind this trend and have led some US VC investors to take advantage of relatively lower valuations in UK companies.

Though greater competition is widely reported to be driving valuations up, this doesn't appear to be leading to lighter due diligence or an increased prevalence of pre-emptive rounds.[187] These are investments where valuations increase without signs of company development and though they can benefit founders through lower dilution, they offer less benefit for investors.

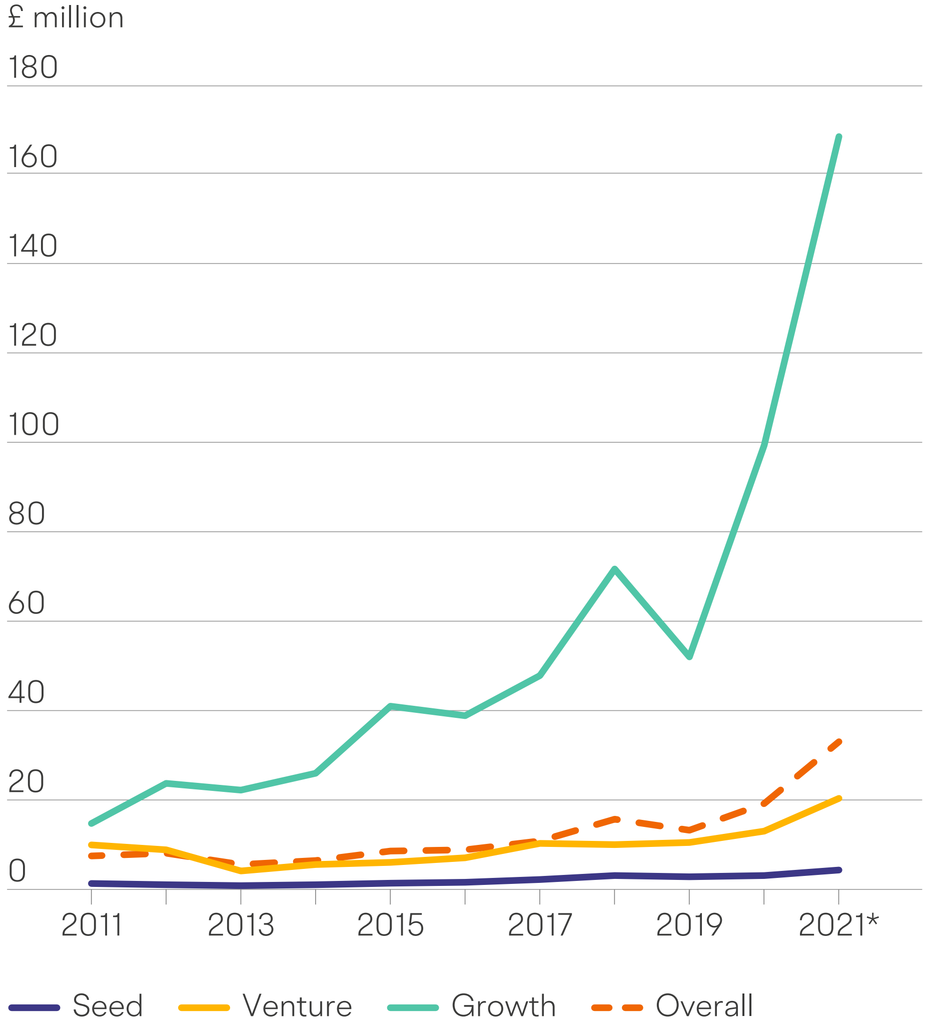
As mentioned above, deal sizes have also been affected by competition. The average size of announced equity deals in 2021 was £8.4m, an 83% increase on 2020. As in previous years, the growth stage has played a major part in this with deal sizes increasing 98% on 2020 to £36m (Figure B.28).

Seed and venture stage deals got larger in 2021 too. The average venture stage deal in 2021 was £5.3m, a 45% increase while the 93% increase at the seed stage was almost as large as for the growth stage. With average seed stage deals up to £1.8m this reverses the trend seen over the past three years of decreasing average deal sizes.

Figure B.29

Average pre-money valuation by business stage

Source: British Business Bank analysis of Beauhurst data



*2021 Data up to Q3 only

Median deal sizes have also increased across all stages in 2021. The current median deal sizes of £13m, £1.8m and £0.5m for the growth, venture and seed stages respectively are the highest since Beauhurst started collecting data in 2011 (Figure B.28).

Deal sizes increased across all stages suggesting a broader availability of capital for equity-backed companies than in 2020, when increased deal sizes were largely concentrated in more established companies. A degree of preference for more established companies in 2020 was also apparent in the much sharper fall in average sizes of initial seed stage deal than follow-on seed stage deals. This too has fallen away in 2021 with initial seed stage deals 104% larger and follow-on deals 100% larger.

Another notable feature of 2021 is that deals worth more than £10m grew in volume, value and in share of the market. The 256 deals worth more than £10m in 2021 accounted for just 14% of deal volume but 82% of investment, up from 71% in Q1-Q3 of 2020. Companies raising mega rounds also expanded in 2021, with 27 deals over £100m in size over the first three quarters of 2021, compared to 11 in the whole of 2020.

These increased deal sizes have been paired with increased valuations at all stages.[188] Average pre-money valuations continued to increase in 2021, with growth of 71% taking the average to £33.5m. This is not just a UK phenomenon, PitchBook shows the global median VC backed company valuation increased by 93% in 2021 to $23.2m.[189]

Figure B.29 shows that company valuations have increased at all stages. Between Q1 – Q3 2021, the growth stage was 69% up, reaching £170m, venture stage grew by 56% to £20.7m and seed stage by 37% to £4.5m. Average valuations grew across all sectors, but tech and business/professional services were the top performers, increasing by 67% and 75% to £38.8m and £41.2m respectively.

Outlier deals explain some of this valuation growth as there have been some very large deals in 2021. Median valuations have still increased at all stages (+10% for seed, +30% for venture and +102% for growth) showing the broad nature of the trend.

Another indicator of increased investor appetite during the year is the prevalence of 'down-rounds' where a company raises an equity round at a lower valuation than previously achieved. 11% of follow-on fundraisings were down rounds in 2021 which brings the level back in line with the 9%-13% range which has been recorded in every year since 2015, with the exception of 2020 when the rate of down rounds was 16%.

The crowning of new unicorns[190] is another market indicator which marks the development of a successful scale up company. 13 new companies gained unicorn status in 2021 including Marshmallow, Thought Machine, and Motorway. This is eight more created than in 2020, bringing the live total to 28 and showing later stage VC funding conditions are strong.[191]

Whilst current conditions are positive, there are signs that the market could slow down in the future. European VC fund managers report higher interest rates and inflation as key risks alongside changes in public market sentiment that could lead to an overall slowdown of VC activity in Europe over the next five years.[192]

Equity investment increased in most Nations and regions in 2021, although London's concentration has also increased

50% of equity deals in the first three quarters of 2021 were in London, accounting for 70% of investment value (Figure B.30). This is up from 47% of deals and 66% of investment in 2020. London's increased dominance in 2021 has been driven by larger increases in both the number and value of deals than the rest of the UK.

Taken together, the non-London regions and Nations saw deal volumes rise by 11% and investment by 92%, lower than the equivalent 33% and 152% increases in London. Deal size played a role too with the average deal for companies in the capital at £11.3m in 2021 compared to £5.1m for companies elsewhere.

Only two regions showed a decrease in equity investment in 2021. Investment in Yorkshire and the Humber dropped by 29% while the 25% fall in the West Midlands is largely attributable to Gymshark's £200m deal which bumped up the 2020 total.

Figure B.30

Number and value of announced equity deals by region and nation

Source: British Business Bank analysis of Beauhurst data

	Number of equity deals (Q1-Q3 2021)	Q1-Q3 2020-2021 % change number of deals	Proportion of deals (Q1-Q3 2021)	Investment (Q1-Q3 2021)	Q1-Q3 2020-2021 % change investment value	Proportion of investment value Q1-Q3 2021
London	908	33%	50%	£10bn	152%	70%
South East	180	31%	10%	£1.3bn	128%	9%
Scotland	147	-31%	8%	£403m	141%	3%
North West	112	33%	6%	£692m	275%	5%
East of England	110	22%	6%	£751m	73%	5%
South West	93	52%	5%	£360m	145%	3%
North East	53	-2%	3%	£127m	40%	1%
Yorkshire and the Humber	52	4%	3%	£79m	-29%	1%
West Midlands	46	18%	3%	£277m	-25%	2%
Wales	42	-29%	2%	£63m	14%	0%
East Midlands	41	78%	2%	£74m	72%	1%
Northern Ireland	27	29%	1%	£61m	226%	0%
UK	1,811	20%	100%	£14bn	130%	100%

As outlined in section 1.3, investor presence is a key driver of investment activity. Encouragingly, the number of unique investors with VC listed as their primary investment strategy has increased in all regions, other than the West Midlands since 2019 (Figure B.31). These improvements across the UK are welcome, but as outlined in section 1.3 London's advantage in investor presence has widened since 2019.

VC financial returns continue to improve driven by strong exit activity in 2021, including several high-profile public listings

UK VC returns continue to show improvement over time. The latest BVCA Performance Measurement Survey[193] reports that as of 31st December 2020, the 10-year horizon Internal Rate of Return (IRR) for VC funds established since 1996 is 14.1% (Figure B.32). This is a 2.5 percentage point increase on the December 2019 position, reflecting increased valuations and strong exit activity in 2020 that have supported substantial capital distributions to Limited Partners (LPs).

Figure B.31

Number of unique equity investors per area (excluding government investors)

Source: British Business Bank analysis of user defined PitchBook search. Results may differ from PitchBook's own published figures

	VC Listed as one investment strategy	VC Listed as one investment strategy	VC Listed as one investment strategy	VC Listed as primary investment strategy	VC Listed as primary investment strategy	VC Listed as primary investment strategy
	2017	**2019**	**2021**	**2017**	**2019**	**2021**
East Midlands	9	12	17	8	9	11
East of England	34	42	66	25	27	47
London	532	735	973	306	374	581
North East	8	10	16	4	6	9
North West	27	39	49	15	21	27
Northern Ireland	8	9	15	6	5	7
Scotland	33	49	65	22	24	26
South East	42	44	79	26	23	42
South West	7	14	31	4	9	18
Wales	2	7	8	2	3	5
West Midlands	18	19	21	11	9	9
Yorkshire and the Humber	7	13	20	4	6	12

Despite the recent improvement, VC returns still lag the returns achieved by large Management Buy-Out (MBO) funds, but the 10-year horizon VC returns exceed the performance of small and mid-size private equity funds. As of December 2020, the 10-year horizon IRR for small, medium and large MBO funds are 11.4%, 13.1% and 14.4%, respectively.

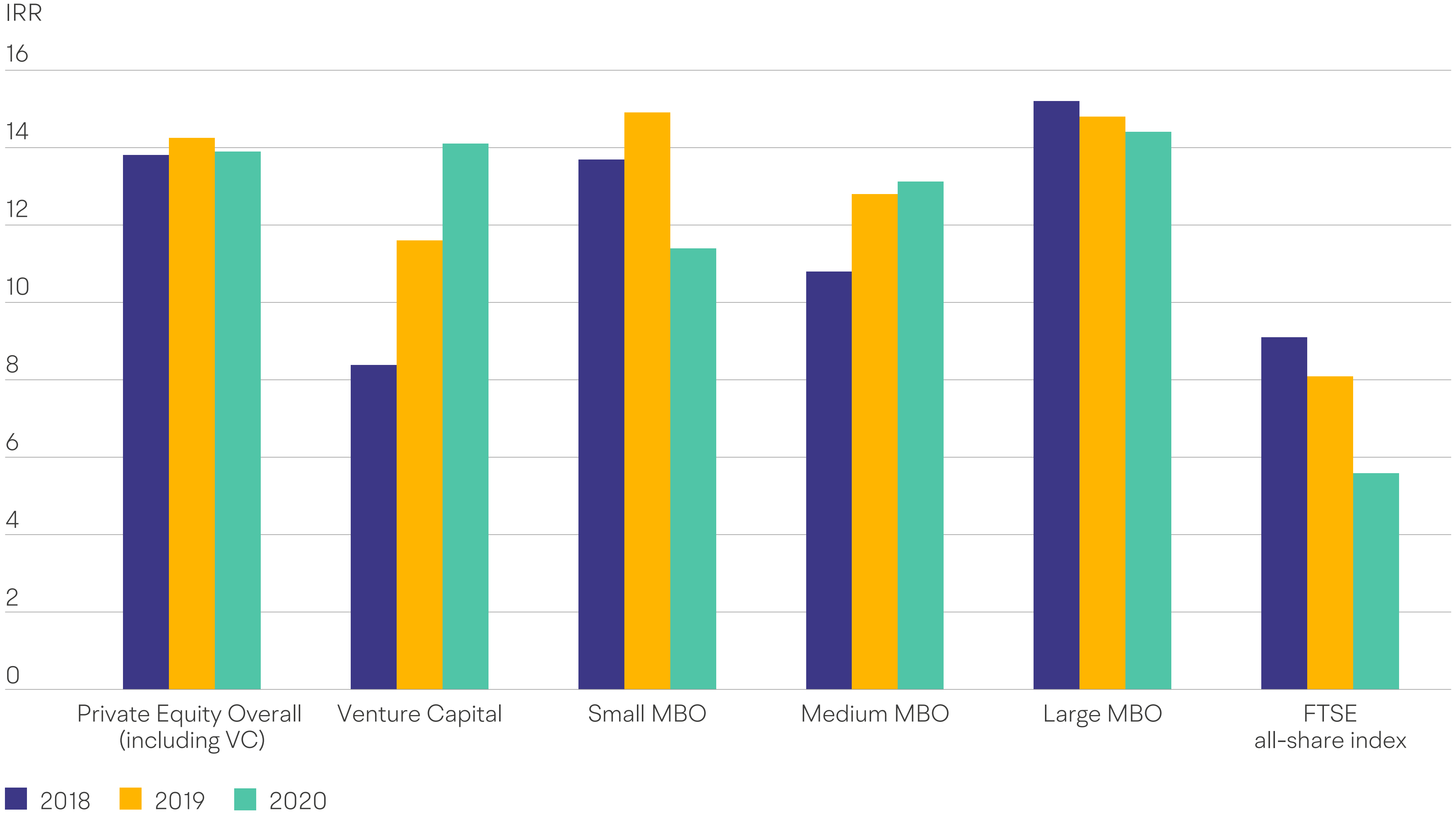
Buyout deals are generally less risky than VC deals due to their shorter holding periods and focus on more established companies. This means VC returns need to exceed those of MBOs to attract many LPs. Therefore, it is encouraging for the VC industry that returns do now exceed medium and smaller MBO funds. In addition, VC returns continue to be higher than the returns from investing in public markets, with the 10-year horizon IRR from the FTSE all-share index decreasing by 2.5 percentage points to 5.6% in 2020.

The continued improvement in VC returns is further demonstrated in the Bank's latest VC returns report. Our report uses different return measures but also showed sharp increases in performance. Both realised and projected returns increased in 2021 relative to 2020 driven in part by the higher pre-money valuations already mentioned.[194]

Figure B.32

Comparison of 10-year horizon IRRs and selected market comparators, by year

Source: BVCA Performance Measurement Survey 2020, 2019 and 2018



Exit routes are another factor behind strong recent returns. Exits ultimately generate financial returns and provide liquidity to LPs, freeing up capital for re-investment. The three main exit routes for VC backed companies are buyouts, mergers and acquisitions, and Initial Public Offerings (IPOs).

Figure B.33 shows that VC backed company exit activity in 2021 was just as exceptional as deal activity. The number of VC-backed exits increased by 76% to 258, whilst exit value[195] increased by 785% to £35.6bn which both represent new records.[196]

IPOs accounted for the bulk of exit value, accounting for £25bn, by far the largest annual amount on record. Former unicorns Deliveroo, Darktrace and Oxford Nanopore Technologies were among the 26 VC-backed companies that undertook an IPO in 2021.

The 2021 cohort is much larger than the six relevant IPOs in 2020 and has also seen a much higher share of UK listings. 16 of the 26 listed in the UK which compared to just one of the six that was listed in the UK in 2020. Listing in the UK should become even more attractive as the recommendations of the Hill Review come into effect later in the year.[197]

Another high-profile exit route comes in the form of Special Purpose Acquisition Companies (SPACs). Several UK companies have exited on US markets in 2021 via a SPAC. These include Cazoo, Arrival, Babylon Health and LumiraDX. The outlook for future SPAC exits is uncertain as there are now signs[198] of the US SPAC market beginning to slow down, and a substantial proportion of SPACs may need to return their investor's capital if they cannot execute an acquisition deal in the time available.[199]

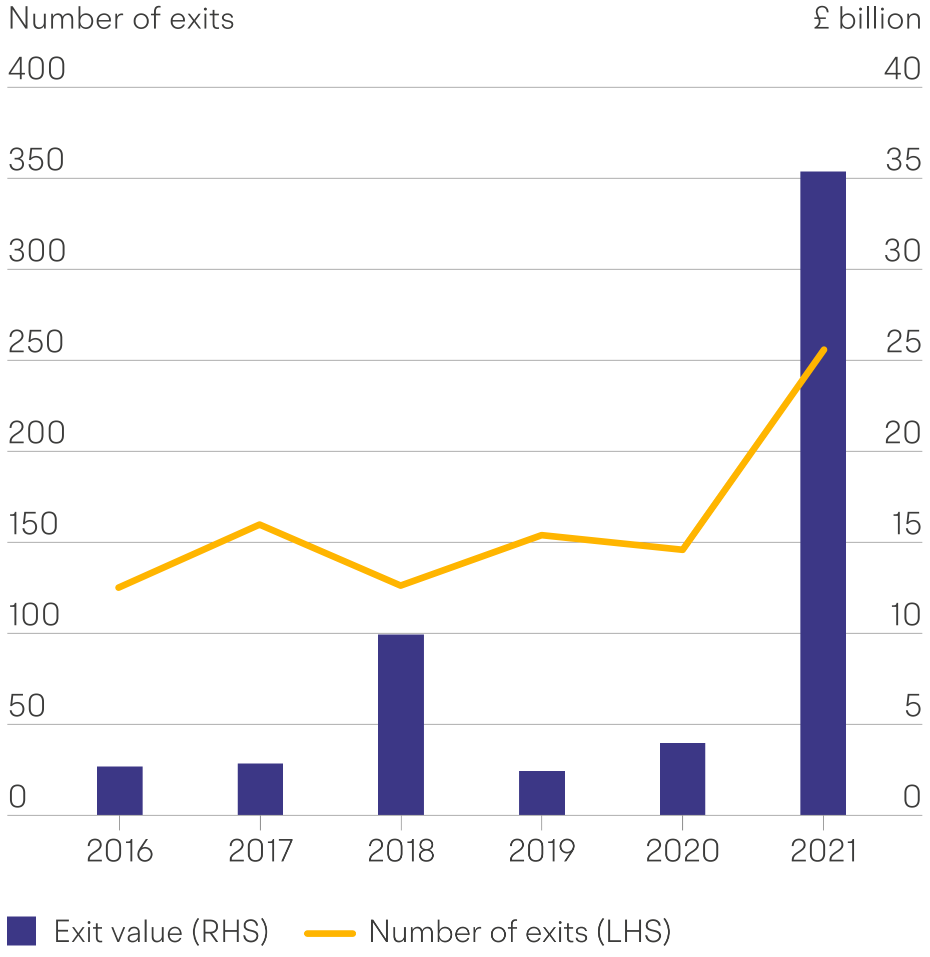
As with many of the other developments discussed in this chapter, the strong exit activity in the UK is consistent with other major markets. EY research suggests that globally, "IPO markets in 2021 proved to be the most active in the past 20 years. Market optimism from the initial rebounding economies, Covid-19 vaccine rollouts and rolling liquidity from government stimulus programs provided strong tailwinds."[200] IPO activity has also been strong in the US and Europe.[201]

Though IPO activity has yielded huge returns in many markets, the post-IPO performance of VC-backed companies has been mixed, both in the UK and internationally.[202] In the UK, KPMG research found that 39% of large listings recorded share price drops,

Figure B.33

Number and value of UK VC-backed company exits, per year

Source: British Business Bank analysis of user defined PitchBook search. Results may differ from PitchBook's own published figures (data as at 04/01/2022)



much higher than the 13% of equivalent companies in 2019 (the most recent comparable year).[203]

This mixed post-listing performance coupled with other developments such as deteriorating market sentiment toward the tech sector[204] could dampen IPO activity in 2022. KPMG do, however, offer a positive note, suggesting company specific factors have driven weak post-listing performance and companies should not be put off from a public listing.[205] Beauhurst research adds to this optimism, suggesting that the pipeline of UK VC-backed companies looking to IPO in 2022 is strong.[206]

IPOs were not the only route for exits for UK VC-backed companies in 2021. There were record levels of buyouts and acquisitions too. In 2021, there were 163 acquisitions of UK VC-backed companies worth £8.3bn, a record in both cases. Particularly notable is that four UK VC-backed companies were acquired at valuation above £1bn with the largest of these being the acquisition of Depop by Etsy. 2021 also saw 59 buyouts with a value of £1.1bn, which as with IPOs and acquisitions, is a record level of activity.

Strong fundraising in 2021 and record levels of dry powder suggests VC funds have sufficient capacity to invest in high growth companies in 2022 and beyond

Global VC fundraising conditions have been strong in recent years. Low interest rates have encouraged capital allocations toward VC in search of higher returns. This appetite continues to grow with 64% of LPs reporting increased appetite for European VC[207] compared to just 31% in last year's Atomico State of the Market report.

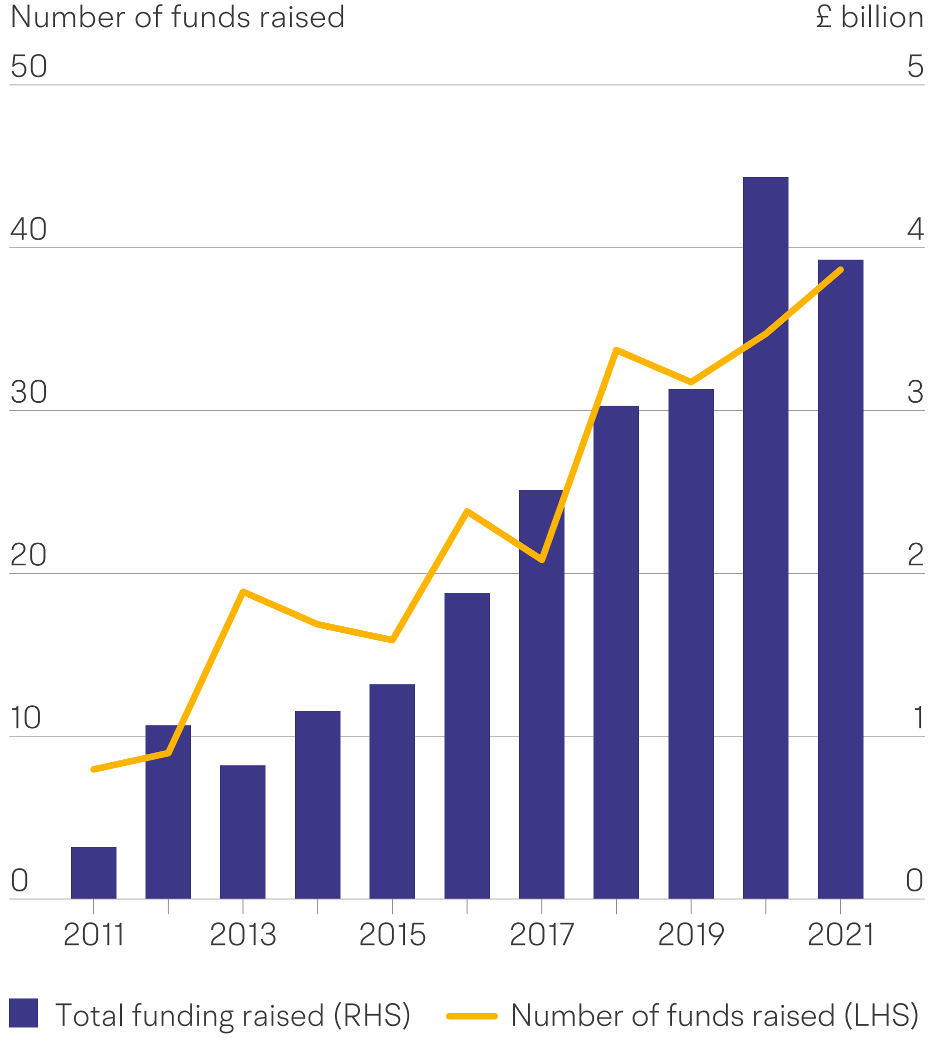
UK funds have been beneficiaries of this with 39 closing in 2021, up 11% on 2020 and continuing the long-term growth (Figure B.34). Within this cohort of new funds were 11 raised by first time fund managers, below the peak of 17 in 2018 but in line with historical figures and a good indication for the long-term health of the ecosystem.

The size distribution of new funds also paints a positive picture for ecosystem health. Of the 28 UK VC funds in 2021 which reported fund size, 11 were smaller than £50m and six were between £50m and £100m. 61% of funds with a 2021 vintage were in these size categories, up from 58% in 2020. Good representation of smaller

Figure B.34

Number and value of UK VC funds per vintage year

Source: British Business Bank analysis of Preqin (data as at 04/01/22)



funds as well as those that close above £100m means that companies at all stages of development should be catered for.

Despite a record level of new funds closing, the total value of VC funds raised in 2021 was just the second highest annual amount recorded at £4bn.[208] Total fundraising was 12% lower than 2020, as a result of decreased average fund sizes. Fund sizes can be volatile given the increasing prevalence of very large funds, but the overall trend remains positive despite the drop in 2021.

Fundraising in a given year is an important driver of dry powder, but funds raised in previous years matter too. Consequently, strong fundraising activity over the past several years means there is lots of dry powder available. Preqin data shows UK VC funds had £9.8bn available to invest, 20% higher than the £8.2bn available at the end of 2020. This record level of dry powder reduces the risk of a near-term slowing in UK equity activity even if interest rates rise further, a prospect analysed in section 2.1.

British Business Bank programmes have an important role in increasing the availability of equity finance to SMEs

Despite larger deals and valuations in 2021, our Equity Tracker report found UK companies continue to receive less VC funding than their US counterparts. This is especially the case for deep tech companies, providing continued support for British Patient Capital (BPC) and the Future Fund: Breakthrough programme.

Evidence also shows that UK institutional investors have lower allocations to VC than their counterparts in the US. The Bank's Managed Funds programme is a fund of funds programme designed to increase institutional capital to the UK's venture and growth capital markets.

The increased concentration of deals and investment in London in 2021 highlights the continued importance of the Bank's regionally focused programmes including the Regional Angels Programme (RAP), Northern Powerhouse Investment Funds (NPIF), Midlands Engine Investment Funds (MEIF) and Cornwall and Isles of Scilly Funds (CIoSIF). These programmes play an important role in increasing the supply of finance in all areas of the UK.

The Enterprise Capital Funds (ECF) programme is another impactful Bank programme. Independent evaluation evidence shows that ECF is helping to close the 'equity gap' by increasing the availability of early-stage equity finance to high potential UK companies. ECF's successes include early investments in Graphcore, GoCardless, Marshmallow, Tractable and Thought Machine, as well as successful exits in Grapeshot and Mimecast.

In addition to the Bank's core programmes, the Future Fund, which was established in 2020 to provide funding to equity backed businesses affected by the Pandemic is another important example of our activity. The Future Fund issued 1,190 innovative companies with Convertible Loan Agreements (CLAs) worth £1.14bn. 265 of these CLAs have converted into equity shares at 31 December 2021,[209] meaning the companies have successfully raised further private sector capital through an equity funding round.

2.7

Bank lending

- Gross bank lending returned to pre-Covid-19 levels in 2021 from the record high in 2020, driven by lower drawdowns of government loans
- Demand for lending has eased since 2020
- Credit conditions were relatively stable in 2021
- Repayments reached a record high as the Bounce Back Loans' one-year repayment holiday ended
- The British Business Bank continues to support bank lending to smaller businesses across the UK as they recover and grow following the pandemic

This section analyses developments in the UK banking market for small and medium-sized enterprises (SMEs) in 2021. It draws on the most recent data from sources including the Bank of England (BoE), UK Finance and the British Business Bank.

Gross bank lending returned to pre-Covid-19 levels in 2021 from the record high in 2020, driven by lower drawdowns of government loans

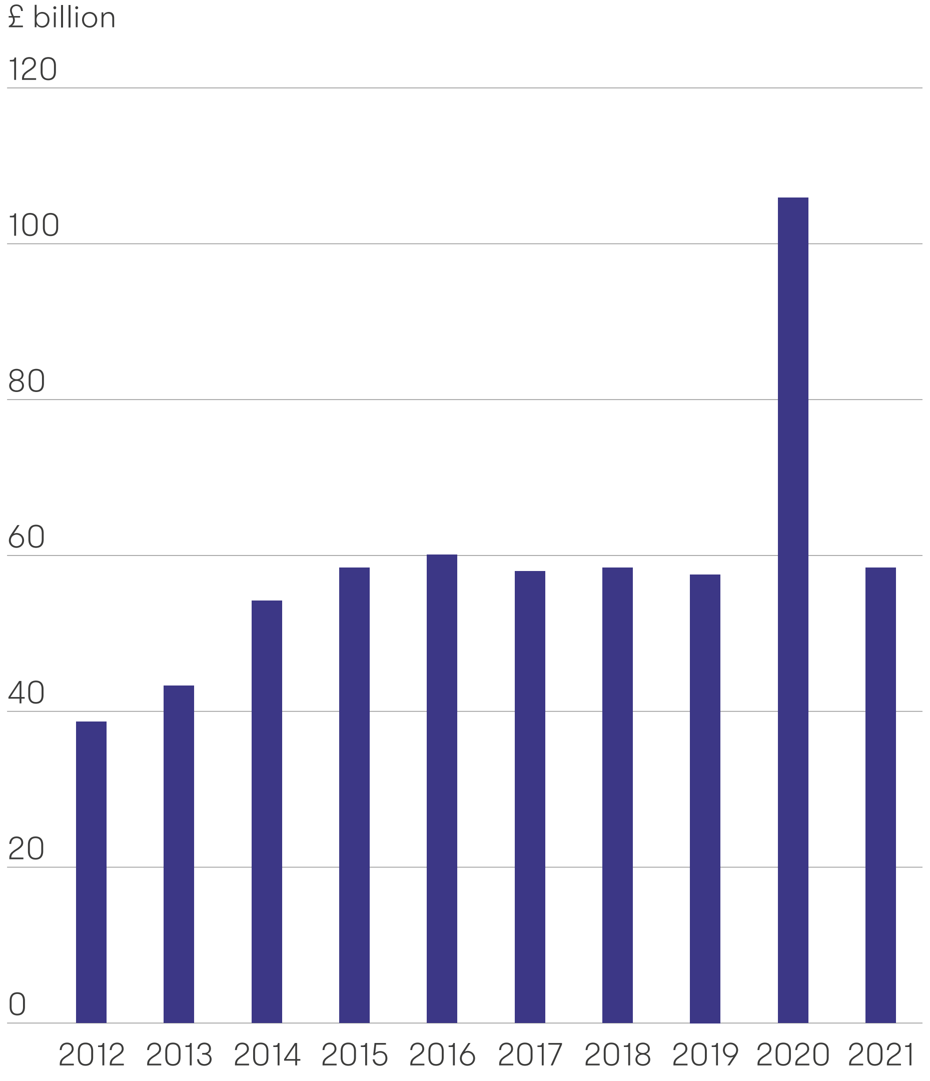
Gross lending (excluding overdrafts) to SMEs by all UK banks in 2021 was £57.7bn, according to the BoE data. This was up 1% from £56.9bn in 2019, before Covid-19. However, 2021 lending was 45% down from 2020, when a record £104.8bn was recorded (Figure B.35).[210] The record gross lending in 2020 was driven by the Bank's Coronavirus Business Interruption Loan Schemes, particularly the Coronavirus Business Interruption Loan Scheme (CBILS) and the Bounce Bank Loan Scheme (BBLS) which were most relevant to SMEs.

While gross bank lending in 2021 was slightly above 2019 in nominal terms, this is not true after accounting for inflation. In real terms, 2019 gross bank lending was £2.4bn above 2021. Furthermore, 2021 gross bank lending was the lowest in real terms since 2013 when lending was still recovering from the Global Financial Crisis.

Figure B.35

Gross bank lending to SMEs

Source: BoE Bankstats



The fall in nominal gross lending in 2021 was driven by lower drawdowns of government loans. CBILS and BBLS closed to new applications in March 2021 with the Recovery Loan Scheme (RLS) opening immediately after. RLS was introduced to provide financial support to businesses as they recover and grow following the pandemic.

According to British Business Bank data, the total value of the CBILS, BBLS and RLS facilities drawn down from banks in 2021 was £8.0bn. This was down significantly from the £56.7bn of CBILS and BBLS drawn down in 2020.[211] Term lending as a share of the total value of the CBILS, BBLS and RLS facilities drawn down from banks also fell in 2021 to 94% from 99% in the previous year. This was largely driven by lower drawdowns of BBLS facilities.

In 2021 the total value of CBILS, BBLS and RLS facilities drawn down by banks was equivalent to around 13% of the BoE's total gross bank lending to SMEs. This compares to around 55% in 2020. However, the reporting populations and products covered by the British Business Bank data on CBILS, BBLS and RLS facilities drawn down, and the BoE data on gross lending, are not identical, so exact comparisons are not possible.

Demand for lending has eased since 2020

The BoE Credit Conditions Survey, conducted with banks and building societies, showed the net balance for demand from small businesses for lending fell (-13.1%) in Q4 2021 (Figure B.36).[212,213] This was the fifth consecutive fall. It followed rises in Q2 2020 (+89.5%) and Q3 (+14.5%) (see section 2.4 for more detail on demand).

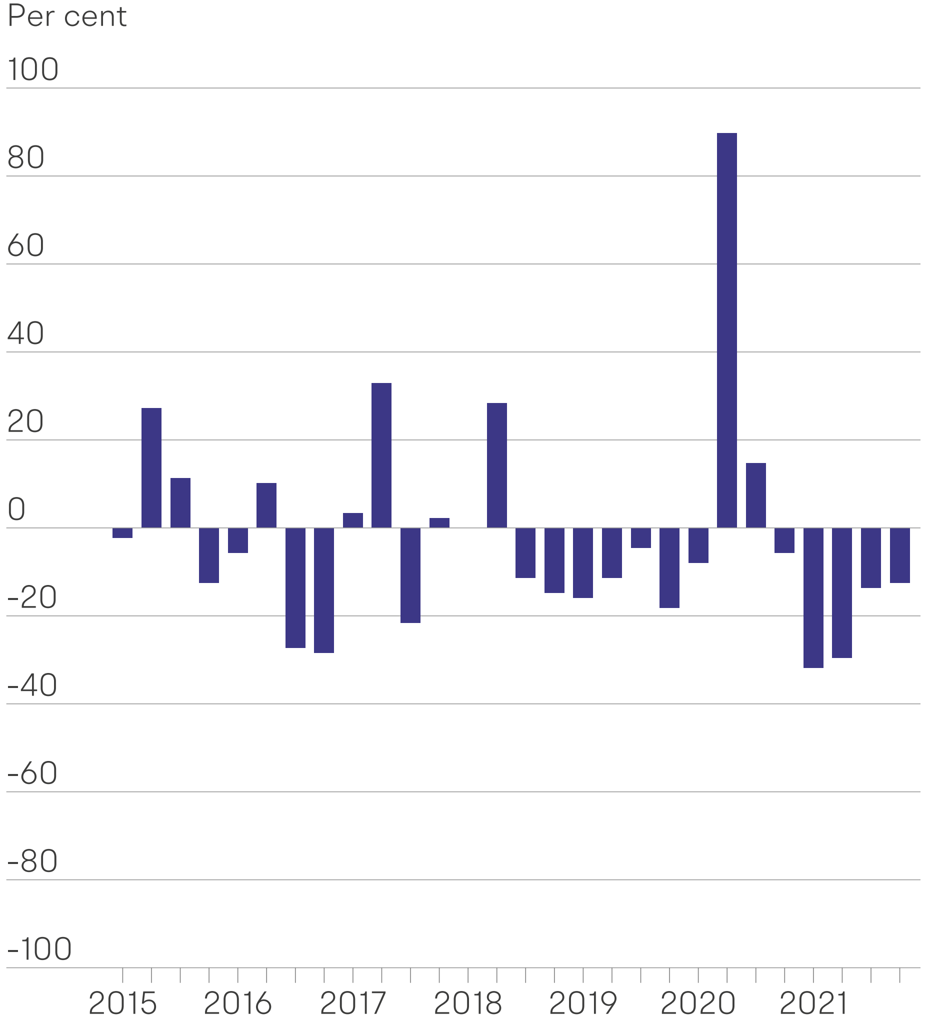
Easing demand was driven in part by the post-pandemic changes to smaller businesses' debt positions that are analysed in section 2.2 and by the subdued business investment discussed in section 2.1. The British Business Bank's market contacts also cited supply chain disruption as a factor. Delays to the delivery of business inputs including transport equipment and other investment goods were reported to have tempered demand.

High deposits were another driver. UK Finance data showed the value of deposits held by SMEs rose in Q3 2021 to £269bn (Figure B.37). This was notable for two reasons. First, the rise was the sixth in a row, one of the longest strings of gains since the series began in 2011. Second, the value was the highest on record. Similarly, the SME Finance Monitor for the three months to

Figure B.36

Change in the overall demand from small businesses for lending, net balance

Source: BoE Credit Conditions Survey



October 2021 showed that the share of businesses holding more than £10,000 of credit balances was 31%.[214] This was one of the highest since the data series started in 2012.

High deposits may reflect precautionary cash buffers in response to perceptions of lingering economic uncertainty. These buffers may have reduced the incentive for further borrowing among the smaller businesses that held them.

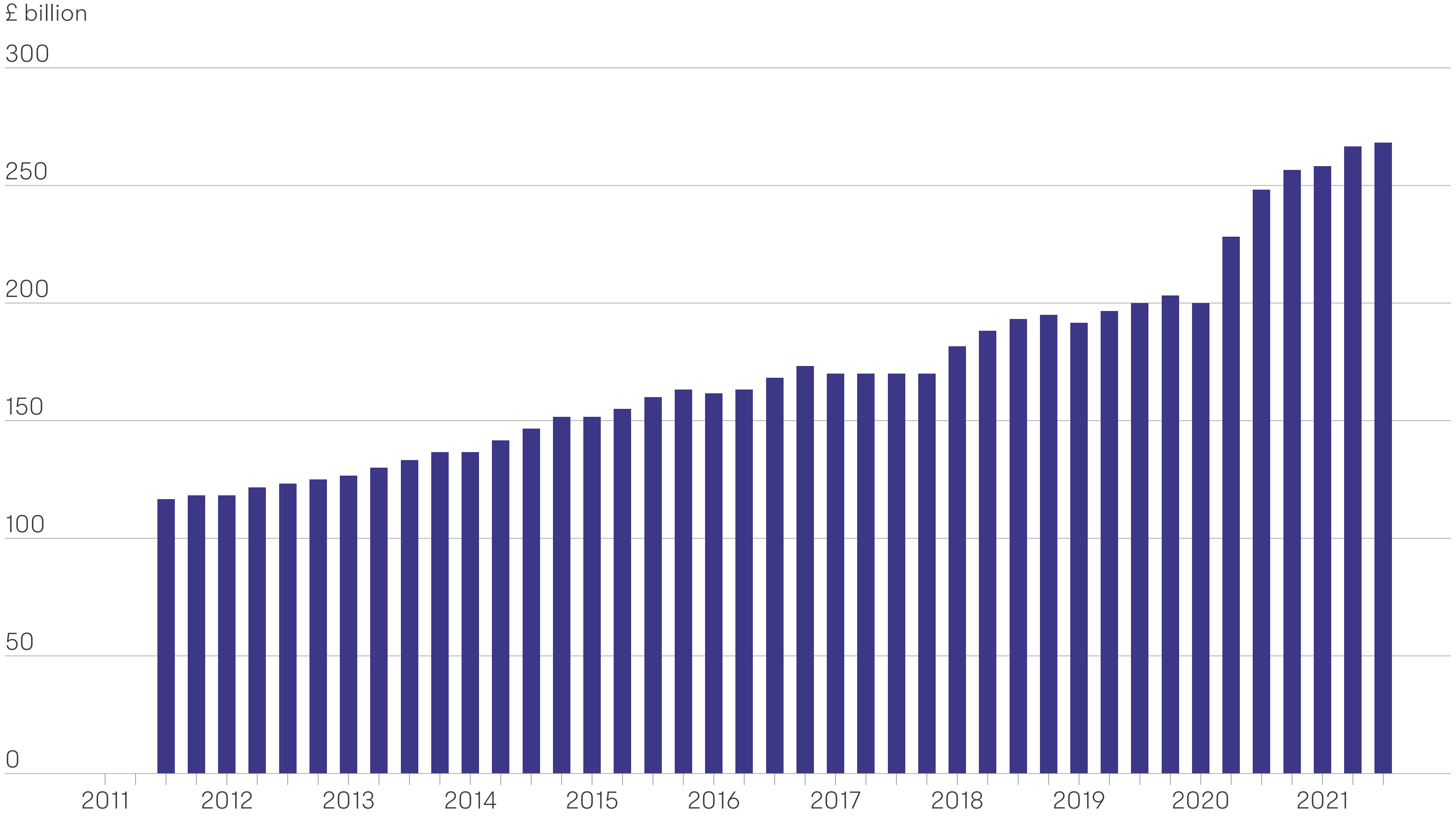
Alongside record deposit levels, 2021 also saw a cautious recovery in demand for traditional forms of working capital finance. These include credit cards, overdrafts, and invoice finance and asset-based lending (which is covered in section 2.11)

Demand for these working capital products had waned during 2020 as some smaller businesses used government loan or support schemes instead. The recovery is likely to be driven by increased cash flow pressure from rising input costs and the closures of CBILS, BBLS, and other government support schemes such as the Coronavirus Job Retention Scheme during the year.

Figure B.37

SME deposits with the seven largest UK banks

Source: UK Finance



The BoE credit conditions survey showed that the net balance for the demand of small businesses for total unsecured lending rose (+23.1%) in Q4 2021. This was the second consecutive rise and the largest since Q2 2010 (26%). Previously, the net balance fell in the year to Q2 2021. The breakdown by type of unsecured lending indicates that improvement in Q4 2021 was driven by the demand for credit card lending.

Similarly, UK Finance data indicated the value of overdraft facilities approved or increased rose in Q3 2021 to £0.7bn, the highest since Q4 2020, but still well below the pre-Covid-19 average. Also, the overdraft utilisation rate rose in Q3 2021 for the third consecutive quarter to 43%. This was the highest since Q1 2020 (54%) but remained under the pre-pandemic average (55%).[215]

Credit conditions were relatively stable in 2021

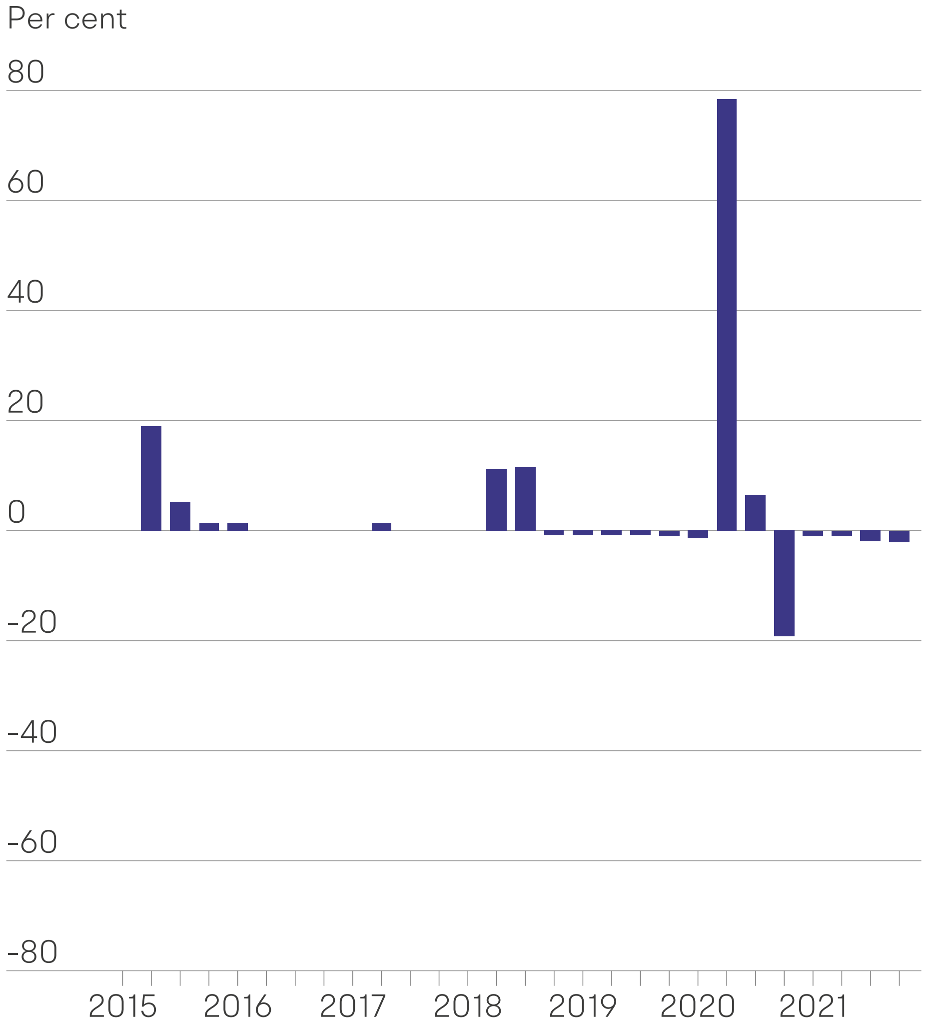
The BoE credit conditions survey showed the net balance for the availability of credit provided to small businesses was broadly unchanged in Q4 2021 for the fourth consecutive quarter (Figure B.38).

The Bank's market contacts also report that lenders did not tighten credit conditions during the year but recognise that the circumstances of individual businesses may have changed as a result of the debt many have taken on following the pandemic. In line with our market contacts, the BoE Agents' summary of business conditions for Q3 2021 saw small companies report some caution among banks to increase lending, particularly to those with high levels of existing debt.[216] As outlined in section 2.2, credit availability was reported to have improved in the Q4 Agents' report but there was still caution over lending to those in sectors most affected by the pandemic.

Figure B.38

Change in the availability of credit provided to small businesses, net balance

Source: BoE Credit Conditions Survey



For smaller businesses that have taken out loans, BoE data indicates that credit remains relatively affordable. While interest rates on a range of SME loans were higher in late 2021 than at the same time a year earlier, they were still lower than prior to the pandemic. The effective interest rate on all SME loans rose from 2.3% in December 2020 to 2.5% in the same month of 2021 but remained below that in February 2020 (3.4%) (Figure B.39). The effective floating rate, which broadly tracks the BoE Bank Rate, is slightly lower than that for all loans while the effective fixed rate is higher.

Repayments reached a record high as the Bounce Back Loans' one-year repayment holiday ended.

According to the BoE data, repayments of bank loans by SMEs totalled £65.7bn in 2021 (Figure B.40). This was up 14% from 2020 and 19% higher than in 2019. It was also the highest on record. Repayment levels were relatively high for most of the year but there were notable increases in May and June when repayments were £5.5bn and £6.1bn, respectively.

Figure B.39

Effective interest rates (new business) for SMEs

Source: BoE Bankstats

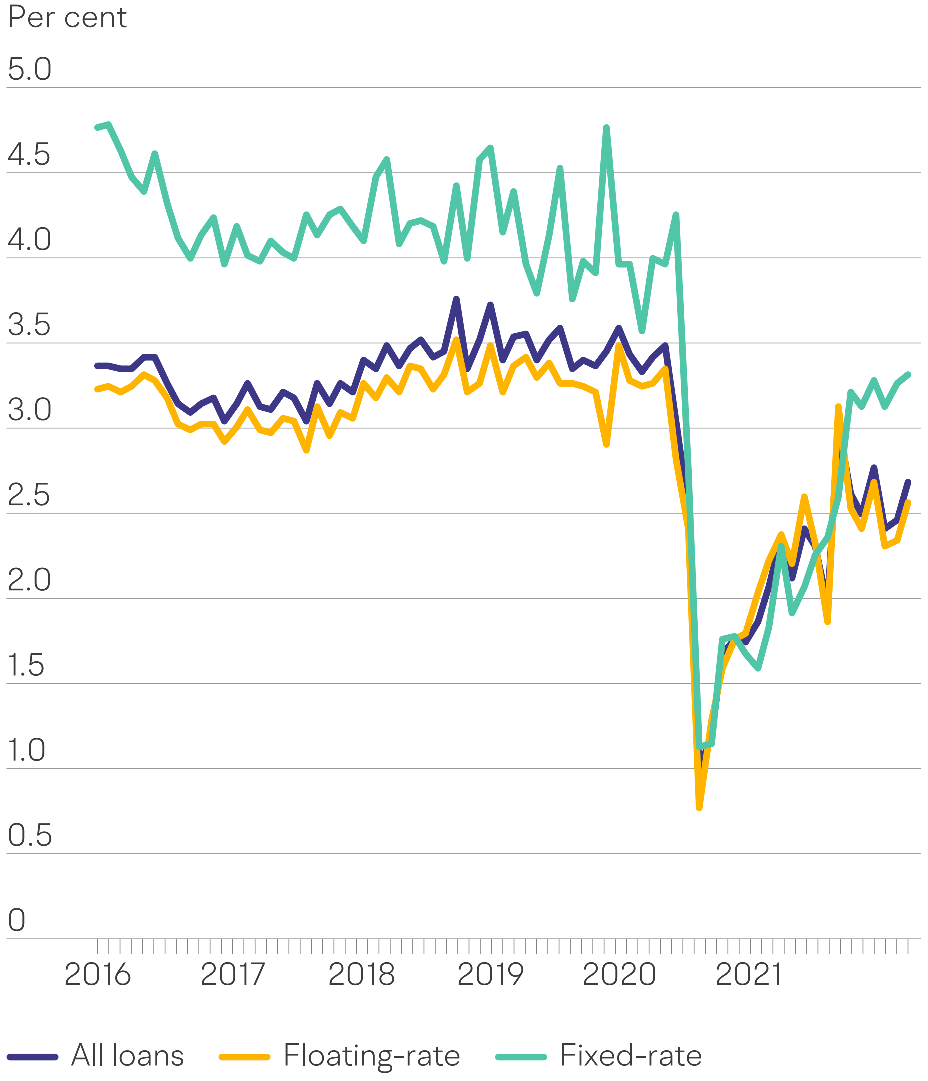
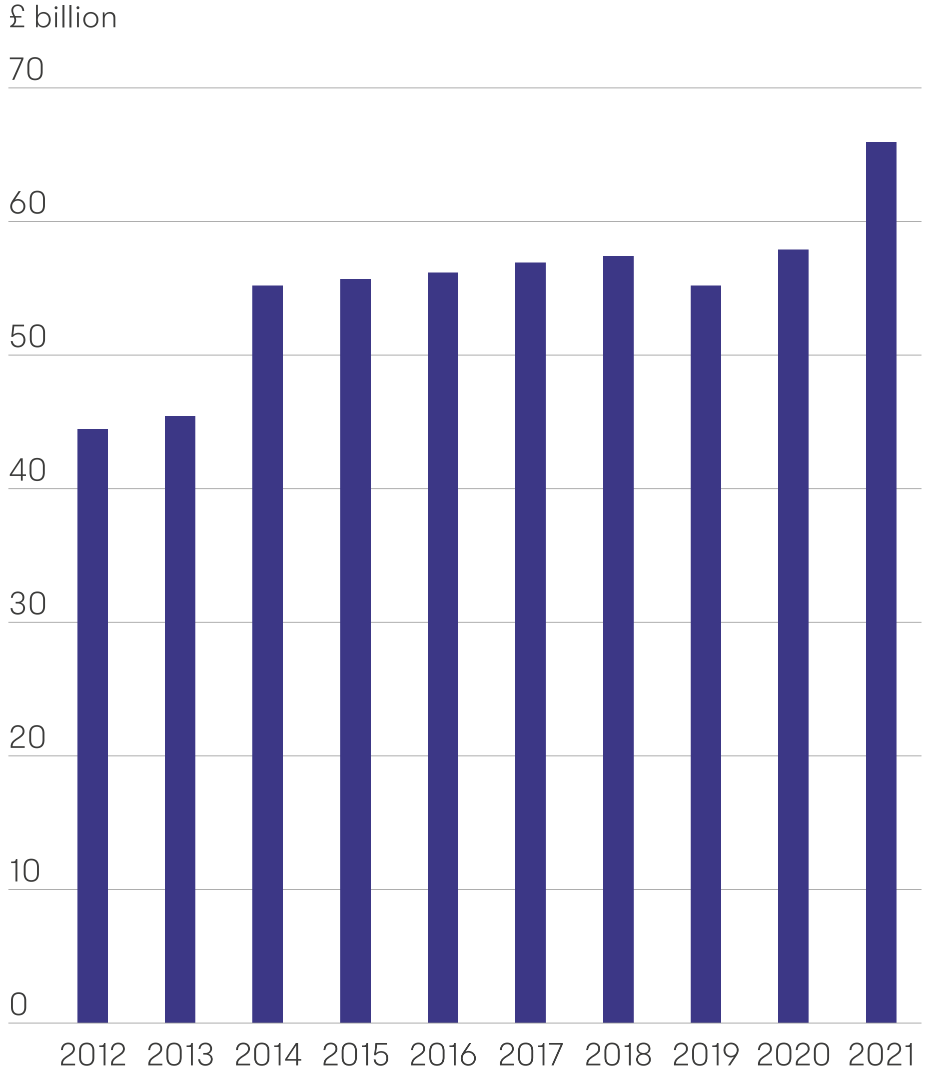


Figure B.40

SME loan repayments

Source: BoE Bankstats



The repayment levels in May and June, the latter of which set a new record, reflect the ending of repayment holidays for the earliest cohort of BBLS users. Some of the repayment volumes may also have reflected SMEs that drew down their BBLS as a precautionary measure but did not end up needing the capital and repaid in full before their repayment holiday ended.

While repayments were at a record high in 2021 in absolute terms, this was not the case relative to the stock of SME loans. British Business Bank calculations based on the BoE data show that in 2021 repayments as a share of the loan stock averaged 2.7%. This was the same as in 2020 but down from 2019 (2.9%) and 2014-2018 (3% or above) (Figure B.41). The lower share was driven by the large increase in the loan stock due to the impact of Covid-19.

The BoE measure of net lending turned negative in 2021. Net lending was a negative £8.0bn. This down from a positive £47.2bn in 2020. The negative net lending in 2021 reflects that the level of repayments exceeded gross lending since April. Likewise, the UK Finance measure of net lending in the first nine months of 2021 was a negative £5.4bn. This compares to positive net lending of £36.7bn in the corresponding period a year earlier.

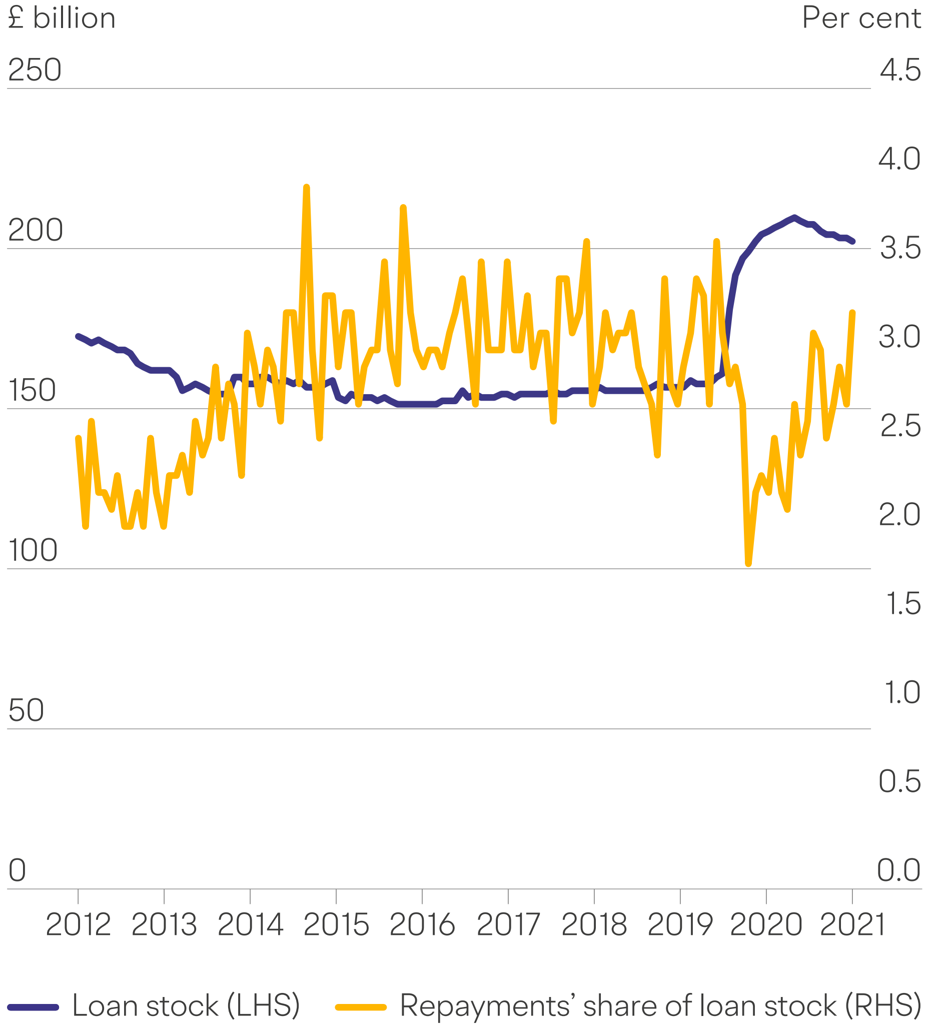
The British Business Bank continues to support bank lending to smaller businesses across the UK as they recover and grow following the pandemic.

To keep the UK economic recovery from the impact of Covid-19 on track, it is crucial for the banking sector to provide smaller businesses with the finance that they need. The British Business Bank continues to support bank lending to smaller businesses through its existing programmes including RLS, the ENABLE Guarantee programme and the ENABLE Build programme.

Figure B.41

SME loan stock, and repayments as a share of loan stock

Source: BoE Bankstats



2.8

Challenger and specialist banks

- Gross lending by challenger and specialist banks fell in 2021 back to pre-pandemic levels from a government loan scheme-driven record high in 2020
- Challenger and specialist banks' share of total gross bank lending rose sharply in 2021 to a record high
- Partnerships and acquisitions between banks and non-bank lenders have provided additional finance options to smaller businesses
- In 2021 five UK start-up banks were granted banking licences, two of which focus on lending to smaller businesses in specific parts of the UK

This section analyses developments in 2021 for the challenger and specialist banks that serve small and medium-sized enterprises (SMEs). The section draws on data from sources including the Bank of England (BoE), the financial reports of challenger and specialist banks, and the British Business Bank.

Gross lending by challenger and specialist banks fell in 2021 back to pre-pandemic levels from a government loan scheme-driven record high in 2020

After gross bank lending to SMEs reached a record high in 2020, mostly driven by government loans schemes, it returned to pre-pandemic levels in 2021 (see section 2.7 for more detail). The story for challenger and specialist banks is similar.

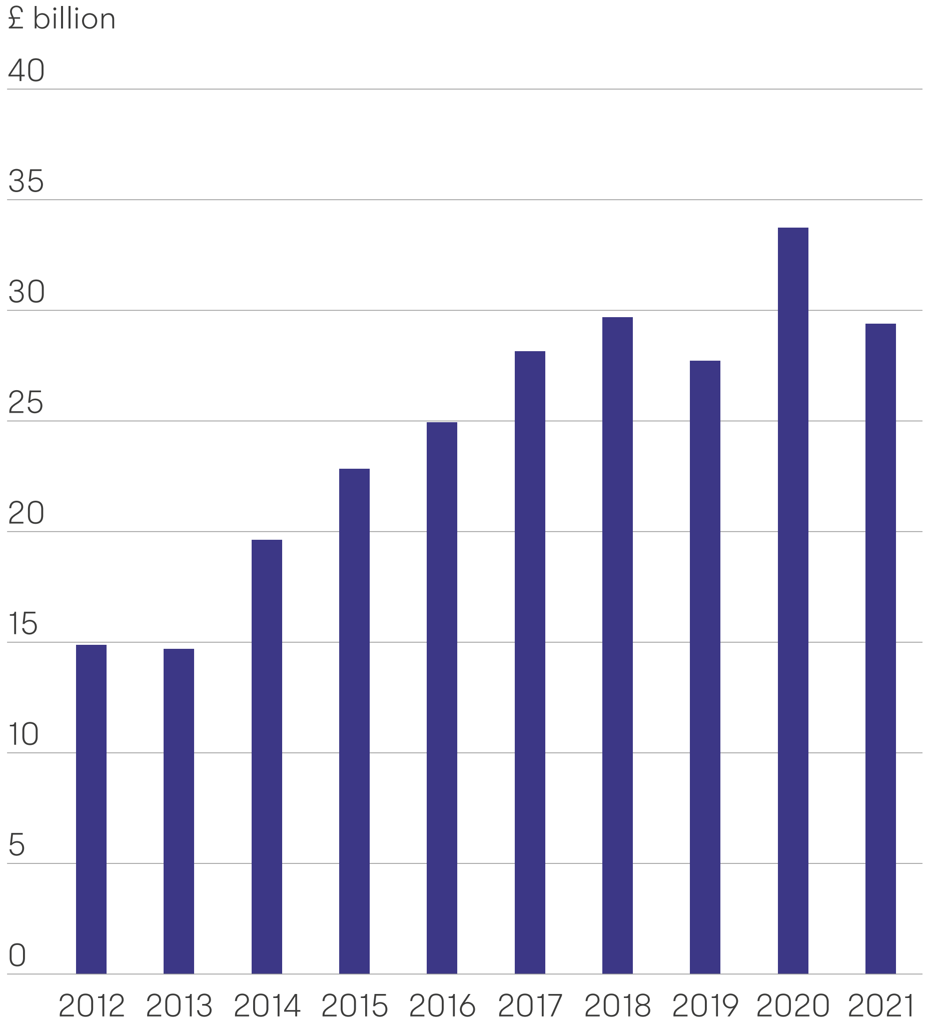
Challenger and specialist banks' gross lending to SMEs in 2021 was £29.2bn. This was up 6% from 2019 (£27.5bn), before the pandemic. However, it was down 13% compared to 2020 (£33.6bn) which was the highest since the data series began in 2012 (Figure B.42).

As noted in section 2.7, the reduced gross lending in 2021 followed the closure of applications to the Coronavirus Business Interruption Loan Scheme (CBILS) and the Bounce Back Loan Scheme (BBLS) in March. Although the Recovery Loan Scheme (RLS) opened immediately after, the total value of the CBILS, BBLS and RLS facilities drawn down from challenger and specialist banks in 2021 was £2.8bn, less than half the £6.9bn for CBILS and BBLS in 2020.

Figure B.42

Gross bank lending to SMEs by challenger and specialist banks

Source: BoE



At the time of writing, none of the individual challenger or specialist banks had reported full year lending figures for 2021. However, a handful had reported data covering part of the calendar year. Despite overall lending by challenger and specialist banks falling in 2021, several reported continued growth in the first half of the year. Their reports show this growth was predominately driven by increases in SME applications for CBILS and BBLS prior to the schemes closing in March 2021.

Our market contacts note the loan books of some challenger and specialist banks that were not accredited for the government loan schemes have also grown. This likely reflects increased demand for market-based lending as the economy continued to recover. However, the fall in overall lending by challenger and specialist banks in 2021 implies the increase in market-based lending was more than offset by the decrease in lending under the government loan schemes.

Challenger and specialist banks' share of total gross bank lending rose sharply in 2021 to a record high

Challenger and specialist banks' share of total gross bank lending to SMEs in 2021 was 51% (Figure B.43). This was the highest since the data series began in 2012 and resumed the trend since the global financial crisis of 2007-08. It was up from 32% in 2020, which in contrast was the lowest on record due to the biggest UK banks delivering the bulk of the government guaranteed loan schemes. Prior to the pandemic, the share provided by challenger and specialist banks had been on an upward trend from around a third in 2013 to approximately a half in 2017-2019.

Challenger and specialist banks have provided a much smaller proportion of loans made under the government schemes than the big five banks thus far. In 2021 the total value of CBILS, BBLS and RLS facilities drawn down from all UK banks was £8.0bn. Of this, challenger and specialist banks accounted for £2.8bn (35%) while the big five banks provided £5.2bn. This compares to challenger and specialist banks accounting for £3.7bn (6%) in 2020.[217]

The rise in the challenger and specialist bank share of gross bank lending in 2021 was largely driven by lower drawdowns of government loans, particularly from the big five banks. Drawdowns under the schemes from the big five banks in 2021 (£6.2bn) were significantly lower than in the previous year (£53.1bn). However, drawdowns of government loans from challenger and specialist banks in 2021 (£2.8bn) were only slightly lower than in 2020 (£3.7bn).

In addition, the British Business Bank's market contacts report SME demand for lending from specialist banks remained firm because they provide products that are not available elsewhere in the market. Furthermore, the BoE Agents' summary of business conditions for Q4 2021 noted smaller companies reported challenger banks were more willing to lend to those in sectors that had been most affected by the pandemic.[218]

When the value of the CBILS, BBLS and RLS facilities drawn down from challenger and specialist banks in 2021 (£2.8bn) is removed from their gross lending in the same year (£29.2bn), it leaves £26.5bn of market-based lending. This compares to £27.5bn in 2019 and £29.7bn in 2020.

In addition to providing lending, challenger and specialist banks also provide business current accounts. The Financial Conduct Authority's Strategic Review of Retail Banking Business Models showed some challenger and specialist banks have increased market share in this space.

The report examined the number of current accounts held by micro businesses (which the FCA defined as SMEs with turnover of less than £2m per year) with the big four banks, scale challengers, mid-tier banks, and digital banks.[219,220] It found the share with current accounts run by digital banks increased to 10% in 2021 from 4% in the previous year and 1% in 2019.

In contrast, the share for the big four banks fell to 67% from 71% in 2020 and 74% in the year before that. The shares for scale challengers, and mid-tier banks, were broadly steady at around 18% and 7% respectively.

The FCA report noted there are signs that some of the historic advantages of large banks may be starting to weaken through innovation and digitisation among rivals and through changing customer behaviour. It also flagged that some smaller banks were able grow their share of SME accounts and lending during the pandemic.

Partnerships and acquisitions between banks and non-bank lenders have provided additional finance options to smaller businesses

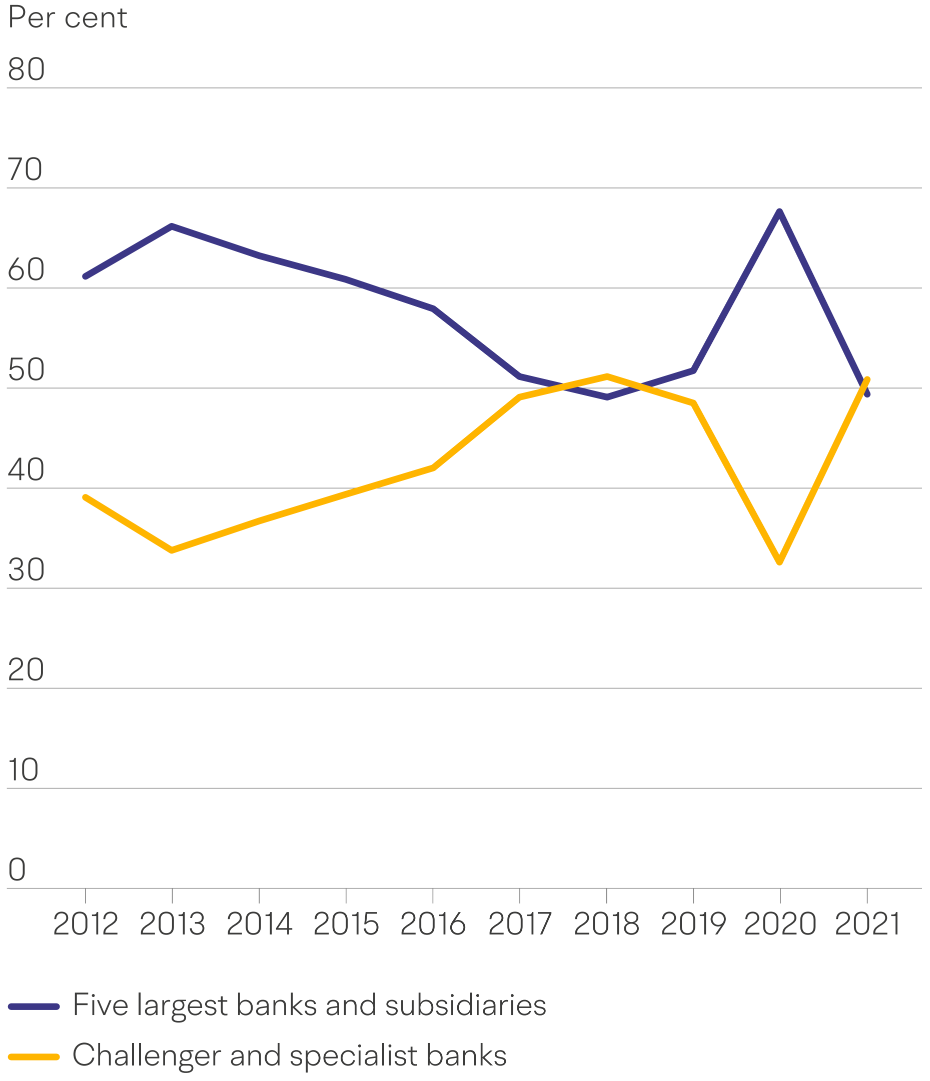
Several digital banks have partnered with non-bank lenders to create additional mechanisms for distributing SME lending in recent years. These partnerships involve forward-flow arrangements where digital banks loan out their deposits to non-bank lenders. This can be attractive as digital banks have large deposit bases and therefore relatively low funding costs. This means they can provide funding to non-bank lenders who offer complimentary products or wider origination capability but cannot access deposits

The partnerships have provided lending that would not have been offered to SMEs otherwise. They have also enabled the digital banks concerned to maximise their lending capacity. Examples include Starling Bank providing £300m of new SME funding through the CBILS product offered by Funding Circle. Similarly, Atom Bank delivered £300m via the RLS and other existing SME loan products on offer by Funding Circle.[221,222] Our market contacts expect to see more banks seeking new mechanisms to distribute finance to SMEs in coming years.

Figure B.43

Share of total gross bank lending to SMEs

Source: BoE



As expected, we have also seen some acquisitions by challenger and specialist banks in 2021. Hampshire Trust Bank, a specialist bank, bought Wesleyan Bank subject to regulatory approval. Wesleyan Bank is the business banking arm of Wesleyan Assurance Society and serves SMEs and professionals such as doctors and dentists.[223]

Similarly, the digital bank Allica acquired the SME loan book of AIB Group (UK). This followed the withdrawal of AIB Group (UK) from the SME lending market in Great Britain.[224] Starling Bank, another digital bank, bought the buy-to-let mortgage specialist, Fleet Mortgages,[225] while the digital bank OakNorth acquired the fintech Fluidly subject to regulatory approval. Fluidly provides automated cash flow forecasting and funding tools to help businesses plan and manage their finances.[226] These acquisitions have the potential to deliver economies of scale and improve profitability for the challenger and specialist banks involved.

In 2021 five UK start-up banks were granted banking licences, two of which focus on lending to smaller businesses in specific parts of the UK

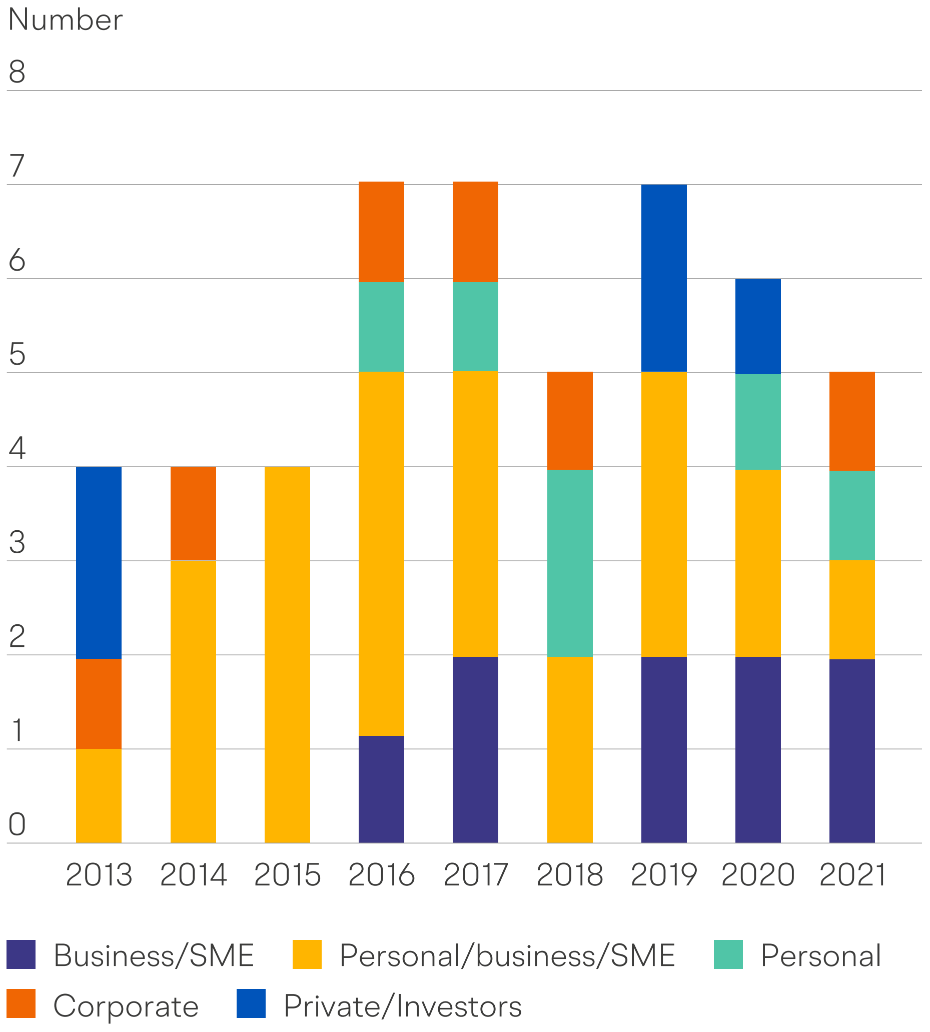
In 2021 the Prudential Regulation Authority (PRA) authorised five UK start-up banks. This was the lowest number of authorisations since 2018, following seven in 2019 and six in 2020. Of the five authorised in 2021, three serve smaller businesses (Figure B.44). This was also the lowest since 2018 when two were authorised and compares to five in 2019 and four in 2020.

Among the three newly authorised banks that serve smaller businesses, two focus on lending in specific parts of the UK. One is Bank North, which is based on Manchester and is a cross between a specialist and a digital bank. Its business model involves 'pods', rather than physical branches, in different UK regions that are empowered to make lending decisions locally.[227] The other is GB Bank, which is Newcastle-based. It specialises in property development loans of between £1m and £5m to customers including smaller businesses across the North-East, Yorkshire, and North-West.[228] At the time of writing both GB Bank and Bank North are preparing to launch.

Figure B.44

Banks authorised by the Prudential Regulation Authority, 2013-2021

Source: British Business Bank analysis of BoE data



The third newly authorised bank that serves smaller businesses is Cashplus Bank. This is a digital bank that provides current accounts and credit cards for small businesses and consumers that are underserved by the high street banks.[229]

Another new entrant during the year was Birmingham Bank, which serves smaller businesses in the Midlands and launched in 2021. This resulted from an entrepreneur acquiring Bira Bank, which served UK independent retail businesses and had a full banking licence.[230]

Separately, Recognise Bank received full PRA authorisation in 2021. This followed it being granted authorisation with restrictions on deposits in 2020. The removal of the deposit restrictions will enable the bank to provide a much wider range of services, with business saving accounts planned to launch in 2022. The bank intends to use the funds from its savings products to increase lending to the UK's small and medium sized businesses via a national network of regional hubs.[231]

Publicly available information indicates that there are a handful of applications for authorisation pending. These include Alba (a smaller business lender in Glasgow with a focus on Scotland and other UK regions) and Revolut (a digital bank).[232,233]

The British Business Bank's existing programmes help challenger and specialist banks to make the SME banking market more diverse, for example through ENABLE Guarantees and our British Business Investments subsidiary.

2.9

Private debt

- After a slowdown in 2020, UK mid-market private debt deals and investment increased substantially in 2021
- Mid-market private debt managers' movement towards larger deals continued in 2021
- After a decrease in 2020, capital invested by the Bank's Small-Cap private debt fund portfolio increased substantially in 2021
- Whilst the amount raised by UK mid-market private Debt remained strong in 2021, there was a significant decline in the number of funds closing with capital consolidating in large, established managers
- ESG-related activity ramped up in global debt markets in 2021, and early indications show ESG considerations are becoming increasingly important to UK private debt managers
- The British Business Bank is committed to continue supporting SME private debt markets

Private debt is a broad finance type involving loans to firms made by non-bank lenders, often structured as General Partner (GP)/ Limited Partner (LP) funds, much like equity funds. Private debt investment strategies range from growth-focused deals worth below £250,000 to Private Equity-backed leveraged buyouts of large corporates.

Whilst these larger, sponsored deals account for the bulk of investment value, there is an SME-focussed segment in the UK which is a vital part of the finance ecosystem. Transactions in this SME-focused segment do not typically involve a Private Equity (PE) sponsor, and aim to unlock growth in recipient businesses.

Private debt funds generally target established, profit-generating companies seeking finance to implement step-change growth plans, which commonly fall outside of bank lending risk appetite. Private debt investments are tailored to borrower needs and typically involve much more flexible repayment schedules than traditional bank loans.

Large scale funds dominate private debt markets. This means leading industry publications (e.g., Preqin's Global Private Debt Report,[234] Deloitte's Alternative Lender Deal Tracker,[235] or the Alternative Credit Council's Financing the Economy report[236]), focus on mid-market deals and tend not to be UK-specific. Though we were able to expand on this data for 2018 and 2019 by working with private debt funds to collect their UK lending figures we do not have an equivalent dataset for 2020 or 2021.[237] Consequently, our analysis of market trends draws on industry publications to analyse the mid-market and the Bank's management information to analyse smaller-cap funds.

After a slowdown in 2020, UK mid-market private debt deals and investment increased substantially in 2021

UK mid-market private debt had a strong recovery in 2021 after the slowdown seen in 2020 following the Covid-19 pandemic. Full-year data from Preqin show a 42% uplift in mid-market private debt deals in 2021 compared to 2020 meaning deal volumes are 19% above 2019. Data from the Deloitte Alt. Lender Deal Tracker only go up to Q3 but also show increased activity (Figure B.45).

This growth in UK deal volumes contrasts with the US and Rest of Europe where deals are still 5% and 8% below pre-pandemic levels respectively. UK activity continued to tilt towards buyouts at the expense of other deal types such as growth capital. Buyouts represented 60% of UK private debt deals in 2019 but this share was up to 67% in 2020 and 2021, according to Deloitte data.[238]

UK mid-market private debt investment values were extremely strong in 2021, increasing to a record £25.9bn according to Preqin. US mid-market investment also reached a record level in 2021 with £135bn deployed while European investment dropped by 51% to £15.8bn.

Mid-market private debt managers' movement towards larger deals continued in 2021

A survey of global private debt fund managers early in 2021 found that two thirds of managers expected to increase the size of the loans they were undertaking in 2021 compared to 2020. Fund managers linked this trend to the fact that many tier-two banks were withdrawing from the smaller end of the leveraged loan market. Large private debt managers are entering this space which in turn creates an opportunity for smaller managers to move up the value chain.[239]

Evidence from Preqin shows this happening in the UK. As figure B.46 shows, both the mean and median size of UK mid-market private debt deals reached record highs in 2021. The mean deal size was £1.0bn (+225% on 2020), with the median £0.2bn (+70% on 2020). This means 2021's record mid-market investment has primarily been concentrated in large deals with 98% of mid-market investment in deals over £50m, and 92% in deals of at least £500m.

Figure B.45

Number of mid-market UK Private Debt deals per quarter, by data type

Source: British Business Bank analysis of Preqin, Deloitte Alternative Lender Deal Tracker

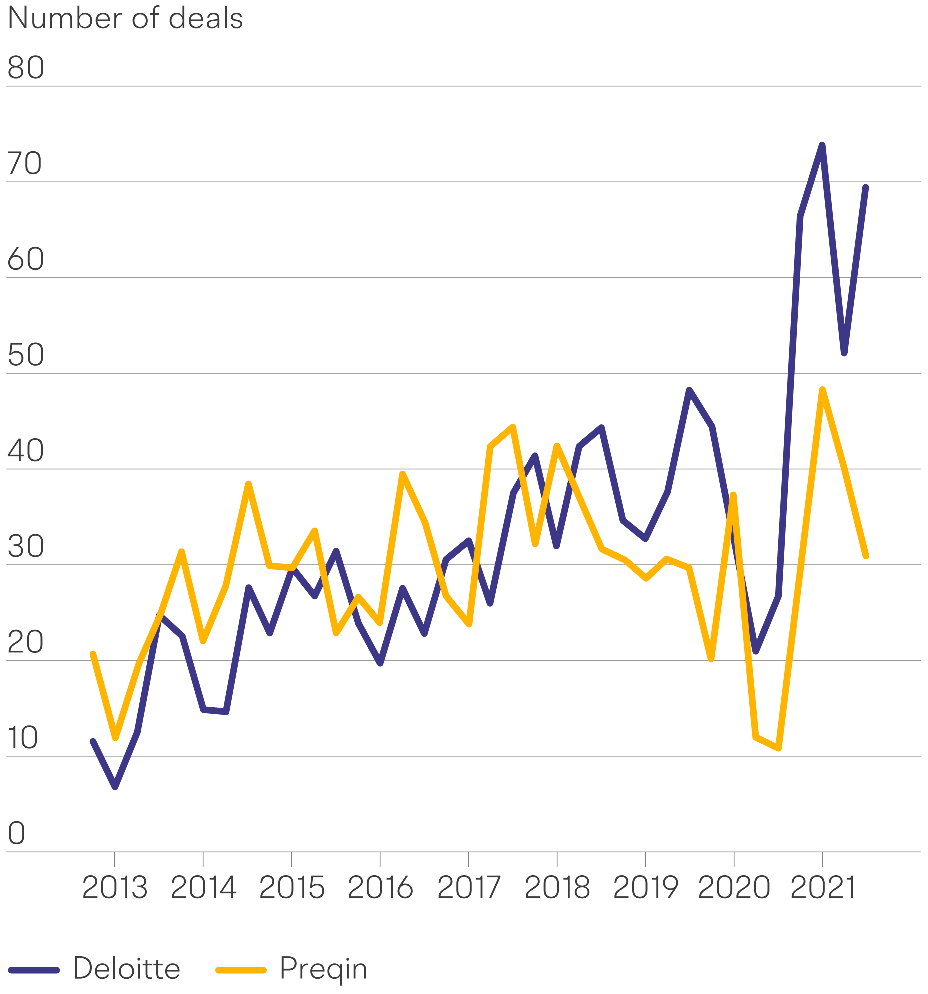
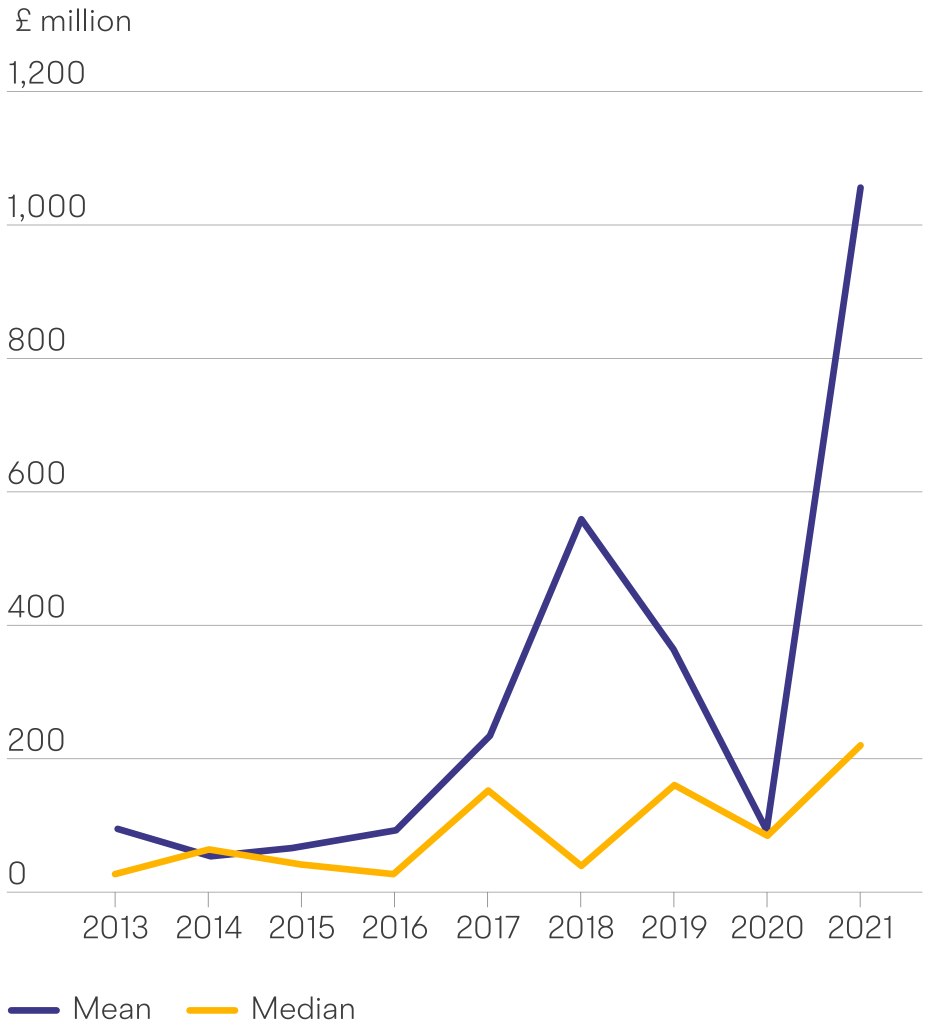


Figure B.46

Mean and median deal size of mid-market UK Private Debt deals per quarter, by deal size bracket

Source: British Business Bank analysis of Preqin



These data paint a clear picture of increasing consolidation of capital in much larger deals, at the expense of investment in smaller businesses. If this trend continues it could have consequences for smaller businesses looking to fuel growth through flexible debt solutions.[240]

After a decrease in 2020, investment by the Bank's Small-Cap private debt fund portfolio increased substantially in 2021

As mentioned above, both the Deloitte and Preqin datasets mostly cover mid-market deals with limited coverage of deals in SMEs and smaller mid-cap companies. Consequently, the Bank's Management Information on our Small-Cap private debt fund portfolio has been used to assess the extent to which these primarily mid-market findings translate into trends at the smaller end of the market.

Encouragingly, much like the mid-cap market, Bank MI shows an increase in Small-Cap private debt fund activity in 2021 following a difficult 2020. In the first three quarters of 2021, investment numbers increased by 18% while investment value grew by a rapid 137% compared to the same period last year. Both the number and value of deals are above pre-pandemic levels, which is a positive indicator after 2020's uncertainty (Figure B.47).

Whilst the amount raised by UK mid-market private debt remained strong in 2021, there was a significant decline in the number of funds closing with capital consolidating in large, established managers

2021 was another strong year for global private debt fundraising, with total assets-under-management (AUM) increasing by 17% to $1.2trn by September 2021. This puts private debt as the third largest alternative asset globally by AUM, behind only private equity and real estate. Although fewer private debt funds closed in 2021, overall fundraising was extremely strong due to a large increase in average fund size.[241]

Figure B.47

Total number and value of investments by British Business Bank Small-Cap Private Debt Funds, by quarter

Source: British Business Bank Management Information

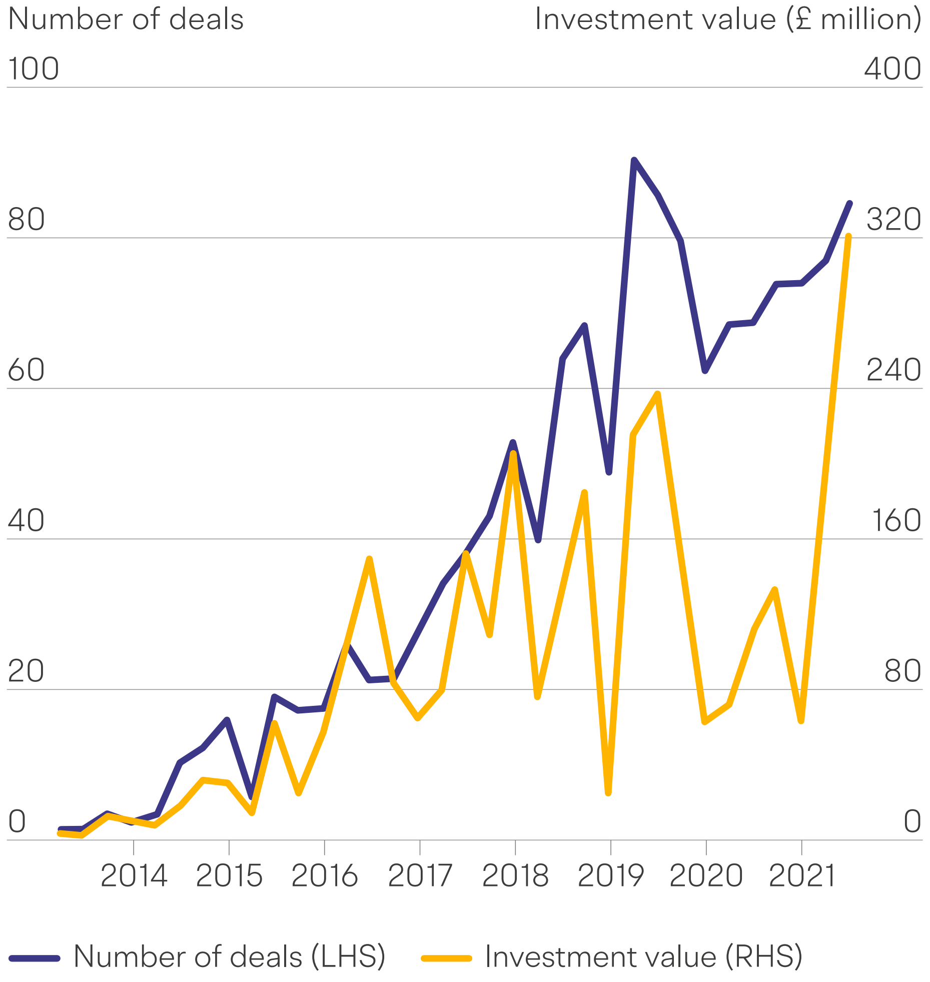


Figure B.48 shows that this trend of fewer, larger funds seen in global private debt markets applies to the UK too. In 2021, 22 UK-based private debt funds closed with a total size of £22bn. This compared to 29 funds closing worth £19bn in 2020.

While this is a 24% decline in the number of funds closing the increase in average size means that total fundraising was up 16%. Fewer UK-based private debt funds closed in 2021 than in any year since 2011, however £22bn represents the second highest annual fundraising total on Preqin's records. The UK has performed strongly compared to the rest of Europe, where the overall number and value of funds closing fell by 40% and 44% respectively.

As noted above, UK private debt funds are getting bigger. This trend has been long-lasting, taking the average fund size from £346m in 2013 to £1.3bn in 2021 (Figure B.49). Of the £22bn raised by UK-based private debt funds in 2021, 84% went to funds at least £1bn in size. Funds smaller than £250m, who are typically involved in SME investment, represented only 3% of all capital raised by UK-based private debt funds in 2021.

Figure B.48

Total number and value of UK-based Private Debt funds by vintage year

Source: British Business Bank analysis of Preqin

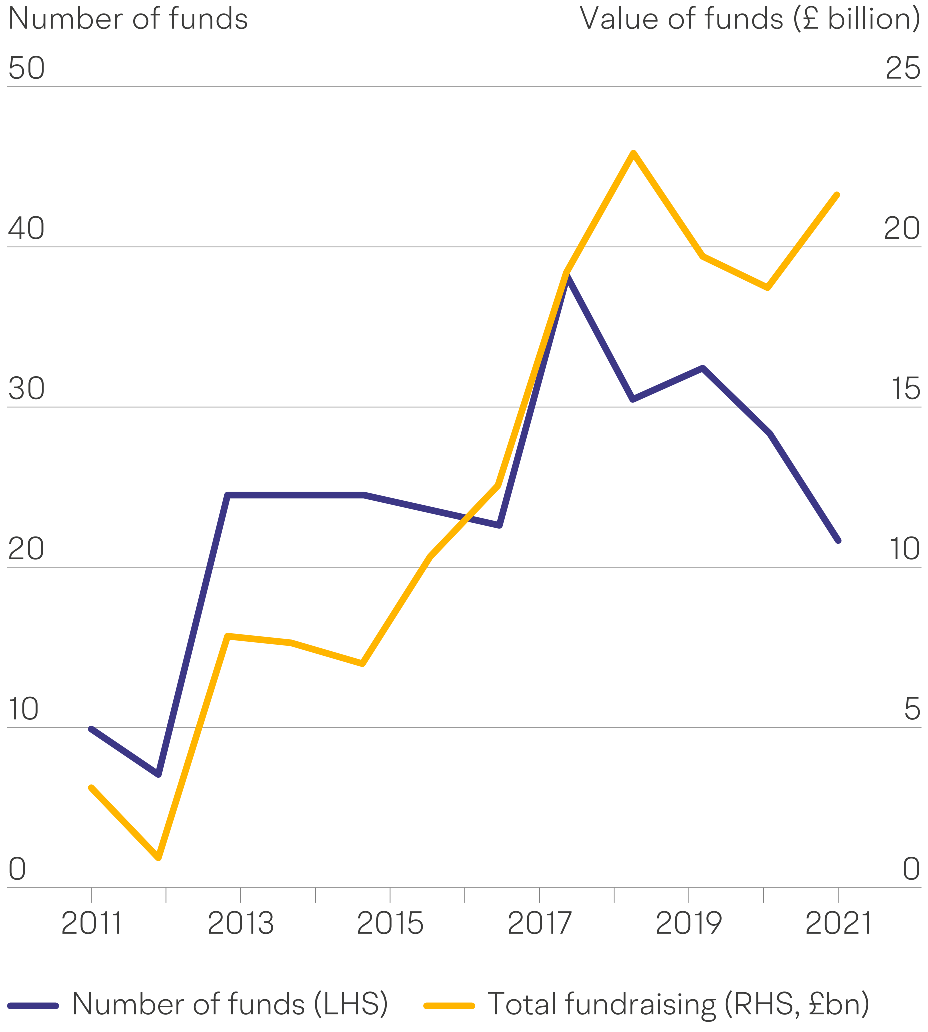
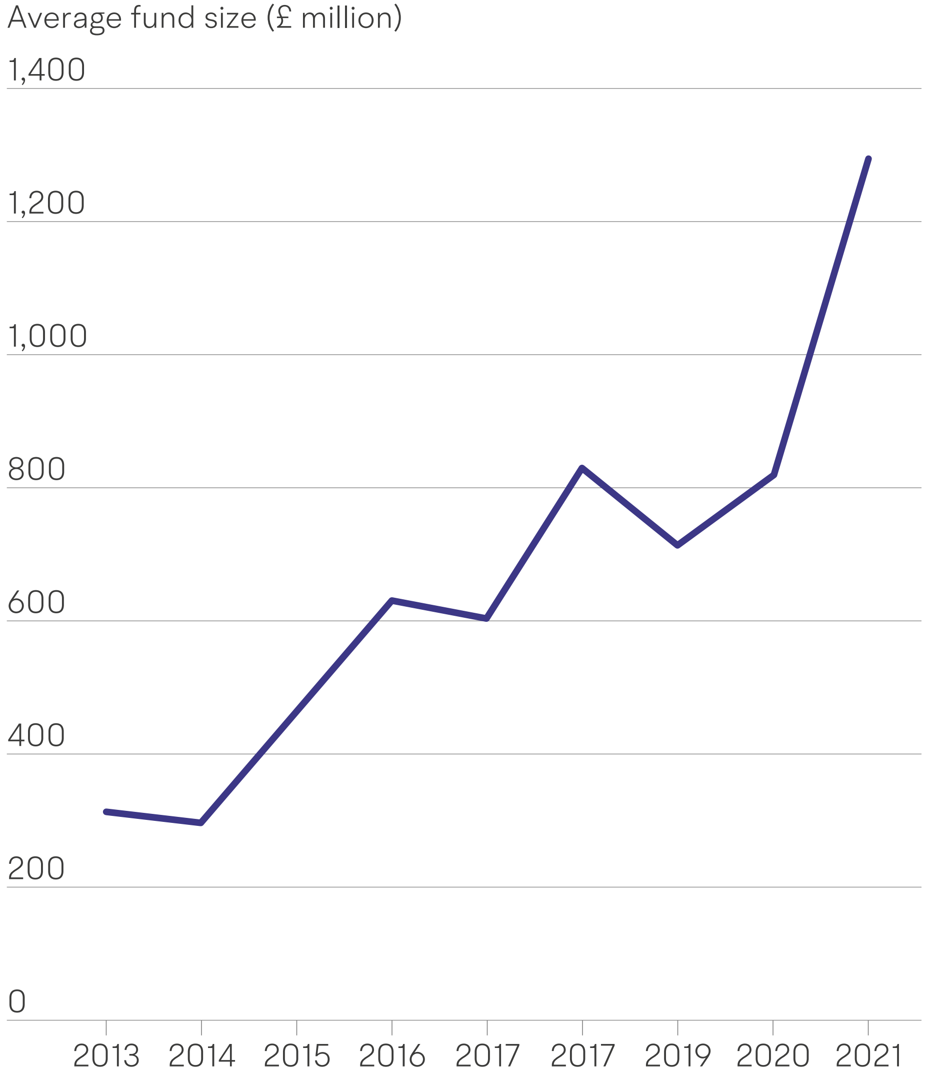


Figure B.49

Average size of UK-based Private Debt funds by year

Source: British Business Bank analysis of Preqin



Preqin notes that larger funds mean larger barriers to entry. This creates a problem for first time managers who represent a small minority of fund closures and a tiny minority of capital. In both 2020 and 2021, only five private debt funds were raised by first-time fund managers, the lowest totals since 2016.

First-time managers raised £436m collectively in 2021 which represents just 2% of all capital raised by UK-based private debt fund managers closing in the year. These trends are of particular concern to the British Business Bank, given our focus on smaller funds of typically less than £250m who concentrate on investment in SMEs.

As Limited Partners (LP's) increasingly look towards making larger investments in established managers, driven by the search for yield in a low interest rate environment, fundraising conditions for these SME-focused managers are likely to deteriorate with implications for the SMEs they support.

At this end of the market, the Bank's Investment Programme plays a pivotal role in anchoring smaller and emerging private debt fund managers. In 2021 the Investment Programme made five commitments worth £184m to such fund managers. In the absence of these smaller private debt funds, smaller businesses across the UK would not have access to the same form of flexible, growth-orientated, capital that larger companies can call on.

ESG-related activity ramped up in global debt markets in 2021, and early indications show ESG considerations are becoming increasingly important to UK private debt managers

As highlighted in section 1.1, smaller businesses represent roughly half of business-made carbon emissions, and finance, including private debt, could be an important instrument to reduce this. Survey evidence gathered by the Bank in 2021 highlighted that Environmental, Social and Governance (ESG) considerations are increasingly important for equity investors and Preqin data highlight a similar story in the private debt space.

Private debt actually has the highest rate of ESG commitment of any private asset class, with 49% of AUM in funds having an ESG commitment. This is substantially higher than asset classes such as private equity and real estate.[242] The Alternative Credit Council reports ESG considerations are most prevalent in Europe, with 88% of managers surveyed viewing them as integral to lending strategies.[243]

The bespoke nature of private debt deals presents an important opportunity for investors to steer recipient businesses toward ESG priorities. There are advantages for borrowers too who can access a flexible product suited to a wide range of investment needs.

Recognising these advantages on both sides, sustainability-linked loans (SLLs) have become an increasingly important instrument in global debt markets and could be a powerful tool in the transition to net zero. SLLs are loans in which Sustainability Performance Targets (SPTs), effectively KPI's relating to ESG criteria, are built into the loan agreement. If borrowers meet these SPTs, which could cover net carbon emissions or diversity of workforce for example, they are rewarded by the margin on the loan being reduced.

If KPIs are missed, or not reported against, they are penalised by loan margins being increased. According to Reorg, 40% of European syndicated leveraged loans originated in H1 2021 included this mechanism, which is known as an 'ESG margin ratchet'.[244] This demonstrates that ESG-linked features are becoming a priority for larger lenders.

The priority is rising among private debt managers too, especially in Europe. There were several high-profile SLLs originated by European private debt managers in 2021, including in the UK, where Ares announced a £1bn financing package for RSK Group with an ESG margin ratchet linked to the company reducing its carbon intensity and improving health and safety management.

Survey data from the Alternative Credit Council points to wider practice too. 18% of European private debt funds reported that it had become common practise to tie a borrower's ESG performance to its lending terms. A further 19% stated that they do this infrequently, and 18% were not currently doing so but had plans to in the future.[245]

The British Business Bank is committed to continue supporting SME private debt markets

UK private debt activity appears to have recovered robustly in 2021, with fundraising conditions also strong. There are, however, warning signs that capital is consolidating in larger, established fund managers at the cost of smaller funds. The longstanding structural issues which create barriers to entry for new fund managers look to be worsening, with LPs preferring to write fewer, larger cheques.

Smaller fund managers, and by extension the SMEs they invest in, may find it increasingly difficult to raise capital. For fund managers in this space, the Bank's Investment Programme continues to play a catalytic role, committing £184m across five funds in 2021. The Bank often cornerstones smaller private debt funds, writing substantial commitments which help leverage additional capital into the asset class.

The flexibility of private debt means it is well-suited to supporting smaller businesses from recovery into growth. Encouragingly, growth investments in SMEs appear to have picked up now that government guarantee schemes have become less dominant in the market. Private debt was critical for the US recovery from the Global Financial Crisis[246] and developments in recent years mean that UK funds are now well-placed to play a role in our current recovery.

2.10

Asset finance

- SME asset finance new business rebounded in 2021 to near pre-pandemic levels
- Supply chain issues and staff shortages have impacted some asset classes
- Alternative finance providers have maintained their higher share of new business compared to 2019
- Green asset finance continues to gain attention, but challenges remain

This section provides an update on developments in asset finance (leasing and hire purchase) markets in 2021, highlighting the rebound in the level of annual new business as the economy reopened following the Covid-19 lockdowns.

Asset finance continues to be the alternative finance instrument used by the largest proportion of smaller businesses surveyed in the Business Finance Survey (9% in 2021). However, this is below the 15% recorded 2017-2019 and, following the unprecedented uptake of government guaranteed loans, it has dropped from third to the fourth most used external finance type behind term loans, bank overdrafts and credit cards.

The asset finance market, through the provision of leasing and hire purchase, helps businesses invest in vehicles, equipment and plant and machinery. Leasing allows businesses to obtain new equipment by renting it for a contracted period without owning it. If a business wants to own the equipment at the end of the contract period, then hire purchase is the appropriate finance option. In both cases, businesses avoid paying the full cost of the equipment upfront, easing pressures on cash flow.

SME asset finance new business rebounded in 2021 to near pre-pandemic levels

The SME asset finance market reported an increase in new business of 25% in 2021 to £19.9 billion following a fall of 21% in 2020 to £16.0 billion. The recovery by this market during 2021 meant the annual new business level was only 1% below 2019, the pre-Covid peak (Figure B.50).

The recovery has not been smooth as further restrictions were introduced to deal with new waves of Covid-19 and global supply constraints led to shortages of equipment to finance in some sectors. In Q1 2021, SME asset finance new business grew by 5% reflecting the third UK lockdown during that quarter and the fact Covid-19 only really started to impact UK SME business finance markets in late Q1 2020.

As BBLS and CBILS closed for new applications and both the vaccination programme and the UK economy gathered pace in Q2 SME asset finance lending increased 96% on Q2 2020. This was unsurprising given the record falls in Q2 2020 as the UK went into the first of its lockdowns.

Q3 and Q4 saw further growth of 18% and 8% respectively compared to the same periods in 2020. This growth was despite the final quarter of 2021 being impacted by measures to deal with the Omicron variant.

As a key external finance type used for business investment the sluggish growth in this measure, driven largely by ongoing uncertainty around when life will return to normal and existing debt levels, in part explains why SME asset finance has yet to surpass 2019 levels.

After the global financial crisis it took seven years for business investment and asset finance to return to pre-crisis levels. The reduced business investment was seen as a key component of the UK's lagging productivity. Covid-19 led to a steeper fall in business investment but so far the rebound has also been quicker with the latest forecasts suggesting it will return to pre-covid levels in 2022.

These forecasts have been backed up by surveys in the second half of 2021. In Q3, the Bank of England's regional agents' assessment of business investment intentions rose to its highest level in 14 years. In addition, the share of businesses planning to invest in plant and machinery rose to the highest proportion in 33 years, according to a CBI survey.

Along with the need to refresh assets that have been neglected because of Brexit and pandemic uncertainties, the expected rebound in UK business investment is likely to be driven by the government super-deduction capital allowance. The super-deduction, which started in April 2021 and lasts until March 2023, will allow companies investing in qualifying new plant and machinery assets to cut their tax bill by up to 25p for every £1 they invest. It should be noted however, that leasing does not qualify for the super-deduction.

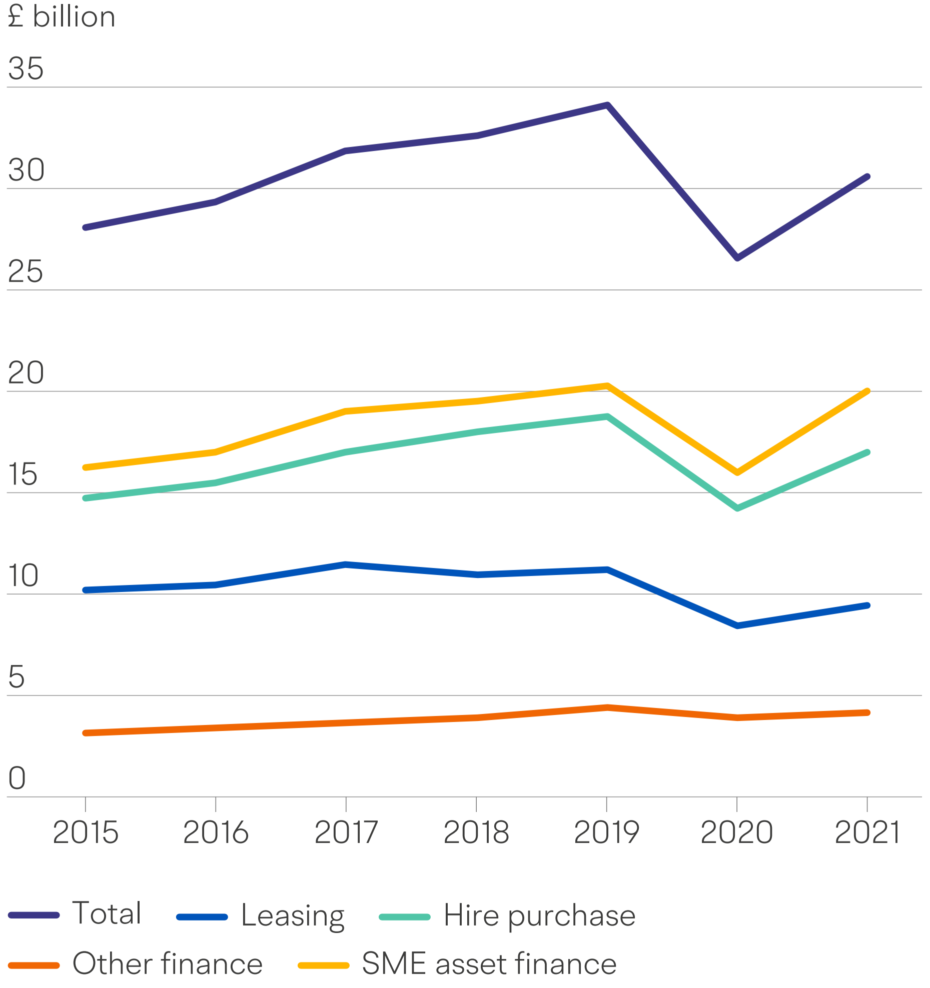
Most economists expect capital expenditure to grow at its fastest pace in years in 2022, but some are wary that the super-deduction will only bring forward some investment and not help create much new spending. Business investment is expected to grow by around 14-16% in 2022.

Figure B.50

Size of UK asset finance market for businesses, new business (a)

Source: Finance & Leasing Association (FLA)

a. Asset finance new business for deals of up to £20 million



Supply chain issues and staff shortages have impacted some asset classes

While for the most part the asset finance market has grown in 2021 certain assets and types of finance have not. For example, IT equipment finance, the most resilient asset finance class during the pandemic as people worked from home and employers upgraded systems, is the only asset type that has seen consistent falls in finance this year.

It has also been a mixed year for commercial vehicle finance. Latterly this has been driven by a semiconductor shortage. There was a 4% increase in respondents recording delayed investment for the transportation and storage industries because of the semiconductor shortage restricting the output of vehicles and the ability to invest.[247] Business investment in transport equipment fell in Q3 2021 and is now 56% below Q4 2019 levels.

Supply shortages in general have impacted not just vehicles but manufacturing too due to supply chain issues and staff shortages. This has reduced smaller businesses' ability to invest and in turn finance providers' ability to lend. How quickly these issues are resolved in 2022 will have significant ramifications for UK growth.

Alternative finance providers have maintained their higher share of new business compared to 2019

The asset finance market is a diverse marketplace that includes a significant number of alternative (non-bank) finance providers as well as traditional banks. As with some non-bank lenders from other finance markets, such as marketplace lenders, several non-bank asset finance providers gained accreditation for the covid loan schemes which supported their lending volumes in 2020 and 2021 and exposed them to potential new clients.

Figures from the FLA show that in 2019, a third of total SME asset finance new business (£6.7 billion) was provided by non-bank lenders (Figure B.51). While the value of new business provided by non-bank lenders fell in 2020, it fell by less than that from banks, increasing their share of total SME asset finance new business to 35.8% in 2020. In 2021 they have held on to nearly all of this extra share (34.9%) and non-bank written new business (£7bn) has already surpassed pre-pandemic levels while new business written by banks is still 3.6% below that recorded in 2019.

The increase in share for alternative lenders was achieved despite the funding challenges many faced during 2020. The main source of funding for most alternative finance providers is wholesale funding markets which were severely disrupted at the onset of the pandemic, delaying their ability to lend, even via the covid loan schemes, in the first half of 2020. Despite the resilience shown by alternative lenders concerns remain that if wholesale markets are once again disrupted it would further impact alternative finance providers' ability to support SMEs.

Figure B.51

Bank and non-bank split of SME asset finance provided by FLA members (£bn), new business (a)

Source: Finance & Leasing Association (FLA)
a. Asset finance new business for deals of up to £20 million

	2019	2020	2021
Bank	13.44	10.27	12.98
Non-bank	6.75	5.73	6.95
Total	**20.19**	**15.99**	**19.93**

Green asset finance continues to gain attention, but challenges remain

Where access to finance is required, asset finance will be key to achieving net zero targets for UK businesses given its important role in funding business investment. There has been much discussion around how exactly to achieve this with industry bodies such as the FLA releasing a 'Green Manifesto'.[248] Despite this, there are still challenges to overcome.

One of the biggest challenges for asset finance providers is the elevated risk attached to many green goods. They are often new to the market and pricing their lifespan, depreciation or obsolescence can be difficult. On this latter point of obsolescence, for many technologies not only are they new but it is still not clear in some cases what will be the dominant technology.

Ordinarily these risks would diminish over time as the market develops but, with the timeframe the government has set to achieve net zero and the increased awareness amongst the public of the environmental challenges we face, this is less likely to happen before significant investments have already been made.

Several asset finance providers have already launched products designed to increase SME usage of electric vehicles while others have partnered with local authorities to support their green initiatives. For example, Shire Leasing and Haydock Finance have been appointed financiers on Greater Manchester's Clean Air Financial Support Scheme (FSS).

Eligible SMEs will be able to use their funding award directly with Haydock or Shire Leasing to arrange finance to help upgrade non-compliant vehicles to lower emission vehicles ahead of the charging Clean Air Zone being introduced in Spring 2022. The FSS will offer eligible owners of a non-compliant vehicle the option of either a lump sum grant, subsidised finance, or a combination of the two to support upgrading to a compliant vehicle.

A second challenge has been around definitions and measurements including what exactly counts as a green good or investment and how to measure environmental impacts. For example, there are no industry or government definitions for measuring carbon footprints for lenders or SMEs to follow to be net zero compliant. Perhaps as a result, our **"Smaller businesses and the transition to net zero"** report found that only 6% of SMEs we surveyed measured their carbon footprint.

Despite these challenges many asset finance lenders are already taking steps and not just with financing green assets, such as the previously mentioned electric vehicles, but also making more environmentally friendly use of existing assets. This latter idea incorporates approaches such as 'Product-as-a-Service,' in other words suppliers retain their assets and shift more to selling the outcome their goods can provide.

The key challenge to make this approach green is what happens to equipment after its first use, when traditionally it would enter the used market to be replaced by a new asset. Using circular economy principles, equipment would be refurbished and repaired and the leasing process would begin again, perhaps at a new price point to reflect age and condition. This would be repeated until there was no economic value in the equipment, at which point its components would be broken down and recycled into a new product.

Asset finance clearly has a huge role to play in both the recovery of UK business investment and achieving net zero targets. As such the British Business Bank will continue to support asset finance providers via products such as ENABLE Funding and the Investment Programme.

2.11

Invoice and asset-based lending

- The value of advances to SMEs has started to recover in 2021 but remains well below pre-pandemic levels
- The number of SMEs using invoice finance and asset-based lending continues to fall but this appears to be slowing
- Invoice finance and asset-based lending can be utilised alongside debt products and there remains significant available funding for SMEs

Invoice finance and asset-based lending (IF/ABL) is a term used to describe funding against a range of business assets including accounts receivables (the debts owed to a business by its business customers, often represented by its invoices), stock and inventory, plant and machinery, real estate and even (sometimes) intellectual property and brands. In various forms, the principles underpinning invoice finance and asset-based lending have enabled funding to British businesses for centuries.

The value of advances to SMEs has started to recover in 2021 but remains well below pre-pandemic levels

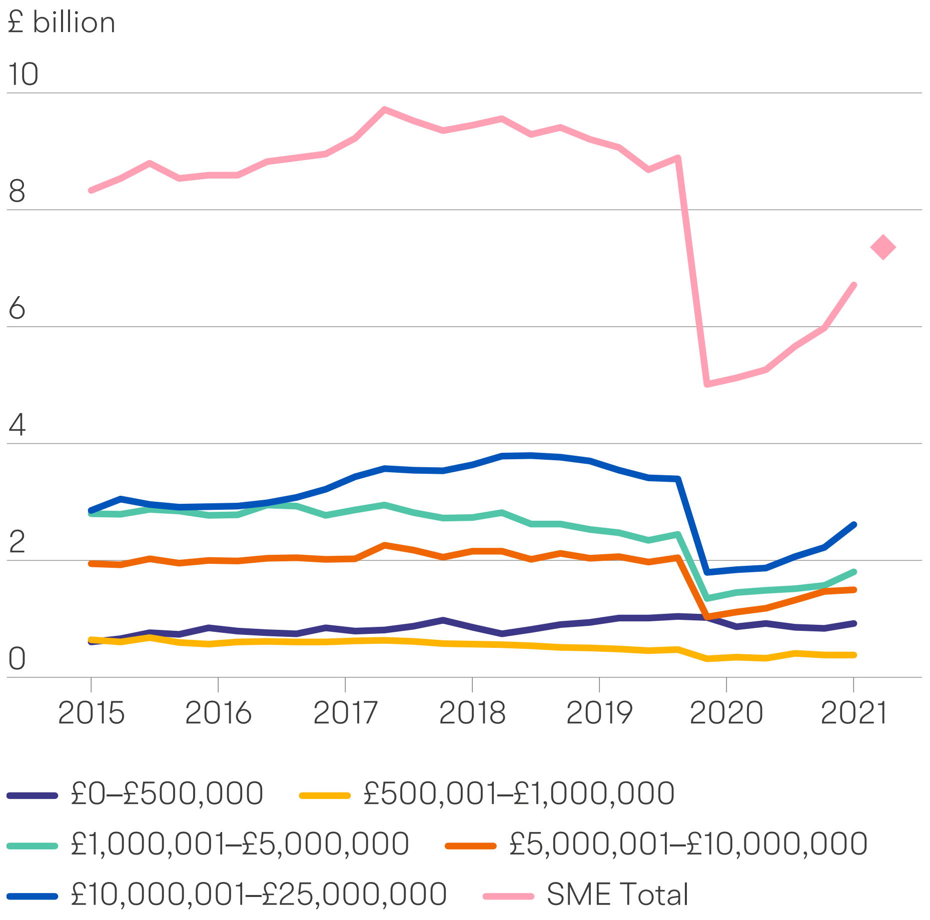
As the UK economy has begun to recover, so has demand for funding through invoice finance and asset-based lending. 2020 saw muted demand for nearly all forms of finance with many SMEs' external funding requirements being met through government-backed schemes or otherwise significantly reduced by other forms of government support. However, early estimates for 2021 suggest outstanding quarterly values of IF/ABL increased steadily throughout the year to end around 37% above Q4 2020 levels, albeit still 18% below Q4 2019 (Figure B.52).

Looking at the end of quarter balances, the increase seen in Q3 2021 of 13% was the fifth in a row and the strongest since the record fall of 44% in Q2 2020. However, at the end of Q3 advance levels remained 25% below the Q1 2020 figure. Early indicators suggest this strong recovery continued through to the end of the 2021, with outstanding balances at the end of Q4 estimated to have grown a further 6.8%.

Figure B.52

Quarterly advances of invoice and asset-based lending, by size cohort

Source: British Business Bank analysis of UK Finance data
Notes: 2021 Q4 data is a UK Finance estimate projected from monthly figures supplied by a representative sample of UK Finance's IF/ABL members.



The three largest business-size cohorts have all experienced five consecutive quarters of growth too. However, the two smallest business-size cohorts have experienced more volatile advance levels with both recording three negative quarters and only two positive ones since the across-the-board falls in advances in Q2 2020.

Despite this, advances to the smallest SMEs were only 13% down as of Q3 2021 compared to 2020 Q1 while for the other cohorts this ranged from 24% to 28%. This reflects the fact advances fell by a lot less to the smallest businesses compared to the other cohorts during the pandemic.

Average advances have bounced back quicker than total values, reflecting the reduction in client numbers. By Q3, average advances were only 16% down on Q1 2020 having fallen 43% in Q2 2020, in line with the fall in the total value of advances. This rebound in 2021 is seen across all firm sizes except for the £0.5m to £1m cohort which has continued to fall in Q2 and Q3 (Figure B.53).

Despite this, the same cohort has seen the greatest increase since the end of 2020 (43%). In comparison, the smallest cohort has seen the smallest increase since the start of the year at only 4.2% but again this likely reflects the fact this was the cohort that fell the least from pre-pandemic levels. The smallest firms are now only 7% down on Q1 2020 average advances while the rest range from 12% (£0.5-1m) to 21% (£5-10m) down.

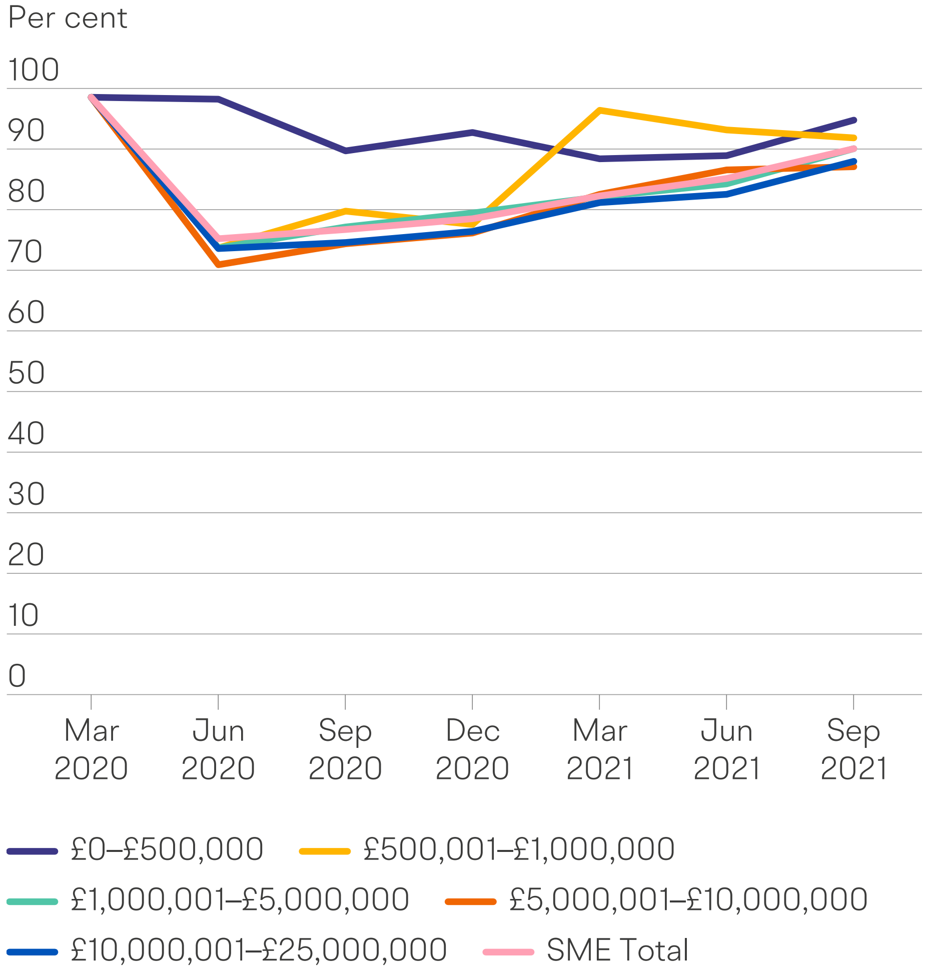
The number of SMEs using invoice finance and asset-based lending continued to fall but this appears to be slowing

In contrast to the recovering advance levels, the reduction in the number of IF/ABL SME clients since the start of the pandemic has continued. In Q3 2021 this stood at just below 33,000, down 4.2% compared to the end of 2020 and 12% down from the end of 2019. In Q3 2021 four of our five size cohorts ranged from 3% to 9% down on Q4 2020, but the largest cohort (£10m-£25m) was up 5%, seemingly reverting to the pre-pandemic trend for IF/ABL products to be utilised by larger and more established businesses.

Figure B.53

Quarterly average advances of invoice and asset-based lending as a percentage of Q1 2020 values, by size cohort

Source: British Business Bank analysis of UK Finance data



Looking at the quarterly outcomes there are signs the general fall in SME clients is slowing. Q2 saw the slowest reduction in SME client numbers since the onset of the pandemic, with two out of the five cohorts growing. This was followed in Q3 2021 by the first increase (0.6%) in the number of SMEs utilising IF/ABL in three years. The Q3 increase was seen across all size cohorts except for the very smallest which fell for the second quarter in a row. Early UK Finance estimates suggest this cautious recovery in numbers held broadly steady in Q4.

The reduction in client numbers over the last couple of years appears to have been driven by lower new customer acquisition. This is likely to be in part a result of the availability of government-backed lending during the pandemic period. There is usually significant churn within the business population using IF/ABL products and the declines seen in 2020 and 2021 have been driven by a reduction in numbers of incoming 'replacement' client businesses.

This has been particularly the case amongst the smallest cohort of businesses. Bucking this trend though, UK Finance reports that the number of clients in construction and transport have recovered to levels last reported at the end of 2019. There is, however, still some way to go to return to pre-pandemic client levels overall.

Invoice finance and asset-based lending products can be utilised alongside debt products and there remains significant available funding for SMEs

The uptick in IF/ABL values essentially front-running the UK's general economic recovery is unsurprising given the nature of the products in releasing working capital at the point invoices are generated rather than when paid by the end-client. Furthermore, it is an excellent funding tool for SMEs looking to generate working capital without shortening payments terms to their customers, flexing their own suppliers, or taking on additional debt. This latter point is particularly important given the record levels of debt taken on by UK SMEs during the pandemic.

Importantly, UK Finance figures show that a large part of agreed facilities are still available suggesting room for SMEs to ramp up use of IF/ABL as the economy recovers. For current SME client businesses, UK Finance estimated there was around £3.5bn of additional funding available. Data is not currently available breaking down utilisation by client-size but UK Finance estimates that these client businesses will be utilising no more than 65% of their current facilities. This would compare to 75% to 80% utilisation pre-pandemic. It is unlikely this will be evenly split between size cohorts though, with the level of average advances to the smallest SMEs suggesting that utilisation will be higher for this cohort of businesses compared to larger SMEs.

2.12

Alternative finance

- Alternative finance has regained some of the ground lost in 2020
- Marketplace lenders continue to evolve
- Balance sheet business lenders offer a wide range of solutions
- Open banking and embedded finance have increased the opportunities and options for alternative lenders and smaller businesses
- Big Tech is looking to use proprietary data to help finance SMEs on their platforms

This section covers the role alternative finance providers play in UK smaller business finance markets. Most alternative finance providers, with a few notable exceptions, do not compete with the traditional banks but complement their offerings.

As such they have not only increased the options available to SMEs but have also increased the accessibility and appropriateness of finance available.

The SME lending landscape has changed substantially since the Global Financial Crisis (GFC), significantly reducing the biggest four lenders' share of SME lending which had stood at around 90% at the end of the crisis.[249] Post-GFC, alternative finance providers, defined as non-bank providers of products such as asset finance, invoice finance, term loans, cashflow loans, venture debt and private debt greatly increased their share of SME finance markets. This has been achieved not only by attracting businesses traditionally served by high street banks but also by being able to offer services to viable SMEs that were previously unable to access funding at all.

Alternative finance has regained some of the ground lost in 2020

By 2019, EY estimated 30% of SME finance was being supplied by non-bank lenders.[250] Furthermore, challenger banks and specialist banks had also eroded the market share of the biggest banks and when combined Innovate Finance estimated alternative lenders and challenger banks were responsible for 65% of SME lending in 2019.[251] However, this trend was reversed by the Covid-19 pandemic and the unprecedented government interventions put in place to support businesses during the economic downturn that followed.

In last year's SBFM we showed that the split between big bank and smaller bank lending had skewed heavily back in the favour of the big banks. Challenger and specialist banks' share of total gross lending fell to 32% in 2020 from 48% in the previous year, the lowest level on record. In addition, many alternative finance markets shrank significantly. As a result, Innovate Finance estimated that alternative lenders and challenger banks were responsible for only 44% of SME lending in 2020.

2021 has seen something of a return to the pre-pandemic trend as government schemes became less dominant after Q1 and market-based lending began to increase again. As discussed in earlier sections, challenger banks have regained the market share they had pre-pandemic while both asset finance and invoice and asset-based lending have grown in 2021.

Marketplace lenders continue to evolve

Marketplace lending was still relatively new when the Covid-19 pandemic temporarily closed the UK economy. Unsurprisingly, the sector has seen huge changes over the last 18 months as a result. During this period, we have seen marketplace lenders (MPLs) exiting the market, amending both funding and lending models and agreeing partnerships.

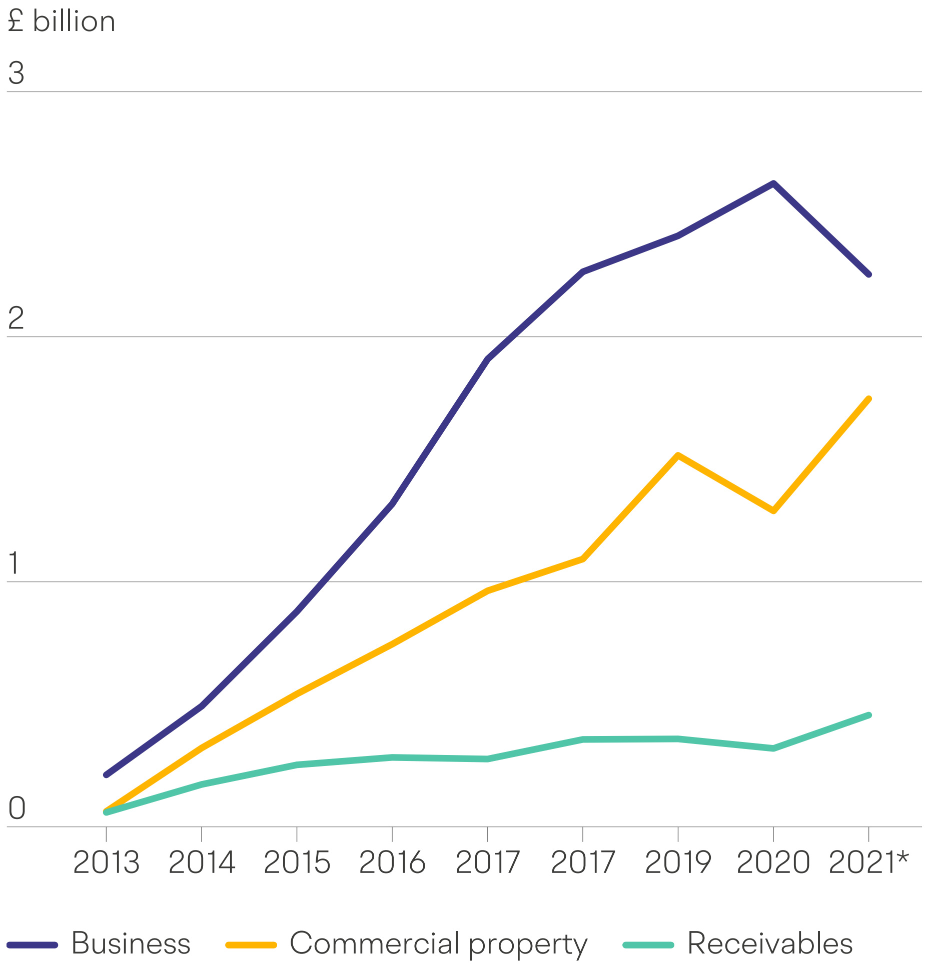
As discussed in the last SBFM, the early months of the Covid-19 pandemic proved a real challenge for many alternative finance providers.[252] This has been particularly the case for marketplace lenders. Despite this, our measure of the value of business lending from finance providers who prior to the pandemic lent using peer-to-peer or marketplace lending models increased to £2.6bn in 2020, up 6.5% from £2.4bn in 2019 (Figure B.54). Other forms of commercial marketplace lending fared less well with both receivables and property finance via MPLs decreasing.

Figure B.54

Gross marketplace lending, split by type

Source: British Business Bank analysis of finance provider submissions and public filings

Note: 2021 data is only partial, several finance providers are yet to publish 2021 full year data.



While total business lending volumes increased, this was largely driven by some MPLs lending significant volumes via CBILS and BBLS as SMEs utilised government backed schemes rather than their usual finance sources. Excluding government guaranteed lending, MPLs' volumes fell significantly in 2020 with several temporarily stopping lending either at all or outside of the government schemes.

While some of our basket of MPLs have not released their 2021 full year business lending numbers yet, the data that is available at the time of writing suggest origination levels will be similar to 2020 if not higher. This is despite CBILS and BBLS closing to new applicants in March suggesting a return to more market-based lending. Furthermore, both receivables and property lending has bounced back above 2019 levels.

How similar this lending is to the MPLs' pre-pandemic approach is less obvious as of yet. At the onset of the pandemic, many lenders saw retail investors withdraw from the market. Furthermore, Covid scheme participation and both actual and potential FCA rule changes led some MPLs to adopt a range of different approaches and structures reliant on institutional rather than retail funding. How much this will persist is still unclear. For example, Funding Circle have announced a June 2022 review on whether to re-open to retail investors.

What is clear though is that MPLs have continued to explore new products, such as Funding Circle's payment finance product, and new partnerships. For most, the increased exposure to big institutional funders that was accelerated by the Covid schemes has aided this process. 2020 and 2021 saw several MPLs enter origination or referral partnerships with banks to better match lending appetite, funding and customer bases.[253,254,255,256]

A report by Lloyds Bank suggests this is a trend that may well continue. It found more UK banks are targeting collaboration with or acquisitions of FinTech firms to strengthen their position in the growing market. 46% of financial services firms said they intend to grow investment in their FinTech capability through acquisition and partnering over the next year, up from 32% in 2020. Developing new products and services was the biggest driver of companies' FinTech plans at 66%, followed by improving client experiences and driving growth at 53% and 49% respectively.

Balance sheet business lenders offer a wide range of solutions

Unlike marketplace lending, these lenders assume balance sheet risk themselves and seek to make a profit in the margin between the rates they take on their own debt, and the loan rates they offer to businesses.

Balance sheet lending covers a spectrum of models including direct lending models, merchant cash advance lending and even R&D tax credit loans. Direct lenders include companies such as iwoca who have raised debt capital and offer easy-to-access or highly flexible loan products for smaller businesses, some of which the banks are more reluctant to lend to.

Merchant cash advance models of lending are popular with independent high street shops and businesses which use card terminals to receive payments with the data from the terminals providing evidence to make cash advance decisions on. Upfront loans are made to the businesses with repayments based on a proportion of all payments made through the terminals. During the pandemic and the resulting lockdowns many of these businesses were unable to operate but as the lockdowns eased this approach has bounced back.

Merchant cash advance products have been offered by companies such as Liberis and YouLend for some time while more and more finance providers are exploring the market including recent offerings from the likes of iwoca. They are available to businesses that have been in operation for as little as four months as long as they are taking a minimum monthly amount via credit or debit card. This means they are often available to newer businesses, who usually struggle to access traditional sources of finance, to help with cashflow and growth plans early in their journeys.

R&D tax credit loans are aimed at innovative businesses. SMEs undertaking eligible R&D activities may claim up to 33% of the expenditure as a cash tax credit from HMRC. They can be a valuable source of cash for businesses to invest in accelerating their R&D, hiring new staff and ultimately growing.

An R&D tax credit loan allows a company to use its future R&D tax credit payments as collateral for a loan. These funds are often accessible within a couple of weeks as opposed to potentially waiting many months to claim and receive the money from HMRC.

Data from the Cambridge Centre for Alternative Finance suggests balance sheet business lending decreased by around 25% in 2020 from 2019, in line with other alternative finance types. However, market contacts report that balance sheet lending volumes increased in 2021, with some noting near 2019 levels later in the year.

Open banking and embedded finance have increased the opportunities and options for alternative lenders and smaller businesses.

Since 2018, Open Banking has enabled SMEs to share their current account information securely with third party providers. The Open Banking ecosystem in the UK now comprises of more than 330 regulated firms made up of over 230 third party providers of services and more than 90 payment account service providers who together account for over 95% of current accounts.[257] It is estimated that half the UK's small businesses now use services powered by open banking technology.

Open Banking and digitalisation in general have also sped up the development of standardised APIs. These allow businesses to talk to each other, regardless of the different software they are running. This in turn is allowing for a lot more embedded finance to be offered. Embedded finance is the use of financial tools or services, such as lending or payment processing, by a non-financial provider.

Embedded finance aims to make accessing finance as seamless as possible for customers, allowing them to access it where and when they need to rather than having to go to a physical bank or search out other online options. The acceleration in embedded finance has in part been driven by customer expectations. This has heightened during the pandemic as more aspects of our lives have moved online. For smaller businesses this is not just about convenience. For many there are operational efficiencies and cost savings that can be achieved.

For the finance providers, not only can embedded finance give them access to a greater number of potential customers, but they can also use the data they gain access to to make credit decisions and to tailor their apps and services to SMEs' specific financial circumstances in much the same way Open Banking can. This is particularly important at a time when more and more smaller businesses no longer fit the standard profile for traditional finance.

Big Tech is looking to use proprietary data to help finance SMEs on their platforms

The eCommerce boom created millions of small businesses all over the world. Many of these businesses are reliant on third-party companies to market and distribute their products, or manage their payments. As many of these small businesses are young, lack assets or a track record, they can struggle to access mainstream forms of business finance. Furthermore, because they are often business to consumer rather than business to business, they cannot utilise invoice finance products to generate cashflow.

New solutions have started to appear, however. The same third-party companies they rely on for their operation are in a unique position to collect data that can be used to predict the ability of a small business to repay short-term credit. They are also in a unique position to collect credit repayments from the small businesses at point of sale, much the same way more established merchant cash advance finance providers do.

As a result companies like PayPal, eBay and Amazon have entered into the SME lending market. PayPal's business loan is called PayPal Working Capital and is offered to merchants selling over eBay and taking payments via PayPal. When making a lending decision, PayPal can review and verify all incoming payments made via PayPal to judge credit worthiness. When collecting the debt, they can take payments directly from the incoming sales revenue.

eBay also launched their Capital for eBay Business Sellers (CEBS) in May 2021. CEBS offers a variety of financing products to support the 300,000 small and medium sized businesses that sell via eBay. This is done via three different lenders, each with a different offer, with loans available from £500 to £5m.

As CEBS is integrated into eBay, lenders can assess the business applying using past performance as a basis for lending. Businesses are eligible if they have been trading actively for more than 3 months and are making more than £500 in monthly sales with eBay saying that 90% of businesses receive confirmation and the funds on the very same day they accept an offer. In the first 3 months, 2,700 small businesses were approved for £25m in loans.

Despite the pandemic and the economic shock it has created, UK SME finance remains an attractive market for many alternative finance providers, be they start-ups or tech giants. These finance providers have shown themselves to be resilient, innovative and vital to large swathes of smaller businesses that struggle to access traditional lending, even during more settled economic times.

As the economy continues to recover and smaller businesses and lenders alike transition back to commercial lending, the British Business Bank will continue to support alternative finance providers via products such as ENABLE Funding and the Investment Programme to further enrich the options available to UK smaller businesses.

Box: Brokers have benefited both smaller businesses and lender diversity

- Broker activity grew in 2021 as market-based lending levels increased
- Brokers are an important source of business for alternative finance providers
- Smaller businesses are more price focused when dealing with brokers

A commercial finance broker aims to match a business to a lender. Through their knowledge and expertise, they will match a borrower's requirements with the most appropriate lender operating in the market. Smaller businesses who have either been unsuccessful in finding the funding they want when approaching a lender direct or who do not have the time or financial confidence can instead tap into the expertise of the broker.

The data in this section comes from the National Association of Commercial Finance Brokers (NACFB) and their 2021 broker survey.[258] The NACFB is the UK representative body with 1,033 member firms employing 2,030 brokers which they estimate represents around 75% of the market. NACFB members are active all over the UK and in 2021 reported that the busiest regions were the East Midlands, followed by London and the East of England.

Broker activity grew in 2021 as market-based lending levels increased

Finance facilitated by brokers increased strongly in 2021 reaching £40.9bn, up from £26.7bn in 2020 (Figure 1), an increase of just over 50%. However, the NACFB have changed their methodology in 2021, increasing the range of value answers that brokers can give when responding to the survey. The previous ranges likely reduced the 2020 number, potentially by around 25%, though it is impossible to be sure.

Figure 1

Broker lending by product type, £bn

Source: National Association of Commercial Finance Brokers

Type of finance	2021	2020
Buy-to-Let finance	7.4	2.3
Cashflow	0.2	0.6
Commercial mortgages	10.9	7.2
Development finance	6.2	5.5
Factoring and invoice finance	1.4	1.1
Leasing and asset finance	9.3	7.5
M&A finance	0.1	-
Short-term and bridging loans	2.1	1.9
Unsecured finance	3.4	0.7
Total	**40.9**	**26.8**

This increase above the methodological change reflects the returning prominence of market-based lending and the ending of the Bounce Back Loan Scheme (BBLS). While brokers played an active role in helping smaller businesses access the Coronavirus Business Interruption Loan Scheme (CBILS) in 2020 (£6.1bn), the majority of SME lending in 2020 came via BBLS which NACFB member brokers had no involvement in. 2021 has seen many market-based lending markets start to recover though new business levels still remain below pre-pandemic levels.

The largest amounts of finance were mostly facilitated in sectors linked to property. Commercial mortgages, buy-to-let and development finance accounted for £24.5bn on their own, 60% of the total 2021 figure. The two non-property linked sectors in the top five were leasing and asset finance, which was the second largest sector, and unsecured finance. Combined, these two sectors accounted for £12.7bn, just under a third of the total. Unsecured finance facilitated grew over 400% and given the low value in 2020 is likely to be entirely down to the BBLS ending and smaller businesses returning to market-based finance for unsecured lending.

The survey also asks why lenders said no in 2021. 29% of lenders said no because they felt the sector was too risky. 25% said no because the SME fell outside the lenders criteria, while poor credit history was the third most common response (17%). This compares with 50% saying it was because the sector was deemed as being too risky in 2020 suggesting lenders are now taking less of a blanket view on certain sectors. Despite this, the survey still gives a strong steer as to which sectors are most frequently deemed too risky with hospitality (45%) and retail (31%) far ahead of third placed commercial property (8%).

Brokers are an important source of business for alternative finance providers

Brokers started to proliferate in the asset finance market in the late 1980s as the large banks started to cut costs and reduce sales staff. Many of those let go became independent brokers, utilising their contacts and years of experience to continue to serve the very same businesses.

In 2021 asset finance specialists remain the second largest subgroup of brokers (22%) within the NACFB membership with commercial mortgage specialists the largest (34%). The Finance and Leasing Association figures show that 22.2% of new asset finance business under £20m was via brokers in 2021, this was up from 21.0% in 2020. The FLA first published the channel split of data in 2015 (16.7%) and the broker introduced channel as a proportion of the total has increased every year since.

After the Global Financial Crisis and the push to increase competition in the banking sector in the UK, the arrival of new challenger and specialist banks created a further avenue for brokers to explore with many of these new banks only dealing with smaller businesses via brokers.

Despite the challenges faced by many finance providers, and alternative lenders in particular during the pandemic, the average size of NACFB member brokers' panels increased in both 2020 (106) and 2021 (117), up from 101 in 2019. While this suggests increasing diversity in both SME finance markets and what brokers are able to offer clients, we are not able to tell from the data available what percentage of these panels were actively lending during these years.

Smaller businesses are more price focused when dealing with brokers

Our Business Finance survey asks SMEs not using a broker for the reason they chose a particular finance provider. Smaller businesses most often report a previous relationship with a lender or a trusted brand as important factors (32% and 18% respectively in 2021) with only 8% mentioning price. This likely reflects the need to be confident with who they are applying to for finance above all else when going direct to a lender.

However, according the NACFB survey, the most common reason given for why broker clients choose a finance provider was that it was the lowest price with 44%. A previous positive experience with the lender was only third with 11%. This suggests the businesses are gaining the reassurance they seek when going direct from going via a broker and are more willing to consider a range of lenders or products. Perhaps backing up the suggestion smaller businesses take comfort from the broker relationship, 50% of broker business in 2021 was from returning customers.

Endnotes

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3. Ethnic Minority-led refers to firms owned, managed or led solely by, or by a majority of individuals identifying as being from an Ethnic Minority background. Female-led firms are owned, managed, or led solely by, or by a majority of, females.
4. Don't know/refused responses to ethnicity of leadership questions were excluded from analysis of the SME Finance Monitor (19%).
5. A more detailed discussion of how these factors affect the experience of entrepreneurs identifying as female and/or being from an Ethnic Minority background available here: British Business Bank (2020) Alone, Together.
6. BVA BDRC SME Finance Monitor, 10 quarters to Q2 2021.
7. ONS (2020), A09: Labour market status by ethnic group and gender.
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83. For example, postcode areas in the top decile for average lending stocks between 2016 and 2021 had levels per registered SME around 2 times greater than the bottom decile. For equity postcode areas in the top decile had received around 70 times more investment per registered SME than the bottom decile between 2016 and 2021. Source British Business Bank analysis of UK Finance, Beauhurst and ONS data.
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91. https://sifted.eu/articles/uk-tech-2022/
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126. BCC Impact Tracker April 2020.
127. Bounce Back Loan (BBLS), Coronavirus Business Interruption Loan Scheme (CBILS), and Coronavirus Large Business Interruption Loan Scheme (CLBILS).
128. The average value of gross SME lending over any April to March period between 2016 to 2019 was c.£58bn. This rose to c.£105bn when covid loan schemes were in effect between April 2020 to March 2021. The value of "excess debt" taken on by SMEs during the pandemic, therefore, can be estimated as c.£47bn. Bank of England data used in this analysis define SMEs as businesses earning less than £25m.
129. Responses in this category also includes 'Don't Know' and 'used grants'.
130. As explored in last year's SBFM : Hotels/Restaurants, Transport, and Wholesale/Retail SMEs experienced some of the largest declines in annual turnover by Autumn 2020.
131. BEIS Business Population statistics 2021.
132. As explored in last year's SBFM: Hotels/Restaurants, Transport, and Wholesale/Retail SMEs experienced some of the largest declines in annual turnover by Autumn 2020.
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139. Similarly, the December BFS report found that 21% of SMEs are either very concerned or fairly concerned about debt repayments.
140. Based on responses to this specific question.
141. British Business Bank analysis of SME FM businesses using external finance, average facility size, and repayment concern rates for 21Q2 and 20Q2.
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146. Business insights and impact on the UK economy, https://www.ons.gov.uk/businessindustryandtrade/business/businessservices/bulletins/businessinsightsandimpactontheukeconomy/latest
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148. Their dataset contains 2.2 million UK businesses tracked over an 18-month period including firms of all sizes, from SMEs to large corporations.
149. Business Finance Survey 2021 – the share varies between 16% to 25% depending on whether undrawn facilities are excluded or included.
150. BEIS business population estimates 2021 https://www.gov.uk/government/statistics/business-population-estimates-2021
151. ONS business demography https://www.ons.gov.uk/businessindustryandtrade/business/
152. BEIS business population estimates 2021.
153. All individuals starting up or ceasing trading have to notify HMRC, for example to meet mandatory requirements for paying tax via self-assessment, but there is no obligation to formally register the firm on start up or closure at Companies House.
154. Registered firms have formally notified relevant authorities to comply with their legal obligations for payment of VAT and/or PAYE (national insurance and income tax for themselves and employees). Zero employee registered firms can voluntarily opt to charge and pay VAT, as beneficial to their business model, or on nearing the registration threshold for mandatory registration of £85,000 gross turnover per annum.
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157. ONS report that births are referred to as 'creations' and deaths referred to as 'closures' however they actually refer to enterprises added to, and removed from, the IDBR, respectively.
158. In addition to the processing of any backlog of new business registrations over the Bank Holiday period, there is also an increase in "opportunity

entrepreneurship" - entrepreneurs starting a business in pursuit of a new opportunity. The Start Up Loans programme, for example, sees a substantial increase in expressions of interest from would-be entrepreneurs each new year.

159. ONS, Business demography, quarterly experimental statistics 2021. ONS report business closures as firms that are removed from the IDBR if turnover and employment are zero for several periods, or they receive notification that the business has ceased trading through an administrative source. https://www.ons.gov.uk/businessindustryandtrade/business/activitysizeandlocation/bulletins/businessdemographyquarterlyexperimentalstatisticsuk/octobertodecember2021
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161. Prashar, N., & Hart, M. (2019). Job Creation and Destruction in the UK 1998–2018. ERC Insight Paper, March cited in GEM Diagnosing Covid-19 Impacts on Entrepreneurship, p.62.
162. GEM Diagnosing Covid-19 impacts on Entrepreneurship p. 63. Additional data for 2020 kindly provided by GEM and ERC - data for "necessity entrepreneurship" in 2019 and 2020 unavailable due to a change in methodology.
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165. BVA BDRC, SME Finance Monitor Q2 2021 'Core' forms of finance include overdrafts, loans (including commercial mortgages) and/or credit cards.
166. BVA BDRC, SME Finance Monitor Q2 2021.
167. Bank of England, Financial Stability report, https://www.bankofengland.co.uk/financial-policy-summary-and-record/2021/october-2021/financial-stability-in-focus
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169. Respondents to the survey included accelerators, incubators, accountants, legal firms, advisors, brokers, Chambers of Commerce, consultants, local authorities, Local Enterprise Partnerships and Combined Authorities, growth hubs, entrepreneurs' groups, trade bodies, finance providers (asset finance, business angels, major and challenger banks, corporate finance, PE & VC funds), universities, science/tech parks, and research institutes, representing every region and nation of the UK.
170. Growth of 20% or more in each of the last three years.
171. Business demography, UK - Office for National Statistics (ons.gov.uk).
172. Respondents were free to select as many as applied so percentages will not sum to 100%.
173. Happy to use finance to grow: BVA BDRC, SME Finance Monitor Q2 2021 Happy to use finance to support net zero actions: British Business Bank (2021) Smaller businesses and the transition to net zero.
174. It should be noted that the views quoted in this report are lifted directly from responses to questions received from intermediaries and should not be read as being the opinion of the Bank or its UK Network Team.
175. The balance was calculated by subtracting the number that stated the markets demand was not met at all well or met less well, from those that stated it was met very well, quite well, or fairly well, and dividing by the total number of responses (excluding proportion stating that they had no experience) to arrive at a percentage.
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181. British Business Bank (2021) "UK Venture Capital Financial Returns 2021".
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183. British Business Bank user defined search of PitchBook on 5th January 2021 (Results may differ to PitchBook's own figures).
184. British Business Bank calculations of Preqin data as at 06/01/2022.
185. British Business Bank user defined search of PitchBook (Results may differ to PitchBook's own figures).
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187. Atomico (2021) 'State of European Tech 2021'.
188. Beauhurst does not have complete coverage of all company valuations but has valuation data for 82% of UK equity investments since 2011.
189. https://pitchbook.com/news/articles/2021-top-VC-deal-fundraising-valuations
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191. The British Business Bank definition is based on companies backed by VCs and other early-stage investors and so this definition excludes companies that other sources may cite as unicorns such as Gymshark, which is Private Equity backed.
192. Atomico (2021) 'State of European Tech 21'.
193. BVCA (2021) 'Performance Measurement Survey 2020'.
194. British Business Bank (2021) "UK Venture Capital Financial Returns 2021".
195. To calculate the IPO exit value, we use the company pre-money valuation as per valuation for other deals and exit types, which is consistent with PitchBook's approach of reporting exit value.
196. The following analysis is based upon British Business Bank user defined searches of the PitchBook platform, figures may vary from those published by PitchBook themselves.
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200. EY (2021) '2021 EY Global IPO Trends report'.
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Acknowledgements

This paper was developed by the British Business Bank Economics Team including Matt Adey, George Anderson, Alasdair Barrett, Joel Connolly, Anthony Gray, Jake Horwood, Elise Katilov, Naren Mistry, Fiona Morrill, Leath Al Obaidi, Martina Tortis, Dan van der Schans, Chris Warner and Zach Witton. We would like to thank all who provided input and comments on the report.

British Business Bank plc
Steel City House
West Street
Sheffield S1 2GQ

t. 0114 206 2131
e. info@british-business-bank.co.uk

british-business-bank.co.uk

Publication date: March 2021