British Business Bank

Small Business Finance Markets 2023/24

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CEO Foreword

British Business Bank is the UK's economic development bank. Our mission is to drive sustainable growth and prosperity across the UK, and to enable the transition to a net zero economy, by improving access to finance for smaller businesses. We use our research, insight and analysis, allied to market intelligence, to design interventions in UK finance markets to help us achieve that aim.

Our annual Small Business Finance Markets report continues to provide a comprehensive and independent assessment of the funding landscape for smaller businesses. It has become a trusted and important information source, informing discussions between policy makers and market participants. This flagship tenth report provides a timely opportunity to assess how smaller business finance markets have changed over the decade since the Bank was established in 2014, in the aftermath of the Global Financial Crisis.

The last decade has been a challenging one for the UK's 5.6m smaller businesses, with several unprecedented economic shocks, the Covid-19 pandemic, and more recently supply chain shortages, high energy prices caused by the invasion of Ukraine and inflation.

An increased choice of finance

Over that time, UK smaller business finance markets have developed considerably, with a greater number and diversity of finance providers and products than ever before. Smaller business lending was heavily concentrated in 2014, with the majority of lending coming from just four large lenders, and this market concentration was seen as a factor in the UK's slow recovery after the crisis.

One of the British Business Bank's founding objectives was to create more diversity of supply in finance markets. There have been 36 new banking licences granted to banks serving smaller businesses since 2014, of which a third have been supported by one of the Bank's programmes. This year, for the third year running, challenger banks collectively have a market share of lending greater than the big five banks, showing the still-increasing diversification of the UK bank lending market.

Whilst it is disappointing to see recent declines in bank lending and equity finance for smaller businesses in 2023, reflecting the challenging economic conditions, it is encouraging to see asset finance has grown 7% in 2023, a third consecutive annual increase.

Funding investment across the UK

UK equity finance markets have matured over the last decade, becoming deeper with a greater range of investors able to support companies at all stages of their development. The Bank has become the largest domestic investor in UK venture and venture growth funds, playing an important role through its Enterprise Capital Funds and British Patient Capital programmes.

Over the last decade, the UK has also established itself as the third largest venture capital market in the world, narrowing the gap with the US over the last ten years. However, the UK still lags behind the US in terms of later stage venture capital funding and funding going to R&D intensive sectors. The UK venture capital market historically has also been reliant on overseas sources of institutional capital. These were significant factors in the Chancellor of the Exchequer's recent request to ask the British Business Bank to explore establishing a vehicle that could receive third-party capital such as pension fund investment, making use of the Bank's track record and market access to a range of promising high growth companies.

Whilst both debt and equity finance markets have become more developed over time, there remain location-based challenges in getting finance to many parts of the UK – particularly equity finance. This highlights the continued need for the Bank's dedicated regional programmes. The success of our Northern Powerhouse, Midlands Engine and Cornwall and Isles of Scilly Investment funds led to the allocation of a further £1.6bn of funding for the Bank. This has enabled us to create the next generation of Nations and Regions Investment Funds over the past year and, for the first time, the Bank has dedicated investment funds in Scotland, Wales, Northern Ireland and the South West and is extending its funds in the Midlands and North of England.

Female and Ethnic Minority-led businesses consistently face challenges in raising finance to start and grow their business. The Bank continues to drive increases in diversity in the market, for example through its role as a founding signatory to the Investing in Women Code. We are currently working on enhancing diversity in our own investment and lending portfolios still further, leading to constructive dialogue between delivery partners and market participants.

Supporting innovation and growth

Finance markets have a fundamental role in backing innovation and supporting business investment in the UK's fastest growing and most innovative companies. This is critical for helping to address the UK's long term structural issues of low business investment and productivity, supporting economic growth. Looking forward, finance markets will also have an important role in the next decade for facilitating smaller businesses in their transition to net zero, which the Bank will support through its strategic objective to build the modern green economy.

We will continue to work alongside delivery partners, policy makers and government so that the UK's smaller businesses have the greatest opportunity to fulfil their potential. This report highlights many of the challenges and opportunities ahead, and I hope it serves as a valuable resource to help address both in equal measure.

Louis Taylor
CEO, British Business Bank

Executive Summary

The last ten years have seen several unprecedented supply side shocks hit the UK economy and smaller businesses. Small business debt and equity finance markets have developed over the decade, with a greater number and diversity of providers and products, to better support businesses at all stages of their development. External finance remains an important resource for businesses responding to challenges and taking advantage of new market opportunities.

In this year's Small Business Finance Markets report we examine how small business finance markets have evolved over the last decade (2014-2023), since the Bank published its first Small Business Finance Markets report in 2014. Smaller business debt and equity finance markets have substantially evolved since 2014 with a greater number and range of finance providers than ever before, but there remain issues in the availability of finance for specific areas and groups of people.

Looking forward, the Bank has identified four key issues that are likely to shape small business finance markets over the next decade. This includes funding the transition to net zero, finance providers' greater use of digital technology and artificial intelligence (AI), the return to more normal interest rates and the need to create a dynamic and resilient economy.

1

The UK economy has experienced several economic shocks over the last decade, but finance providers, together with government support, have helped smaller businesses

The past decade has been characterised by several unprecedented supply side shocks including the UK leaving the EU, the Covid-19 pandemic and high inflation resulting from not only supply chain shortages as economies re-opened after the pandemic, but also the Russian invasion of Ukraine.

Following the economic recovery from the Global Financial Crisis (GFC), UK small business debt and equity finance markets developed over the last decade with increased numbers of new finance providers and broader types of finance offered. Finance markets have become deeper and better able to support businesses. The pandemic marked a noticeable period when UK finance markets sustained the real economy during the lock down period, delivering support from the Government's Covid loan schemes and equity-based Future Fund scheme to avoid businesses running out of cash.

Finance markets have a fundamental role in funding new innovations and supporting business investment. This is critical for helping to address the UK's long term structural issues of low business investment and productivity.

As interest rates return to more normal levels, after being ultra-low for most of the last decade, this will create its own challenges for smaller businesses to adapt to the higher cost of finance. Whilst we are already seeing signs of higher business closures in 2022 and 2023, higher interest rates will help support the efficient allocation of capital within the economy.

2

The smaller business lending landscape has changed substantially over the last decade with a greater range of debt finance providers than ever before

Smaller business lending was heavily concentrated pre and post GFC with the majority of lending coming from just four large lenders in 2014. The lack of diversity in the UK small business lending market was seen as a factor in the UK's slow recovery post GFC.

Open banking and technological advances (and increased consumer appetite for embracing digital offerings), together with the relaxation of banking regulations around the granting of new licences, have lowered barriers to entry for new banks and for non-bank lenders. Since 2014 there have been 60 new banking licences granted with 36 serving smaller businesses.

The four largest banks and their subsidiaries supplied around 63% of smaller business bank lending (excluding overdrafts) in 2014. Excluding the market disruption caused by the Covid-19 pandemic, where large banks made an important contribution to keeping funds flowing, the big banks' share of smaller business lending has been steadily declining since 2014 and fell to a series low of 41% in 2023. Since 2021, challenger banks collectively have a market share of lending greater than the big banks, showing the bank lending market is now more diversified.

Marketplace lending and platform lending also emerged as individuals looked for higher returns on their savings in the decade of low interest rates following the GFC. In 2014 these were very much nascent business models, but have developed rapidly to become a large part of the lending market. By 2019, these lenders contributed £2.75bn of business lending and £1.35bn of commercial property lending. Non-bank lenders have also gained significant shares in asset finance and invoice and asset-based lending markets. In addition, private debt funds have emerged since the GFC to provide alternative non-bank sources of debt finance to growing businesses.

Changes to the UK small business lending market over the decade have been positive, so the market is now more diversified and resilient than ever before, giving smaller businesses greater choice of funding options available.

3

UK equity finance markets have matured over the last decade, becoming deeper with a greater range of investors able to support companies at all stages of their development

Equity finance is important for backing innovation and innovative companies scaling up to address the UK's long standing productivity gap. The UK equity finance market has matured from being predominantly an early stage focused market in 2014 to one supporting companies at all stages of their development. Ten years ago, seed stage companies represented around half of all announced equity deals, compared to 38% in 2023. Venture stage companies represented the greatest proportion of equity backed deals at 44% of all deals in 2023. The progression of the market can also be seen through the increase in follow-on deals which has increased from being a third of all deals in 2014 to 56% in 2023. This shows the UK is better able to support later stage venture capital (VC) backed companies.

A key part of the market deepening has centred around a wider range of investors entering the UK market. At the earlier stages of the market, crowdfunding platforms and angel investors have become frequent sources of private funding. At the later stages of the market, there has also been a rapid expansion in participation from non-traditional investors such as corporate VCs, mutual funds and family offices, including investors based overseas.

As a result of these market developments, the UK's overall equity investment gap with the US over the past ten years has narrowed, most significantly at the seed stage of the market, where the UK is now ahead of the US. However, gaps remain at the later VC stage where US companies received 1.4 times as much VC funding on a GDP weighted basis in 2019-21.

Whilst the UK has established itself as a globally leading VC market, particularly in sectors such as fintech and software, gaps also remain in funding R&D intensive sectors. UK VC investment in R&D intensive sectors represented 0.26% of GDP in 2019-21, compared to 0.44% in the US, a difference of 1.7 times.

The UK has established its position as a global leader in VC, being the third largest VC market in the world. The UK has strengthened this position compared to ten years ago. The UK's share of global VC investment value has risen from 3.4% in 2014-16 to 5.9% in 2021-23.

4

There remain regional and place based challenges in getting finance to many parts of the UK, particularly equity finance

Whilst areas outside of London largely receive external debt finance in line with their population of smaller businesses, regional differences remain in smaller businesses demand and use of external finance, which are not fully explained by sectoral and business demographic factors. Moreover, more localised gaps exist for areas with specific geographic characteristics, such as rural areas and coastal towns, and social economic factors, such as high deprivation.

Regional funding gaps are most acute for equity finance, where London's dominance has increased over time. The number and value of equity deals in London has increased at a faster rate than the rest of the UK, so that by 2023, the capital received 46% of deals and 58% of total investment.

London's increasing share of equity deals may be attributed to greater access to skilled labour, financial expertise as well as a positive networking environment. However, while the effect has been greater in London, clustering effects have also been seen in cities outside of London.

Whilst UK equity ecosystems have developed over the decade with a greater number and breadth of equity investors, the growth in investor presence has been greatest in London, further reinforcing regional imbalances. From 2017, the number of unique VC offices per region increased more in London than areas outside of London (186% compared to 142%). London's VC market remains substantially deeper than areas outside of the capital.

Alongside the evidence we present on access to finance by social group, this shows there is more work to be done in unlocking potential to drive growth in hard-to-reach groups and areas.

5

Finance to female and Ethnic Minority businesses has changed little over the decade, but recent initiatives are beginning to raise awareness of the issues

Female and Ethnic Minority-led businesses face challenges in raising finance to start and grow their business. Over the past ten years, these businesses have been more likely to be discouraged from applying for finance, despite greater availability of finance options and providers in the market. Not knowing where to find the right finance, lower awareness of finance options and increased perceptions of rejection remain as key barriers for these groups.

A lack of data on funding to female and Ethnic Minority-led businesses makes measuring progress difficult. Where it exists, there are some signs of improvement. The share of equity deals to teams with at least one female founder has increased by almost ten percentage points over the past decade, but the share of investment going to all-female teams remained static at just 3%. Lending from Community Development Financial Institutions (CDFIs) to these groups surpasses their respective shares compared to the overall business population.

The importance of collecting and reporting data on gender and ethnicity, and wider characteristics such as age, socioeconomic background and disability is widely recognised. Government and industry-led surveys now track the demand and funding outcomes for some of these groups. Initiatives like the Investing in Women Code (IWC) have increased transparency and accountability. IWC VC signatories outperform the wider equity market in terms of their investment into female founders.

An important next step will be to ensure these insights feed through to lending and investment decisions.

Research has shown the importance of representation amongst decision-makers. Incorporating a wider range of perspectives and backgrounds in finance decision-making will lead to more inclusive and equitable decisions, enabling lenders and investors to realise the full economic gains of unleashing potential.

6

The Bank has identified four key issues for smaller business finance markets over the next decade

Having examined how finance markets have changed over the last decade, the Bank has identified four key issues that are likely to shape small business finance markets over the next decade and beyond.

1. Smaller businesses contribute a sizeable share of the UK's Green House Gas (GHG) emissions, but face difficulties transitioning to net zero. Over the next decade, finance markets will have a critical role in funding new innovations and smaller businesses adoption of cleaner technologies, supporting smaller businesses transition to net zero. The British Business Bank will work alongside finance providers and the Government to create a modern green economy.

2. Artificial intelligence (AI) has the potential to shape small business finance markets over the next decade. Finance providers are already using predictive AI but generative AI is creating new opportunities, with fintech and new entrants leading the way in its adoption. Going forward AI could help increase the availability and lower the cost of finance to smaller businesses helping to address some of the finance market challenges outlined earlier. The British Business Bank is helping to support the development of fintech and finance providers using new technologies and delivery models.

3. Interest rates are unlikely to return to the ultra-low levels seen in much of the last decade. Finance markets have already begun to accommodate the new higher interest rate environment, but smaller businesses will need to adapt. This will put pressure on small business investment and survival in the short-to-medium term. The British Business Bank aims to continue to drive sustainable growth by ensuring businesses can access the right type of finance they need to start, grow and thrive. It will do this by ensuring there are a range of finance solutions available in the market to meet different business needs.

4. Recent economic conditions have resulted in rising small business closures. Whilst this creates disruption in the short run, this could result in a more dynamic economy if resources are freed up to be redeployed into new productive uses. The creation and growth of new and innovative businesses will help the UK economy to become more resilient to future shocks and disruption and take advantage of new opportunities. The Bank's Start Up Loans and early-stage equity programmes remain targeted at supporting the new start-up businesses that are vital to the UK economy.

Introduction

This is the tenth annual British Business Bank Small Business Finance Markets report. The latest report assesses how small business finance markets have developed over the last decade (2014-2023) since the first report was published in 2014, as well as assessing more recent trends.

The British Business Bank has the mission to drive sustainable growth and prosperity across the UK, and to enable the transition to a net zero economy by improving access to finance for smaller businesses. To deliver this mandate requires an understanding of the current state of smaller business finance markets.

This report provides insight into the latest market developments and trends, allowing the Bank to constructively engage with market providers and stakeholders to benefit smaller UK businesses.

New evidence and analysis

The British Business Bank has continued to refine and improve the evidence and analysis used in this report.

- We have updated our Business Finance Survey and combined it with our updated survey of market intermediaries and Devolved Nations to provide new market insights.
- We continue to make use of the Bank's management information and feedback from market contacts.
- This report also references a wide range of evidence drawn from academic, government and market research. We are keen to increase the range of researchers we work with.

Structure of the report

The report is split into two sections to allow consideration of both longer-term market issues and developments, and more recent trends in smaller business finance, including the latest position.

Part A of this year's report is dedicated to examining how smaller businesses finance markets have changed over the last decade since the Bank published its first Small Business Finance Markets report in 2014. It explores how smaller business debt and equity markets have developed over that time with increased number of providers and products. Whilst there have been improvements in market diversity, several market issues remain including challenges in financing hard to reach places and people. The remaining section of Part A identifies four key issues that will impact on small business finance markets over the next decade and beyond.

Part B examines recent trends in small business finance markets. The section starts off by reviewing the small business population and smaller business demand for external finance. It then explores female and Ethnic Minority entrepreneurs' access to finance and finance for environmental sustainability. Part B of the report then considers recent trends in the availability of different types of debt and equity finance most widely used by small businesses.

Aggregate flow and stock of smaller business finance

- The flow of bank lending declined in 2023, and is now at a similar level to 2016
- Asset finance grew for the third year in a row
- Equity investment into smaller businesses has declined to levels last seen in 2020

This section brings together the latest data from a range of sources on the number and value of various types of external finance provided to smaller businesses in the UK.

Consistent and comprehensive data outlining the number and value of the aggregate stock and flows of all types of external finance to smaller businesses is not available. However, the summary table provides a good estimate. The table has been revised from previous years to include a breakdown of total bank stock by lending and overdrafts. For the first time, the table also considers changes from 2014 in both nominal and real terms using 2022 prices. While flows of different types of finance are not directly comparable, the data shows that bank lending is still the single largest form of external finance for smaller businesses.

Figure 2 shows the same information as Figure 1, but with the data presented in real terms using 2022 prices to take into account the effects of inflation over time.

Figure 1

Estimates of the nominal flow & stock of external finance for UK smaller businesses (£ billion) (a)

Finance type		2014	2019	2020	2021	2022	2023	As of
Bank lending flows	Gross flows (b)	53.4	56.9	104.9	57.7	65.1	**59.2**	Dec-23
Source: Bank of England	Net flows (c)	-1.7	2.1	47	-8.0	-8.4	**-9.3**	Dec-23
Bank lending stock Source: Bank of England	Outstanding amount (d)	155	156	205	200	188	**175**	Dec-23
Bank overdraft stock Source: Bank of England	Outstanding Amount (d)	12.4	11.4	8.3	8.7	8.9	**8.6**	Dec-23
Total bank stock Source: Bank of England	Outstanding Amount (d)	167	168	213	209	197	**185**	Dec-23
Asset finance flows Source: FLA (e)		14.5	20.0	16.0	19.6	21.9	**23.5**	Dec-23
Other gross flows of SME Finance								
Private external equity Source Beauhurst (f)		3.1	8.6	9.5	18.8	16.7	**6.5**	Sep-23
	Number of announced deals	1,489	2,142	2,403	2,912	2,702	**1,512**	Sep-23

(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) 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.
(c) Net flows do 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 flow data does not include these adjustments.
(d) Movements in amounts outstanding can reflect breaks in data series as well as changes in the underlying flow.
(e) The Finance & Leasing Association (FLA) whose members make up 90-95% of the market.
(f) Beauhurst is a data provider that records announced equity deals including crowdfunding deals.

The flow of bank lending declined in 2023, and is now at a similar level to 2016

Gross lending (excluding overdrafts) to small and medium-sized businesses (SMEs) by banks was £59.2bn in 2023. This was 9% lower in nominal terms and down 15% in real terms compared to 2022, reflecting higher borrowing costs and economic uncertainty weighing on the demand for lending. Banks were also more cautious about the ability of businesses to repay. The flow of bank lending in 2023 was the joint third-highest on record in nominal terms, level with 2016.

The total stock of bank lending (comprising outstanding lending and overdrafts) in 2023 was £185bn. This was down 6% nominally, but by 12% in real terms, compared to 2022 largely due to increased repayments, particularly of government-guaranteed Covid-19 loans.

Over the ten year period (2014-2023) gross lending increased 11% in nominal terms, but fell 14% in real terms. Gross lending peaked in 2020 at £104.9bn (£109.9bn in 2022 prices). The trend in the total stock of bank lending over this period mirrored that of the gross lending flows. The nominal total stock of bank lending in 2023 was also up 11% from 2014, driven by

Figure 2

Estimates of the real (2022 prices) flow & stock of external finance for UK smaller businesses (£ billion) (a)

Finance type		2014	2019	2020	2021	2022	2023	As of
Bank lending flows Source: Bank of England	Gross flows (b)	64.1	62.8	109.9	60.7	65.1	**55.3**	Dec-23
	Net flows (c)	-2.1	2.3	48.8	-8.5	-8.4	**-8.7**	Dec-23
Bank lending stock Source: Bank of England	Outstanding amount (d)	186	172	215	210	188	**164**	Dec-23
Bank overdraft stock Source: Bank of England	Outstanding Amount (d)	14.9	12.6	8.7	9.1	8.9	**8.0**	Dec-23
Total bank stock Source: Bank of England	Outstanding Amount (d)	201	185	223	220	197	**173**	Dec-23
Asset finance flows Source: FLA (e)		17.4	22.1	16.8	20.7	21.9	**21.9**	Dec-23
Other gross flows of SME Finance								
Private external equity Source Beauhurst (f)		3.7	9.5	10.0	19.8	16.7	**6.1**	Sep-23
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a very large increase in the stock of bank lending in 2020 following the introduction of government Covid-19 loan schemes. Yet, in real terms, the total stock of bank lending was 14% lower.

Asset finance grew for the third year in a row

SME asset finance new business increased 7% in 2023 to £23.5bn, according to Financing & Leasing Association data. In nominal terms this was the third increase in a row and the highest level on record, £1.6bn above the 2022 total. It followed a rise of 11% in 2022 and 23% in 2021. The increase highlights the continued rebound in the level of new business as supply chain pressures eased and smaller businesses looked to replace ageing vehicles and machinery.

In real terms, 2023 was also the third annual increase in a row, albeit only by 0.3% (£0.06bn). This followed increases of 6% and 23% in 2022 and 2021 respectively. While 2023 represented a record total in real terms, it is still 0.5% below the £22.1bn high reported in 2019. Asset finance has increased by 26% in real terms since 2014.

Equity investment into smaller businesses has declined to levels last seen in 2020

Smaller businesses raised £6.5bn of equity finance over the first three quarters of 2023, 53% less than during the same period in 2022 (55% in real terms). While there was a sharp decline in activity in the second half of 2022, investment now appears to be stabilising at around £2bn per quarter in 2023. Total investment is on track to reach a similar full year total to 2019 and 2020, assuming investment levels in Q4 do not deviate from the Q1-Q3 average.

Later stages of the UK market have continued to experience the largest reductions in investment. Growth stage investment in the first three quarters of 2023 was £2.4bn, 65% lower than during the same period in 2022. Venture and seed stage investment fell by 43% and 31% in 2023, respectively, compared to the same quarters in 2022. The growth stage was the main driver of market expansion over 2021 and H1 2022, and subsequently has also experienced the largest drop in both percentage and absolute terms since market conditions have worsened from H2 2022 onwards.

Over a longer timeframe, smaller business equity investment in Q1-Q3 2023 was 194% higher in nominal terms than Q1-Q3 2014, and 130% higher in real terms. This illustrates the development of the market over the past decade, even despite the recent downturn.

Part A: Market developments over the last decade (2014-2023)

1.1

The macroeconomy and its impact on small business finance markets

- UK economic growth has been subdued over the past decade while inflation and interest rates were low for most of the period
- Business investment and productivity growth in the UK remained weak
- Finance markets have a fundamental role in funding innovation and supporting business investment
- UK debt and equity finance markets have substantially developed following the recovery from the Global Financial Crisis to support a growing smaller business population
- A return to more historically normal interest rates will cause challenges in the short run but help to support efficient capital allocation within the economy

This section examines how the UK's macroeconomy has impacted on small business finance markets over the last decade. The UK economy experienced several economic shocks over the last decade, but its debt and equity finance markets have substantially developed with greater numbers of providers that have been able to support a growing population of smaller businesses. Interest rates were low for most of the decade but have since returned to historically average levels, creating challenges for smaller businesses.

UK economic growth has been subdued over the past decade while inflation and interest rates were low for most of the period

UK real GDP growth averaged 1.6% between 2014 and 2023, compared to the UK's long-run average of 2.3% between 1984 to 2013.[1] The latest country comparison data for 2022 shows UK economic growth averaged 1.7% over the period from 2014, which lagged the US (2.3%), but was above the Group of 7 (G7) average[2] (excluding the UK) of 1.3%.[3] UK economic growth was broadly flat in 2023 compared to 2022.[4]

The past decade has been characterised by several unprecedented supply-side shocks to the UK economy, which have had an adverse impact on the wider economy and smaller businesses. The shocks included the result of the Brexit referendum in 2016, uncertainty in 2019 about the withdrawal agreement the Government had negotiated with the EU, the Covid-19 pandemic in 2020 and the large rise in the prices of energy and food resulting from the Russian invasion of Ukraine in 2022.

The impact of the Covid-19 pandemic, including lockdowns to manage the spread of the virus, led to large contractions in real GDP in major economies in 2020, with the UK economy shrinking 10.4%. However, as the UK and other economies re-opened during the spring and summer of 2021, activity rapidly rebounded.

UK real GDP data for 2020 and 2021 was revised higher by the ONS in 2023.[5] Consequently, the UK's economic recovery from the Covid-19 pandemic was much stronger than previously thought. Before the revision, real GDP was 0.2% lower in Q2 2023 compared to its pre-pandemic level of Q4 2019. However, the revised data showed real GDP was 1.6% higher than in Q4 2019.[6] Despite the upward revision, UK real GDP growth still lagged most other major economies over this period e.g., real GDP in the US and Eurozone was respectively 7.4% and 3% higher than their pre-pandemic levels.[7]

Between 2014 and 2021, annual consumer price inflation in the UK was broadly in line with the Bank of England (BoE) target of 2%. However, inflation was well above the target in 2022 (9.1%) and 2023 (7.3%).[8] The higher inflation reflects the disruption that the Covid-19 pandemic caused in supply chains and labour markets, especially the hospitality and transport sectors. The resulting shortages of products and labour generated inflation pressures in the UK and other major economies.[9] The inflation pressures were exacerbated by the very large rise in the prices of energy and food resulting from the Russian invasion of Ukraine in 2022. UK annual inflation peaked at 11.1% in October 2022, but subsequently showed downward movement and in December 2023 was at 4%.[10]

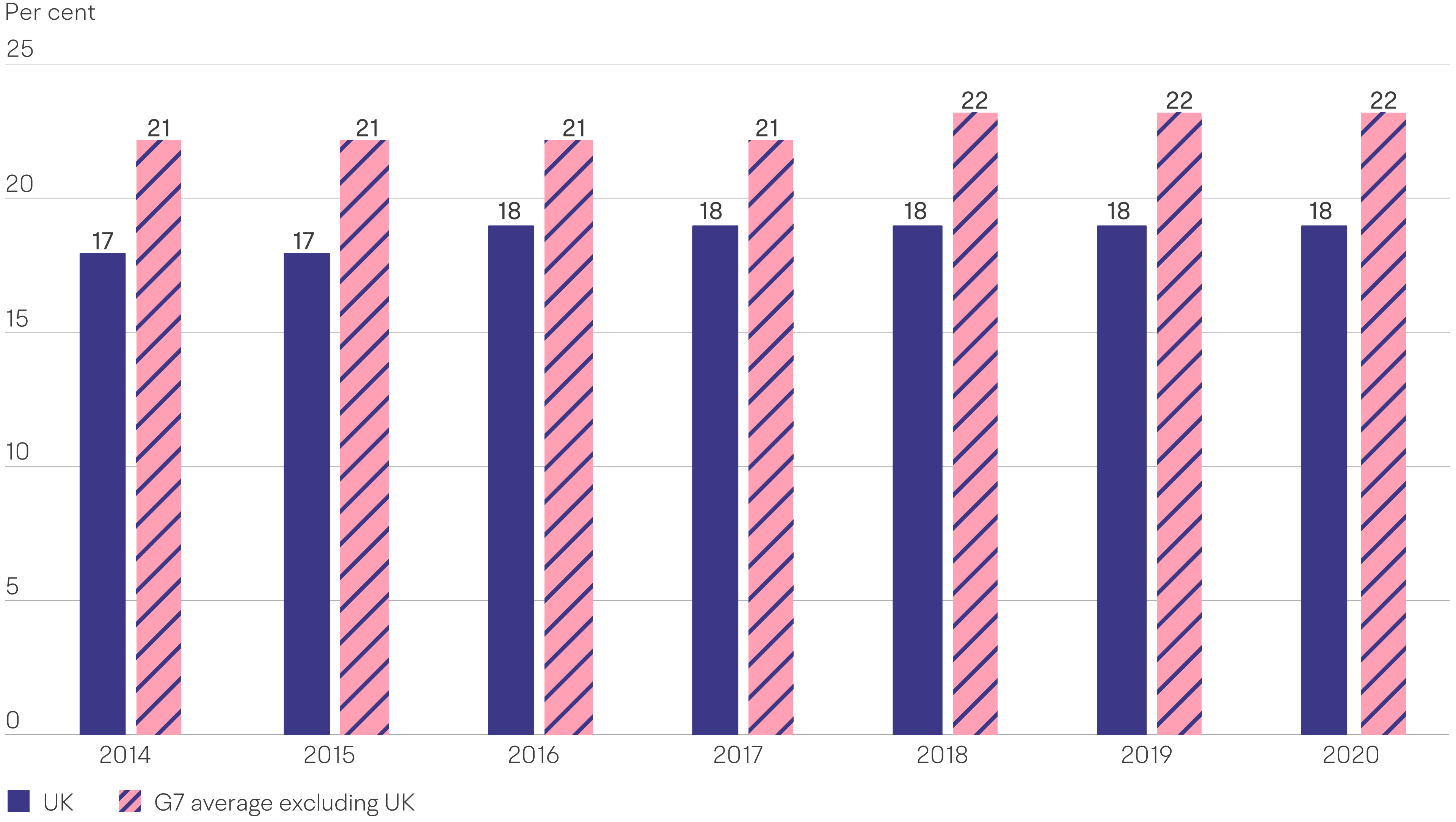
Interest rates were very low in the UK and other major economies for most of the past decade. This was a consequence of inflation being relatively modest at the time and central banks easing monetary policy in response to the supply-side shocks. The BoE's Bank Rate was held at 0.5% following the Global Financial Crisis (GFC) in 2008 to stimulate the economy before being lowered to 0.25% in 2016. Bank Rate was subsequently raised to 0.5% in 2017 and 0.75% in 2018.

When the Covid-19 pandemic struck, the need for emergency support to the economy led Bank Rate to be lowered to 0.25% on 11th March 2020 and again to 0.1% on 19th March 2020, the lowest on record. Bank Rate remained at this level for over a year-and-a-half before the BoE raised it in December 2021 in response to the sharp rise in inflation. There has been 13 further increases since then with Bank Rate at 5.25% at the time of writing. This represents a return to more normal levels, with the current Bank Rate broadly in line with the average in the decade to 2007.

Business investment and productivity growth in the UK remained weak

Business investment continued to be weak over the past decade, with the UK consistently ranking the lowest in the G7 economies and among the lowest in the OECD. The latest comparative data available for 2020 shows gross fixed capital formation in the UK comprised around 18% of GDP over the period from 2014. This was lower than the average for the G7 excluding the UK (22%) (Figure A.1). Business investment is important because it is a key driver of productivity.

Figure A.1
Gross fixed capital formation as a share of GDP
Source: OECD and British Business Bank calculations.



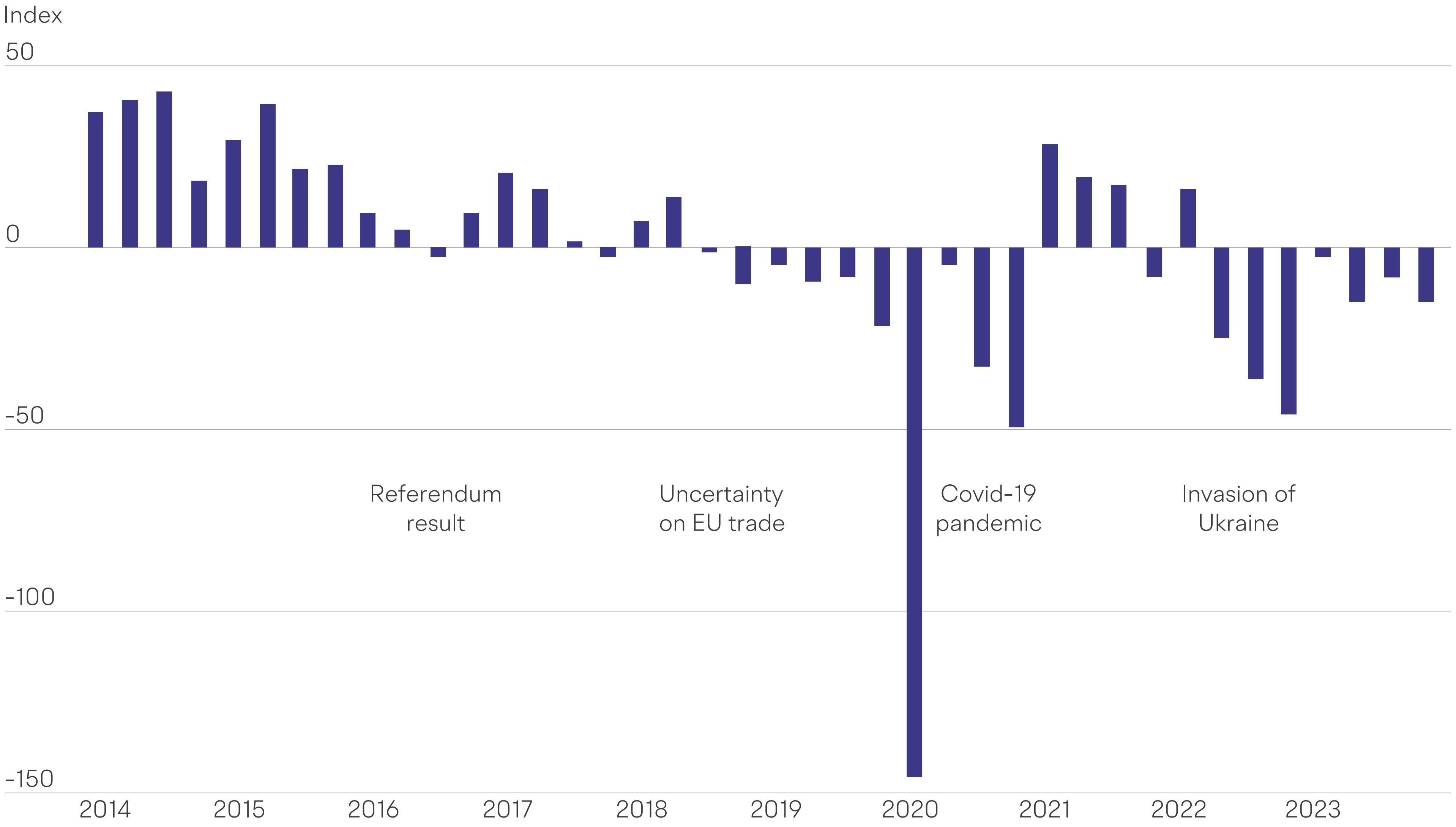
Some of the weakness in business investment may reflect a decades-long shift towards greater investment in intangible assets like software, databases, design, research and development (R&D) and business processes. Investment in intangibles is more difficult to measure than investment in tangible assets[11] as they are often excluded from company accounts but have an important role for productivity.[12]

Between 2014 and 2023 there were distinct periods when small businesses confidence about their future performance turned negative. For example, small business confidence plunged substantially in 2020 due to the impact of the Covid-19 pandemic. Similarly, the sharp rise in the prices of energy and food resulting from the Russian invasion of Ukraine led to small business confidence declining to -46 in Q4 2022, the weakest in two years (Figure A.2). Typically, low business confidence is associated with firms postponing or scrapping plans to grow their business through new investment and/or hiring additional staff.

Figure A.2

Small business confidence

Source: Federation of Small Businesses.



Labour productivity in the UK weakened following the GFC in 2008 and has consistently been lower than in the US, Germany and France. In 2019 workers in the US produced 28% more value added per hour than in the UK. Similarly, Germany and France were respectively 14% and 13% more productive than the UK.[13] Productivity is important because it is directly linked to increasing economic growth and improving living standards.

While the UK has many world class companies, it also has a long tail of low productivity companies. A recent report by the Productivity Institute found that many of the firms in the UK in the bottom of the productivity distribution are not resilient and adaptive and are barely surviving the economic pressures they are facing.[14] Other evidence suggests a widening gap between the labour productivity of highly productive 'frontier' firms and median firms over 1997 to 2021, with greater improvements seen in frontier firms over the time period.[15]

Finance markets have a fundamental role in funding innovation and supporting business investment

External finance is an important enabler of business innovation. As highlighted in last year's Small Business Finance Markets report, innovation can be both new-to-market and new-to-business.

Frontier-shifting technologies often result from R&D activities where groundbreaking ideas eventually develop into innovative new tangible devices and products. Equity finance is a particularly important source of funding for early-stage companies developing innovative products with the potential for strong growth.

Once commercialised new-to-market innovations are launched, they become suitable for wider adoption. Evidence suggests businesses are more likely to develop new products and improved processes if they are users of external finance than non-users of finance. Two thirds of innovators (65%) used some form of external finance, compared to 58% of non-innovators.[16] The majority of businesses are likely to use debt finance to support business investment and growth.

Finance markets, by funding new business innovation and business adoption of new processes, have a critical role in addressing the UK's long term structural issues of low business investment and productivity.

UK debt and equity finance markets have substantially developed following the recovery from the Global Financial Crisis to support a growing smaller business population

Following the long economic recovery from the GFC, UK smaller business debt and equity finance markets developed over the last decade with increased numbers of new finance providers and broader types of finance offered. Therefore, finance markets have become deeper and better able to support businesses. There have also been improvements over recent years in the wider business ecosystem, with increases in the number of incubators, accelerators and business support organisations.

Together, these developments in finance markets and the wider business ecosystem have contributed to supporting the rise in the Small and Medium Enterprise (SME) business population from 5.25m businesses in 2014 to a peak of 6.0m at the outset of 2020.

Finance markets have also become more resilient, especially compared to the GFC where tight lending conditions slowed down the economic recovery. This was evident during the Covid-19 pandemic where UK finance markets were able to support and sustain the real economy during the periods of lockdown. UK finance markets delivered the support from the Government's Covid loan schemes and equity-based Future Fund scheme to avoid businesses running out of cash. Bank lending to smaller businesses increased by 84% (£48bn) in a single year. Government support, for example the Coronavirus Job Retention Scheme (i.e. furlough) also played a key role in supporting businesses through lockdown and the rebound in economic activity once restrictions were relaxed.

A return to more historically normal interest rates will cause challenges in the short run but help to support efficient capital allocation within the economy

Over a decade of ultra-low interest rates in the UK and globally have had major impacts on smaller businesses and finance markets. Cheap money led to global asset prices increasing, as highlighted by large price rises in the public equity and residential property markets over the decade. Low interest rates also supported the development and expansion of alternative assets as investors looked for higher returns, with increased capital allocations toward private equity (PE) and venture capital (VC). Low interest rates also facilitated the development of peer-to-peer/marketplace lending markets as investors looked for higher yields for their savings.

The higher Bank Rate has created challenges for smaller businesses, which will need to adapt to increased borrowing costs on external finance. Figure A.3 shows effective interest rates on new business lending were 7.5% in December 2023.[17] This was around half a percentage point higher than in May 2023 (6.9%), and substantially higher than the 3.2% charged on average in 2016. The increased interest payments, together with higher input costs, have squeezed business cash flows.

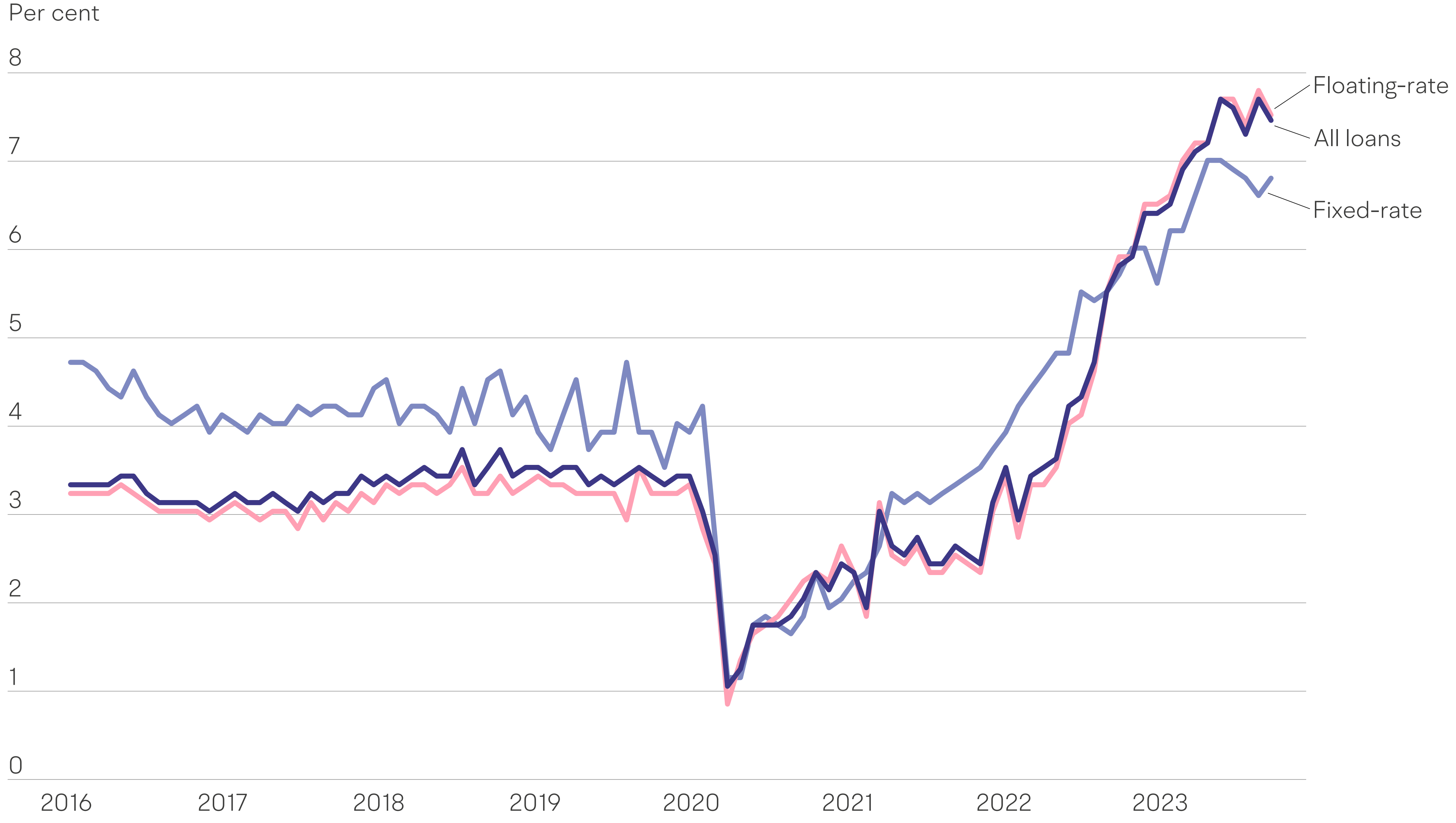
A British Chambers of Commerce survey shows the net balance for small business cash flow turned negative in Q3 2022 and was the weakest in one-and-a-half years.[18] This followed the sharp rise in input costs resulting from the Russian invasion of Ukraine. The balance has subsequently improved somewhat but in Q4 2023 was only marginally positive.

The latest UK Finance BVA BDRC SME Finance Monitor data suggests smaller businesses held the equivalent of 27% of their turnover in credit balances, a lower proportion than in 2022 and back to levels seen in 2020.[19] Some smaller businesses have experienced an increase in their debt servicing requirements. Smaller business arrears for commercial loans have also risen from low levels since Q1 2023 and stood at 1.3% in August 2023.[20]

Figure A.3

Effective interest rates for smaller businesses (new business)

Source: BoE.



The low cost of finance for much of the decade had helped to keep the quarterly number of insolvencies low at around 3,900 between 2014 and 2019 compared to around 4,500 between 2000 and 2013. The number declined even further in 2020 and 2021 due to the additional Government support.

There are already signs of stress as the number of business insolvencies has increased during the last two years. Figure A.4 shows the number of quarterly insolvencies in England and Wales was 6,788 in Q4 2023. This is the highest level since Q2 2009 (6,351).[21] The higher number of business closures is leading to a decline in the overall number of businesses which at the start of 2023 was 5.6m, down from the 2020 peak of 6m.

Whilst business closures cause disruption and distress in the short run, they are part of a dynamic market mechanism that allocates resources efficiently in the economy. Greater business churn can help to foster competition, innovation, and productivity, which will assist the UK in addressing its long-term structural problems of low investment and productivity. A dynamic economy also confirms the need for more business startups with innovative ideas and products. This will be considered in more detail within section 1.6 forward look of issues affecting finance markets over the next decade.

Figure A.4

Number of company insolvencies in England and Wales

Source: Insolvency Service.

1.2

Debt finance has supported sustainable growth

- The smaller business lending landscape has changed substantially over the last decade
- Reduced barriers to entry have led to greater competition within banking
- Big banks remain an important part of small business finance markets
- Non-bank lenders have filled markets exited by the traditional lenders
- Non-bank lenders have created new business models, targeting different funders and borrowers
- UK smaller businesses have never had as many finance options as they have now

This section explores how the smaller business lending landscape has changed substantially over the last decade with a greater range of debt finance providers than ever before.

Prior to the Global Financial Crisis (GFC) the majority of smaller business lending came from four big lenders. During the GFC the effectiveness of the UK smaller business finance markets came under strain and the supply of finance to smaller businesses reduced significantly. While the factors at play in this reduction impacted lenders big and small, the lack of diversity in the UK smaller business lending market was seen as a factor in the slow post-GFC recovery. As discussed in our 2017 'The Benefits of Diverse Finance Markets for Smaller Businesses' report, decreasing the reliance on a small number of lenders can not only increase the overall supply of finance but also who can access finance, where finance can be accessed, the speed of access, the terms and how it can be accessed.[22]

Various measures were taken to try address the overreliance on a small number of lenders, these included:

- several studies of the small business banking ecosystem;
- relaxing regulations around new licences for banks;
- initiatives such as open banking; and
- creating the British Business Bank with a mandate that included increasing the diversity of finance and finance providers supporting UK smaller businesses.

The smaller business lending landscape has changed substantially over the last decade

The smaller business lending landscape has changed substantially since the GFC, significantly reducing the biggest four lenders' share of SME lending which had stood at around 90% at the end of the crisis.[23] Post-GFC, challenger and specialist banks serving smaller businesses have grown in number and importance. Alternative finance providers, which includes provider of asset finance, invoice finance, term loans, cashflow loans, venture debt and private debt, greatly increased their share of lending to smaller businesses.

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 businesses that were previously unable to access funding at all. This is because 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 smaller businesses but have also increased the accessibility and appropriateness of finance available.

Reduced barriers to entry have led to greater competition within banking

While the decrease in the supply of finance to smaller businesses during the Global Financial Crisis was initially cyclical, the economic and regulatory environment post-GFC meant that structural issues limited the supply of appropriate finance for several years after the crisis.

One solution suggested was increasing competition in the banking industry, a challenge highlighted by the fact Metro Bank was the first new high street bank for 100 years when it secured its banking licence in 2010. As a result, there was a push to lessen the barriers to entry for new banks into the UK market with a raft of changes to the authorisation approach and the supporting regulatory framework.[24]

In addition to regulatory changes, technological advances have further lowered barriers to entry for new banks (and non-banks). This included innovations such as 'bank in a box', software as a service and the cloud all leading to huge IT savings. At the same time, the proliferation of the internet, smartphones and social media has increased the channels and lowered the cost of customer acquisition. It is now possible for finance providers to be digital only, without the need to establish a costly network of branches in order to enter finance markets. 45% of surveyed market intermediaries identified digitalisation transformation as one of the top changes to the financial ecosystem over recent years.[25]

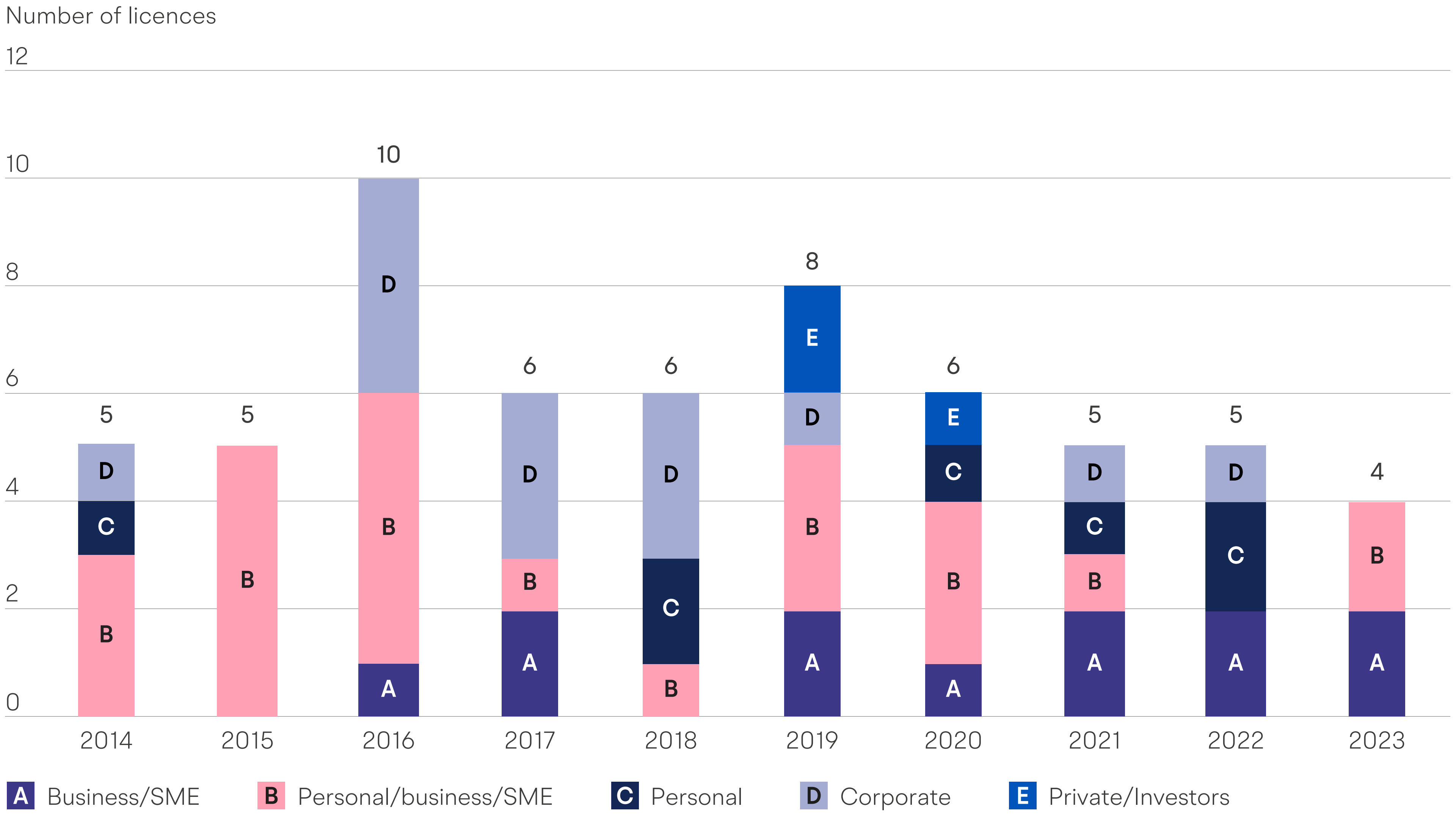
Since 2014 there have been 60 new banking licences granted with 36 serving smaller businesses (Figure A.5). Furthermore, while the five biggest banks and their subsidiaries supplied around 63% of SME bank lending (excluding overdrafts) in 2014, this figure fell each year until 2018 when challenger and specialist banks provided just over half (51%) (Figure A.6).

As a result of the Government support through the Covid loan schemes this trend was reversed in 2020, with the big five banks supplying 68% of gross new bank lending. This has now reverted again and in 2023

Figure A.5

Number of new UK banking licences

Source: British Business Bank analysis of BoE data.



challenger and specialist banks were again leading the way with a record 59% market share. In nominal terms, challenger and specialist bank lending to smaller businesses has increased from £19.5bn in 2014 to £35.5bn in 2022 and was down only slightly in 2023 (£34.8bn) (see section 2.8 challenger and specialist banks).

Big banks remain an important part of smaller business lending markets

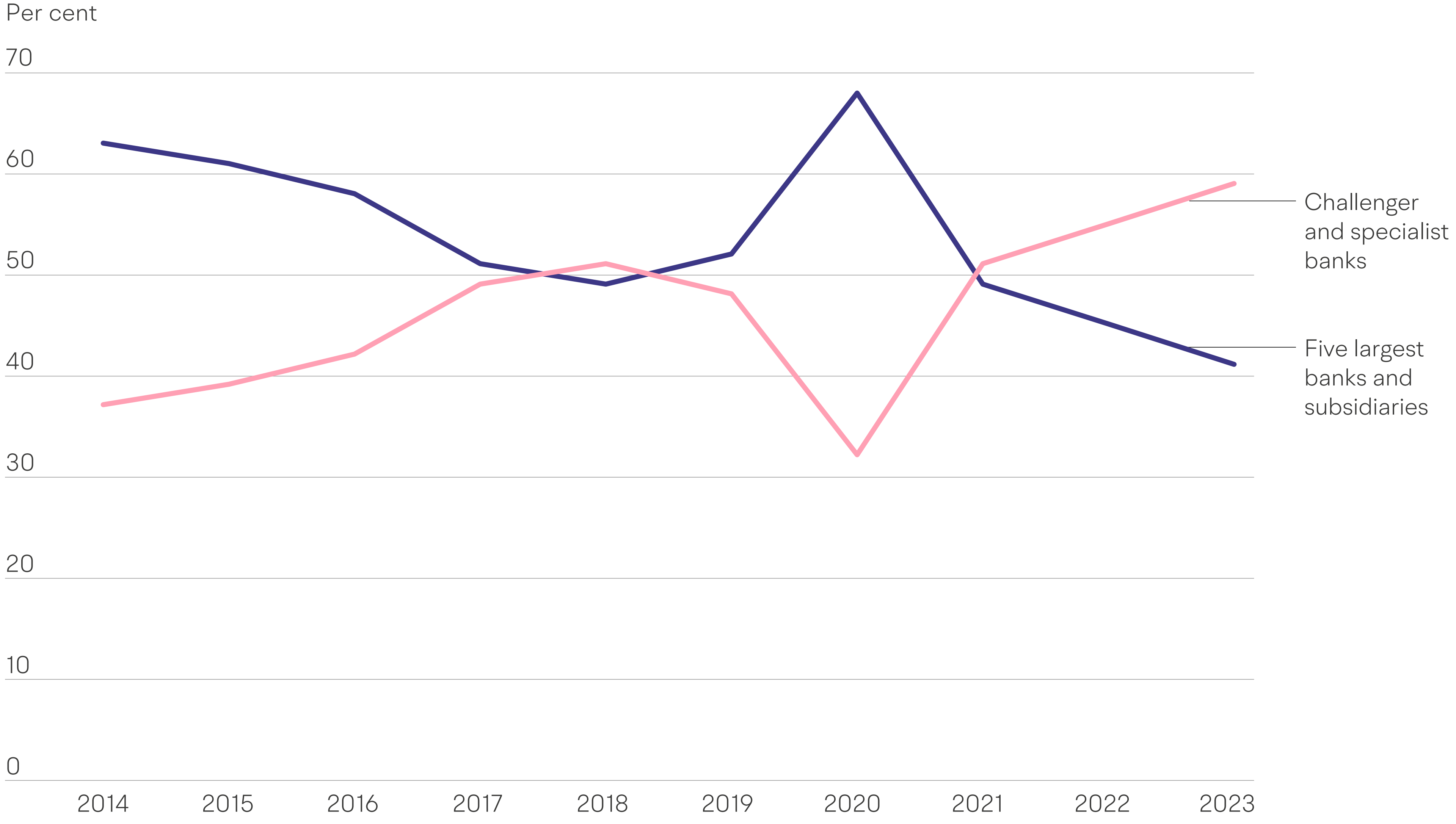
Despite the changes over the last decade, big banks remain an important part of the smaller business lending landscape. While the challenger and specialist banks have supplied more new lending in the last couple of years, the big five banks still supplied 41% in 2023. Furthermore, our Business Finance survey shows that 51% of smaller businesses only approach their main bank when seeking finance.

This latter point likely reflects longstanding relationships and trust, but it is not just that. The big banks retain a significant small business footprint via the large number of personal and business bank accounts utilised by smaller businesses for their day-to-day banking and via a physical presence on the high street. This is still

Figure A.6

Share of total gross bank lending to smaller businesses

Source: BoE and British Business Bank calculations.



an important factor for many businesses who do not feel comfortable having an entirely digital relationship with their finance providers. This was particularly important during the Covid pandemic when the big banks played a key role in the early months of the Covid loan schemes, as they were able to utilise their existing customer relationships to deliver the majority of the early Government-guaranteed lending.

In addition to their wide reach, the big banks typically offer a full range of services such as asset finance and invoice finance alongside core bank products like overdrafts. This means smaller businesses, who are often time poor, can potentially get all their finance needs from one provider, which is not always possible with challenger or specialist banks or non-bank lenders. It is also the case that, where a smaller business can get their funding from a big bank, it may be cheaper as the sizeable customer deposits and access to other cheap funding sources that the larger banks typically have means they can often charge less for a product than a specialist or non-bank lender can.

Non-bank lenders have filled markets exited by the traditional lenders

In 2019, prior to the Covid pandemic, it was estimated 30% of SME finance was being supplied by non-bank lenders.[26] While they likely lost ground due to the Covid loan schemes and more latterly increased wholesale funding costs, these alternative finance providers are now very much part of the mainstream for many smaller businesses looking to borrow and are able to reach many parts of the market more traditional lenders cannot or do not wish to reach.

Non-bank lenders have made progress over the last decade either by targeting markets that banks have left altogether or by addressing specific under-served segments of the market. One example of this is there has been significant growth in lending by private debt funds.

Private debt refers to bespoke lending structures, tailored to the specific needs of borrowers, provided by non-bank lenders. Prior to the GFC, products of this nature were commonly supplied by the big banks but new regulations on capital requirements and heightened risk aversion caused many high street banks to retrench and focus on simpler loan structures with lower operational costs. Private debt funds stepped in to close some of the gap and are often the only, or most viable funding solution for smaller businesses and mid-cap firms who require flexibility in terms of a financing structure.

Since the GFC, private debt has become an increasingly important source of finance for smaller businesses that are seeking to grow quickly, with over £1bn of growth-specific finance provided to such businesses by private debt funds during 2018 and 2019.[27] In the current uncertain economic environment, private debt providers are able to provide flexible capital to support their existing borrowers and provide new capital for companies with growth potential.

Non-bank lenders have also gained significant shares in asset finance and invoice and asset-based lending (IF/ABL) markets. This has in part been achieved by targeting under-served sectors of the market, such as specialist equipment asset finance, or by offering a different customer proposition such as streamlined applications and more flexible approaches. The Finance and Leasing Association estimate that 37% of new SME asset finance was supplied by non-bank lenders in 2023 with challenger and specialist banks also increasing their share in recent years. UK Finance estimated for IF/ABL the non-bank number stood at around 20-30% in 2019.

Non-bank lenders have created new business models, targeting different funders and borrowers

As well as technological and regulatory innovations there have also been many business model innovations over the past ten years. In addition, smaller business frustration post-GFC with traditional lenders, the low interest rate environment and the changing financing needs of the smaller business population have also been important for allowing non-bank lenders to gain a share of the total lending market. 17% of intermediaries identified the rise of fintech companies as being one of the top three issues to impact the UK financial ecosystem over recent years.[28]

Some of the most well-known examples of this are marketplace lending, which for many lenders started out as peer-to-peer lending, and platform lending. In 2014 these were very much nascent business models.

From the firms the British Business Bank tracks, just under £1bn of small business lending was originated in 2014 with about £513m of that being in the form of business lending, £290m of commercial property lending and £171k via receivables finance. By 2019, this had increased to £4.5bn with about £2.75bn of that being business lending and £1.35bn of it being commercial property lending.

These models have not been without challenges during this period. There have been some failures, often around more niche products, while regulation has limited who some of these products can be marketed to and rising risk-free interest rates have lessened the appeal for some investors. Furthermore, Covid and the Covid lending schemes have led to business and funding model changes for some, as discussed at length in a previous edition of this report.[29] Even though volumes in 2022 and 2023 appear not to have yet returned to the peak seen in 2021, the market is now more mature, and has established greater links to and partnerships with institutional investors and traditional lenders.

UK smaller businesses have never had as many finance options as they have now

Not only have we seen new entrants to the markets, new business models and new products developed but initiatives such as Open Banking and digitalisation in general have also sped up innovation in alternative and traditional lenders alike.[30] The development of standardised Application Programming Interfaces (APIs) has allowed businesses to talk to each other, regardless of the different software they are running. This means UK smaller business have never had as many finance options as they have now.

Developments in the regulatory environment post-GFC created opportunities for the disruption of existing finance markets allowing the creation and growth of new innovative fintech businesses. As a result, the UK smaller business lending landscape has changed dramatically for the better but there is still room for new providers and greater competition. The British Business Bank and its commercial subsidiaries will continue to support both new lenders and those looking to expand their smaller business offerings as we enter our second decade.

1.3

Equity finance has backed innovative businesses

Over the past decade the UK equity finance market has evolved to support more innovative companies at all stages of development

This market expansion has been driven by a more broad-based range of investors supplying finance

The UK has established itself as a globally leading venture capital (VC) market, particularly in sectors such as fintech

However specific gaps remain in the market, particularly at later stages and in R&D intensive sectors

This section assesses how the UK smaller business equity finance market has evolved over the past decade, from being predominantly early stage focused in 2014 to one now supporting companies at all stages of their development. It explores how the supply of finance has become more broad-based, funded by a greater range of investor types than ever before. Finally, the section looks at the sectors that the UK has strengths in, including software and fintech, as well as those where the UK is less globally competitive.

Over the past decade the UK equity finance market has evolved to support more innovative companies at all stages of development

Over the past ten years the UK equity finance market for smaller businesses has experienced a period of significant expansion, enabling thousands of innovative companies to start and scale. Looking at overall trends in equity finance as a key indicator of this growth, there has been a 47% increase in the number of deals comparing 2014-16 to 2021-23 (using Beauhurst data on announced deals up to Q3 2023). On an investment basis, this translates into a 265% increase in investment across the same period.

This long-term expansion of the market has been driven by a number of tailwinds, including a prolonged low-interest rate environment increasing the relative attractiveness of the VC asset class, rapid increases in sectoral innovation (such as in AI, life sciences and fintech), and government funding initiatives – e.g. British Business Bank equity programmes and tax schemes such as EIS and SEIS – playing an important role in stimulating the market.

The UK market has also matured during this time into one that supports companies at all stages of their development. This evolution can be seen through the shift in the composition of equity deals by company growth stage, as shown in Figure A.7.[31] Ten years ago, seed stage companies represented nearly half of all announced deals, with venture companies accounting for around a third.

At this time, one of the key market frictions was the 'valley of death' for early stage innovative companies, who were yet to generate revenue and struggled to bridge the gap between informal/angel finance and formal VC funding. Research from the Department for Business, Innovation & Skills[32] noted that this gap was generally found to exist for funding amounts between £250,000 and £2 million. The issue was compounded by the fixed cost of due diligence leading fund managers to focus on fewer, larger investments in more established businesses.

The Bank's Enterprise Capital Funds (ECF) programme, established in 2006, has sought to increase the supply of equity finance within this part of the market by investing in emerging UK fund managers.

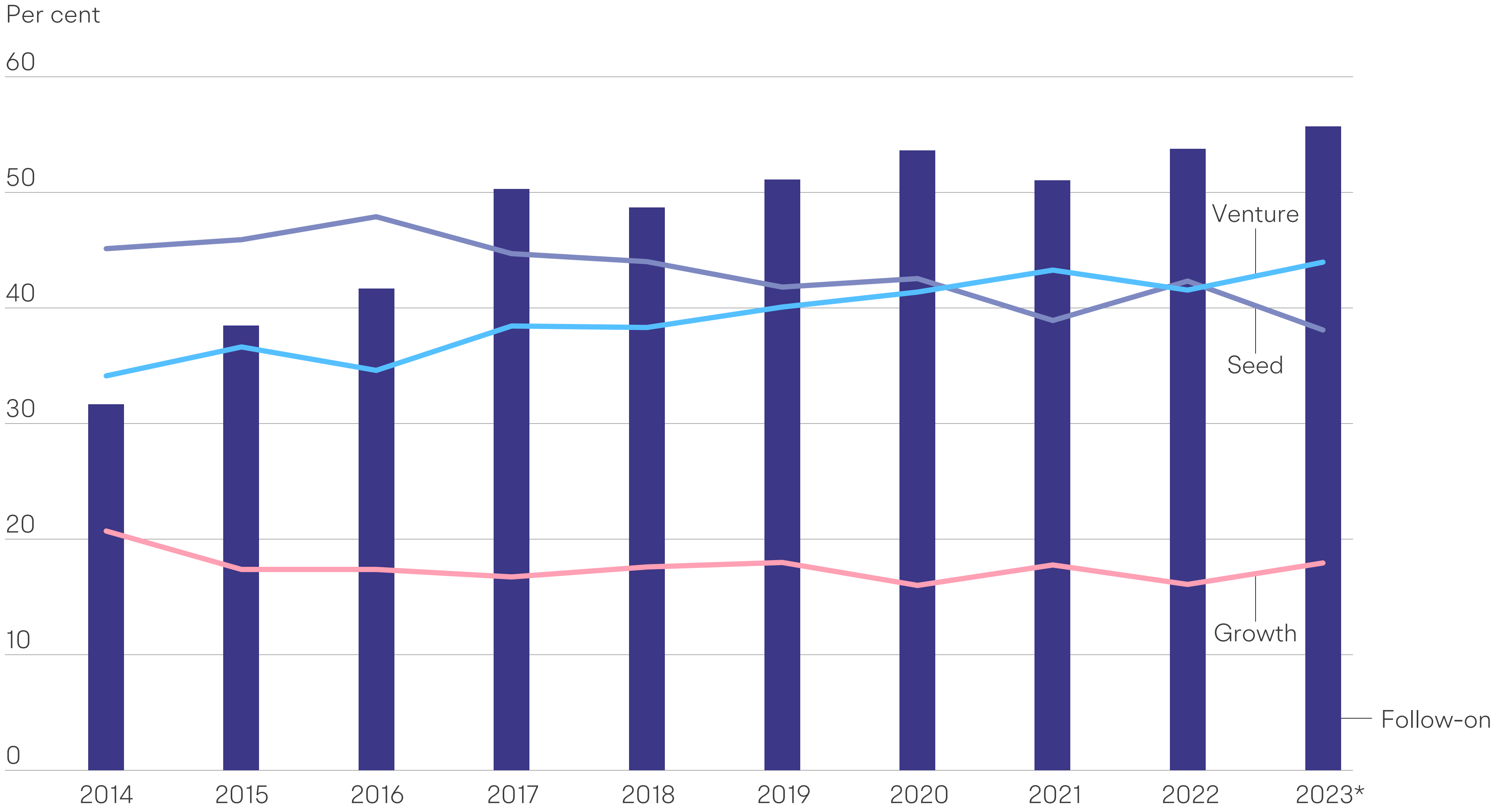
As of 2023, venture stage companies now represent 44% of all deals – compared with 38% for seed stage businesses. The UK ecosystem is also now more able to scale high quality, globally competitive companies. Our Small Business Equity Tracker 2023 report found that the UK is home to 40 equity-backed unicorn companies, with more than half having secured funding through a programme offered by the Bank.

The development of the market can also be seen through the increase in follow-on deals over the period, which provides an indicator of the ecosystem's ability to successfully scale high-growth companies. The proportion of all deals that are follow-on has risen from around a third in 2014 to 56% in 2023, an increase of over 20 percentage points. Exploring this trend further with data on individual round numbers, in 2023 a fifth of all deals involved companies raising their fourth or higher round. In 2014 the equivalent share was less than 5%, demonstrating the pipeline progression that has taken place over this period.

Figure A.7

Share of UK smaller business equity deals by company stage

Source: British Business Bank analysis of Beauhurst data.



*2023 data is up to Q3 only.

This expansion has been driven by a deeper and more broad-based range of investors supplying finance

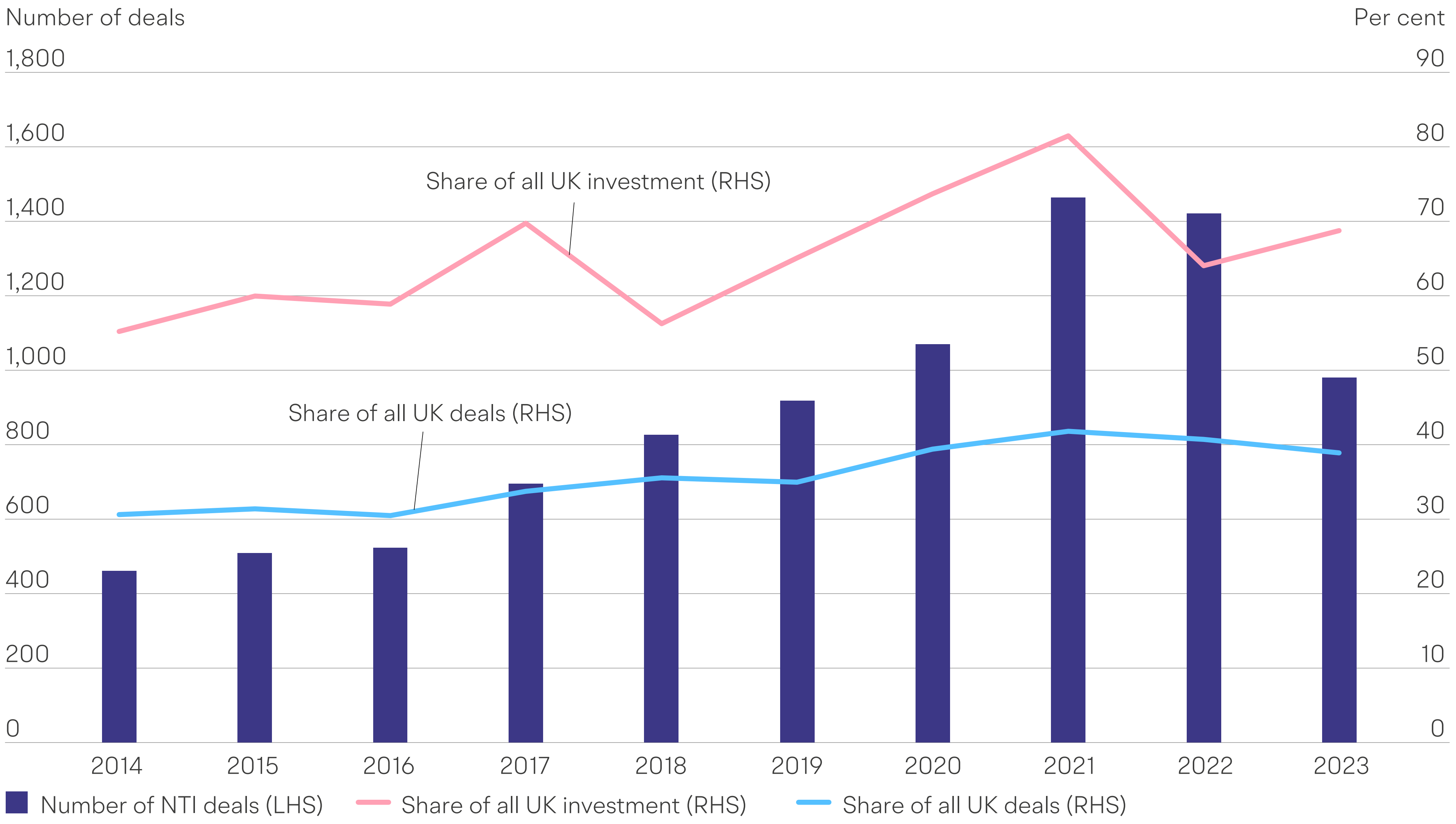
The deepening of the market also been driven by a wider range of investors participating in UK deals – increasing the total volume of finance supply as well as the types of finance available to businesses at different growth stages. This evolution means the market is in a significantly better position to deal with the current downturn than in previous cycles.

At the earlier stages of the market, for example, crowdfunding platforms have become a more common and influential source of private funding – opening up early-stage venture investing to a much larger pool of public retail investors. Examples of high-profile crowdfunding platforms include Seedrs and Crowdcube. By 2021-23 these platforms have become an active part of the UK smaller business equity market, involved in 19% of smaller business deals.

Figure A.8

UK VC deals involving non-traditional investors (NTIs)

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



Angel investors also continue to provide a valuable source of support for early-stage companies looking to start their growth journey. In addition to equity finance this support can include experience, strategic advice and networks. Over the past decade angel investors have become more professional and formalised, working in network and syndicates to collaborate and source deals. As of 2021-23, 24% of UK smaller business equity deals were backed by an angel investor.[33]

At the later stages of the market, there has also been a rapid expansion in participation from other forms of non-traditional investors (NTIs) such as corporate VCs, private equity funds and asset managers. This trend has been mirrored across other developed markets, with corporations looking to VC investing as a way of remaining at the innovation frontier. Crossover investors[34] have also played a more active role in funding late-stage companies, which have generally remained private for longer amid a subdued initial public offering (IPO) environment.

During this time overseas investors have expanded their role in the later stages of the UK market, where they are able to write large cheques – reflecting the larger pools of capital they have available. The proportion of UK smaller business equity deals involving overseas investors has risen from 14% in 2014-16 to 28% in 2021-23, with a disproportionate contribution at growth stage (38% of deals in 2021-23).[35] While this trend has increased the supply of late-stage finance, it has also contributed to market challenges in retaining successful companies – with firms receiving overseas investment more likely to exit abroad.

To understand the impact of these trends on the overall market, Figure A.8 shows that the proportion of deals involving NTIs[36] has increased steadily over the past decade from 31% in 2014 to 39% in 2023. The number of these deals has also increased by 159% between 2014-16 and 2021-23, significantly outpacing growth in volumes across the wider VC market. On an investment basis, the share of UK VC investment supported by NTIs has also risen from 55% in 2014 to 69% in 2023, and on average the deals backed by these investors have been twice as large than those across the wider equity market since 2014.

The UK has established itself as a globally leading VC market, particularly in sectors such as fintech

The UK has established its position as a global leader in VC investment over the past decade. Today the UK VC market is the third largest in the world, raising £72bn across the 2021-23 period, behind only the US (£582bn) and China (£213bn). It is also the largest market in Europe by a significant margin, attracting more investment during the past three years than France, Germany and Sweden combined.

The UK has also strengthened this position when compared to ten years ago. Its share of global VC investment value has risen from 3.4% in 2014-16 to 5.9% in 2021-23, while its share of European VC investment value has also increased from 33% to 34% in 2021-23. These trends are reflected when analysing the number of deals, demonstrating that the UK ecosystem is globally competitive on both a volume and value basis.

Underneath this overall growth in market size, the UK has also fostered comparative advantages in specific sectors. For example, the UK now accounts for over 11% of global investment in the fintech sector, and 48% of European fintech investment, making this industry a real success story for the UK VC ecosystem. Some of the largest fintech deals globally over the past ten years have involved UK companies, such as Checkout.com and SumUp.

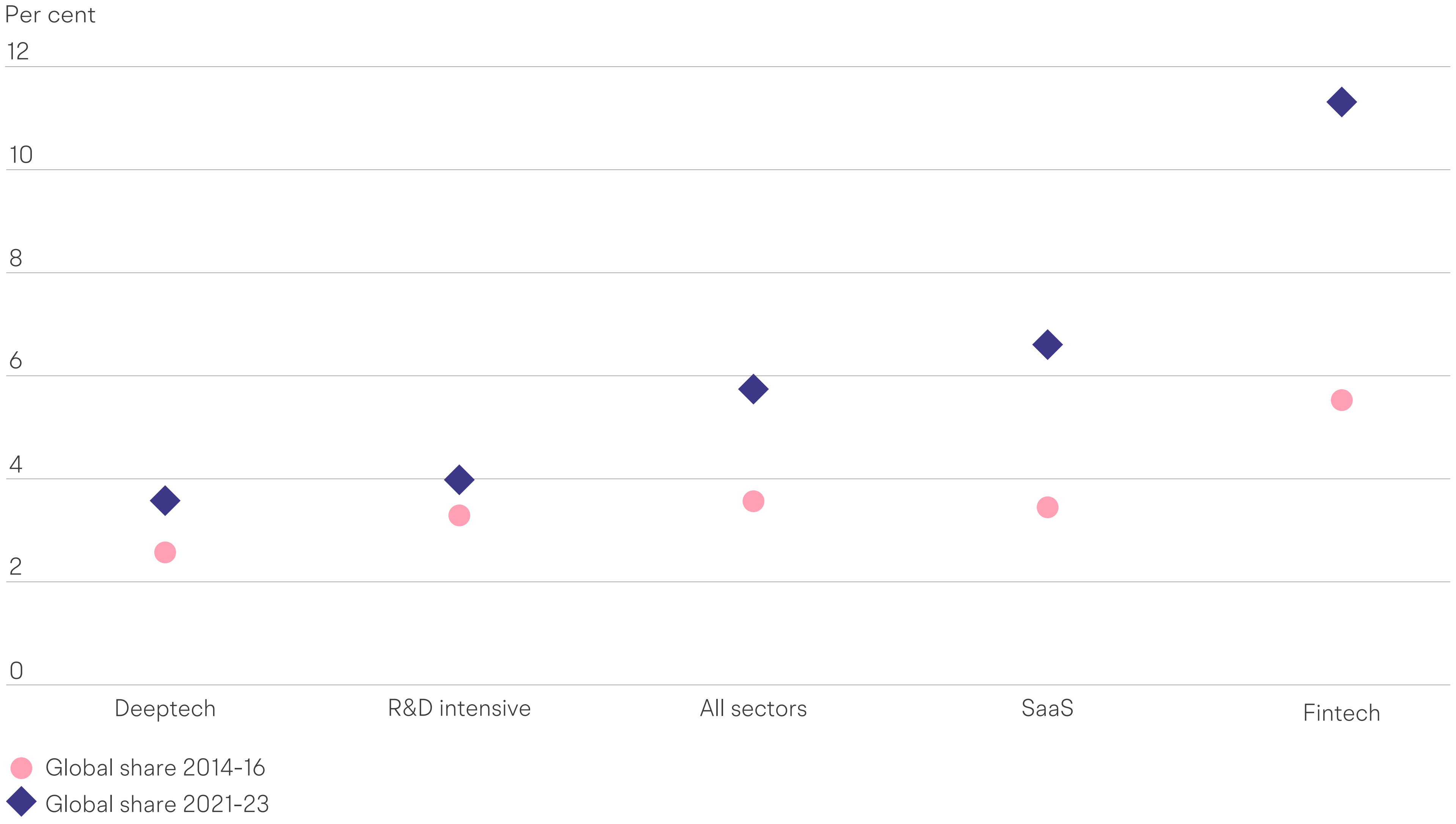
There are several factors behind the UK's specialisation in fintech, and the resulting growth in VC investment in the sector. These include an innovation-enabling regulatory environment. This is exemplified by the Financial Conduct Authority's regulatory sandbox established in 2016, as well as talent and networks leveraged from the UK's world leading financial services industry. Growth, innovation and technological adoption across the broader industry have provided VC-backed startups with a strong market in which to apply their solutions.

In deeptech and R&D intensive sectors, where VC investment requires specialist technical and scientific knowledge, as well as large pools of patient capital, the UK market is further from the global forefront. Its global

Figure A.9

UK share of global VC investment by sector

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



position has still improved over the past decade, with the UK now accounting for 3.6% and 4.0% of total investment in these sectors, respectively, in 2021-23.

British Patient Capital (BPC) and the Future Fund: Breakthrough programme have an important role in helping to address the market failures that have historically resulted in an undersupply of finance in these sectors. The BPC interim evaluation found that the programme has performed well in crowding in private sector finance and generating additional business growth, innovation and job creation.[37]

Specific gaps remain in the market, particularly at later stages and in R&D intensive sectors

Comparing the UK to the US, the most developed VC market in the world, is a useful reference point in identifying whether different parts of the market are functioning effectively. Accounting for variation in economy size, measuring the amount of VC investment as a proportion of GDP provides a benchmark for assessing the existence of market gaps by growth stage.

To understand how these gaps have changed over time, again this analysis compares three-year periods at the start and end of the past decade. For the latter, 2019-21 is used for the most accurate and representative picture. This period provides a more stable recent market comparison to the US, versus including 2022 and 2023 data. Since 2022, there has been a significant market correction which affected US and UK activity at different paces.

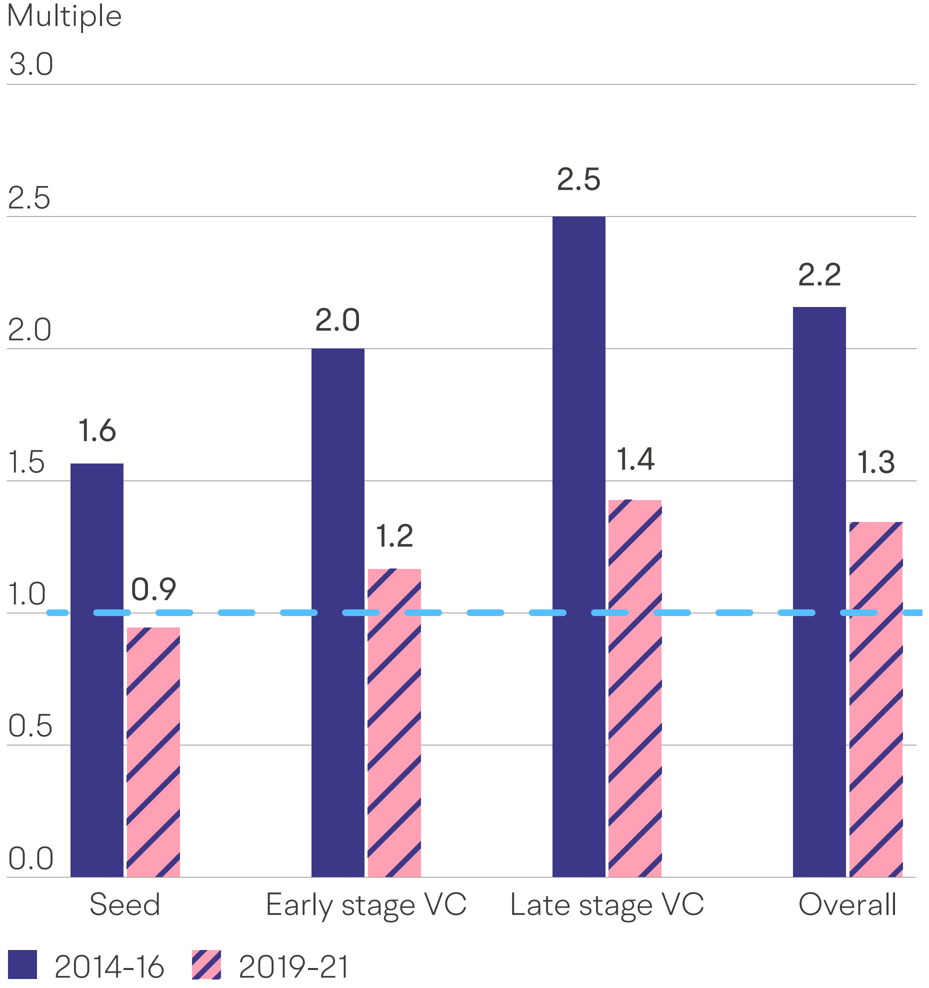
The UK's equity investment gap with the US has narrowed most significantly at the seed stage of the market over the past ten years. During 2014-16 UK seed stage investment represented 0.02% of GDP (compared with 0.03% in the US), early-stage VC investment comprised 0.07% of GDP (0.14% in the US) and late-stage VC investment accounted for 0.11% of GDP (0.28% in the US).

Figure A.10 shows the ratio of US to UK VC investment after making this GDP adjustment (where a multiple of 1 indicates that the US and the UK receive the same amount of GDP-weighted investment). On a GDP-weighted basis this equated to the US receiving 1.6x as much investment at the seed stage, 2x as much at early VC stage and 2.5x as much at late VC stage (Figure A.10). By 2019-2021, however, these multiples have reduced to 0.9x, 1.2x and 1.4x. While gaps in the market have

Figure A.10

US-UK VC investment value multiples (adjusted for GDP)

Source: British Business Bank analysis of PitchBook, Office for National Statistics and Bureau of Economic Analysis data.



reduced across all stages, the UK now raises more seed stage investment than the US after taking into account the relative size of both economies.

The seed stage of the UK market has strengthened over the past decade. Using Beauhurst data on smaller business equity deals, total seed investment rose seven-fold from £0.3bn in 2014 to a peak of £2.2bn in 2022. Investment at this stage has also been relatively resilient in 2023, despite the recent downturn, with £1.2bn raised during Q1-3 2023. However, despite the wider improvements in the availability of seed funding, finance intermediaries still consider it challenging to raise early-stage equity finance.[38]

Elsewhere the investment gap with the US is still most acute at later stages of the market, where the US raises 1.4x more investment than the UK on a GDP-adjusted basis. While this represents a significant improvement compared to 2014-16, it still highlights that certain frictions such as the cycle of low institutional investment and small fund sizes continue to result in an undersupply of finance in this part of the market.

In addition, the overall UK-US gap also remains concentrated in deeptech and R&D intensive sectors. In 2019-21, for example, UK VC investment in these sectors represented 0.26% of GDP, versus 0.44% in the US, a multiple of 1.7x.

As the largest domestic investor in UK VC, BPC will continue to focus on addressing these issues to build a patient capital ecosystem for innovative companies. The Future Fund: Breakthrough programme, for example, is funding later stage R&D intensive companies across a range of deeptech sectors, while the Life Sciences Investment Programme is making cornerstone commitments in later stage life sciences venture growth funds with a strong UK focus. Looking ahead, the Bank's Growth Fund and Long Term Investment for Technology & Science (LIFTS) programme will seek to catalyse institutional funding in the UK's growth economy as part of the Mansion House reforms.

1.4

Unlocking potential in hard to reach places

Despite overall market improvements, regional disparities in smaller businesses' use of external finance remain

Both sectoral and place-based factors continue to shape regional disparities in external finance use

Equity markets have become broader and deeper throughout the UK, but London remains dominant

This section highlights challenges remain in getting finance to smaller businesses located in many parts of the UK. This is particularly acute for equity finance where London's dominance remains.

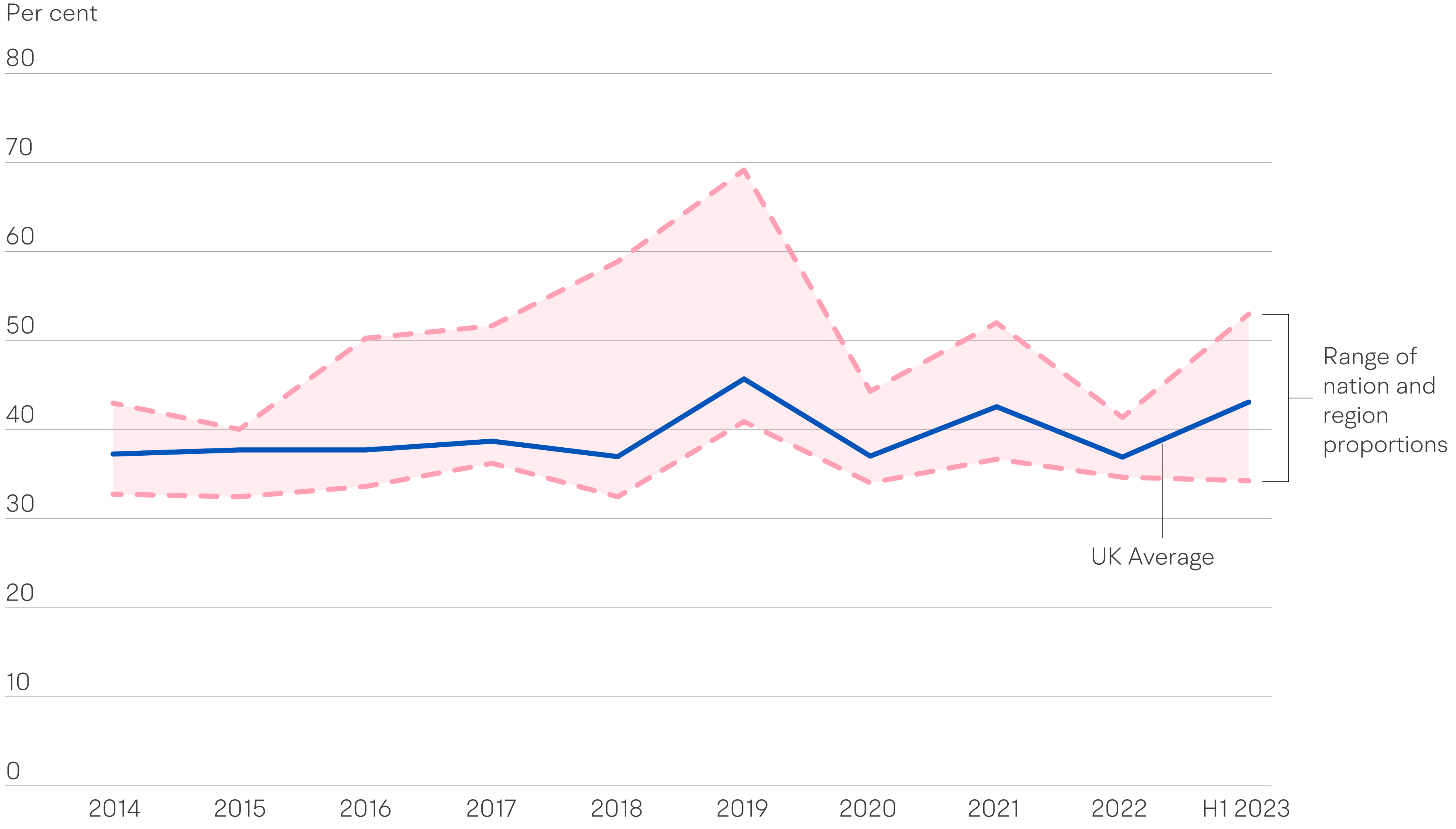
Despite overall market improvements, regional disparities in smaller businesses' use of external finance remain

In H1 2023, the gap between the highest and lowest national/regional shares of smaller businesses using external finance, while reduced over the pandemic years, had returned to higher levels than in 2014 (Figure A.11).[39]

Figure A.11

Proportion of smaller businesses using external finance (upper & lower nation and region range)

Source: UK Finance BVA BDRC SME Finance Monitor Survey.



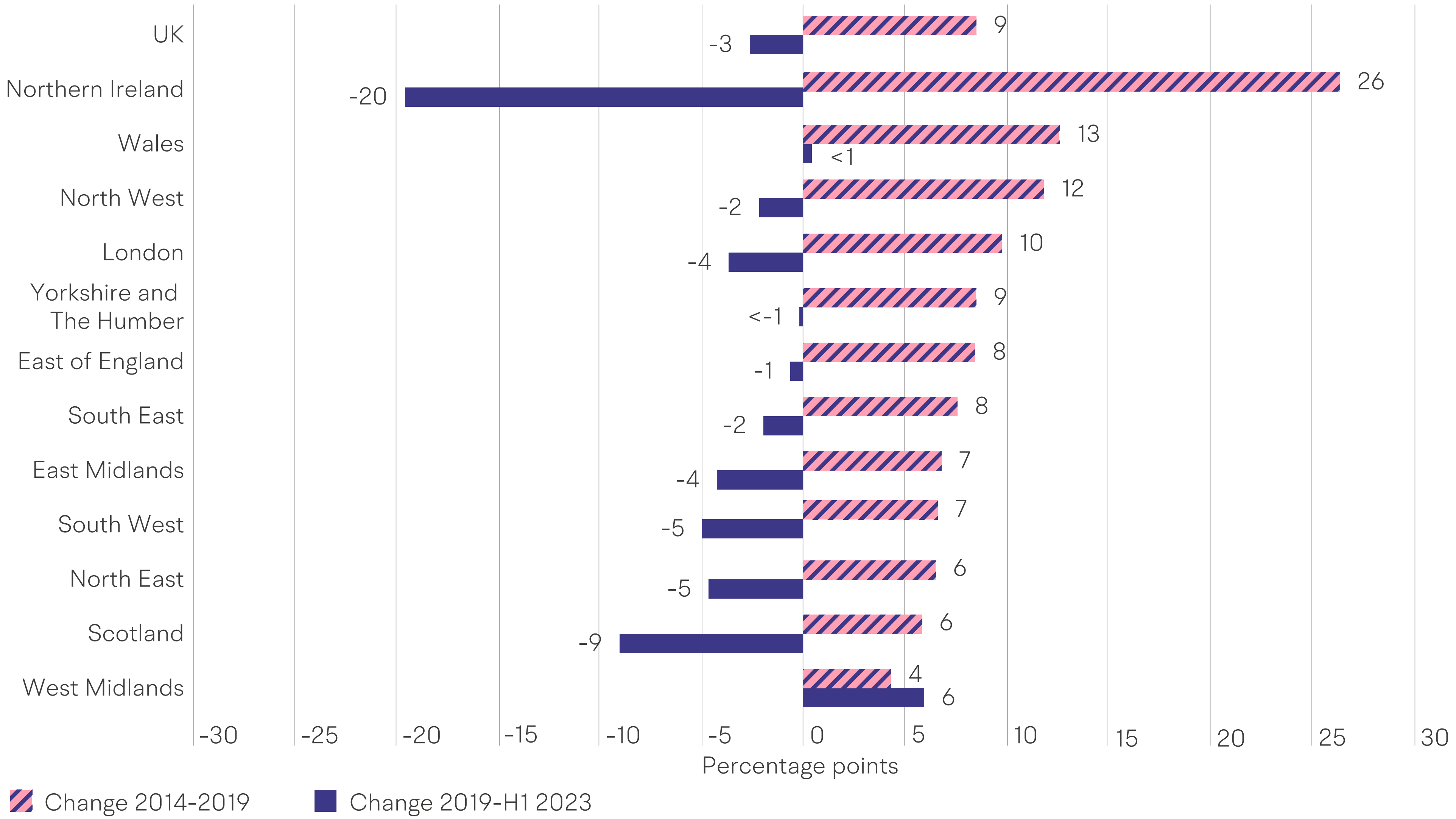
The Covid-19 pandemic played a key role in shaping external finance use trends in recent years, due to place-based differences both in smaller businesses' uptake of pandemic-related support (ranging from 15% to 42% on Government-backed loans and from 15% to 44% on public business grants in 2020)[40], and in the impact this had on finance use in the post-pandemic period. In 2019, all parts of the UK had higher external finance use levels than in 2014 (Figure A.12). However, as of H1 2023, only the West Midlands had seen a net increase on that measure since the last year before the Covid-19 pandemic. Seven of the 12 UK Nations and regions had seen a net decline over the same period, while the remaining five had seen no significant change (change greater than 2 percentage points difference).

The H1 2023 data shows external finance use was generally back on an upward trajectory, but recovery was uneven for different finance types across the UK. For instance, use of bank overdrafts, despite falling sharply in 2020 and 2021, had resumed growing in the majority of the UK Nations and regions by H1 2023, but was still decreasing or flat in five of them.

Figure A.12

Net change in the proportion of smaller businesses using external finance by UK nation and region

Source: UK Finance BVA BDRC SME Finance Monitor Survey.



Sub-national differences in smaller businesses' capacity to navigate finance options have also persisted over the past decade. In a recent British Business Bank survey of finance intermediaries, between 52% and 70% of respondents in each UK Nation and region reported lack of awareness of finance options as one of the biggest barriers to finance access for smaller businesses.[41] Their capacity to access relevant information has not significantly improved in recent years, with only 60% of UK smaller businesses reporting they knew where to obtain this in 2023 (compared with 65% in 2016), and sub-national proportions still ranging widely, from 52% in Scotland up to 77% in Northern Ireland.[42]

Both sectoral and place-based factors continue to shape regional disparities in external finance use

Part of the variation in external finance use across the UK can be explained by local differences in smaller businesses' sectoral composition. This is due to sector-specific patterns in finance use levels, which have persisted over the last decade.

Primary sectors including agriculture, fishing, forestry, mining and utilities and wholesale/retail have consistently had the highest average proportion of UK smaller businesses that reported using finance over the last decade (46% and 45% respectively). In contrast, average usage rates were slightly lower in manufacturing (41%), transport/communications (40%) and hospitality (43%) and reached their lowest in construction (37%) health (37%) and real estate (34%).[43]

Nevertheless, sectoral composition does not adequately explain all differences in smaller businesses' external finance use across the UK. Our annual Nations and Regions Tracker reports have identified further place-based factors shaping this measure at the sub-national level.[44] These are summarised in Box 1.

Box 1: Place-related factors influencing smaller business access to finance: Findings from the British Business Bank's 2021, 2022 and 2023 Nations and Regions Tracker reports

The majority of investors are close to the businesses they invest in (2021). Travel distance is a key factor influencing equity investor preferences. Our analysis of investor-investee pairings between 2011-2020 revealed that in 82% of these, investors had an office within two hours of the equity investment recipient, and in 61% within an hour.

Rural businesses face greater challenges in accessing appropriate finance (2021). Despite showing higher propensity to use external finance (39% in 2020) than their urban counterparts (36%), rural smaller business owners were more likely to say they had no choice but to inject personal funds into their business during 2020, the first year of the Covid-19 pandemic (37% v. 32%). Finance awareness levels are similar between rural and urban smaller businesses, but the former (excluding medium businesses) are less likely to have a trained financial decision maker (24% v. 27%).

Smaller businesses in deprived areas are more inclined to seek finance, but face more barriers to get it (2022). Smaller businesses in deprived areas are more inclined to seek growth-oriented external finance (36%) than those in less deprived areas (33%). Yet, they are also more likely to feel discouraged from applying (26% v. 22%) and to show lower awareness of non-core finance options. Before the pandemic (2019), these businesses also had a higher rejection rate for finance applications (43% v. 25%). In addition, deprived areas show a higher concentration of businesses with characteristics linked to increased barriers in accessing finance, such as having low credit balances, reporting a profit and being Ethnic Minority-led (see section 1.5 unlocking potential in under-served groups).

Addressing regional gaps in smaller business finance access can support a more equitable, regionally balanced transition to net zero (2022). Our analysis confirmed that Nations/regions with the lowest GVA per head and 'thin' finance markets also tend to have the highest share of turnover/employment in high-emission industries and as such, they may face a more difficult transition net zero. Meanwhile, our research also highlighted opportunities for levelling up, showing that businesses developing climate solutions were on average more likely to receive a first equity round and follow-on rounds than peers in other sectors, and that equity investment in this sector is less concentrated in London than the UK's overall equity market.

33 Innovation-led clusters across the UK show potential for equity finance to drive growth (2023). Our analysis identified 33 innovation-led clusters demonstrating that there are significant innovative investment hotspots beyond the Golden Triangle of Greater London, Cambridge, and Oxford. Academic spinouts play a significant role in the majority of these, accounting for an average 23% of Technology/IP-related deals and 28% of investment value across all clusters between 2011 and Q2 2023. However, academic spinouts located outside of the Golden Triangle face a more challenging equity environment, as shown by their tendency to complete smaller deals, to secure their first (announced) investment later in life and to rely more on government investors.

Coastal towns face multi-dimensional challenges that make it harder to secure long-term investment (2023). Coastal town-based smaller businesses show lower appetite for growth-oriented external finance (26% in 2022) than their counterparts based elsewhere (31%). This is coupled with a more risk-averse attitude and a lower propensity to pursue ambitious growth plans, which could reflect the significant challenges confronting coastal economies in recent years (ranging from low productivity to poor transport connectivity). At the same time (and despite being underrepresented in UK equity investment), many coastal town-based businesses are taking advantage of equity investment opportunities in fast-growing sectors such as net zero.

Equity markets have become broader and deeper throughout the UK, but London remains dominant

The number and value of equity deals in London generally grew faster than in the rest of the UK over the past decade (Figure A.13-14), leading to increased concentration of equity activity in the capital. Prior to 2014, London accounted for 34% of UK equity deals, but this increased to 42% in 2014 before peaking at above 50% in 2022. By Q1-Q3 2023, London's share was reduced but still much higher than in 2014, at 46% of UK equity deals and 58% of the related investment value (see section 2.5 equity finance).

London's increasing share of equity deals may be attributed to greater access of skilled labour, financial expertise as well as a positive networking environment. However, while the effect has been greater in London, clustering effects have also been seen in other UK cities. These include Edinburgh, Manchester, Glasgow and also Bristol & Bath.

Figure A.13

Number of equity deals in London and rest of the UK

Source: British Business Bank analysis of Beauhurst data.

From 2014 to 2022, equity investment has generally grown at all stages throughout the UK, but deal numbers were growing faster in London than elsewhere, particularly at the later stages. Over the same period, seed stage equity deals in London rose by 77% compared to 62% in the rest of the UK. Similarly, deal numbers at the venture stage increased by 189% in London relative to 77% in the rest of the UK. Growth stage equity deals also expanded in London by 139%, while the trend was broadly flat in the rest of the UK.

Imbalances also remain in the geographical distribution of equity investors across the UK. From 2017, the number of unique VC offices per region increased more in London (186%) than areas outside of London (142%). Specifically, high-growth enterprises (HGEs) located outside of London have more limited local access to VC investors compared to their counterparts within the capital, which (as discussed in Box 1) tends to increase their barriers to accessing equity finance. London had 32 unique investors per 100 HGEs in Q1-Q3 2023, surpassing the figures from 2017 and 2019, and marking a 33% increase from 2021 (Figure A.15). The corresponding ratio outside of London was merely three investors per 100 HGEs in both years.

Figure A.14

Equity investment in London and rest of the UK

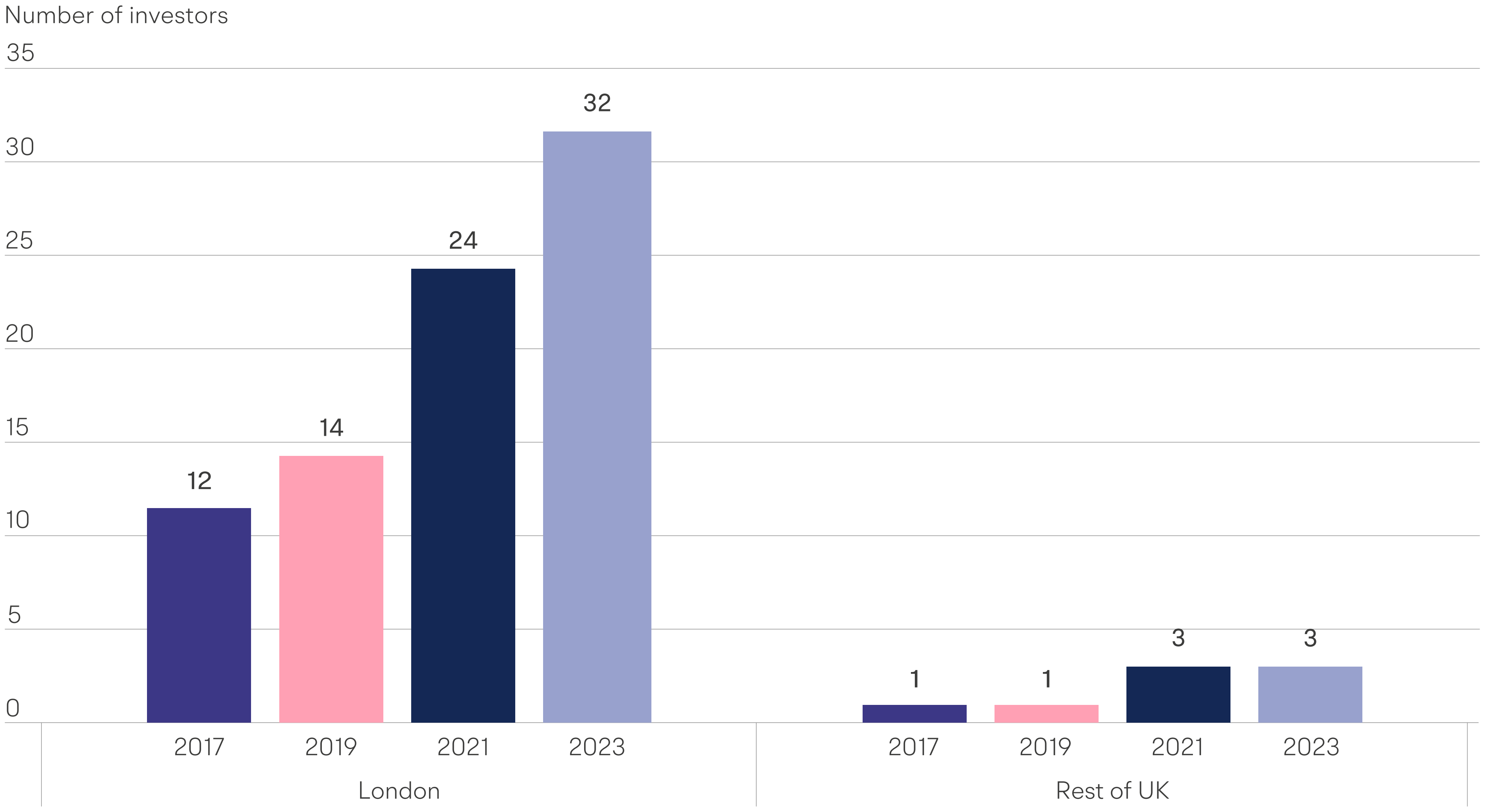
Source: British Business Bank analysis of Beauhurst data.

Overall, the evidence in this section confirms that addressing regional imbalances in smaller businesses' access to finance across the UK remains an ongoing challenge and continues to be a priority for the Bank. The new £1.6bn Nations and Regions Investment Funds are enabling the Bank to increase investment towards addressing regional finance access imbalances and expand the geographical coverage of its regionally-focused interventions, strengthening synergies with the Regional Angels Programme and the positive regional impacts of other UK-wide programmes we deliver.

Figure A.15

Number of unique VC investors per 100 high-growth enterprises

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



1.5

Unlocking potential in under-served groups

Under-served entrepreneurs face challenges in accessing finance needed to grow

Less finance going to female and Ethnic Minority businesses over the past decade, but signs of improvement in some parts of the industry

When decision makers and funders are more representative, investment into founders is more balanced

Funders need to consider barriers, report diversity data, measure impact and reflect this in decision making, to unlock entrepreneurs' potential

The profile of business leaders and owners is becoming more diverse, but as the OECD notes there remains a long way to go before the entrepreneurial population, and their funding, fully reflect the diversity of the wider population.[45]

This section highlights the challenges that under-served groups have faced in accessing finance over the past ten years, and it explores the extent to which these challenges persist, focussing on female and Ethnic Minority entrepreneurs. A more detailed exploration of wider characteristics is available in the Bank's Alone Together research.[46] The Bank's Finance Survey asked about disability and business ownership/leadership for the first time in 2023, with the results explored in more detail in section 2.3 DEI and finance for female, Ethnic Minority and disabled entrepreneurs.

Under-served entrepreneurs face challenges in accessing finance needed to grow

Gender and ethnicity have a considerable effect on entrepreneurial opportunities and outcomes, with businesses led by female or Ethnic Minority founders having a positive impact on society and the environment.[47] However, the rate of female entrepreneurial activity remains below male activity.[48] Ethnic Minority entrepreneurs overall have reported higher entrepreneurial activity rates than non-Ethnic Minority entrepreneurs[49] but some groups have poorer outcomes, particularly those living in deprived areas and having lower incomes.[50] The pandemic and subsequent economic conditions have exacerbated some of these challenges.[51] Under-served entrepreneurs' businesses that start up and grow are important in creating jobs, innovating, and solving environmental, social and governance problems.[52]

Businesses led by people with a disability, female or those from Ethnic Minority backgrounds are more likely to be younger businesses and/or smaller compared to their White and male-led counterparts.[53] This creates difficulties in accessing finance due to a shorter track record for credit applications,[54] leading to higher interest rates and stricter loan terms.

Ethnic Minority-led businesses are more willing to use external finance to grow and develop their business but are more likely to face barriers to applying (discussed more in section 2.3 DEI and finance for female, Ethnic Minority and disabled entrepreneurs).[55] This suggests unmet demand for finance and is illustrated by Ethnic Minority-led businesses having been at least twice as likely as White-led businesses to report needing finance but not applying (Figure A.16).

Female-led businesses are typically less willing to use finance to grow their business. In recent years, a significantly higher proportion of female-led businesses have reported needing finance but not applying. Together these disparities highlight the complexities under-served groups face in accessing capital for growth.

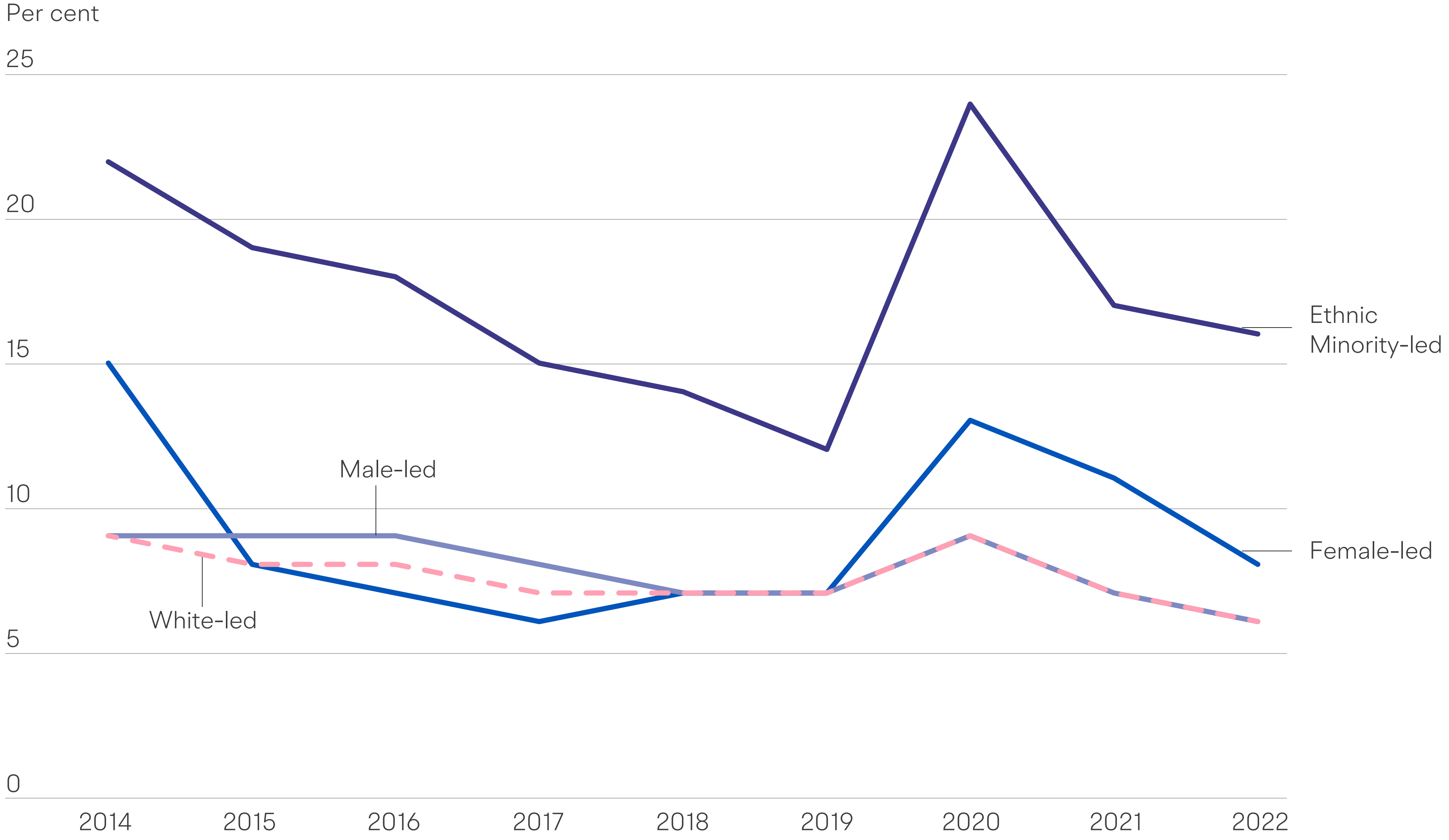
There are a number of barriers these groups face in applying for finance. For example, most Ethnic Minority-led smaller businesses that needed finance but didn't apply cited the likelihood of rejection as a reason for not applying. Perceptions of rejection disproportionately prevented women-led smaller businesses from seeking finance in 2016 and 2019 too. Not knowing where to find appropriate finance is another recurring barrier to applying for finance for a higher share of female and Ethnic Minority-led smaller businesses (Figure A.17).[56]

Some under-served groups have lower awareness of different finance options available to them. For example, female and Ethnic Minority-led smaller businesses have had significantly lower awareness of alternative types of finance like equity, VC and asset finance, over 2015-2023 (compared with male-led and White-led businesses) and gaps have not improved over time.

Figure A.16

Proportion of smaller businesses reporting a need for finance but not applying

Source: British Business Bank analysis of DBT Longitudinal Small Business Survey. Base sizes vary by year.



In 2023 the Bank's Finance survey found businesses led by those with a disability were aware of a narrower range of finance types.[57]

Addressing discouragement amongst under-served groups and the importance of raising awareness of finance options, along with providing clear information and signposting on the types of finance available, has been highlighted by organisations like the Lending Standards Board and the Enterprise Research Centre.[58] Wider research has called for finance providers to improve financial inclusion and ensure the needs of different communities are met.[59]

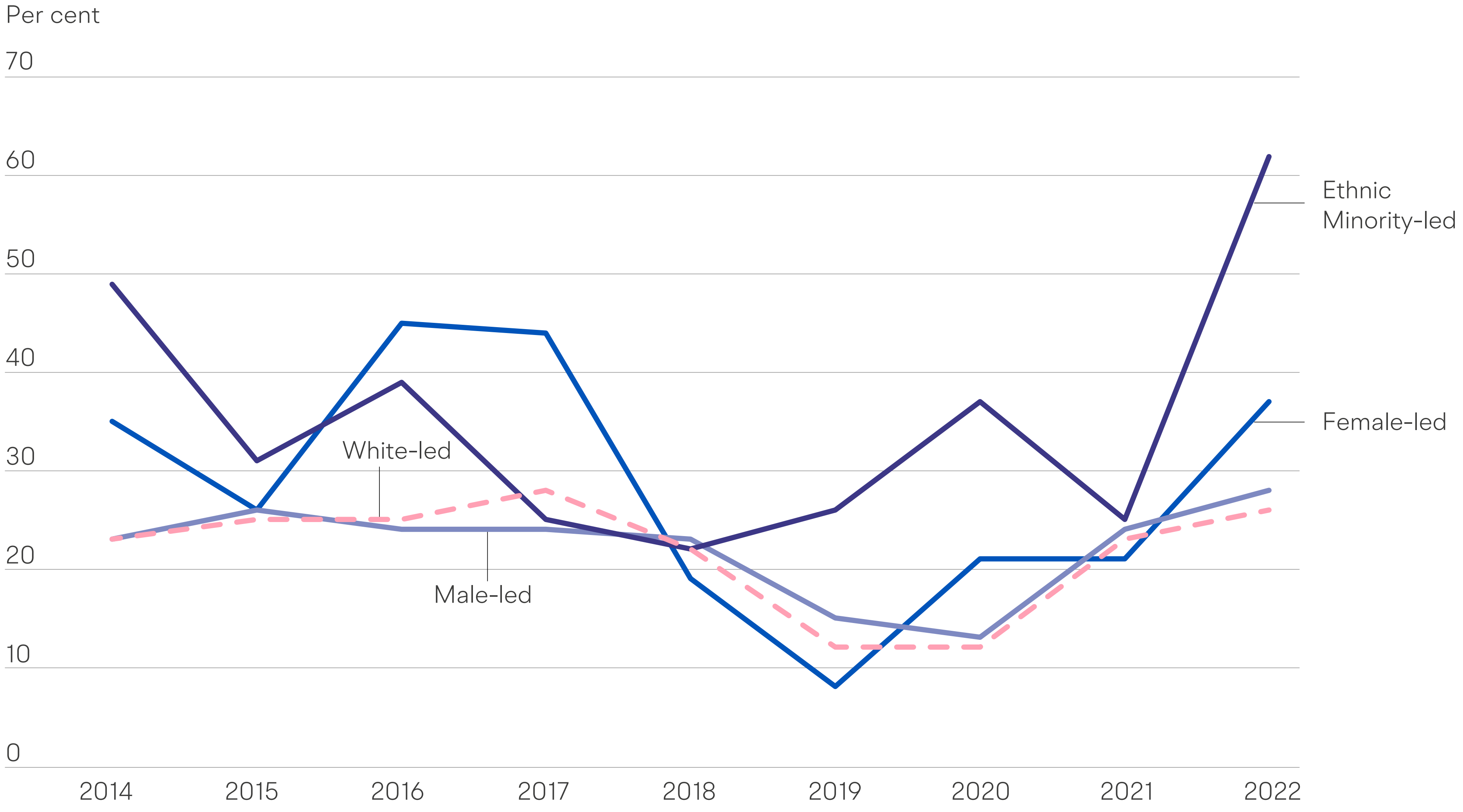
Less finance going to female and Ethnic Minority businesses over the past decade, but signs of improvement in some parts of the industry

Ethnic Minority-led businesses are significantly more likely to have been turned down for finance. In 2021, 15% of Ethnic minority-led businesses reported having an application for finance rejected over the past ten years, compared to 4% of White-led businesses.[60] They are also more likely to have not been given a reason.[61]

Figure A.17

Proportion of smaller businesses not knowing where to find appropriate finance (of those that needed finance but didn't apply)

Source: British Business Bank analysis of DBT Longitudinal Small Business Survey. Base sizes vary by year.



These statistically significant differences have been sustained over a number of years.[62] Possibly as a result of higher rejection rates, Ethnic Minority-led businesses have been significantly more likely to use debt from alternative sources, such as loans from family, friends, owners or directors and peer to peer or marketplace platforms.[63]

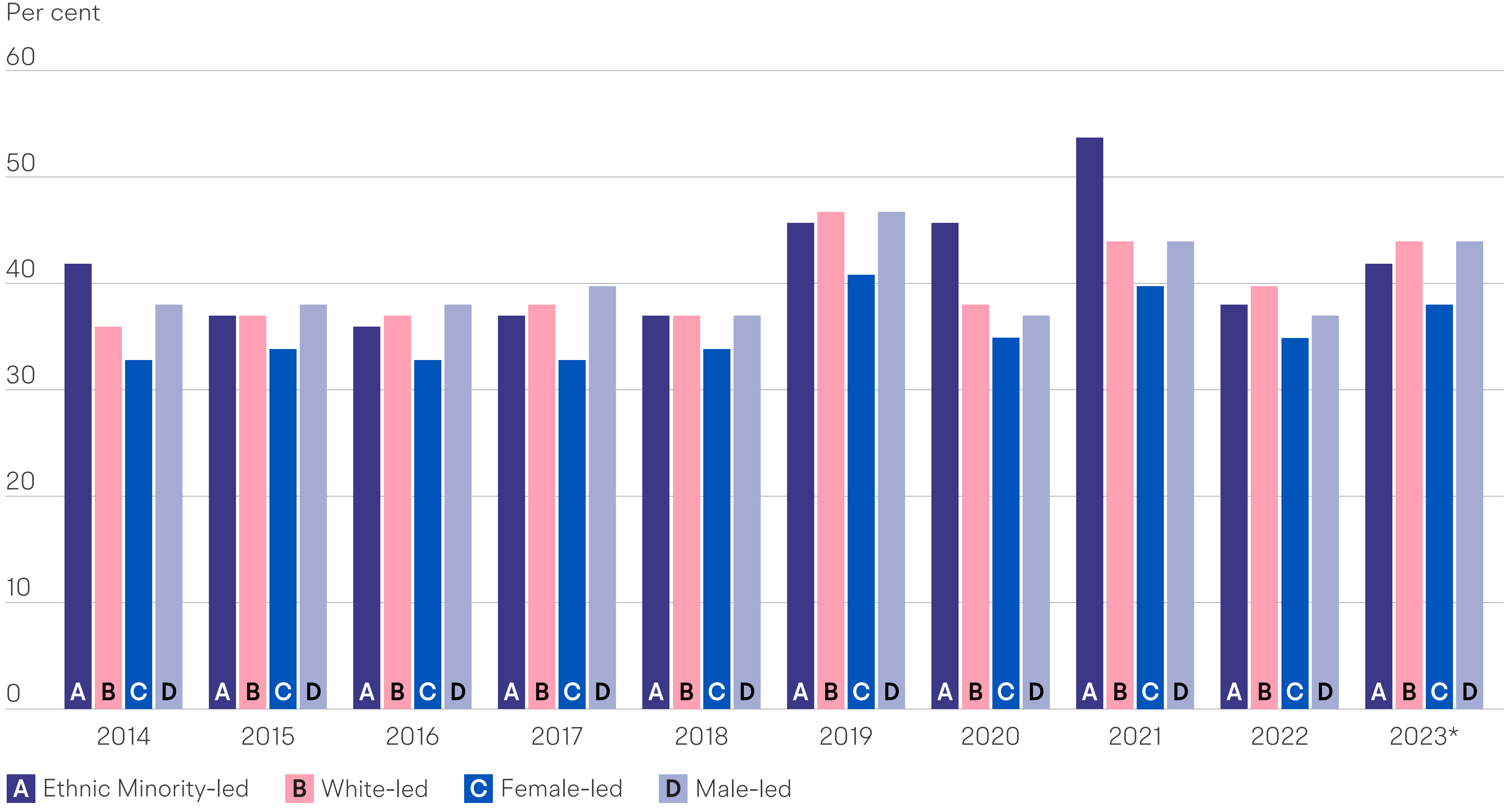
Women-led businesses have also faced lower approval rates, as shown by UK Finance analysis of Investing in Women Code (IWC) signatories' data. 72% of women-led businesses that applied obtained debt funding compared to 79% for male-led businesses in 2023. Women-led businesses also obtained lower average facility sizes (£174k compared to £507k for male-led businesses). Women-led businesses are typically younger and less likely to make a profit[64] so information asymmetries may be contributing to the greater difficulties in securing finance.

The combination of supply and demand side factors has led to lower use of finance amongst female-led businesses compared to male-led businesses and this position hasn't changed since 2014 (Figure A.18).[65]

Figure A.18

Proportion of businesses currently using any type of finance

Source: UK Finance BVA BDRC SME Finance Monitor. Base sizes vary by year.



*2023 data is Q1 and Q2 only.

Some parts of the lending market work well. For example, 15% of Community Development Financial Institutions' (CDFIs) business lending in 2022 went to Ethnic Minority-led businesses and 36% went to women-led businesses. This was above the share of the business population those groups account for.[66]

Equity markets show a mixed picture.[67] Whilst the share of deals to teams with at least one female founder has increased by almost 10 percentage points over the past decade,[68] the increase was driven by mixed gender teams (Figure A.19). The investment received by all female teams remained flat at 3% in 2023, the same figure as at the start of the period.

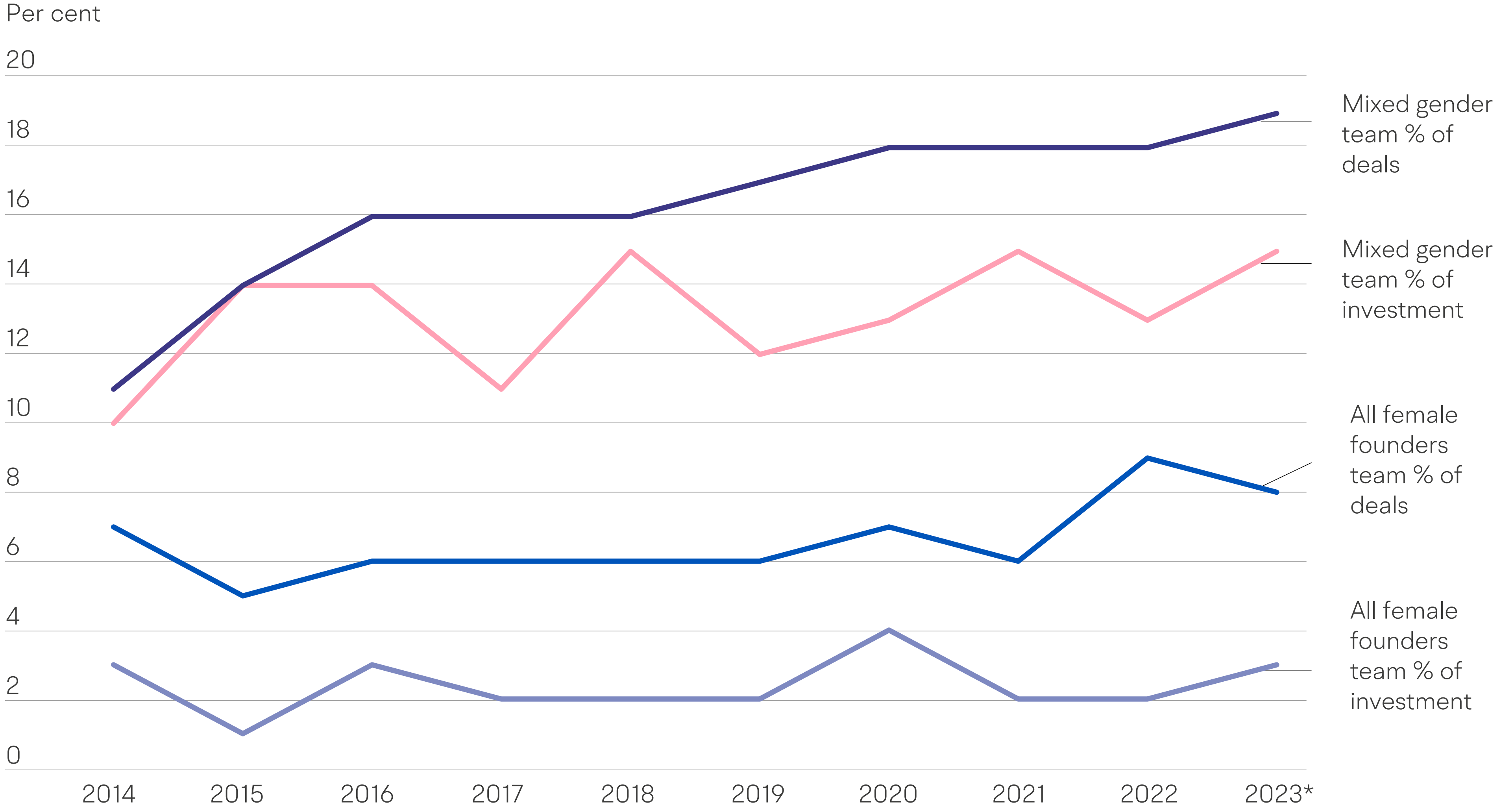
Some parts of the equity market have shown signs of improvement. For example, IWC signatories are more likely to invest in female founded firms than the wider market.[69] Signatories that have consistently reported data over 2020-22 have increased their share of funding to female founders from 32% in 2020 to 38% in 2022 (Figure A.20).

Less is known about equity investment to Ethnic Minority founders. Around 11% of VC deal rounds and 9% of investment value went to non-White founders over 2013-2023, with Black female founders particularly

Figure A.19

Proportion of equity deals and investment received by all-female and mixed gender founder teams

Source: British Business Bank analysis of Beauhurst data.



*2023 data up to Q3 only

underrepresented.[70] British Business Bank research has also highlighted improvements in first-time funding for Ethnic Minority founders across the equity market. Teams with at least one Ethnic Minority founder made up 26% of first-time deals and 42% of investment value 2022, up from 19% respectively in 2014.[71] However, a lack of regularly reported, fund-level data makes this difficult to track and gaps difficult to appraise.

When decision makers and funders are more representative, investment into founders is more balanced

Research suggests that gender biases can affect lending and investment decision-making. Female founders are typically asked more prevention/ defensive-focussed questions when pitching, resulting in lower funding raised.[72] Investment committees that encompass a range of perspectives and backgrounds are better equipped to appraise markets and make well-informed judgements, improving decision-making.[73]

Lack of representation and diversity across the UK VC industry and investment decision-makers across gender, ethnicity and socioeconomic background has been well documented, with limited signs of improvement over the

Figure A.20

Share of VC deals received by companies with at least one female founder

Source: IWC Signatory data (2020 to 2022). Data from 27 funds (IC deals: n=439, n= 507, n=553) and British Business Bank analysis of Beauhurst data.

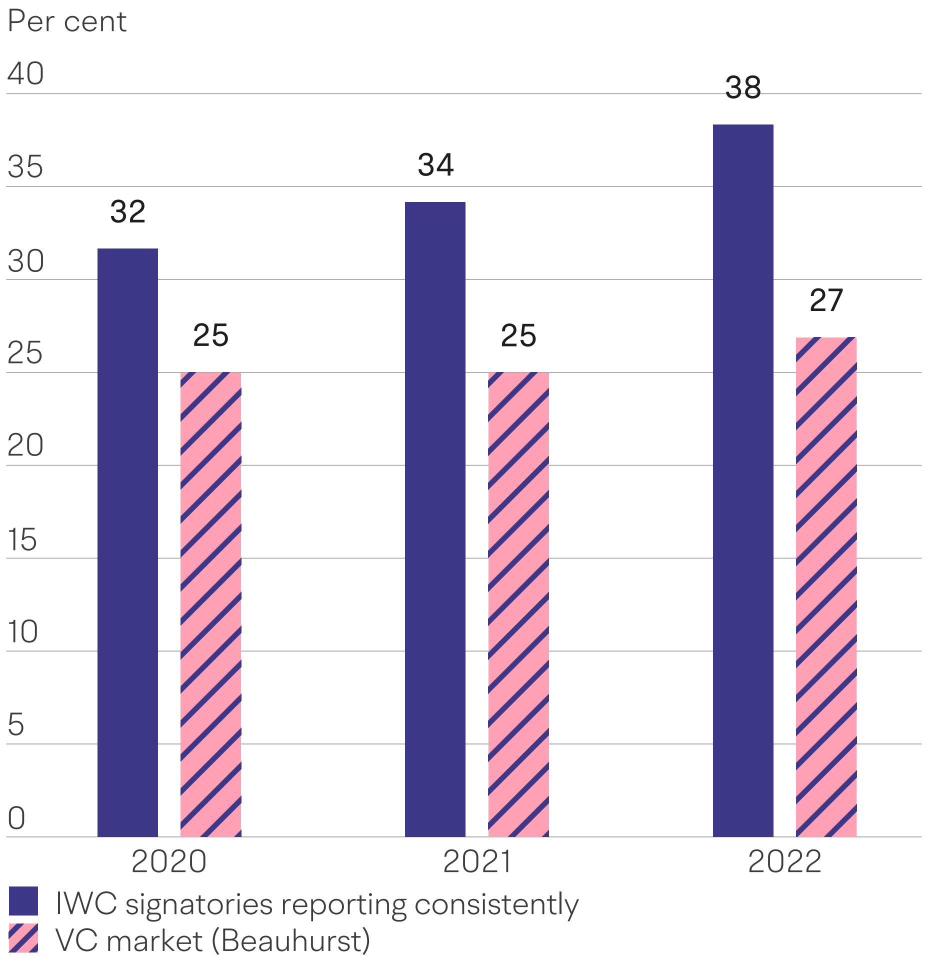
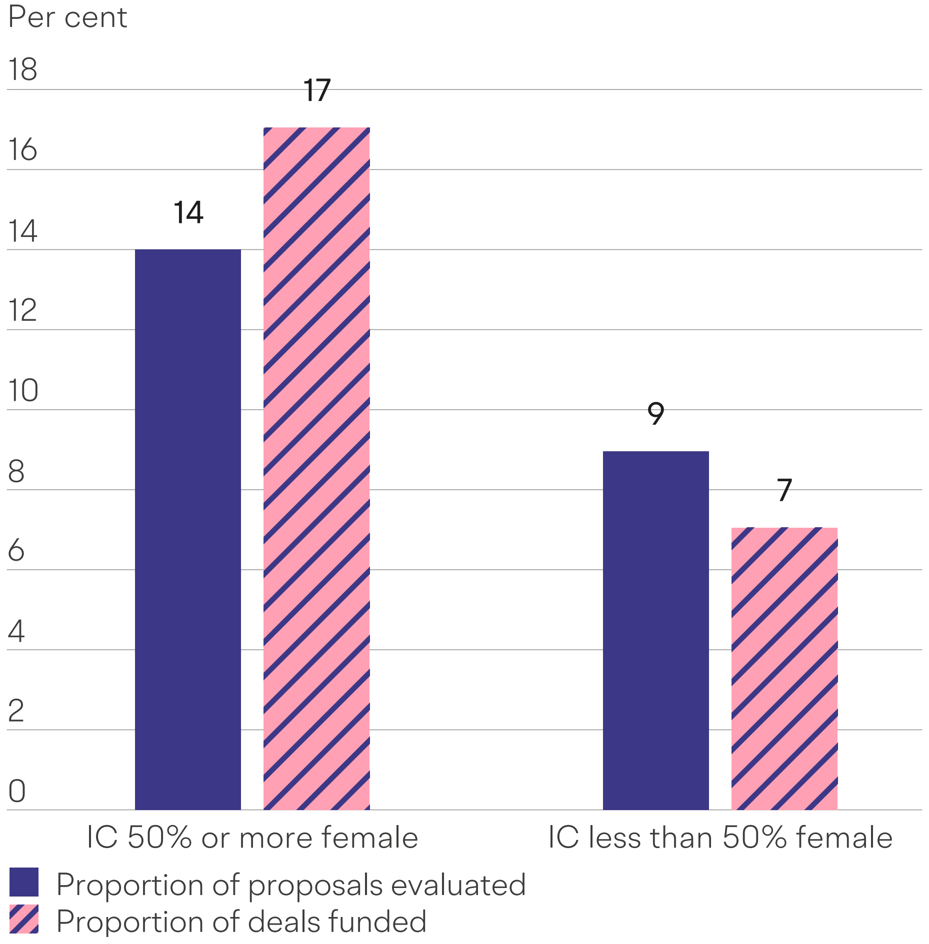


Figure A.21

Proportion of equity deals evaluated and funded from all-female founder teams, by investment committee composition

Source: Investing in Women Code 2023. n=2,689 proposals evaluated, n=1,714 deals funded.



past few years.[74] Ethnic and gender diversity diminishes as seniority increases. For example, IWC data shows higher female and Ethnic Minority representation amongst investment teams than investment committees.[75] Where investment committees are gender balanced, teams with at least one female founder are more likely to receive funding (Figure A.21). When an investment committee has at least one Ethnic Minority member, Ethnic Minority founders are more likely to be funded and success rates are more in line with all-White teams' success rates.

British Business Bank research found that VC funds and founders ranked improving the diversity of senior decision makers, including Investment Committees, and investment teams sourcing propositions, as the most effective actions in improving diversity of investment.[76]

Funders need to consider barriers, report diversity data, measure impact and reflect this in decision making, to unlock entrepreneurs' potential

Persistent barriers and lower levels of finance and investment going to under-served founders over the past decade have implications for their ability to grow their businesses. This creates a missed opportunity in terms of returns for finance providers and economic growth. One of the Bank's strategic objectives is to unlock the potential of under-served groups.

Increased engagement between policymakers and finance providers has led to some positive developments. Business surveys provide useful insights, with the Bank's own Finance Survey now reporting on access to finance for disabled entrepreneurs. The importance of tracking and monitoring protected characteristics within portfolios is widely recognised, but challenges remain with collecting, storing and reporting on personal data. Beyond gender and ethnicity, characteristics like age, socioeconomic background and disability can impact on access to finance but are not yet widely evidenced and understood.

The Bank is seeking to develop its understanding of the diversity of our own investment and lending portfolios. We are proud of the impact of our Start Up Loans programme[77], which has made 40% of its loans to women entrepreneurs and 20% to Ethnic Minority entrepreneurs.[78] British Business Bank-supported deals outperformed the wider private equity/ venture capital market in share of deals to companies with at least one female founder.[79] Evaluations of our programmes consider the reach and impact of lending and investment to female and Ethnic Minority groups.

Data needs to feed through to decision-making to effect change. The Bank is starting to integrate diversity, equity and inclusion considerations into discussions with delivery partners in relation to their own operations and their portfolio. The Bank is developing the angel ecosystem in under-served nations and regions, focussing on women angel networks, recruiting an additional 90 new female angels and supporting investment rounds of almost £7m to female and mixed gender teams across the North and Devolved Nations.

As the UK's largest Limited Partner (LP), the British Business Bank and British Patient Capital are signatories to the Investing in Women Code and drive change by leading by example, as well as promoting the Code to other LPs and VCs. The Bank is also working with existing VC signatories to track their adoption of the actions recommended by the Bank's research to improve investment diversity.

1.6

Forward look: Issues affecting finance markets over the next decade

Finance markets have an important role in supporting smaller business transition to net zero by funding innovation and the adoption of energy efficiency and clean technologies

Finance providers greater use of innovative technologies, particularly in digital and Artificial Intelligence (AI), has the potential to shape smaller business finance markets over the next decade

Interest rates have returned to their long run levels, and smaller businesses will have to adapt to the “new normal” to deliver sustainable growth

A dynamic and innovative smaller business sector is increasingly important for the UK to respond to future economic challenges and opportunities in an uncertain world

Having examined how finance markets have changed over the last decade, the Bank has identified four key issues that are likely to shape small business finance markets over the next decade and beyond.

This includes funding smaller businesses' transition to net zero, the impact of AI and digital technologies on small business lending and investment and smaller business adaptation to interest rates returning to historically average levels after a period of ultra-low rates. Finally, the need for a dynamic smaller business sector, with high numbers of business start-ups and scale-ups is outlined, so that the UK can respond to future economic challenges and opportunities.

Finance markets have an important role in supporting smaller business transition to net zero by funding innovation and the adoption of energy efficiency and clean technologies

Smaller businesses contribute a sizeable share of the UK's Green House Gas (GHG) emissions.[80] Of the UK's estimated total 427 mtCO_2e of territorial GHG emissions emitted in 2021, 69% (293 mtCO_2e) was produced by business activity.[81] The Bank estimates smaller businesses generated approximately 149 mtCO_2e in 2021, forming 35% of the UK's total emissions in 2021 and 51% of all business-driven emissions.[82]

If the UK is to meet its net zero targets by 2050, smaller businesses must be part of the solution. Smaller businesses face many barriers transitioning to net zero, including scarce financial and human resources, time constraints, lack of awareness, knowledge and expertise, absence of perceived benefits, unsuitability of formal management tools and the complexity of sustainability standards. Access to finance is a key barrier for 28% of the smaller businesses prioritising environmental sustainability over the next 12 months.[83]

Finance markets have a critical role in funding innovation and the adoption of new cleaner technologies. The transition required to meet the UK's net zero objectives will require significant investment across all areas of the economy. The Government's green finance strategy estimated that an additional £50-60 billion of capital investment per year will be required through the late 2020s and 2030s to meet the UK's net zero commitments, with private sector investment forming the majority of this.[84] The IPCC estimates that a three to six-fold increase in transition finance is needed by 2030 to limit warming to 1.5 degrees C.[85]

The finance system therefore needs to increase the flow of debt and equity finance used to support climate objectives. This involves increasing the amount of capital available to businesses in the supply chain, but also giving providers and recipients of finance access to accurate and consistent information on pathways to decarbonisation that enables them to make informed and effective decisions.

The Committee on Climate Change (CCC), has highlighted technology as key to making the UK's net zero emissions target feasible and cost-effective.[86]

Equity finance is particularly important for funding new innovative companies developing, commercialising and scaling new technologies that will help provide solutions to current energy challenges. The clean tech sector as a whole has seen steady and consistent growth in equity investment over the past few years due to factors such as shifting investor preferences.

Net zero focused companies have not been immune from the wider slowdown in VC markets seen over H2 2022 and 2023. The number of net zero related deals in Q1-Q3 2023 fell 18% and investment fell 45% compared to the same quarters in 2022. Given the scale of the climate challenge, it is important that clean tech companies are not affected by current cyclical factors affecting funding. Equity investment into net zero related companies will need to be maintained and increased further to meet the funding needs of companies developing and commercialising solutions for reducing carbon use.

Alongside the private sector, public finance institutions have an important role in providing early investment, and signalling technology and future areas of potential that will create the conditions for an acceleration of net zero investment.[87]

The British Business Bank is committed to supporting the UK's transition to a net zero economy by 2050. The Bank has a strategic objective to build a modern green economy by financing innovative solutions to climate change.

The Bank is a working with stakeholders to improve small businesses' ability to report on their own emissions. The Bank is particularly engaged with Bankers for Net Zero's 'Mobilising SMEs for Climate Action' workstream identifying market solutions to enable efficient and scalable GHG emission reporting for smaller businesses.[88] Bankers for Net Zero, alongside Icebreaker One, are developing an automated emissions reporting for every smaller business in the UK (known as Project Perseus).

The Bank will continue to ensure its programmes are targeted at market gaps, supporting smaller businesses' transition to net zero. The Bank is also developing a green finance offer. It will pursue collaboration opportunities with its delivery partners, supporting initiatives which enable small businesses to become more environmentally sustainable.

Finance providers greater use of innovative technologies, particularly in digital and artificial intelligence (AI), have the potential to shape small business finance markets over the next decade

Artificial intelligence (AI) is based on the principle that computers can be designed to emulate the products of human intelligence or build capabilities which go beyond human intelligence.[89] Developments in AI are continuing at a rapid pace and these advances are likely to have a profound impact on small business finance markets over the next decade. The finance & insurance sector was identified as the sector more exposed[90] to AI than any other sector in the UK.[91]

Most UK financial organisations are using predictive AI. A recent survey of UK Finance members showed 90% were already using predictive AI in back-office functions including fraud detection, risk modelling, data and management information (MI) and marketing.[92] Predictive AI uses advanced analytical techniques based on statistical algorithms to recognise patterns in large, organised datasets to support data analysis functions and make predictions. For example, outlier detection tools are used by Bank's fraud departments to identify unusual card usage or regression models are used to predict the probability of loan default ahead of making a lending decision.

Generative AI is relatively new compared to predictive AI, but interest in its potential use in financial services is increasing rapidly. More than 70% of surveyed UK Finance members have generative AI at the proof of concept or pilot phase, suggesting its use will become more widespread in the future. Generative AI can interpret and generate high quality outputs including text and images from unstructured data sources.[93]

Generative AI based systems can help to evaluate businesses' creditworthiness through advanced algorithms and data analytics[94], considering factors beyond traditional financial metrics like business growth and ability to repay the loan.[95] It can also be used to generate personalised loan offers, recommendations, and financial insights tailored to individual businesses.[96]

AI is also beginning to impact on VC investment. Generative AI is freeing VC firm employees from repetitive tasks as it allows greater analysis of multiple data sources. This is faster and easier than a team of analysts performing this research manually.[97]

Despite the potential, there are currently uncertainties around the practical application of generative AI. It is important to note that current applications of generative AI are still at a relatively superficial level such as chatbots and image generation, but this is likely to change.

Both types of AI train models using data, which has increased rapidly in recent years through initiatives such as Open Banking[98] in 2018, which has allowed individuals and smaller businesses to share their financial information with different providers in a secure way.[99] The increased quality and coverage of VC databases in recent times can also provide valuable insights informing investment decisions. PitchBook's exit indicator is an example of predictive AI, which considers a range of information to predict company exit outcomes.[100]

Greater use of AI over the next decade by finance providers will increase the availability and lower the cost of finance to smaller businesses, but not all will benefit. Evidence suggests fintech platforms can provide additional finance to higher risk applicants[101] and make more diverse lending decisions, with a greater proportion of lending going to female led businesses and ethnic minority owned businesses.[102] However, young untested businesses with no prior access to the banking system are still likely to be excluded from accessing finance.[103] Technology can also be biased if it replicates past lending decisions from biased credit decision data.[104]

To summarise, generative AI has the potential to improve the availability of finance to smaller businesses over the next decade, especially those smaller businesses that are currently financially excluded or without collateral. Greater process automation will lower the cost of providing finance, which will benefit smaller businesses and start-ups that are looking to raise smaller amounts of finance.

The Bank will continue to support greater diversity in the supply of debt finance supporting new challenger banks and fintech companies that utilise new technologies, including AI.

Interest rates have returned to their long run levels, and smaller businesses will have to adapt to the "new normal" to deliver sustainable growth

The next decade is likely to be characterised by higher interest rates, compared to the previous decade where the Bank Rate was below 1% for the majority of the Bank's existence. The Bank of England (BoE) initiated a course of monetary tightening in Q2 2022 as a response to inflationary pressures. Analysis of yield curves available in November 2023 suggests financial markets expect the UK Bank Rate to exceed 4% until at least 2026/27. The consensus, therefore, is for rates to remain relatively higher for longer even with inflation falling in late 2023.

Higher interest rates will have multiple impacts on the UK economy over the next few years as it transitions to a new normal. Higher rates directly lead to an increase in the cost of finance for businesses either currently borrowing or looking to borrow. Further examples of more adverse and direct effects on smaller businesses' use of finance are illustrated in Figure A.22.

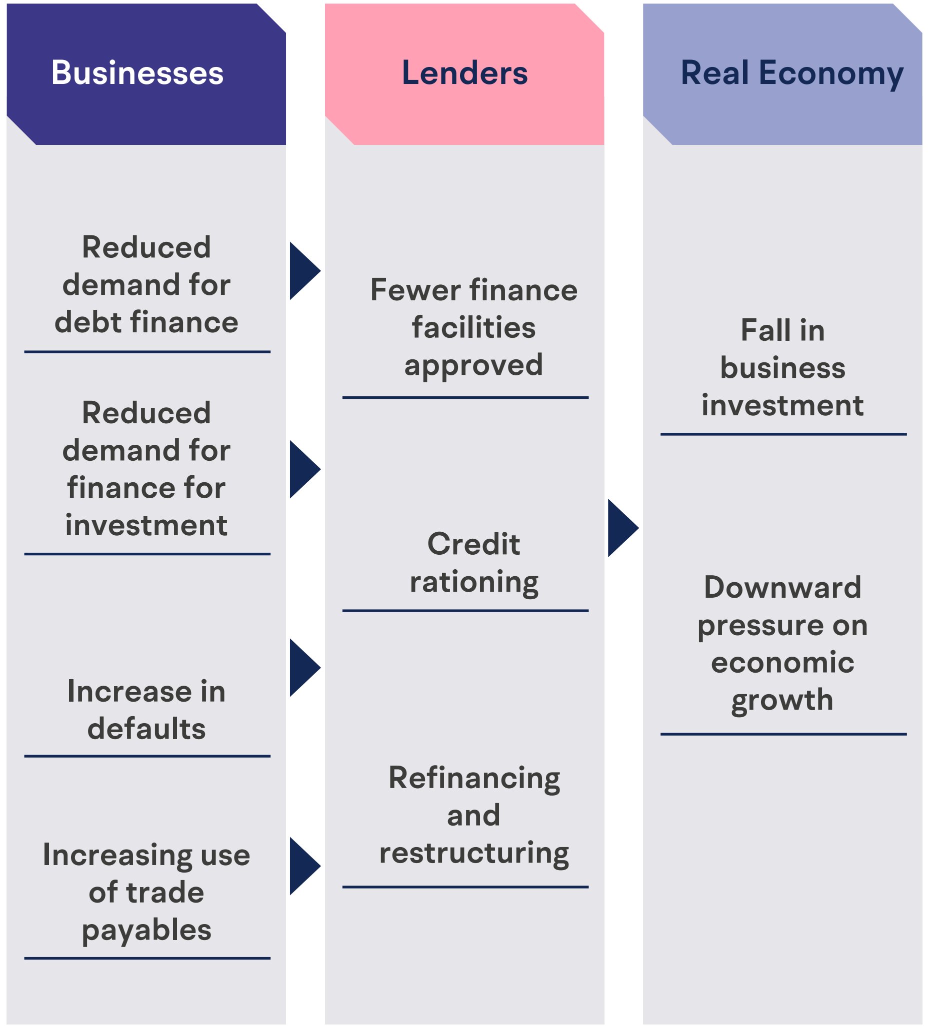
The first likely effect is that smaller businesses will reduce their overall demand for finance. The type of finance they do apply for may also switch away from investment to liquidity purposes, driven by the higher hurdle rate used to determine whether an investment is profitable or not. Lower rates of business investment could put business growth rates at risk over the longer term, especially if businesses find the transition to a higher interest rate environment challenging.

Those businesses with variable rate loans may also come under pressure to meet their debt repayments. As a result, they may look for alternative solutions to support cashflow, for example extending their time-to-payment and maximising trade payables. In the extreme this could cause issues for other smaller business suppliers in the supply chain as they are hit by a trade receivable squeeze from late payments. The cumulative effect of these impacts is likely to put upward pressure on finance default rates.

These impacts will also have a knock-on impact on lenders. Falling demand for finance will reduce the overall number and value of finance facilities approved, the latter measured in real terms. Lenders could also increase credit rationing, for instance by tightening their

Figure A.22

Potential adverse impacts of higher interest rates on smaller businesses and their use of finance over the next few years



credit scoring and affordability criteria as informational gaps increase their aversion to risk. Deep rooted market frictions arising from asymmetric information barriers are also expected to worsen in times of economic uncertainty. This makes it even more difficult for businesses to access finance in times of need.

Early evidence indicates the extent to which these impacts could be realised over the next few years. The Q3 2023 Bank of England Agent Summary of business conditions reported a reluctance amongst businesses to take out new loans with some even making early repayments to allay concerns about future higher credit costs.[105] Survey data from the SME Finance Monitor Q2 2023 suggests around 50% of those smaller businesses who use finance are on variable rates and this is evenly spread across business size and sector.[106] This is equivalent to up to around 1.2m[107] businesses that could be exposed to higher interest rates on their existing debt. 67% of finance intermediaries also suggested smaller businesses are not well equipped to reduce their debt burden over the next 12-18months.[108]

On the supply side, the Bank of England report[109] found that lenders were cautious and concerned about the ability of businesses to repay borrowing, even in sectors where demand was relatively strong. Consistent with this, smaller businesses reported difficulty in raising finance due to banks applying more cautious affordability tests to loan applications – for example, by tightening loan to value restrictions.

Finally, the BoE found that large firms were also having to tighten trade credit terms with their clients and supply chains. With respect to smaller business late payments, the 2023 Q3 SME FM survey found that 14% of smaller businesses saw cash flow late payments as a major obstacle to running their business in the following 12 months, the highest share since the onset of the Covid-19 pandemic.

These impacts could very well strengthen over the course of the next couple of years and potentially beyond, affecting the relationship and availability of finance between lenders and smaller businesses as they adapt to the new normal of higher interest rates. The Bank will continue to support lending markets and viable businesses to access the finance they need to support sustainable growth, for example through its debt products such as the Recovery Loan Scheme and ENABLE Guarantees.[110]

A dynamic and innovative smaller business sector is important for responding to future economic challenges and opportunities

The importance of smaller businesses to the UK economy is well documented, making up 99% of the business population and 61% share of total employment.[111] Following the last four years of economic disruption, the latest figures presented in section 2.1 small business population show a rise in the number of smaller business deaths relative to new business births.

This reduction in the population of smaller businesses is not unexpected given the severity of recent economic challenges. Whilst there are substantial disruption costs for the businesses and individuals affected, a rise in business deaths does not necessarily result in worse economic outcomes. The extent to which an economy can effectively reallocate resources to more productive and innovative uses determines the impact of external and unexpected shocks. There is a range of evidence showing examples of successful start-ups emerging in times of poor prevailing economic conditions. Around one quarter (24%) of companies in the 2019 Fortune 500 list were estimated to have been founded at a time when the US economy contracted.[112] Closer to home, the Bank has previously published examples of household name British businesses that emerged during times of economic difficulty.[113]

Both business creation and closure are characteristics of a dynamic economy over the long run as they allow new ideas to flourish and support economic resilience. The more new and innovative businesses that can be successfully produced by an economy, the more resilient it is to future shocks and disruption. A nimble business population and finance market that can better support new business formation is a critical enabler to achieving this.

Business dynamism is a term used to describe the rate at which businesses enter and leave the market. The "job reallocation rate" is one example of how to measure business dynamism. This metric looks across the economy at jobs created due to firms either entering the market or expanding, compared to the number of jobs reduced due to firms either exiting or shrinking. This generates a reallocation of jobs due to firing and hiring. When the job reallocation rate is high, more jobs are moving from shrinking firms to growing firms. If growing firms are relatively more productive than the shrinking ones, this 'job churn' process boosts productivity and is a net benefit to the economy.

The ONS published experimental data on business dynamism in the UK economy covering the two decades between 1999 and 2019.[114] Analysis of this data by the Resolution Foundation found that the UK's reallocation rate appears to have been broadly stable since the early 2000s.[115] Whilst reallocation rates for incumbent UK businesses has remained relatively stable, there has been a general decline in the reallocation rate associated with new and closing businesses. The UK reallocation rate fell for new and closing businesses from an average of 2.7 across 2000-2009 to 1.9 between 2010-2019, a 32% reduction. This implies that jobs lost from closing businesses are less likely to be offset, or reallocated, to new businesses and start-ups.

The next ten years may prove to be just as challenging for smaller businesses as the last ten years, with the transition to net zero and continued geopolitical disruption sowing seeds of uncertainty. Over the next decade, financial markets have an important role in supporting the creation of new business start-ups and scale-up businesses creating jobs and bringing new innovation to market.

Learning from the post-GFC experience is crucial as the Bank continues to support smaller business financial markets to empower businesses during all parts of the economic cycle into the 2020s. The Bank's Start-up Loans and early-stage equity programmes stand ready to fund new and innovative businesses to help the UK respond to unknown challenges ahead.

Part B: Market changes over the last year

Small business characteristics

2.1

Small business population

Smaller businesses make up an important part of the UK economy in 2023

The UK business population increased in 2023, for the first time since the start of the pandemic, driven by increased numbers of unregistered businesses

The number of registered business closures continues to exceed the number of business start ups, leading to a fall in the registered business population

This section reviews the current stock of UK businesses and the components of change over time incorporating insights from the Department for Business and Trade (previously Business, Energy and Industrial Strategy (BEIS)) business population estimates and Office for National Statistics (ONS) business demography.

Smaller businesses make up an important part of the UK economy in 2023

At the start of 2023, the 5.5 million population of SMEs had a workforce of 16.7 million, including 4.0 million working proprietors. SMEs formed 99.9% of all businesses, accounting for around three-fifths of UK employment and just over half (£2.4 trillion) of private sector turnover. Therefore, large businesses (greater than 250 employees) made up just 0.1% of the UK total business population (7,960 businesses) but 47% of turnover and 39% of employment (Figure B.1).

Private sector employment increased 1.7% between 2022 and 2023, increasing from 27.1 million to 27.5 million. Simultaneously, total employment in SMEs also rose by 1.7% over the period, from 16.4 million at the beginning of 2022 to 16.7 million at the start of 2023. Therefore, SME share of total employment in the private sector remained at 61%.

The UK smaller business population increased in 2023, for the first time since the start of the pandemic, driven by increased numbers of unregistered businesses

There were an estimated 5.6 million UK private sector businesses at the start of 2023, a 0.9% increase on the total reported at the start of 2022.[116] This reversed some of the decline seen in 2022, where the business population fell 1.5%, but the business population remained below its peak of 6.0 million in 2020. Overall, stock of businesses in 2023 is around the level last seen in at the start of 2016.

Figure B.1

UK business composition by business number, employment and turnover

Source: DBT Business population estimates 2023.

Figure B.2 shows these impacts were not evenly distributed by type of firm. There were 3% more unregistered zero employee firms at the start of 2023 compared to the previous year. This also reversed the decline in 2021. Numbers for these unregistered firms are estimated by DBT and do not feature in the ONS business birth and death rates data covered elsewhere in the section.

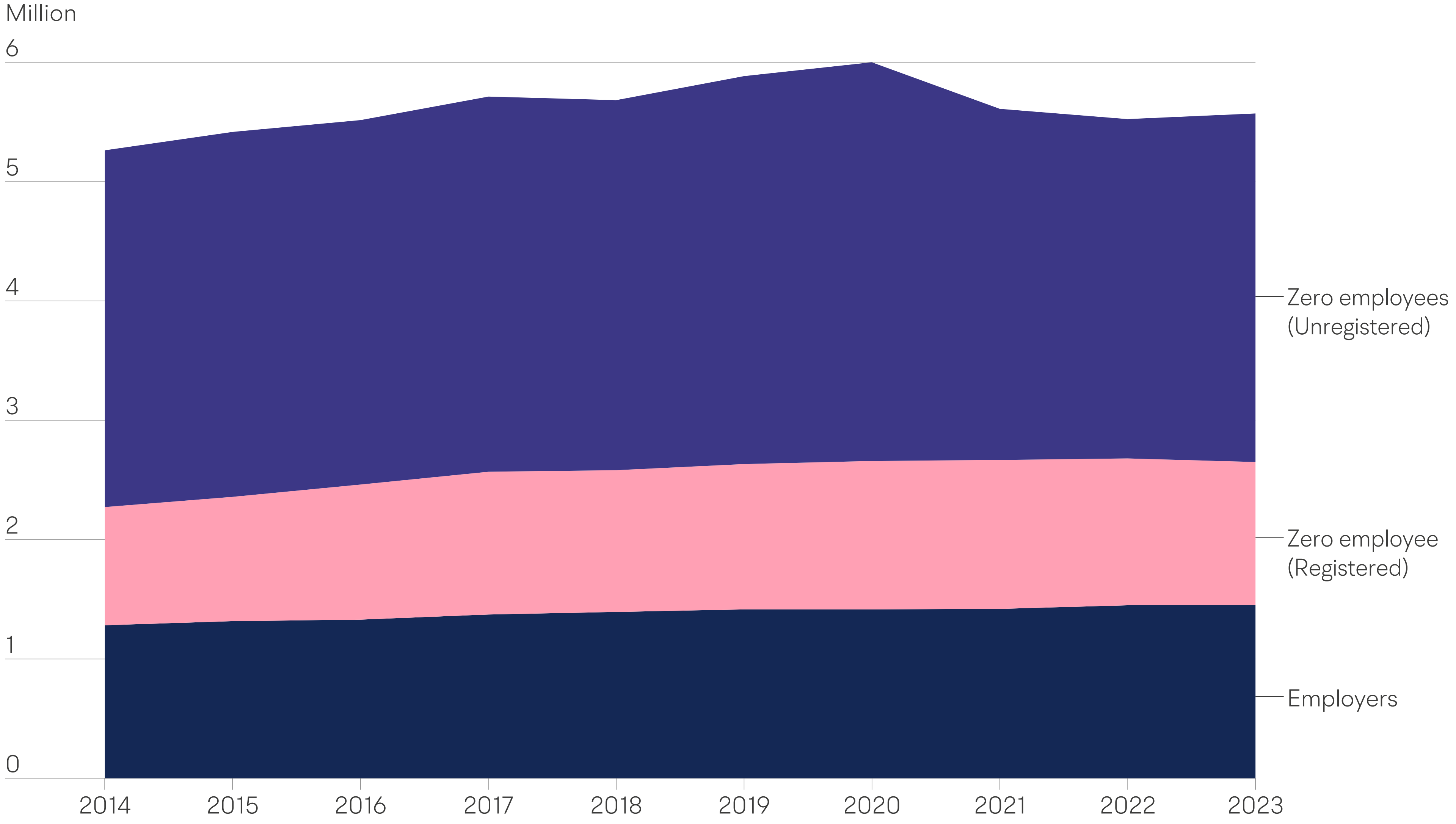
In contrast, zero employee registered firms and small and medium sized employers (1–249 employees) showed a net decrease to the start of 2023 by 2.5% and 0.1% respectively.

Therefore, the increase in the business population between 2022 and 2023 was driven by unregistered businesses, the largest category of UK businesses. These are likely to be very small businesses comprised of self-employed individuals.

Figure B.2

UK business population

Source: DBT Business population estimates 2023.



The number of registered business closures continues to exceed the number of business start ups, leading to a fall in the registered business population

The overall business population is affected by the number of business start-ups and closures.[117] VAT and PAYE registrations (and de-registrations) are used as a proxy for business start-ups (and closures). This does not take into account unregistered businesses which have increased in number between 2022 and 2023.

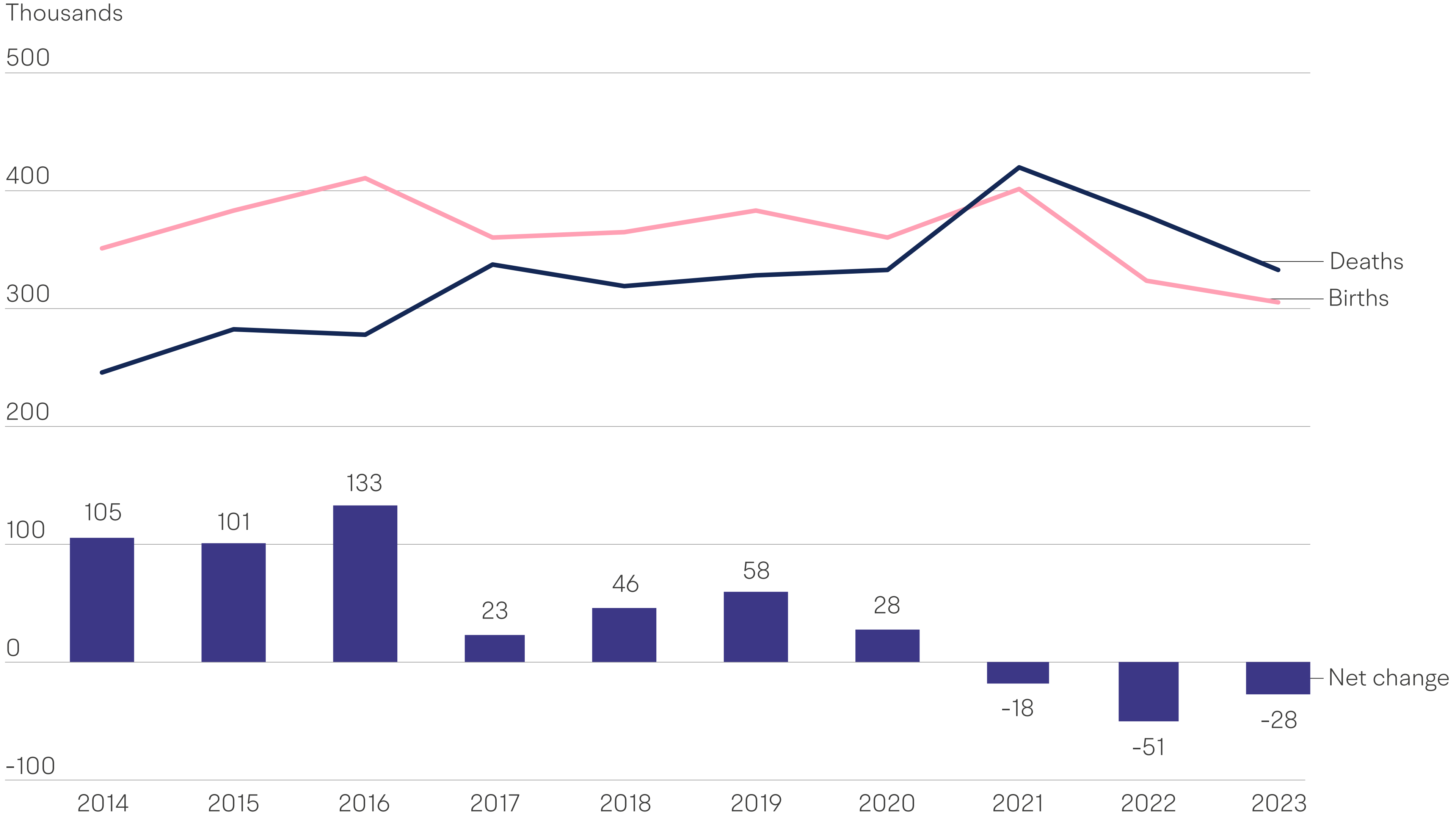
The UK business population has exhibited a steady increase since 2014 with the number of business births exceeding the number of business deaths each year.[118] 2021 marked a pivotal shift, where the number of business closures (420,000), outnumbered the number of new businesses (402,000), leading to a net decline of 18,000 businesses.

This has marked the beginning of a challenging period for UK businesses, which intensified in 2022 with a further net decline of 51,000 businesses; 327,000 were created while 378,000 closed. The pattern of closures surpassing new businesses persisted into 2023, with a net decline of 28,000 businesses.

Figure B.3

Number of UK business births and deaths

Source: ONS Business Demography 2020 and Business Demography, Quarterly Experimental Statistics 2023.



2.2

Small business demand for finance

- Business use of finance increased in 2023
- Greater use of credit card and overdraft finance as business cashflows come under pressure
- Businesses are more likely to shop around for finance in 2023 than previously

This section highlights smaller businesses use of and demand for external finance covering a wide range of debt, equity and grant products.[119] It uses smaller business survey data from the UK Finance BVA BDRC SME Finance Monitor and the British Business Bank's Business Finance Survey.

Business use of finance increased in 2023

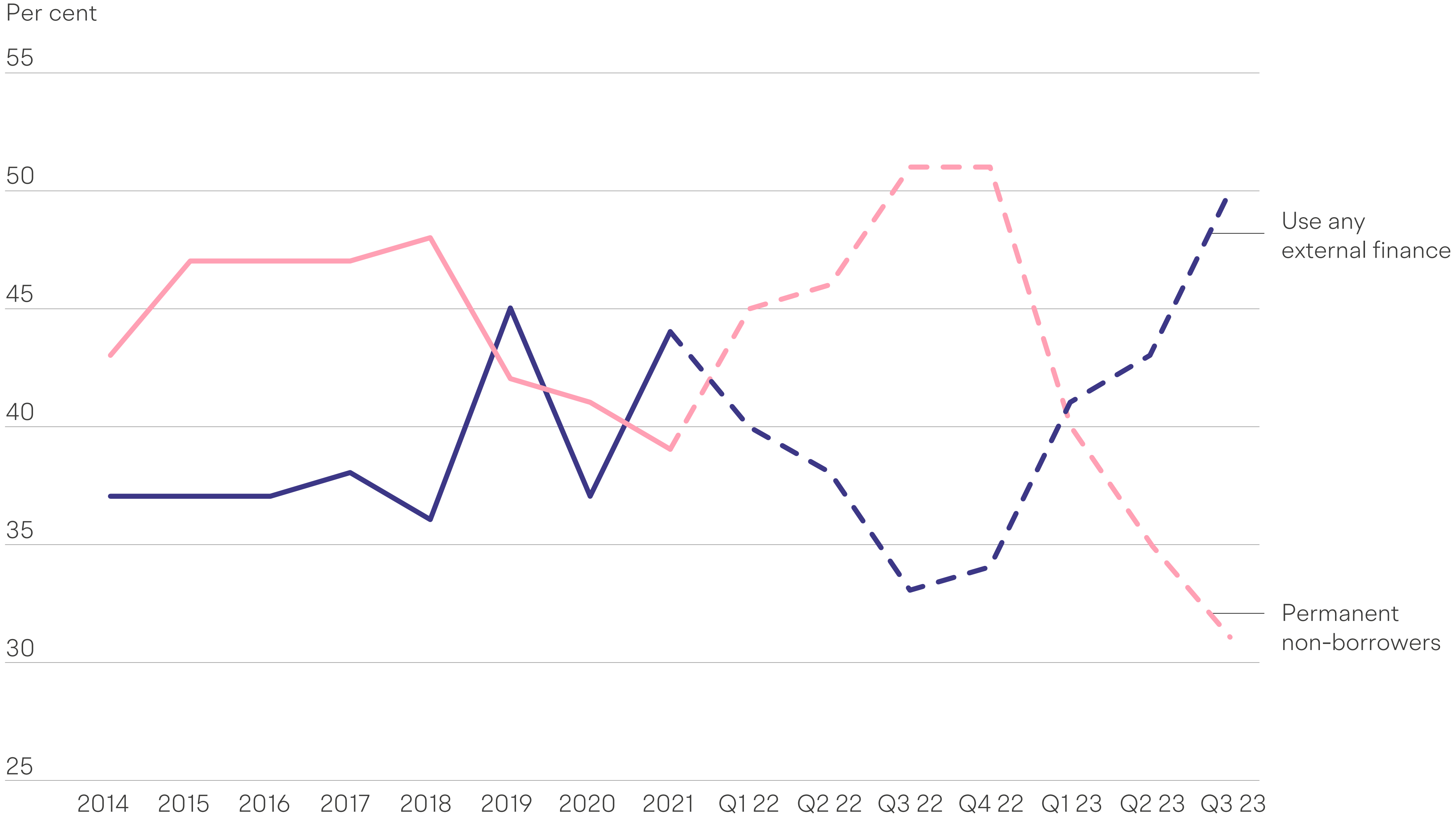
Smaller business use of finance has varied over time. From 2014 to 2017, the use of external finance remained relatively stable, with around 37% to 38% of all smaller businesses engaging with external finance options (Figure B.4).[120] During this period, the percentage of permanent non-borrowers was also stable, fluctuating around 47%.[121]

The impact of the Covid-19 pandemic is evident in 2020, with a decrease in the use of external finance to 37% across all smaller businesses as businesses became more cautious about taking on debt.

Figure B.4

Proportion of smaller businesses using external finance and permanent non-borrowers

Source: UK Finance BVA BDRC SME Finance Monitor.



In 2021, there was an increase in the use of external finance to 44% among all smaller businesses, and a decrease in permanent non-borrowers to 39%. This reflects smaller businesses' adjustment to the post-pandemic environment and the utilisation of financing options to support recovery. Interestingly, medium sized businesses showed a significant decrease in their use of external finance to 37%, which differs to small businesses.

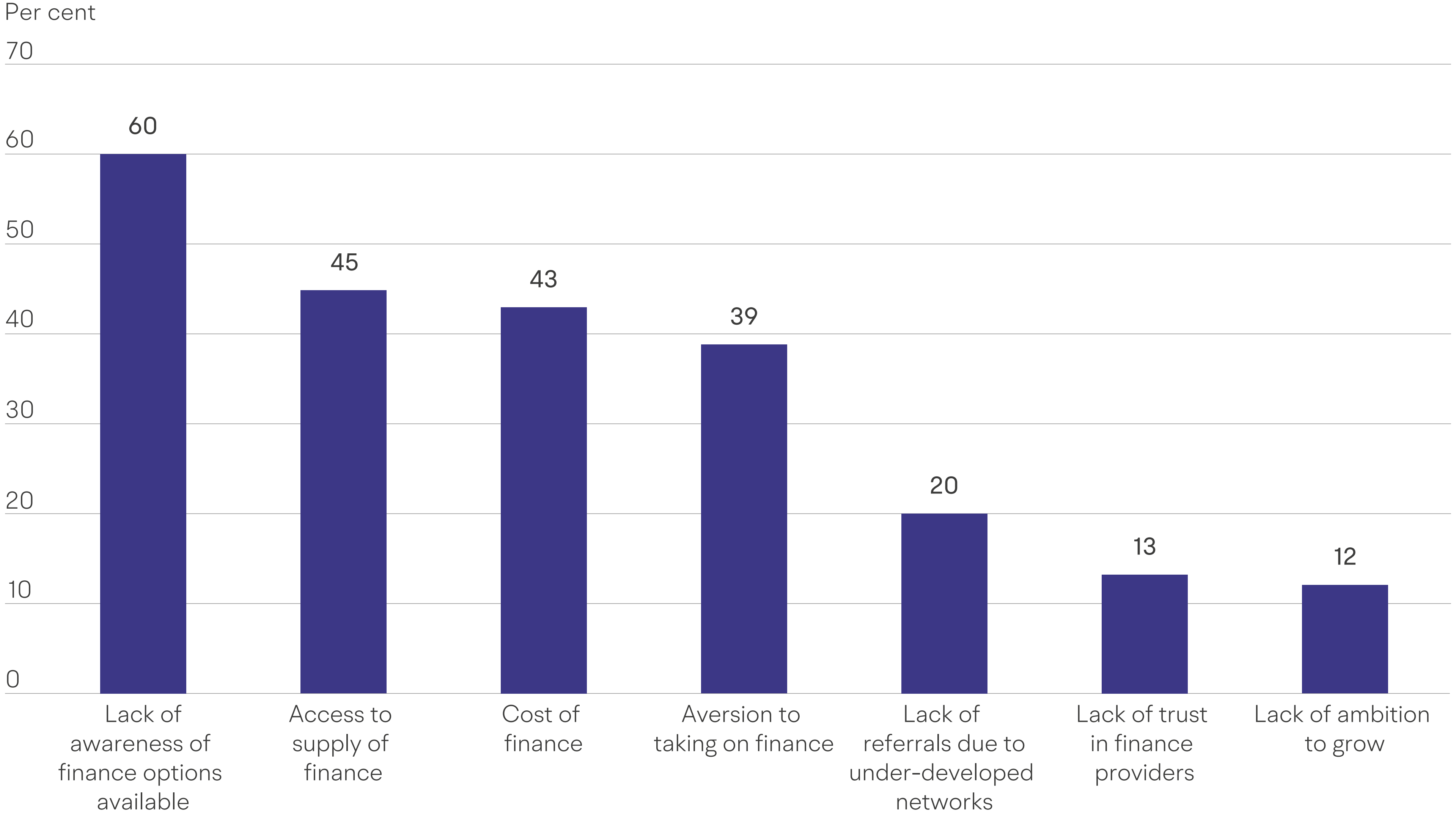
Throughout 2022, smaller businesses were more cautious about using finance with an increase in permanent non-borrowers reaching 51% by Q3 and Q4. Despite this, the last quarter saw a slight increase in the use of external finance.

In contrast, the financial landscape changed in 2023. The use of external finance saw a consistent rise over the year from 41% in Q1 to 50% in Q3 2023. The speed of this increase indicates a growing need among businesses for finance to support cash flows. This is supported by evidence from the latest Bank Finance survey, which shows working capital was the main reason for seeking finance for 58% of smaller businesses in 2023, up from 53% the year before. This was a significant increase.

Figure B.5

Barriers to smaller business demand for external finance in region or nation

Source: British Business Bank UK Network intermediary survey 2023 (n= 725).



Finance use overall is affected by both supply side and demand side factors. Market intermediaries reported a lack of awareness of finance options (60%), followed by access to supply (45%) and cost of finance (43%) as the main barriers affecting smaller business demand for finance (Fig B.5).[122] The Bank's 2023 Finance Survey also revealed smaller business awareness of some alternative finance types had fallen from a year ago, including invoice financing, equity crowd funding platforms, marketplace lending and finance from business angels.

Further, there are some differences in smaller businesses' capacity to navigate finance options across the UK's nations and regions. For instance, the same survey shows that the share of smaller businesses reporting that they are confident in their ability and skills to obtain external finance from finance providers is 7 in 10 or more in Northern Ireland (77%) and the East of England (70%); these are also the areas of the UK where the highest share of businesses report being confident about obtaining finance product information (37% and 33% respectively). Conversely, only just over half of smaller businesses in Scotland (52%) and the South East of England (53%) are confident in their ability and skills to obtain external finance, and these areas of the UK also show the lowest levels of confidence in obtaining finance product information amongst local businesses (25% in both).

The forthcoming Devolved Nation survey, established by the UK Network team of the Bank, will provide a detailed analysis of the sub-regional composition of the Nations. This survey aims to dissect and understand the distribution and characteristics of small businesses within these specific regions and present insights into regional variances and trends.[123]

Greater use of credit card and overdraft finance as business cashflows come under pressure

Smaller business use of different finance products is related to changes in the wider economy. Figure B.6 shows how finance use has changed since 2014.

In 2014, 16% of smaller businesses used an overdraft, which climbed to 23% by 2019. However, the economic shock induced by the Covid-19 pandemic saw a steep decline to 13% in 2020, reflecting the availability of Government supported loans. By Q3 2023, overdraft usage had increased substantially to 17%. The increased use of overdrafts may reflect pressure on smaller business cash flows from higher input costs and also higher interest rates, leading to a preference for shorter and more flexible forms of finance.

Credit card financing has also shown similar trends to overdrafts, increasing from 11% in 2021 to 20% in Q3 2023. This provides further evidence of smaller businesses adapting to a changing financial environment by opting for more readily accessible forms of credit to manage ongoing economic challenges.

In parallel, bank loans and mortgages presented a relatively flat trajectory up until 2017, after which a modest rise was observed. The peak of utilisation at 17% in 2021 may be attributed to businesses seeking longer term financing to withstand the effects of the pandemic, as well as from Government-backed support.[124] Loan use has shown a gentle decline to 10% by Q3 2023, possibly reflecting the higher costs for taking out new lending.

Smaller business use of leasing and hire purchase arrangements have remained relatively consistent over time, apart from a slight increase in 2019 and a subsequent decline in the following years. Smaller business use then increased over 2023 from 9% in the first quarter to 11% in Q3 2023.

Lastly, the utilisation of grants soared during the pandemic, underscored the critical role of government support in sustaining smaller businesses through unprecedented times. By Q3 2023, the reduced usage to 4% suggests a return to more normal funding conditions.

Businesses are more likely to shop around for finance in 2023 than previously

The Bank's Business Finance Survey provides information on the extent to which smaller businesses explore different finance providers when they have a finance need. Figure B.7 shows this has varied over time.

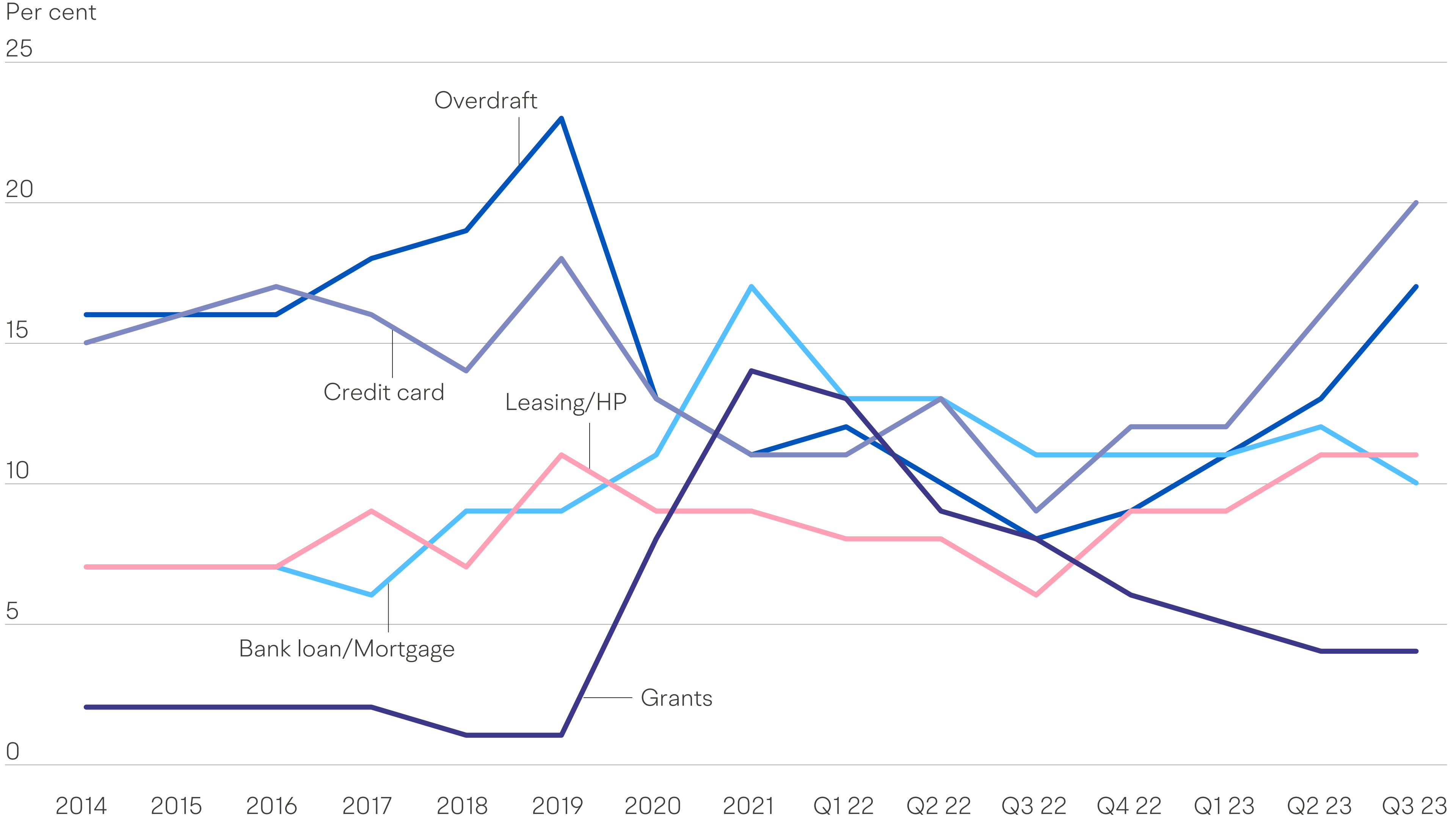
In 2014, 65% of smaller businesses only considered a single finance provider when seeking finance, but by 2018 this has reduced to 55%, due to a more competitive lending environment and greater range of finance options available.

When the pandemic struck in 2020, there was a pronounced pivot back towards smaller businesses considering only a single provider (most likely to be the main bank providing current account facilities), with 75% of smaller businesses considering only one provider

Figure B.6

Small businesses use of different finance types

Source: UK Finance BVA BDRC SME Finance Monitor.



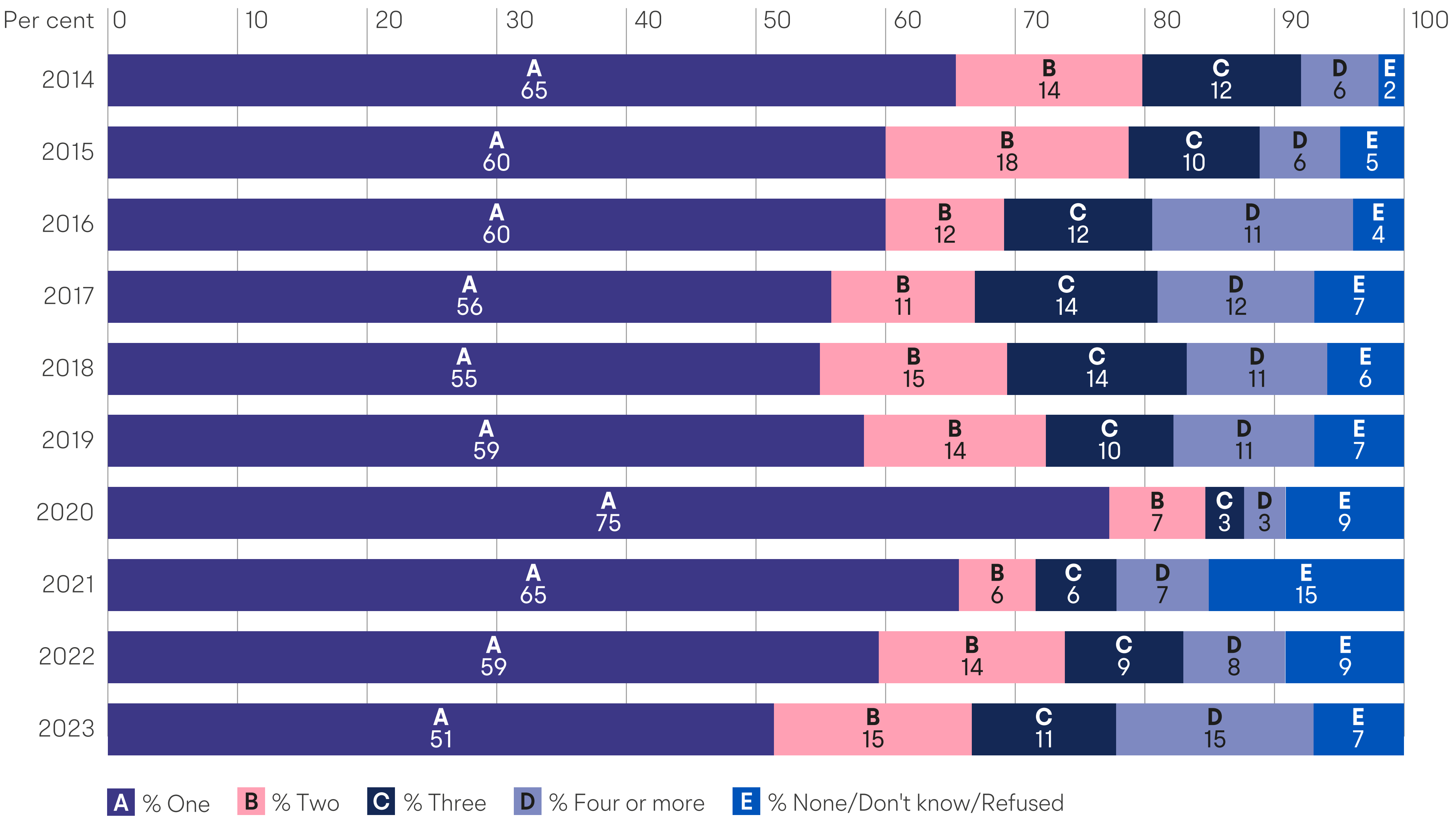
of finance. The disruption caused by the Covid-19 pandemic had a large impact on finance markets, as smaller businesses largely sought finance from Government-backed finance schemes to meet their immediate financing needs.

The data from 2022 reflects a return to pre-pandemic patterns, with a reduction to 59% of smaller businesses only considering a single provider, which has continued into 2023, with 51% considering one provider. The return to pre-pandemic levels of finance providers considered suggests smaller finance markets have largely returned being competitive with a range of different finance providers and options available.

Figure B.7

Number of finance providers considered

Source: British Business Bank Business Finance Survey 2023 – Ipsos. Base sizes varies by year.



Diversity, equity and inclusion and net zero for smaller businesses

- 2.3 DEI and finance for female, Ethnic Minority and disabled entrepreneurs
- 2.4 Finance for environmental sustainability

2.3

DEI and finance for female, Ethnic Minority and disabled entrepreneurs

Under-served groups remain dissuaded from seeking finance by actual or perceived barriers to access

Barriers in accessing finance, particularly for Ethnic Minority-led businesses and those led by someone with a disability, are a constraint on growth and innovation

More Ethnic Minority-led businesses are considering applying for some form of finance over the coming year, with a higher share expecting to use government-backed finance

Most smaller businesses are aware of how to improve diversity and inclusion within their business, with some making this a priority over the coming year

This section complements the under-served groups analysis in section 1.5 unlocking potential in under-served groups of this report by highlighting more recent developments in access to finance for female and Ethnic Minority-led businesses.[125]

In 2023, the British Business Bank's Finance Survey included a question on disability and awareness and prioritisation of diversity and inclusion, with those results reported in more detail in this section.

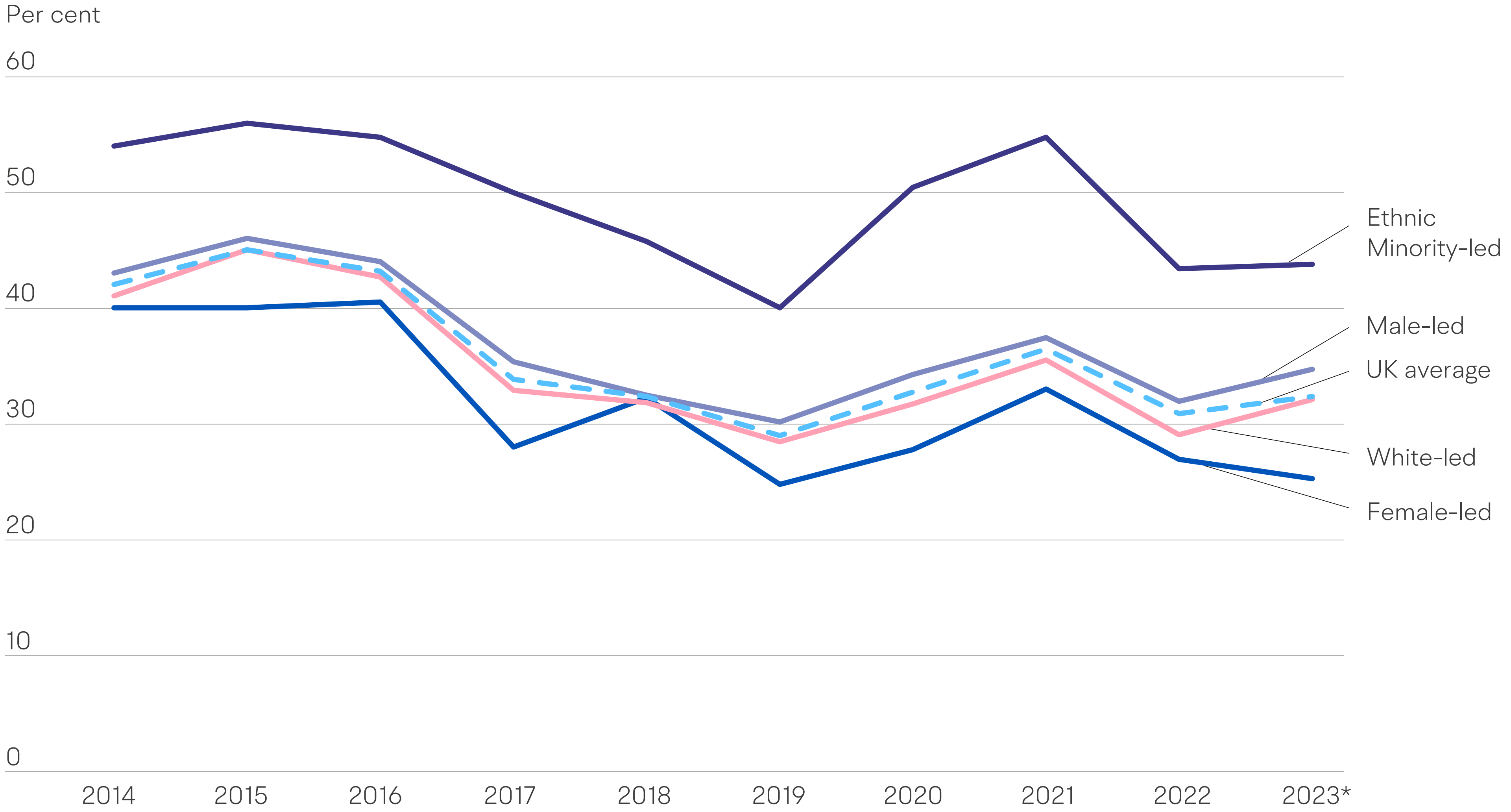
Under-served groups are dissuaded from seeking finance by actual or perceived barriers to access

Female and Ethnic Minority-led smaller businesses make up around 25% and 8% of the UK business population respectively. Approximately 8% of businesses are led by those with a disability. These groups face particular barriers in accessing finance, and as highlighted in the Bank's Alone Together research, intersectionality can compound these challenges.[126]

Figure B.8

Proportion of smaller businesses willing to use external finance to help their business grow and develop

Source: UK Finance BVA BDRC SME Finance Monitor. Base sizes vary by year.



*2023 data is Q1 and Q2 only.

As highlighted in section 1.5, female-led businesses are typically less willing to use finance to grow than their male-led counterparts, with Q1 and Q2 data indicating the gap widened in 2023 (Figure B.8). Willingness to use external finance amongst female-led businesses has declined from 40% in 2014, to 25% in 2023, significantly lower than for male-led businesses (43% and 35% respectively). Around 57% of female-led businesses agree they never think about whether they could or should use more external finance. This is significantly higher than the 52% of male-led businesses reporting the same over 2022 and 2023.[127] This may reflect barriers they perceive or already encountered in seeking finance.

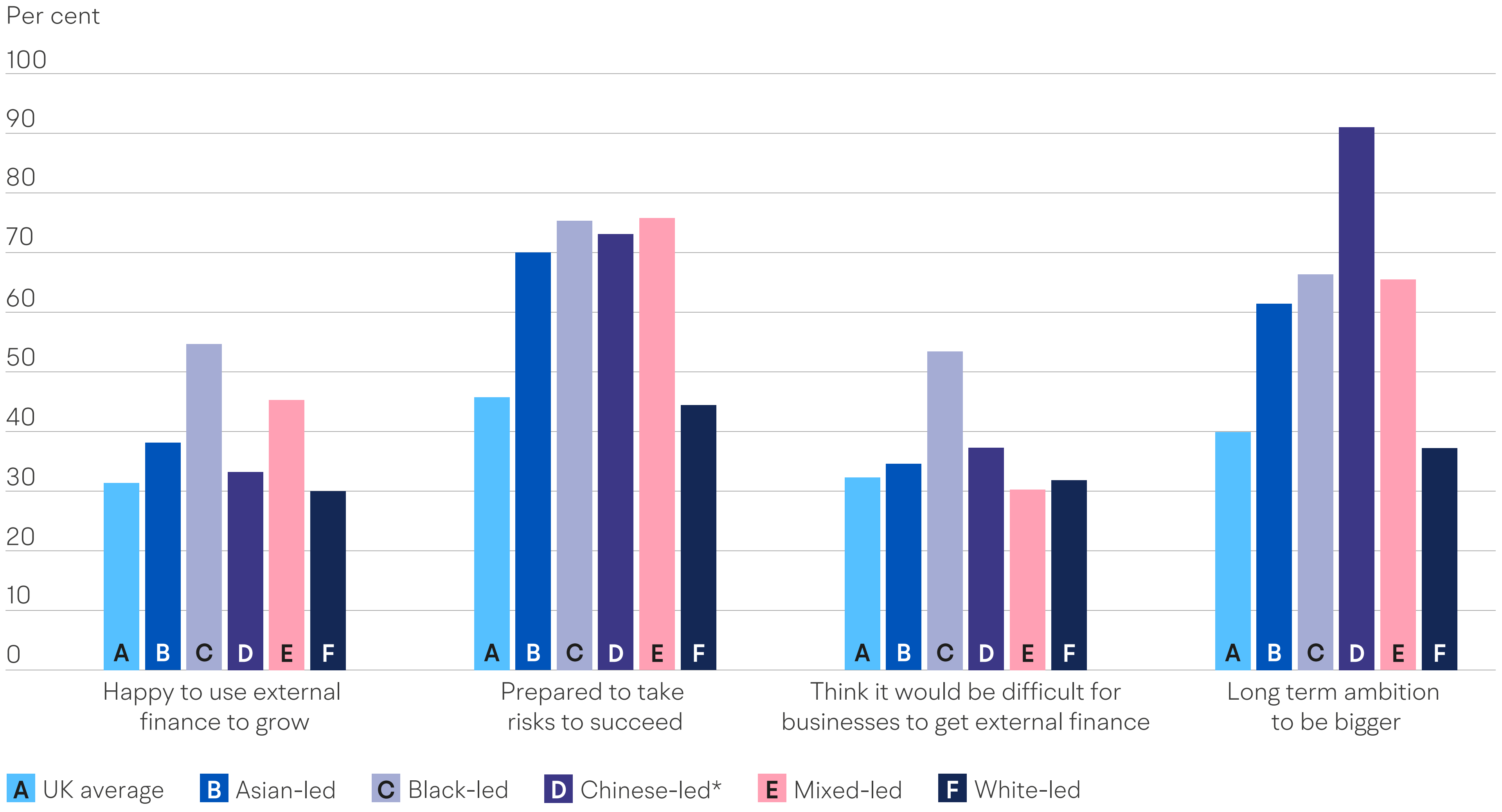
Ethnic Minority-led businesses tend to be more willing to use finance, more ambitious and more willing to take risks, but significantly more likely to think it would be difficult for them to get finance over 2021 and 2022.

Where sample sizes and survey design allow, it's important to look at differences between ethnic groups. Black-led businesses tend to be the most open to using finance for growth, but over half (53%) think it would be difficult to get finance (Figure B.9). This could be acting as a growth constraint for these businesses, particularly

Figure B.9

Smaller businesses' attitudes towards finance use and business enhancement

Source: UK Finance BVA BDRC SME Finance Monitor, Q1 2022-Q2 2023.



*base sizes for Chinese-led businesses are very small at n=45. Shown for indicative purposes only.

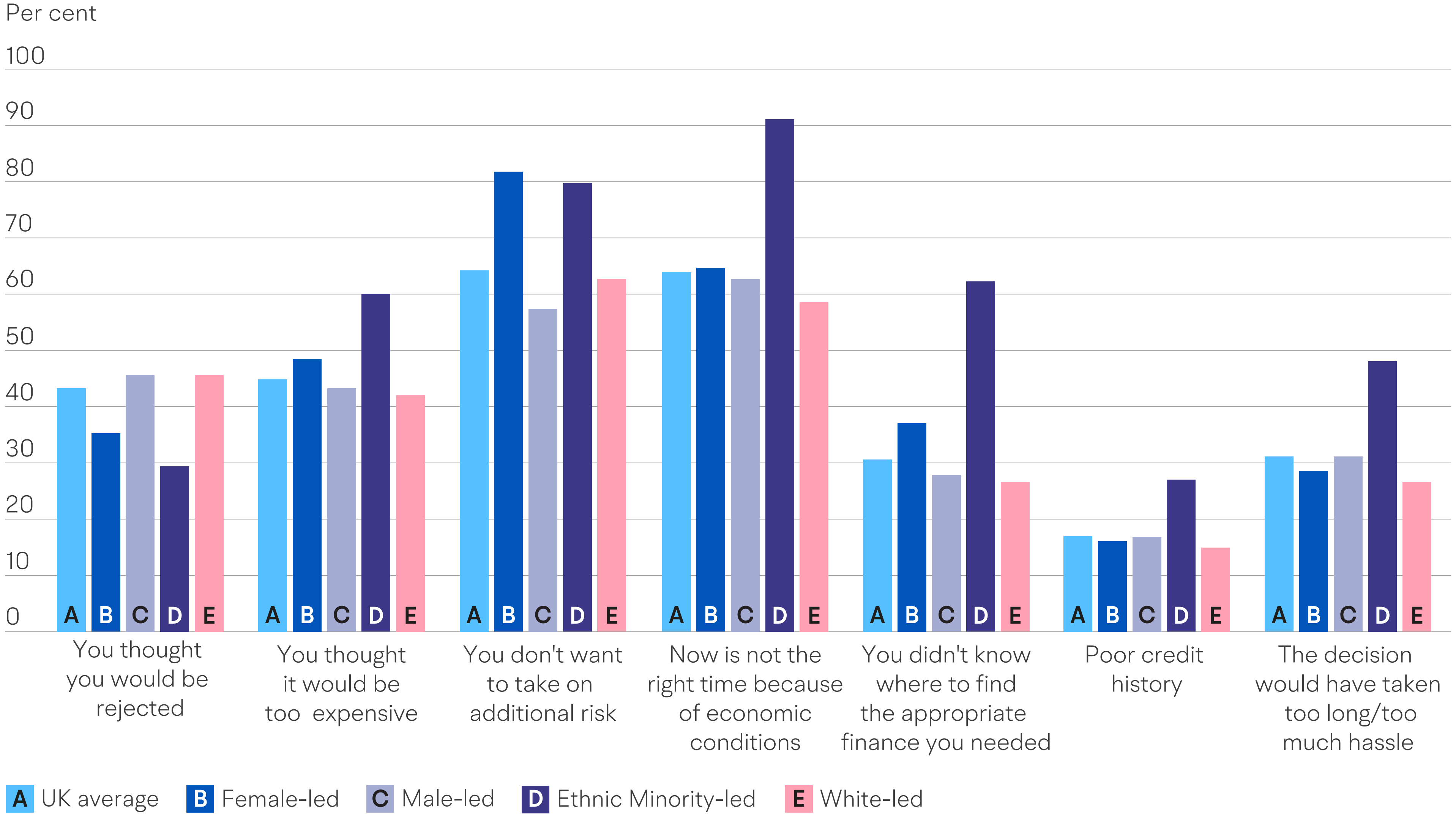
given Black-led businesses are more than twice as likely to report a need for funding (13% compared to an average of 6% across all smaller businesses).[128]

Ethnic Minority-led and female-led businesses are more likely to be 'would-be seekers' of finance, that is, needing finance but not applying. The share has decreased from 2021 to 2022 for both Ethnic Minority and female-led businesses (shown in Figure A.17), but the gap with White-led and male-led businesses remains. In 2022, economic conditions and concerns over risk were increasingly reported amongst most female and Ethnic Minority-led smaller businesses as reasons not to seek finance (Figure B.10). This represents a large increase from 2021, highlighting that under-served groups might be facing a higher credit constraint due to concerns over economic conditions.[129] Concerns over likelihood of rejection for Ethnic Minority-led businesses have decreased since 2021, but not knowing where to find the right finance has increased substantially for female and Ethnic Minority-led businesses (discussed more in section 1.5).

Figure B.10

Reasons for discouragement amongst businesses that needed finance but didn't apply

Source: British Business Bank analysis of DBT Longitudinal Small Business Survey 2022.



In 2023, less than half of Ethnic Minority-led businesses and around a third of those led by someone with a disability were confident in knowing where to obtain information on finance types and providers available (48% and 35% respectively) (Figure B.11). Two thirds of female businesses felt confident in this. As explored in section 1.5, not knowing where to find the appropriate finance needed is a key barrier to applying.

Barriers in accessing finance, particularly for Ethnic Minority-led businesses and those led by someone with a disability, are a constraint on growth and innovation

Previous Bank analysis has found that Ethnic Minority-led businesses are significantly more likely to be turned down for finance.[130] This has persisted over 2022-2023, with Ethnic Minority-led businesses indicatively more likely to have ended their application process without a facility than other businesses, although low base sizes on applications limit the analysis. This appears to be a particular problem amongst zero employee businesses, with credit issues and affordability as key reasons for being turned down and Ethnic Minority led businesses are significantly more likely to be zero employee businesses (79% compared to 76% of White-led businesses).[131]

As noted in previous Small Business Finance Markets reports, Ethnic Minority-led businesses are more likely to report not being given a reason for being turned down.[132] Guidance from the Lending Standards Board emphasises the importance of providing information and signposting for businesses rejected for credit, to increase access to finance for Ethnic Minority-led businesses.[133]

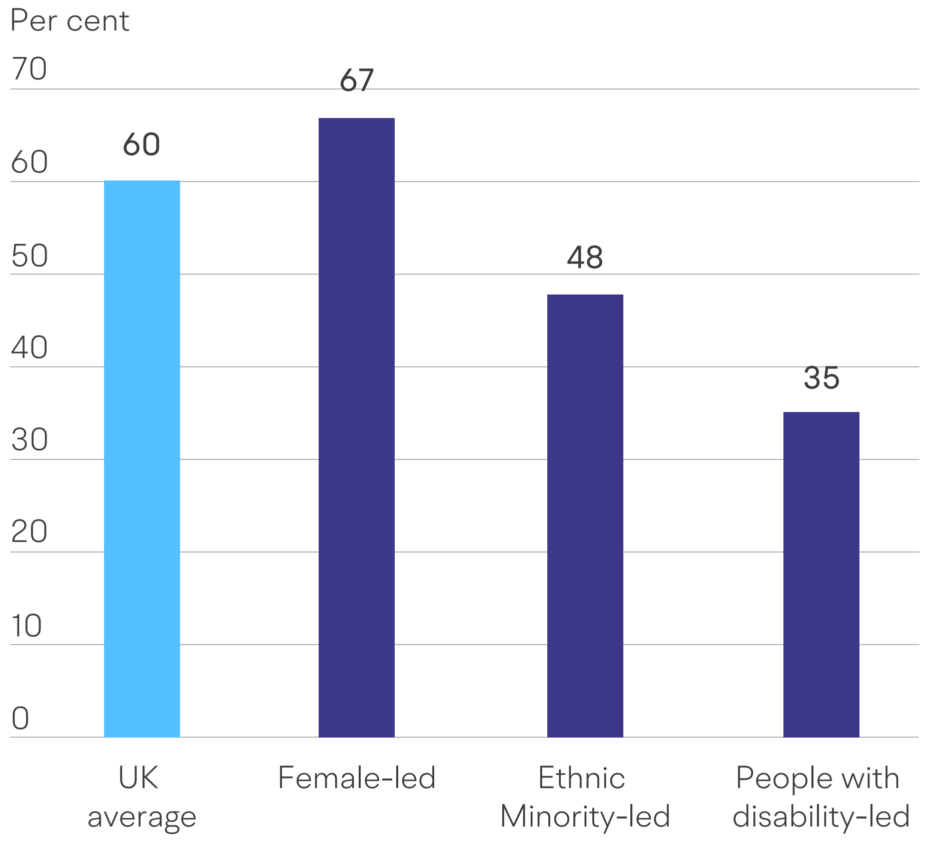
The implications of Ethnic Minority-led businesses not being able to get finance have been highlighted in previous British Business Bank research.[134] SME Finance Monitor data suggests Ethnic Minority-led businesses have been significantly more likely to have made their staff redundant as a result, though base sizes are low.[135]

Ethnic Minority-led businesses were significantly more likely to say that access to finance was a major barrier to running their business (14% compared to 5% for White-led businesses, over the 18 months to Q2 2023) (Figure B.12). Asian and Black-led businesses were three times more likely to cite it as a major barrier than White-led businesses.

Figure B.11

Share of smaller businesses confident in knowing where to obtain information on finance types and providers available

Source: Business Finance Survey 2023- Ipsos. n=822 (female-led=266, Ethnic Minority-led =64, people with disability-led=72). Differences with average not statistically significant due to low base sizes.



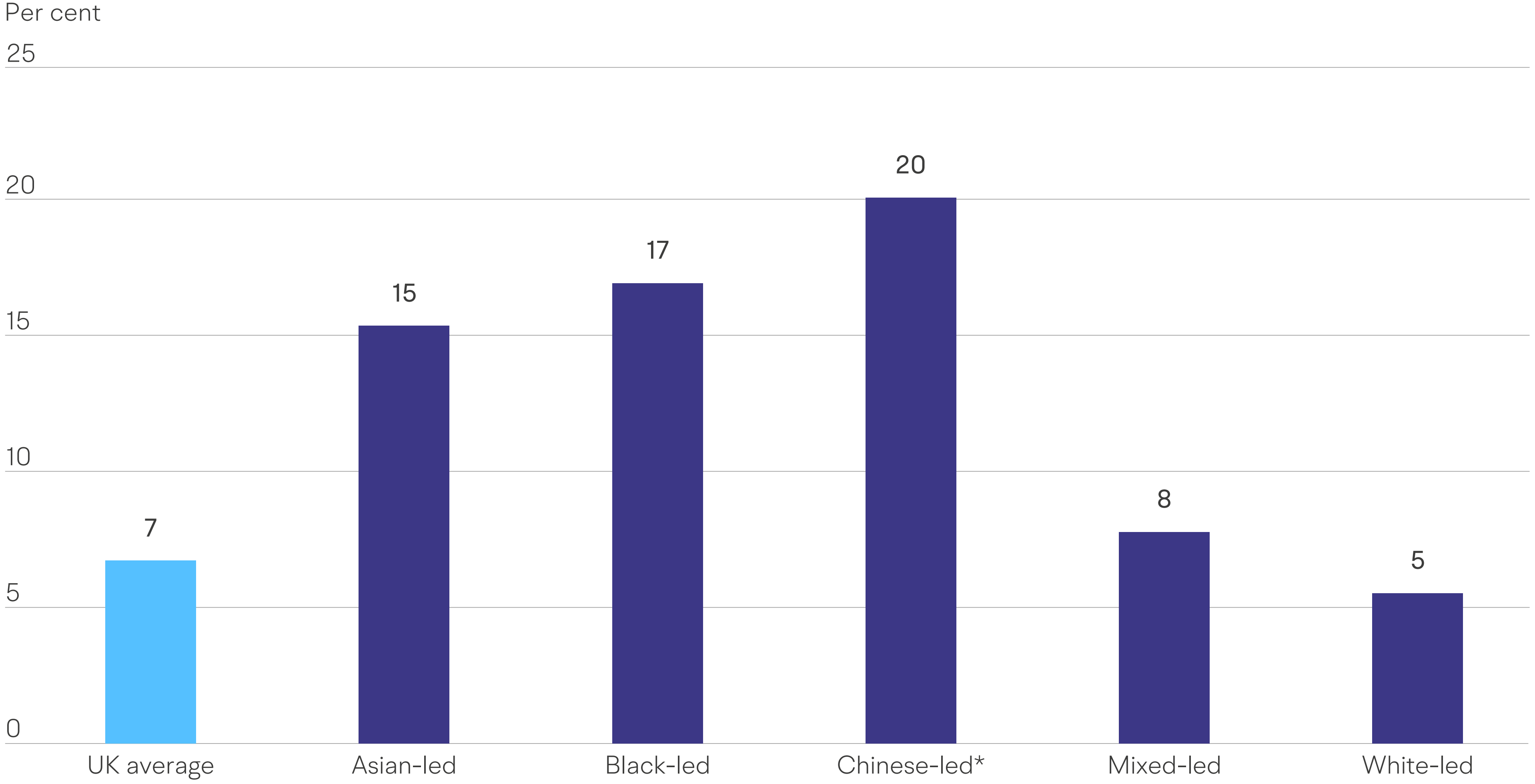
42% of Ethnic Minority-led businesses and 31% of those led by people with a disability said that lack of access to external finance presented an obstacle to developing or introducing new products, processes or services in 2023 (compared to an average of 17% across all smaller businesses). For these businesses, access to finance was the most reported obstacle to innovating.[136]

Lack of access to external finance for under-served groups could result in foregone economic growth as businesses are unable to innovate without the means to do so. Evidence also suggests that under-served entrepreneurs are particularly effective at designing products and services to reach disadvantaged or underrepresented groups, in addition to being ambitious with a growth mindset.[137] Enabling these entrepreneurs to innovate and grow could result in a more inclusive economy, in addition to realising growth potential.

Figure B.12

Share of smaller businesses agreeing that access to external finance is a major obstacle to running their business in the next 12 months

Source: UK Finance BVA BDRC SME Finance Monitor, Q1 2022-Q2 2023.



*base sizes for Chinese-led businesses are very small at n=45. Shown for indicative purposes only.

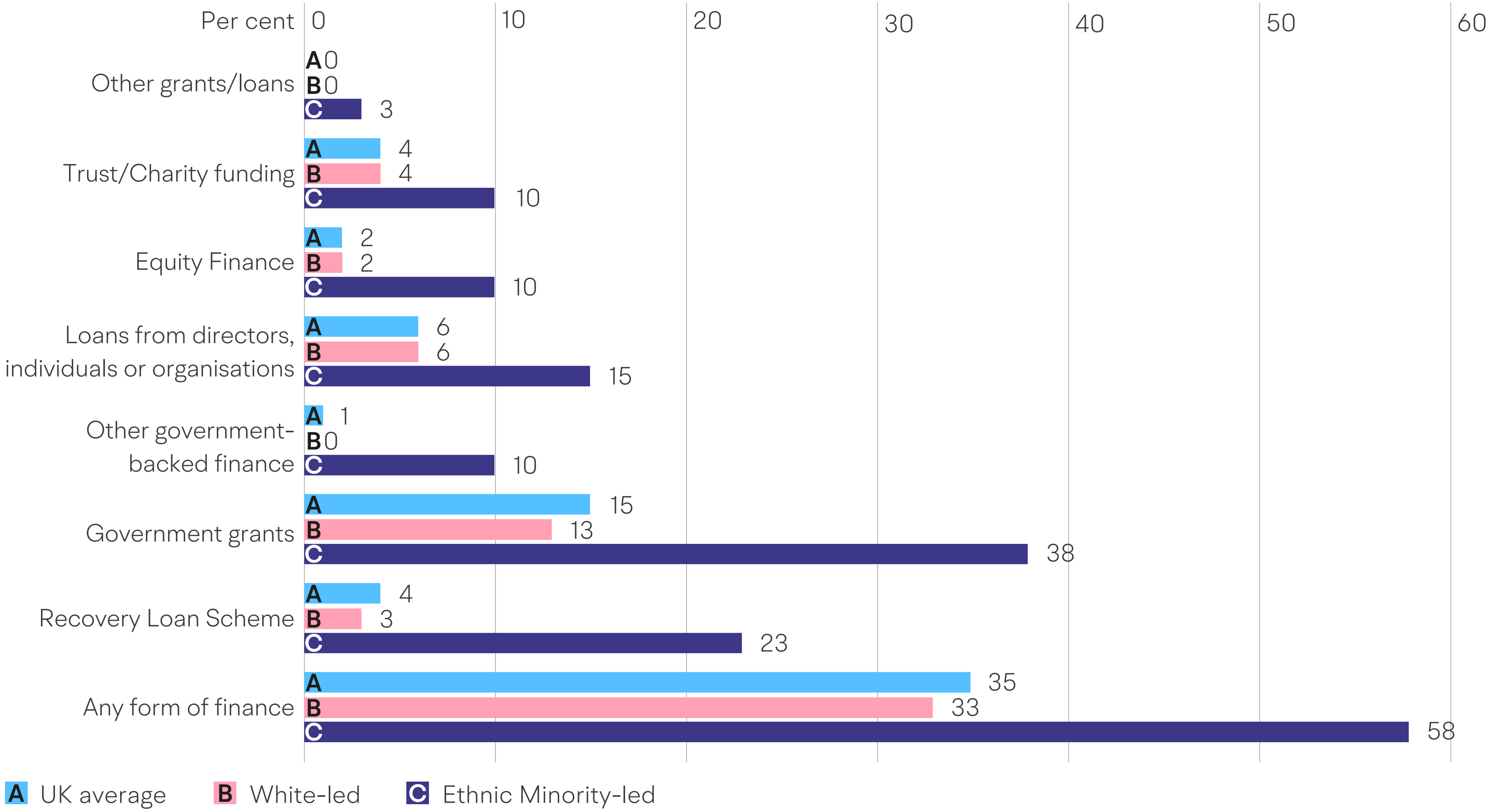
More Ethnic Minority-led businesses are considering applying for some form of finance over the coming year, with a higher share expecting to use government-backed finance

Consistent with Ethnic Minority-led businesses' higher willingness to use finance, highlighted in section 1.5, Ethnic Minority-led businesses were more likely to have sought or considered finance in the past three years (58% compared to 41% of White-led businesses).[138] Most are considering applying for some form of finance over the next twelve months (Figure B.13) (note, responses are from September to December 2023). Ethnic Minority-led businesses are significantly more likely to consider applying for the Recovery Loan Scheme[139], grants, other government-backed finance, loans from directors, other individuals or organisations and equity finance, compared with both White-led businesses and the UK average.[140] Smaller businesses led by people with a disability were also more likely to consider applying for government-backed finance (4% compared to 1% of businesses not led by people with a disability).

Figure B.13

Share of smaller businesses considering applying for finance over the next 12 months

Source: Business Finance Survey 2023- Ipsos. n=1,723 (Ethnic Minority-led n=86, White-led n=1,536). Only significant differences between Ethnic Minority-led and White-led are shown.



In the year to Q2 2023, 17% of Ethnic Minority-led businesses anticipated having a need for finance over the next 3 months, with 12% planning to apply and over a quarter (26%) planning to inject personal funds.[141] Asian-led and Black-led companies were six and four times more likely to seek new equity than White-led companies (18%, 12% and 3% respectively).[142] Future need for finance was particularly high amongst Black-led businesses (26%), with 21% planning to apply and 39% planning to inject personal funds.

As highlighted in previous Small Business Finance markets reports, a higher share of Ethnic Minority-led businesses have injected personal funds and felt that they had to do so. This could act as a constraint for entrepreneurs that can't afford to put their own funds into their business.[143]

Most smaller businesses are aware of how to improve diversity and inclusion within their business, with some making this a priority over the coming year

Three-quarters of smaller businesses (74%) know a least a little about improving diversity and inclusion amongst employees, leadership and/or suppliers, or developing an offering accessible to a wider community of customers. Almost half (46%) agreed they knew at least a fair amount. Compared to when the question was last asked in our 2021 Business Finance Survey, overall knowledge of diversity and inclusion improvement has decreased from 80% knowing a little and 59% knowing a fair amount.[144]

Of those smaller businesses that had at least heard of improving diversity and inclusion in 2023 (82%), 40% said it's a high priority over the next 12 months, equating to a third of all smaller businesses. As Figure B.14 shows, prioritising diversity and inclusion is correlated with larger businesses (both in terms of employees and turnover), innovation, planning to grow, prioritising environmental sustainability and being female-led.

Ethnic Minority-led businesses and those led by people with a disability were also more likely to prioritise diversity and inclusion, although the results are not significant reflecting smaller base sizes.

This reflects previous findings from British Business Bank and Enterprise Research Centre research that female and Ethnic Minority-led businesses are more likely to have social goals and priorities.[145]

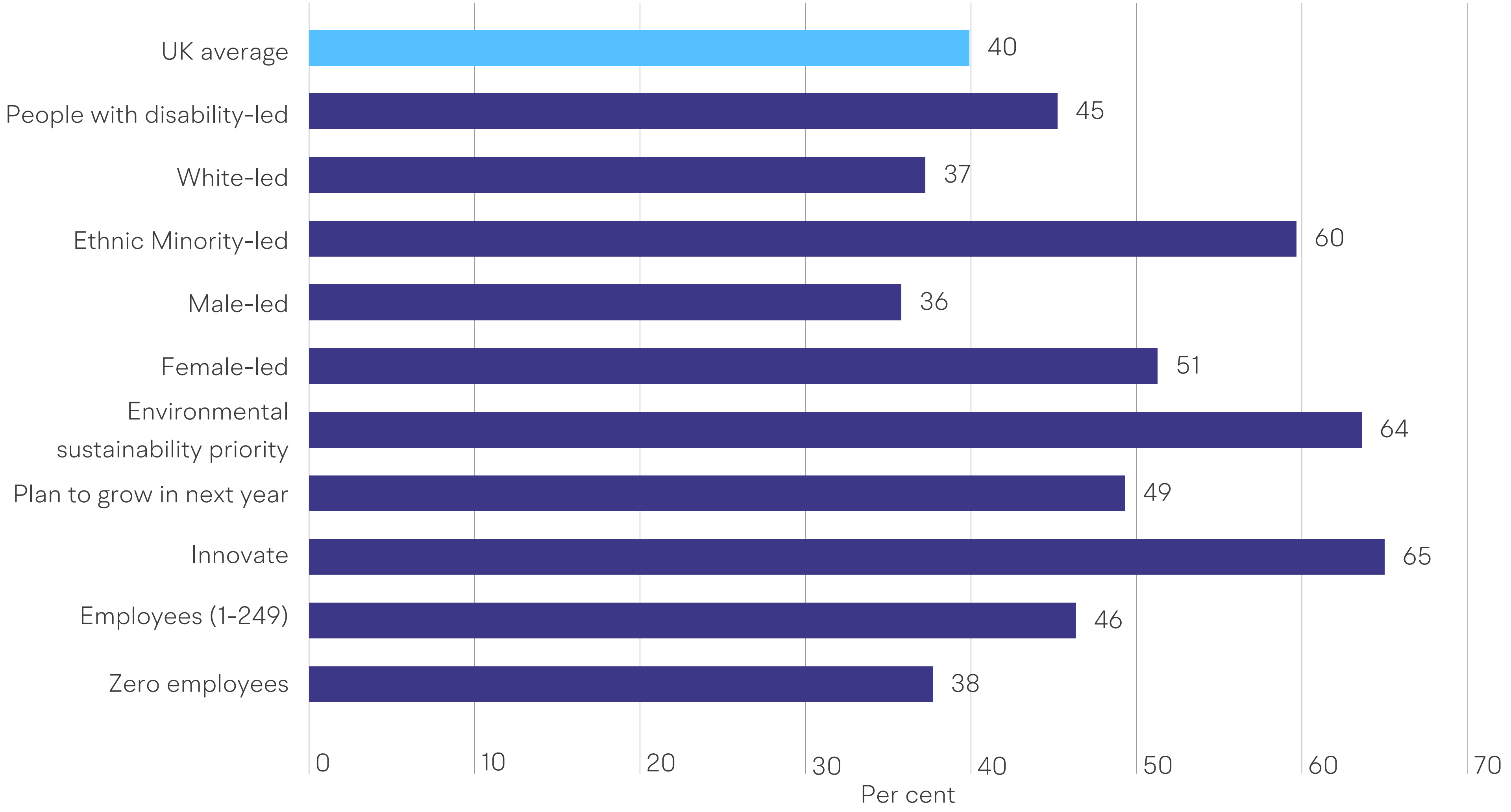
Across micro, small and medium businesses in 2022, one in four were paying workers the Real Living Wage, implementing programmes to promote mental health, and promoting gender and ethnic equality in the workplace. Just under one in five prioritised suppliers that value social responsibility and ethical employment practices, with 15% monitoring the impact of their products and services on community wellbeing over the past 12 months. Half of businesses undertaking pro-social practices said they led to new product or service innovations.[146] This illustrates the range of social activities being undertaken by smaller businesses and their positive social and economic impacts.

The British Business Bank's activity in unlocking the potential of entrepreneurs regardless of where and who they are, is explained in more detail in section 1.4 and section 1.5. The Bank's own Finance Survey tracks access to finance for female, Ethnic Minority and disabled business leaders and owners on an annual basis. The Bank's evaluations also quantify the reach of programmes to these groups, and in 2024 the Bank will commence work on enhancing our understanding of diversity in our own investment and lending portfolios. The Bank is also encouraging others to improve their reporting and transparency, through engagement with our delivery partners and the wider ecosystem, along with publishing research on how investors can improve the diversity and representativeness of their investment portfolios.[147]

Figure B.14

Share of smaller businesses that reported improving diversity and inclusion as a high priority for their business, of those aware of it

Source: Business Finance Survey 2023- Ipsos. n=718. Base sizes vary.



2.4

Finance for environmental sustainability

Smaller business awareness of the Government's legal commitment to net zero has increased in 2023, but remains at 2021 levels

Economic conditions remain the most frequently cited barrier to becoming more environmentally sustainable, but uncertainty around government policy has become an important issue in 2023

There has largely been no change in the proportion of smaller businesses measuring their carbon emissions

This section explores smaller businesses' attitudes and progress towards environmental sustainability over the past three years using data from the Bank's latest and previous Small Business Finance surveys. The section also examines smaller businesses reported barriers to becoming more environmentally sustainable and the proportion of businesses measuring their carbon emissions.

Smaller business awareness of the Government's legal commitment to net zero has increased in 2023, but remains at 2021 levels

The latest British Business Bank Small Business Finance survey results show 97% of smaller businesses are aware of the Government's legal commitment for the UK to reach net zero emissions by 2050, which is slightly higher than figures reported in 2021 and 2022 respectively (95% and 93%).

Figure B.15

Smaller businesses' awareness of the UK Government's net zero target and the implications of climate change

Source: British Business Bank Business Finance Survey 2023 – Ipsos. Base = all businesses (n=1,169 in 2022, n=822 in 2023).

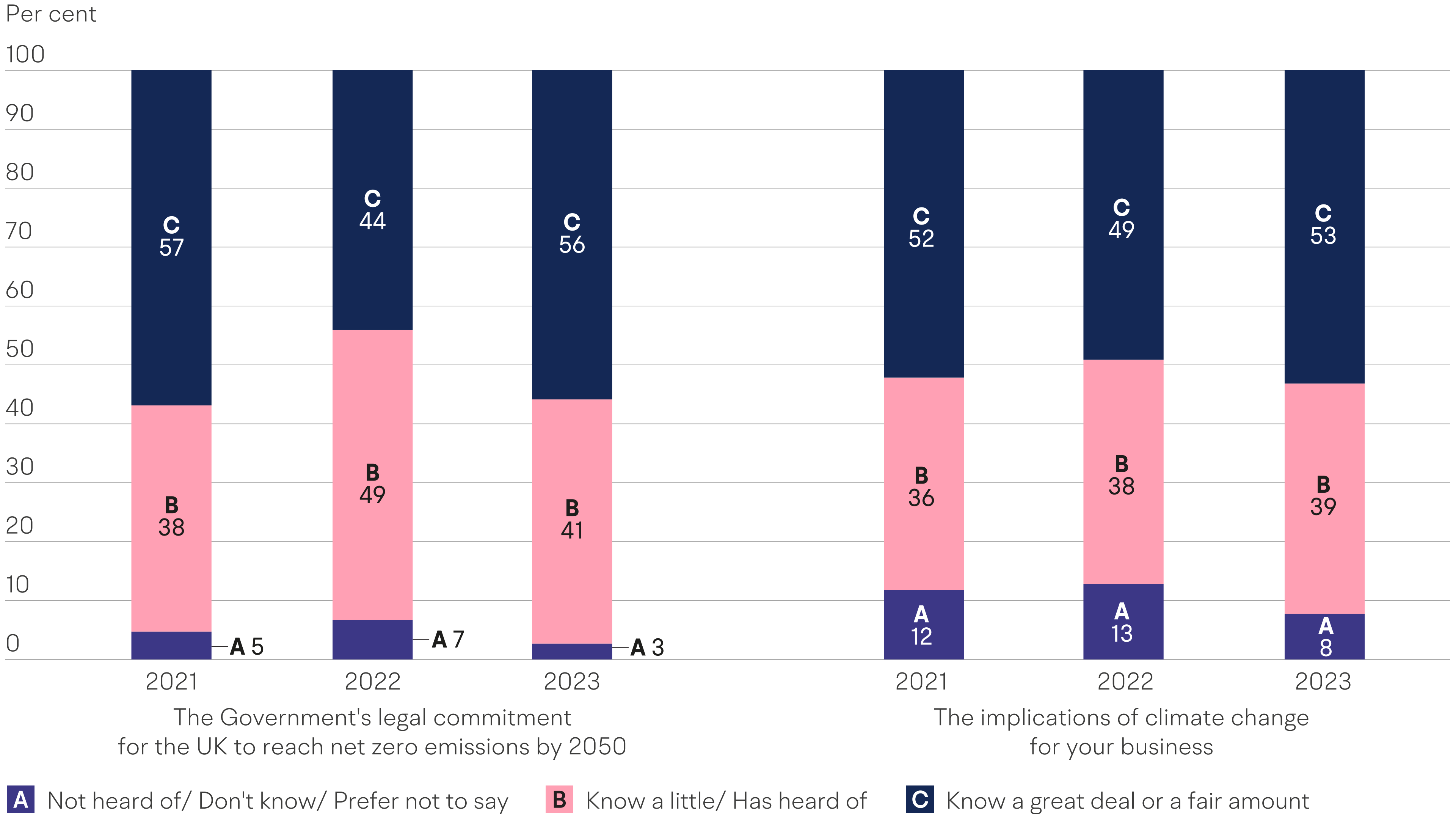


Figure B.15 shows there has been a large increase in the proportion of businesses that indicated they knew a great deal or a fair amount about the Government's legal commitment to net zero targets, which increased from 44% in 2022 to 56% in 2023, although it remains at a similar level to 2021 (57%).

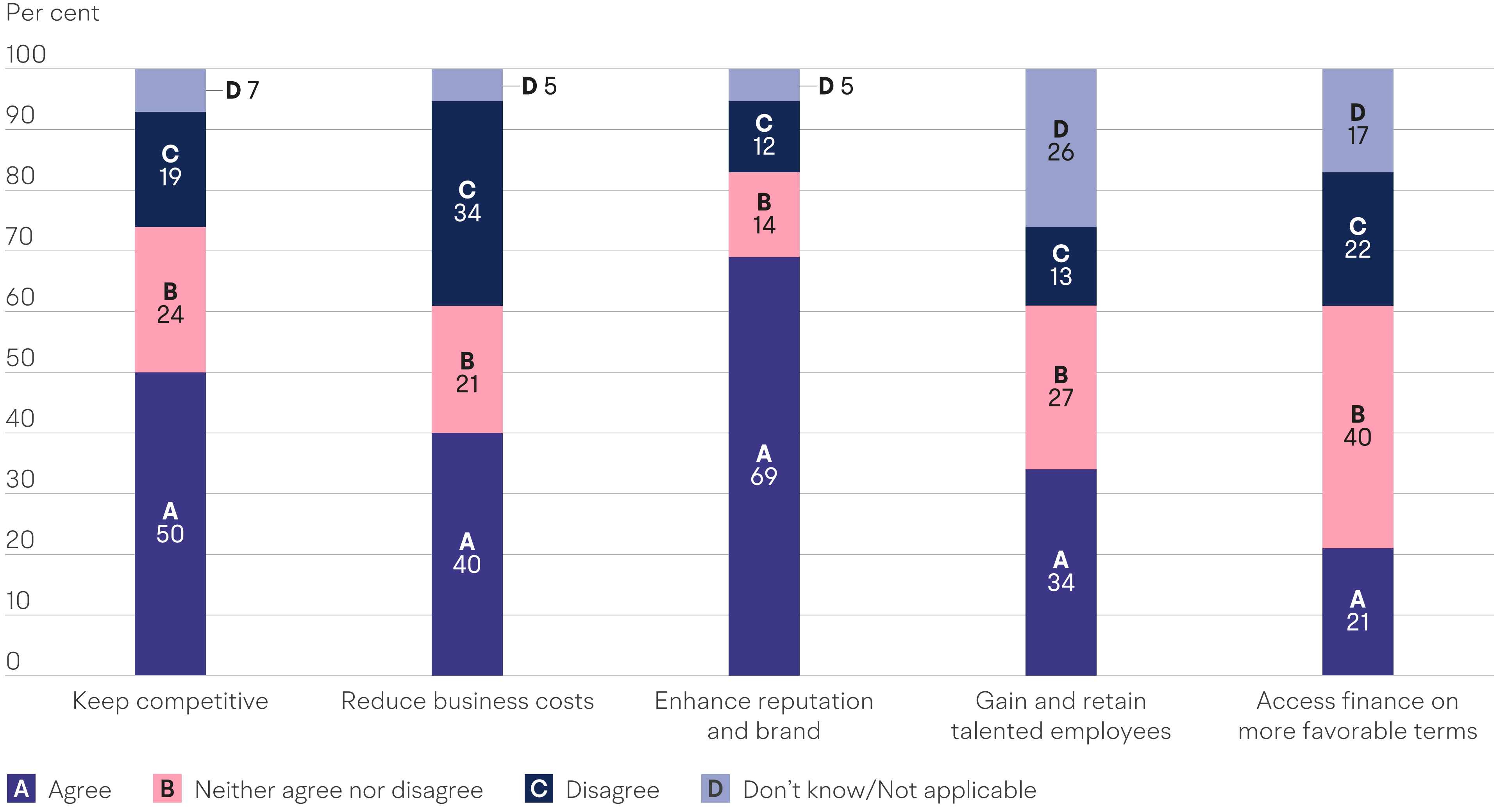
There is a similar picture in terms of smaller businesses reporting they knew a great deal about the implications of climate change on their business which increased from 49% in 2022 to 53%, but this also remains at similar levels to 2021 (52%). The COP26 climate change conference occurred in Glasgow in 2021, with the resulting strong media coverage likely to have increased business owners awareness of climate change. This increased awareness was not sustainable over the longer term, but it is positive awareness has now increased to these levels.

Smaller businesses generally have a positive perception of environmental sustainability practices on business reputation but are more uncertain when it comes to its impact on retaining talented employees and helping the business to raise finance on favourable terms. 69% of smaller businesses believed adopting environmental sustainability practices would enhance the business reputation and brand, whilst 50% believed it will help enable the business to be competitive (Figure B.16).

Figure B.16

Smaller businesses attitudes to the implementation of environmental sustainability practices

Source: British Business Bank Business Finance Survey 2023 – Ipsos. Base = All businesses who consider environmental sustainability a priority in the next 12 months (n=462).



40% of businesses thought implementing business environmental sustainability practices helped businesses to reduce costs, but 34% of businesses thought it led to higher costs, suggesting the picture is more mixed. Only a minority (34%) believed implementation of environmental sustainability practices helped businesses to retain talented employees and 21% believed it helped businesses to raise finance on more favourable terms. A slightly higher proportion (22%) of respondents disagreed with the statement that adopting environmental sustainability practices would lead to accessing finance on more favourable terms. It is unclear whether respondents felt adopting greater environmental sustainability practices had no impact on finance terms or whether it would lead to finance being accessed on worse terms.

50% of smaller businesses viewed becoming more environmentally sustainable over the next 12 months as a priority (with 16% saying it is a very high priority). This is slightly higher than 46% of businesses answering this question in 2022. Prioritisation is correlated with business size, with 47% of zero employee businesses reporting it as high priority compared to 71% of medium sized businesses.

Economic conditions remain the most frequently cited barrier to becoming more environmentally sustainable, but uncertainty around government policy has become an important issue in 2023

Of those businesses who are prioritising environmental sustainability in the next 12 months (50%), respondents were asked their views on the obstacles to reaching environmentally sustainability.

Current economic conditions were the most frequent cited obstacle towards becoming more environmentally sustainable in the next 12 months, given by 55% of businesses (Figure B.17). While this was a considerable decline of 12 percentage points compared to 2022 when 67% of businesses reported it as a barrier), current economic conditions remained the most frequently quoted barrier for smaller businesses towards adopting sustainability practices.

Younger (less than five years old) and smaller businesses (less than 10 employees) were most likely to cite the economy as a barrier. Last year's Small Business Finance Markets report highlighted economic headwinds were testing the ability of smaller businesses to becoming more environmental sustainable, but it appears these pressures eased slightly in 2023.[148]

Uncertainty about government policies and regulations became the second most cited barrier, given by 52% of smaller businesses. This was not cited as a barrier in the 2022 survey, but may reflect policy changes announced by the Government in October 2023 relating to delaying the adoption dates for phasing out the sale of combustion engines cars and gas boilers, and the removal of requirements for rental properties to have an Energy Performance Certificate (EPC) of C or higher.[149]

31% of smaller businesses in 2023 stated that their main obstacle in becoming more environmentally sustainable was awareness of what steps to make, while 29% acknowledged that availability to relevant advice was the main challenge for their business. Almost a quarter (24%) of smaller businesses also indicated they lacked access to the necessary tools and skills to make their business sustainable. Combining these three categories together as they relate to information barriers, led to 46% of smaller businesses reporting this as a barrier, making it the third largest barrier to becoming more environmentally sustainable overall.

Almost a third of smaller businesses (32%) that viewed environmental sustainability as a priority said their ability to measure or monitor carbon emissions and to make changes to their premises or suppliers was a challenge in their journey towards environmental sustainability.

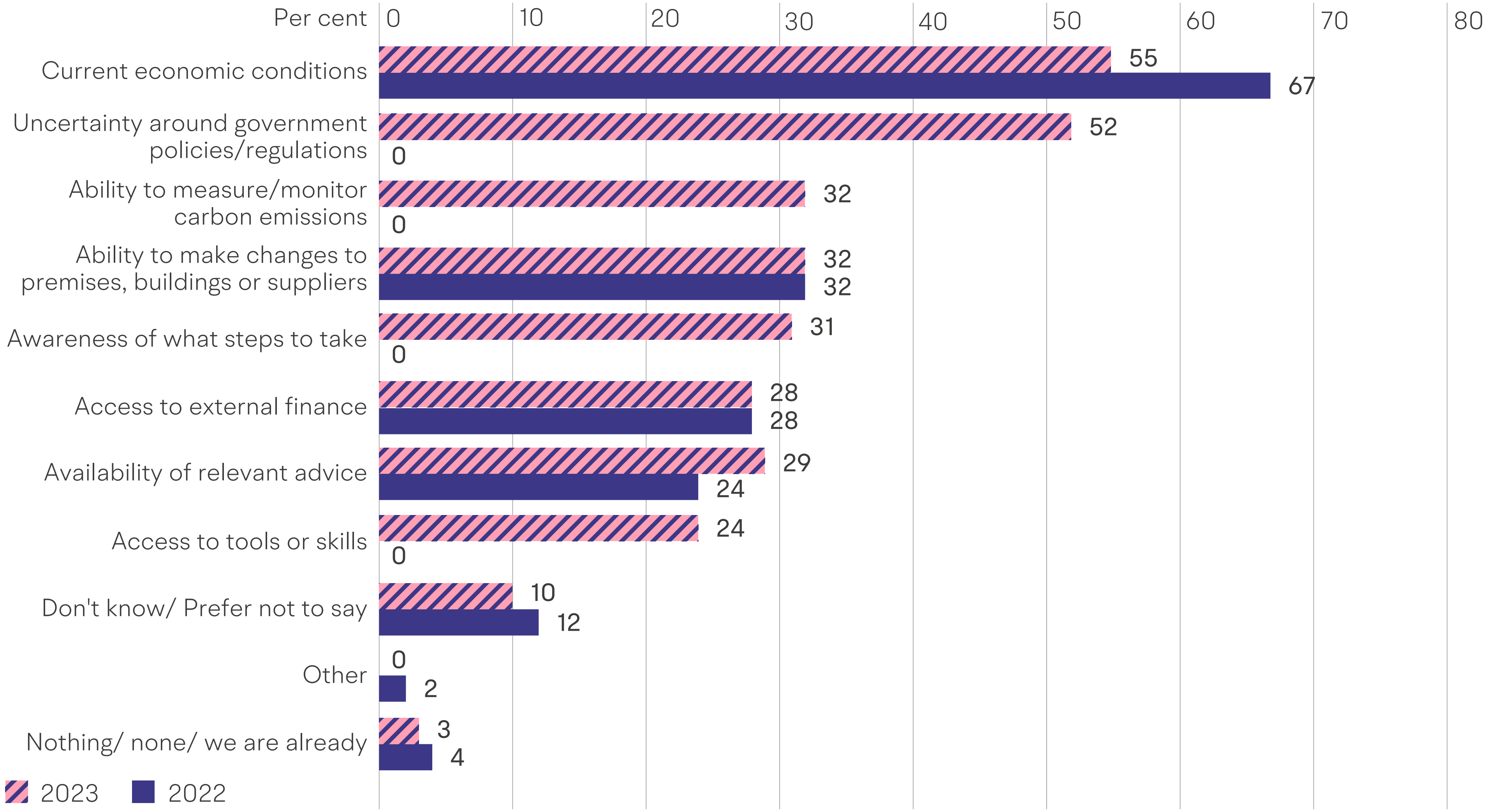
28% of smaller businesses mentioned access to finance as their main barrier, the same percentage as reported this issue in 2022. Whilst an important issue for some businesses, especially those lacking internal resources to fund environmental sustainability measures, this suggests other barriers like lack of information, uncertainty on economic conditions and clarity on future net zero policy and targets are more prevalent barriers.

Whilst 32% of smaller businesses reported ability to make changes to the premises, building or suppliers as a barrier to becoming more environmentally sustainable, this was significantly higher for businesses that rented or leased their business premises (42%). Access to finance as a barrier to environmental sustainability was also more frequently reported by businesses that rented their business premises (38%) compared to businesses overall (28%), which may reflect lack of collateral.

Figure B.17

Main obstacles faced by businesses in trying to become more environmentally sustainable in the next 12 months

Source: British Business Bank Business Finance Survey 2023– Ipsos. Base = All businesses who consider environmental sustainability a priority in the next 12 months (n=599 in 2022, n=462 in 2023).



There has been no change in the proportion of smaller businesses measuring their business carbon emissions

The latest British Business Bank Small Business Finance survey shows 5% of smaller businesses stated they were measuring, monitoring or reporting their business carbon emissions. This is a similar proportion to the 6% of smaller businesses reporting they measured their carbon footprint in the previous five year, in previous 2021 Business Bank research.[150] This suggest there has been no real change in the proportion of businesses reporting their carbon emissions over the last three years, although 14% of smaller businesses in the latest survey reported they intend to start doing so.[151]

Measuring carbon emissions is linked to business size with 32% of medium sized businesses compared to 2% of zero employee businesses. 11% of employer businesses overall measure their emissions. Businesses in the production sector were also more likely to measure their emissions than other sectors (11%).

Businesses that sought finance in the last three years were slightly more likely to report they measured their emissions (7%) compared to smaller businesses overall (5%).

Smaller businesses were asked about what barriers they faced for measuring their carbon emissions. Lack of knowledge of what to measure, monitor and report was the most frequent reported barrier (43%), followed by lack of capacity (40%) and lack of necessary skills (36%). 64% of smaller businesses overall reported at least one obstacle to reporting their carbon emissions.

As highlighted earlier in the section, only around half of businesses are prioritising environmental sustainability over the next 12 months. There are therefore large differences in the scale of businesses reporting barriers to measuring carbon emissions between business that are prioritising environmental sustainability and those that are not (Figure B.18).

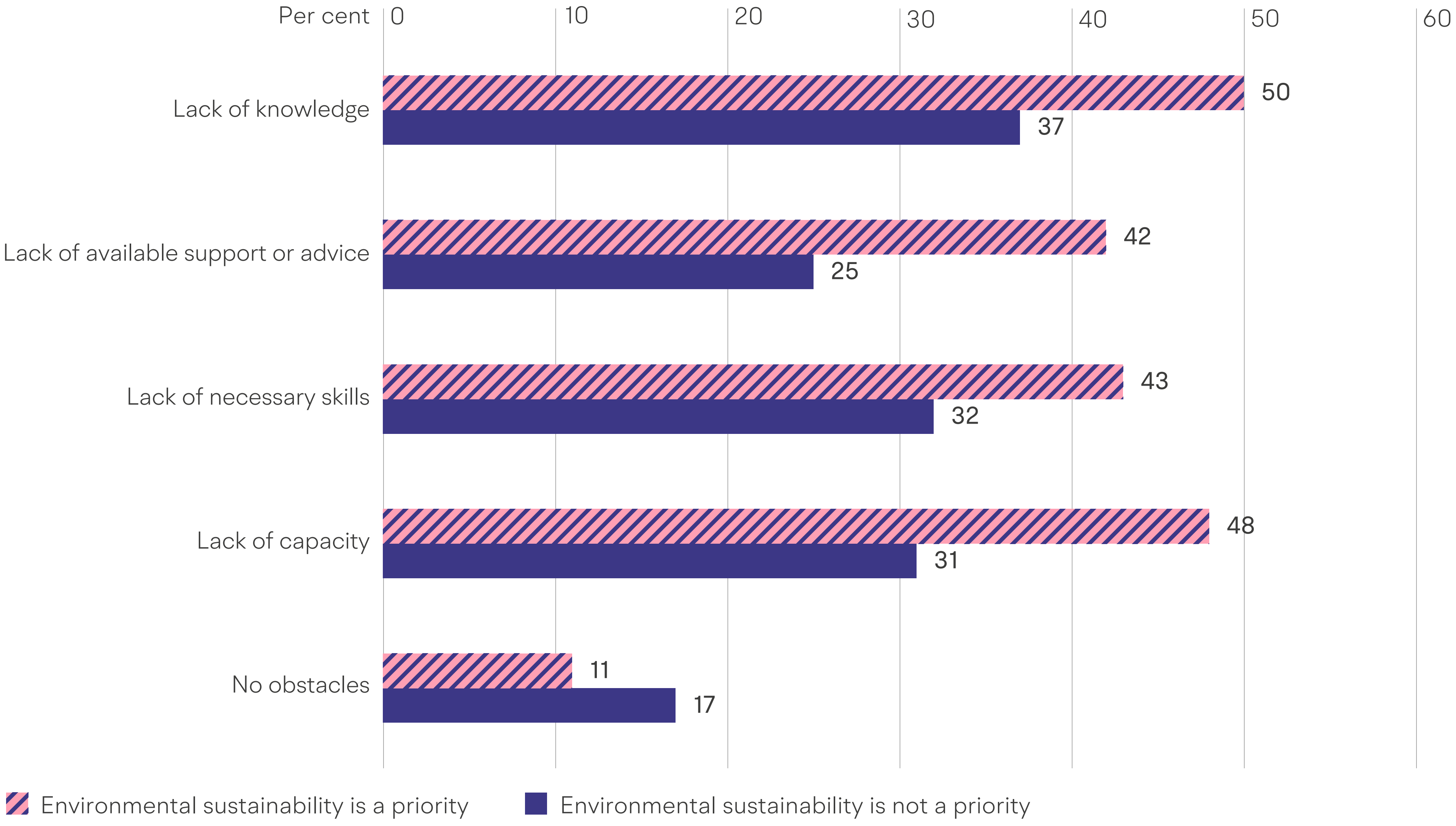
75% of smaller businesses who are prioritising environmental sustainability reported a barrier to measuring emissions compared to 56% that are not, which might indicate the latter group have not considered measuring emissions to the same extent as those prioritising environmental sustainability. Lack of knowledge (50%) and capacity (48%) were the key barriers for environmental sustainability focused businesses, which were significantly higher than for businesses where environmental sustainability was not a priority.

The Bank is working with stakeholders to improve smaller businesses ability to report on their own emissions. The Bank is engaged with Bankers for Net Zero's 'Mobilising SMEs for Climate Action' workstream identifying market solutions to enable efficient and scalable GHG emission reporting for smaller businesses.[152] Bankers for Net Zero, alongside Icebreaker One, are developing Project Perseus to enable automated emissions reporting for every smaller business in the UK.

Figure B.18

Smaller businesses views on obstacles to measuring, monitoring or reporting their carbon emissions

Source: British Business Bank Business Finance Survey 2023 – Ipsos. Base = all businesses (n=822).



Equity finance and private debt

– 2.5 Equity finance

– 2.6 Private debt

2.5

Equity finance

- Equity investment into smaller businesses has declined to levels last seen in 2020
- Later stages of the market continue to experience the largest reductions in investment and valuations
- The proportion of down rounds in the market has increased to a ten-year high
- The concentration of equity deals in London fell below 50% in 2023, though its share of investment remained high
- Exit activity and fundraising have both declined over 2023, but dry powder is near record levels
- British Business Bank programmes continue to focus on increasing the supply of equity finance to smaller businesses throughout the market cycle

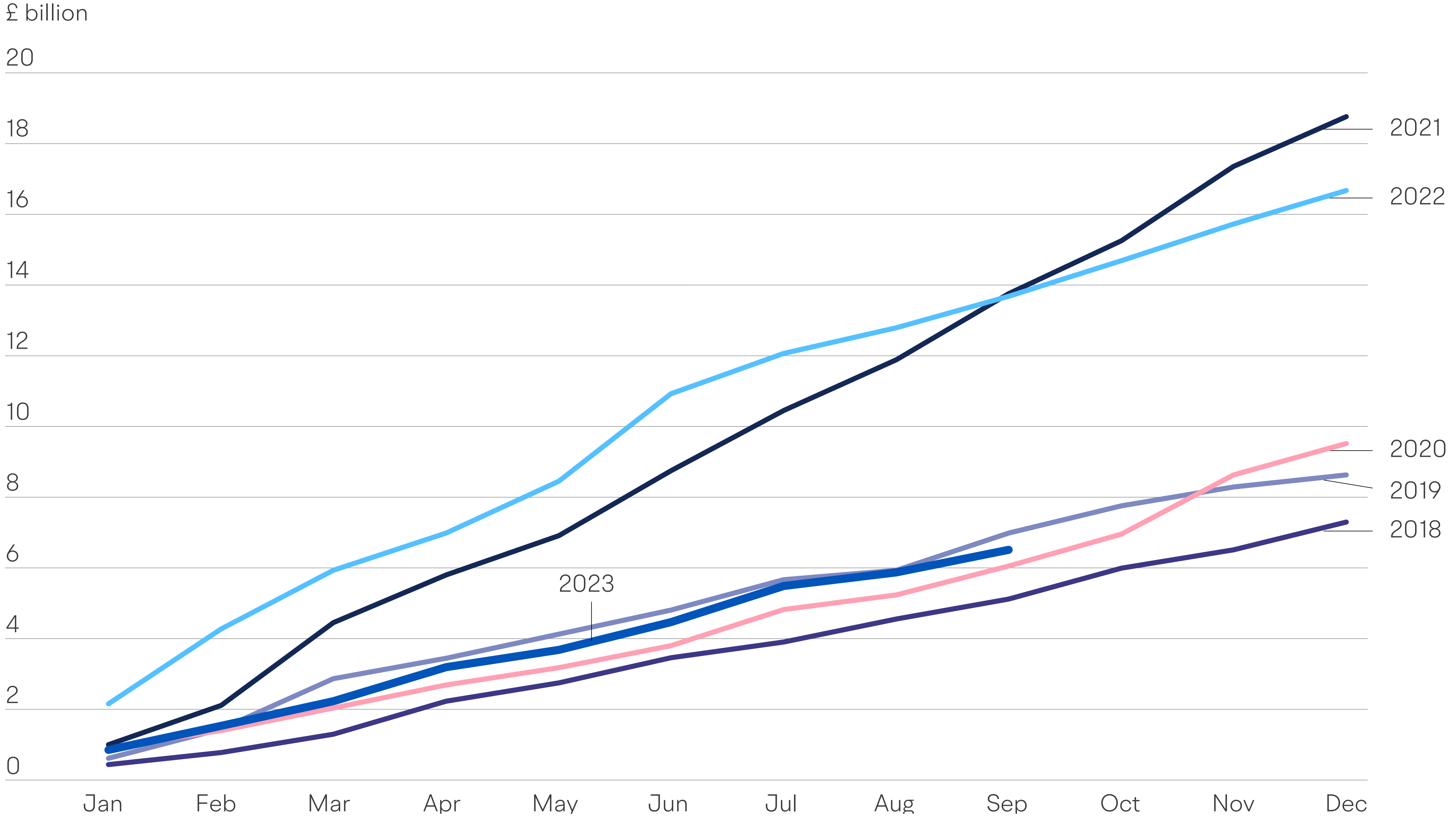
This section offers a comprehensive review of the latest trends in the UK smaller business equity finance market, drawing upon data from Beauhurst up to the end of September (Q3) 2023. The Bank's Small Business Equity Tracker report, to be published later this year, will provide a more definitive assessment of market trends in 2023, once sufficient time has passed to capture and validate equity deals across the full year.

While Beauhurst does track unannounced deals, this analysis focuses on announced deals for which more detailed information is available. Deals supported by institutional investors are more likely to be announced than those involving other investor types, such as business angels. The Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) serve as good indicators of business angel activity.[153] A total of £2.5bn was raised by 6,750 companies between 2021 and 2022 through the schemes, highlighting the importance of business angels for the early-stage equity ecosystem.[154]

Figure B.19

Cumulative monthly equity investment by year

Source: British Business Bank analysis of Beauhurst data.



Equity investment into smaller businesses has declined to levels last seen in 2020

The findings from the Bank's Small Business Equity Tracker 2023 report revealed an 11% overall decline in UK smaller business equity investment in 2022, with the number of equity deals falling by 7%. Following record levels of activity in 2021, the middle of 2022 marked a clear turning point in the market. Concerns about potential over-valuations and a lack of exit opportunities led to a 47% reduction in equity investment when comparing the first and second halves of the year.

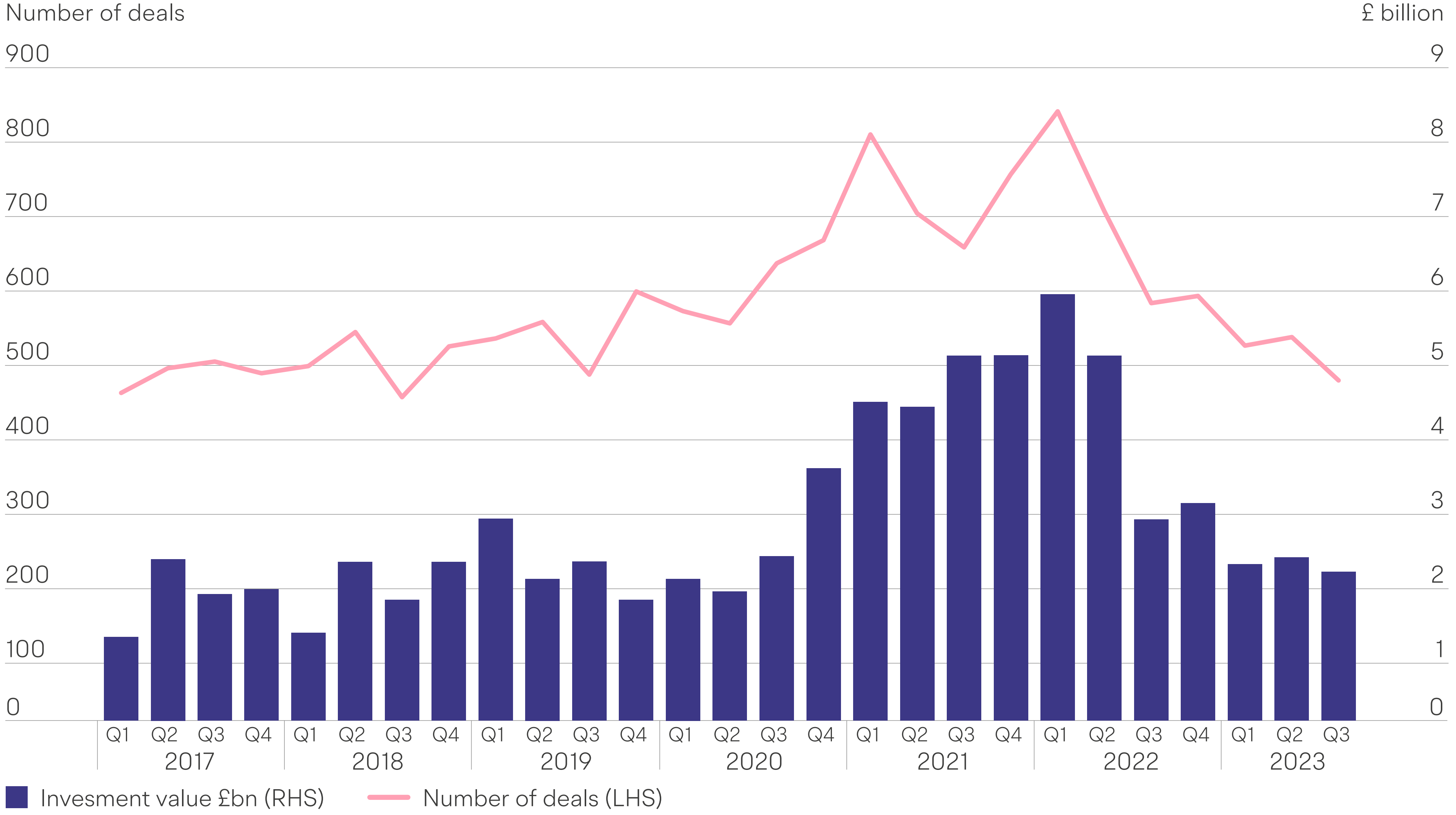
The most recent data has confirmed the continuation of this downward trend through 2023, as investment has now reverted to levels last seen in 2020. Figure B.19, for example, shows the trajectories of cumulative monthly equity investment by year. This illustrates the extent to which 2021 and 2022 were outlier years, while 2023 is showing more typical investment levels. Total funding in 2023 is on track to reach a similar full year total to 2019 and 2020, assuming investment in Q4 2023 does not deviate significantly from the Q1-Q3 average.

Figure B.20 shows the number and value of UK smaller business equity deals by quarter, highlighting the

Figure B.20

Number and value of announced equity deals per quarter

Source: British Business Bank analysis of Beauhurst data.



slowdown in activity that has occurred in the market since Q2 2022. The period between Q1-Q3 2023 saw a total of 1,512 UK small business equity deals announced, which is 29% lower than the equivalent period in 2022. This total is 13% lower than in Q1-Q3 2020 and 5% lower than in Q1-Q3 2019.

On an investment basis, there has been a more significant reduction in activity in 2023. The first three quarters of 2023 saw £6.5bn raised by smaller businesses, which is a 53% decline on Q1-Q3 2022. However, this total is 8% higher on the equivalent period in 2020, showing more resilience compared to historical levels before the market peak.

Q3 2023 saw a total of £2.1bn invested across 468 announced smaller business equity deals. This was a decline of 26% in investment and 19% in the number of deals compared to Q3 2022. However, looking at the latest three quarters in Figure B.20, quarterly investment values appear to be stabilising in 2023 around the quarterly average for 2019 and 2020. While this can be interpreted as a return to longer term trends from the highs of 2021 and 2022, deal activity now has to support a larger pipeline of companies than four to five years ago.

The market decline over the past 18 months is not unique to the UK and can be seen across other global regions, as highlighted in Atomico's State of European Tech 2023 report.[155] They note that the total anticipated investment value for 2023 is projected to be less than half of that observed in 2021 across all global regions. Despite this, the total amount invested in Europe in 2023 is expected to be 18% higher than in 2020 indicating the return to pre-pandemic levels of activity is a global trend.

Whilst inflation rates in the world's largest economies appear to have peaked and are now declining, global interest rates are unlikely to return to levels seen during the 2008-2020 period. In December 2023, participants of the monthly Federal Reserve meeting noted that there is "an unusually elevated degree of uncertainty" about the economic outlook, with further rate increases still possible.[156] In the UK, the Bank of England's November Monetary Policy Report indicated that the market-implied path for Bank Rate was to gradually decline from 5.25% in 2024 to 4.25% by the end of 2026.[157]

This economic uncertainty has translated into a subdued exit environment, preventing funds from realising returns and recycling capital into new deals. The number of venture capital (VC)-backed initial public offerings (IPOs) has remained low. In the latest European Private Capital Outlook[158] report, PitchBook expects no meaningful recovery in the value or volume of VC-backed IPOs in 2024. They also note that "...recent listings of Arm, Ionos, and Oddity Tech have all returned -5%, -21%, and -27% YTD, as of November 2023" exacerbating the challenges in the market.

The publication of PitchBook's Q4 Venture Monitor in January also offers an early insight into the complete annual 2023 VC trends in the US.[159] Across the year, a total of $170.6bn was invested in US VC, which is 30% less than in 2022, and 51% less than in 2021.

Later stages of the UK market continue to experience the largest reductions in investment and valuations

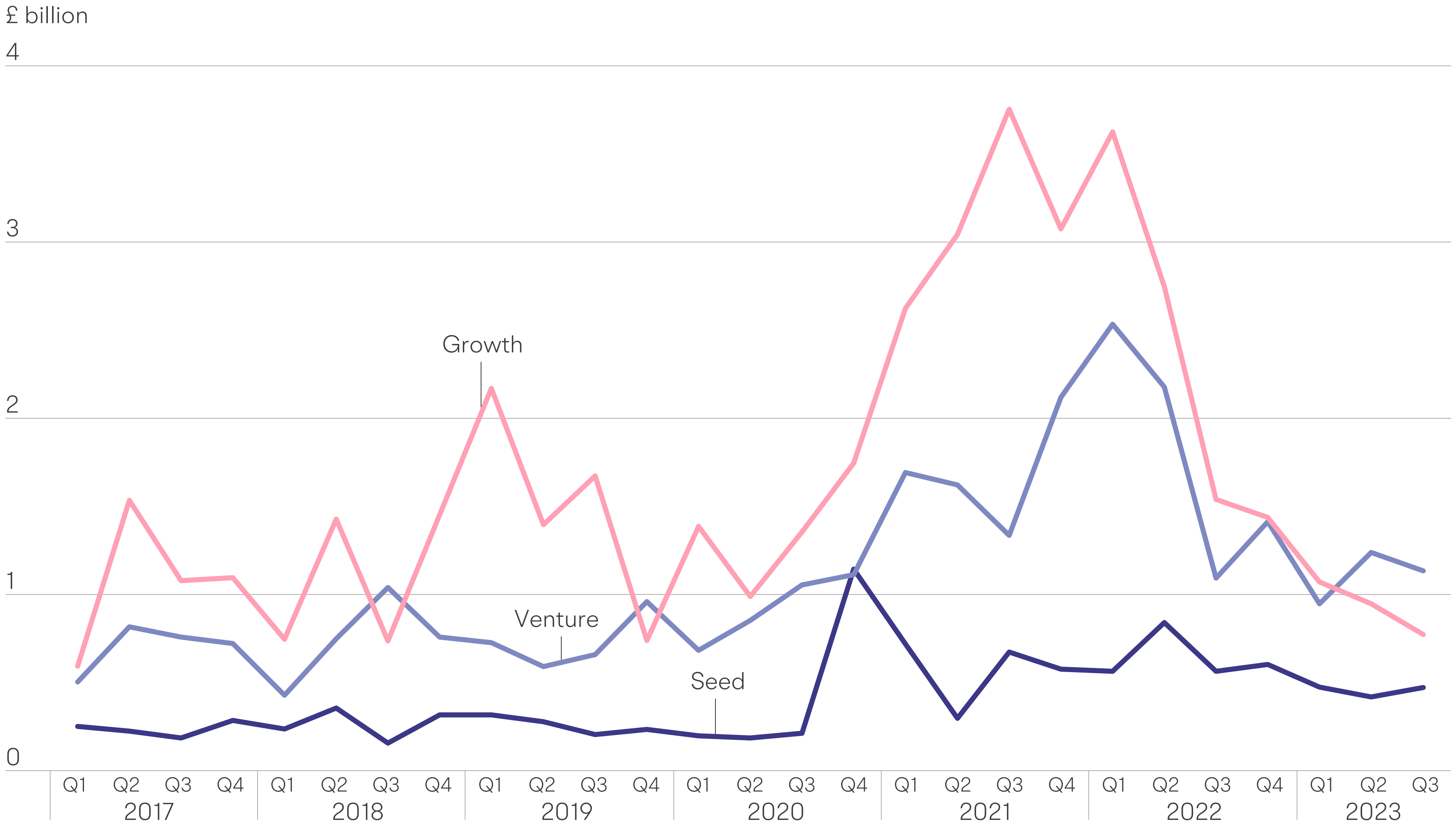
Beauhurst classifies equity deals into four stages: seed, venture, growth and established. These stages reflect product development, commercialisation, sales, and profitability levels in the recipient company. As in previous reports, we combine the growth and established stages for simplicity, which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

As illustrated in Figure B.21, total growth stage investment in the first three quarters of 2023 was £2.4bn, 65% lower than during the same period in 2022. Growth stage investment in Q3 2023 was 50% lower than in the same quarter a year earlier, and 19% lower on the quarter when comparing Q3 2023 to Q2 2023. The growth stage was the main driver of the increase in overall investment over 2021 and the first half of 2022, and subsequently also experienced the largest drop in both percentage and absolute terms when the market conditions worsened from H2 2022.

Figure B.21

Value of announced equity deals by stage

Source: British Business Bank analysis of Beauhurst data.



In the first three quarters of 2023, a total of £2.9bn in investment was raised by venture stage companies, 43% less than the amount raised during the same period the year before. Seed stage investment fared slightly better with a total of £1.2bn raised in the first three quarters of 2023, a 31% decline on the year before.

The total amount of growth stage capital raised by UK companies has now declined each consecutive quarter since Q1 2022. Furthermore, the number of deals at this stage declined for all three consecutive quarters of 2023. Seed and venture stage activity, on the other hand, appears to be stabilising in 2023. The amount of seed stage funding raised in Q3 2023 is in line with the Q1 2023 figure at £0.4bn, while the equivalent change at venture stage was a 20% increase (though venture investment has fallen further from its 2022 peak).

Investments in seed stage businesses generally carry the greatest risk for investors due to uncertainties regarding technology, product development, and the market fit for those early-stage companies. Survey evidence from the Bank's intermediaries survey indicates that it has remained particularly challenging to raise early-stage equity finance in 2023.[160] Despite this, seed stage company valuations are less exposed to current public market exit conditions compared to later stage companies, which might explain why investment values at the early stage have held up more resiliently.

Looking at equivalent investment trends in the US with data from PitchBook's Q4 Venture Monitor[161], seed and early-stage VC investment experienced declines of 40% and 44% respectively in 2023, but still exceeded pre-pandemic annual totals. Late-stage investment fared better, with a decline of 14% in 2023, suggesting that this part of the market is recovering at a faster rate than in the UK. However, demand for late-stage capital in the US is still outpacing supply by around 2.5 times.

Compared to investment value, deal numbers tend to be a better indicator of the strength of the overall equity market, since outliers have a smaller impact on these trends. As shown in Figure B.22, the number of seed stage deals fell by 35% over the first three quarters of the year compared with the same period in 2022. The number of venture deals fell by 25%, with the number of growth stage deals declining by 20%. This suggests that the resilience of seed investment value described previously is being driven by a shift to larger deal sizes.

The number of first-time announced deals fell by 32% for the Q1-Q3 2023 period compared to the same timeframe a year ago. This was slightly more than the number of follow-on deals, which declined by 26%. As a percentage of the total number of deals, venture stage deals made up 44% of all deals in the first three quarters of the year, followed by seed with 38%, and growth with 18%. Apart from the proportion of seed stage deals falling by three percentage points, the overall composition of deals by stage is close to the long-term average.

Average equity deal sizes saw a large increase during the 2020-2021 period, largely driven by growth stage deals. This was mainly due to the amount of capital available at later stage of the market and the number of growth companies moving down the investment pipeline.

In our 2023 VC Returns report[162], we noted that fund managers have more recently reported a decrease in competition for deals, especially from non-traditional investors and overseas investors. Among those surveyed by the Bank in 2023, 34% reported seeing less competition in the part of the UK VC market they focused on, compared to a year ago.

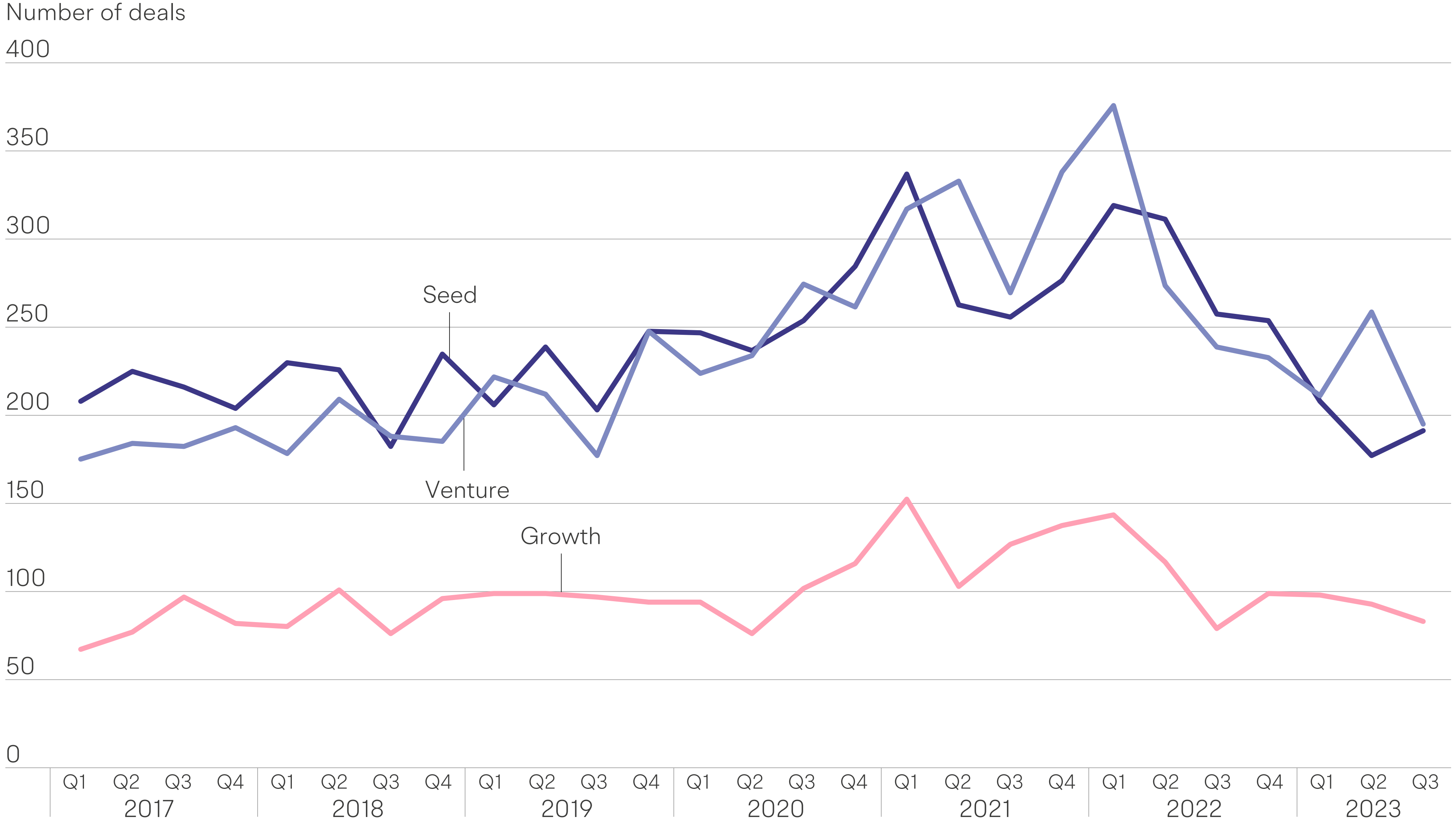
The number of deals involving at least one overseas investor fell by 36% in the Q1-Q3 2023 period compared to Q1-Q3 2022. This was a faster decline than across the wider market, where the total number of deals fell by 29% from 2,117 to 1,512. PitchBook[163] also reports on non-traditional investor participation in deal numbers falling in 2023 amid a broader correction in deal activity. The pullback from venture capital of these “tourist investors” has likely driven valuations down further.

As shown in Figure B.23, the average overall deal size fell to £4.8m in the first three quarters of 2023, a decline of 29% compared to the year before. Growth stage deals

Figure B.22

Number of announced equity deals by stage

Source: British Business Bank analysis of Beauhurst data.



saw the largest decline out of all three stages, with the average deal size falling by 52% year-on-year, from £22.2m to £10.7m.

The average deal size at the venture stage fell to £4.8m in 2023, which is 21% below the overall year average of £6.1m in 2022. In contrast, the average seed stage deal size increased again in 2023, rising by 9% from £2.1m to £2.3m in the first three quarters of the year.

A small number of very large outlier deals in a year may skew the mean average deal size of the data, affecting statistical inference. Figure B.24 shows the annual median deal sizes by stage. On an annual basis, the overall median deal size has essentially remained the unchanged from 2022, increasing by 1% to £1.2m.

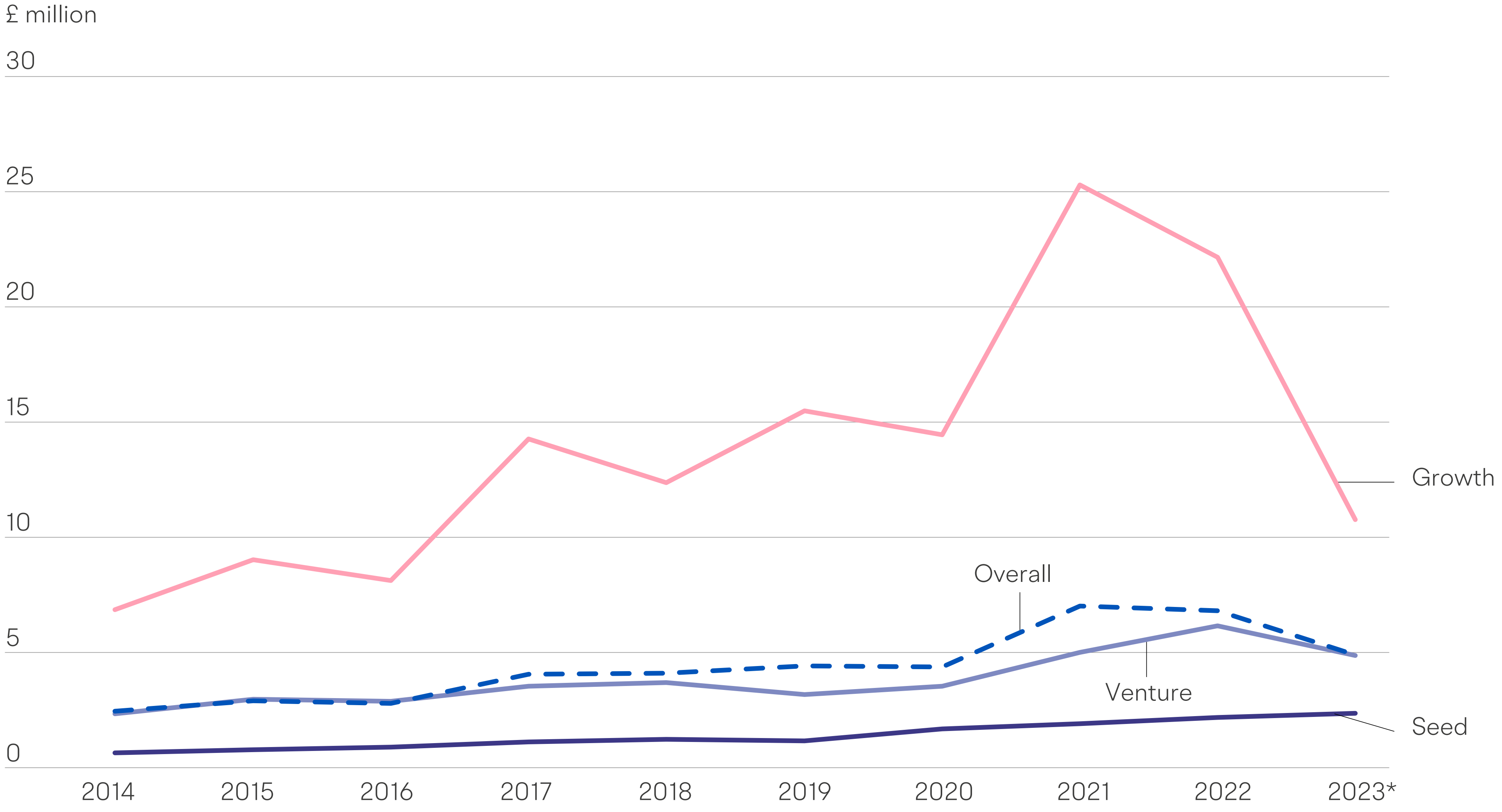
The median growth stage deal size decreased by a further 40% in 2023, falling from £6.9m in 2022 to £4.1m in 2023. This comes after the median growth stage deal size had already declined by 16% between 2021 and 2022.

The median venture stage deal size fell by 20% from £2.0m in 2022 to £1.6m in 2023. This suggests that the path of venture deal sizes is lagging that of growth deal sizes, peaking in 2022 rather than 2021. Conversely the median deal size for the seed stage has hit a new high, increasing by 18% year-on-year to £0.6m in 2023.

Figure B.23

Average deal size over time by business stage

Source: British Business Bank analysis of Beauhurst data.



*2023 data up to Q3 only

There were four announced mega deals (i.e. equity deals larger than £100m) in the first three quarters of 2023, with the Q4 number still being unknown at the time of writing. However, the full year numbers of mega deals for 2022 and 2021 were 27 and 34 respectively, again highlighting the deterioration in conditions at the top end of the market. The average size of mega deals has also fallen to £130m in 2023, from £148m in 2022 and £159m in 2021.

The average pre-money valuation for companies raising equity funding in 2023 fell by 28% year-on-year to £21.3m. Average pre-money valuations have fallen even more sharply at the growth stage. The average pre-money valuation for companies raising a growth stage deal fell by 55%, declining from an average of £140.5m in 2022 to £62.9m in 2023.

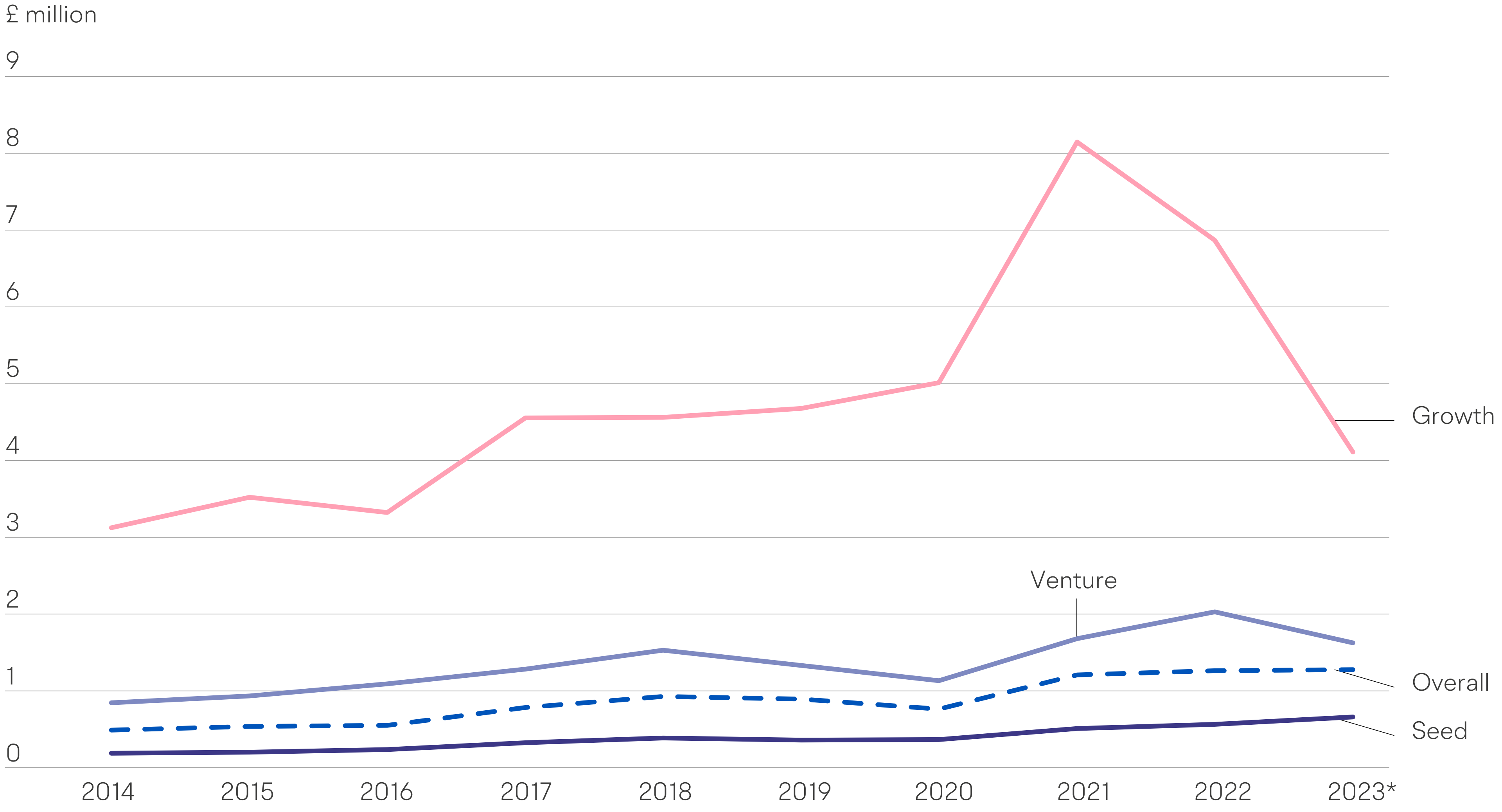
Pre-money venture stage valuations remained relatively flat, falling by 1% from their peak in 2022. The average seed stage valuation, on the other hand, increased by 30% from the year before, rising from £5.7m in 2022 to £7.4m in 2023 mirroring the trend that has been observed for deal sizes.

This decline likely represents a market correction following a period of unsustainable activity when

Figure B.24

Median deal size over time by business stage

Source: British Business Bank analysis of Beauhurst data.



*2023 data up to Q3 only

companies were able to raise funding at over inflated valuations. In 2023 some of these companies are now needing to return to a market with significantly less capital available, resulting in mark downs. Particularly at later stages, the fall in valuations is being affected by difficult exit conditions, subdued public markets, and the poor performance of recent VC-backed IPOs.

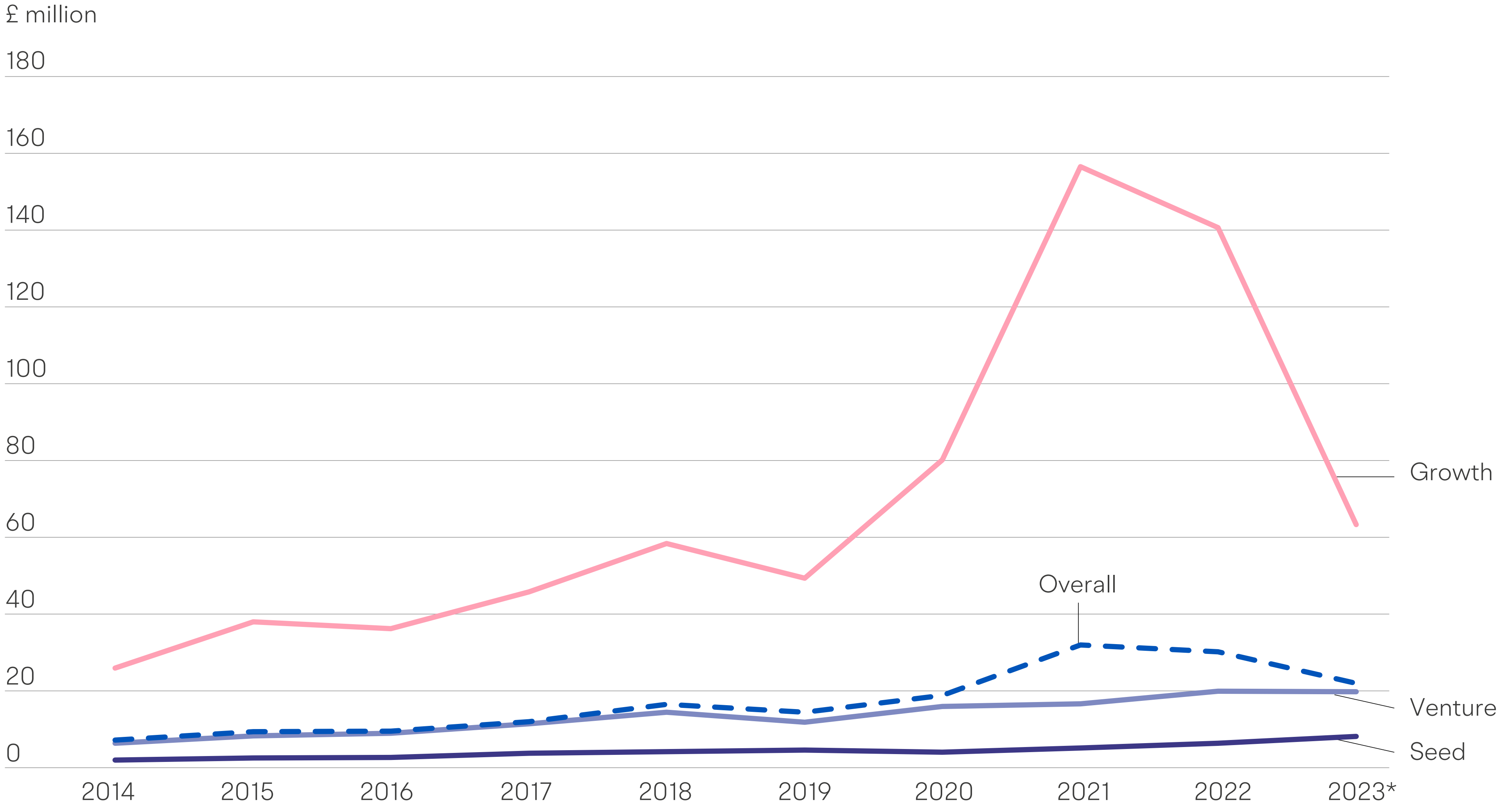
Market feedback from fund managers collected through the Bank's 2023 UK Venture Capital Financial Returns report indicated that 72% of fund managers believed the current state of the VC market for providing opportunities for successful exit was either poor or very poor, with 50% stating that exit opportunities are now worse than they were a year ago.[164]

The trend of UK growth stage companies experiencing the largest declines in their valuations mirrors patterns observed in other markets. Atomico's State of European Tech[165] report found that average European Series C pre-money valuations were down 64% year-on-year, falling from $252m in 2022 to $90m in 2023. Seed stage pre-money valuations, however, remained fairly flat, falling just 2% compared to the previous year.

Figure B.25

Average pre-money valuation by business stage

Source: British Business Bank analysis of Beauhurst data.



*2023 data up to Q3 only

The proportion of down rounds in the market has increased to a ten-year high

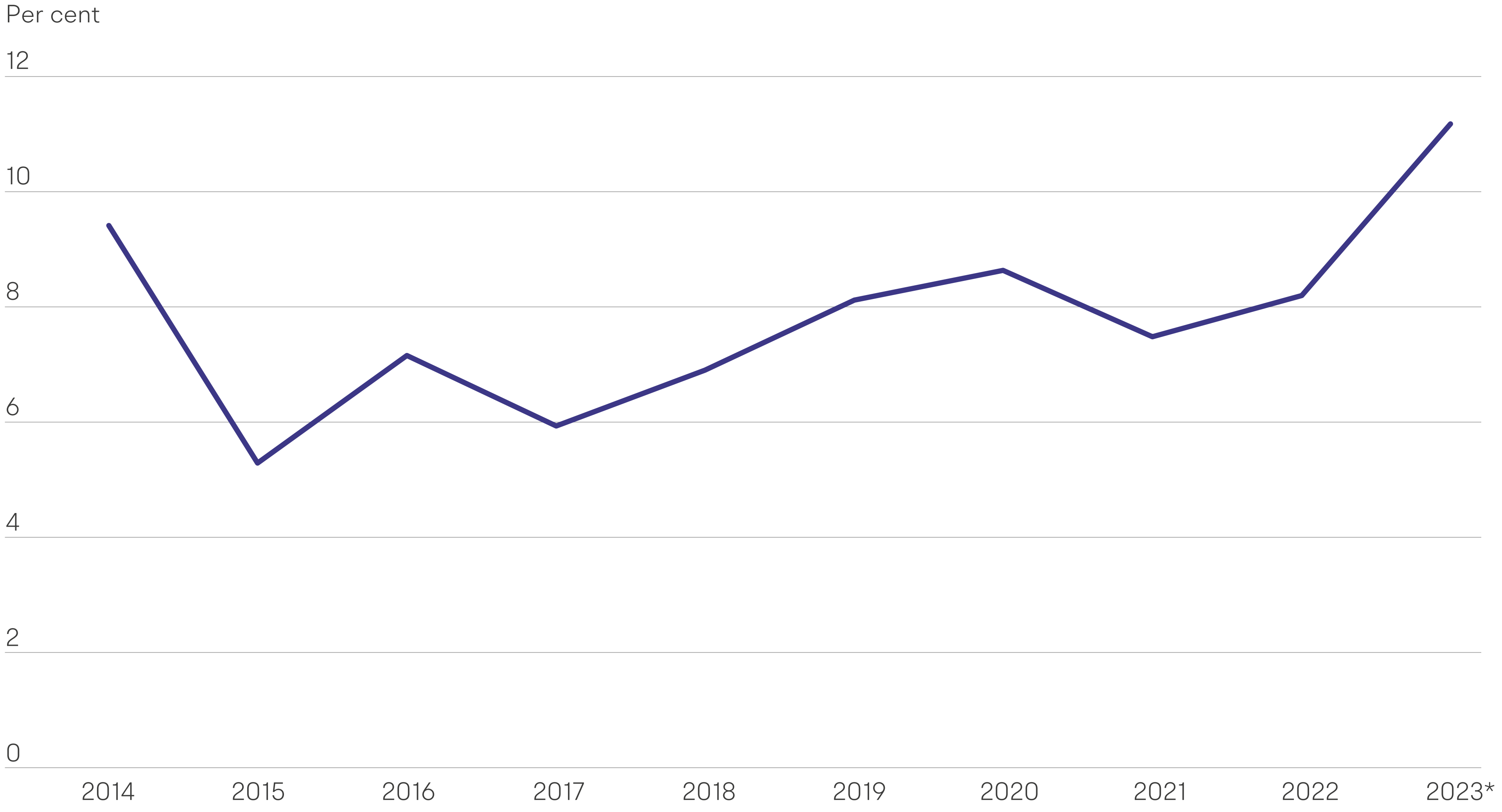
Another indicator that can help us measure levels of investor appetite is the prevalence of down rounds, where a company raises capital at a valuation lower than that in its previous financing round.[166] As shown in Figure B.26, 11% of follow-on fundraisings were down rounds in the first three quarters of 2023, which is three percentage points higher than the ten-year average. When limiting our sample to growth stage deals only, the proportion of down-rounds increases to 19% for the same period.

Looking further into the reasons for this increase, PitchBook note that “companies that raised during the venture frenzy of 2020 and 2021 were able to secure fresh capital with high revenue multiples, particularly in the fintech, cloud and enterprise SaaS verticals. If startups failed to reduce their cash burn when the fundraising market turned sour in mid-2022, they're likely now having to come to terms with taking funding at a major discount to their last valuation.”[167]

Figure B.26

Down rounds as a proportion of all announced smaller business equity deals

Source: British Business Bank analysis of Beauhurst data.



*2023 data up to Q3 only

The concentration of equity deals in London fell below 50% in 2023, though its share of investment remained high

Looking at regional trends in smaller business equity finance, London remains the region with the highest number of deals, though its share of UK deals fell from 52% in 2022 to 46% in 2023. The capital's share of investment remained almost flat at 58% in 2023, compared to 60% the year before. On an annual basis the number of deals in Q1-Q3 2023 increased in only two of the English regions, the East Midlands and the West Midlands, with the former being the only region to experience an increase in both deal numbers and investment value.

London accounted for 38% of growth stage deals in the UK in 2023. This was nine percentage points lower than the five-year average of 47%, and 13 percentage points lower than its share in 2022. On a value basis, 53% of the total growth stage investment went to London-based companies, though this is 17 percentage points less than in 2022.

The Bank's 2023 Nations and Regions Tracker[168] highlighted that London has recently seen a much larger percentage decline in funding compared to

Fig B.27

Number and value of announced equity deals by nation and English region

Source: British Business Bank analysis of Beauhurst data.

Nations and English regions	Number of equity deals (Q1-Q3 2023)	Q1-Q3 2022-2023 % change number of deals	Deal proportion of UK total (Q1-Q3 2023)	Investment £m (Q1-Q3 2023)	Q1-Q3 2022-2023 % change investment value	Investment proportion of UK total (Q1-Q3 2023)
London	703	-35%	46%	3,768	-60%	58%
South East	160	-14%	11%	886	-28%	14%
Scotland	118	-24%	8%	295	-48%	5%
East of England	107	-27%	7%	554	-38%	9%
North West	88	-27%	6%	175	-64%	3%
South West	82	-33%	5%	187	-51%	3%
West Midlands	52	4%	3%	153	-23%	2%
Yorkshire and The Humber	49	-36%	3%	130	-42%	2%
Wales	48	-14%	3%	94	49%	1%
East Midlands	42	17%	3%	91	65%	1%
North East	37	-43%	2%	47	-69%	1%
Northern Ireland	16	-27%	1%	58	39%	1%
UK	**1,512**	**-29%**	**100%**	**6,452**	**-53%**	**100%**

other nations and regions, because the area experienced very high growth from mid-2020 onwards. The value of announced deals in the London region increased by over 220% between H1 2020 and H1 2022, rising from £2.4bn to £7.8bn. The total amount of equity investment outside the capital region increased by 137% during the same time period.

Exit activity and fundraising have both declined over 2023, but dry powder is near record levels

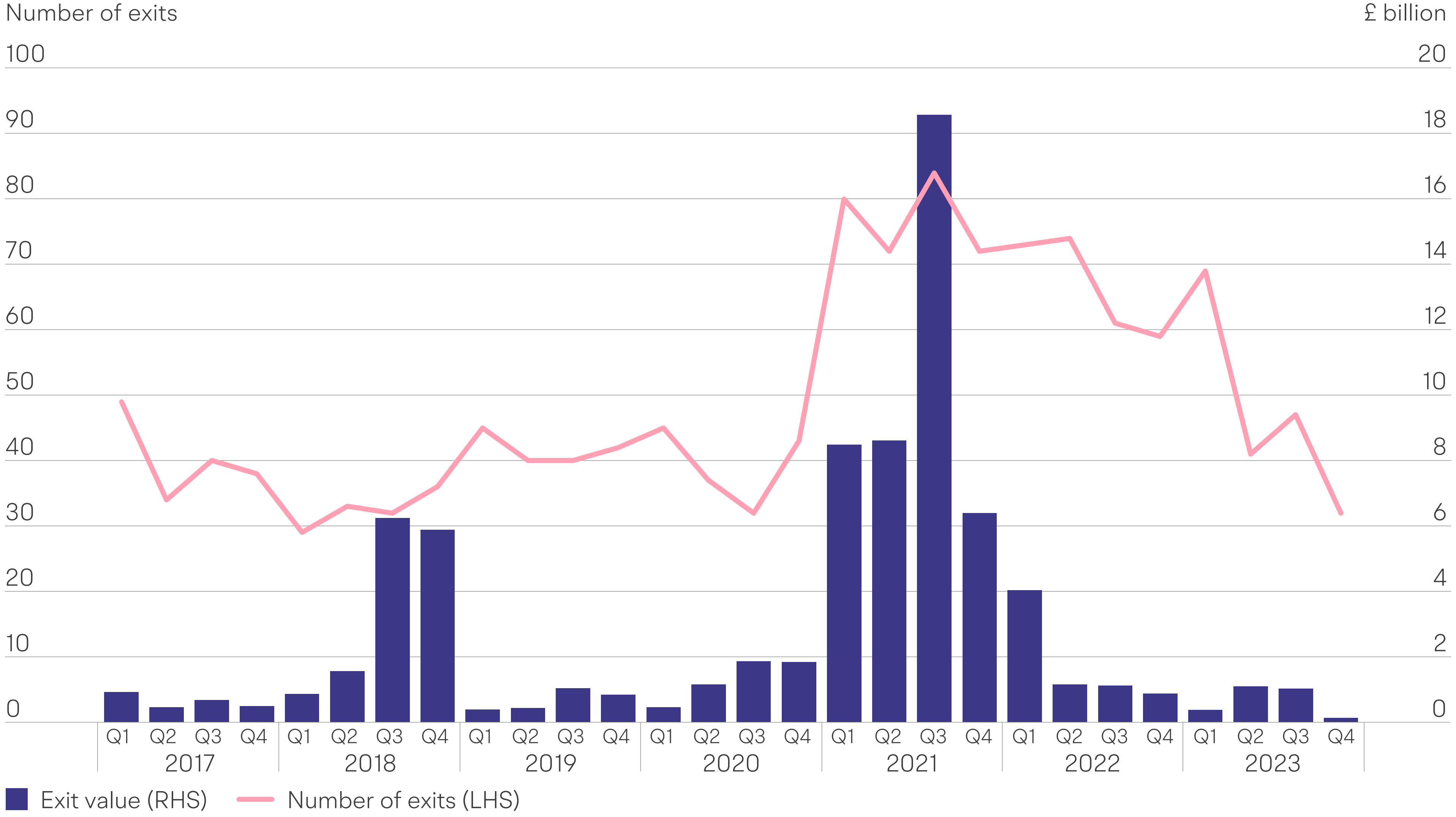
Focusing on recent trends in VC-backed company exits, 2021 was a record year for UK VC-backed company exits with more than £18bn realised. However, since the middle of 2022 there has been a sharp deterioration in exit opportunities. Initial Public Offerings (IPOs) have been heavily impacted by wider macroeconomic factors affecting public market valuations, and acquisitions have slowed due to an increased focus among large corporates on profitability over expansion.

In 2023 the number of UK VC-backed exits decreased by 29% to 188, with the exit value decreasing by 67% to £2.3bn. While it is likely that more exits will be recorded for Q4 2023 as additional deals are announced and

Figure B.28

Number and value of UK VC-backed company exits

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



identified, the total UK exit value has returned to levels last seen in 2019 and the number of transactions continues to decline from its 2021 peak.

There were only three IPOs in 2023, with mergers/acquisitions making up most of the limited company exits. The highest number of IPOs was reached in 2021 (31), with only seven recorded in 2022. One contributing factor to the subdued level of public market exits is the poor performance of the VC-backed companies that have listed recently. However, of the high-profile IPOs that have occurred since the market downturn in 2022, a number have been in healthcare and life sciences – including MiroBio (£357m), DJS Antibodies (£258m), Ducentis (£352m) and YgEia3 (£547m).

In recent years, the prevalence of low interest rates has encouraged an increased allocation of private capital towards VC in search of higher returns. As a result, by Q1 2022 there was a substantial amount of dry powder (committed but undeployed capital) stockpiled in funds[169], ready to be invested in high growth companies. In the second half of 2022, however, challenging market conditions and concerns around potential overvaluations led to fund managers slowing their rate of deployment, meaning these high cash reserves were not getting spent.

Figure B.29

UK VC fundraising and dry powder levels

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

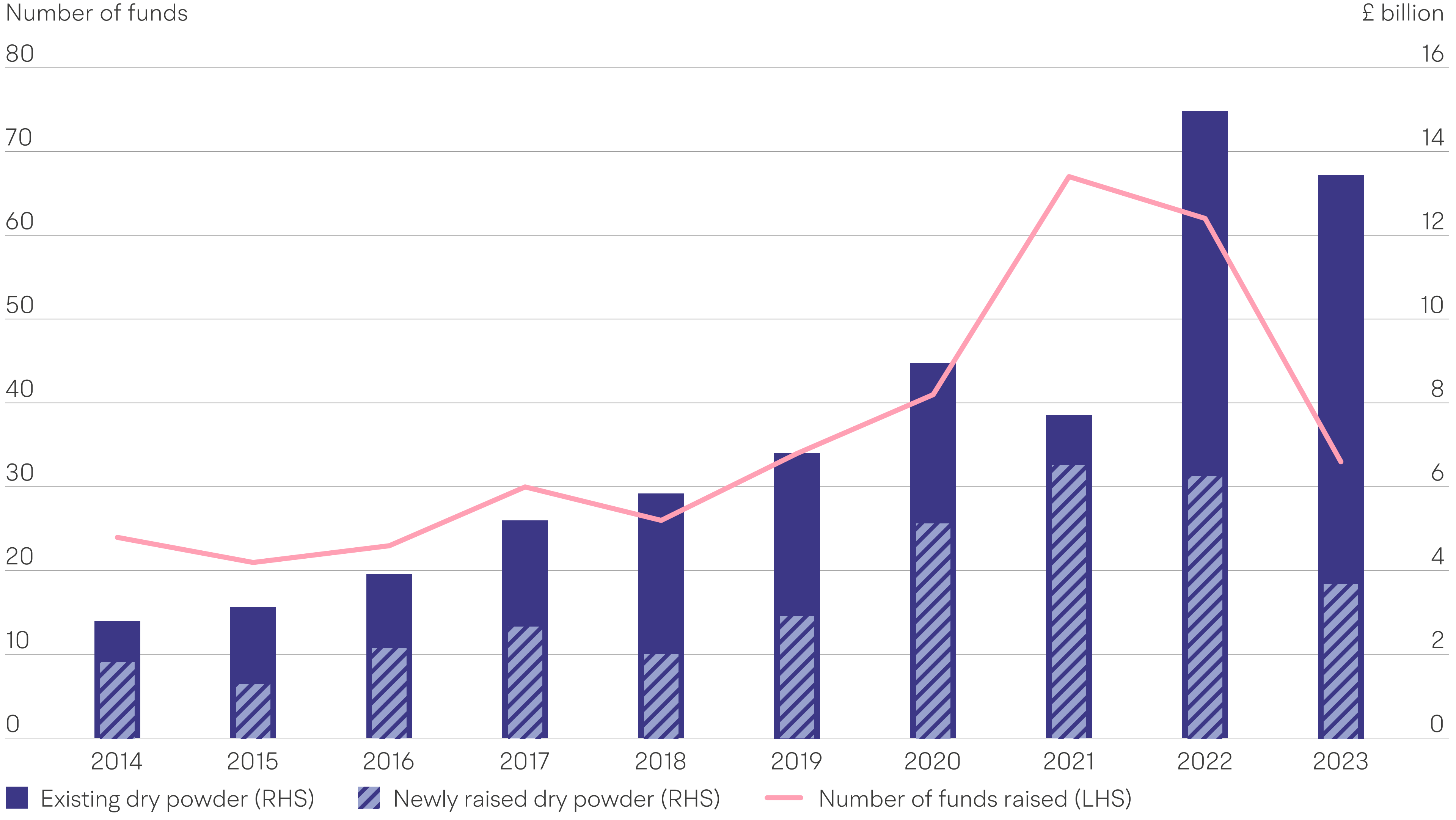


Figure B.29 shows the total level of dry powder in UK-based VC funds at the end of each year, as well as the share of this that has been added through new fundraising each year. The data shows that, by the end of 2023, UK VC funds had £13.4bn of total dry powder to invest. This was 10% less than in December 2022, but still 58% more than at the same point in 2021. Funds in other regions, such as wider Europe and the US, are also experiencing similarly high levels of dry powder compared to historical levels.

With the overall decline in macroeconomic conditions, fundraising conditions have also become more difficult. The number of new funds raised in 2023 fell by 47%, from 62 in 2022 to 33 in 2023. The total amount raised by VC fund managers in the UK was £3.7bn, 41% less than the amount raised in 2022. However, due to the limited levels of capital deployment and dealmaking in the market recently, dry powder remains near record levels.

As part of the survey responses gathered for the Bank's UK VC Financial Returns 2023 report, 48% of fund managers responded that the market conditions for raising a new fund are now worse than they were a year ago, with 36% of them stating that they are about the same. 24% of fund managers also responded by saying that they have pushed back their plans for future fundraising as part of the market slowdown.

PitchBook[170] are expecting global VC fundraising of around £121bn in 2023, which would mark the lowest total since 2015. Despite the rate of new fundraising slowing down, high dry powder reserves will enable fund managers to continue to be able to invest in promising investment opportunities and support their existing companies over the short to medium term.

British Business Bank programmes will continue to focus on increasing the supply of equity finance to smaller businesses throughout the market cycle

As first highlighted in the Bank's Small Business Equity Tracker 2023 report, the latter half of 2022 saw a significant decline in equity finance and this downturn continued into 2023. Through its range of equity finance programmes, the Bank is committed to supporting business across all stages through these challenging market conditions, and to ensuring that the market has the breadth and depth to best recover from the current downturn.

The latest data in this report shows that dealmaking activity at the growth stage of the UK market continues to be restricted by a subdued exit environment, preventing venture funds from recycling capital. British Patient Capital will continue to support funds in raising capital through these challenging market conditions and will support R&D intensive companies seeking late-stage funding rounds through its Future Fund: Breakthrough programme.

Trends in 2023 also highlighted that, while seed stage investment has held up relatively well, the number of deals is now starting to fall more significantly. This further emphasises the continued need for the Bank's Enterprise Capital Funds (ECF) programme, which increases the availability of early-stage equity finance to high potential UK companies by supporting emerging fund managers.

The Bank will monitor equity market conditions very carefully and stands ready to adapt our programmes accordingly. The forthcoming 2024 Equity Tracker report, covering full year 2023 data, will provide a more in-depth assessment of the trends affecting UK equity finance.

2.6

Private debt

Private debt is an important source of finance for driving business growth and innovation

Since the middle of 2021 there has been a significant slowdown in mid-market deals, and this continued into 2023

Private debt fundraising has been relatively resilient over the past year, though funds have taken longer to close

Investors are optimistic about the future returns available from private debt

Private debt funds are an important funding source for businesses that fall outside commercial banks' risk appetite but have growth potential. This section explores recent trends in private debt dealmaking in the UK, breaking down the latest data by market segment, deal type and comparing to other countries. The section also assesses how the UK private debt fundraising market has been affected by recent shifts in the macroeconomic environment.

Private debt is an important source of finance for driving business growth and innovation

Private debt refers to bespoke lending structures, tailored to the specific needs of borrowers, provided by non-bank lenders. This asset class grew in the aftermath of the 2007-2008 Global Financial Crisis (GFC) when traditional banks reduced their lending, particularly to smaller businesses, creating a gap in the market for private debt funds.

Whilst high street banks have some appetite for riskier corporate lending, most of their lending volumes tend to be through more standardised products focused on lower risk lending. As a result, private debt is often the most viable funding solution for smaller businesses and mid-market firms who require flexibility in their financing structure.

Private debt funding can be an important source of capital for businesses looking to invest in innovation and achieve long-term growth. The lending may be assessed against companies future cash flows, for example, rather than existing physical asset security. Bullet repayments also help firms access the capital they need for growth purposes, rather than having to meet regular repayment obligations.

Since the middle of 2021 there has been a significant slowdown in mid-market deals, and this continued into 2023

Leading industry publications on the private debt market such as Preqin's Global Private Debt Report[171] and Deloitte's Private Debt Deal Tracker[172] focus on mid-market deals[173], given that the market is generally dominated by large funds undertaking buyouts in corporates. Therefore, our analysis of the UK private debt market draws on these mid-market data sources, but complements them with data from the Bank's small-cap private debt portfolio – given the Bank's focus on this specific part of the market for smaller businesses.

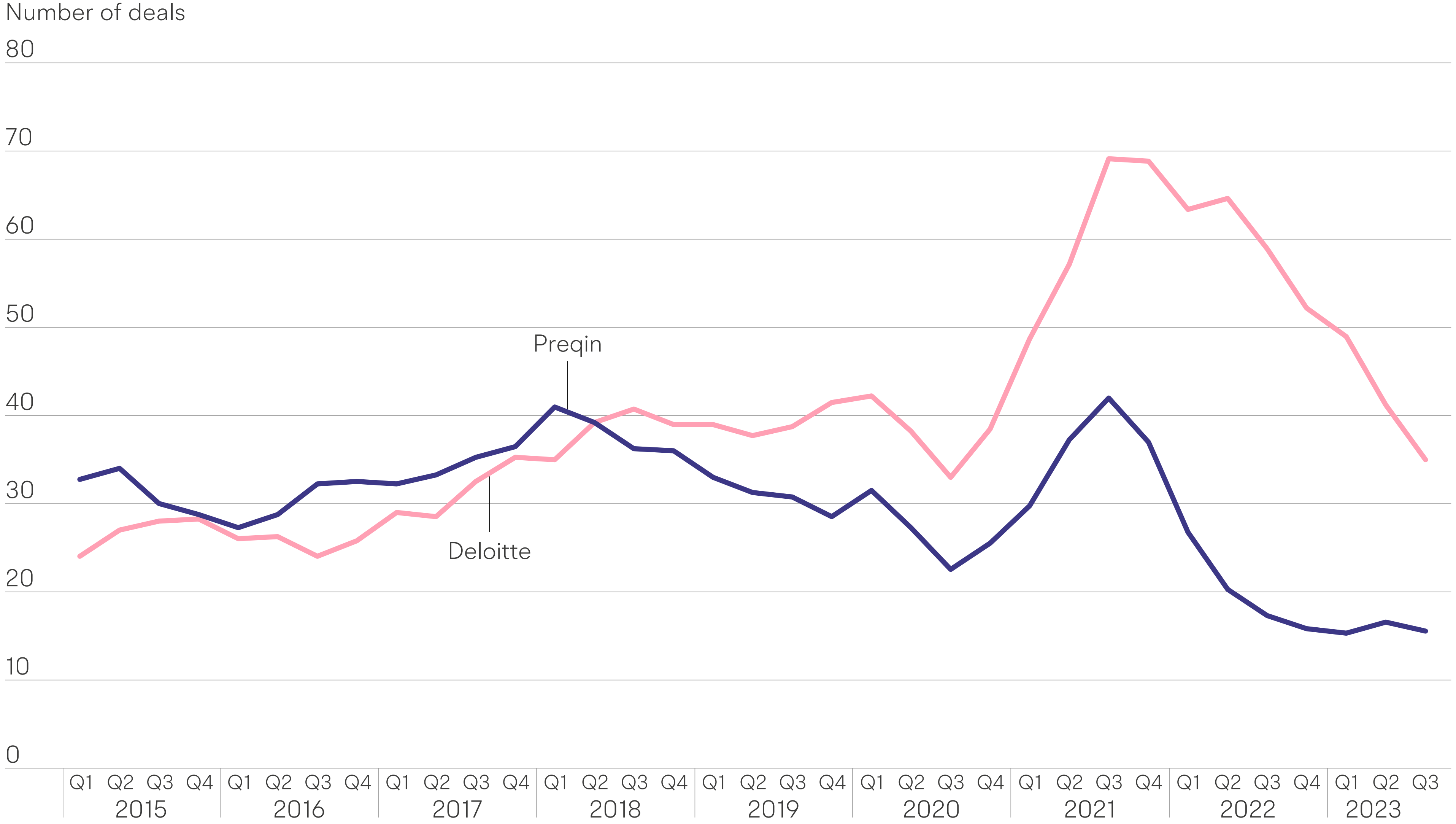
In similar fashion to other private capital markets, the latest data for 2023 shows that there has been a continuation of the slowdown in UK private debt dealmaking. As illustrated in Figure B.30, which uses a four-quarter moving average to smooth out volatility in quarterly data, the number of deals has been on a general downward trend since the middle of 2021. In the year to Q3 2023, an average of 35 UK deals were recorded by Deloitte, the lowest average since Q3 2020. While both sources have displayed similar trends in recent years, Deloitte now records a higher volume of activity through its greater coverage of private debt providers.

Overall, there have been 99 UK mid-market deals during the first three quarters of 2023, representing a 41% decline on the equivalent period in 2022. International data from Deloitte's Private Debt Deal Tracker indicates that this year-on-year decrease has been experienced in other European markets, with deal counts falling by 40% and 18% in Germany and France respectively. Across the rest of Europe, the number of deals also fell by 28% over this period.

Figure B.30

Number of mid-market UK private debt deals by data source (four-quarter moving average)

Source: British Business Bank analysis of Preqin Ltd and Deloitte.



In terms of the drivers of this trend, as explored in section 1.1, during 2023 there was a steady increase in central bank interest rates in the UK and other developed economies to control inflation. This increase in the cost of borrowing, combined with weaker business growth, has reduced demand for debt financing.

These shifts in economic conditions have also made private debt funds more selective when considering new investments. Deloitte note that “deals are also taking longer than they have traditionally – financing, for the most part, is tougher to arrange and investors are generally spending longer periods of time on diligence, so there is also the potential for some Q4 spillovers into 24Q1”.[174]

Taking a more historical view beyond the recent downturn, Deloitte data shows that the market remains on an overall upward trend over the past ten years. However, the number of deals is currently at levels last seen during the 2018-2020 period.

Looking at the breakdown of mid-market deals by purpose, the most common deal type in 2023 was bolt-on M&A (accounting for 39% of UK deals). These types of private debt deals typically involve the recipient company acquiring a smaller company to integrate into its business for strategic purposes. They can become more common during downturns when larger mergers and acquisitions become more expensive and higher risk to finance, therefore making smaller and more strategic acquisitions preferable. In general, bolt-on M&A transactions have become more popular over the past decade, with their share of overall deals rising from 11% in 2014 and 25% in 2019.

The second most common deal type in 2023 was leveraged buyouts (LBOs), representing 31% of all UK private debt deals during the year. These kinds of deals involve the use of debt finance to acquire a controlling stake in a company. While this share is in line with historical averages, it has declined from 38% in 2022. The absolute number of LBO deals has fallen by 50% in Q1-3 2023 compared with the same period in 2022.

This is partly due to private equity funds, which play an important role in this deal type, adjusting to a higher interest rate environment, lower debt availability and weaker business growth.

While sources such as Deloitte and Preqin provide good coverage of mid-market private debt deals, data is more scarce on deals involving smaller businesses and small-cap companies (generally defined as having an annual turnover of up to £100m).

To gain some insights into deal trends in this part of the market, we use the Bank’s management information (MI) on its small-cap private debt fund portfolio. This data covers 39 smaller business-focused debt funds that the Bank’s commercial subsidiary, British Business Investments, has invested in through the Investment Programme (IP).

Figure B.31 displays the number and value of smaller business deals involving these small cap private debt funds, using a four-quarter moving average to account for volatility in the underlying quarterly data. In the year to Q2 2023 an average of 70 deals were completed per quarter, down 8% compared to Q1 2023 and down 18% versus Q2 2022. The trends show that there has been a steady decline in deal volumes since the market peaked in the middle of 2022.

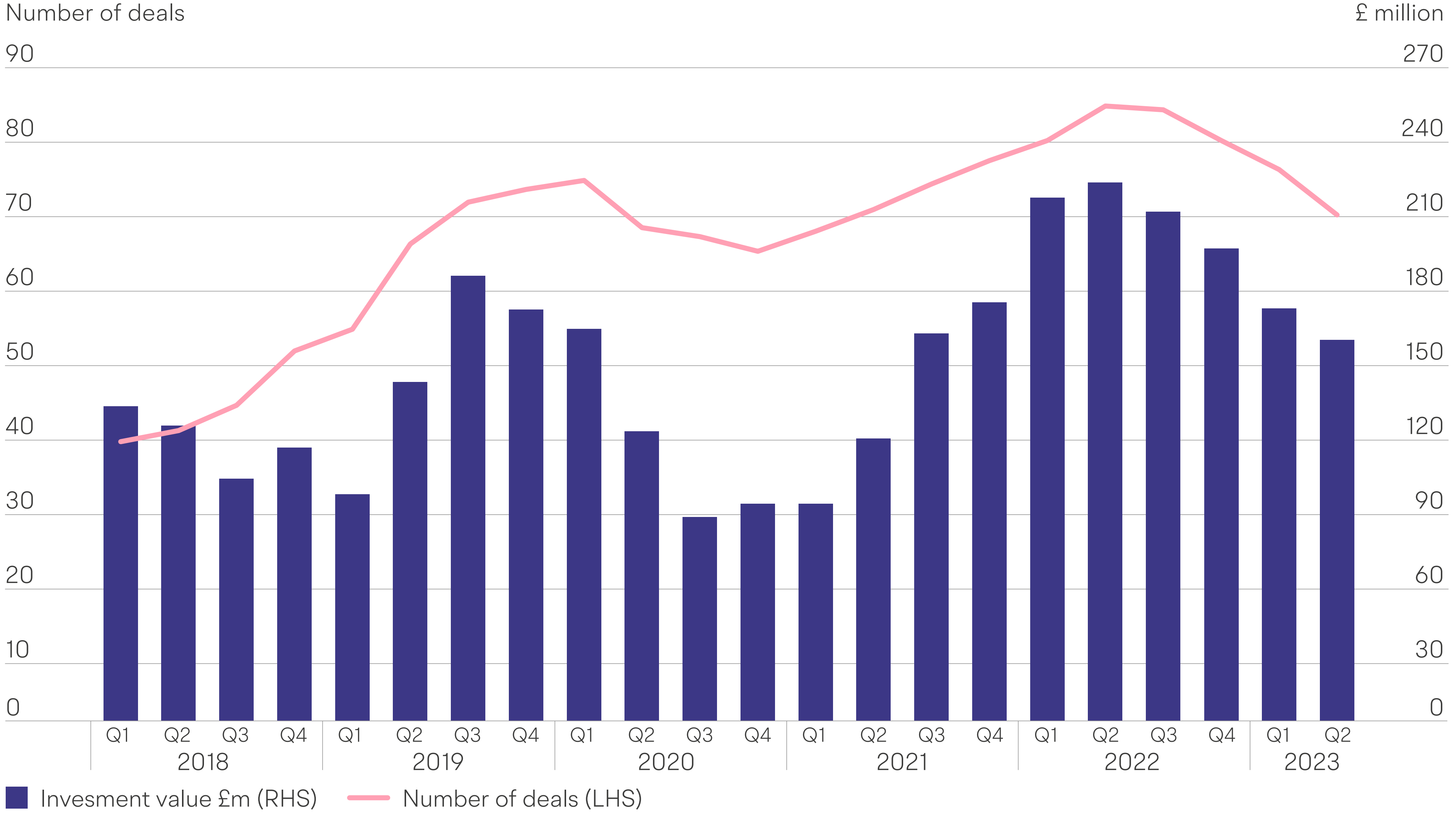
This contraction has been driven by similar factors such as high inflation and changes in interest rates affecting business confidence. However, the decline has been less pronounced so far than for mid-market activity. One reason for this is that mid-market deals have been particularly affected by the retreat of private equity investors from LBO and merger and acquisition (M&A) deals.

These small-cap deal trends are very similar when looking at the data on a value basis. The amount of capital advanced by small-cap private debt funds was £158m in the year to Q2 2023, a decrease of 8% on the previous quarter and 29% on a year ago. Overall, while there is also a clear downward trend in this part of the market, small-cap activity peaked 6-12 months later than for mid-market deals, indicating that it may also take longer to recover.

Figure B.31

Number and value of deals by British Business Bank small cap private debt funds (four-quarter moving average)

Source: British Business Bank Management Information.



Private debt fundraising has been relatively resilient over the past year, though funds have taken longer to close

As illustrated in Figure B.32, full year data from Preqin shows that the value of UK private debt fundraising remained flat between 2022 and 2023 at £24.9bn. However, this is still higher than the long-term average over ten years of £18.7bn. Underlying quarterly data shows that there has been a slight increase in activity since the start of 2023. By volume a total of 31 funds closed in 2023, which was an increase of 29% on the number recorded in 2022.

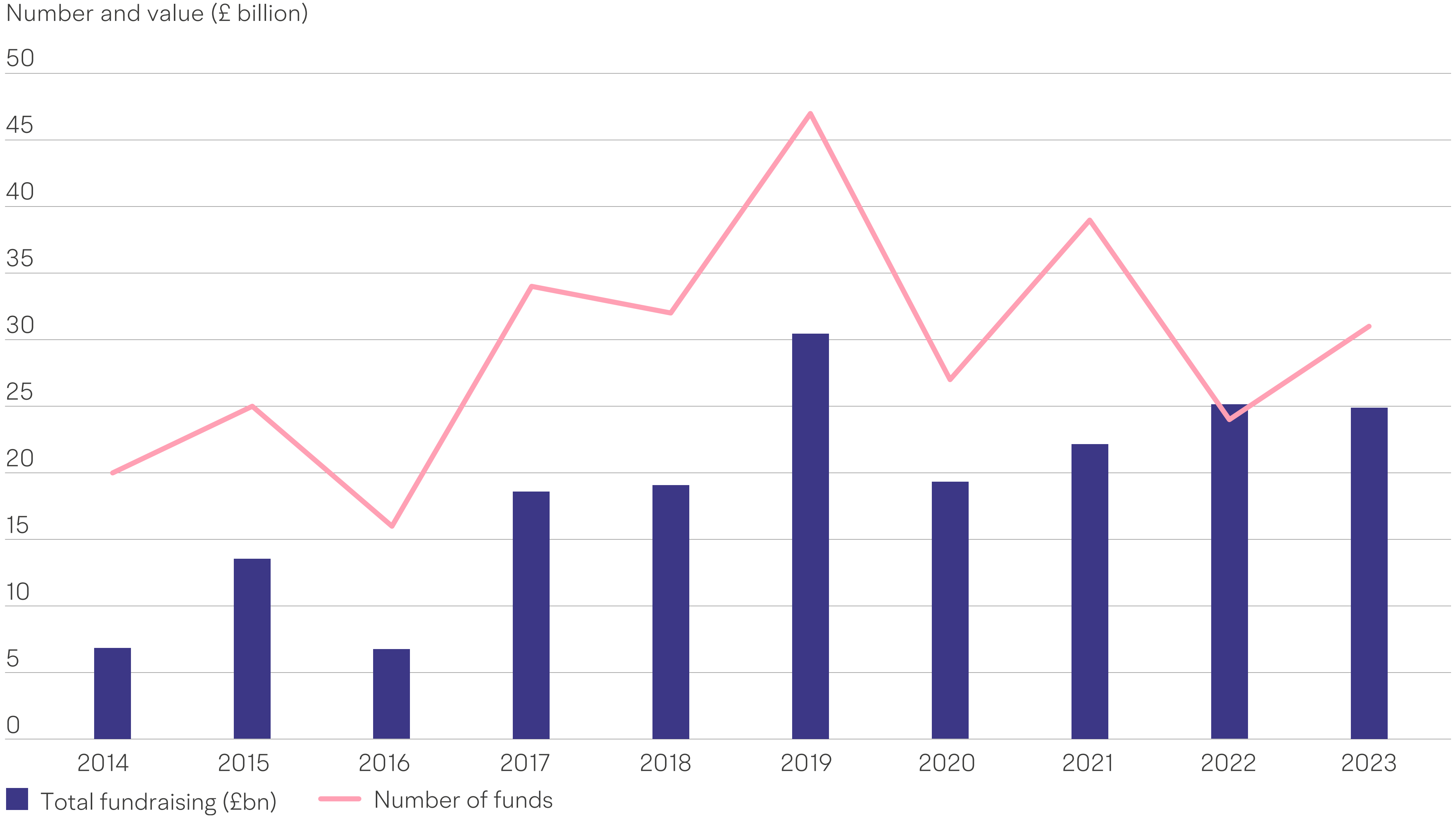
Globally, Preqin data also shows that the aggregate capital raised by private debt funds is on track to match or exceed levels seen in 2022. Limited partners (LPs) – i.e. investors seeking to contribute capital to private fund structures – have been attracted to this asset class due to its ability to outperform other private asset classes in higher interest rate environments and provide a reliable income stream.

In their 'Alternatives in 2024' report[175], Preqin note that "given inflationary pressures and rapidly rising interest rates, investors have been drawn to the floating-rate

Figure B.32

Number and value of UK-based private debt funds raised

Source: British Business Bank analysis of Preqin Ltd.



nature of private debt. Consequently, private debt fundraising has outperformed most other private capital strategies for the year." The extent to which this translates in overall financial performance will take time to materialise and depend on how the demand side of the market also reacts to recent shifts in the macroeconomic environment.

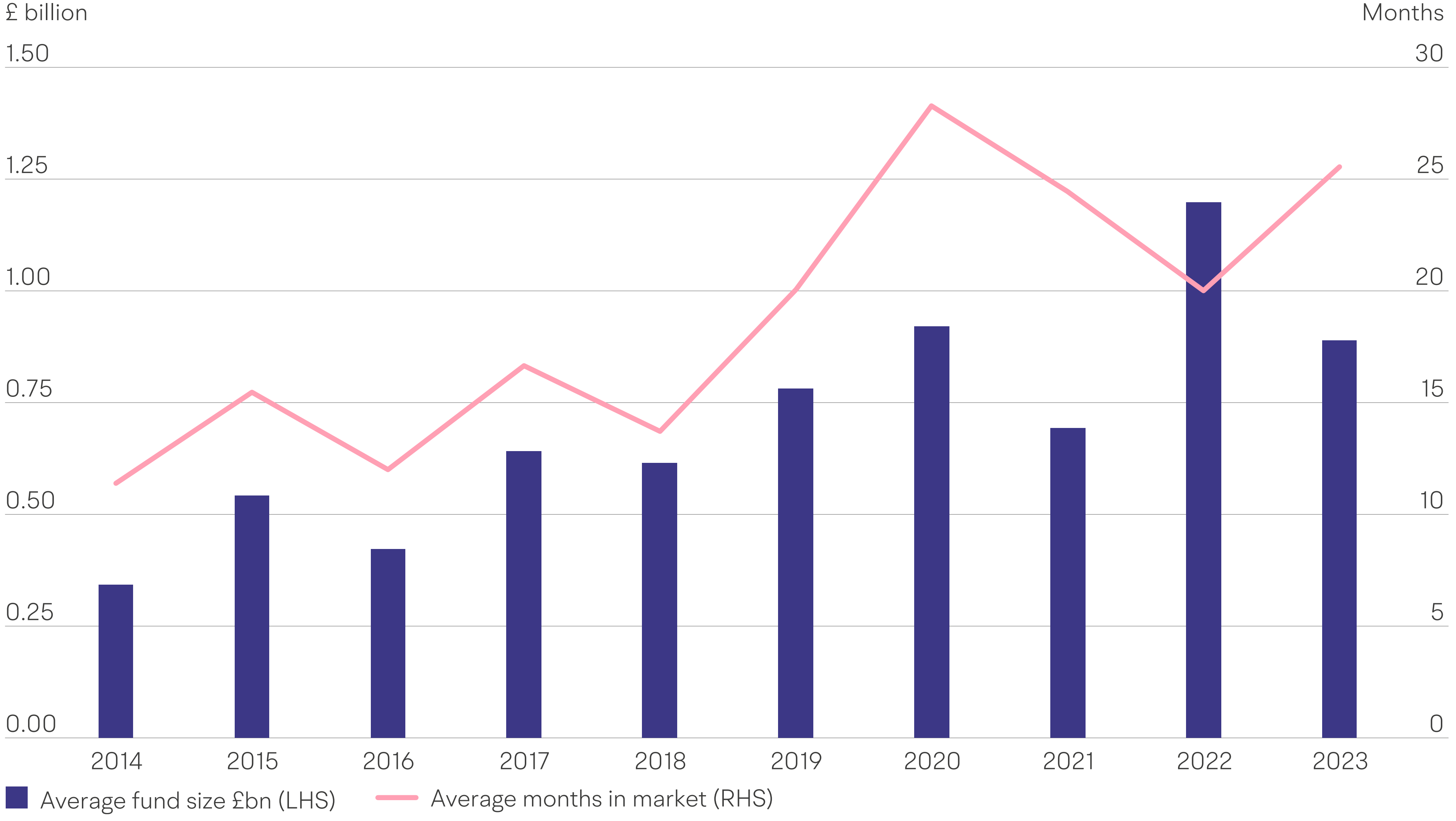
Previous fundraising data for 2022 showed that, while fewer private debt funds were closing, more money was being raised overall due to large increases in the average fund size. This suggested that investors were becoming more discerning in their allocations, with larger commitments going to fewer managers. The latest data for 2023, however, indicates that funds are closing at smaller sizes more recently, with the average fund size falling by 26% to £890m. This reflects the trend in 2023 of overall fundraising remaining level but with higher numbers of funds closing in the market.

As well as closing at smaller sizes, UK private debt funds are now also taking longer to close. In 2023, funds spent an average of 26 months in the market attracting capital from LPs – an increase from an average of 20 months in 2022. In addition, UK funds raised less capital last year as a proportion of their target size. At final close, average

Figure B.33

Average fund sizes and time (months) spent fundraising

Source: British Business Bank analysis of Preqin Ltd.



fund size as a proportion of target fund size was 92%, down from 113% in 2022 and below the historical ten-year average of 104%. These trends show that, while overall fundraising has remained resilient, there have been more nuanced underlying challenges in the market.

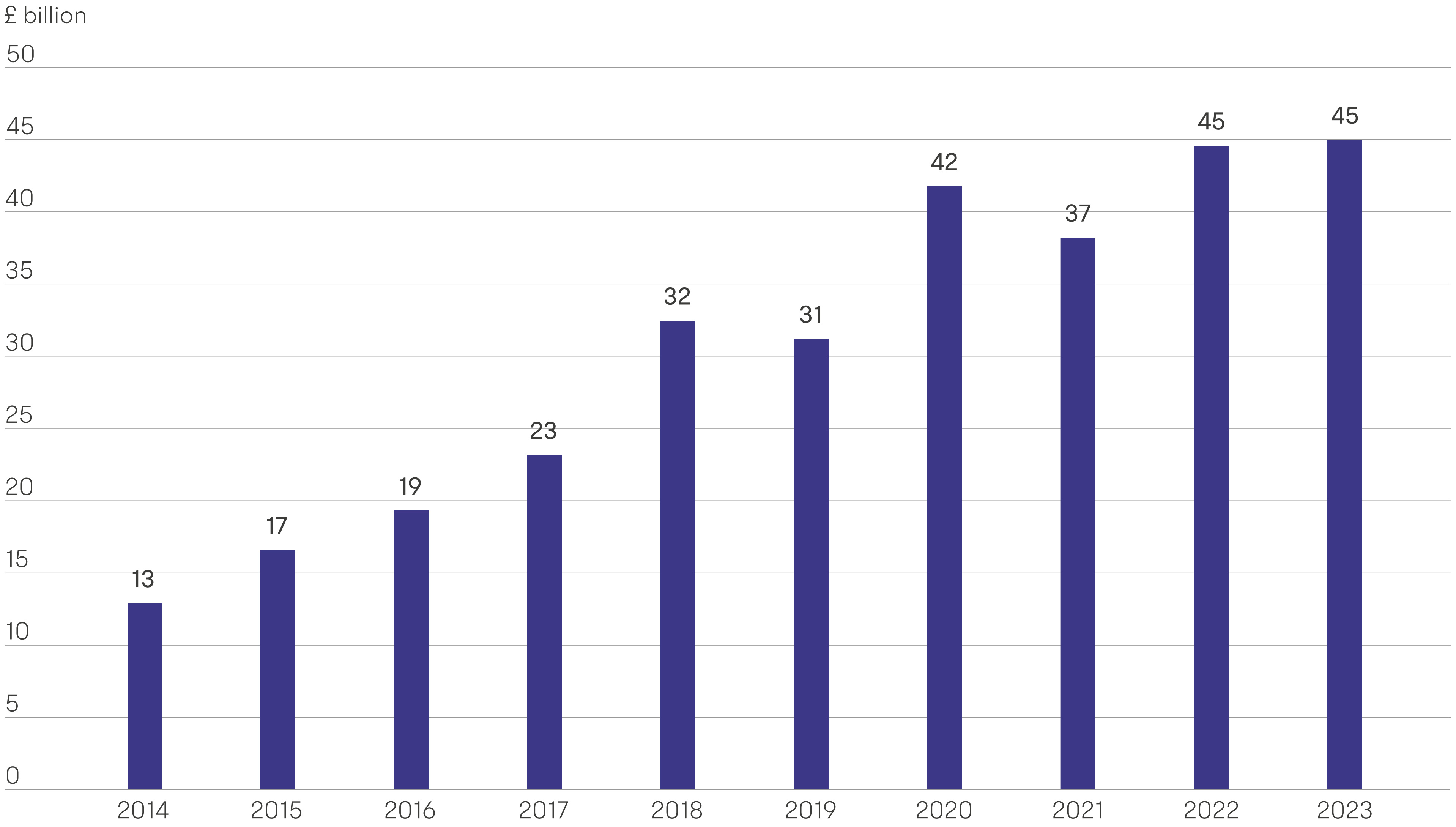
Looking at the strength of the future fundraising pipeline, data from Preqin shows that a total of five first time UK funds closed in 2023, down from six in 2022 and below the ten-year average of 7.1. This represented 16% of all funds that closed during the year, which is low by historical standards. This indicates that investors may be concentrating their capital in more experienced managers during these more challenging market conditions. While a high share of follow-on funds demonstrates that the market is maturing, a lack of emerging fund managers could have implications for the health of the future ecosystem.

As private debt fundraising has stayed relatively flat in 2023, with slower deployment, there has been a slight increase in the amount of dry powder in the market. Figure B.34 shows that, at the end of 2023, UK private debt funds had accumulated dry powder of £45.0bn, up slightly from £44.6bn at the end of 2022 and significantly higher than in 2021 (£37.1bn).

Figure B.34

Dry powder levels in UK private debt funds

Source: British Business Bank analysis of Preqin Ltd.



Investors are optimistic about the future returns available from private debt

Private debt is an asset class that can benefit from a tighter monetary policy environment and help provide diversification and stable returns to investors. As economic conditions become more challenging and traditional bank lenders become more risk averse, this allows private debt funds in the future to have a greater role in providing business finance. Alongside increasing market share, the returns from private debt investments (versus other asset classes) are also supported during times of rising interest rates as funds generally tend to use floating rate instruments.

The Bank's VC Financial Returns 2023 report found that, while achieving the highest internal rates of return (IRRs) over a five and ten-year horizon, VC and private equity had seen the lowest performance in the year to Q1 2023 with IRRs of -13.2% and -4.7%, respectively. The returns of UK private debt funds had been more stable, though, recording an IRR of 5.8% over this period (versus a five-year IRR of 6.2%). This highlights the relative resilience of this asset class in more challenging market conditions.

In its Investor Survey from November 2023, Preqin reported that global investors were positive about the near-term performance of private debt assets. When asked about their expectations for the performance of their private debt portfolios in the next year, nearly half (45%) of investors expected private debt to perform better, while just 9% expected it to perform worse. This represented an improvement in investors' outlook when compared to previous surveys in 2022 and 2023.

However, while some elements of the economic environment are conducive to improved private debt performance, defaults and impairments can become an increased risk during prolonged periods of high interest rates. The economic outlook remains uncertain with concerns about the prospects for political change, higher taxes and continued subdued growth.

In addition to the slowdown in dealmaking across mid-market and small-cap companies, there are indications that capital is becoming more concentrated with more established fund managers amid more uncertain market conditions. Longstanding structural market issues continue to create barriers for new private debt fund managers to enter the market, with investors preferring to write fewer, larger cheques to established GPs.

Average fund sizes, for example, have been on a long-term upward trend over the past decade. Data from 2023 also shows that, while overall fundraising has been relatively resilient, funds are taking longer to close on average and generally raising less than their target size.

To address these issues, British Business Investment's (BBI) Investment Programme (IP) will continue to play an important role in supporting the market through cornerstone investments that leverage additional capital into the asset class, committing £145m across seven funds in 2023. Particularly in periods of economic weakness, private debt is a valuable source of finance to smaller businesses requiring capital for growth and more flexible repayment schedules. In addition, by funding companies outside of London, IP is also supporting the long-term growth of regional economies and the Government's levelling up agenda.

Bank lending

- 2.7 Bank lending
- 2.8 Challenger and specialist banks

2.7

Bank lending

Gross bank lending was down in 2023 but the joint third-highest on record

Higher borrowing costs and economic uncertainty weighed on the demand for lending

Banks were more cautious about the ability of businesses to repay lending

Gross repayments were the second highest on record after 2022

The British Business Bank continues to support bank lending to UK smaller businesses

This section analyses developments in the UK banking market for smaller businesses in 2023. It draws on the most recent data and market intelligence from sources including the Bank of England (BoE), UK Finance and the British Business Bank.

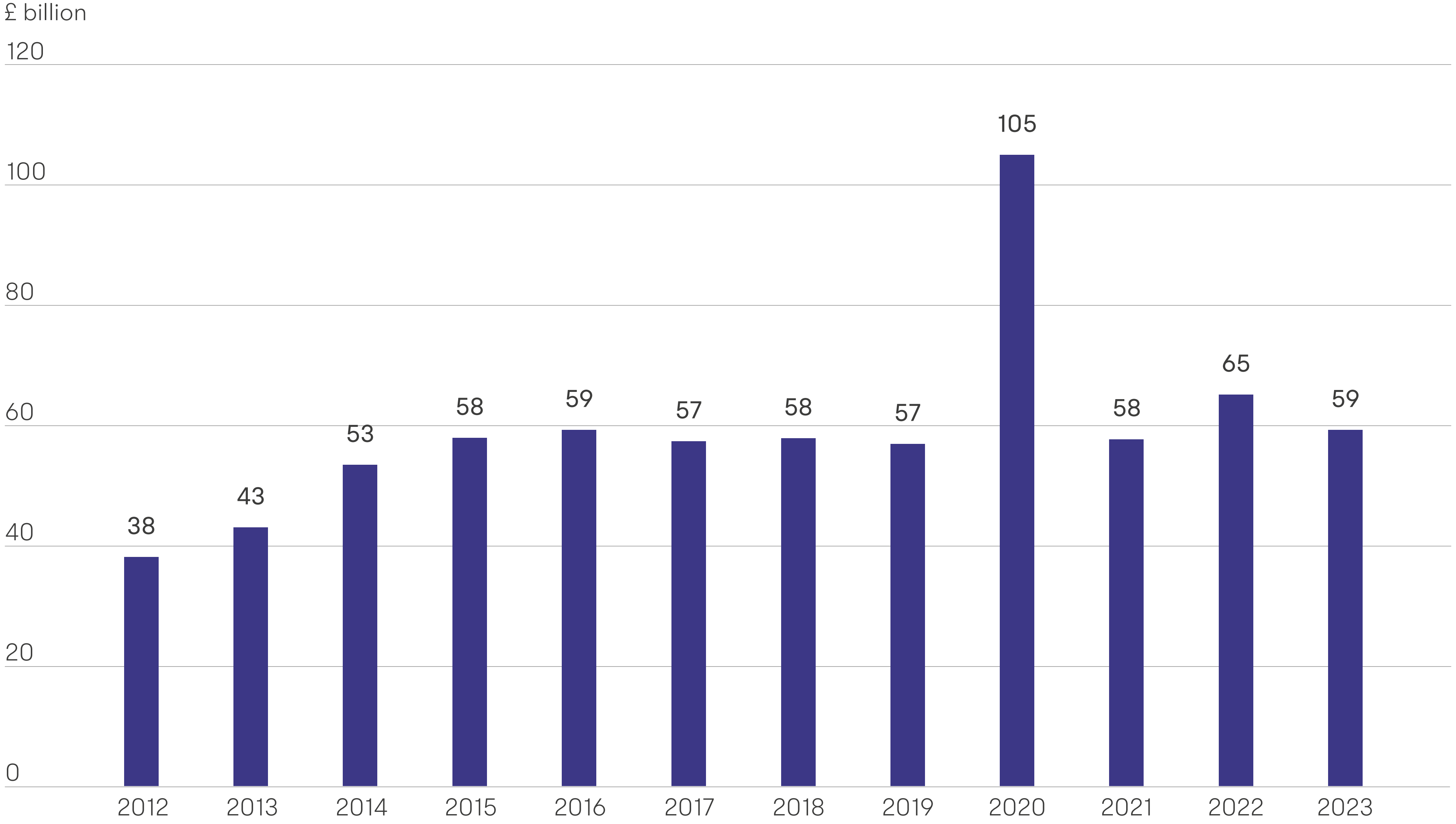
Gross bank lending was down in 2023 but the joint third-highest on record

Nominal gross bank lending excluding overdrafts to small and medium-sized enterprises (SMEs) in 2023 totalled £59.2bn, according to BoE data.[176] This was down 9% from 2022. However, it was the joint third-highest (with 2016) on record after 2020 (£104.9bn), which was largely driven by government-guaranteed Covid-19 loans, and 2022 (£65.1bn) (Figure B.35).

Figure B.35

Annual gross bank lending to SMEs

Source: BoE.



Although gross bank lending in 2023 fell 9% compared to 2022 in nominal terms, in real terms, gross lending was down by 15%.

Market-based lending, which is gross lending by banks excluding government-guaranteed loans, in 2023 was £58.7bn.[177,178] This was down from 2022. It excludes drawdowns from banks under the Recovery Loan Scheme (RLS).

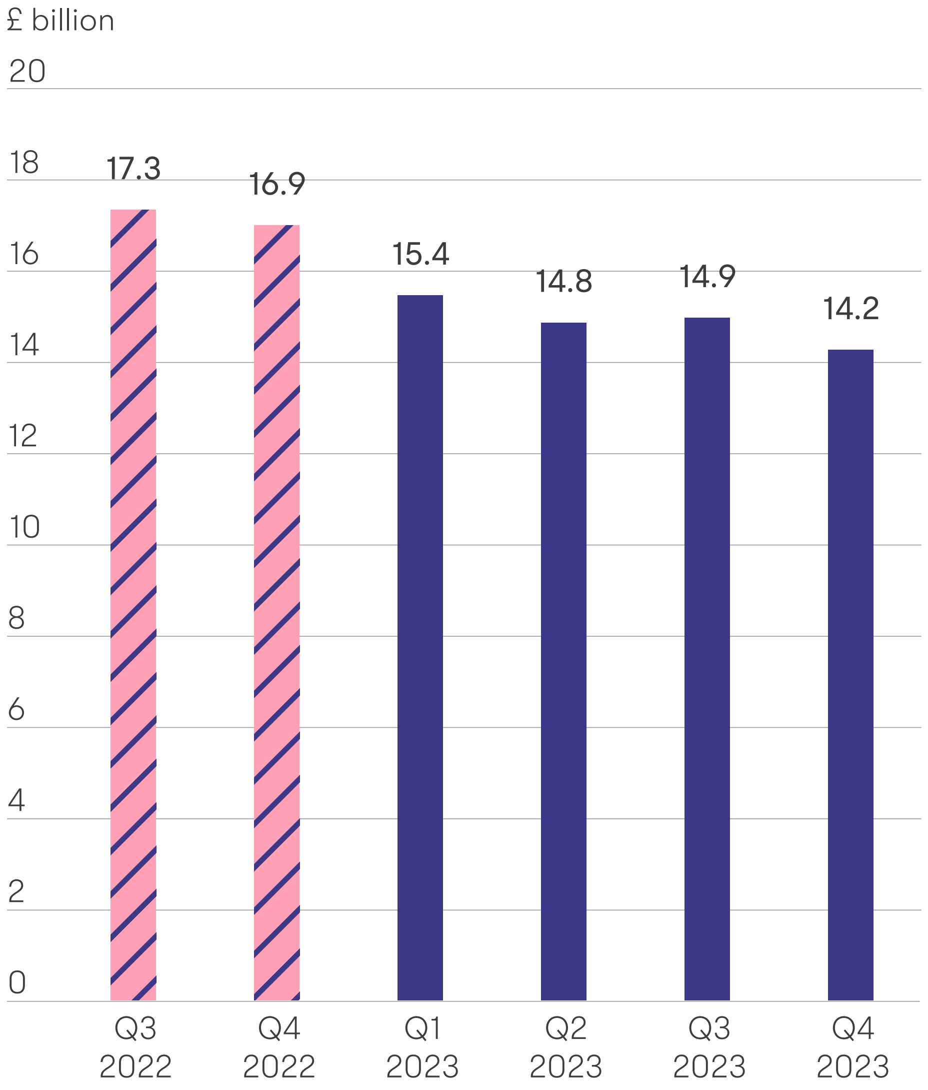
For context, gross lending in 2022 also included drawdowns under the RLS. Gross lending in 2022 excluding RLS was around £64bn. This was the highest on record for market-based lending. It followed gross lending in 2021 including drawdowns made under the Coronavirus Business Interruption Loan Scheme (CBILS), Bounce Back Loan Scheme (BBLS) and RLS. The impact of CBILS and BBLS was significant due to a large increase in applications in the months leading up to both schemes closing in March 2021. Gross lending in 2021 excluding CBILS, BBLS and RLS was around £49bn. This was up slightly from 2020, when gross lending excluding CBILS and BBLS was about £48bn.

The quarterly breakdown shows gross lending continued to fall in the first half of 2023 but was broadly flat in Q3 before it fell again in the final quarter of the year (Figure B.36). In Q1 2023 gross lending totalled £15.4bn, seasonally adjusted. This was down 9% from the previous quarter and followed a fall of 2% in Q4 2022. However, it remained higher than the quarterly average in 2019 (£14.2bn). Similarly, in Q2 2023 gross lending fell 4% to £14.8bn. In Q3 2023 gross lending rose 1% to £14.9bn, the first increase in four quarters. However, gross lending subsequently fell 5% in Q4 2023 to £14.2bn.

Figure B.36

Quarterly gross bank lending to SMEs

Source: BoE.



Box 2: Asset finance within the BoE gross bank lending measure

The BoE gross bank lending measure consists of term lending and can include other products such as asset finance and invoice finance. However, the BoE does not provide the breakdown by product type.

While the British Business Bank can estimate the value of asset finance within gross lending, it is unable to do so for other products such as term loans and invoice finance.

The BoE reports that gross lending in 2022 totalled £65.1bn. Of this, commercial property lending accounted for £16.7bn.

Based on market intelligence and some consolidated financial accounts, we estimate that between £10.4bn (16%) and £14.4bn (22%) of the gross lending was likely to be asset finance and reported within relevant Financing & Leasing Association data. The lower estimate is based on UK banks only while the upper comprises both UK banks and international banks operating in the UK.

When the commercial property lending figure and our asset finance estimate are deducted from gross lending in 2022, between £34bn and £38bn remains. This is likely to be comprised of term loans and invoice finance.

Our market contacts report that, in many cases, lending provided via asset finance and invoice finance can be substituted for term lending (see section 2.10 asset finance and section 2.11 invoice and asset based lending for more details on developments in asset finance and invoice finance).

Higher borrowing costs and economic uncertainty weighed on the demand for lending

The BoE's agents reported over the course of 2023 that businesses were generally reluctant to take out new loans. This was attributed to the higher cost of borrowing and uncertainty about the UK economic outlook (see section 1.1 macroeconomy and its impact on small business finance markets).[179] Separate BoE data showed interest rates on new fixed and floating loans for SMEs during 2023 reached their highest levels since records began in 2016.[180] In contrast, the agents reported that the working capital needs of businesses remained high.[181] This reflects that elevated input costs continued to squeeze the cash flow of many businesses. The UK Finance BVA BDRC SME Finance Monitor reported that the use of credit cards and overdrafts trended higher in the 11 months to November 2023. Credit cards were the most used form of funding over the period, followed by overdrafts.[182]

Another factor that likely weighed on the demand for lending was the total value of SMEs' deposits held at the seven largest UK banks remained relatively high.[183] The latest available UK Finance data for Q3 2023 showed SMEs' current account credit balances and deposit account balances totalled £242bn. This was down 9% from the same period in 2022, continuing the downward trend since the record high in Q4 2021 (£271.5bn). However, the total value of SMEs' deposits remained well above that in Q4 2019 (£203.3bn) (Figure B.37).

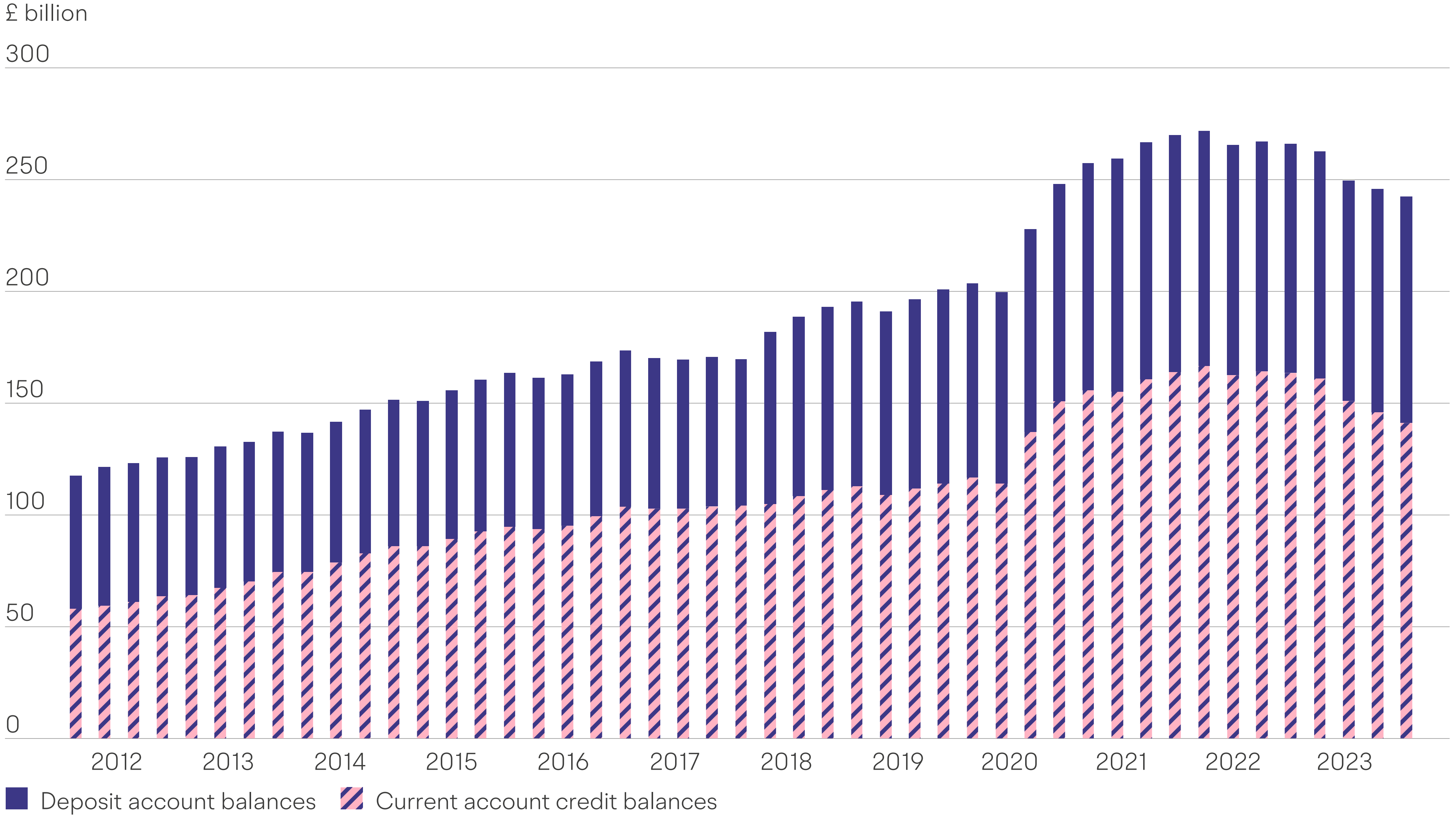
The BoE Credit Conditions Survey, along with UK Finance data on SME loan applications, indicate that the demand for lending remained subdued in 2023. The BoE survey showed banks and building societies reported the demand for secured lending from small businesses decreased in Q1 2023 for the second consecutive quarter. It subsequently increased slightly in Q2 2023 before broadly decreasing in the final two quarters of the year.[184]

The UK Finance data showed SME loan applications to the seven largest banks started to stabilise in early 2023 after falling to a record low during 2022. In Q1 2023 the number and value were 12,921 and £5.1bn

Figure B.37

Total SME deposits at the 7 largest UK banks

Source: UK Finance and British Business Bank calculations.



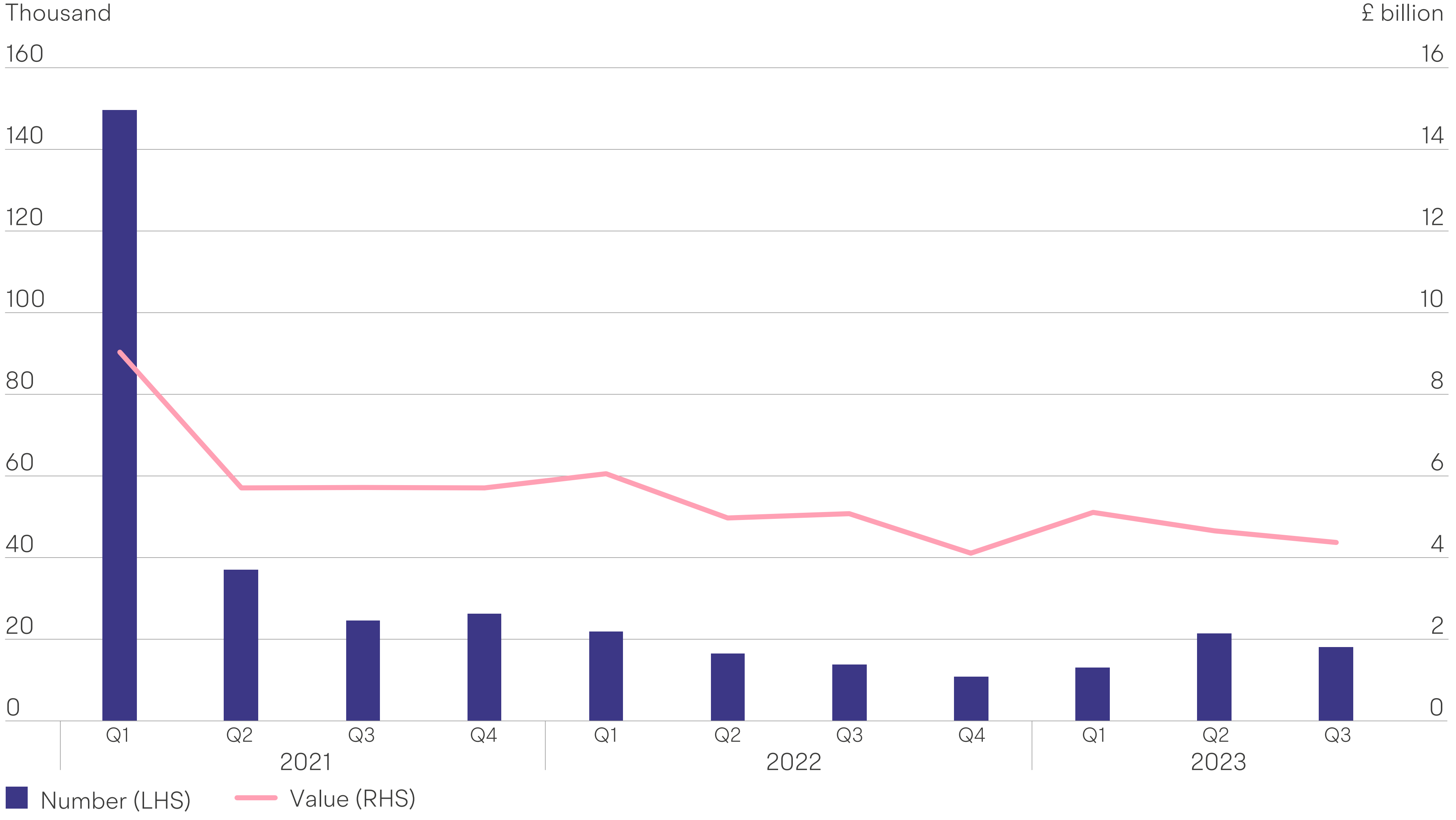
respectively. While both were up from record lows in the previous quarter, they remained well below their pre-pandemic averages (39,852 and £6.1bn). In Q2 2023 the number (21,356) was up again while the value (£4.6bn) was down. The latest available data for Q3 2023 showed both the number (18,006) and value (£4.4bn) were down (Figure B.38).[185] By business size, the changes in SME loan applications over the last two years have largely been driven by small businesses.

Despite the low number and value of SME loan applications shown by the UK Finance data, our market contacts report the demand for bank lending from many smaller businesses remains high. The disparity could reflect that the UK Finance data does not capture applications made to challenger and specialist banks. The big five banks have traditionally been the main driver of gross lending.[186] However, this was not the case in 2023 for the third consecutive year, with challenger and specialist banks accounting for a higher share of total gross lending than the big five banks (see section 2.8 challenger and specialist banks for more details). It could also reflect that some businesses which would like to borrow do not actually apply for reasons including failure to get pre-approval for a loan, high levels of existing debt and elevated borrowing costs.

Figure B.38

SME loan applications to the 7 largest UK banks

Source: UK Finance and British Business Bank calculations.



Banks were more cautious about the ability of businesses to repay lending

The BoE's agents reported during 2023 that banks were more cautious on new lending to smaller businesses. In general, banks were applying more cautious affordability tests to loan applications.

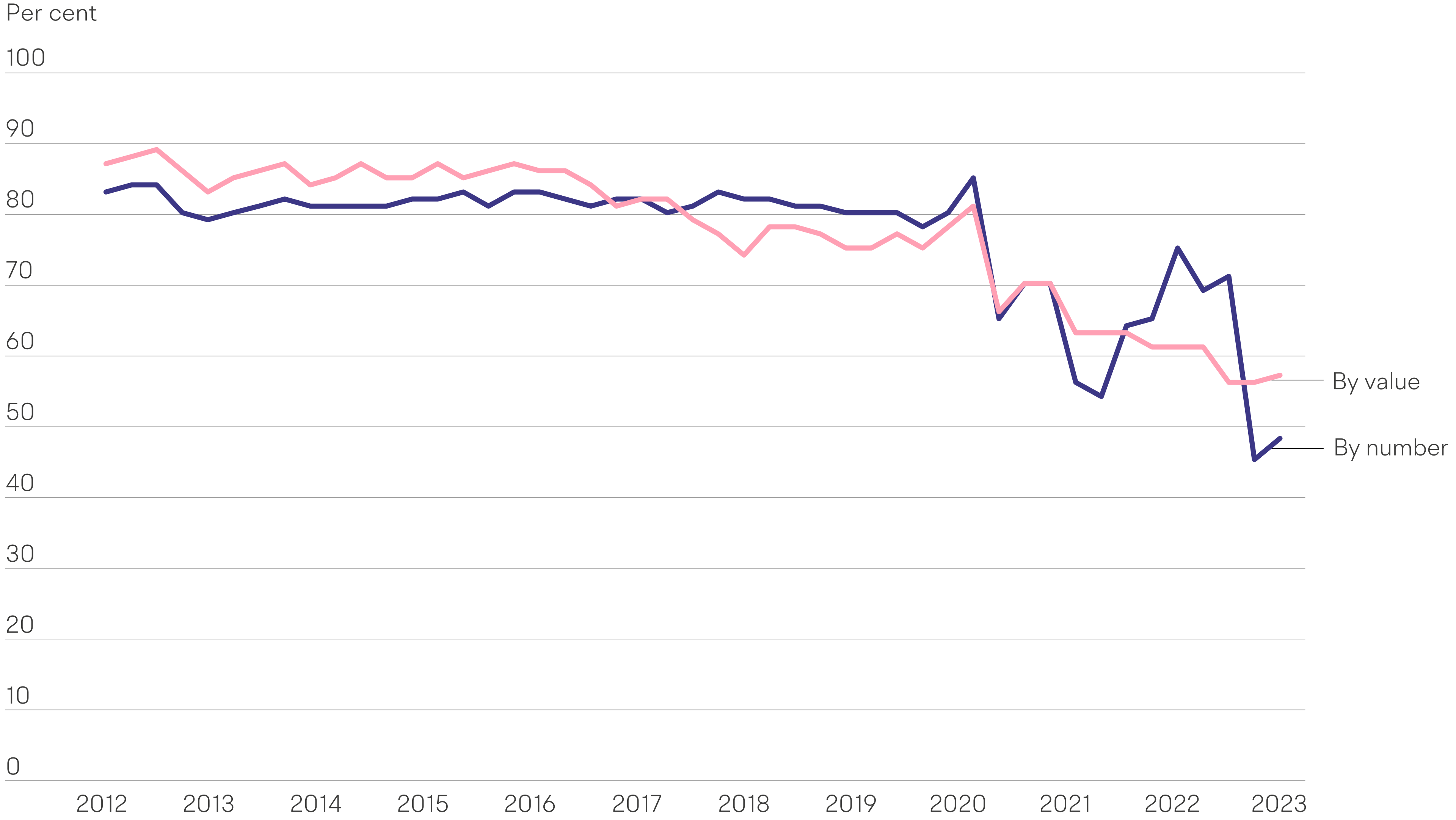
The agents also reported that banks were increasingly preferring to lend to businesses in strong financial positions while access to credit for lower-rated businesses remained weak. This does not bode well for smaller businesses because the debt levels of many remain higher than before the pandemic, likely leading to some deterioration in their creditworthiness.[187]

The success rates for SME loan applications at the seven largest banks provide an insight into the availability of credit but for only part of the market as they exclude challenger and specialist banks. In terms of bank loan approvals, the success rate in Q1 2023 was 71%, according to British Business Bank calculations based on UK Finance data.[188] This was up slightly from Q4 2022 (69%) but remained well below the pre-pandemic average (82%). However, in Q2 2023 the success rate was down sharply to 45%, the lowest on record. The fall

Figure B.39

SME loan success rates at the 7 largest UK banks

Source: UK Finance and British Business Bank calculations.



was mostly driven by a very large rise in the number of SME loan applications, particularly by small businesses, in that quarter. The latest available data for Q3 2023 showed the success rate was a little higher at 48%.

In terms of the value of loan applications and approvals, the success rate in Q1 2023 was 56%. This was down from Q4 2022 (61%) and a record low. The decline was mostly due to a lower value of applications by medium-sized businesses in the quarter. The success rate was steady in Q2 2023 (56%), and little changed in Q3 2023 (57%) (Figure B.39).

Gross repayments were the second highest on record after 2022

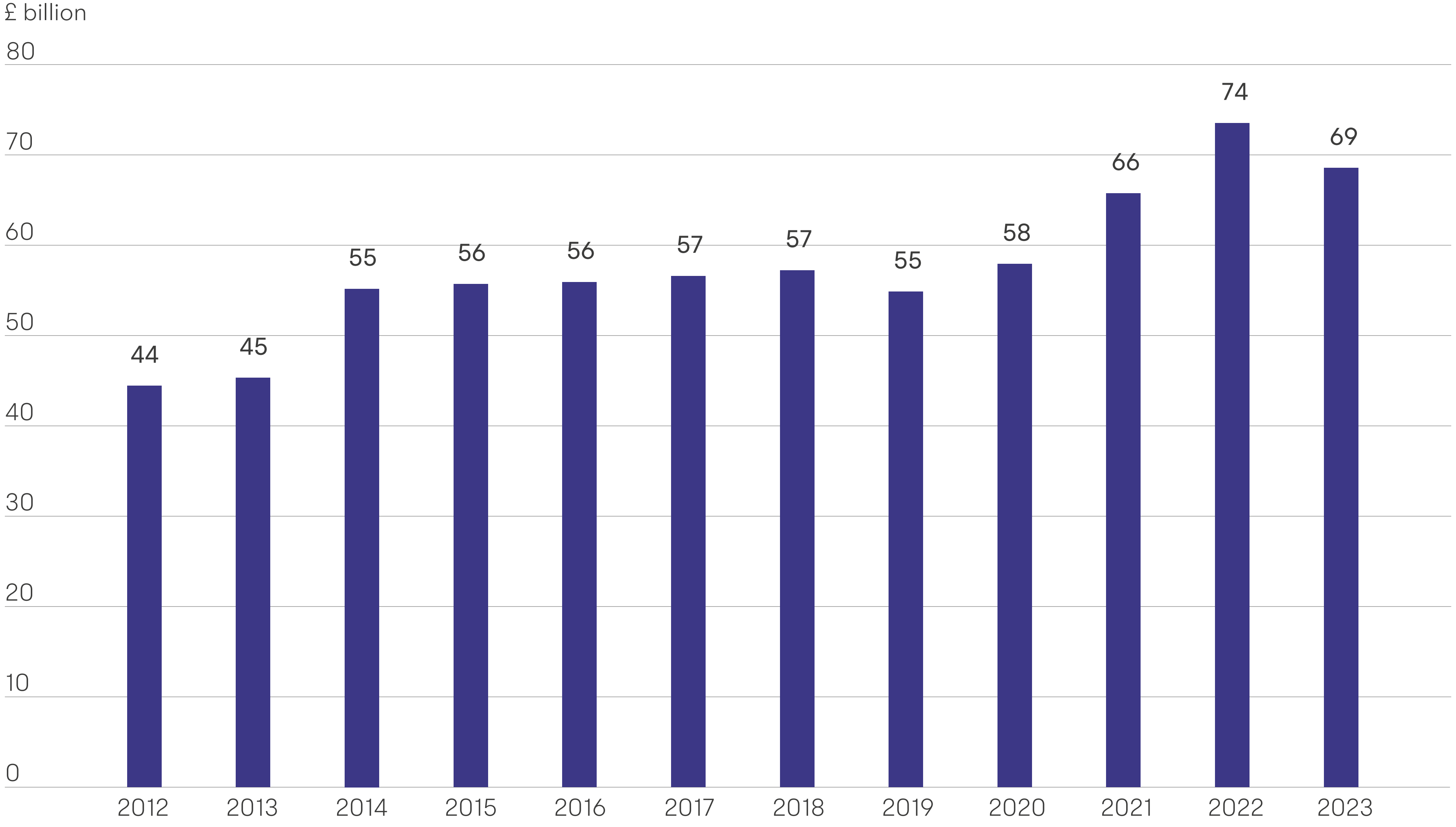
Nominal gross repayments from SMEs in 2023 totalled £68.5bn. This was down 7% from the previous year but the second highest on record after 2022 (£73.5bn) (Figure B.40). However, in real terms, gross repayments were down 13% from 2022.

The fall in gross repayments in 2023 largely reflects that the one-year holiday on paying interest and repaying the principal on BBLS ended in late 2022. As a result, by the end of 2022 all those smaller businesses that had drawn

Figure B.40

SME gross repayments

Source: BoE.



down BBLS had started paying interest and repaying the principal or paid the facilities back in full. Department for Business and Trade data as of 30 June 2023 showed the majority (76%) of BBLS facilities drawn down from lenders including banks were either fully repaid (12%) or on schedule (65%).[189]

Despite the fall in nominal gross repayments in 2023, repayment levels remained very high. The BoE's agents reported many firms were looking to make early repayments to reduce their exposure to higher interest rates.[190] Also, our market contacts believe a large amount of the repayments by smaller business in 2023 was repaid from lending that had been refinanced by other banks. Our contacts noted there were instances of smaller businesses with government-guaranteed loans refinancing with another bank when their application for more finance was not approved.

The BoE measure of nominal net lending in 2023 was a negative £9.3bn. This was down from negative net lending of £8.4bn in 2022 and the largest on record. The widening in 2023 reflected that the fall in gross lending of 9% was larger than the decline in gross repayments of 7%. Net lending was negative in 2023 for the third consecutive year. In real terms, net lending was a negative £8.7bn in 2023. This was slightly larger than in 2022 and similarly the largest on record.

The British Business Bank continues to support bank lending to UK smaller businesses

In the current environment of weak economic growth, high input costs and elevated interest rates, it remains crucial for smaller firms to access the finance they need from the banking sector to maintain cash flow and, where possible, invest in and grow their business.

The British Business Bank stands ready to support bank lending to smaller businesses across the UK through its existing programmes including RLS, the ENABLE Guarantee programme and the ENABLE Build programme and the Nations and Regions Investment Funds.

2.8

Challenger and specialist banks

- Gross lending by challenger and specialist banks in 2023 was the second highest on record
- Challenger and specialist banks' share of total gross lending reached a record high
- The cost of funding increased
- Mature challenger and specialist banks were able to raise capital while some of the newer ones struggled
- Four banks were granted UK banking licences in 2023, of which three directly serve smaller businesses

This section analyses the developments in 2023 for the challenger and specialist banks that serve smaller businesses. It draws on data from sources including the Bank of England (BoE) and the British Business Bank.

Gross lending by challenger and specialist banks in 2023 was the second highest on record

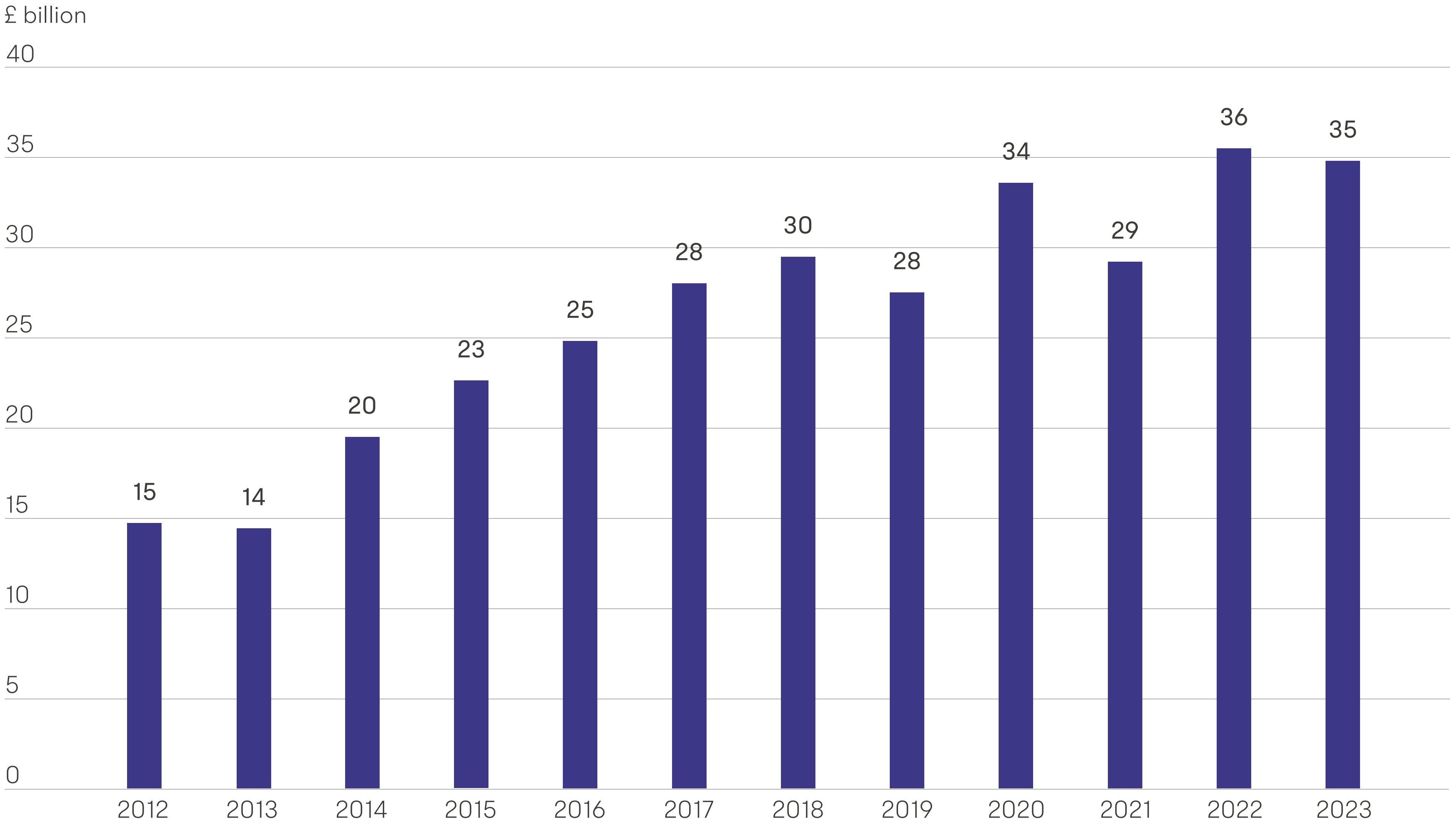
Nominal gross lending excluding overdrafts to small and medium-sized enterprises (SMEs) by challenger and specialist banks in 2023 was £34.8bn, according to BoE data. This was down 2% from the previous year. It was the second highest on record after 2022 (£35.5bn) (Figure B.41).

While gross lending by challenger and specialist banks in 2023 fell by 2% in nominal terms, this was not the case when accounting for inflation. In real terms, challenger and specialist banks' gross lending was down 8% from 2022.

Figure B.41

Gross lending to SMEs by challenger and specialist banks

Source: BoE.



Market-based lending, which is bank lending that is not guaranteed by the government, by challenger and specialist banks in 2023 was £34.5bn. This excludes drawdowns under the Recovery Loan Scheme (RLS). The figure for 2023 was broadly unchanged from the market-based lending in 2022 of around £35bn, which also excludes RLS. However, it was higher than the market-based lending in 2021 of about £26bn, which excludes the Coronavirus Business Interruption Loan Scheme (CBILS), Bounce Back Loans (BBLS) and RLS. Similarly, the figure for 2023 was higher than the market-based lending in 2020 (also around £26bn), which excludes CBILS and BBLS.

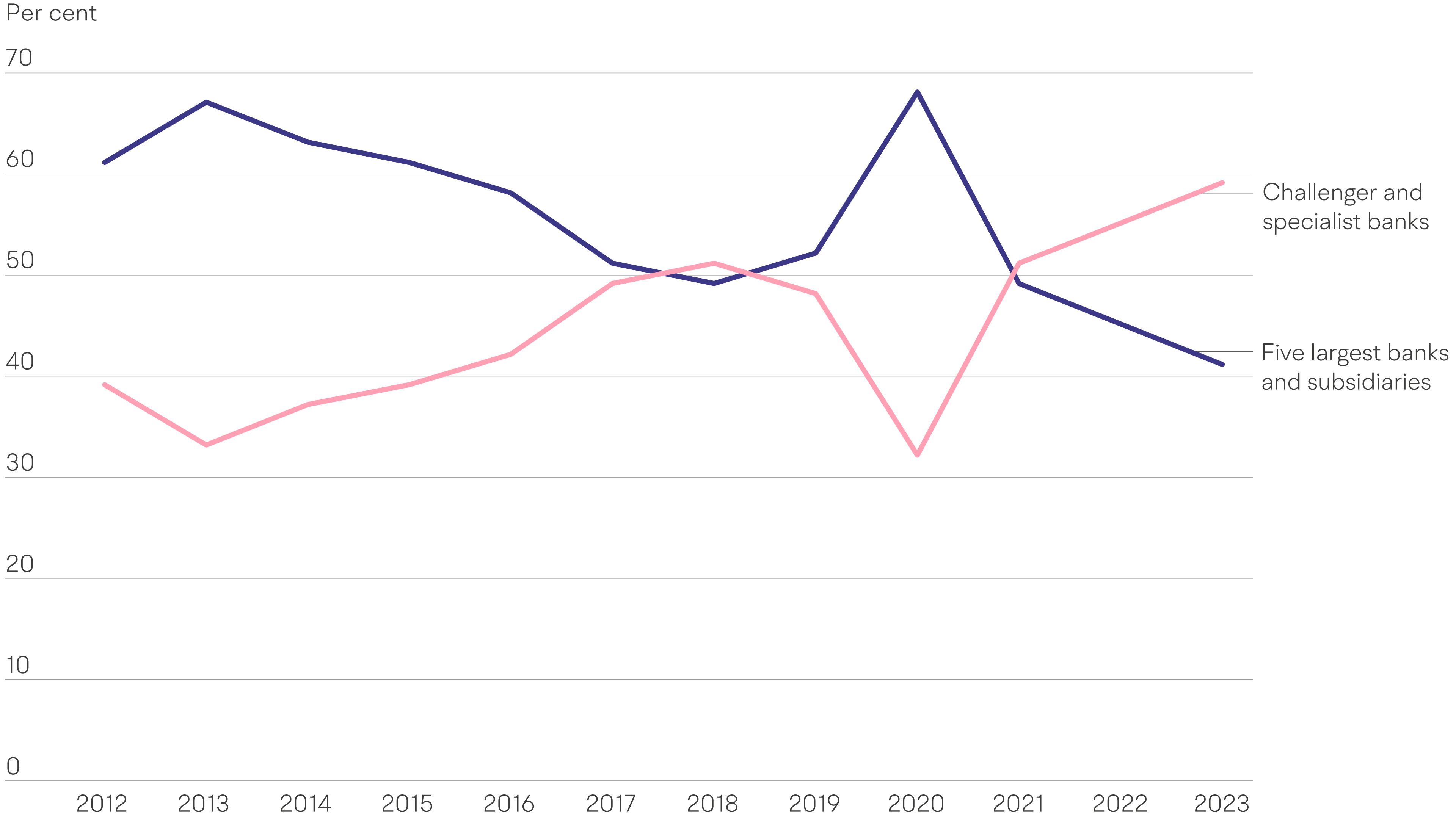
Challenger and specialist banks' share of total gross lending reached a record high

The share of total gross lending to SMEs by challenger and specialist banks in the 2023 was 59%. This was up from 55% in 2022 and the highest on record. It was also the third consecutive year in which the challenger and specialist banks' share for the period exceeded that of the big five banks (Figure B.42).[191]

Figure B.42

Share of total gross bank lending to smaller businesses

Source: BoE and British Business Bank calculations.



The record-high share was solely driven by a fall in gross lending by the big five banks. In 2023 the big five banks' gross lending was £24.3bn, down 18% from 2022. This compares to the previously mentioned fall of 2% in gross lending by challenger and specialist banks (Figure B.43).

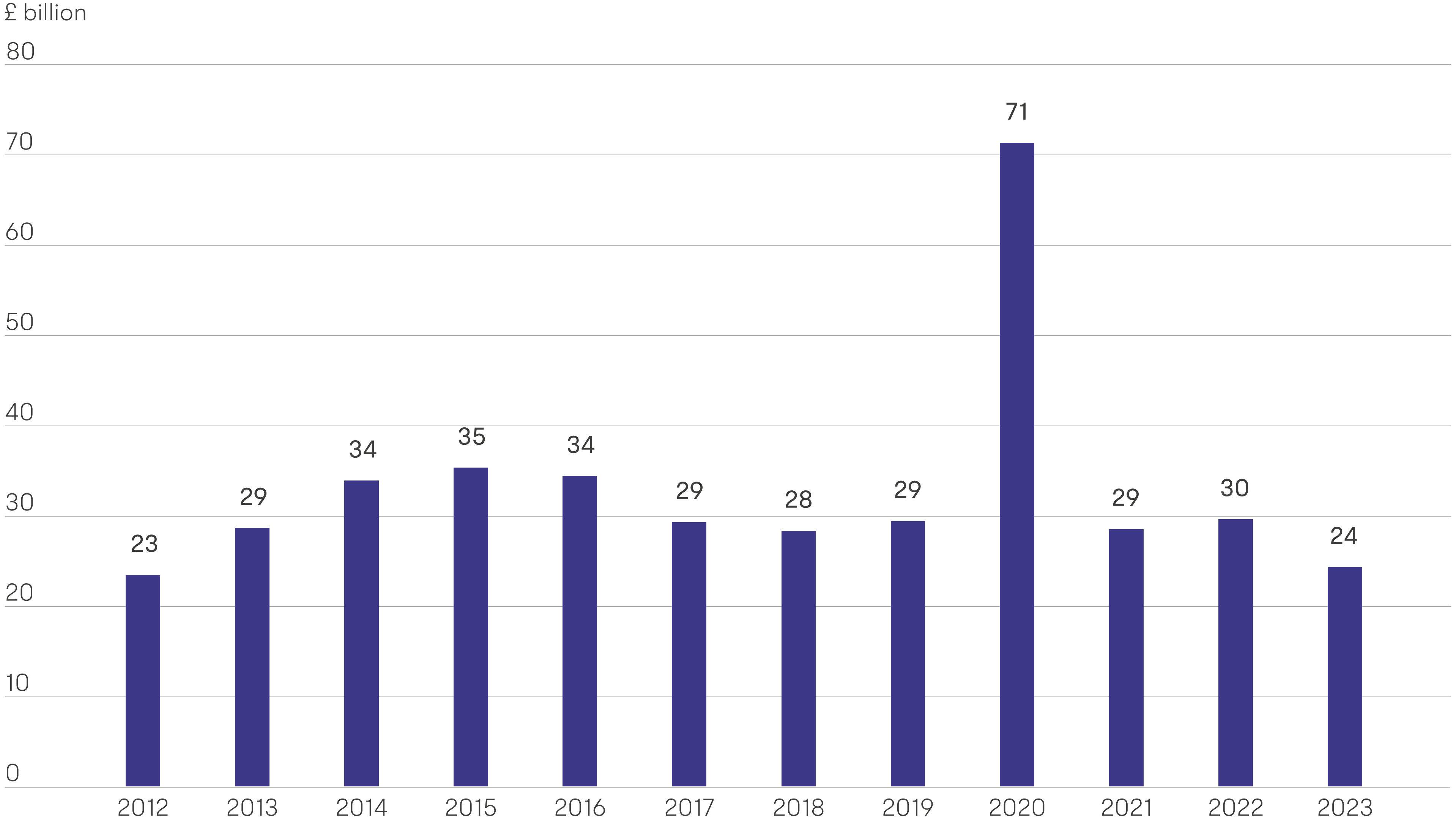
Quarterly data shows gross lending by challenger and specialist banks fell in the first half of 2023 before starting to rise again in Q3. In Q1 challenger and specialist banks' gross lending was £9bn. This was down 5% from Q4 2022 (£9.5bn), which was the second highest on record after Q2 2020 (£10.2bn). In Q2 gross lending by challenger and specialist banks was £8.2bn, down 9% from Q1. However, in Q3 it was £8.7bn, up 6%. Similarly, challenger and specialist banks' gross lending was up 2% in Q4 to £8.9bn. In contrast, gross lending by the big five banks fell in Q4 to £5.5bn, the fifth consecutive decline (Figure B.44).

Challenger and specialist banks provided a larger proportion of government-guaranteed loans than the big five banks in 2023 for the second consecutive year. The total value of RLS facilities drawn down from banks was £437m. Of this, challenger and specialist banks accounted for £280m (64%) while the big five banks provided £157m. It followed challenger and specialist

Figure B.43

Gross lending to smaller businesses by the big five banks

Source: BoE and British Business Bank calculations.



banks comprising around two-thirds of the £1.4bn of RLS drawn down from banks in 2022. This contrasts with challenger and specialist banks providing a smaller proportion of facilities under the government loan schemes than the big five banks in the previous two years. In 2021 challenger and specialist banks accounted for more than one-third of the £8.6bn of CBILS, BBLS and RLS drawn down from banks. Of the £56.7bn of CBILS and BBLS drawn down from banks in 2020, challenger and specialist banks comprised about 10%.

The cost of funding increased

Challenger and specialist banks faced cost of funding pressures during 2023. The cost of customer deposits increased, driven by higher interest rates paid on them. The Bank's market contacts reported that, in general, challenger and specialist banks were willing to pay more competitive rates than other banks to attract deposits to fund their increased lending to smaller businesses. According to our contacts, most of the smaller challenger and specialist banks remain largely reliant on deposits with, as a proxy, the ratio of wholesale funding to retail (deposit) funding for typical specialist banks averaging less than 15%.

The increase in the cost of deposits was exacerbated by a change in the deposit mix as customers increasingly moved their money out of accounts that paid no or low interest such as current accounts to those offering higher rates such as fixed-term and notice accounts. A possible explanation for this shift is the cost-of-living crisis.[192]

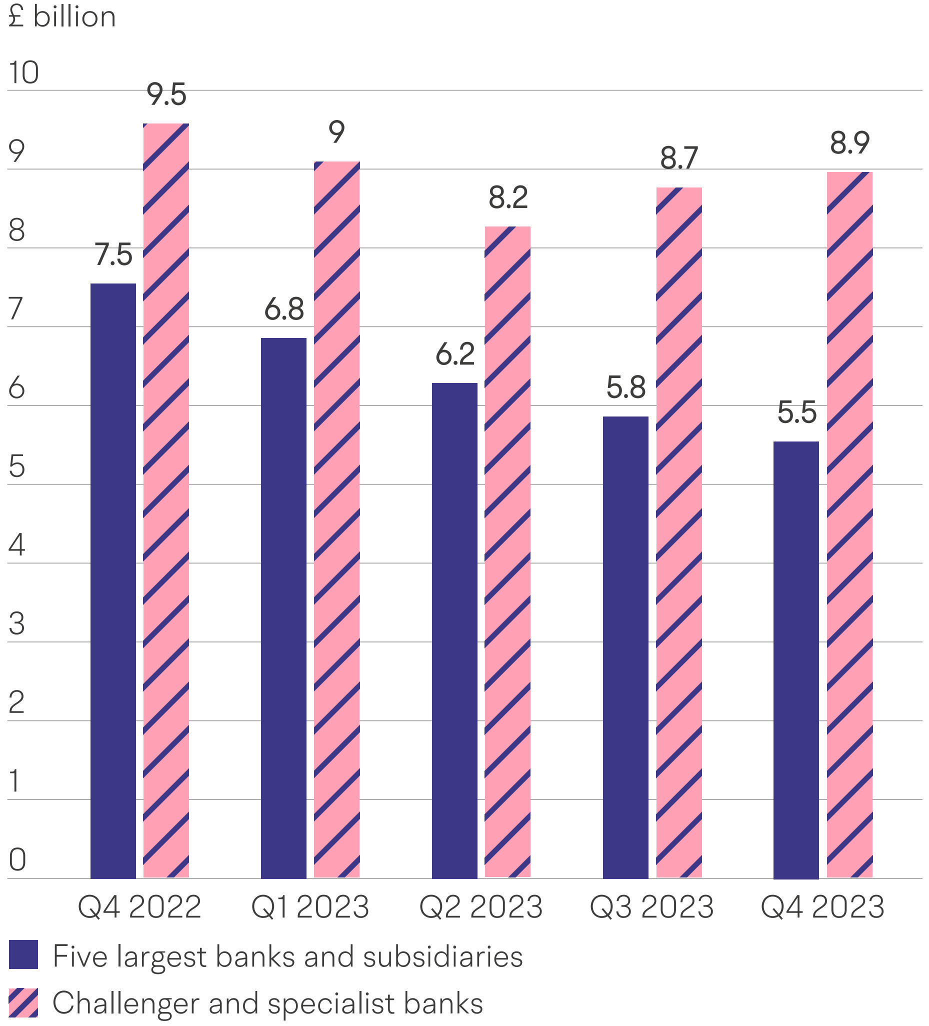
The cost of wholesale funding also trended higher. The two-year Sterling Overnight Index Average (SONIA) swap rate, a key benchmark of the cost of wholesale funding, averaged 4.87% in 2023. This was up from an average of 2.99% in 2022, indicating the cost of wholesale funding increased by nearly 2 percentage points. It followed an increase of more than 2 percentage points between 2021 and 2022 (see section 2.9 alternative lending and commercial broker finance for more details).

On top of the higher cost of funding from deposits and wholesale markets, our market intelligence is that the upcoming Basel 3.1 reforms have the potential to increase the cost of capital faced by challenger and specialist banks.[193] Our market contacts report that some challenger and specialist banks have already started to price in the prospective increased capital costs, which has deterred some businesses from taking on term lending.

Figure B.44

Gross lending by the big five and challenger and specialist banks

Source: BoE and British Business Bank calculations.



Mature challenger and specialist banks were able to raise capital while some of the newer ones struggled

Most of the challenger and specialist banks that were founded in the wake of the Global Financial Crisis (GFC) are now mature, with multi-billion-pound balance sheets largely comprised of lending to smaller businesses. Many of these were able to attract fresh capital during 2023. They included the specialist smaller business lenders DF Capital[194], Cambridge & Counties Bank[195] and Cynergy Bank[196] each raising £20m of Tier 2 capital[197] from British Business Investments (BBI), the Bank's commercial subsidiary. Similarly, Secure Trust Bank, a specialist lender that was founded well before the GFC, raised £90m Tier 2 capital of which BBI invested £20m.[198]

Several digital banks also raised capital during 2023. Zopa Bank, which was founded in 2005 as a peer-to-peer lender but gained a UK bank licence in 2020, raised £75m in Tier 2 capital.[199] Similarly Atom Bank, founded in 2014, raised £100m from existing shareholders.[200]

However, the higher interest rate environment in 2023 dampened investors' appetite for assets across a range of sectors including smaller banks. The risk to the balance sheets of some smaller banks from higher interest rates was highlighted in March 2023 when regulators in the US closed Silicon Valley Bank (SVB), which served tech and VC-backed start-ups. The BoE subsequently applied to put SVB UK into insolvency, but this was avoided when it was bought by HSBC.

Some of the newer challenger and specialist banks struggled to raise capital. In August 2023 smaller business lender Ashman Bank, which the Prudential Regulation Authority (PRA) had authorised to operate with restrictions (AWR) in 2022, delayed its launch amid continued discussions with multiple investors on raising the capital required for moving to a full banking licence.[201] This followed Bank North, a digital bank for regional smaller businesses that was AWR in 2021, announcing in 2022 it would withdraw from the UK market because it was unable to raise the required capital.

Four banks were granted UK banking licences in 2023, of which three directly serve smaller businesses

In 2023 the PRA authorised four new banks. This was one less than in 2022 (five), which jointly with 2014, 2015 and 2021 was the lowest since 2014 (see section 1.2 debt finance for more details).

The four banks were Alba Bank[202], Griffin Bank[203,204], LHV Bank[205] and Conister Bank.[206] Of these, Alba, LHV, and Conister directly serve customers including smaller businesses.

Both Alba and Griffin, which are start-ups, were AWR. Alba is Scotland's first bank solely dedicated to smaller businesses. Griffin is a UK 'Banking as a Service' (BaaS) platform that enables non-bank fintech businesses to build and launch banking products for customers including smaller businesses. Consequently, Griffin is set to serve smaller businesses indirectly.

LHV and Conister were authorised without restrictions. Previously, LHV operated in the UK as a branch of an Estonian bank. LHV acquired the smaller business loan book of Bank North in 2022 and offers commercial real estate investment loans and trading loans. It has regional hubs in Leeds and Manchester.

Conister is a bank incorporated in the Isle of Man. Its website indicates the bank has been active in the UK for several years and currently lends about £0.35bn to UK smaller businesses annually.

Publicly available information indicates there are a handful of applications pending. The most well-known is the fintech Revolut, which applied in 2021. Revolut is currently authorised as an electronic money institution that offers products including business accounts for sole traders and smaller businesses.

There are likely to be fewer start-ups applying for bank licences in the next year or two than was the case in the mid-late 2010s. This largely reflects that tougher market conditions have made raising capital more challenging as well as launching a start-up bank in the UK being expensive in terms of time and capital.

Nearly two-thirds of the banks authorised since 2014 (60%) offer services to customers including businesses and smaller businesses, according to Bank calculations based on BoE data. Among these, four in 10 (40%) provide products for personal, business and SME customers. One in five (20%) offer services only to businesses and smaller businesses.[207,208]

The British Business Bank continues to support challenger and specialist banks in making smaller business banking markets more diverse through its programmes including RLS, the ENABLE Guarantee and those of BBI.

Alternative lending and debt products

– 2.9 Alternative lending and commercial broker finance
– 2.10 Asset finance
– 2.11 Invoice and asset based lending

2.9

Alternative lending and commercial broker finance

- Broker activity contracted in 2023
- There was increased funding for those smaller businesses previously declined
- Diverse lending panels are key to the broker offering
- There was a mixed picture for alternative finance providers in 2023
- Non-bank and fintech lenders faced challenging funding conditions
- Raising equity became more challenging for fintech businesses in 2023
- Open banking and partnerships continue to improve smaller business funding options

This section covers the role commercial finance brokers and alternative finance providers play in UK smaller business finance markets.

The data in this section comes from the National Association of Commercial Finance Brokers (NACFB), the UK representative body, with 1,172 member firms employing 2,440 brokers, which they estimate represents around 75% of the market, and from a combination of alternative lenders' public reports and bespoke data requests.[209]

Brokers are an important intermediary in smaller business finance markets, particularly for commercial property and asset finance transactions. Through their knowledge and expertise, they try to match a borrower's requirements with the most appropriate lender operating in the market. Smaller businesses that have either been unsuccessful in finding the funding they require when approaching a lender directly or who do not have the time or financial confidence can instead tap into the expertise of the broker.

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 smaller businesses but have also increased the accessibility and appropriateness of finance available.

Broker activity contracted in 2023

In 2023, NACFB members facilitated £38 billion in lending, a decrease of 16% from 2022's £45 billion and 7% below 2021's £41 billion. This decrease mirrored the wider market trends where demand for finance was subdued, and bank lending contracted by 9.1% in nominal terms (see section 2.7 bank lending for further detail). Asset finance was the only outlier, seeing strong growth throughout the year (see section 2.10 asset finance for further details).

High interest rates and inflation were the most cited reasons for the decrease. Lenders surveyed by the NACFB reported a decrease in completions due to higher interest rates. Furthermore, 66% of brokers observed a decreased appetite for funding among smaller businesses, attributing it to higher rates in 2023.

In addition, 86% of NACFB member brokers reported that inflation caused moderate or significant concern among their clients, influencing their borrowing decisions. Market contacts suggested these concerns and the generally deteriorating economic conditions had manifested in the stalling of some large property lending transactions and an increase in short-term borrowing to mitigate the current economic conditions.

Despite the challenges noted, by value, the majority of broker facilitated finance remained property related, at 73% in 2023. Leasing and asset finance was the highest non-property lending product, estimated to account for 16% of lending (Figure B.45). Unsurprisingly, given the types of finance facilitated, 71% of brokers facilitated construction sector transactions while 65% facilitated real estate transactions.

While economic conditions have played a significant role in dampening recent borrowing, the higher lending figures seen in previous years were also significantly boosted by pandemic-related funding. Looking ahead, the NACFB expects the value of broker-originated transactions to stabilise and plateau over the near term.

There was increased funding for those smaller businesses previously declined

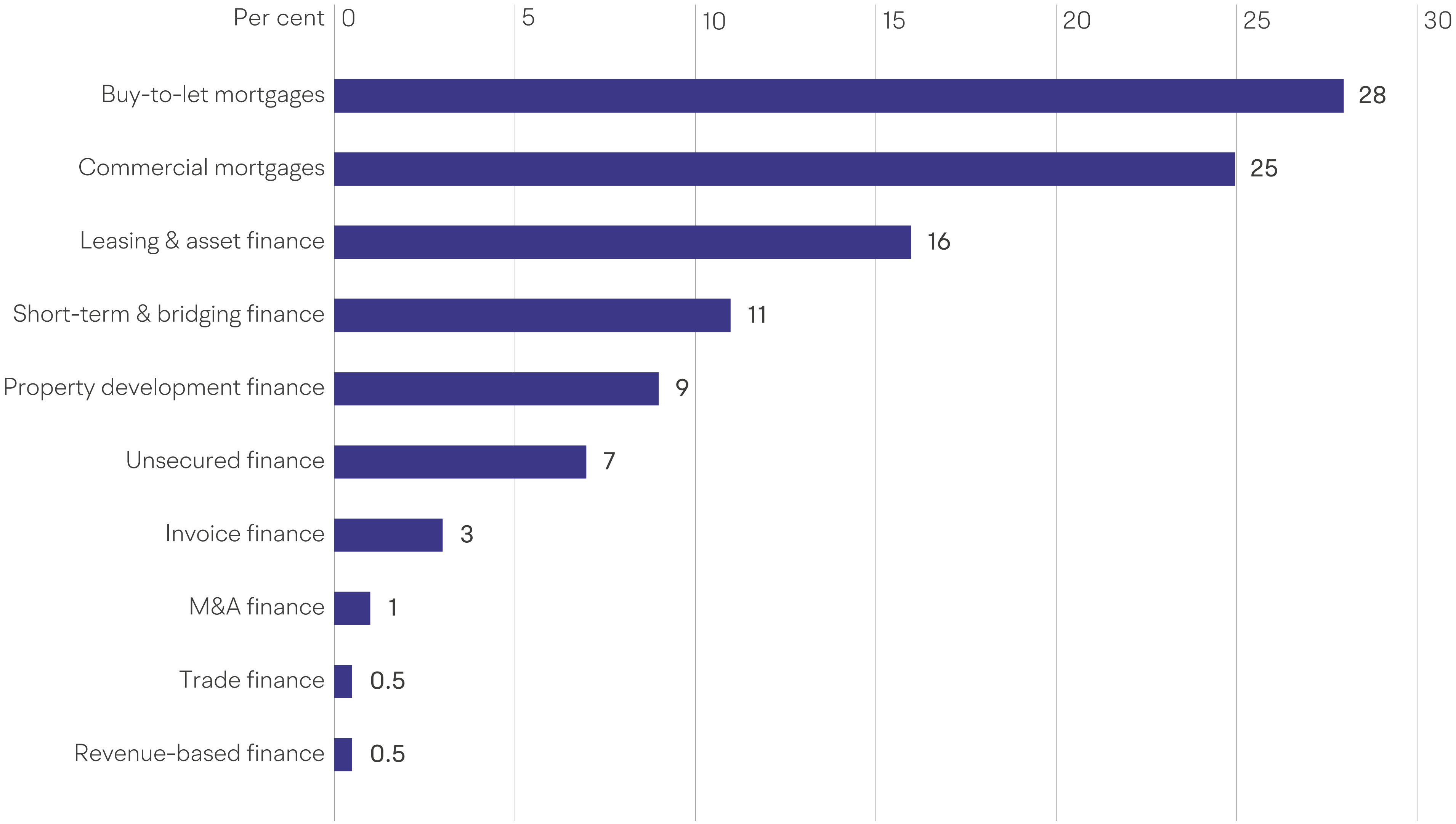
Funding for those previously declined increased in 2023. 32% of new clients successfully funded by NACFB members had been previously denied funding elsewhere, a 3% increase from 2022. This likely reflects the increase in declined rates seen in recent quarters, which stood at around 50% of finance applications in November 2023.[210] Although both rejection rates and the funding for those previously declined increased, 35% of commercial lenders surveyed still said they lacked a formal referral system for declined direct enquiries.

Despite the lack of formal referral systems in place, broker facilitated finance remains key for many lenders. 69% of lending to smaller businesses by surveyed lenders was through commercial intermediaries. Furthermore, 61% of lenders surveyed by the NACFB reported increased collaboration with brokers due to economic challenges and 98% of lenders expected their relationships with brokers to strengthen or remain consistent in 2024.

Figure B.45

Percentage of total transaction value, by finance type

Source: NACFB survey 2023



Diverse lending panels are key to the broker offering

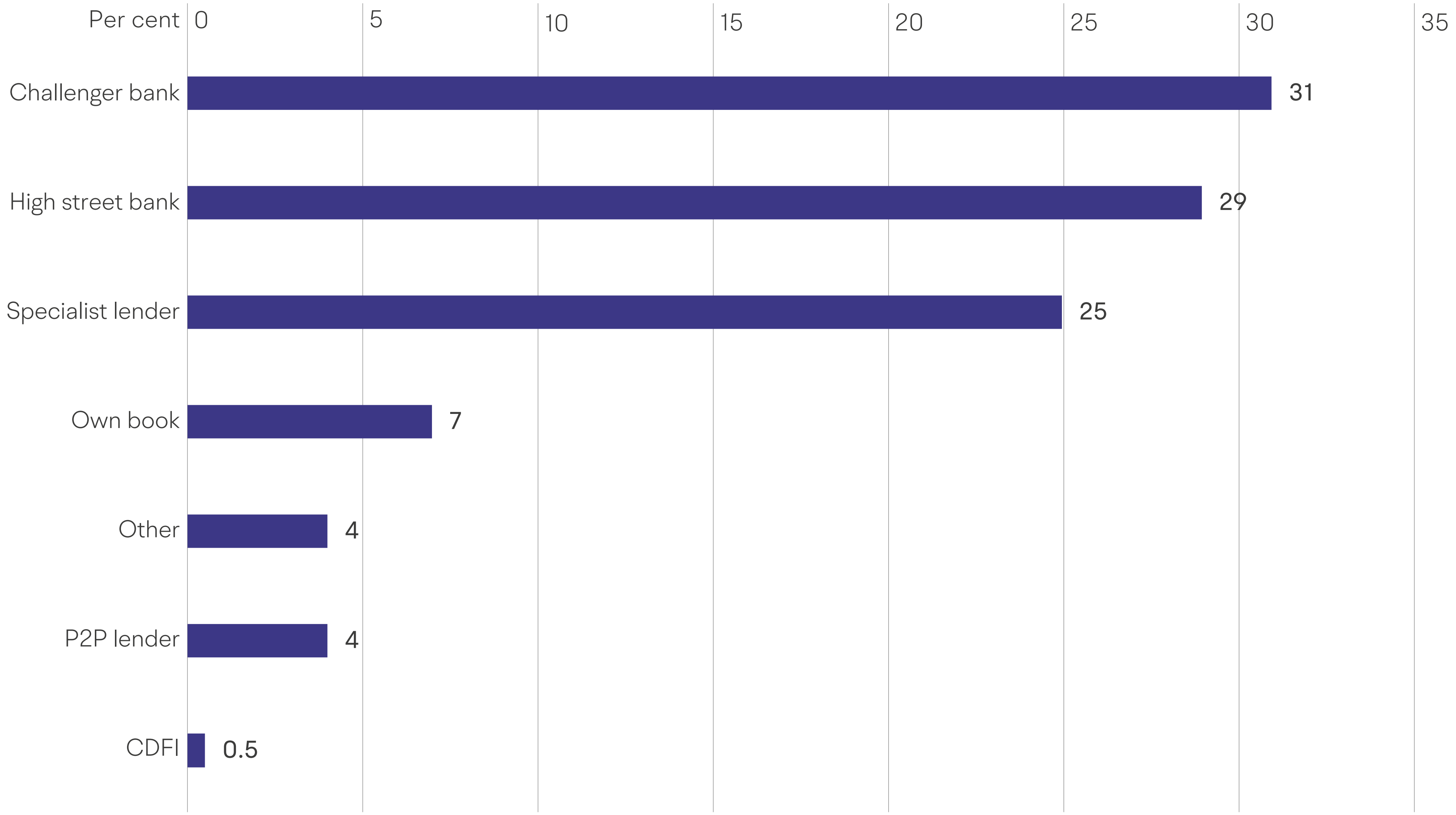
In 2023, the survey reports challenger banks provided 31% of finance brokered. This was closely followed by high street banks (29%) and specialist lenders (25%) (Figure B.46). Last year the survey asked about the most common type of lender brokers had used, with challenger banks easily coming out on top with 49% of respondents, ahead of high street banks in second (24%).

While the 2022 and 2023 numbers are not comparable statistics, the NACFB noted that brokers observed a strong 2022 for challenger banks followed by a perceptible tightening of criteria in 2023. On a more positive note, some brokers reported alternative finance providers had picked up some of the slack and this may have in part accounted for the increase in funding for those previously turned down for finance. This included a significant increase in transactions involving NACFB members who provide 'own book' lending, now accounting for about 7% of all successful deals.

Figure B.46

Percentage of total transaction value, by lender type

Source: NACFB survey 2023



There was a mixed picture for alternative finance providers in 2023

At the time of writing only half the lenders we track had published or provided comparable 2023 lending volumes and some of the larger lenders were yet to do so. Of those who had, a third had seen volumes grow compared to 2022 while the other two thirds have seen them shrink. Despite this, aggregate origination for those who had published was up around 15% for both business and property lending.

One of the lenders posting strong growth was ThinCats. They lent £395m in 2023, an increase of 31% on what was itself a record year in 2022. Funding Circle, the largest business marketplace lender in the UK, has so far only reported UK H1 2023 origination. This came in at £471m, up on H2 2022 (£454m) but down on H1 2022 (£641m). As such, despite brokers noting increased alternative lender activity, given the large number of outstanding returns, and the mixed picture from those who have reported, it is too early to tell what the full 2023 picture will look like.

Figure B.47

2 year SONIA swaps

Source: Bloomberg.

Non-bank and fintech lenders faced challenging funding conditions

As well as the weak economic environment dragging down demand, the increase in interest rates seen in 2023 has impacted non-bank and fintech lenders more than banks. Banks typically have access to deposits, the cost of which is usually lower than wholesale funding. In 2022, the cost of wholesale funding for many non-banks rose by around 50%. The 2-year SONIA rate was higher still in 2023, peaking in July at 6.23% before falling to 4.03% at the end of the year (figure B.47).

As noted in our 2022/23 Small Business Finance Markets report[211], much of the non-bank lender space appears to have entered a stage of consolidation as many lending models continue to mature. Most marketplace lenders have moved from retail funding to institutional funding while balance sheet lenders have sought to widen their sources of funding.

For the larger non-bank lenders there were notable announcements such as Fleximise, Nucleus and Iwoca, all landing funding from big banks to increase their lending to UK smaller businesses. Funding Circle also furthered their partnership with Atom Bank to provide up to £150m in funding to small businesses and welcomed Allica Bank as a new investor.

Commercial property and landlord lenders also raised funds in 2023, including LendInvest and Kuflink. In addition, LendInvest completed a securitisation of £410m of its UK prime buy-to-let mortgage book. This was its fifth and largest securitisation, with its first back in 2019 being worth £259m.

Market intelligence confirms there is demand from non-bank lenders for additional funding and, significantly, interest from the challenger and specialist banks as well as big banks to supply this funding. While hurdles remain to match supply and demand, it is encouraging that the dialogue is ongoing given the potential benefits for UK smaller businesses and the economy as a whole of matching those with funds to those with the potential customer reach.

Raising equity became more challenging for fintech businesses in 2023

UK fintech businesses raised £615m in the first three quarters of 2023, 83% lower than the same period in 2022 (£3.5bn). While 2022 was a record year for the value of deals, 2023 to Q3 is the lowest since 2016 and before there was something of a step change in values in . While the 2023 figure is likely to increase as more deals are announced and Q4 data is collected, it is still likely to fall well short of the 2017-2020 annual average of £1.5bn let alone the record values seen in 2021 (£4.1bn) and 2022 (£4.2bn).

Deal numbers are also down significantly in the first three quarters of 2023, albeit not as much as values. So far 138 deals have been announced, down 43% on the same period last year (243) and again the lowest since 2016 (114). Given the greater fall in values, the average deal size has fallen from £14.5m for 2022 to Q3 to £4.5m in 2023, also well below the average deal size seen between 2017 and 2020.

While the wider UK smaller business equity market has also seen falling values and volumes in 2023 (see section 2.5 equity finance), the falls in investment into the fintech sector has been greater. This likely reflects the fact that while investment in the wider equity market started to decline in H2 2022, fintech still registered an increase in investment. Furthermore, fintech investment had grown at a quicker rate in recent years.

Open banking and partnerships continue to improve smaller business funding options

As noted in previous editions of the Small Business Finance Markets report, in recent years non-bank lenders have been exploring partnerships and open banking to improve their smaller business offerings and this theme continued in 2023. Iwoca partnered with CRIF to utilise open banking to offer instant decisions on loans up to £25k and 24-hour decisions on larger loans up to £500k.

Others, such as Funding Circle, have used partnerships to diversify their offerings. Funding Circle have partnered with Enface, an embedded finance solutions provider, to offer a small business credit card. FlexiPay transactions more than doubled in H1 2023 to £90m, with over £150m FlexiPay transactions since launch. Initially, FlexiPay was solely funded through Funding Circle invested capital. However, in June 2023, the group drew down on a newly set up senior debt facility provided by Citibank.

As the alternative lending sector adapts to the challenges it currently faces and continues to evolve smaller business lending markets, the British Business Bank will be there to support alternative finance providers to further enrich the options available to UK smaller businesses. This support is predominately provided via products such as ENABLE Funding and the Investment Programme but also by using its role as a convenor within the market.

2.10

Asset finance

Asset finance new business continued to grow in 2023

Supply chain issues easing has supported vehicle expenditure

Asset finance application success rates are much higher than other finance products

Broker and sales finance channels reported record levels of new business in 2023

This section provides an update on developments in the asset finance (primarily leasing and hire purchase) market in 2023, highlighting the growth in the level of annual new business despite the weak economic backdrop and limited business investment.

Asset finance continues to be the alternative finance instrument used by the largest proportion of smaller businesses. The Finance & Leasing Association (FLA) calculates that as much as 40% of business investment in vehicles, machinery and equipment has been funded by asset finance.

The asset finance market, through the provision of various forms 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 traditionally the most common finance option. In both cases, businesses avoid paying the full cost of the equipment upfront, easing pressures on cash flow.

Asset finance new business continued to grow in 2023

The smaller business asset finance market reported an increase in new business of 7% in 2023 to £23.5 billion following an increase of 11% in 2022 to £21.9 billion (Figure B.48). The asset finance market overall (including new business provided to larger businesses and the public sector) grew by 12% in 2023 to reach a record nominal level of £38.3 billion.

New asset finance lending to smaller businesses had recovered strongly following the pandemic. During 2023, the market continued to grow although the pace of growth slowed as the year progressed – Q1 saw growth of 18%, Q2 9%, Q3 3% and Q4 1%. The further growth in this market in 2023 was despite the subdued economic environment in 2023 and in part likely reflected pent-up demand, given recent low business investment, with many smaller businesses utilising ageing equipment and vehicles.

One regulatory change that may also have helped is that the full expensing of asset purchases was made permanent.[212] Although, as with the super deduction[213], specialist leasing businesses remain unable to use the allowances and pass them on to lessees. The Office for Budget Responsibility forecast that full expensing will increase real business investment by about £3 billion a year over the forecast period (up to 2028 to 2029).[214]

Sentiment about economic conditions and the prospects for new business growth picked-up slightly in the final quarter of 2023. The FLA's Q4 2023 Industry Outlook Survey showed that almost half of asset finance respondents (49%) expected economic conditions to improve slightly over the next twelve months, and more than three-quarters anticipated some increase in new business over the same period.[215]

Supply chain issues easing has supported vehicle expenditure

In last year's Small Business Finance Markets report we noted supply chain issues had continued to impact the availability of assets and that this had particularly impacted transport equipment and especially new car finance.[216] The ongoing easing of supply chain issues has led to significant increases in these markets in 2023.

The business new car finance and commercial vehicle finance sectors reported new business up 51% and 11%

respectively in 2023, compared with 2022. By contrast, new business provided for plant and machinery fell in 2023 by 6%, for business equipment decreased by 4% and for IT equipment finance fell by 24%.

Unsurprisingly, given growth was driven by increases in car and commercial vehicle leasing, operating leasing has seen a huge increase in 2023 (44%), far more than any other instrument. Operating leasing is a popular approach for many businesses who need cars or commercial vehicles. Furthermore, with the increases in the cost of purchasing, especially second-hand vehicles, leasing rather than purchasing a vehicle out right may have become more cost effective or a more affordable option for many smaller businesses.

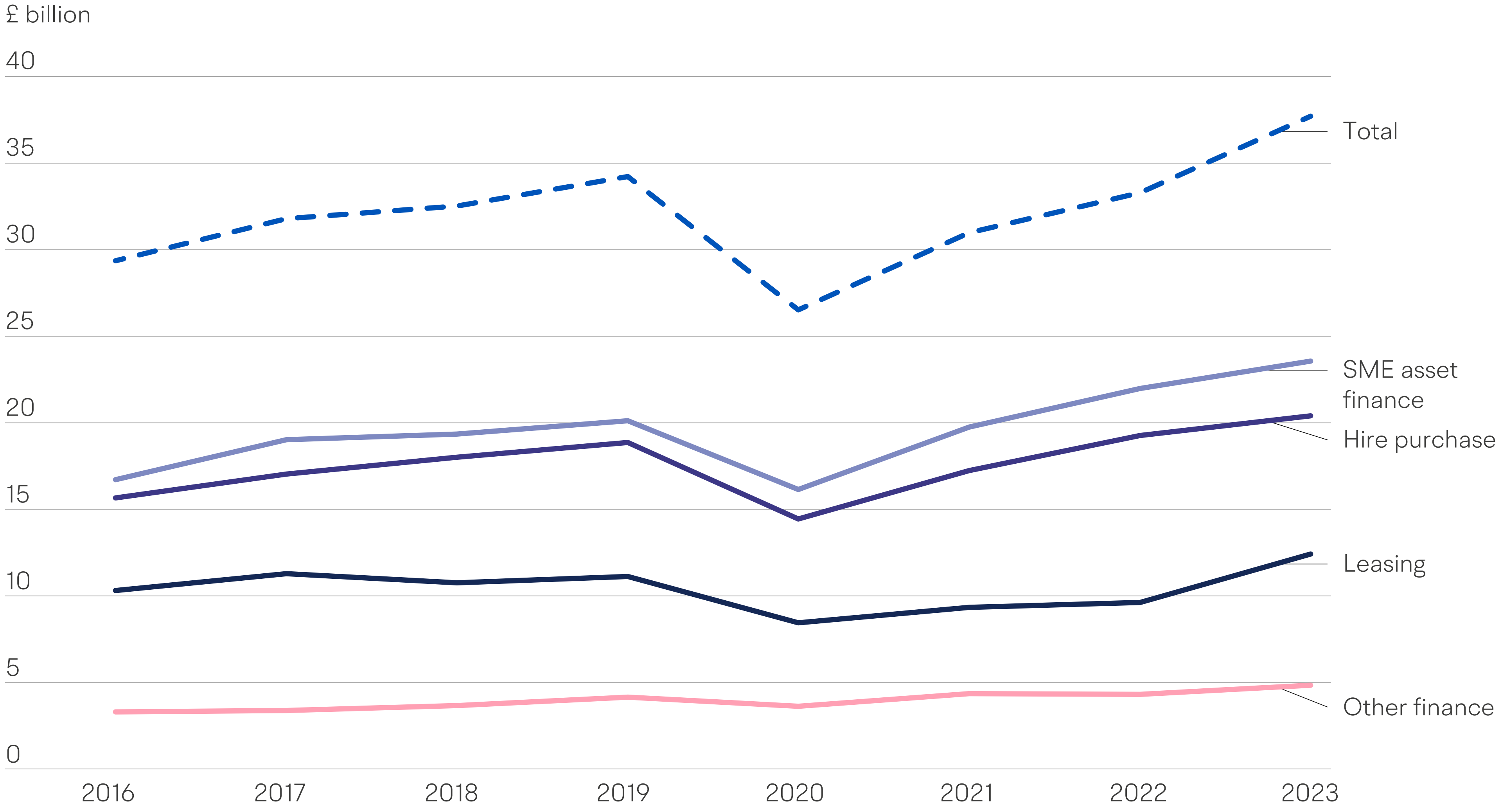
Asset finance application success rates are much higher than other finance products

As shown in the aggregate flow and stock of smaller business finance section, unlike asset finance, most major finance products showed decreases across 2023. As well as the continuing easing of supply chains and pent-up demand, asset finance application success rates have not only remained high at 99% but are in fact higher than in 2019 (95%).

Figure B.48

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.

This is in stark contrast to success rates for core bank lending products (Figure B.49). Bank lending success rates have fallen from 56% at the end of 2019 to 36% by Q2 2023 while overdraft success has fallen to 48% from 61% as the end of 2019. This difference likely reflects that asset finance has had historically low default rates and is largely underwritten on a loss given default basis rather than on probability of default basis like unsecured lending. As such, asset finance is less impacted by deteriorating credit ratings.

Broker and sales finance channels reported record levels of new business

Asset finance new business provided to SMEs through the direct finance channel increased 3% to £7.1bn in 2023 (Figure B.50), while broker-introduced SME finance grew 7% in 2023 and sales finance increased by 11%.

The direct sales channel was still 2% below its pre-Covid level in 2023 but broker-introduced finance reached a record £7.2bn in 2023, 29% higher than in 2019 and sales finance also reached a new high of £9.3bn, 28% higher than in 2019.

Figure B.49

Product success rate

Source: UK Finance BVA BDRC SME Finance Monitor, all applications Q1 22 to Q2 23 with a response.

As noted in the section 2.9 alternative lending and commercial broker finance, brokers can expose smaller businesses to a wider array of finance providers via their diverse lender panels. Therefore, some of the increases in the broker channel may be linked to the increase in asset finance provided by non-banks. The non-bank share stood at 35% in 2014 with much of the market supported by large banks. The non-bank share fell further to 33% in 2019. Post-covid, the share has increased and in 2023 was 37%.

Asset finance plays a significant role in helping smaller businesses invest and grow. The availability of asset finance will be crucial over the coming years for 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 the Recovery Loan Scheme, ENABLE Funding and the Investment Programme.

Figure B.50

Small business asset finance new business by channel

Source: Finance & Leasing Association (FLA)

2.11

Invoice and asset-based lending

The value of advances to smaller businesses were little changed in 2023

Average advances increased again in 2023

The number of smaller businesses using invoice finance & asset-based lending was flat throughout the year

New finance providers and lending models make the full picture less clear

IF/ABL providers expect to see continued appetite for their products

This section explores recent trends in invoice and asset-based lending.

Invoice finance & 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 UK businesses for centuries.

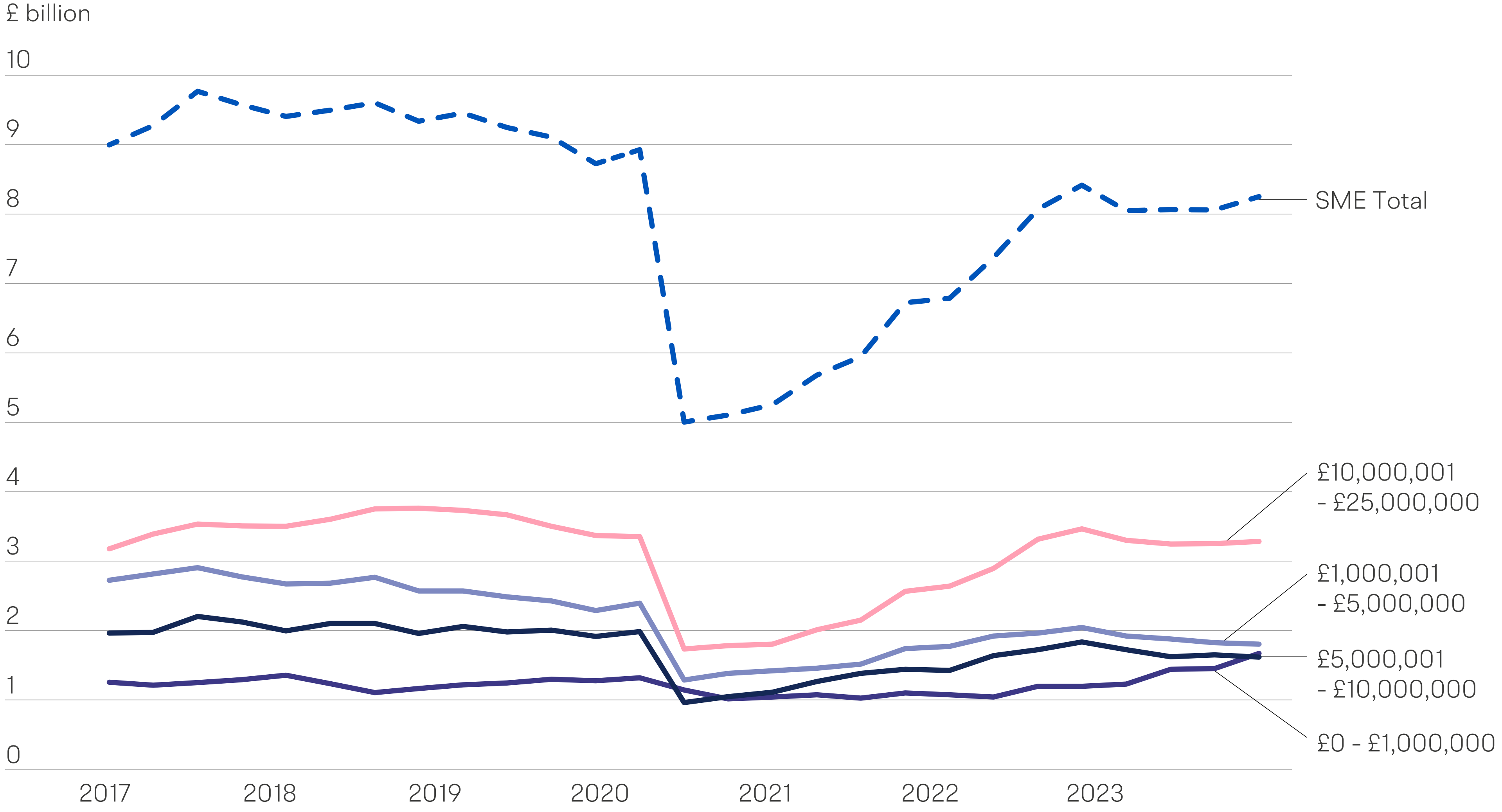
The value of advances to smaller businesses were little changed in 2023

Smaller business advances in 2023 remained around those levels seen in the last three quarters of 2022, at just above £8bn. While the Q1-Q3 quarterly average increased by 2.2% in 2023, this was entirely driven by Q1 which was 9.4% higher than the same quarter in 2022. In contrast, both Q2 and Q3 2023 settled lower than the 2022 equivalents, down 0.1% and 2% respectively (Figure B.51).

Figure B.51

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

Source: British Business Bank analysis of UK Finance data.



Note: 2023 is up to Q3

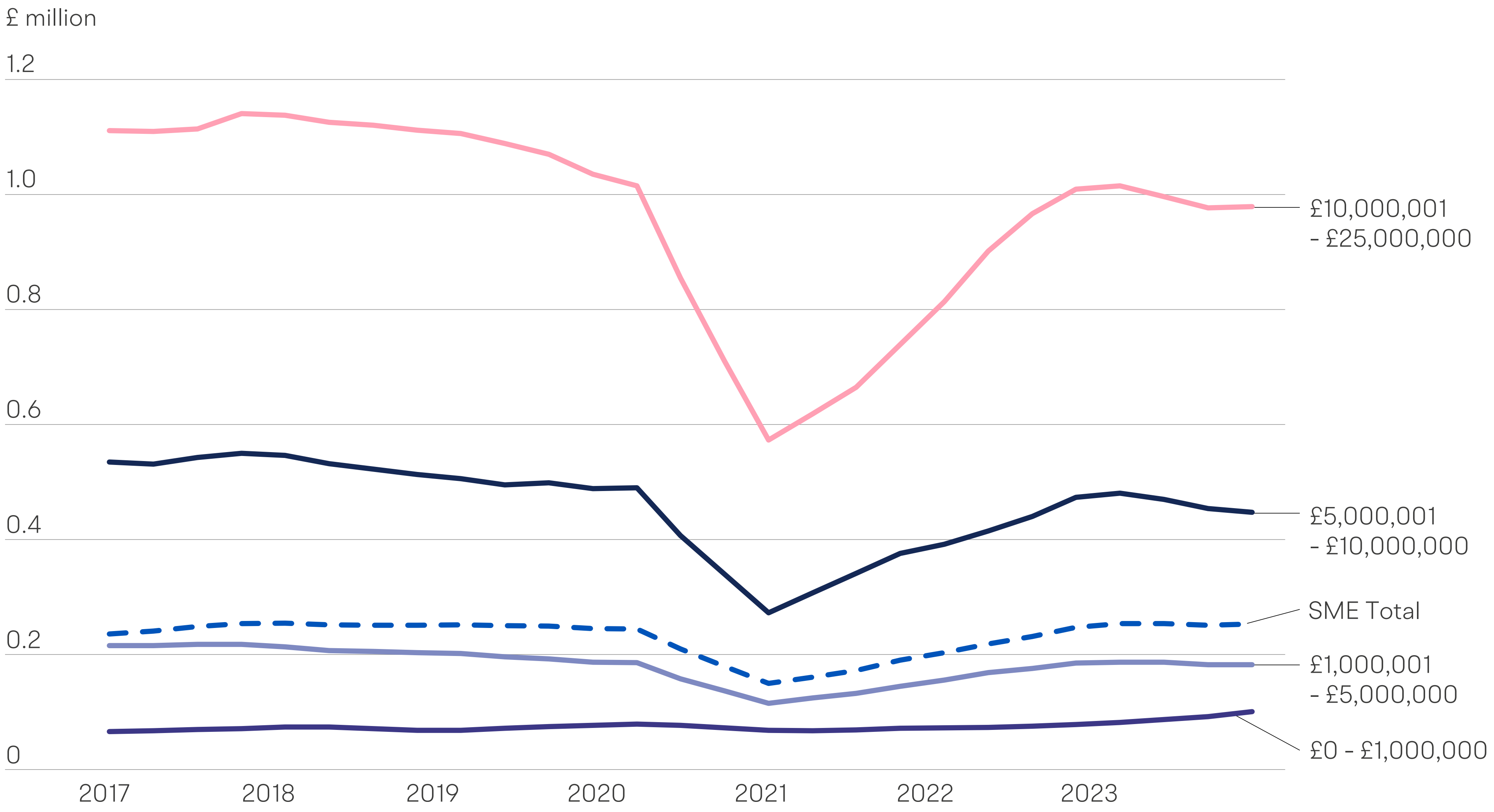
The 2023 Q1-Q3 average remained 12% below the pre-Covid 2019 equivalent and rather than further closing this gap, UK Finance estimates that at the end of Q4 2023, advances to smaller businesses will be similar to, if not slightly lower than the level seen at the close of 2022. This is partly driven by a quieter Q4 in terms of client sales, as indicated in the wider economic data. Early indications are that sales in Q4 2023 were around 2% lower than in Q4 2022, reflecting broader concerns over the economy slowing down.

Last year we noted it was predominately the case of the larger business size cohorts having the largest increase in advances, this has almost entirely reversed in 2023. The cohort of smallest businesses (turnover of £0-1m) has seen the largest increase (34%) in Q1-Q3 2023 advances. This is helped in part by submissions from many providers indicating a steady increase in the number of smaller businesses using invoice finance in the last year. The next two cohorts experienced decreases in advances of 7% and 6%. The largest cohort (£10-25m) saw advances grow again but only just (1%) and much slower than the previous year which saw extremely strong recovery from the pandemic (45%).

Figure B.52

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

Source: British Business Bank analysis of UK Finance data.



Note: Average of 3 quarters. 2023 is up to Q3.

Average advances increased again in 2023

While no individual quarter reached the series high of Q3 2022, consistently high outcomes across quarters led to a 2% growth in average advances per client business in Q1-Q3 2023 (£249,717) compared to the same period in 2022 (£243,950) (Figure B.52). In nominal terms, this was also 2% above the pre-Covid Q1-Q3 2019 level.

In 2022, the increase in average advances was broad based with all cohorts recording positive changes. The higher average advances in 2023 have been entirely driven by the smallest cohort which saw growth of 31%. All other cohorts saw a decrease, ranging from 2% to 6%.

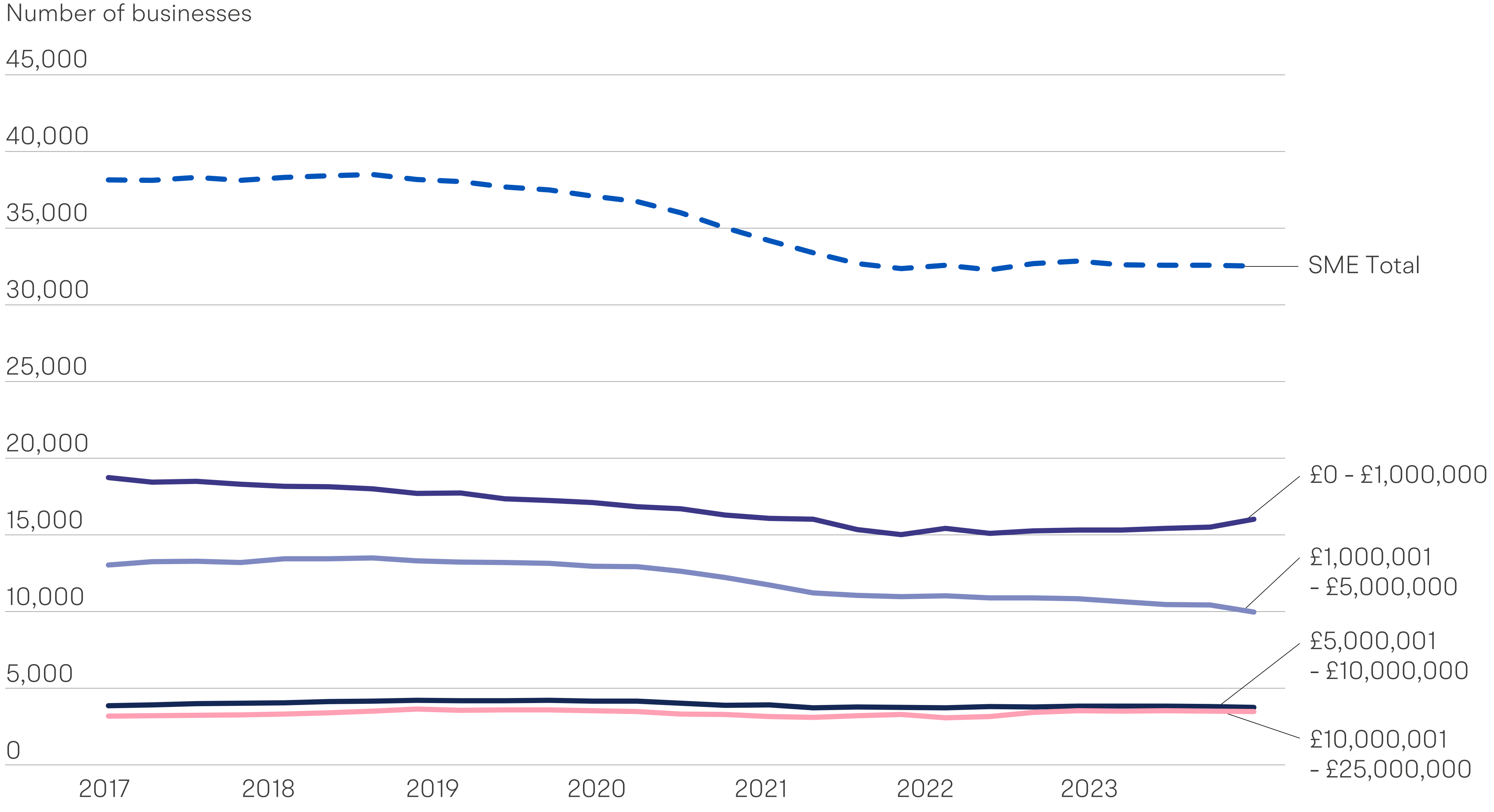
The number of smaller businesses using invoice finance & asset-based lending was flat throughout the year

The number of SMEs using IF/ABL was broadly flat (-0.1%) in Q1-Q3 2023 compared to the same period in 2022 (Figure B.53). There has been little change in numbers since Q2 2021 following a sharp fall during the Covid pandemic.

Figure B.53

Quarterly number of smaller businesses using invoice and asset-based lending, by turnover size cohort

Source: British Business Bank analysis of UK Finance data.



Note: 2023 is up to Q3

The picture remains more mixed when broken down by size cohort. The smallest cohort and the largest cohort both saw growth, 3% and 4% in client numbers respectively. The other two cohorts both declined, ranging from 0.4% to 9%.

For the smaller client businesses this is likely to reflect working capital requirements increasing because of inflation, cost pressures and particularly energy prices, potentially combined with a requirement to look back to commercially provided finance facilities as the funds released by the various Covid interventions rolled-off. For the largest cohort this follows an increase of 6% in 2022 and appears to be a continuation of the renaissance in the use of IF/ABL by larger companies.

New finance providers and lending models make the full picture less clear

There are more options for businesses than there were ten years ago when the Bank was established. Many of these next generation of products will have regard to debtor books and other assets for security but not always treat them in the way that ‘traditional’ whole turnover invoice finance providers will, in terms of taking assignment of (effectively purchasing) all the debts outstanding to a business client. In the invoice finance space, there are several specialist providers either focussing on specific sectors or offering single or selective invoice finance. Some of these will not be captured in the data referenced here, making the picture less clear.

IF/ABL providers expect to see continued appetite for their products

As in 2022, market contacts have continued to report increasing cash pressures within client businesses as the ongoing economic challenges impact cashflow. They have also seen further increases in insolvencies and fraud amongst the client base, albeit remaining limited. Despite this, many IF/ABL providers expect to see continued appetite for their products as banks tighten credit conditions on other products and the economic challenges continue.

The British Business Bank continues to support IF/ABL lenders via both the Recovery Loan Scheme, with the specific Asset-Based Lending variant launched in December 2023 to complement the Invoice Finance and Asset Finance variants, and British Business Investment programmes.

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