SME finance in London

Final report to the Greater London Authority

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Contents

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Executive Summary

Introduction and methodology

1. In July 2013, SQW and the Centre for Enterprise and Economic Development Research (CEEDR) at Middlesex University were commissioned by the Greater London Authority (GLA) to undertake research on SME finance in London. The aim of the study was to review current supply and demand for different types of finance and then identify the size, scale and type of funding gaps. The study considered whether there was evidence to justify a new publicly-backed finance initiative for SMEs in London.

2. The study involved: a desk-based review of academic literature and the most recent data-sets on supply and demand for SME finance; consultations with 28 stakeholders and financiers; and consultations with 13 individual businesses. There was a presentation of the draft findings to a meeting of the LEP SME working group on 16th September 2013.

Review of academic literature

3. The academic literature highlights that market failures in terms of SMEs accessing external finance have worsened since the economic downturn and although most attention has focused on the reduction in bank lending, the credit crunch has had an impact on all types of SME finance used for different stages of SME development. However, it is important to make the distinction between market failures and finance gaps. The extent to which the finance gap for SMEs, in London and across the country, is down to market failures is difficult to know and ultimately depends on how much of the unmet demand is coming from businesses with viable propositions.

London's business base

4. A consistent message from study consultees was that the needs and profile of SMEs in London are different to elsewhere in the UK. It has the highest start-up rates, the highest density of businesses and the highest incidence of high growth firms, across all sectors. London is seen as the main hub in the UK for startups and more high growth companies which is contributing to a substantially greater demand for external finance than elsewhere, and in particular for risk finance. Globally, London is increasingly being seen as a hot-spot for innovation and start-up activity which is helping to attract talent and investment particularly to areas such as Tech City.

Supply of SME finance

5. The data on both debt and equity finance clearly shows the reduction in supply in London over the last two to three years. Overall, the amount of supply for both types of finance is still markedly higher in London than in other parts of the country, as would be expected with the size of the business base. When supply is assessed as a proportion of the business base, London is slightly below the UK average in terms of bank finance, but in equity finance it is 50% higher. As confirmed in the study consultations, this is due to the concentration of

equity investors in the London area and clusters of high growth firms which are more likely to attract this type of risk finance.

6. The study feedback highlighted that it has become more difficult for London SMEs to secure bank finance owing to more stringent terms and conditions. An increased willingness from the banks to try to re-establish relationships with the SME community was acknowledged, and this has been helped by Government initiatives such as Funding for Lending and the Enterprise Finance Guarantee scheme. The main alternative providers of debt finance (in addition to the banks) in London were seen as the East London Small Business Centre and the GLE Group.

7. The main sources of VC finance were highlighted as being DFJ, Octopus and MMC. For seed/ early stage VC funding in London the main players include No 1 Seed, Notion, Playfair Capital and Passion Capital (all targeting seed equity at the digitech market in London). Although the supply of equity finance has reduced over recent years, there still remains significant levels of investment driven in large part by demand from high growth companies in new and emerging sectors such as the digital and creative sectors located in Tech City.

Demand for SME finance

8. An analysis of the Small Business Survey suggests that demand for external finance amongst London SMEs has increased marginally over the last two years. Around half of London SMEs seek finance for working capital but there are also more businesses in London than elsewhere looking for finance to grow and expand. The SBS data also suggest a higher likelihood of discouraged borrowers in London: this came through in the consultations with many highlighting the difficulty of startups with no track record or existing firms with cash flow problems looking for alternatives to bank finance because they did not expect to secure bank finance, or not at an affordable rate.

9. Assessing the demand for equity is challenging in the absence of detailed data based on a comprehensive survey (the SBS covers the whole SME market which overwhelmingly seeks debt finance). However, a recent Tech City survey showed that one in three businesses believed lack of investment cash is constraining their growth. This also came through in the consultations, which highlighted a resurgence in demand for risk finance both in terms of start-up/seed finance and VC funding to take firms to the next level of growth.

10. The feedback from consultations also indicated some increase in demand for alternative forms of finance (both debt and equity), as offered for example by Funding Circle, Zopa and CrowdCube. But overall levels of demand are relatively low and it would appear that the vast majority of SMEs has yet to look into these alternative sources.

Finance gaps

Overall scale

11. Using feedback from the most recent 2012 Small Business Survey and data from the UKBAA and BVCA, we estimated the current and projected finance gaps in London between 2012 and 2016. This approach is illustrative and cannot be regarded as definitive particularly because of a lack of robust data on the demand for equity finance. It is estimated that there is

currently a gap in debt finance of around £1 billion in London. The finance gap in relation to angel and VC funding is estimated to be around £343 million. Over the five year period, the aggregate SME finance gap in London is estimated to be over £7 billion (Table 1).

Table 1: Estimating the finance gap up to 2016 (£m)

	2012	2013	2014	2015	2016	Total 2012-16
Debt finance gap	£1,087	£1,108	£1,131	£1,153	£1,176	£5,655
Angel/ VC finance gap	£343	£350	£357	£364	£372	£1,787
Total finance gap	£1,430	£1,459	£1,488	£1,517	£1,548	£7,441

Source: SQW

12. The approach described above to estimating the economic value of the finance gaps in London highlights the magnitude of the issue, particularly in terms of debt finance. However, it should be recognised that there are a range of initiatives and funds that are available (or which will soon be available) which will be meeting some of this unmet demand including Funding for Lending, the Business Bank, Business Angel Co Investment Fund and Enterprise Capital Funds.

13. It is difficult to quantify how far these initiatives will address the finance gaps in London. On the supply side, there remains a large degree of uncertainty around some initiatives such as the Business Bank. The availability of finance in the future will also be highly dependent on the performance of individual funds. It is also difficult to predict how much of the available finance will be allocated to London SMEs. Economic conditions will determine scale of demand and there is also the viability of the applications to factor in. The challenge for the GLA in developing any new Fund is to work with existing initiatives to make sure any new initiative complements and fits with other funds being developed by the public and private sectors.

Main areas of finance gaps in London

14. We conclude from the research, that there are currently five main areas in which London's SMEs face gaps in finance. The first two relate mainly to debt finance and have been exacerbated by the reduction in bank finance. Alternative sources of funding are appearing but awareness remains low. These gaps are around i) small scale debt finance to enable startups to begin to operate and ii) re-financing to manage debt, where the company is judged to lack track record, and probably does not have high growth potential, but is potentially viable over a reasonable time perspective, and may generate some new, otherwise unrealisable, opportunities as the economy moves on again. .

15. On the equity side, most of the feedback acknowledged the existing supply of equity finance in London but reinforced the fact that demand is, and will continue to, outstrip supply. The situation is fairly fluid, as there has been a marked rise over the last two years in the rate at which new business angel/HNW individuals have entered the market, and new funds have been marketed in London with different approaches and profiles. But there is also some evidence that these new entrants may be more conservative/more interested in syndicated deals than their predecessors, while most of the latter's resources are locked into existing investments. Three main finance gaps were identified: angel investment for amounts of

between £50k and £250k; early stage VC funding around the traditionally recognised £250k to £2m; and larger scale equity for large growth companies.

Recommendations for GLA activity

16. The consultations with stakeholders and financiers confirmed that the well-established 'system failure' in small scale equity provision continues to exist, and under present market conditions – for reasons linked both to demand and supply – the gap may be growing in scale and significance. The picture is complex and changing, but the consultations identified other areas, with regard to debt finance, where there are also issues related to the on-going withdrawal of the banks.

17. Unanimity of views could not be expected, given the different interests involved, and while the specific role of Business Bank and the future of CfEL are still being resolved. But the great majority of those consulted on the five funding gaps saw these gaps as highly likely to persist; more tentatively, there was also a degree of consensus on where and how GLA might work towards plugging these gaps. Potential areas of activity for GLA are presented in Table 2 below.

Table 2: Main finance gaps and potential role for GLA

Finance gap	Type of finance	Likely persistence of gap	Potential role for GLA
Mezzanine funding	Debt, with link to equity	Medium-term	• Market broking: information to SMEs; networking & enabling with banks & other funding providers; consider further possible direct role alongside private funders, drawing in EU finance. GLA would need to work closely with the Business Bank to ensure there was no duplication • Encouraging more businesses to access mezzanine finance would help increase SME knowledge of equity funding with the likely effect of pushing businesses to be more ambitious in terms of the SME finance escalator
Start-up finance	Debt	Medium term	• Amplify London district and London-wide provision, working primarily through CDFIs. If supporting the provision of start-up grants and/or loans, the GLA would need to recognise that the funding is unlikely to be recycled
Angel finance	Small scale equity: £50k+	Medium-long term	• Market broking, focused on supply side: initiatives to facilitate effective networking between providers- forming links, also linking with next-stage VC funders; investigate scope for enhancing provision by bringing EU funding alongside existing providers
Small-scale equity	£250k-£2m equity	Long term	• Establish small equity fund, with clear aim of focusing on plugging specific gap/s for a defined investment period; investigate arms-length management options, including adding to established fund management operations; develop parameters for exit

Finance gap	Type of finance	Likely persistence of gap	Potential role for GLA
			strategy • Operate separately an 'investment readiness' programme, utilising others with direct experience in the market
Medium-scale equity for new/ complex technology firms	£2m-£10m	Long term	• Build co-funding mechanism, linked to existing fund manager, with risk equally shared between public and private sector to minimise state aid issues

Source: SQW

18. Even at a time of churn, these potential roles for the GLA are in areas where the funding system is, we judge, highly likely to remain sub-optimal from the business user perspective: intervention at the London level might be expected to have a significant beneficial economic effect. In putting forward these suggestions, which essentially seek to use public money to facilitate and plug gaps where purely private actions are producing sub-optimal economic return, it is recognised that public resources are also limited and the potential benefits must be balanced against those from meeting other demands.

19. If the recommendations are taken forward, an emerging initiative – in total and in terms of its constituent elements – should be subjected to market testing and appraisal. The identified gaps are seen as medium-long term, and any response will need to be shaped with a view to this timescale as well as taking into account the potential efficiencies from scaling, But the funding system is changing substantially, with the emergence of new players and new mechanisms such as crowdfunding, and on-going review will also be important.

20. The interest of GLA, and its potential roles, were warmly received by those involved in SME funding in London. But a new public initiative, particularly at this time, will need to continue to be seen as relevant and appropriate monitoring and evaluation systems and processes will need to be put in place. The initiative's effectiveness and fit with other schemes should be subject to independent evaluation after no more than two years of operation. Assessing the financial and economic impact of any new initiative will need to take into account the relatively long timescale required for equity schemes to generate returns.

1. Introduction

1.1 In July 2013, SQW and the Centre for Enterprise and Economic Development Research (CEEDR) at Middlesex University were commissioned by the Greater London Authority (GLA) to undertake research on SME finance in London. The aim of the study was to review current supply and demand for different types of finance and then identify the size, scale and type of funding gaps. The study considered whether there was evidence to justify a new publicly-backed finance initiative for SMEs in London.

Background to the study

1.2 The importance of providing access to finance support to SMEs has been recognised in London's recent economic development strategy and policy documents. The Mayor's Economic Development Strategy[1] includes an objective to ensure that London has the most competitive business environment in the world.

1.3 Whilst acknowledging that London has a strong investment community, the Economic Development Strategy suggests that there are finance gaps in London which are holding back the implementation of good and innovative business ideas. In addition, the Mayor's Economic Development Strategy has an objective to make London one of the world's leading low carbon capitals by 2025 and a global leader in carbon finance.

1.4 The London Enterprise Panel (LEP) is the local enterprise partnership for London and was set up in 2012. Supporting SMEs is one of the LEP's four key priorities. In the LEP's recent Jobs and Growth Plan[2], there were four main areas of activity for supporting SMEs: access to finance; increasing trade and exports; workspace; and business support and networks. Under access to finance, partners agreed to map out the current provision, identify any gaps the LEP could fill, and assess the need and potential for a finance scheme of up to £25 million to leverage funding which would assist London SMEs with potential to grow that are having difficulties accessing capital.

1.5 At the same time as launching the Jobs and Growth Plan, the LEP published London's Growing Places Fund Round 2 Prospectus[3]. This involved a call for projects over the summer of 2013 under the four priority areas. Around £40 million is likely to be available for projects, of which around £25 million has been ring-fenced for a finance initiative. Bids from potential suppliers have been invited, to test market views of where and how a new mechanism might be pitched. We understand that the bids received by GLA will be considered alongside the findings of this study in late 2013 to decide what actions the GLA will take to address any finance gaps for SMEs.

Methodology

1.6 The study was undertaken by SQW and Dr Robert Baldock from Centre for Enterprise and Economic Development Research (CEEDR), Middlesex University Business School. The

[1] Mayor of London (2010), The Mayor's Economic Development Strategy for London
[2] London Enterprise Panel (2013), Jobs and Growth Plan
[3] London Enterprise Panel (2013), London's Growing Places Fund Round 2 Prospectus: Request for proposals

project team also included Adrian Lewis from Sanders Thomas Ltd. The team is grateful to all the individual consultees who contributed to the study both in terms of time and signposting us to relevant data and research.

1.7 The study involved the following main research tasks.

- A desk-based review of policy and academic literature on access to finance for SMEs. Whilst most of the literature tends to focus on the UK situation as a whole, there are certain implications which can be drawn out that are particularly relevant to Greater London.
- A desk-based review of relevant data-sets on the supply and demand of SME finance in London. On the supply-side, the main data sources used were British Banking Association (BBA) lending data, British Venture Capital Association (BVCA) statistics, Capital for Enterprise (CfEL) investment data. The main sources of data reviewed on SME demand were the Small Business Survey (SBS), the SME Finance Monitor and Federation of Small Business surveys.
- Consultations with stakeholders and financiers. These discussions covered the availability of SME finance and recent trends, current levels of demand and how this has changed and to what extent it is different to other parts of the UK. We also asked consultees about whether there are market failures and finance gaps and if so what types of businesses are worst affected. Overall we consulted with 28 individuals.
- Consultations with businesses. These undertook short interviews with 13 businesses with discussions primarily focused on individual experiences of applying for debt and equity finance.
- Presentation of draft findings to the LEP SME working group on 16th September 2013.

1.8 This final report consolidates and updates the findings from an Interim Report and Consultation Report and also feedback from the presentation to the LEP SME working group on 16th September 2013.

Structure of the report

1.9 The report is structured as follows.

- Section 2 provides context in terms of the recent academic and policy literature on market failures and finance gaps, how these gaps have changed over recent years and whether the gaps are more relevant to different types of businesses.
- Section 3 contains a profile of the London SME base and its characteristics relative to other parts of the country. Data on start-up rates, business density and prevalence of high growth firms have been included.
- Section 4 assesses the evidence on the supply of SME finance in London including a review of the available data from BBA, BVCA and CfEL, and a summary of the qualitative feedback from our own primary research. We also include case studies of some of the main sources of SME finance in London.

- Section 5 presents a review of the evidence of demand for SME finance. This draws on data from SBS, SME Finance Monitor, FSB surveys and the qualitative evidence from our consultations.
- Section 6 summarises the key points from consultees on finance gaps for SMEs in London, including an attempt to quantify the gap
- Section 7 presents our conclusions and recommendations on where we see the GLA having a role in addressing some of these finance gaps.

2. Market failures and finance gaps

2.1 In this section we provide context in terms of reviewing recent academic and policy thinking on market failures, and gaps between the supply and demand for SME finance. Inevitably most of the literature tends to focus on the UK situation as a whole but there are certain implications which can be drawn out that are particularly relevant to Greater London, based on the specific characteristics of London-based businesses.

Distinction between market failures and finance gaps

2.2 The Department for Business, Innovation and Skills (BIS) recently produced a review of SME Access to External Finance (2012)[4]. The review describes the main market failures as relating to imperfect or asymmetric information on both the demand and supply side[5].

2.3 In terms of debt finance there is perceived to be a financing gap for businesses that lack track record and collateral, which makes it difficult for the lender accurately to assess risk[6]. As a result, some young companies with good business ideas fail to secure the funding they require to grow[7]. The BIS review also highlights the existence of an 'equity gap' for high growth potential SMEs. For example, many SMEs with growth potential may only require relatively small investments, particularly at an early stage but, due to the risk and due diligence costs, investors and risk capital fund managers tend to focus on fewer, larger investments in more established (lower risk) businesses[8].

2.4 There is an important distinction to be made between market failures in financial markets and finance gaps (CEEDR, 2009)[9]. Business surveys show that in some cases where a firm is unsuccessful in applying for finance the owner manager acknowledges that the barrier to securing funding was down to the weaknesses of the business case or the viability of the company. A market failure in financial markets only occurs when a viable business proposition fails to secure the required finance.

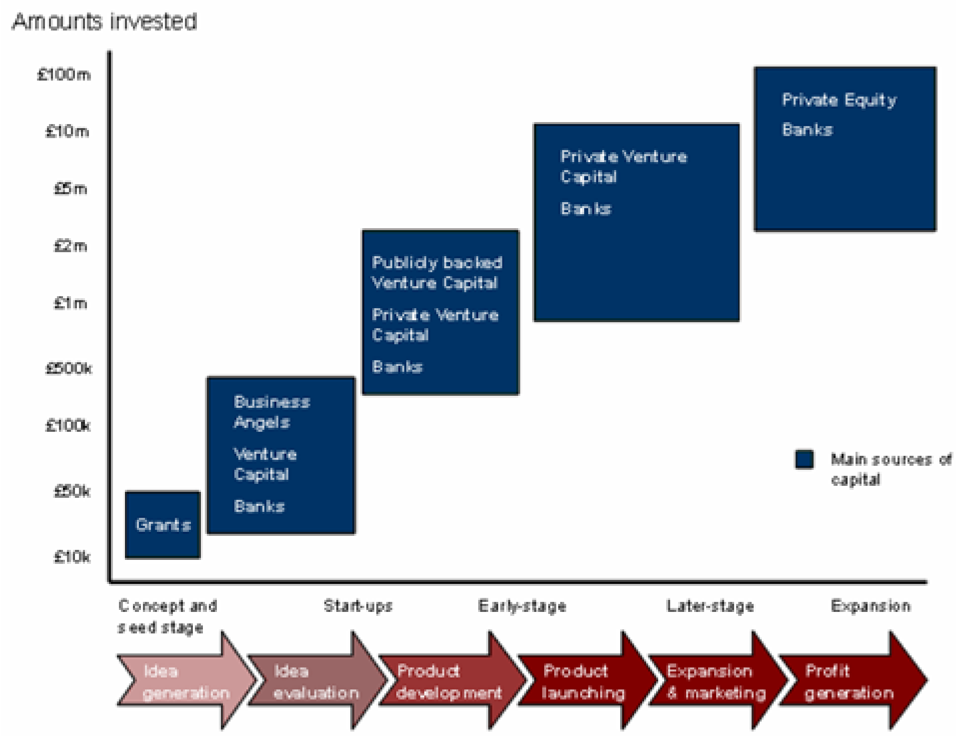
2.5 This highlights the importance of 'investment readiness', which is the ability of owner managers to identify and decide upon appropriate types and sources of finance, and to make winning pitches. The lack of investment readiness can be a barrier to implementing supply side schemes in the access to finance area. As is noted by an OECD discussion paper, owner managers may lack the information and skills required, in particular to make choices between debt and equity sources of finance: there is a natural aversion to equity, as this is seen as 'giving away' some of the business; also to make the case to financiers[10].

[4] BIS (2012), SME Access to External Finance: BIS Economics Paper no.16
[5] Mason & Kwok (2010) Investment readiness programmes and access to finance: a critical review of design issues; Hsu D. (2004) What do entrepreneurs pay for venture capital affiliation
[6] Stiglitz & Weiss (1981) Credit rationing in markets with imperfect information
[7] Oakey (2003) Funding innovation and growth in UK new technology-based firms: some observations on contributions from the public and private sectors
[8] Mason et al (2010) The City's Role in Providing for the Public Equity Financing Needs of UK SMEs
[9] Middlesex University (2009), London Development Agency Access to Finance Scoping Study
[10] Mason, C. and Kwok, J, Facilitating access to finance: Discussion Paper on Investment Readiness Programmes, OECD [Available at http://www.oecd.org/daf/psd/45324336.pdf]

Changes in finance gaps in recent years

2.6 SME finance market failures and finance gaps have worsened since the economic downturn. A lot of the attention has focused on the reduction in bank lending primarily because this is the main source of SME finance[11]. However, the recession and credit crunch has had an impact on all types of SME finance used for different stages of SME development, as typified in the SME finance escalator (Nesta, 2009)[12], which is shown below.

Figure 2-1: SME Finance Escalator



Source: Nesta (2009)

More acute finance gaps for innovative firms?

2.7 Cowling et al (2012)[13] reviewed how SME financing has changed since the economic downturn. Their research found that during the recession lenders tended to focus on firm size rather than growth potential. This has resulted in small firms with potential to grow being constrained by limited investment finance.

2.8 The research also found that the fall in the supply of finance has been followed by a reduction in demand for finance by SMEs. Some of the reduction in demand will have been the result of SMEs being discouraged from applying for debt finance because of the changes in lending criteria. Credit rationing is believed to have peaked in early 2009 when around 119,000 businesses were denied credit. Cowling et al concluded that the recession has led to a significant decrease in the ability of smaller firms to access external credit, and that this may have limited their potential to contribute to economic recovery.

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[11] Fraser, S. (2009) Small Firms in the Credit Crisis: Evidence from the UK survey of SME finances
[12] Nesta (2009), Reshaping the UK Economy: the role of public investment in financing growth
[13] Cowling et al (2012), Small business financing in the UK before and during the current financial crisis

2.9 North et al (2013)[14] also highlight that during and since the economic downturn it has become more difficult for innovative Technology Based Small Firms (TBSFs) to access external finance. TBSFs seeking early stage finance are described as being the worst affected. In terms of equity finance, the research found that the equity gap between £250,000 and £2 million has worsened due to blockages in business angel investment and early stage private equity, with venture capitalists increasingly preferring fewer larger investments focused on later stage developments. With debt finance, the study indicates that TBSFs have found that banks are requiring higher levels of security and collateral than they can afford.

2.10 Research by Lee et al (2013)[15] highlights that innovative firms are more likely than other firms to apply for finance and that the gap has widened since the recession. Based on analysis of the Small Business Survey results from 2008, 2010 and 2012, the study found that innovative firms now find it harder than all firms to access finance. Moreover, since the recession it has become more difficult for all firms to secure finance.

Some sectors are also more vulnerable to finance gaps

2.11 In recent years certain sectors have been judged to face increased difficulties in accessing finance in comparison to others. For example, certain creative industry sub-sectors have reportedly found it more difficult to access finance. An analysis carried out by Fraser (2011)[16] found that the software, publishing, and TV and film sub-sectors are more likely to have finance applications declined compared to non-creative industry businesses. The research suggests that this comes down to viability of the firm and a lack of understanding between the businesses and finance providers (i.e. heightened asymmetric information).

2.12 Research carried out by GLA investigated why the UK, and London specifically, has not been as successful as the US in developing global firms such as Facebook or Google[17]. The research highlighted that there are equity gaps for startups and early stage companies, particularly in London because of the concentration of high tech sectors (e.g. social media, life sciences and software) which are more likely to require finance to fund growth. It is maintained that these sectors need more start-up funding to enable them to grow and stay in London.

2.13 Recent research by Technopolis (2011)[18] into the European VC market highlights the importance of size and scale of these funds to address the financing requirements of young innovative businesses. Not only do they need to provide early stage risk investment, but they also need the ability to provide follow-on early growth finance. GFK's (2013)[19] survey of London's Tech City businesses highlights the need for seed finance and adequate VC follow-on funding to get these businesses to market, and also highlights the need for a viable AIM and specialist LSE young tech business IPO market for VC exits[20].

[14] North et al (2013), Funding the growth of UK technology-based small firms since the financial crash: are there breakages in the finance escalator?
[15] Lee et al (2013), Credit and the crisis: Access to finance for innovative small firms since the recession
[16] Fraser (2011), Access to Finance for Creative Industry Businesses
[17] GLA (2011), The UK equity gap: Why is there no Facebook or Google in the UK?
[18] Technopolis (20011) The Role of Different Funding Models in Stimulating the Creation of Innovative New Companies. What is the most appropriate model for Europe?
[19] GFK (2013) TechCity Futures
[20] CEEDR (2013) Investigation into the motivations behind the listing decisions of UK companies

Future targeting of access to finance support

2.14 Publicly funded access to finance support initiatives need to be based on where there are known finance gaps and evidence of market failures. However, it is also interesting to consider if support should be targeted on certain types of businesses. A recent paper by Mason and Brown (2013)[21] criticised suggestions that business support should move away from start-up programmes and focus on high growth business support programmes. Mason et al maintain that the heterogeneous nature of high growth firms in sector, age and size make it difficult to target support on certain types of businesses. They state that high growth firms are not only found in technology-rich sectors. Taking a pipeline approach, it is argued that there should continue to be support for startups but focused on new firms with certain growth-related characteristics (e.g. approach to innovation and internationalisation).

Summary of academic review

2.15 Market failures in terms of SMEs accessing external finance have worsened since the economic downturn and although most attention has focused on the reduction in bank lending, the credit crunch has had an impact on all types of SME finance used for different stages of SME development.

2.16 It is important to distinguish between market failures and finance gaps. The extent to which the finance gap for SMEs, in London and across the country, is down to market failures is difficult to assess, as it ultimately depends on how much of the unmet demand is coming from businesses with viable propositions.

2.17 There is significant academic evidence that innovative firms are more likely than other firms to apply for finance and that the gap has widened since the recession. Analyses of the Small Business Survey results from 2008, 2010 and 2012, found that innovative firms now find it harder than all firms to access finance.

2.18 As we go on to discuss in the next section, since London has a greater concentration of high technology and innovative firms, the finance gap for innovative firms is a significant cause for concern.

2.19 However, as we also discuss London already attracts greater levels of SME finance, and particularly equity finance, compared to other parts of the country. The key question is obviously the extent to which supply is currently meeting levels of demand.

[21] Mason, C and Brown, R (2013), Creating good public policy to support high growth firms

3. London's business base

3.1 The purpose of this section is to provide more context on the London SME base and its characteristics relative to other parts of the country. A consistent message highlighted in our consultations was that the needs and profile of SMEs in London are different to elsewhere: we found that several important points of distinction were supported by the available data, as set out below.

Start-up rates and business churn

3.2 Data for the last two years on business births show that London has the highest start up rate across the UK regions and countries. It has also one of the highest death rates, but the balance of births over deaths has been more positive than in all other parts of the UK. London's high business 'churn' rate reinforces the perception of a dynamic and competitive city-regional economy.

Table 3-1: Business birth rates, death rates and churn (% of all active enterprises)

	2010			2011		
Region/ country	Birth rate (%)	Death rate (%)	Churn	Birth rate (%)	Death rate (%)	Churn
London	12.8	11.6	24.4	14.6	10.4	25.0
North East	9.4	11.0	20.4	11.2	9.9	21.1
North West	9.7	11.2	20.9	11.1	10.7	21.8
Scotland	10.0	9.8	19.8	10.9	9.1	20.0
South East	9.8	10.2	20.0	10.8	9.5	20.3
West Midlands	9.4	11.0	20.4	10.5	10.0	20.5
East	9.5	10.1	19.6	10.5	9.6	20.1
Yorkshire and The Humber	9.9	11.1	21.0	10.5	10.0	20.5
East Midlands	9.1	10.7	19.8	10.3	9.8	20.1
South West	8.6	9.6	18.2	9.6	9.2	18.8
Wales	8.3	10.2	18.5	9.3	9.5	18.8
Northern Ireland	7.8	8.9	16.7	6.5	8.6	15.1
United Kingdom	10.0	10.6	20.6	11.2	9.8	21.0

Source: ONS – Inter Departmental Business Register

Business density

3.3 The size and spatial concentration of the London economy, as measured by all key economic metrics (businesses, employment, sales, GVA etc), is different to other parts of the country. Not only does London have the highest number of SMEs and businesses generally, but it also has the highest density of businesses, measured per head of population. This is shown in Table 3-2, below.

Table 3-2: Business density

UK region/ country	No. of businesses per 10,000 adults (2012)
London	1,231
South East	1,098
South West	1,096
East of England	1,080
East Midlands	880
West Midlands	818
Y. and the H.	806
Northern Ireland	798
Wales	769
North West	754
Scotland	735
North East	625
U.K.	935

Source: BIS (2012) Business Population Estimates

3.4 Greater concentration of businesses in all types of sectors makes London a magnet for attracting workers and investment, and consultees highlighted emerging new rapidly growing clusters of economic activity, where numbers were increasing and individual businesses were growing rapidly.

High growth firms/ SMEs

3.5 Several studies have highlighted the importance of high growth firms to overall economic growth and employment creation. For example, a Nesta study (2009)[22] showed that 6% of UK businesses with the highest growth rates generated half of the new jobs created by existing businesses between 2002 and 2008, and suggested that economic policy should focus on promoting innovation and on the small number of companies with high growth potential, rather than broadly based business support programmes for new startups and SMEs.

3.6 Recent data produced by the Business Growth Fund[23] highlighted that there are currently over 4,300 mid-sized SMEs demonstrating high levels of growth (defined as 33% sales growth over the last three years) across the UK. This is 10% higher than a year ago.

3.7 As shown below, the data show that London has the highest incidence of high growth firms, with 19% of these mid-sized firms. It also has nearly 40% of all the high growth firms in the UK (much higher than the 17% of all SMEs and all businesses). In other words, a disproportionately high proportion of high growth firms are based in London.

[22] Nesta (2009), The vital 6 per cent
[23] BGF Growth Companies Barometer - http://www.businessgrowthfund.co.uk/growth-companies-barometer-2013/

3.8 Many consultees emphasised the concentration of high growth sectors in London and the emergence of start-up hotspots for digitech and creative sectors such as Tech City in East London.

Table 3-3: Incidence of High Growth Firms across the UK

Region	Total Population	High Growth Firms	Incidence of HG Firms	% of all HG Firms
London	8,518	1,619	19%	37%
Yorkshire & Humberside	1,508	269	18%	6%
South East	4,177	711	17%	16%
North West	1,894	320	17%	7%
Wales	509	85	17%	2%
South West	1,462	244	17%	6%
East Anglia	2,158	358	17%	8%
Scotland	1,361	224	17%	5%
North East	505	80	16%	2%
East Midlands	1,249	194	16%	4%
West Midlands	1,614	249	15%	6%

Source: BGF Growth Companies Barometer 2013

London's international profile

3.9 London has one of the largest city economies and is a global centre for international finance[24]. When measuring the characteristics of the London economy and business base it is therefore important to compare with other major global cities. In our research, some of our consultees emphasised the growing profile of London in relation to technology startups, innovation and the availability of equity finance to support these startups.

3.10 The city's international standing can be seen in recent research produced by the Startup Genome project[25] which shows that London is viewed as the seventh highest performing global city in terms of its start-up ecosystem: five of the leading six are US cities. The research takes into account entrepreneurship activity, the performance of startups, funding and other support that is available. According to the report, 'in recent years London has burst onto the scene and has become the most successful Startup Ecosystem in Europe, producing the largest output of startups in the European Union by far'. As shown in Figure 3-1, the top three cities are reported to be Silicon Valley, Tel Aviv and Los Angeles.

[24] Oxford Economics/ City of London Corporation (2011), London's Competitive Place in the UK and Global Economies
[25] Startup Genome (2012), Startup Ecosystem Report 2012. The project brings together researchers from Stanford University and the University of California, Berkeley

Figure 3-1: Ranking of global start-up ecosystems

Ecosystem	Ranking	Startup Output Index	Funding Index	Performance Index	Talent Index	Support Index	Mindset Index	Trendsetter Index	Differentiation from SV Index
Silicon Valley	1	1	1	1	1	1	1	1	1
Tel Aviv	2	2	1	12	5	5	9	17	18
Los Angeles	3	4	6	2	3	13	11	4	11
Seattle	4	19	7	6	2	4	6	11	14
New York City	5	3	4	8	12	9	8	7	8
Boston	6	10	1	7	7	8	7	5	20
London	7	7	5	10	9	2	3	14	17
Toronto	8	6	9	3	10	3	15	12	5
Vancouver	9	13	12	9	4	14	2	9	19
Chicago	10	8	15	5	14	7	13	18	9
Paris	11	14	13	4	17	6	12	15	6
Sydney	12	5	14	16	6	12	16	1	3
Sao Paulo	13	9	10	15	19	11	5	16	4
Moscow	14	16	19	18	11	10	14	8	2
Berlin	15	15	11	13	13	20	18	5	16
Waterloo	16	11	16	14	16	17	17	10	13
Singapore	17	18	8	19	8	16	20	19	12
Melbourne	18	12	17	20	15	18	19	3	15
Bangalore	19	17	18	17	18	15	10	20	10
Santiago	20	20	20	11	20	19	4	13	7

Source: Startup Genome Project

Business profile summary

3.11 The above data-sets illustrate how London differs from other parts of the country and provide some context for the consensual message coming through the consultations. London is seen as the main hub in the UK for startups and more high growth companies which is contributing to a substantially greater demand for external finance than elsewhere, and in particular for risk finance. Globally, London is increasingly being seen as a hot-spot for innovation and start-up activity which is helping to attract talent and investment.

4. Supply of SME finance

4.1 This section of the report reviews the supply of SME finance in London. A summary of the main findings of the desk review is included below with additional analysis provided in Annex B. In addition, we also provide a summary of the feedback from our consultations with stakeholders, financiers and businesses.

Desk review

4.2 The main source of data on debt finance is the BBA figures on bank lending by all the major high street banks. The table below shows all data for London over the last seven quarters. All indicators in terms of the number and value of loan and overdraft facilities approved as well as the level of loan repayments have been on a downward trend. Although the value of overdraft facilities approved only dropped marginally from £214 million to £211 million (1% decrease), there has been a significant decrease in the value of loans approved to London businesses, dropping from £1.6 billion in quarter three of 2011 down to £0.9 billion in the first quarter of 2013 (representing a reduction of 45%).

Table 4-1: Supply of overdraft and loan facilities over time for SMEs in London

	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	% diff.
Value of overdraft balances (£m)	1,411	1,280	1,591	1,438	1,405	1,316	1,324	-6%
No. of overdraft facilities approved	8,923	8,382	10,634	8,755	8,559	7,945	8,447	-5%
Value of overdraft facilities approved (£m)	214	175	224	164	186	217	211	-1%
Value of loan balances (£m)	19,737	19,324	19,130	19,032	18,608	18,465	18,453	-7%
No. of loan facilities approved	7,774	6,270	7,338	5,897	5,363	4,950	6,216	-20%
Value of loan facilities approved (£m)	1,653	1,275	1,174	919	875	976	903	-45%
New Loans (£m)	1,347	1,235	1,327	1,085	1,083	1,116	1,153	-14%
Loan repayments (£m)	1,599	1,475	1,273	1,219	1,290	1,286	1,186	-26%

Source: BBA

4.3 As would be expected, given the size of London's business base, it continues to have the highest number of loans and greatest value approved across the UK regions and countries. However, when analysing the numbers based on the business base (e.g. per 10,000 SMEs), the region does not fare so well. There are currently 77 loans approved per 10,000 SMEs in London compared to 90 per 10,000 SMEs in the UK (except Northern Ireland). The only region with a lower figure is the South East with 59 loan facilities approved per 10,000 SMEs. Whilst this could be interpreted as y insufficient supply of bank finance for London's SMEs, but it might also be the result of lower demand. In our later analysis we present data which shows demand for bank finance is lower in London than in other parts of the country.

4.4 Other BBA recently published data[26] showed the combined bank lending (loans and overdrafts) to SMEs in London in 2012 was £20.6 billion. This represented a 4.2% decrease on the equivalent figure for 2011. In 2012 the London postcode areas with the highest total level of SME lending were W and SW whereas Sutton (SM) and WC have attracted comparatively small levels of bank lending. There are only two postcode areas (NW and Harrow) where lending levels have actually increased between 2011 and 2012. All the BBA data reinforces the common perceptions that, over the last few years, banks have been lending less to SMEs. However, the extent to which this is down to supply or demand factors is more difficult to gauge: as shown later, even if London firms are at least as likely to look to expand using external finance, they may be accessing a wider range of sources of funding.

4.5 On the equity side, the main dataset is produced by BVCA. Between 2010 and 2012, while investment levels fell markedly, London accounted for approximately a quarter of all companies invested in by VCs, and well over a third of all financial investment by VCs. This reflects the fact the size of the business base in London, but also a strong tendency for venture capitalists to invest in London and the South East. The table below shows that in 2012 over £2 billion was invested in London out of a total of £5.7 billion, representing 36% of the UK VC market.

Table 4-2: Value of VC investments by region

	Amount invested (£m)			**% of amount invested nationally**		
	2010	2011	2012	2010	2011	2012
London	3,469	2,901	2,062	42	44	36
South East	1,160	1,138	1,281	14	17	22
South West	739	209	172	9	3	3
East of England	78	127	424	1	2	7
West Midlands	910	496	332	11	8	6
East Midlands	76	203	163	1	3	3
Yorkshire & The Humber	479	252	131	6	4	2
North West	607	692	535	7	11	9
North East	346	112	410	4	2	7
Scotland	171	334	159	2	5	3
Wales	39	58	87	-	1	2
Northern Ireland	163	21	9	2	-	-
Total	8,237	6,544	5,767	100	100	100

[26] BBA (2013), Geographical spread of SME borrowing – data released July 2013

Source: BVCA

4.6 Comparing the different parts of the UK based on their business base, London also compares favourably in terms of the number of businesses invested in per 10,000 VAT registered enterprises (46 companies in London that have received VC investment compared to a UK average of 31). This would indicate that VC investment is spread across a comparatively large number of businesses. Indeed, over the 2010 to 2012 period, only the North East of England, which has a much smaller business base, has seen more companies per 10,000 in receipt of VC investment.

4.7 Capital for Enterprise (CfEL) is a fund management company owned by BIS, and the largest single investor in UK venture capital. According to recent CfEL data[27], over the last decade over 930 companies have received funding, receiving at least £520m. The geographical distribution of funds is broadly similar to VC investments as reported by BVCA. Nearly a quarter (24%) of CfEL investments have been made in London with 30% of the total investment value in London. In terms of angel investment, a recent study by the UKBAA[28] found that most angels are attracted to seed and early stage deals and, as shown below, the largest proportions of investment are secured in London and the South East.

4.8 The BVCA, CfEL and UKBAA investment data demonstrate that London SMEs perform better relative to other regions in attracting and securing equity finance. This has long been a trend in equity finance, with investors focussed in London and the South East given the concentration of potential deals and returns. Nevertheless, levels of equity finance investment in London SMEs declined in recent years, in common with other parts of the country.

Consultation feedback

4.9 The view reflected in almost all consultations was that London is currently underserved, with the demand for SME finance outstripping the supply. It is recognised that London is better provided for in terms of the location of finance providers. A global capital market centre, it has much larger concentrations of VC and equity fund providers than are found elsewhere in the UK. However, it was also emphasised that significant capital funds flow out of the region, rather than to London businesses (e.g. investment funds going to the SE/East regions or even overseas). Also, that London is under-represented in terms of some public funding, including that from the European Union (ERDF/ESF) which is frequently used as a match for other sources of small business funding. These views hold for both debt and equity finance in London, but there are important differences between the nature of shortages for SME debt and those for equity finance.

Supply of debt finance

4.10 Banks remain the primary source of finance for SMEs in London, but, as highlighted in our interim report, less so now. As would be expected, our consultations highlighted different perspectives on bank lending. From the banks' perspective their ability and willingness to lend has improved over the last two to three years.

[27] Capital for Enterprise Limited (2013), CfEL Equity Scheme Data
[28] UKBAA/ Deloitte (2013), Taking the pulse of the angel market

4.11 Prior to the credit crunch in 2007/08 banks were lending at unusually low margin rates with terms and conditions that were very favourable to SMEs. Lending was supported by property in the form of commercial mortgages, with many startups funded by domestic property mortgage funding. With the collapse of the property market, a great deal of finance went out of the market, and the banks no longer lent in the same fashion.

4.12 Even before 2007, the banks did not lend on a large scale to startups: these were typically self-funded through domestic mortgage finance or other forms of personal borrowing and unsurprisingly this has not changed. The other area where banks have not been substantially involved is in meeting the requirement for 'patient capital': longer term loans (15-20 years) which stretch beyond the capital value of assets. This is an issue of considerable importance to larger established SMEs and one which the Business Bank is looking to address.

4.13 One of our bank consultees stated that there are no longer any significant constraints to the supply of bank finance to SMEs within London. In their view it is a lack of demand which is resulting in lower levels of bank lending. The banks express their desire to increase lending: some are engaging in more 'outreach' activity across London to stimulate demand, recognising the need to demonstrate a renewed willingness to lend.

4.14 However, the overwhelming feedback from consultees was that the availability and affordability of bank finance has reduced significantly in recent years. Many believed that the supply of debt finance in London has been severely curtailed by changes in bank lending policies and approaches post 2007/08, due mainly to tighter restrictions on lending, but also attributable to more stringent terms and lending conditions, which has been particularly evident in certain sectors (e.g. hospitality and creative sectors, where there are many startups, and which tend to provide more 'intangible goods and services'). Banks increasingly want to see track record and at least 18 months of trading performance. Some consultees highlighted an increasing trend towards bank overdrafts being cancelled or renegotiated, and bank loans being called in. The time it now takes to apply for bank finance and the fact that decisions are made centrally (rather than by someone familiar with the business) was highlighted as being particularly problematic for firms looking for relatively small loans either to start up or to provide working capital.

4.15 Those consultees with more of a focus on debt finance suggested that the restrictions around bank finance are unlikely to be significantly different in London compared to other parts of the country. But it was also pointed out that London has a higher rate of overdraft refusals potentially linked in to a higher business churn rate. Although banks are now saying they are willing to lend (in contrast to the period in 2009/10 when they were actively discouraging borrowers), most consultees believed that the effective supply of bank finance was continuing to decline, as borne out by the recent BBA statistics for London.

4.16 According to FSB research, the availability of SME finance (referring here primarily to debt finance) has remained static in London over the last two to three years, with around 50% of FSB members being refused finance compared to an average across the UK of 40%. The FSB argued that there tends to be higher interest rates for bank lending in London compared to other areas which, together with higher business overheads generally, makes it difficult for London SMEs.

4.17 Consultees believed that as a result of the reduction in bank finance, SMEs have increasingly been looking to alternative forms of finance. The most commonly cited examples were peer-to-peer lending (mainly for established SMEs) and crowd funding (primarily for startups) but SMEs are also increasingly looking at debt factoring, leasing, invoice finance and changing supplier payments (e.g. requiring payment within 15 days instead of 30 days) as a means of better managing cash flow. In a later section we summarise the feedback on alternative sources of finance.

Examples of debt finance initiatives in London

4.18 There are a number of key debt finance initiatives available at the London level which were highlighted in the consultations. The case studies below highlight the main loan products and provide a sense of scale of activity and level of funding that is currently available to London SMEs.

East London Small Business Centre

East London Small Business Centre (ELSBC) has provided 'loans of last resort' for 26 years to new and existing small businesses in London. All lending is based on the viability of the business plan and the passion of the entrepreneur to make it happen. The clients seeking help with access to finance are supported through the centre's business advisors on the development of the plan and all the financials.

For new business startups, loans up to £10k are available and for existing businesses up to £25k. All businesses must be based in a London borough and subject to business viability. The clients and business plans are presented to an independent loan fund panel at ELSBC. They have been running Sharia compliant loans of up to £10k for over ten years. ELSBC was innovative 25 years ago by introducing short term loans against order and demand continues to be high.

ELSBC also provides low interest start-up loans of up to £5,000 for 18-30s and provides business support and manages the Arts Council's Creative Industries Loans of up to 25k, available to this growth sector on a Pan London basis. ELSBC also manages the London Legacy Loan Fund – loans of up to £10k for startups and established SMEs in Tower Hamlets and Newham.

During 2012, they supported over 1600 businesses which represented a 50% increase in business support on the previous year, showing demand is ever increasing. The main challenge highlighted by ELSBC is that demand for business support on access to finance, leading to successful lending is challenging, alongside sourcing new capital for lending. – The centre currently has £3.5m on loan to clients and £1.5m available to lend, through own and managed funds, which is being utilised rapidly.

GLE

GLE provides a range of debt finance: the New Enterprise Allowance Loan Scheme (NEALS) which are typically loans of £1k; Start-Up Loan Scheme for 18-30 year olds, typically around £6.5k; and the Croydon Enterprise Loan Fund which has an average investment of £17k. About 200 loans are made per month between the 3 funds with 85-90% being start-up loans. The Regional Growth Fund will start lending soon – providing 3 year loans of about £20K to established businesses. In terms of available finance, NEALS has around £2.5m to lend up to March 2014, around £700k is available through Start-Up Loans, and £350k is also available through the Croydon Enterprise Loan Fund to March 2014. The Regional Growth Fund will lend £2.4m over the next 12 months, with £7.2m committed over 3 years. A further fund – the London Loan Fund, backed by Lloyds Bank and the EIB and targeted at existing businesses, is expected to launch in late 2013. The Lloyds/EIB fund, which will be London only, has a £5m commitment over three years. GLE is also involved in invoice discounting, provided through IGF Invoice Finance, which is a GLE subsidiary. Each year, GLE provides financial support to just under 3,000 SMEs, of which two thirds are loan clients

Other relevant debt finance initiatives

4.19 The Government has introduced or supported various initiatives over the last year or two aimed at improving the supply of debt finance. Many of these initiatives have specifically been aimed at encouraging banks to increase levels, or the availability, of SME lending. There have also been examples of the Government providing support to alternative forms of debt finance such as peer to peer lending platforms. The table below also includes details of some of the larger London debt finance schemes.

Table 4-3: Debt finance initiatives

Name	Source of funding	Purpose	Size/ scale	Performance
Enterprise Finance Guarantee[29]	Public (Capital for Enterprise).	Bank loan guarantee scheme to enable additional lending to viable SMEs lacking adequate security to secure a commercial loan. Government acts as guarantee, covering 75% of loans; lenders cannot claim for more than 13% of the total that they have lent from government.	Over £2 billion up until 2014-15. Businesses must have annual turnover of less than £41m; loan can be £1k to £1m, for between 3 months and 10 years	Launched in January 2009. Lending of £1.88bn has been offered to over 18,000 economically viable small businesses. However, just 885 loans were offered in the first quarter of 2013, (a total loan value of £92m) compared to 2,376 (a total loan value of £255m) in the second quarter of 2010. Recent evaluation report indicated that the scheme was genuinely addressing the market failure.
Business Finance Partnership[30]	Public (Capital for Enterprise).	Funding to increase the flow of credit to SMEs diversifying sources of finance and make them less reliant on bank lending. 2 strands - the first strand	£1.2bn available with £100m allocated to the Small Business Tranche of the	Launched in May 2012. Under the first strand the first 6 funds have been set up and together they manage £863 million of government investment alongside over £1 billion

[29] http://www.startups.co.uk/enterprise-finance-guarantee.html
[30] http://news.bis.gov.uk/Press-Releases/Small-businesses-offered-110-million-of-new-finance-684c2.aspx

Name	Source of funding	Purpose	Size/ scale	Performance
		invests in fund managers who lend to medium sized businesses with turnover of up to £500 million. The second strand of the Business Finance Partnership invests in non-traditional lenders that provide an alternative source of lending for small businesses with turnover up to £75 million.	BFP	from private investors. Under the second strand, seven different lenders (e.g. Funding Circle, Zopa) have received £85 million of government investment and will lend more than £240 million to small businesses by attracting matching private sector investment.
Funding for Lending[31 32]	Public (Bank of England).	Bank loan incentive schemes designed to enable loans to be used as security for more borrowing at a lower rate with Government/Bank of England. Supersedes the National Loans Guarantee Scheme.	Up to £80bn available up to 2015	Launched in July 2012. Cheaper lending to banks and building societies is aimed to increase lending to businesses by lowering interest rates and increasing access to credit.
Business Bank[33]	Public	New institution will bring together £1billion of new Government capital and £2.9billion of existing capital which will work alongside private sector contributions with the potential to be enhanced by guarantees.	£1bn	The business bank organisation will bring together Capital for Enterprise Ltd (CfEL - the existing delivery agency for BIS), key policy teams in BIS and new expertise from the private sector. Expected to be operational by Autumn 2014.
UK Export Finance Scheme[34]	Public	UKEF provides trade Credit Insurance to exporters and Guarantees to banks to support UK exports.	Funding available through range of schemes.	In 2012-13 UKEF supported £4.3 billion of business through the issue of guarantees to banks and insurance policies to exporters, up from £2.3 billion the previous year.
Start Up Loans Programme[35]	Public (BIS)	Loans to young people aged 18-30 to start a business in England. Age cap is due to be lifted, so scheme will be available for all those aged 18 and above who want to start a business or whose business is less than one year old	£10m pilot in 2012/13, £32.5m in 2013/14, and £40m in 2014/15[36]. Average loan size is c. £5k, though there is no limit (some	So far it has provided loans worth £39m to nearly 6,700 businesses

[31] http://www.theguardian.com/business/2012/jul/13/bank-of-england-new-lending-scheme
[32] https://www.gov.uk/government/policies/making-it-easier-to-set-up-and-grow-a-business--6/supporting-pages/getting-banks-lending
[33] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/203148/bis-13-734-building-the-business-bank-strategy-march-2013.pdf
[34] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207721/ecgd-ukef-annual-report-and-accounts-2012-to-2013.pdf
[35] http://www.startups.co.uk/government-launches-startup-loans-for-young-entrepreneurs.html
[36] http://www.startups.co.uk/government-launches-startup-loans-for-young-entrepreneurs.html

Name	Source of funding	Purpose	Size/ scale	Performance
			have been above £10k)	
London Legacy Loan Fund[37]	Public (East London Small Business Centre)	Providing debt finance to entrepreneurs seeking to start a new business or existing businesses that have been unable to obtain finance from commercial banks.	Total funding of £500k will be available providing loans of up to £10k	No data available
East London Business Centre Loan Fund[38]	Public (East London Small Business Centre)	Providing 'loans of last resort' to new and existing small businesses in east London.	New business loans from £1,000 up to £10,000. Existing business loans up to £25,000	No data available
Croydon Enterprise Loan Fund[39]	Public (GLE)	Set up in 2008 to help Croydon businesses, unable to access finance from banks.	New business loans up to £5,000. Existing business loans up to £25,000	Over the last four years £1.3m has been lent to 150 businesses and 100 jobs have been created as a result of the fund.

Source: Various websites

Supply of equity finance

4.20 Equity finance is more widely used in London than in other parts of the UK. Based on the feedback from consultees, London appears to be particularly well placed to address the equity finance needs of its SMEs. It is the UK centre and major European centre for equity finance with considerable numbers of private and public backed VCs with either HQs or offices located there. There is also a significantly large business angel network and base of HNW investors and considerable attraction to overseas investors (notably through the Tech City and operation of UKIIF).

4.21 London's higher levels of equity finance activity compared to other parts of the UK are highlighted in BVCA and CfEL regional data. Most consultees referenced the larger concentration of SMEs and higher proportion of high growth innovative SMEs as reasons for this difference. The large numbers of businesses in emerging technology sectors in London (particularly focused around Tech City) is believed to be one of the main reasons for a greater supply of equity financing. It was also stated that London has the ecosystem to support VC investment. Other parts of the UK cannot compete on attractiveness and opportunities – overseas investors are predominantly London-based.

4.22 However, following the credit crunch there has been a notable decline in the supply of equity SME finance. This is evident in the BVCA data and was confirmed by consultees. In terms of VC funding, 'three years ago there were 15 large VC firms and now there are only four with sufficient capital to write a £5m cheque'. For investments of up to £1m range, business angel activity has grown rapidly – some consultees saw exponential growth. In the £1-£3m range

[37] http://www.goeast.org/pages/raising_finance_business_loads/0/raising_finance_and_business_loans.html
[38] http://www.goeast.org/pages/raising_finance_business_loads/0/raising_finance_and_business_loans.html
[39] http://www.gle.co.uk/finance/loan-finance.php

there are relatively few players (primarily DFJ, Octopus and MMC). The £3-10m Growth capital range has shrunk and the £10-20m Development Capital range has shrunk. At the £20m end the supply has got better, as investors are investing in more established SMEs.

4.23 The main sources of seed/ early stage VC funding in London include No 1 Seed, Notion, Playfair Capital and Passion Capital (all targeting seed equity at the digitech market in London). In addition, there are now believed to be around eight seed incubators providing seed funding across the city (usually around £50k then follow-on finance in the £100k to £2m range), accelerator training and mentoring. The first accelerator was Seedcamp opening in London in 2007. This was followed by others such as TechStars and SeedCloud.

4.24 Even in light of this activity, most consultees believed the supply of equity finance to be most constrained at the early stage of investment. Whilst London and the SE has the advantage for seed finance of having more angels and high net worth individuals, feedback from consultees indicated that many angels have locked into follow-on investments, restricting their ability to fund other new businesses.

4.25 In terms of the publicly backed funds, many of those previously supported by the London Development Agency have closed to new investments (e.g. London Technology Fund and Creative Capital Fund). Some consultees argued that as London is seen to have a greater supply of SME finance, it loses out on significant public sector investment in access to finance schemes provided, for example, through ERDF or Regional Growth Fund support.

Angel investment

4.26 According to the British Business Angels Association, there are around 15,000 active business angels operating in the UK[40] making equity investments either individually or in syndicate. Angels tend to invest individually, and deal sizes have fallen in recent years, to an average of around £40,000 to £50,000. However, the number of syndicate business angel investments has been increasing, with investors increasingly look to pool together resources, knowledge and contacts as well as offering a way of sharing risk. Syndicate investments now have an average value of £300,000.[41]

4.27 Business angels have benefitted from tax relief which has helped to further stimulate investments. For instance, under the Seed Enterprise Investment Scheme (SEIS), investments worth up to £150,000 qualify for 50% tax relief. Indeed, one financier consulted as part of the study stated that the tax incentives for business angels were now among the most generous in the world, meaning that high net worth individuals will continue to see them as possible investment avenues.

4.28 Financiers and businesses commented on the growing importance that angel investments are having within the SME community. Several of the businesses spoken to stated that they were now a more efficient alternative to banks: one consultee stated that the bulk of the recent investment in their business had come from high net worth individuals. The growth of equity crowd funding platforms such as Crowdcube will only help to facilitate angel investments.

[40] Cited in A. Davis (2012) *Seeds of Change: Emerging sources of non-bank funding for Britain's SMEs*
[41] Ibid.

4.29 Of course, not all SMEs are turning to business angels. Consultees also pointed to the fact that meeting with angels can be expensive (angels usually charge for initial meetings) and no investment or other outcome might follow. There was a perception amongst some of the more established 'mid-tier' SMEs that business angels could not provide the level of investment needed and that they primarily catered for young firms and startups seeking smaller amounts of finance.

4.30 One financier also stated that business angels may not be able to meet any increase in demand for their services. Angels are quickly running out of the financial capacity to take on more investments and are also wary of taking on lots of additional risk.

Examples of equity finance initiatives in London

4.31 Case studies are provided below of three of the key sources of equity finance. These provide an illustration of the scale of activity in London.

DFJ Esprit

DFJ Esprit manages four Funds, the most recent is a €100m equity fund, of which approximately half has been invested. Typically €20-30m is invested each year. Ten of the portfolio of 60 companies are in London. All are SMEs and typically 10 of the 60 companies get follow-up investments in any one year, and eight new investments are made annually. DFJ Esprit invest between £0.5m to £5m, typically alongside other co-investors. DFJ Esprit's main sectors are electronics, software, internet, med-tech and mobile. Increased number of investments have been made in London recently as DFJ Esprit has focused more on early stage companies, with London being seen as one of the best places to fund startups in Europe.

Passion Capital

Passion Capital is a venture capital fund established in April 2011 with £37.5m under management. It is an ECF (Enterprise Capital Fund) meaning it includes UK Government funding alongside private investors. The seed fund is targeted at assisting digital entrepreneurs in and around Tech City London. The firm itself is based in Tech City alongside many of its portfolio companies. The fund is initially aimed at funding seed, very early stage, businesses – usually with initial prototyping in place and ready move to the early growth phase with further R&D and initial marketing. As the invested businesses develop the fund will switch to follow-on funding alongside new investors – funds are being held back for this. The fund has already invested £5.6m of initial financing, of which attracted a further £36m in additional funds from new investors. Payback is expected within 8-9 years, although they have already had two very successful trade sale exits. Across the portfolio of 37 companies (managed by 3 fund managers), the average seed investment size is £182k – which is very small for a VC fund, the smallest investment has been £15k! Small-scale funding is possible because the firm has very straightforward compliance and due diligence requirements, so no lengthy support service costs for legals, etc. Also, the fund is investing in large numbers of local TechCity businesses, which it can easily meet on a day to day basis: They are effectively investing due diligence time into these as they develop to see if they are worth considering for further larger scale follow-on funds in future. They have only invested a small proportion of the fund to date; as noted, considerable resources are being kept back for larger scale follow-on funding.

Seedcamp

Seedcamp is backed by Angels, VCs, and Corporates across Europe with a HQ in London.US backed, but with its activity focused on London. It offers small equity investments; a range of support services is also provided, including office space at the Google Campus accelerator site for 3-5 months, financing assistance with links to VCs and angels, market positioning and Entrepreneurial MBA-type business training. Seedcamp also offers intensive support mentoring for up to a year after which businesses are expected to be led/assisted by their follow-on investors including Angels and VCs. But Seedcamp continues to support these businesses over their life cycle. They now receive 2000 applicants annually, and take on around 20 p.a. (1%). They are looking for HG potential startups – the key is innovation and market potential. Each Seedcamp businesses will receive €50k equity investment, any additional funding is entirely dependent on their individual requirements and pitching. The average business assisted by Seedcamp goes has gone on to receive $1.3M £1.5m in equity funding, with this average likely to increase in the coming years. From 2007-10 the numbers approaching the fund grew rapidly, since then growth has continued, but more slowly, as there are a number of new accelerators in London (7-10 in total – operating in a similar fashion – some have more sector focus than others). Seedcamp will make anywhere from €1m-€2M of equity funding available to new recruits annually. This is all private funding from the fund's VC/Angel/Corporate/equity investors.

Angel Capital Group

ACG which is based in Pall Mall SW1 was spun out of GLE 4 years ago as a privately owned Fund management and angel organisation including the 185-member London Business Angel network. It presents 40-45 investor ready companies p.a. for BAs to assess. ACG provides business angel equity directly to SMEs and through SEIS and EIS funds. £250k p.a. is available to invest from the SEIS fund and £300k/£500k p.a. to invest from the EIS fund. The LBA network has 185 Business Angel members, of which around 100 are active (i.e. come to events). 40 BAs invest through the SEIS & EIS funds (mainly new BAs) and 40-50 invest direct p.a. The median investment is £37.5k with a range from £5k to £350k.

Investments are expected to increase in terms of the numbers of Business Angels and size of investments up to 2015. However this is subject to the Government maintaining current tax breaks for angel investors. Tax breaks are fundamental to the market and are not expected to change before 2015 (i.e. under the current Government). The volume of BAs is static in the SEIS and EIS funds. More are investing directly – a 10-20% p.a. increase. Seventeen deals were completed in both calendar years 2011 and 2012. Eighteen have closed to date in calendar year 2013 and ACG expects to complete 22+ in the year, based on the deals in the pipeline. This is about the capacity of the network. The trend is away from sub-£150k (total) deals towards a £500k-£ 1.5m deal range.

Other relevant equity finance initiatives

4.32 The following table summarises the main initiatives and funding sources which are available and seek to increase the supply of equity finance. These are a mix of national and London specific initiatives.

Table 4-4: Equity finance initiatives

Name	Source of funding	Purpose	Size/ scale	Performance
Business Angel Co-Investment Fund[42]	Public (central government)	The £50m Angel CoFund has been created with a grant from the Regional Growth Fund and is able to make initial equity investments of between £100,000 and £1 million to SMEs alongside syndicates of business angels	Evergreen £50m from the Regional Growth Fund.	Launched November 2011.In its first year £24million has been invested in 18 innovative and entrepreneurial British companies. Every £1 invested by the Angel CoFund (£6million total) has leveraged a further £3 from business angel syndicates (£18million total).
Enterprise Capital Funds[43]	Public (Capital for Enterprise) – including some EU funding	Commercially-managed venture capital funds providing equity finance to high growth potential SMEs seeking between £500,000 and £2m.	Up to £200m to 2014.	12 active funds with commitments totalling nearly £400m, of which £240m has been committed by HM Government. £166m has been invested through the funds in 144 fast-growing UK businesses with several strong exits and significant follow-on financings for portfolio companies already achieved
BBA's Business Growth Fund[44] [45]	Private	Independent fund of up to £2.5 billion, backed by five of the UK's main banking groups - Barclays, HSBC, Lloyds, RBS, and Standard Chartered - and working in collaboration with the British Bankers' Association. The BGF will invest approximately £2m and £10m per business in return	£2.5bn available over 7-10 years.	Launched in May 2011

[42] http://www.capitalforenterprise.gov.uk/bacf
[43] http://www.capitalforenterprise.gov.uk/ecfp
[44] http://www.businessgrowthfund.co.uk/what-we-are-looking-for/
[45] https://www.gov.uk/government/news/new-growth-fund-opens-for-business

Name	Source of funding	Purpose	Size/ scale	Performance
		for a minimum 10 per cent equity stake and a seat on the board for a BGF director. Firms must have an annual turnover between £5m and £100m.		
Enterprise Investment Scheme[46]	Public (administ-ered by HMRC)	Designed to help smaller higher risk trading companies raise finance by offering a range of tax reliefs to investors who subscribe for new shares in those companies Investors can invest up to £1m in qualifying shares and receive 30% of the cost of the investment as a relief against income tax.	Expected to deliver £260m per year (according to Capital for Enterprise).	In operation since 1994. Income tax exemption rise from 20 to 30% announced by the Chancellor in 2011.
Seed Enterprise Investment Fund[47]	Public (administ-ered by HMRC)	Designed to help smaller, early-stage companies to raise equity finance and complements the EIS. Income tax relief is available at 50% of the cost of the shares, up to a maximum annual investment of £100,000.	Funding available through tax breaks	Launched in April 2012.
Venture Capital Trust Scheme[48]	Public (administ-ered by HMRC)	Encourages individuals to invest in small, unlisted higher-risk trading companies indirectly through the acquisition of shares in a VCT. VCTs are similar to investment trusts and must have HMRC approval	Funding available through tax breaks	First introduced in 1995
UK Innovation Investment Fund (UKIIF)[49]	Private and public	Government investment of £150 million creating the UK Innovation Investment Fund (UKIIF) matched by £180m in private investment, giving the fund a total of £330 million to invest in businesses. The UKIIF is a venture capital fund that invests in growing small businesses, new businesses working in digital, life sciences, clean technology and advanced manufacturing. Rather than investing directly in companies, the UKIIF pays into a fund that is used by	Currently £330m but anticipated to be worth £1bn over 10 years	Launched in June 2009

[46] http://www.icaew.com/~/media/Files/Technical/Corporate-finance/Guidelines/tecpln11488-cff-guideline-58-2-final.pdf
[47] http://www.icaew.com/~/media/Files/Technical/Corporate-finance/Guidelines/tecpln11488-cff-guideline-58-2-final.pdf
[48] http://www.icaew.com/~/media/Files/Technical/Corporate-finance/Guidelines/tecpln11488-cff-guideline-58-2-final.pdf
[49] https://www.gov.uk/government/policies/investing-in-research-development-and-innovation/supporting-pages/growthaccelerator-and-the-uk-innovation-investment-fund

Name	Source of funding	Purpose	Size/ scale	Performance
		venture capitalists who have the expertise to invest in business.		
MMC London Fund[50]	Private and public (including some EU funding)	Equity funding for early stage, fast-growing businesses in London. The fund is managed in London by MMC Ventures together with the Mayor of London, partly funded by ERDF and SME Wholesale Finance Ltd. The new £11m fund is specifically focused on investment in London businesses - and as it is a matching fund, at least £22m will actually be invested in the Capital as a result. The Fund co-invests alongside other venture capital firms, business angels and other MMC funds including the EIS Fund. Investment sizes typically range from £1 million to £1.5 million	£22m	Launched in 2013

Source: Various websites

4.33 A number of London specific funds which were supported by the London Development Agency (LDA) have recently closed. These included the London Technology Fund, the Creative Capital Fund and the Capital Fund.

Alternative sources of finance

4.34 As is evident above, although SMEs seeking external funding have tended to use banks and mainstream equity finance providers as their first port of call, in recent years a more diverse range of financiers have entered the market and are being increasingly used by London SMEs. Drawing on the thoughts of SME financiers, stakeholders and London businesses, it has been possible to learn more about the role that the alternative sources of finance play within the SME community, and the extent to which these sources are filling actual or potential supply gaps.

Peer-to-peer lending

4.35 The economic crisis has also seen the emergence of crowdfunding as an alternative to banks in accessing debt finance. Crowdfunding (also known as peer-to-peer lending) initiatives work by giving businesses access to small contributions from lots of individuals. In exchange, businesses will offer an equity stake or will pay interest on their loan.

4.36 Since the onset of the economic crisis, a number of different crowd funding platforms have gained prominence. Ones such as Funding Circle and Rebuilding Society (profiled below) have given firms access to debt finance. Alternatives such as Crowdcube and Seedrs have

[50] http://www.mmcventures.com/londonfund.aspx

instead facilitated equity investments (typically ranging from £100,000 to £125,000)[51], with users in both platforms being able to invest as little as £10.

4.37 Since launching in 2011, Crowdcube has helped fund 64 businesses with a total investment of over £12 million.[52] Half of these businesses are based in London and the South East. The majority of Crowdcube's 42,000 investors are also London/ South East based. Our consultation with Crowdcube highlighted that each month they receive applications from around 100 businesses with demand highest in London which represents 50% of the applications.

Funding Circle

Launched in 2010, Funding Circle sought to respond to the perceived low lending levels amongst the five major UK banks, and the low interest rates that investors were facing. Funding Circle's founders set up an online platform to help businesses find low cost loans quickly and investors earn better returns.

The typical loan value is £65,000 although they vary from £5,000 to around £1,000,000. As of October 2013, £155 million had been lent to British businesses with around 25,000 individuals having lent to businesses through the website. London has accounted for £20 million of total Funding Circle lending.

Increasingly, the public sector is using Funding Circle as a way to help support SMEs. Through the Business Finance Partnership, BIS has used Funding Circle to invest £20 million in businesses while local authorities (including LB Camden) have used the site to invest in businesses in their local area.

Businesses that have secured loans from Funding Circle have commented on the fact that compared to banks, the processes involved have been quicker and more user-friendly, enabling them to access external finance relatively quickly. Firms have used loans for a range of purposes including working capital and growth reasons such as purchasing new equipment and shop refurbishments

rebuildingsociety.com

Founded in December 2011, rebuildingsociety.com describes itself as a peer-to-business crowd funding platform that helps "businesses looking for funding to obtain commercial finance by bringing them together with lenders looking to get better returns on their investment than is possible through savings accounts."

Its primary target market is profitable UK registered firms that are more than two years old with SMEs coming to rebuildingsociety.com primarily to secure finance for working capital, buying assets, and re-financing existing debt. The average loan value is around £50,000 although the size of the largest loans on the website has been increasing in recent times and is now £2,000,000.

rebuildingsociety.com encourages entrepreneurs to actively involve lenders in the business, encouraging lenders to become ambassadors to the businesses they

[51] Cited in A. Davis (2012) *Seeds of Change: Emerging sources of non-bank funding for Britain's SMEs*
[52] http://www.crowdcube.com/infographic (accessed 4 September 2013)

are involved in. Businesses using rebuildingsociety.com have come from all over the UK. However, over the last 6 months, of the 100 or so businesses that have applied for a loan through rebuildingsociety.com, around 25 per cent have been based in London

4.38 Those interviewed from Rebuilding Society and Funding Circle confirmed that demand for peer-to-peer lending platforms had increased over the past two to three years, with SMEs increasingly seeing it as a viable alternative to bank lending. The consultee at Funding Circle pointed out that in June and July 2013, total loans were worth around £40 million, representing around 11 per cent of the total amount lent through the site. The consultee from the Rebuilding Society noted that the growing number of competitors in the peer-to-peer lending market was further evidence of the growing demand for the facility.

4.39 Financiers and individuals said the main advantage of peer-to-peer platforms was that the application was quick and uncomplicated (especially when compared to banks), meaning that they could receive external finance for use in the short-term. Furthermore, with the facilities being web-based, applicants could apply for finance at times and from locations most convenient for them rather than being restricted by bank branch locations and opening hours.

4.40 Nevertheless, the consultation process revealed that awareness of crowd funding platforms amongst SMEs was relatively poor. Some firms had heard of the bigger names in the field (e.g. RateSetter and Funding Circle) but were uncertain about how they operated and which types of businesses they targeted. Some of the business consulted said that such sources were not really appropriate for established medium-sized SMEs, even though Funding Circle is actively targeting them.

CDFIs

4.41 Community Development Finance Institutions (CDFIs) are social enterprises that support communities that provide affordable finance to organisations unable to secure funding from mainstream high street banks. According to the Community Development Finance Association, there are currently around 60 CDFIs operating within the UK.[53]

4.42 CDFIs tend to focus on supporting startups and smaller SMEs. However, given the dynamism of small business in London, it seems surprising that in 2012, according to a report on the sector,[54] London accounted for only c£1.5m of £30m invested nationally through this route. Some consultees were clear that the likely explanation was the constraint on available resources: in recent years, the public sector role has been limited by funding cut-backs: this situation has been exacerbated in London where, as noted earlier, ERDF match has not been available on the scale elsewhere.

Fredericks Foundation

The Fredericks Foundation was set up in 2001 and provides a range of business

[53] http://www.cdfa.org.uk/about-cdfis/
[54] Community Finance for Businesses, 2012 - CDFA

support and microloan funding to help start-up companies. Most of Fredericks' clients choose self-employment as the best (and sometimes the only), route out of benefit-dependency. As a result of the economic downturn, as well as helping people off benefits, Fredericks Foundation has branched out to assist existing companies in need of finance who are unable to obtain it from their bank. As part of a consortium of CDFIs, the Fredericks Foundation is a delivery partner of the Government's 'Start-Up Loans Company' scheme (SULC). Average start up loan sizes are probably under £5k. SULC loans are at a fixed rate of 6%, usually 3-5 year term loans. SULC is restricted to 18-30s and ex-services personnel.

The organisation was also recently awarded funding through the Regional Growth Fund to offer loans to startups or expanding businesses refused loans by the banks. Following the RGF award in 2012, the organisation set up lending ups in different parts of the country including a £200k lending hub in London. The London hub opened in January 2013 is staffed 3 days a week by a loans manager. The number of applications from London businesses for loans is currently relatively small but expected to grow. Although the London hub has only been open a year, they have found that the demand in London is greater for start-up and micro finance to existing micro businesses than at any of their other sites across the UK.

AIM

4.43 AIM is the London Stock Exchange's market for smaller growing companies. Since its launch in 1995, some 3,000 companies from around the world have joined AIM in order to access the capital needed for growth. AIM members cover a wide variety of different firms including early stage firms, VC backed SMEs, and more established companies.

4.44 Amongst the stakeholders consulted, there was a perception that SMEs have not really turned to AIM when looking for external finance. Indeed, one consultee went so far as to say that the use of AIM has been in steady decline for a number of years and that it is unlikely that this trend will be reversed. The reluctance to use AIM has been attributed to a number of factors including the complexities and prohibitive costs involved in the process, and uncertainties over the amount of funding that firms will receive. The received view was that, in its current form, AIM is relevant only to larger SMEs.

4.45 There has clearly been a downward trend in the performance of the AIM market since the recession as highlighted by recent data[55] which indicate that IPO numbers remain historically low, with investor preferences shifting to larger companies (Mason et al., 2010)[56] and the lower end of the AIM market at under the £50m cap remaining largely illiquid and unappealing for new IPOs. However, that said, there are indications that the picture may be improving looking ahead to 2014[57].

[55] AIM Monthly Reports
[56] Mason et al (2010) The City's Role in Providing for the Public Equity Financing Needs of UK SMEs
[57] http://www.ftadviser.com/2013/09/16/investments/uk/london-s-ipo-market-sees-activity-increase-oEKvVBTEhzkiIlXDF5y4fO/article.html

Summary of supply of SME finance

4.46 The data on both debt and equity finance clearly shows the reduction in supply in London over the last two to three years. Overall, the amount of supply for both types of finance is still markedly higher in London than in other parts of the country, as would be expected with the size of the business base. Assessing supply as a proportion of the business base shows that in terms of bank finance, London is slightly below the UK average, but in equity finance it is 50% higher than the national average. As highlighted in the consultations this is due to the concentration of equity investors in the London area and a concentration of high growth firms which are more likely to attract this type of risk finance.

4.47 Most of our consultations highlighted it has become more difficult for London SMEs to secure bank finance owing to more stringent terms and conditions. An increased willingness from the banks to try to re-establish relationships with the SME community was acknowledged, and this has been helped by Government initiatives such as Funding for Lending and the Enterprise Finance Guarantee scheme. The main alternative providers of debt finance (in addition to the banks) in London were highlighted as the East London Small Business Centre and the GLE Group.

4.48 The main sources of VC finance were highlighted as being DFJ, Octopus and MMC. For seed/ early stage VC funding in London the main players include No 1 Seed, Notion, Playfair Capital and Passion Capital (all targeting seed equity at the digitech market in London). Although the supply of equity finance has reduced over recent years, there still remain significant levels of investment, driven in large part by demand from high growth companies in new and emerging sector such as the digital and creative sectors located in Tech City.

5. Demand for SME finance

5.1 In this section we review evidence on the demand for SME finance in London. A summary of the main findings of the desk review is included below with additional analysis provided in Annex C. We also include the main areas of feedback from our consultations with stakeholders, financiers and businesses on levels of demand.

Desk review

5.2 An analysis of the Small Business Survey results demonstrates that the demand for external finance has increased in London over the last two years (between 2010 and 2012) from 14.0% of firms in 2010 to 15.8% in 2012. This demand is defined as those SMEs seeking or applying for external finance during the previous 12 months. It brings London into line with UK average demand in 2012 (15.9%).

5.3 There appears to be greater incidence of SMEs making multiple applications for external finance in London in 2012 (6.8%) compared to the UK (4.7%), and representing a considerable rise from 2010 when only 2.9% of London SMEs sought finance more than once. There are two possible reasons for an increase in multiple applications: a lack of initial success in applying for finance, leading to seeking other substitute forms of finance; and/or a general increase in demand for different types of finance in London.

5.4 Although fewer London SMEs reported problems accessing external finance compared to the UK average (6.2% in London and 7.8% across the UK), there was a higher proportion of discouraged borrowers, and therefore latent demand, with 13.4% requiring external finance but not applying compared to 11.7% in the UK as a whole[58]. London's SMEs also exhibited much stronger latent demand for external finance when compared to the UK as a whole in 2010. The main reason cited by London SMEs for not applying for the external finance that they required was fear of rejection, with two fifths (39.7%) stating this compared with less than one quarter (23.7%) across the UK. Growth orientated SMEs are most likely to be discouraged from applying for finance.

5.5 Just over half of London's SME finance seekers (51.9%) did so for working capital, slightly less than for the UK as a whole (56.8%). The proportion of London's SMEs seeking finance for working capital has fallen considerably from 81.3% in 2010. Refinancing appears to have been far more prevalent in London (11.9%) than in the UK as a whole (3.4%) in 2012. This may reflect bank tightening on SME finance (particularly overdrafts), but also a desire to pay down debts and reduce their costs on the part of the SMEs. Expansion and growth reasons for seeking finance were significantly more represented amongst London's SMEs (5.5%) than for the UK as a whole (2.3%).

5.6 London's SME finance seekers were typically looking for larger amounts of finance than their UK SME counterparts. In 2012 the average amount of finance sought was £285,000 in London, compared with £171,000 across the UK. Bank finance was still by far the main form of finance sought by London's SMEs. Nearly half (47.7%) of London SMEs seeking finance sought bank loans and three in ten (29.4%) sought overdrafts. These figures were slightly

[58] Note: these are % of those not seeking finance; representing 11.4% and 9.8% of total SME populations respectively

lower than for the UK as a whole (49.4% and 33.1% respectively). Loans from family and friends played a much greater role in London (7.3%) than in the UK as a whole (1.8%).

5.7 This difference is also reflected in the most recent FSB survey undertaken in 2011 (mainly representing smaller firms) which shows that in London SMEs have been using their own savings and retained profits more than bank finance. The SME Finance Monitor 2012 also shows that London has a higher proportion of SME owners investing their own funds compared to the UK average.

5.8 A significant failing of the SBS survey, and indeed other SME surveys reviewed in this study, is the inability to provide robust evidence of demand for equity finance demand. Previous studies demonstrate that equity finance is only sought and used by a small minority of SMEs. The London sample of SMEs from the 2012 SBS is not large enough to capture reliable information on risk funding, which is most relevant to innovative, creative and technology based businesses in early stage development.

5.9 Overall, in the UK there is a sign that the demand for business angel and venture capital equity has been increasing. The proportion of SMEs seeking business angel finance rose from 0.9% in 2010 to 1.4% in 2012, and in respect of venture capital it rose from 0.2% to 0.9%. There is also an indication in the 2012 SBS survey that peer-to-peer and crowd funding lending is taking place; take-up by 0.3% of SMEs in the UK as a whole.

5.10 The trend changes in the SBS data between 2010 and 2012 would appear to demonstrate that London is experiencing a slight easing in the accessibility of external finance. However, it remains a concern that over two-fifths (41.7%) of London's SME finance seekers in 2012 experienced problems (albeit down from 47.3% in 2010) and that 38% were not able to receive all of the finance they required (down from 42% in 2010).

5.11 One interesting issue highlighted in FSB research, and which was discussed with consultees, was in relation to changes in banks' terms and conditions for lending, specifically around interest rates and the costs of borrowing. According to the FSB member survey in 2011, the average rate paid by London members was 9% whilst the UK average was 7%. Changes to bank lending criteria introduced following the credit crunch has undoubtedly played a role in discouraging some potential borrowers. However, in the most recent FSB London Small Business Index[59], there has reportedly been a marked reduction in interest rates with more businesses now paying less than 4%. The feedback stated that this reduction was in part due to the UK Government's Funding for Lending Scheme.

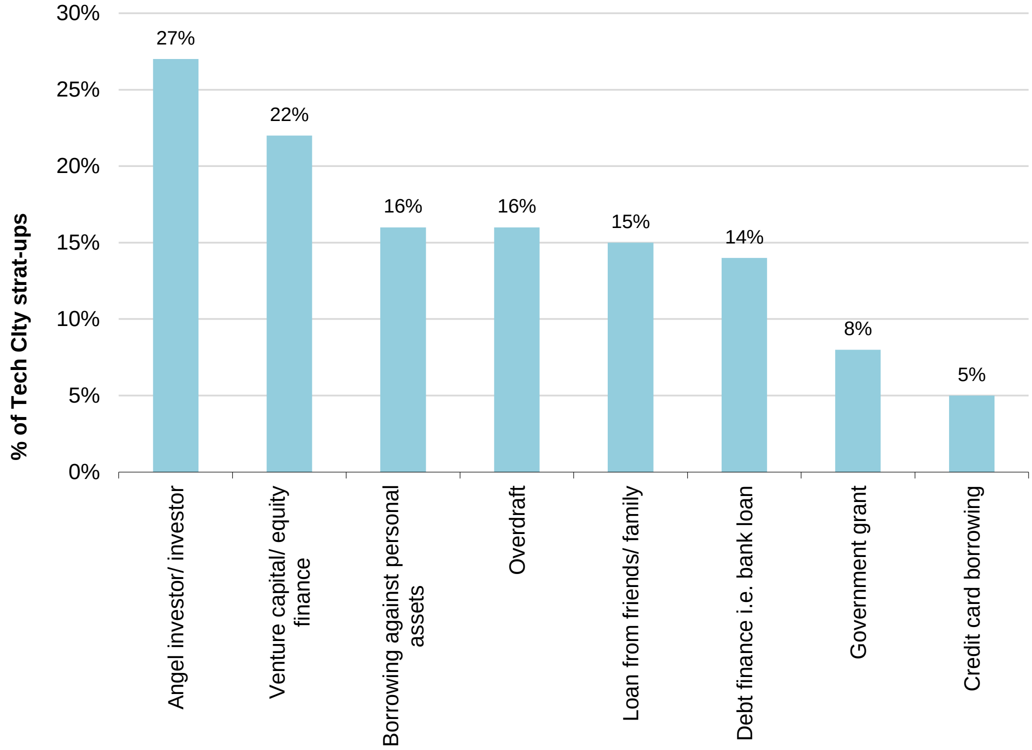
5.12 A small number of London-specific business surveys have focused on access to finance issues. One notable example is a survey commissioned by TechCityInsider.net and partners of Tech City startups in East London[60]. The survey was carried out in early 2013 and includes feedback from 141 businesses in the technology sector on the main issues affecting growth. It highlights the different financing requirements of young tech businesses when compared to the wider London SME population.

5.13 In terms of access to finance issues, the headline finding is that almost one in three (29%) businesses believed that lack of investment cash is holding back their business. Just under four out of five businesses (78%) stated that they have used some kind of investment or

[59] FSB London (2013), the FSB London Small Business Index – Quarter 2 2013
[60] GfK (2013), The TechCity Futures Report

financing in the past. The research found that firms use on average 3.4 sources of finance. As shown below, the most popular source of finance is angel investors (27%) followed by venture capital (22%), borrowing against personal assets (16%) and bank overdrafts (16%).

Figure 5-1: Main sources of finance used by Tech City startups



Source: GfK/ TechCityInsider (2013)

5.14 The survey found that more than two in five respondents (43%) have looked for a second round of investment or looked to renegotiate the terms of their existing investment. Of those looking for further investment, almost a quarter (23%) have had problems, including the length of time it took to secure capital, investors and banks unwilling to take a risk, and a straight refusal of funds.

5.15 Further analysis of the Small Business Survey results along with other data from SME Finance Monitor and the FSB research is provided in Annex C. We now go on to discuss the feedback from the primary research on demand for SME finance.

Demand for debt finance

5.16 We found different views on the demand for debt finance, paralleling those on supply. The banks expressed the view that there had been a reduction in the number of loan applications: Barclays reported that since 2007 the number of London applications had reduced by 18%, although this was still less than the 25% drop at the UK level. It was suggested that the London market has held up better, which was partly attributed to specific factors such as the 2012 Olympics. Barclays also highlighted that in recent months there has been an increase in loan applications nationally, particularly amongst larger businesses with sales of over £1m. However, the micro business market remains flat.

5.17 A number of consultees highlighted a trend for deleveraging which would lead to fewer loan applications and this is highlighted in the BBA data for London. Whilst this may be true, the point was also made by consultees that SMEs have become more reluctant to apply for bank finance because of the stricter lending terms and conditions, and the centralised process which results in a lengthier and more convoluted application process.

5.18 It was also reported that some SMEs have started to look at alternative sources of debt finance. One supplier of debt finance stated that many good viable businesses come to them saying 'it is not worth approaching the banks'.

5.19 In addition, others say that for many types of SMEs this demand for long-term debt has been replaced by increased requirements for short-term cash flow/ liquidity debt finance. One consultee raised the potential risk of businesses starting to overtrade as the economy recovers and then soon running out of working capital.

5.20 Whilst some SMEs will have accessed alternative debt finance there is likely to be some element of suppressed demand in relation to debt finance. This is believed to apply to start-up firms with no track record and some existing SMEs that have either been struggling financially or that do not have an asset base.

5.21 Although the overall level and most characteristics of demand for debt finance were believed to be similar to that in other parts of the country, many consultees pointed to London's high start-up and business churn rates leading to greater demand for start-up finance.

Demand for equity finance

5.22 On the equity side, consultees were generally in agreement that demand is greater in London than in other areas. Part of the reason for this stemmed from the upsurge in SMEs in growing sectors. The obvious example of this is Tech City which over the last 12 months saw the creation of more than 15,000 new businesses.

5.23 According to one consultee, high growth potential innovative early stage businesses are attracted to London and tend to cluster there. It was suggested that latent demand is particularly strong at the start-up/early investment stage for innovative high growth potential businesses, particularly in relation to those in the middle growth bracket, which will seek out the crowdfunding options – the real high flyers will get accelerator funding.

5.24 Consultees also stated that the increased demand for equity start-up finance can put down to a combination of the increasing availability of Business Angel investment, EIS investment, cheap rentals in East London, and the development of digital technologies that have become cheaper to get off the ground (e.g. it was stated that with £40k you can launch an analytics business but the same money may only buy some equipment in the med-tech field).

5.25 Illustrating the increase in demand for angel investment, the Angel Capital Group stated it could double its current investments if the capital was available. The same consultee stated that there is demand for capital throughout the UK, but London is the start-up hub that is growing faster relative to the rest of the UK.

5.26 One VC stated demand in terms of the number of business plans they have received over the last few years has been relatively consistent at 2,000 per year. However, they highlighted that opportunities have increased because of the growth in Shoreditch/East London and there is significant latent demand which would come forward with proposals if more capital were available *('in the current climate a business could make 200 presentations and not get an offer. If it was down to 5 presentations to get an offer more would come forward').*

5.27 Another consultee characterised a key area of demand in terms of young entrepreneurs moving to London from other parts of Europe, attracted by the Microsoft/ Google accelerators and the growing profile of Tech City. For them London is viewed as the centre of European innovation. However, there is limited or no follow-on finance available for high tech startups once they have started – for one company supported by the consultee, it took six months to secure growth funding. It was stated that there is a desperate and increasing need for growth funding to take businesses to next level and markets. This will be risk finance as the companies do not have trading track records and need considerable amounts of funding: £200k to £2m.

Alternative sources

5.28 Consultees believed there has been an increase in demand in alternative sources of finance, particularly for SMEs that traditionally used bank finance. Peer-to-peer lending and crowdfunding were highlighted as becoming a more popular source of finance for SMEs, both for debt finance and equity finance. With interest rates being so low, lenders are looking for new ways to make returns on their savings.

5.29 It is difficult to assess the apparently/potentially growing role of crowdfunding lenders in London. An issue here is that they do not appear to be lending to startups and are focusing on businesses that have track records of at least three years. Therefore, in many respects they are offering an alternative that the banks are already supposed to be doing – lending to small businesses that have a track record – but perhaps with less onerous T&Cs (e.g. security and interest).

5.30 The Government's support for non-bank sources such as Funding Circle and Zopa (through the Business Finance Partnership) was viewed by consultees as a positive step, which would increase the choice and availability of SME finance. Technology has obviously played an important role in the development of these new forms of financing.

5.31 Based on feedback from SMEs, awareness of the different types of financial sources was not extensive. Businesses themselves were happy to admit that their knowledge of other financing options was quite poor. Those consulted had heard of equity funding, and peer-to-peer funding arrangements in particular, but were not necessarily sure of how these worked, and how they could benefit their own business.

5.32 Similarly, knowledge of public financing schemes did not appear to be extensive. Consultees all pointed to the fact that there were lots of government initiatives in operation but very few were able to name any or state what they were designed to do. Businesses and stakeholders were nearly unanimous in their view that more needed to be done to make SMEs aware of the different funding sources available to them. Some recommended a new resource or portal for SMEs that could provide information and guidance on finance providers and the various financing options they are able to provide.

Summary of demand for SME finance

5.33 An analysis of the Small Business Survey suggests that demand for external finance amongst London SMEs has increased marginally over the last two years. Around half of London SMEs seek finance for working capital but there are also more businesses in London than elsewhere looking for finance to grow and expand. The SBS data also suggested a higher incidence of discouraged borrowers in London; this came through in the consultations with many highlighting the difficulty of startups with no track record or existing firms with cash flow problems looking for alternatives to bank finance because they did not expect to secure bank finance, or not at an affordable rate.

5.34 Assessing the demand for equity is challenging in the absence of detailed data based on a comprehensive survey (the SBS focuses on the whole SME market which overwhelmingly seeks debt finance). However, a recent Tech City survey showed that one in three businesses believed lack of investment cash is constraining their growth. This also came through in the consultations, which highlighted a resurgence in demand for risk finance both in terms of start-up/seed finance and VC funding to take firms to the next level of growth.

5.35 The feedback from consultations also indicated some increase in demand for alternative forms of finance (both debt and equity), as offered for example by Funding Circle, Zopa and CrowdCube. But overall levels of demand are relatively low and it would appear that the vast majority of SMEs have yet to look into these alternative sources.

6. Finance gaps for London SMEs

Factors shaping funding, and potential gaps, in London

6.1 Our interpretation of the earlier analysis is that there are dynamic factors in play, which apply particularly in London. Some firms which reported that they could not raise finance are likely subsequently to have been successful through different routes, or may have adopted a different business plan, under which they adopted a different funding model, or reduced their growth aspiration, and did not need debt/equity finance up front.

6.2 There are also significant differences in London, which relate both to scale and type of demand, and to the characteristics of supply. Specifically:

- The high volume of start-up and early-stage firms, which by definition have a limited track record at best
- A level of ambition – in terms of scale of funding demand - which is on average considerably higher than in other parts of the UK
- The high representation of growth-oriented firms, including many tech-based firms requiring relatively 'patient' capital
- A varied supply, particularly of venture capital, which is private-sector-led and dynamic in looking for new opportunities/niches
- The focus of the supply on commercial funds, which seek to minimise both transaction costs and risk, and operate profitably over a relatively short timescale: this makes obvious sense from a business perspective, but may mean that some economically-worthwhile opportunities, linked to substantial future growth, are foregone
- Given this focus, and the type of demand, specific gaps in the funding ladder are likely to involve early-stage funding, where the amounts are significant but still relatively small, and where there are relatively high transaction costs.

6.3 In the sections below, we set out the evidence we found from our consultations within the sector. A striking part of the process was the willingness of senior figures close to the market to participate in the study, and the high degree of consensus on the prospects for firms seeking different types of funding in London.

6.4 It is also important to emphasise that the gaps these consultations point to are about system failure rather than market failure: all players in the market may well be operating rationally in their own terms, and there is undoubtedly a working market, or series of markets, in which providers and takers are coming together and doing deals. But the scale and nature of these may still be sub-optimal from a wider economic perspective. And therefore there may still be a case for enabling actions from the public sector, especially where such actions are time-limited, and/or partnership-based, and operate in a form which can stimulate deal flow, and improve both the growth prospects of individual firms, and wider business confidence.

6.5 In the remainder of this section, we consider this question first with regard to debt finance, then equity.

The debt finance gap

6.6 Those consulted saw specific gaps in relation to:

- Finance to enable startups to begin to operate
- Re-financing to manage debt, where the company is judged to lack track record, and may be potentially viable over a reasonable time perspective, but probably does not have high growth potential.

6.7 Issues around these types of funding are not new, but they have been exacerbated by the massive reduction in the availability of bank funding during the last four years. Banks were traditionally the main source for the second category, and important for the first. Although some alternatives are available, these tend to be more niche (with a local or sector focus, or specific to certain types of business, such as social enterprises, or offered by business suppliers/clients). Being pushed to seek out new alternatives, which might provide more customised offers, could be advantageous to the businesses. It is, however, likely to require more investment of a business's time, as the alternatives do not operate as generic funding mechanisms in the same way as the banks did, nor to the same scale. The implication is that there may be some gaps relating to information on alternative sources, and how to select appropriate routes.

6.8 Key points raised by our consultees were:

- A widely-held view, shared by funding providers and business representative organisations (e.g. FSB) that although the banks were now under pressure to lend more to small business, the overall availability of debt funding through the banks was, and would remain, limited: there would be no return to pre-recession levels. This pointed to a need regularly to check what was on offer, and to encourage and enable suitable funding to be provided where gaps emerge
- A specific aspect of the gap for 'low growth business finance', raised as a national issue by CfEL, is the current lack of mezzanine finance - debt that can be converted to equity. This is important for the flexibility it offers, but also because it will be treated as equity investment by other backers, and can therefore make it possible to access other loans
- The view that enterprise development in London was being seriously constrained by the lack of start-up finance: this was highlighted by those actively involved in the market, notably GLE. The position was not being significantly alleviated by CDFIs, despite the notable activity of the Fredericks Foundation, and its potentially important role.

The equity finance gap

6.9 Those consulted pointed to the considerable activity by SME equity providers, including business angels, which had been affected by, but continued through, the recession. They noted that with even a selective economic recovery, demand was likely to increase further, and this could be expected to further stimulate supply. There were already good providers, including for seed finance. But those consulted also saw many business angels, and some relatively small funds which had been active earlier, as being heavily constrained in terms of their potential role with new business and startups. At a time of considerable turbulence, they were keeping their level of risk to a manageable level by focusing on second and third round funding.

6.10 As with debt, the nature of equity gap was characterised by scale and risk. Those consulted saw:

- Business angels and the role of high net worth individuals becoming more important, and efforts being made (e.g. to link together and scale up these sources, both through networks and the Business Angel Co-Investment Fund. Nevertheless , there remained constraints on reach and effectiveness, not least in linking disparate providers and planning for both early funder exit and subsequent rounds of funding: again, this pointed, in part, towards a public sector enabling role
- An enduring gap for equity in the range from £250k to £2m, where transaction costs were high for private sector providers; as many of the businesses looking for this scale of funding were at a fairly early stage, the risks were also seen as potentially disproportionate
- A gap for larger-scale equity, in the £2m -£10m range, for more complex technology-based propositions, where there may be a longer than usual gap before returns are delivered and exit is possible.

6.11 CfEL identified the £250k+ and technology gaps, and has been involved in efforts to fill these, for example through the UK Innovation Investment Fund. Other parties highlighted the scale issue, but some believed that other funds were developing specialisms based on experience, which were enabling them to reduce risks and transaction costs. The gap might still be there, but for funding up to £1m (GLE) or £1.5m (SME Wholesale) rather than £2m. Others, however, such as Seedcamp, saw the gap as up to £5m in some circumstances.

6.12 The concentration in London of business growth and demand for longer-term/patient funding, notably at TechCity but also around Imperial College and other university incubators, has led to new entrants on the supply side, as well as to active marketing/re-packaging of offers. The balance is not easy to strike between meeting demand, by focusing on specific sectors where demand is evident and expertise is growing, and risking the over-stimulation of the market and receiving too many low-grade propositions.

6.13 Two examples illustrate the increasing diversity, and different, complementary, ways forward:

- Passion Capital, the recent ECF (established 2011), which has a remit only to fund London based businesses and to focus initially on very early stage investments. By investing in a comparatively large number (34 in 2 years) of portfolio companies that are local there is effectively an ongoing due diligence process taking place as the businesses develop, with follow-on funding available to those that are successful and retained.

- The US Silicon Valley Bank (SVB), a recent entry to the market, with a rather different offer, which seeks to identify prospects, to which it then offers a commercial banking service, with linked mentoring. The aim is to bring through tech-based startups to the point where they are ready for +$4m investment, which SVB would typically be involved in as a co-investor. SVB saw London as the obvious point of entry to the UK market, and probably later to other European centres.

Quantifying the gap

6.14 In an attempt to quantify the scale of the funding gap, we have used feedback from the most recent (2012) Small Business Survey. An analysis of the London results was included in the Interim Report. Although the sample size for London is greater with the SME Finance Monitor, the questions used in SBS lend themselves better to quantifying the gap. It should be highlighted that this approach has been used to illustrate the potential scale of the gap and cannot be regarded as definitive[61]. The quantification of the gap for equity finance is caveated, as the sample size for London (543 SMEs) is not large enough to capture reliable information on risk funding.

6.15 Table 6-1 shows the steps involved in estimating the gap. As well as using the SBS feedback, the number of SMEs in London (805,085) has been taken from BIS's Business Population Statistics[62]. Using this approach, it is estimated that there is currently a finance gap of around £1 billion in London.

Table 6-1: Quantifying the finance gap using SBS feedback

Metric	Number/ value
No. of London SMEs	805,085
% of London SMEs seeking external finance	15.8%
No. of London SMEs seeking external finance	127,000
% of London SMEs that could not raise any finance	28.7%
No. of London SMEs that could not raise any finance	37,000
% of these SMEs with viable business plans[63]	20.0%
No. of SMEs with viable business plans	7,000
Average amount sought	£285,000
Gross unmet demand from those who could not raise any finance	£2,078,022,000
% of London SMEs that only received some of the finance	9.3%
No. of London SMEs that only received some of the finance	12,000
% of these SMEs with viable business plans	20.0%
No. of SMEs with viable business plans	2,000
Average amount sought (assumption that they typically received half)	£142,000

[61] Note we also do not take into account the 'discouraged borrowers' - c.11% in London 2012, which are most likely to be debt finance seekers , but which according to Barclays are likely to decline proportionately as the economy picks up - with more marginal businesses having the confidence to apply.
[62] https://www.gov.uk/government/publications/bis-business-population-estimates
[63] Assumptions as previously used in CEEDR (2009), LDA Access to Finance Scoping Study

Metric	Number/ value
'Unmet' demand from those that only received some of the finance	£336,683,000
Gross unmet demand	£2,414,705,000
% that could not be sourced from elsewhere	45.0%
Total finance gap	£1,086,617,000

Source: SQW analysis based on SBS 2012/ BIS business population data for 2012

6.16 However, as already highlighted the London sample of businesses in the SBS is not large enough to capture information on demand for equity funding. Therefore the estimate of £1 billion relates overwhelmingly to debt finance. In order to estimate the finance gap in relation to equity finance we have used the same approach but using the small proportions of SBS respondents that have applied for angel and VC finance. The calculations are shown in Table 6-2. For average amounts sought, figures calculated from the most recent UKBAA and BVCA data have been used. The total finance gap in relation to angel and VC funding is therefore estimated to be around £343 million. Combining the two estimates results in a total finance gap of £1.4 billion.[64]

Table 6-2: Quantifying the finance gap solely in relation to angel and VC finance

Metric	Number/ value
% of London SMEs seeking external finance	15.80%
No. of London SMEs seeking external finance	127,000
% of those seeking external finance that applied for angel finance	1.40%
No. of London SMEs seeking angel finance	2,000
% of those seeking external finance that applied for VC finance	0.90%
No. of London SMEs seeking VC finance	1,000
% of London SMEs that could not raise any finance	28.7%
No. of London SMEs looking for angel/VC finance that could not raise any	1,000
% of these SMEs with viable business plans	20%
No. of SMEs with viable business plans	200
Average angel investment (UKBAA data)	£523,000
Average VC investment (BVCA data for London)	£10,796,000
Unmet demand from those who could not raise any angel/VC finance	£762,880,000
% that could not be sourced from elsewhere	45.0%
Angel/ VC finance gap	£343,296,000

Source: SQW analysis based on SBS 2012/ BIS business population data for 2012/ BVCA and UKBAA data for 2012

6.17 As already highlighted, London's economy is the most dynamic in the UK. Many consultees stated that it will be one of the areas to recover quickest in terms of economic growth. Quantifying the current finance gaps for SMEs in London is difficult and dependent on feedback from surveys such as the Small Business Survey. Projecting how these gaps may

[64] It could perhaps be argued that there may be overlap with these two sets of estimates since a small proportion of the overall demand for finance already relates to equity. However, bearing in mind the various stages we go through to deflate the number of businesses missing out on finance we believe our combined estimates are on the conservative side

change over the coming years is even more challenging and will be subject to a range of macro-economic factors and the impact of new Government initiatives, most notably the Business Bank.

6.18 However, we have presented figures below which assume a 2% annual increase in the number of SMEs in London, and therefore the same levels of increase in the finance gaps. Although this is much lower than the annual increases between 2010 and 2012 (6% and 8% respectively[65]), the figure is broadly in line with GLA's projections of GVA and employment growth over this period of between 1-2%[66]. The population of London is expected to grow at a similar rate[67]. On this basis over the five year period, the total SME finance gap in London would be over £7 billion (Table 6-3).[68]

Table 6-3: Projecting the finance gap up to 2016 (£m)

	2012	2013	2014	2015	2016	Total 2012-16
Debt finance gap	£1,087	£1,108	£1,131	£1,153	£1,176	£5,655
Angel/ VC finance gap	£343	£350	£357	£364	£372	£1,787
Total finance gap	£1,430	£1,459	£1,488	£1,517	£1,548	£7,441

Source: SQW

Initiatives/ funds have recently been announced to address some of these gaps

6.19 The approach described above to estimating the economic value of the finance gaps in London highlights the magnitude of the issue, particularly in terms of debt finance. However, a range of initiatives and funds are available, or announced, which should meet some of this demand (as described in Section 4, above). On the debt finance side, these include Funding for Lending (£80 billion initiative between 2012-15), the Business Bank (bringing together £1 billion of new Government capital and £2.9billion of existing capital from late 2014), and the Start Up Loans Programme (c. £70 million being invested over the next two years).

6.20 In terms of equity finance, there are national initiatives such as the Business Angel Co Investment Fund (c. £10-20 million still available from the original £50 million fund), Enterprise Capital Funds (c. £160 million available through active funds) and BBA's Business Growth Fund (£2.5 billion available over the next 7-10 years). In London, a new MMC London Fund worth £22 million has also recently been launched.

6.21 In terms of the numbers, this enhanced supply should have a significant impact, particularly but not only with regard to debt finance. It is, however, still difficult to quantify how far these initiatives will address the finance gaps in London. Considerable uncertainty remains around timing and terms, not least regarding the Business Bank. The availability of finance in the future will also be highly dependent on the performance of funds. Effective demand is then also a key factor: it is difficult to predict how much of the available finance will be successfully bid for and taken up by London SMEs. Economic conditions, now expected to be reasonably buoyant, will determine scale of demand, and the extent to which the

[65] SQW analysis of BIS business population estimates 2010 to 2012
[66] GLA Economics (2013), London's Economic Outlook: Spring 2013
[67] ONS Subnational Population Projections – September 2012
[68] In addition to an increase in the number of businesses, the next few years is also likely to result in greater demand for SME finance associated with economic upturn – again this illustrates that we have included a conservative estimate

applications are viable and meet funders' criteria, will also need to be factored in. The challenge for the GLA in developing a new Fund is to work efficiently and effectively with existing initiatives to make sure any new initiative complements and fits with other funds being developed by the private sector and others.

Implications

6.22 The consultations have reinforced the findings of the desk review that finance gaps exist for London SMEs both in terms of debt and equity finance. Most of the research has indicated that gaps in debt finance have been in relation to start up and for working capital/ re-financing. Combined, these gaps will account for a significant proportion of the £1.1 billion annual figure estimated above (SBS analysis highlighted over 60% of demand for finance was for working capital or re-financing). From our review of current and future initiatives, it would appear that there are already major Government-supported initiatives that will be addressing some of these debt finance gaps over the coming years and making a difference in this area would require huge sums of investment because of the number businesses involved. The implication is that in this area, the GLA's role should be more about information provision and coordinating the funding already being made available than investing directly.

6.23 On the equity finance side, the research also found gaps in London (and the UK) and that these are particularly evident at the seed and early growth stages of business development where there is a strong focus on R&D activity leading into commercial developments targeting new technical and overseas markets. This perception of the equity gap updates, but in many respects is a continuation of, the gap identified in many economic studies of UK business funding, dating back as far as the MacMillan Committee in 1931. In 2013, the gap has specific features, which have been exacerbated by a number of factors.

6.24 First, the equity gap for innovative and highly technical R&D based businesses which struggle to obtain finance because of information asymmetries, lack of track record and the comparatively high cost of funding such high risk ventures is now larger because there are more of them. R&D activity is an important part of all advanced economies, recognised as such by both private and public sectors. The questions are mainly about the mix, and how research and development can best be harnessed to bring through commercial and wider economic benefit. The resulting businesses are typically too early stage or risky for traditional bank debt finance, but they are also deemed to be too expensive and risky for VCs to fund. Early stage investments follow something close to the Pareto Principle, except that even fewer, probably no more than 10-15%, are really successful and median returns on early stage UK venture investments typically negative. This is not attractive to private VCs, who have typically moved to undertaking less risky later stage investments in recent years – investing at £2m/£5m plus levels. This leaves a 'traditional' equity gap of between £250k and £2m; fluctuations in supply and demand mean that this range can be extended both lower and higher in London (and the UK).

6.25 Secondly, it is generally understood that business angels and HNWs have entered the early stage investment market, but that they are limited individually to investments of up to £50k and collectively in business angel networks (BANs) to collective investments of up to £250k. Whilst London has been well served by angels and network groups, there are difficulties in obtaining angel investment because existing investments have been locked-in: there are problems in obtaining angel exits and follow–on VC funding. Angels have been forced to keep existing investments for longer, and this has limited follow-on funding and severely restricted the amount of fresh new early stage angel investment available (this finding is collaborated by the Mason et al., 2010 report to City of London).

6.26 Thirdly, since the onset of the global financial crisis in 2007/08 there has been a considerable decline in the overall amount of private equity investment in the UK, which whilst focused particularly on London and South East, is well below where it was previously (BVCA figures). Although there are some new entrants from the USA, there is also a perception that the UK does not have the appetite for equity investment exhibited in the US, and that this conservatism has been exacerbated by recent economic conditions. Others (e.g. Seedcamp, SEEDRS) argue that the investors (angels, VCs and City financial organisations) do not have sufficient knowledge of where to successfully invest in the current early stage innovation markets – which are vastly different from the previous boom periods.

6.27 Fourth, the situation in London is different from the rest of the UK because London, and particularly Tech City, is seen as a European and global centre for innovation and new digitech activity, attracting a considerable influx of investment and entrepreneurial activity. This has been fuelled by the recent 'accelerator' investments by major tech companies such as Google, Yahoo, Microsoft, Telefonica etc, leading to a burgeoning creative software and infocomms sector with many hundreds of new startups and young early stage R&D businesses which are totally unsuited to traditional debt finance and exhibit a high and increasing demand for seed and early stage equity funding.

6.28 The result is that London appears to be undersupplied for seed and early stage equity funding. Despite the introduction of some public backed equity schemes, there is still greater demand in London than supply, and this appears to be on a different scale to anywhere else in the UK.

6.29 Seed funding is typically small-scale for early proof of idea and R&D and supplied by grants from the TSB, founding partners and in London increasingly by accelerators (e.g. Seedcamp, which offer €50,000 equity investment to each of 20 investee startups annually in London). There appears, however, to be a shortage of seed funding for the tier of middle to HG startups that do not attract the Seedcamp/accelerator type funding in London. These will seek alternative funds from angels (e.g. London Business Angel Network) and equity crowdfunders. The former appear to be quite conservative in their investments in the post crisis era, whilst the latter (e.g. SEEDRS and Crowdcube) are relatively new, small-scale and untested.

6.30 The problem area for seed funded businesses is obtaining next stage early R&D equity and follow-on VC funding at comparatively low levels of investment, perhaps as low as £50k, because there are insufficient angels/HNWs, private VCs will not operate at such small investment levels and even public ECFs are typically investing at much higher levels (typically £250k to 2m).

6.31 Some respondents (Seedcamp, Passion Capital, SEEDRS) emphasised that UK VCs do not invest at the early stages and in sufficient amounts to cover the risks and succeed in the way that US VCs operate. What is required is a scaled up early stage VC operation that allows sufficient early stage funding and follow-on funding to facilitate effective portfolio business growth and ensure profitable exits.

6.32 The findings from the consultations therefore point to a more complex environment, in which GLA might have a role in facilitating the development and operation of SME funding markets. Small-scale equity is potentially important, but it is not the only factor. Intervention might involve a series of complementary actions, of different types and at different levels:

- information provision and networking, notably with regard to mezzanine funding and angel finance
- working with experienced fund managers to lower the risks and transaction costs involved in relatively small equity propositions, and in early stage technology-based businesses where there are longer lead-in times co-funding start-up activity,
- working with local CDFIs to improve the supply of debt finance for a range of SMEs.

6.33 We explore these possible options further in our final section on conclusions and recommendations.

7. Conclusions and recommendations

Finance gaps for London SMEs

7.1 We conclude from the research set out in this report, that there are currently five main areas in which London's SMEs face gaps in finance. The first two relate mainly to debt finance and have been exacerbated by the reduction in bank finance. Alternative sources of funding are appearing but awareness remains low. These gaps are around i) small scale debt finance to enable startups to begin to operate and ii) re-financing to manage debt, where the company is judged to lack track record, and probably does not have high growth potential, but is potentially viable over a reasonable time perspective, with some new opportunities as the economy moves on again, which may not otherwise be realisable.

7.2 On the equity side, most of the feedback acknowledged the existing supply of equity finance in London but reinforced the fact that demand is, and will continue to, outstrip supply. The situation is fairly fluid, as there has been a marked rise over the last two years in the rate at which new business angel/HNW individuals have entered the market, and new funds have been marketed in London with different approaches and profiles. But there is also some evidence that the angel entrants may be more conservative/more interested in syndicated deals than their predecessors, while most of the latter's resources are locked into existing investments. Three main finance gaps were identified: angel investment for amounts of between £50k and £250k; early stage VC funding around the traditionally recognised £250k to £2m; and larger scale equity for large growth companies.

Policy considerations

7.3 Our findings suggest that there are a number of finance gaps facing London's SMEs. This conclusion is in accord with the Breedon Review (2012) observation that "the UK has one of the most sophisticated global financial centres, but UK finance does not fully serve the needs of smaller businesses." Whilst London has the most sophisticated SME finance market in the UK, the evidence shows that it also faces the greatest SME financing demands and the most severe examples of financing gaps and shortfalls in service provision – most notably for seed and early stage potential high growth (HG) businesses.

7.4 In addressing these finance gaps directly, the GLA must choose between i) servicing the needs of the many in terms of meeting London's high demand for start-up and SME business development micro finance through alternative debt finance, and ii) meeting the needs of the expanding, but relatively few, group of early stage potential HG businesses.

7.5 We recommend that the priority focus which can potentially provide greatest returns to the London economy is through selective financial assistance to potential HG startups, early stage growth businesses and more established businesses with growth potential (e.g. change technologies, new cycles of technology). A further area for support could be through the provision of 'patient capital' via mezzanine finance for established lower growth developing businesses.

7.6 The successful provision of new SME finance in London by the GLA will need to be based on careful consideration of the approaches and models best suited to address the specific finance gaps being targeted. The bullets below set out some of the underpinning considerations which we believe, from a research perspective, should shape and bound a possible initiative or initiatives.

- The policy focus could be on promotion and filling information gaps. A 'one-stop hub' could be designed for London SMEs, with the aim of making this recognised as the place to go to for advice on finance, and which would effectively network with the myriad of London's current SME finance provision (Breedon suggests a German style KfW agency approach).
- Emphasis could be placed on ensuring that SMEs are finance ready, understand their financing requirements and are able to present their case to the appropriate finance providers.
- The GLA could establish a 'suite' of financing initiatives which target the various gaps in the market it prioritises for assistance. For example this might include a VC fund for seed and early stage HG investments and also a mezzanine fund for more established low growth SME patient capital.
- Any VC and quasi equity funds created would need to be designed to have the scale and longevity required to effectively impact the HG market. Since the funding available is likely to be relatively small-scale in terms of the VC market (where £25m is considered a minimum entry level fund size) it is crucial that a model is selected which leverages other private funds. This can be achieved in various ways, for example: (i) by co-investment as in the case of the Scottish Co-investment fund which matches funding with angel networks; or (ii) fund of fund approaches which invest selectively in existing funds which at least match investment. Since the level of GLA VC funding is likely to be relatively small-scale (rather than the £150m UKIIF example), an alternative approach could be to adopt the recent ECF Catalyst Fund approach of matching/top-up funding into the new funds of existing successful VCs.
- If a VC fund is to achieve lasting success and a legacy, it must be planned for at least a 10 year cycle, enabling it to effectively manage early stage HGs to successful exits. It is widely acknowledged that for some energy and meditech businesses this process may take even longer.
- For new GLA VC funds to succeeed, they should be managed by existing private sector VCs with a suitable successful track record of early stage HG investment. To encourage greater private sector investment into the early stage equity market, GLA should consider whether it requires a pari passu approach on an equal footing with private sector investors. On the one hand this may be more suited for later stage equity, which would require less encouragement, whilst for early stage equity high quality private VCs may require more investment leverage to enter the market. Furthermore, it is crucial that GLA early stage VC investment adds value and does not duplicate existing investment by cherry picking the best investment cases, but allows the next tier (what Oakey, 2003, describes as the 'probably fundable', rather than 'definitely fundable') of HGs to be funded.

- New VC funds should not be too prescriptive in targeting specific high tech sectors, as this could restrict the scale of activity necessary for success (the lessons of the NAO report, 2009). On the other hand, it is vital that the private VCs funded understand the new tech activities of London's new potential HG businesses.

- The range of seed and early stage VC funding, from relatively small-scale seed investments (perhaps at well below £250k) on the one hand to substantive follow-on early/mid stage R&D investments (perhaps at beyond the EU state aid limit of £2m) suggest the need for a flexible fund, or fund of funds approach, linking in and topping-up existing specialist VCs in the London market.

7.7 The above criteria take into account not only the views fed back to us from experienced operators in this short study but the experience and recommendations of well-recognised earlier work (NAO, 2009; Lerner, 2010; BIS, 2011, Technopolis European Study, 2011 etc.) and contemporary VC activities as exhibited by recent ECFs. As noted, there are a range of alternative types of finance which are expected to enter and further develop in the London market over the next few years. These include an increasing (but as yet not fully tried and tested) role for crowd equity funders (e.g. CrowdCube and SEEDRS), operating mainly at the lower entry levels, but also the increasing development of trade equity (e.g. large pharmaceutical company investments into early stage HGs, Breedon, 2012 and Cave, 2012) and development of new models of SME public funding through the City bond market (Breedon, 2012). However, the development of a flexible VC funding approach appears to be most appropriate for London's SME HG financing needs for the foreseeable future to 2016 and beyond.

Parameters for a possible intervention on SME equity finance

7.8 In summary, the recent history of the UK VC market is of private sector VC providers moving out of early stage investment (pre dating the 2007/08 financial crisis): there has been a concerted effort from government to plug the equity gap in the £250k-£2m range with ECFs. The current London market has a particularly strong demand for early stage VC funding and the introduction of Passion Capital and the new MMC fund are addressing this in part. However, it is apparent that the demand outstrips the supply and that London needs much greater scale of VC funding activity.

7.9 Key requirements for the new equity funding in London are that it should complement and not crowd out what is already in place. This was a near-consensus view among those consulted. We interpret this as meaning that any new public-backed intervention should be designed in the form of a collaborative model, in which there are clear incentives to share experience and build the overall scale of provision.

7.10 Specifically, we recommend that a new initiative should:

- Have the scale and flexibility to meet the early stage and follow-on financing requirements of targeted early stage HG SMEs

- Enable funding at relatively small scale levels initially to support the early seed companies (i.e. below £250k) and bridge across the shortfall of angel funds

- Address early stage SME follow-on equity funding requirements, as a key to freeing up 'locked-in' angel funds for earlier stage investment
- 'Go with the grain rather than reinventing the wheel' – providing funding to expert private VC managers with a good track record and understanding of the new tech HG start-up market in London
- Encourage partner VC working at an early stage and private co-investment leveraging (e.g. with business angels, or using a fund of funds model to lever in matching private and foreign investment e.g. like UKIIF)
- Avoid prescriptive approaches such as sector specific targets (target early stage innovation and HG potential) and plan around EU state aid restrictions which prevent assisting businesses which already have seed VCs and investment caps at £2m
- Work with seed/accelerator style VCs that can offer the support and mentoring that can facilitate higher success rates and returns on investments. Good VCs/equity investors will nurture businesses and add value to their performance
- Ensure some degree of flexibility in terms of the finance that can be provided. Feedback from consultees, alongside the particular characteristics of the London business base, reinforced the need to broaden out beyond the traditional £250k-£2m equity gap limits.

7.11 In summary, it should create a VC investment framework which conforms to Lerner's (2010) vision of an effective support service network which the private sector VCs can flourish in, once the public catalyst funds have run their course and established the right framework.

Shaping a way forward

7.12 The consultations with stakeholders and financiers confirmed that the well-established 'system failure' in small scale equity provision continues to exist, and under present market conditions – for reasons linked both to demand and supply – the gap may be growing in scale and significance. The picture is complex and changing, but the consultations identified other areas, with regard to debt finance, where there are also issues related to the on-going withdrawal of the banks.

7.13 Unanimity of views could not be expected, given the range of those involved, and the specifics relating to the role of Business Bank and the future of CfEL are still being resolved. But there was some consensus from the great majority of those consulted on the five funding gaps cited on the likely persistence of these gaps and, more tentatively, on where and how GLA might work towards plugging these gaps. Potential areas of activity for GLA are presented in Table 7-1, below.

Table 7-1: Main finance gaps and potential role for GLA

Finance gap	Type of finance	Likely persistence of gap	Potential role for GLA
Mezzanine	Debt, with link	Medium-term	• Market broking: information to SMEs;

Finance gap	Type of finance	Likely persistence of gap	Potential role for GLA
funding	to equity		networking & enabling with banks & other funding providers; consider further possible direct role alongside private funders, drawing in EU finance. GLA would need to work closely with the Business Bank to ensure there was no duplication • Encouraging more businesses to access mezzanine finance would help increase SME knowledge of equity funding with the likely effect of pushing businesses to be more ambitious in terms of the SME finance escalator[69]
Start-up finance	Debt	Medium term	• Amplify London district and London-wide provision, working primarily through CDFIs. If supporting the provision of start-up grants and/or loans, the GLA would need to recognise that the funding is unlikely to be recycled
Angel finance	Small scale equity: £50k+	Medium-long term	• Market broking, focused on supply side: initiatives to facilitate effective networking between providers- forming links, also linking with next-stage VC funders; investigate scope for enhancing provision by bringing EU funding alongside existing providers
Small-scale equity	£250k-£2m equity	Long term	• Establish small equity fund, with clear aim of focusing on plugging specific gap/s for a defined investment period; investigate arms-length management options, including adding to established fund management operations; develop parameters for exit strategy • Operate separately an 'investment readiness' programme, utilising others with direct experience in the market
Medium-scale equity for new/ complex technology firms	£2m-£10m	Long term	• Build co-funding mechanism, linked to existing fund manager, with risk equally shared between public and private sector to minimise state aid issues

Source: SQW

7.14 Inherent in this thinking is that, even at a time of churn, these potential roles for the GLA are in areas where the funding system is highly likely to continue to be sub-optimal, and where intervention at the London level might be expected to have a significant beneficial economic effect.

7.15 In putting forward these ideas, which essentially seek to use public money to facilitate and plug gaps where purely private actions are producing sub-optimal economic return, it is recognised that public resources are also limited and there will be other demands. If these ideas are taken forward, the emerging initiative – in total and in terms of its constituent elements – should be subject to market testing and appraisal. While the gaps are seen as

[69] See Figure 2.1

medium-long term, the funding system has been shown to be changing substantially, with the emergence of new players and new mechanisms such as crowdfunding.

7.16 Finally, the interest of GLA, and its potential roles, were warmly received by those involved in SME funding in London. But a new public initiative, particularly at this time, will need to continue to be seen as relevant and appropriate monitoring and evaluation systems and processes will need to be put in place. The initiative's effectiveness and fit with other schemes should be subject to independent evaluation after no more than two years of operation. Assessing the financial and economic impact of any new initiative will need to take into account the relatively long timescale required for equity schemes to generate returns.

Annex A: Supply side data

A.1 This section provides an overview of the supply of SME finance in London drawing on business lending data from the British Banking Association, data on venture capital investment from the British Venture Capital Association, data on the uptake of UK Government supported initiatives and a summary of the main access to finance initiatives relevant to SMEs in London. Note that some of the data presented strictly covers where supply is meeting demand, because it sets out the evidence on aspects such as loan approvals.

Debt finance

Bank lending – Bank of England

A.2 The most recent quarterly lending statistics produced by the Bank of England shows how lending to SMEs and repayments have changed since the second quarter of 2011 (Table A-1). The data relates to loans by UK monetary financial institutions to UK non-financial businesses and repayments by them. The data exclude bank overdrafts.

A.3 In the second quarter of 2011, gross lending was £11.3 billion. In the first quarter of 2013, this had decreased to £10.2 billion. Over the last two years, repayments by SMEs have been higher than gross lending producing a negative net lending figure.

Table A-1: Recent trends in lending to SMEs (£ billions)

Date	Gross lending	Repayments	Net lending
2011 Q2	11.3	12.2	-0.9
2011 Q3	11.8	12.3	-0.5
2011 Q4	11.0	12.5	-1.5
2012 Q1	10.1	12.1	-2.0
2012 Q2	9.5	11.0	-1.5
2012 Q3	9.1	10.5	-1.4
2012 Q4	9.4	10.8	-1.5
2013 Q1	10.2	10.4	-0.2

Source: Bank of England

Bank lending – British Banking Association

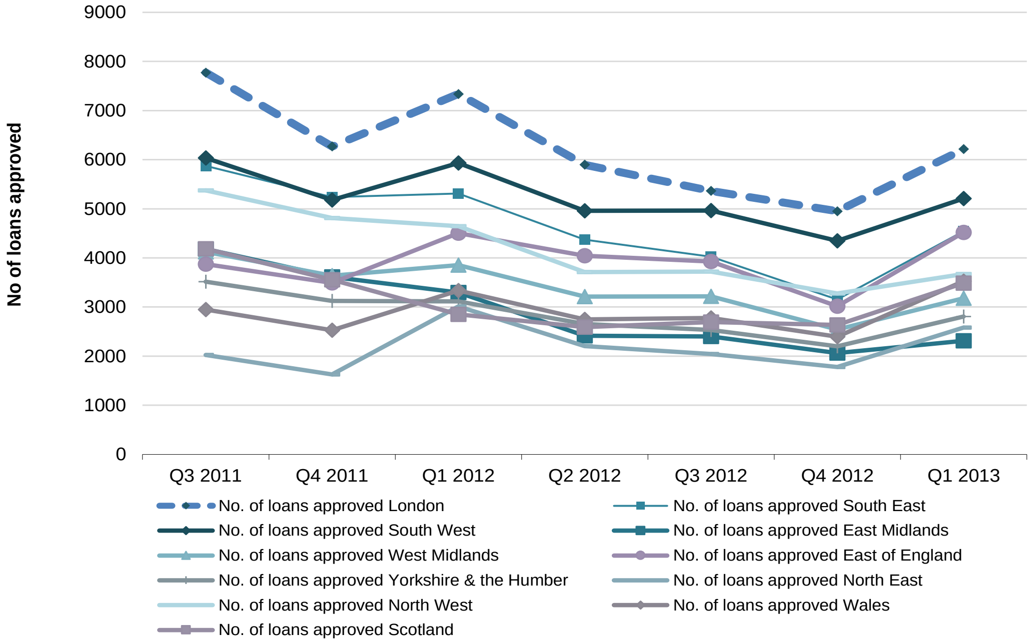
Quarterly lending data

A.4 This sub-section presents the most up to date data produced by the British Banking Association on the provision of loan and overdraft facilities to SMEs[70]. Figure A-1 shows the change in the total number of new loan facilities approved from the third quarter of 2011 up to the first quarter of 2013. As would be expected, given the size of London's business base,

[70] BBA (2013), Q1 2013 Quarterly Release Aggregates

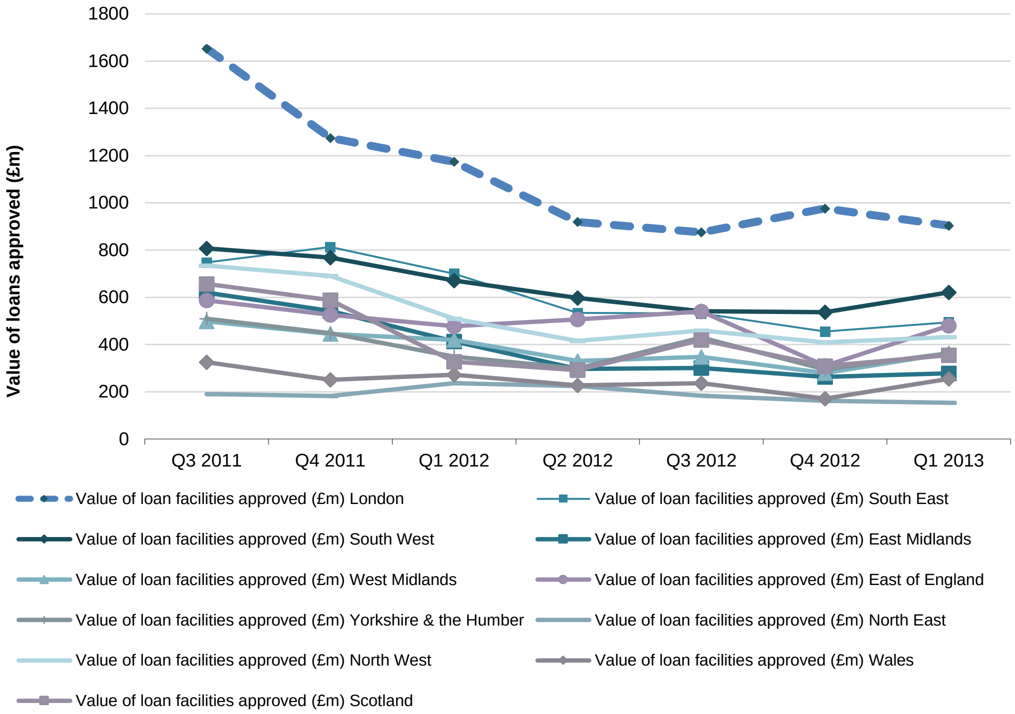
it consistently has the highest number of loans approved. The number of loan approvals has decreased from around 7,800 in quarter three of 2011 to around 6,200 in the first quarter of 2013. Following on from this, Figure A-2 shows a similar downward trend in the value of new loans approved in each quarter since the end of 2011. In London the decrease is most notable, compared to other regions. In quarter three of 2011, the value of new loans approved was £1.65 billion. By quarter one of 2013, this had decreased to £903 million.

Figure A-1: Number of new loan approvals for SMEs – Q3 2011 to Q1 2013



Source: BBA

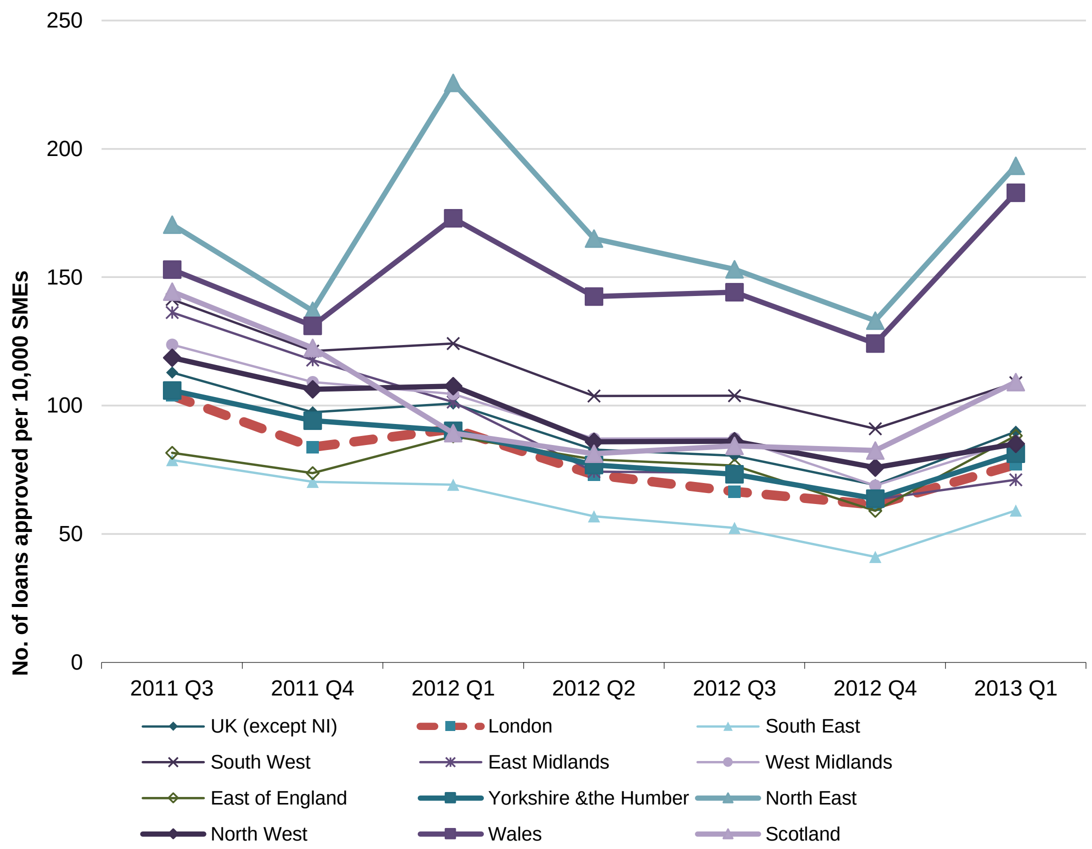
Figure A-2: Value of new loan approvals (£m) for SMEs – Q3 2011 to Q1 2013



Source: BBA

A.5 London consistently has had the highest number of loan facilities approved and also the greatest value of loans approved. However, when analysing the numbers based on the business base (e.g. per 10,000 SMEs), the region does not fare so well. There are currently 77 loans approved per 10,000 SMEs in London compared to 90 per 10,000 SMEs in the UK (except Northern Ireland). This is shown in Figure A-3. The only region with a lower figure is the South East with 59 loan facilities approved per 10,000 SMEs.

Figure A-3: No. of loan facilities approved per 10,000 SMEs – Q3 2011 to Q1 2013



Source: BBA

A.6 Using the same BBA dataset, it is possible to do a similar analysis based on overdraft facilities approved each quarter. Although there have been fluctuations, the latest quarterly figure for London of £211 million is only marginally down on the £214 million approved in quarter three of 2011. For most parts of the country, the value of overdraft facilities approved by the major banks in the most recent quarter is broadly similar to what was approved at the end of 2011. The table below shows all data for London over the last seven quarters. All indicators in terms of the number and value of loan and overdraft facilities approved as well as the level of loan repayments continue to be on a downward trend.

Table A-2: Supply of overdraft and loan facilities over time for SMEs in London

	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1
Value of overdraft balances (£m)	1,411	1,280	1,591	1,438	1,405	1,316	1,324
No. of overdraft facilities approved	8,923	8,382	10,634	8,755	8,559	7,945	8,447
Value of overdraft							

	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1
facilities approved (£m)	214	175	224	164	186	217	211
Value of loan balances (£m)	19,737	19,324	19,130	19,032	18,608	18,465	18,453
No. of loan facilities approved	7,774	6,270	7,338	5,897	5,363	4,950	6,216
Value of loan facilities approved (£m)	1,653	1,275	1,174	919	875	976	903
New Loans (£m)	1,347	1,235	1,327	1,085	1,083	1,116	1,153
Loan repayments (£m)	1,599	1,475	1,273	1,219	1,290	1,286	1,186

Source: BBA

Geographical spread of SME borrowing

A.7 The BBA recently published detailed analysis of SME borrowing in the UK[71]. Table A-3 shows total lending (loans and overdrafts) for all UK regions over the last two years. In both 2011 and 2012, the amount lent to SMEs in the London area was substantially higher than that seen in any other in region. However in all regions there was a notable decrease in lending levels over this period with London seeing a reduction of 4.2%.

Table A-3: Lending levels to SMEs (£m) by region

	2011	2012	Change	% Change
London	21,528	20,630	-898	-4.2%
South East	14,053	13,401	-652	-4.6%
South West	12,099	11,360	-739	-6.1%
East Midlands	5,768	5,548	-220	-3.8%
West Midlands	9,427	8,897	-530	-5.6%
East of England	7,204	6,974	-230	-3.2%
Yorkshire & the Humber	7,439	7,104	-335	-4.5%
North East	3,320	3,202	-118	-3.6%
North West	11,628	11,021	-607	-5.2%
Wales	4,951	4,779	-172	-3.5%
Scotland	7,446	7,384	- 62	-0.8%
Total	104,864	100,300	-4,564	-4.4%

Source: BBA

A.8 By combining deposit and borrowing data we can also establish London's net lending position. Table A-4 shows that in both 2011 and 2012, levels of bank deposits by London SMEs were higher than the amount lent by banks to SMEs. This can be interpreted in two ways. On the one hand it could suggest that the supply of bank loans has been contracting, or that the demand for bank loans has been declining – both would explain why bank deposits

[71] BBA (2013), Geographical spread of SME borrowing – data released July 2013

have been higher than lending levels. Furthermore, Table A-4 shows that the lending situation in London became even more positive between 2011 and 2012 with a 21% change in average net lending position.

Table A-4: Average net lending position (aggregate deposits minus aggregate borrowing – £m)

	2011	2012	Change	% Change
London	£11,099	£13,448	£2,349	21%
South East	£4,751	£6,619	£1,869	39%
South West	-£2,287	-£896	£1,391	-61%
East Midlands	£616	£1,175	£560	91%
West Midlands	-£749	£482	£1,230	-164%
East of England	£1,189	£1,966	£777	65%
Yorkshire & the Humber	£512	£1,254	£742	145%
North East	-£372	-£7	£366	-98%
North West	-£337	£985	£1,323	-392%
Wales	-£1,596	-£1,172	£424	-27%
Scotland	£939	£1,741	£802	85%
Total	£13,763	£25,594	£11,831	86%

Source: BBA

A.9 As highlighted in Table A-5, there are some significant differences in overall lending balances across London. In 2012 the postcode areas with the highest total level of SME lending were W and SW whereas Sutton (SM) and WC have attracted comparatively small levels of bank lending. Nevertheless, as shown, in only two postcode areas (NW and Harrow) have lending levels that actually increased between 2011 and 2012.

Table A-5: Total lending levels for SMEs by London postcode area (£m)

	2011	2012	Change	% Change
London	£21,528	£20,630	-898	-4%
E - London	£1,592	£1,535	-57	-4%
EC - London	£1,114	£877	-237	-21%
N - London	£1,895	£1,840	-55	-3%
SE - London	£1,047	£1,023	-24	-2%
SW - London	£2,026	£1,957	-69	-3%
WC - London	£307	£298	-9	-3%
NW - London	£1,747	£1,767	20	1%
W - London	£2,399	£2,371	-28	-1%
BR - Bromley	£517	£475	-42	-8%
CR - Croydon	£660	£643	-17	-3%
EN - Enfield	£772	£733	-40	-5%
GU - Guildford	£1,252	£1,182	-70	-6%

	2011	2012	Change	% Change
HA - Harrow	£1,475	£1,503	28	2%
IG - Ilford	£842	£758	-84	-10%
KT - Kingston upon Thames	£1,191	£1,085	-106	-9%
RM - Romford	£517	£512	-4	-1%
SM - Sutton	£219	£209	-10	-5%
TW - Twickenham	£770	£727	-43	-6%
UB - Southall	£634	£591	-43	-7%
WD - Watford	£552	£544	-8	-1%

Source: BBA

A.10 As shown in Table A-6, in 2012 only three postcode areas had a negative average net lending position, indicating that bank deposits were more prevalent than bank lending. Indeed, in 2011 three additional postcode areas had a negative position which suggests that over the course of a year, bank lending became less popular. The W, SW, and EC areas have tended to have the largest aggregate figure while UB, IG and HA have tended to have the smallest.

Table A-6: Average net lending position for SMEs (aggregate deposits minus aggregate borrowing – £m)

Area	2011	2012	Change	% change
London	£11,099	£13,448	£2,349	21%
W - London	£3,064	£3,256	£192	6%
SW - London	£1,997	£2,168	£171	9%
EC - London	£2,160	£2,084	-£75	3%
WC - London	£1,293	£1,358	£65	5%
GU - Guildford	£801	£1,013	£212	27%
SE - London	£705	£915	£210	30%
KT - Kingston upon Thames	£486	£609	£123	25%
TW - Twickenham	£466	£613	£147	32%
NW - London	£453	£557	£104	23%
WD - Watford	£179	£247	£69	39%
SM - Sutton	£142	£185	£44	31%
BR - Bromley	£102	£184	£82	81%
RM - Romford	£87	£148	£60	69%
CR - Croydon	£17	£124	£107	645%
E - London	-£43	£124	£167	388%
N - London	-£46	£132	£178	385%
EN - Enfield	-£85	£28	£113	133%
UB - Southall	-£116	-£4	£111	96%
IG - Ilford	-£254	-£112	£141	56%

Area	2011	2012	Change	% change
HA - Harrow	-£308	-£182	£126	41%

Source: BBA

Equity finance

A.11 This section draws primarily on data published by the British Private Equity & Venture Capital Association (BVCA), the industry body for the private equity and venture capital industry in the UK[72]. The data presented below refers to investments in all sizes of businesses, not just SMEs.

VC investment

A.12 Table A-7 and Table A-8 show that a notable proportion of the UK's venture capital activity has focused on London. Between 2010 and 2012, London accounted for approximately a quarter of all companies invested in by VCs, and over a third of the overall financial investment by VCs. This reflects the fact the size of the business base in London but also a more general tendency for Venture Capitalists to invest in London and the South East.

A.13 As with bank loans, the supply of venture capital investment has become more constrained. The figures in Table A-7 and Table A-8 show that between 2010 and 2012, there were falls in the amount invested and the number of companies invested in – a trend seen on a national level as well.

Table A-7: Number of VC investments by region

	Number of companies			% of companies nationally		
	2010	2011	2012	2010	2011	2012
London	212	208	191	26	26	23
South East	125	119	115	15	15	14
South West	46	49	49	6	6	6
East of England	47	34	39	6	4	5
West Midlands	72	70	77	9	9	9
East Midlands	37	41	32	4	5	4
Yorkshire & The Humber	50	39	39	6	5	5
North West	66	61	66	8	8	8
North East	46	74	82	6	9	10
Scotland	61	45	67	7	6	8
Wales	41	50	37	5	6	5
Northern Ireland	20	13	26	2	2	3
Total	823	803	820	100	100	100

Source: BVCA (2013)

[72] BVCA (2013), BVCA Private Equity and Venture Capital Report on Investment Activity 2012

Table A-8: Value of VC investments by region

	Amount invested (£m)			% of amount invested nationally		
	2010	2011	2012	2010	2011	2012
London	3,469	2,901	2,062	42	44	36
South East	1,160	1,138	1,281	14	17	22
South West	739	209	172	9	3	3
East of England	78	127	424	1	2	7
West Midlands	910	496	332	11	8	6
East Midlands	76	203	163	1	3	3
Yorkshire & The Humber	479	252	131	6	4	2
North West	607	692	535	7	11	9
North East	346	112	410	4	2	7
Scotland	171	334	159	2	5	3
Wales	39	58	87	-	1	2
Northern Ireland	163	21	9	2	-	-
Total	8,237	6,544	5,767	100	100	100

Source: BVCA

A.14 In addition, Table A-9 shows that London compares favourably in terms of the number of businesses invested in per 10,000 VAT registered enterprises, indicating that VC investment is spread across a comparatively large number of businesses. Indeed, over the period shown, only the North East as a region has seen more companies per 10,000 in receipt of VC investment.

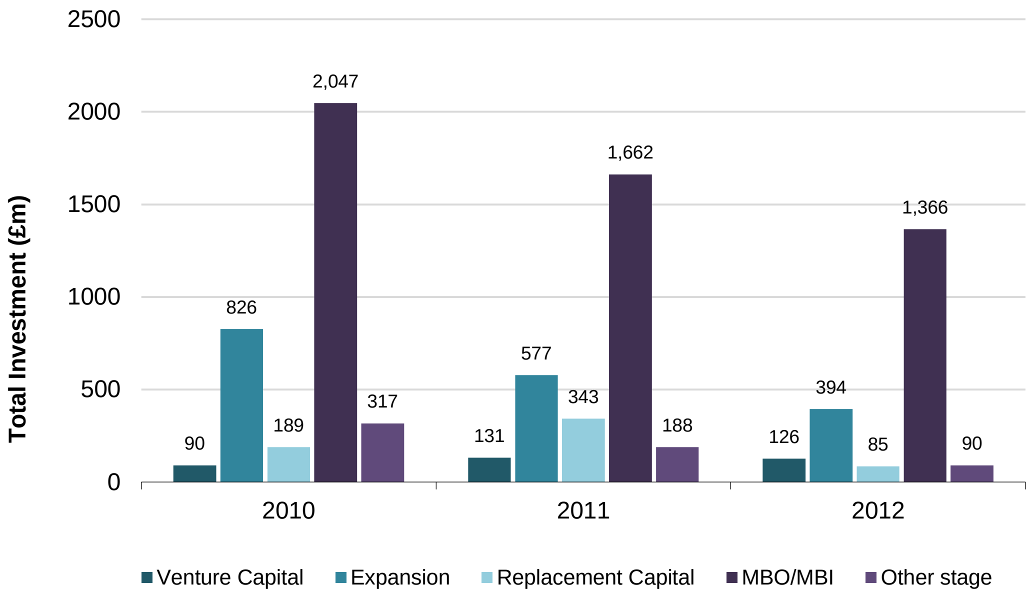
Table A-9: Number of companies that VCs have invested in per 1,000 VAT registered enterprises

	2012	2011	2010
London	0.54	0.53	0.46
South East	0.32	0.3	0.29
South West	0.19	0.21	0.20
East of England	0.19	0.14	0.15
West Midlands	0.34	0.34	0.37
East Midlands	0.21	0.24	0.18
Yorkshire & The Humber	0.27	0.21	0.21
North West	0.26	0.24	0.26
North East	0.61	1.00	1.08
Scotland	0.32	0.23	0.34
Wales	0.36	0.45	0.33
Northern Ireland	0.24	0.16	0.31
Total	0.32	0.32	0.31

Source: BVCA

A.15 Figure A-4 shows the different ways that BVCA members have chosen to invest. As shown, in 2010, 2011 and 2012 venture capital investment only accounted for a small proportion of overall activity. The main role of BVCA members has been in financing management buy-outs and buy-ins, and in financing business expansion. Investment in these two areas did, however, steadily decline over the period, as did 'other stage' development. Venture capital financing levels and investment in replacement capital fluctuated over the period concerned although they have accounted for a comparatively small proportion of all BVCA member investment.

Figure A-4: VC investment stage analysis for London



Source: BVCA

A.16 The BVCA data also shows VC investment by sector. As shown in Table A-10, nearly half of all the companies invested in 2012 were in the health care and consumer services, and nearly a quarter were in technology. These by some margin represent the two sectors most frequently invested in. Although health care and consumer services also accounts for a substantial proportion of the members' overall investment, the technology sector does not. Despite accounting for 23% of all companies invested in, the technology sector only represents 6% of all VC investment. This may well reflect the stage of investment in technology companies, which could be skewed towards early stage investments, which by their nature may be lower than later stage investments.

Table A-10: VC investment by sector in London (for 2012)

	Number of companies invested in	% of all invested companies	Value of investments (£m)	% of all investment
Oil & Gas, basic materials & industrials	26	14%	223	11%
Consumer goods	11	6%	81	4%
Health care & consumer services	89	46%	1,160	56%

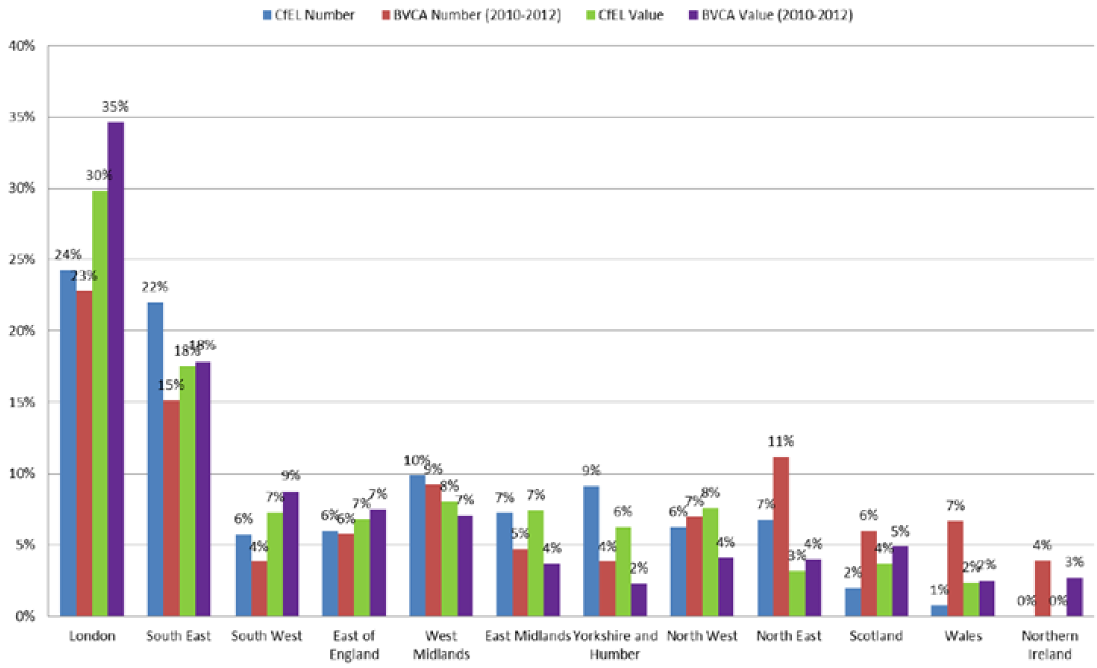
	Number of companies invested in	% of all invested companies	Value of investments (£m)	% of all investment
Telecoms, utilities & financials	17	9%	457	22%
Technology	44	23%	118	6%
Other	4	2%	22	1%
Total	191	100%	2,061	100%

Source: BVCA

Capital for Enterprise Investments

A.17 Capital for Enterprise (CfEL) is a fund management company owned by BIS which manages venture capital and debt guarantee schemes on behalf of the public and private sectors. CfEL is the largest single investor in UK venture capital. According to a recent CfEL update[73], over the last decade over 930 companies have received funding, receiving at least £520m. As shown below the distribution of funds is broadly similar to VC investments as reported by BVCA. Nearly a quarter (24%) of CfEL investments have been made in London with 30% of the total investment value in London.

Figure A-5: CfEL investments by region



Source: CfEL (2013)

Note: The number of CfEL fund investments in the South East is distorted by the Finance South East Accelerator fund which provides a large number of mezzanine loans.

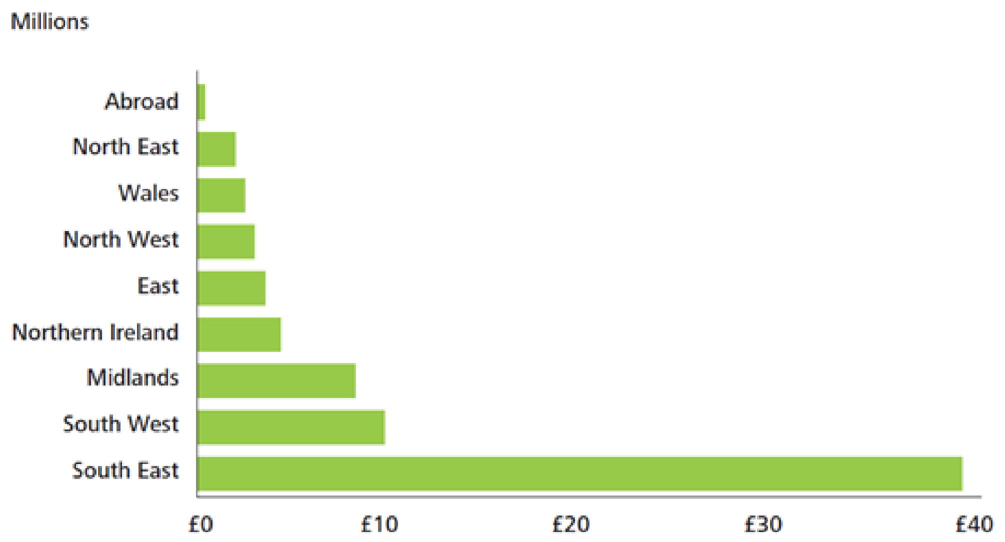
Angel investments

A.18 Angel investors are another source of finance for SMEs particularly for early stage companies. Since the investments in companies are made privately, it is difficult to

[73] Capital for Enterprise Limited (2013), CfEL Equity Scheme Data

accurately quantify the size of the market. However, the UK Business Angel Association (UKBAA) estimates each year around £850m is invested in the UK by 18,000 angel investors. A recent study[74] by the UKBAA analysed a sample of angel deals to establish some of the key characteristics of the angel market. The research found that most angels are attracted to seed and early stage deals and as shown below the largest proportions of investment are secured in London and the South East.

Figure A-6: Angel investment received by region (2012/13)



Source: UKBAA (2013); Note that South East includes London

Regional analysis of Enterprise Finance Guarantee

A.19 As highlighted above, the Enterprise Finance Guarantee is one of the main Government supported initiatives to increase the supply of debt finance and address the reduction in bank lending. Based on the latest available statistics produced by BIS, by March 2013 loans worth £2.14 billion have been offered through the scheme to 20,903 businesses across the UK. This has resulted in loans worth £18 billion being drawn down by 18,196 businesses.

A.20 A total of 2,342 EFG loans had been drawn in London (13% of the overall national figure) with a total value of £254 million (14% of the national total). However, when comparing the value of EFG loans drawn down in London with other parts of the country per 10,000 businesses, London does not rank so highly. In fact, with 28 loans per 10,000 businesses in the region it is the second lowest figure amongst all the UK regions with only Northern Ireland's being lower. In areas such as the North West, this figure has reached as high as 51. Overall, certainly within the English regions, the take-up is lowest in the most prosperous regions, i.e. in London, the South East and East of England. The evaluation of EFG notes that this lower level of take-up may be due to availability of collateral in those regions, and so lending may occur through conventional sources[75].

[74] UKBAA/ Deloitte (2013), Taking the pulse of the angel market
[75] Allinson, G., Robson, P. and Stone, I. (2013) *Economic Evaluation of the Enterprise Finance Guarantee (EFG) Scheme*, BIS: London

Table A-11: No. of EFG Loans offered/ drawn down per 10,000 businesses in UK regions (by March 2013)

	Loans offered per 10,000 businesses	EFG loans drawn per 10,000 businesses
North West	56.8	50.7
North East	52.3	46.0
East Midlands	51.3	44.9
West Midlands	51.9	44.5
South West	47.5	42.1
Yorkshire and The Humber	47.3	41.3
Scotland	44.1	38.7
Wales	42.0	36.9
East of England	39.6	34.1
South East	39.1	33.5
London	**32.8**	**28.0**
Northern Ireland	17.4	15.0
UK	43.2	37.6

Source: BIS (2013)

Annex B: Small Business Survey Analysis

Introduction

B.1 The BIS Small Business Survey (SBS) 2012 is a random quota sampled survey of 5,723 UK SMEs and 543 London SMEs weighted to be representative of the UK SME population by size, sector and region[76]. This provides an opportunity to benchmark London data against that for the UK as a whole. The SBS contains a section of questions on access to finance, exploring success rates and the reasons for problems in accessing external finance, including a measure of latent demand and discouraged borrowers. Data presented is also compared to findings from the previous BIS SBS 2010 to provide indications of key recent trends.

Demand for external Finance

B.2 The focus is on examining the London SME sector's demand for external finance and where unmet and latent demand may be occurring that might demonstrate finance gaps for these businesses. London region data is compared to the UK-wide situation and attention is given to whether any clear recent trends are taking place. It should be noted that the data presented here are for all SMEs, whereas the SBS reports only present data for employer SMEs. This decision has been taken in order to provide a better representation of all London SMEs and to increase the sample size and allow more robust cross tabulation.

Overall Demand

B.3 The **overall demand for external finance**, defined as those seeking or applying for external finance during the previous 12 months has **increased in London, from 14% in 2010 to 15.8%, bringing London into alignment with UK demand in 2012** (15.9%).

B.4 There also appears to be **greater incidence of SME multiple applications for external finance taking place in London in 2012 (6.8%) compared to the UK (4.7%)** and **representing a considerable rise from 2010 when only 2.9% of London SMEs sought finance more than once**. The increased incidence of multiple applications is often a measure of lack of initial success in applying for finance, leading to seeking other substitute forms of finance, but could also be indicative of a general increase in demand for different types of finance in London.

Difficulties Experienced Obtaining External Finance

B.5 **One in sixteen (6.2%) of London's SMEs experienced problems in accessing external finance during the past year, lower than for the UK (7.8%) in this period.** London's SMEs experienced slightly less problems accessing finance in 2012 than in 2010 (6.5%) and have generally experienced less problems than in the UK as a whole in this period.

[76] The UK Small Business Survey (SBS 2012) is extremely robust. Statistical confidence levels are available in the main report on pages 11-12.

Latent Demand for Finance

B.6 **A higher proportion of London's SMEs not applying for finance (13.4%) required external finance but did not apply, when compared to the UK as a whole (11.7%).** Although the question was set in a different manner in 2010, it is evident that London's SMEs also exhibited much stronger latent demand for external finance when compared to the UK as a whole in 2010.

B.7 **London displays greater prevalence of discouraged borrowers than in the UK as a whole,** amongst those exhibiting latent demand (% of latent demand): **The main reason cited by London SMEs for not applying for the external finance that they required was fear of rejection, with two fifths (39.7%) stating this compared with less than one quarter (23.7%) for the UK as a whole.**

B.8 Where multiple (not necessarily priority) reasons are provided: two thirds (66.7%) believe that the cost of finance will be too expensive compared with 56.9% in the UK as a whole; nearly two thirds (62.8%) fear rejection compared with less than half (45.6%) for the UK as a whole (significant at below .01 level). However, **London's SMEs also exhibit a significantly (at beyond .001 level) more cautious approach to borrowing with four out of five (80.8%) with latent demand stating that they did not want to the risk of taking on more finance, compared with just over three fifths (61.7%) for the UK as a whole.** London SMEs were also significantly (at beyond .001 level) more concerned with the prevailing poor economic conditions (71.8%) than in the UK as a whole (46.7%). Just over one fifth (21.5%) were unclear where to find the external finance required, slightly higher than for the UK as a whole (19.6%).

Understanding of Finance

B.9 Surveyed SME managers that had sought external finance during the past year were asked how well they believe they understand finance provision. **London's SME finance seekers exhibit a slightly higher proportion with a reasonable understanding in 2012: Two thirds (66.7%) compared with 62.8% for the UK as a whole**. Around half the proportion of London SME finance seekers (7.4%) claimed to have poor understanding of external finance provision, when compared to the UK as a whole (13.9%). This represents a substantial change from 2010, when London SME finance seekers (56.3% compared with 45.4% for the UK as a whole) exhibited particularly poor understanding of external finance. This may be strongly related to dissatisfaction with banks (in particular) and other financiers at that time.

Main Reasons for Seeking Finance

B.10 Working capital remains by far the main reason for seeking finance and this is in line with other small business studies. For example, the FSB 2012 membership survey concluded that the main reason for seeking finance was to assist cash flow (43%).

B.11 **Just over half of London SME finance seekers (51.9%) did so for working capital, slightly less than for the UK as a whole (56.8%).** It is notable that London SME finance seekers' demand for working capital has fallen considerably from 81.3% in 2010, when cash flow issues appear to have been particularly problematic within the London region, when compared to the UK as a whole (58.2%).

B.12 The other main reasons for seeking external finance have been for: acquiring capital equipment and vehicles (15.7%, a significantly (beyond .05 level) lower proportion than for the UK as a whole 24.1%); refinancing, which appears to have been significantly (at beyond .001 level) far more prevalent in London (11.9%) than in the UK as a whole (3.4%); purchasing land and buildings (9.2% in London compared to 8.1% in the UK as a whole).

B.13 It is also notable that **expansion and growth reasons for seeking finance were significantly (at beyond .05 level) more represented amongst London's SMEs** (5.5%) than for UK as a whole (2.3%).

Amount of External Finance Sought

B.14 **London's SME finance seekers are typically looking for larger amounts of finance than their UK SME counterparts**. In 2012 the average amount of finance sought was £284,603 in London, compared with £171,244 for the UK as a whole. This is also demonstrated by the significantly (at beyond .001 level) smaller proportion of London SME finance seekers requiring under £100,000, when compared to the UK as a whole (72.8% compared to 79.1%), and the higher proportion of London SME finance seekers requiring over £1m (9.3% compared to 2.7%). These trends appear to be similar to those found in 2010, although at the £1m plus level, London's SME demand appears to have risen quite sharply from 2.7% in 2010.

B.15 To some extent London's higher average levels of SME finance might be skewed by the incidence of financing through headquarters, but nevertheless, the requirements for funding is within London and given the relatively small proportion of SMEs that are multi-site[77], these findings are more likely to representative of the higher growth and cost requirements of SMEs located in the London region.

Types of Finance Sought

B.16 **Bank finance is by far the main form of finance sought by London's SMEs**. This has consistently been the case in the SBS surveys and also in other UK SME surveys, such as the FSB 2012.

B.17 In 2012, nearly half (47.7%) of London SMEs seeking finance sought bank loans and three in ten (29.4%) sought overdrafts. These figures are slightly lower than for the UK as a whole (49.4% and 33.1% respectively). The rebalancing of SME bank finance in London towards short loans, rather than overdrafts, is in line with the national UK trends (BIS, 2013)[78]. This pattern fits with the high proportion of SMEs undertaking refinancing in London, which may

[77] IDBR 2012 data suggests less than 7% are multi-site
[78] BIS (2013) data shows a contraction in the proportions of SME overdraft and loan applications, but with a much greater contraction in overdrafts since 2007. BDRC (2013) UKSME Finance Monitor regional data indicated that, amongst those seeking finance in the last 12 months, London had a much higher proportion of first time loan applications; 57% compared to 29% for the UK as a whole.

well have experienced requirements from their banks to reduce their overdraft facilities and take out alternative term loans or invoice financing options[79].

B.18 A product of the banks shift of lending from overdrafts has been the increase in factoring and invoice finance in London to 2.8% in 2012 (0% in 2010), but this still remains below the overall UK proportion (3.2%).

B.19 **Loans from family and friends play a significantly (at beyond .001 level) greater role in London (7.3%) than in the UK as a whole (1.8%).** This may be due to factors such as difficulties raising early stage firm finance and cultural issues around higher densities of ethnic minority owned businesses in London. London previously exhibited higher proportions of informal family and friend finance in 2010 (2.7% compared to 1.2% of the UK as a whole), but this proportion has risen quite considerably, perhaps indicating some issues around a lack of suitable or affordable formal funding streams (e.g. for early stage businesses)[80].

B.20 Another important form of finance for early stage SMEs is grant funding[81] and there has been a considerable decline in demand for grant funding in London which has fallen from 11.5% in 2010 to just 0.9% in 2012, well below the UK-wide level (3.9%).

B.21 Leasing and hire purchase finance was sought by 7.9% of London's SME finance seekers in 2012, slightly less than for the UK as a whole (8.7%). There appears to have been a decline in the demand for this type of finance in London from 2010 (11.6%), when it was significantly (at beyond .01 level) far greater than for the UK as a whole (3.6%).

B.22 A significant failing of the SBS survey, which is focused on SMEs in general, is an inability to pick up any cases of equity finance demand in London in 2012. Previous studies demonstrate that equity finance is only sought and used by a small minority of SMEs (typically less than 2%, SBS 2007)[82]. **The London SBS 2012 sample of SMEs is not large enough to capture reliable information on risk funding which is most relevant to innovative, creative and technology based businesses in early stage development.**

B.23 **Overall, in the UK there is a sign that the demand for business angel and venture capital equity has been increasing.** The proportion of SMEs seeking business angel finance rose from 0.9% in 2010 to 1.4% in 2012, and in respect of venture capital it rose from 0.2% to 0.9%. There is also an indication in the 2012 SBS survey that peer to peer and crowd funding lending is taking place; 0.3% for the UK as a whole.

B.24 Whilst the figures for equity funding are minute in terms of the proportional scale of financial lending, the importance of this type of funding should not be overlooked. **For**

[79] Ullah et al. (2011) observed these trends amongst a survey of 100 UK technology based small firms. . BDRC (2013) UKSME Finance Monitor regional data indicated that, amongst those seeking finance in the last 12 months, London has a lower proportion of overdraft application success; 66% in London received some funding, compared with 73% for the UK as a whole.

[80] BDRC (2013) UKSME Finance Monitor indicated a higher proportion of London SME managers having to inject finance into their business than in the UK as a whole; 24% compared to 16%.

[81] North et al. (2013) found that grant funding was particularly important for early stage technology SMEs.

[82] BDRC (2012) UK SME Finance Monitor, Quarter 3 2012, indicates around 1% had sought external equity in the last 12 months, with only one in thirty rejected by banks considering equity finance compared with one in ten considering other forms of debt finance.

example, the 0.9% of London SMEs seeking business angel equity funding in 2010 scaled up could represent upwards of 800 SMEs[83].

Difficulties Obtaining Finance

B.25 Exploring the extent of difficulties experienced in obtaining finance, it should be noted that a majority of seekers do receive all of the funding that they require.

B.26 Of those seeking finance, a lower proportion in London experienced problems (41.7%) compared to the UK as a whole (50.9%). Also a lower proportion in London were unable to receive any finance (28.7%) compared with the UK as a whole (38%), although a higher proportion in London (9.3%) only received some of the funding that they required, when compared to the UK as a whole (3.5%). Only a small proportion (1.9%) in London experienced problems (i.e. delays with negotiations, or requiring an alternative funder), but eventually received all the funding they required.

B.27 **Overall the trend changes from 2010 demonstrate that London is experiencing an easing in the accessibility of external finance**. More SMEs in London are applying for finance and are able to obtain some or all of the finance that they require. In 2010, 39.3% of SME finance seekers could not raise any finance.

B.28 However, it remains a concern that in London in 2012 more than two fifths of SME finance seekers experienced problems (down from 47.3% in 2010) and that 38% were not able to receive all of the finance they required (down from 42% in 2010). It is evident, perhaps due to a wider range of finance available in London, that a significantly (at beyond .05 level) higher proportion of those going to an alternative secondary finance source were able to obtain all the finance they required (50% compared to 30.5% for the UK as a whole).

B.29 Obtaining external finance is perceived as a barrier to growth by three in ten SMEs in the UK (30.5%), with similar proportions in London (30.8%).

Reasons for Problems Seeking Finance

B.30 The main reasons mentioned amongst those encountering problems in raising external finance for SMEs in London were: **insufficient security** (34.9%, significantly at beyond .001 level more than for the UK as a whole, 8.5%); and **not meeting the lenders' criteria** (23.3%, compared with 33.7% in the UK as a whole). It is notable that a high proportion of London SMEs experiencing problems were not receiving reasons for their rejections (25.6% compared with 16.5% in the UK as a whole).

B.31 **The indication is that a majority (65.2%) of finance seeking London SMEs experiencing problems may be 'marginal borrowers', due in particular to lack of security and not meeting lending criteria** (also includes short credit history for younger trading SMEs 7%). This compared to 57.2% of SME finance seekers encountering problems in the UK as a whole.

[83] Note this relates to 0.9% of SME finance seekers in London (i.e. 0.9% of 14%). GLA 2012 data states London has 805,085 SMEs. http://www.london.gov.uk/moderngov/documents/s22201/SMEs%20in%20Londons%20Economy.pdf

B.32 **The significantly (at beyond .05 level) higher proportion of London SMEs** experiencing problems with bank finance being **referred to the Enterprise Finance Guarantee (EFG), 20.7% compared with 10.5% for the UK as a whole**, would appear to support evidence for the higher incidence of marginal bank proposals in London[84].

B.33 An important question here is the extent to which these SMEs are really marginal or unsuitable to the whole London finance market, or unaware of or unwilling to apply for more suitable types of finance.

B.34 Relatively few London SMEs were rejected because of inadequate business plans (2.3%), less than for the UK as a whole (2.9%).

B.35 Significantly (at beyond .001 level) fewer London SMEs rejected the terms offered by lenders, when compared to the UK as a whole (12.1%).

Types of London SMEs Seeking Finance in 2012

B.36 Although the SBS 2012 data sample size is insufficient to run robust detailed cross tabulations against much of the descriptive data presented, it is possible to draw out key trends by employment size, broad sector and trading age.

B.37 Applicant trends tend to follow the general London SME population characteristics with more than half of applicants (57.4%) being self-employed and over one third (34.3%) being micro businesses (1-9 employees). The largest sectoral demand came from business services (22%) and other services (35.8%) and the greatest proportion of demand by firm trading age was from established firms over ten years old (47.7%).

B.38 There are also clear trends in terms of higher proportions of SMEs within employment size categories applying for finances. **Self-employed firms were significantly (at beyond .001 level) less likely to apply for finance: 12.4% applied for finance compared to 28.6% of medium sized firms (with 50-249 employees).** Furthermore, applications decline with increasing trading age, with **those trading less than 4 years significantly (at beyond .01 level) more likely to apply for finance than those trading longer (5-10 years 17.9%; 10+ years 12.6%).**

B.39 In terms of broad sector**, there is disproportionately high representation of applicants amongst the other services (20.9%), TRAD (19.4%) and administrative services (19.4%).**

B.40 **Growth oriented SMEs in London[85]** (defined as those seeking to grow in the next 2-3 years)**, were far more likely** (significant at beyond .001 level) **to have sought external finance in the last year (21.1% compared with 5.7% of non-growth oriented businesses).**

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[84] BIS (2013) indicates a general rise in marginal bank debt finance applications, particularly as company credit ratings are downgraded.

[85] London's SMEs are significantly (<.001 level) more growth oriented than their UK counterparts (64.4% compared to 56.4% for the UK as a whole), SBS 2012.

Types of London SMEs having difficulties obtaining finance in 2012

B.41 Again there are clear trends with the larger London SMEs exhibiting higher proportions of applicants experiencing problems: **medium sized SMEs (50-249 employees) were significantly (at beyond .01 level) to have problems (14.3%) when compared with their smaller London counterparts, with only 4.8% of self-employed businesses experiencing difficulties.** Similarly, it is the **youngest trading SMEs, trading less than 4 years (13.3%) that experience proportionally more problems than their older counterparts, with significantly less (at beyond .01 level) SMEs trading for over ten years experiencing problems (2.2%).**

B.42 Amongst the broad sectors examined, administrative (14.7%) and business services (10.3%) were significantly (at beyond .05 level) more likely to experience problems accessing finance.

B.43 In terms of marginal bank lending, it is notable that 5 out of six problem cases referred to the EFG in London were self-employed, with similar numbers in other services and aged less than four years.

B.44 **Growth oriented SMEs in London were significantly (at beyond .001 level) more likely to encounter problems in accessing external finance than their non-growth counterparts; 7.4% compared to 4.1%.** However, only half the proportion of growth oriented SMEs experiencing problems in London failed to obtain any finance (14.9% compared with 28.6%).

Types of London SMEs with Latent Demand

B.45 Examining those London SMEs that had not applied for external finance during 2012, 13.4% were reluctant borrowers tat stated they needed external finance, but had not applied.

B.46 Whilst none of the cross tabulations undertaken reveal statistically significant results, there are some key findings: micro businesses (1-9 employees) exhibit the highest proportion (21.7%) by employment size; businesses trading between 5-10 years (28.1%) exhibit the highest proportion by trading age; the construction (17.9%), TRAD (17.2%), administrative (16.7%) and other services (15.5%) exhibited the highest proportions amongst the broad sectors.

B.47 **Growth oriented SMEs in London were significantly (at beyond .001 level) more likely to be discouraged/latent demand borrowers; 18.9% compared with 5.2% of their non-growth oriented counterparts.**

Annex C: Other demand side data

SME Finance Monitor

C.1 Another source of data on business demand for finance is the SME Finance Monitor produced by BDRC Continental on behalf of the British Banking Association (BBA) Business Finance Taskforce. The SME Finance Monitor reports quarterly at the UK level.

C.2 Based on the most recent results, the most common type of funding used by SMEs is a bank overdraft which is used by 20% of SMEs (Table C-1). Credit cards (17%) and bank loans/ commercial mortgages (9%) are the other two most common sources of funding. The survey results also state that only 1% of SMEs used equity funding from third parties during this period.

Table C-1: Use of funding by SMEs in Q1 2013

	Total	0 employees	1-9 employees	10-49 employees	50-249 employees
Unweighted base:	20032	4006	6615	6403	3008
Bank overdraft	20%	17%	29%	35%	32%
Credit cards	17%	14%	21%	37%	45%
Bank loan/ Commercial mortgage	9%	6%	15%	22%	27%
Leasing or hire purchase	6%	4%	10%	23%	33%
Loans/ equity from directors	4%	3%	9%	13%	11%
Loans/ equity from family and friends	5%	4%	7%	3%	3%
Invoice finance	2%	1%	4%	10%	16%
Grants	1%	1%	2%	4%	5%
Loans from other 3rd parties	1%	1%	2%	3%	4%
Any of these	41%	35%	55%	69%	72%
None of these	59%	65%	45%	31%	28%

Source: SME Finance Monitor Q1 2013

C.3 At the regional level, data is available for the last two years, 2012 and 2011. In this first set of results (Table C-2), SMEs were asked if they are currently using any of the following forms of finance: Bank overdraft, Credit cards, Bank loan/Commercial mortgage, Leasing or hire purchase, Loans/equity from directors, Loans/equity from family and friends, Invoice finance, Grants, Loans from other 3rd parties, Export/import finance. If they are not using any of these sources, they were asked whether they have used any external finance in the previous 5 years. Just under half (44%) of SMEs in London are currently using external finance. This is in line with the UK average as is the proportion of SMEs who have never used external finance (52%).

Table C-2: Use of external finance in last 5 years

	Unweighted base	Use now	Used in past but not now	Not used at all
East Anglia	1788	44%	5%	51%
East Midlands	1398	44%	4%	52%
London	2400	44%	4%	52%
North West	1814	43%	6%	51%
North/North East	1003	40%	6%	54%
Northern Ireland	1000	47%	3%	51%
Scotland	1610	43%	4%	53%
South East	2427	44%	4%	51%
South West	1816	41%	4%	55%
Wales	1198	44%	5%	51%
West Midlands	1804	44%	4%	53%
Yorkshire & Humber	1797	48%	3%	49%
All SMEs	20,055	44%	4%	52%

Source: SME Finance Monitor 2012 Annual Report

C.4 Table C-3 focuses on SMEs' financial behaviour in the last 12 months and splits SMEs into three groupings. The first group is those businesses that have had a 'borrowing event' which includes: new loan/ overdraft application or renewal; the bank cancelling or renegotiating their facility; the SME cancelling or reducing their facility; or automatic renewal of an overdraft. The second group is for those that have not had such an event but would have liked to borrow, and the final group is for those SMEs who did not wish to borrow and these are described as 'Happy non-seekers'. Across the UK regions and nations, London has one of the lowest levels (21%) of SMEs who have had a borrowing event in the last 12 months. It also has the highest proportion (12%) of SMEs who have not borrowed but would have liked to.

Table C-3: Financial behaviour in last 12 months

	Unweighted base	Had a borrowing event	No borrowing event but would have liked to have borrowed	Happy non-seekers of borrowing
East Anglia	1788	23%	8%	69%
East Midlands	1398	23%	10%	68%
London	2400	21%	12%	66%
North West	1814	21%	8%	70%
North/North East	1003	21%	10%	69%
Northern Ireland	1000	29%	10%	62%
Scotland	1610	22%	10%	68%
South East	2427	23%	9%	67%
South West	1816	26%	8%	66%

	Unweighted base	Had a borrowing event	No borrowing event but would have liked to have borrowed	Happy non-seekers of borrowing
Wales	1198	23%	8%	69%
West Midlands	1804	24%	10%	67%
Yorkshire & Humber	1797	23%	10%	67%
All SMEs	20,055	23%	10%	68%

Source: SME Finance Monitor 2012 Annual Report

C.5 Table C-4 provides a breakdown of those SMEs who have had a borrowing event in the last 12 months. In London's case, 8% of SMEs had a new loan/ overdraft application approved, 3% had their facility cancelled or renegotiated by the bank, and 1% of SMEs chose to reduce or repay the debt.

Table C-4: Borrowing events in the last 12 months

	Unweighted base	New loan/ overdraft application/ renewal	Loan/ overdraft cancelled/ renegotiated by bank	Chose to reduce/pay of facility	Auto renewal of overdraft
East Anglia	1788	11%	3%	1%	12%
East Midlands	1398	10%	4%	2%	10%
London	2,400	8%	3%	1%	12%
North West	1814	11%	3%	2%	9%
North/North East	1003	10%	3%	2%	9%
Northern Ireland	1000	12%	4%	2%	15%
Scotland	1610	11%	4%	1%	9%
South East	2,427	11%	4%	2%	10%
South West	1816	13%	4%	2%	11%
Wales	1198	13%	3%	1%	9%
West Midlands	1804	11%	4%	1%	11%
Yorkshire & Humber	1797	9%	2%	1%	14%
All SMEs	20,055	11%	3%	1%	11%

Source: SME Finance Monitor 2012 Annual Report

C.6 As shown in Table C-5, London has the highest proportion (30%) of SME owners or directors who have invested personal funds in the business because they had no choice. A slightly lower than average proportion of SME owners in London chose to invest (14%). Overall, the proportion of SME owners investing their own funds (44%) is marginally higher than the UK average of 42%.

Table C-5: Injection of personal funds in previous 12 months

	Unweighted base	Injected fund - chose to do so	Injected fund - had no choice	Not something you have done
East Anglia	1346	16%	23%	61%

	Unweighted base	Injected fund - chose to do so	Injected fund - had no choice	Not something you have done
East Midlands	1047	16%	27%	57%
London	1798	14%	30%	57%
North West	1359	18%	25%	57%
North/North East	750	20%	23%	57%
Northern Ireland	750	18%	21%	61%
Scotland	1205	21%	24%	55%
South East	1825	19%	24%	58%
South West	1359	20%	26%	54%
Wales	898	19%	28%	53%
West Midlands	1351	17%	23%	59%
Yorkshire & Humber	1344	15%	27%	58%
Total	15032	17%	25%	57%

Source: SME Finance Monitor 2012 Annual Report

C.7 Based on the number of SMEs that applied for an overdraft facility in the past 12 months, 73% of SMEs across the UK now have the overdraft facility. In London, this figure was 66%, which was third lowest across all UK regions and nations.

C.8 Based on the number of SMEs that applied for a loan facility in the past 12 months, 57% of SMEs across the UK now have the loan facility. In this case, the London figure was slightly below the UK average at 55%.

C.9 Table C-6 presents feedback on the main obstacles for SMEs over the next year. Across the UK, access to finance is perceived to be an issue for 10% of SMEs. In London, only 7% of SMEs cited access to finance as an obstacle. In London, like most areas, the current economic climate (30%) and legislation and regulation (11%) are seen as being the biggest constraints. The results are based on the proportion of SMEs that believed something was a 'major' obstacle.

Table C-6: Obstacles to running the business in the next 12 months

	Un-weighted base	The current economic climate	Legislation and regulation	Cash flow/ issues with late payment	Access to external finance	Availability of relevant advice	Staff related issues
East Anglia	449	27%	10%	12%	12%	4%	5%
East Midlands	349	28%	11%	9%	7%	3%	1%
London	602	30%	11%	9%	7%	5%	3%
North West	450	32%	9%	16%	11%	7%	3%
North/ North East	250	29%	17%	6%	10%	3%	3%

	Un-weighted base	The current economic climate	Legislation and regulation	Cash flow/ issues with late payment	Access to external finance	Availability of relevant advice	Staff related issues
Northern Ireland	250	42%	17%	14%	14%	9%	2%
Scotland	400	36%	10%	15%	13%	8%	3%
South East	600	31%	12%	9%	11%	6%	4%
South West	450	30%	14%	10%	12%	5%	2%
Wales	300	34%	13%	11%	8%	6%	2%
West Midlands	450	32%	12%	12%	13%	8%	2%
Yorkshire & Humber	450	32%	10%	9%	6%	7%	1%
Total	5000	31%	12%	11%	10%	6%	3%

Source: SME Finance Monitor 2012 Annual Report

C.10 Table C-7 shows that in London 13% of SMEs plan to apply for further external finance and a further 25% 'would-be-seekers' of finance who foresee some issues in being able to borrow. The remaining 64% of SMEs are described as 'Happy non-seekers'. This is broadly similar to the UK profile of responses.

Table C-7: Financial plans for next 3 months

	Unweighted base	Plan to apply/renew for finance	Future would-be-seekers - with identified need	Future would-be-seekers - no immediate identified need	Happy non-seekers
East Anglia	449	17%	3%	13%	66%
East Midlands	349	9%	2%	22%	67%
London	602	13%	2%	22%	64%
North West	450	17%	3%	11%	69%
North/North East	600	7%	*	22%	71%
Northern Ireland	250	13%	4%	22%	61%
Scotland	400	14%	2%	17%	66%
South East	600	14%	3%	19%	64%
South West	450	16%	3%	20%	61%
Wales	300	9%	*	22%	68%
West Midlands	450	20%	3%	14%	63%
Yorkshire & Humber	450	9%	3%	23%	65%
Total	5000	14%	2%	19%	65%

Source: SME Finance Monitor 2012 Annual Report (data suppressed)*

C.11 The reasons for 'would-be-seekers' not planning to apply for finance in the next three months are shown in Table C-8. In London, 46% of the would-be-seekers are reluctant to borrow now, 14% have issues with the principle of borrowing, 18% have issues with the processes of borrowing, and 18% stated that they have been discouraged in some way. Note that the sample sizes for the regions are quite small here, and so some caution is needed in interpreting and using the data.

Table C-8: Future would-be seekers – main reason for not planning to apply

	Un-weighted base	Reluctant to borrow now (any)	Issues with principle of borrowing	Issues with process of borrowing	Discouraged (any)	Direct (put off by bank)	Indirect (think they would be turned down)
East Anglia	74	49%	6%	24%	18%	6%	12%
East Midlands	77	55%	28%	10%	2%	-	2%
London	115	46%	14%	18%	18%	3%	15%
North West	73	34%	6%	30%	28%	-	28%
North/ North East	41	60%	-	1%	32%	-	32%
Northern Ireland	42	32%	14%	28%	21%	-	21%
Scotland	77	49%	13%	11%	15%	*	15%
South East	103	50%	12%	14%	14%	*	14%
South West	74	62%	2%	2%	23%	-	23%
Wales	50	62%	17%	9%	12%	-	12%
West Midlands	73	59%	1%	24%	11%	-	11%
Yorkshire & Humber	81	42%	26%	6%	18%	-	18%
Total	880	50%	12%	15%	17%	1%	16%

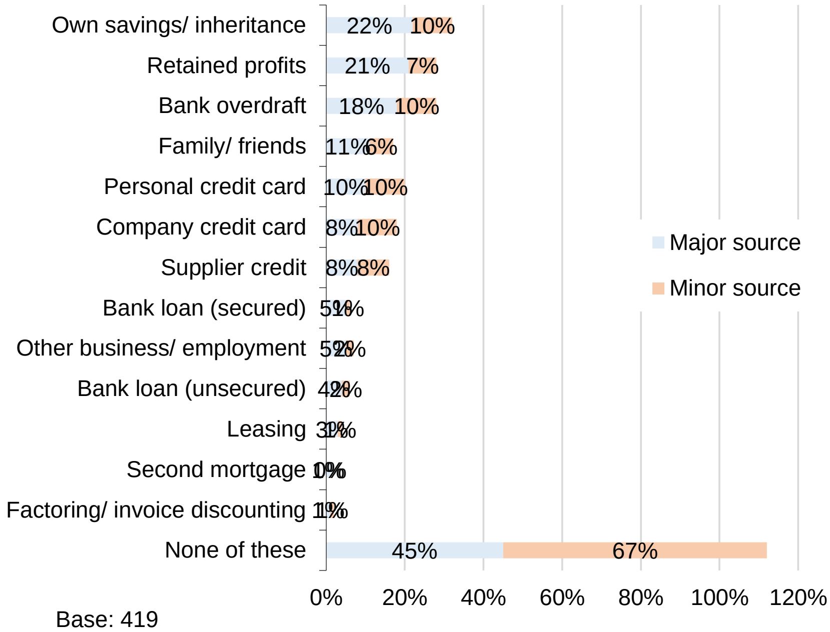
Source: SME Finance Monitor 2012 Annual Report

FSB Member Surveys

C.12 The latest FSB member survey was undertaken in 2011 and reported in early 2012[86]. Data is available for London members which can be compared to UK membership. However, the sample size for London is relatively small with a base of 419 responses out of a total of 11,367[87]. The two graphs below show the different types of finance used by FSB members in the previous 12 months. In London the most common source of finance is the company owner's own finances or inheritance which is a major source of funding for 22% of members. Across the UK, the most common source of finance was bank overdraft with 25% of members using this to fund their business.

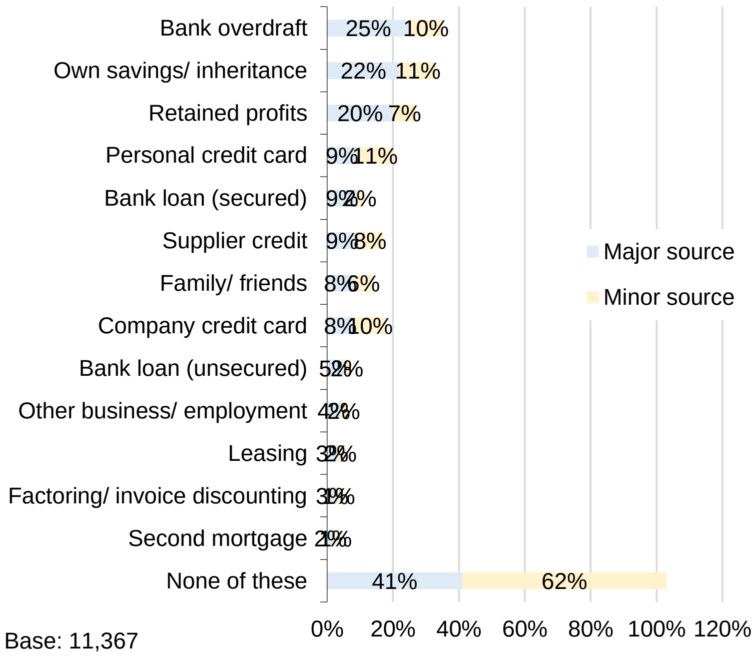
[86] FSB (2012), The FSB 'Voice of Small Business' Member Survey Pan London LEP
[87] As well a relatively small sample for London, it should also be noted that FSB surveys represent feedback from members' sectors rather than the SME business base as a whole.

Figure C-1: Sources of finance used by FSB members in London



Source: FSB Voice of Small Business Survey 2011/12

Figure C-2: Sources of finance used by FSB members in UK



Source: FSB Voice of Small Business Survey 2011/12

In the survey, SMEs were asked about the interest rates that they are paying on their bank loans and overdrafts. The average rate paid by London members was 9% whilst the UK average was 7%. As highlighted in the most recent FSB London Small Business Index[88], there has been a reduction in interest rates with more businesses now paying less than 4%. It is stated that this reduction will be in part due to the UK Government's Funding for Lending Scheme.

[88] FSB London (2013), the FSB London Small Business Index – Quarter 2 2013