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ABSTRACT

This paper reviews the financing profile and the institutional provision of equity and debt finance for small firms in the United Kingdom. It also looks at the changing real cost of funds. It concludes that the United Kingdom is well provided with institutional sources of finance. Contrary to many claims, the paper suggests that it is now a borrowers market for businesses seeking finance for proposals with growth potential, albeit at an all time high financing cost. The paper also suggests that claims for yet more equity capital for start-ups that will never grow to any size may be misplaced.

Paul J. Burns
October, 1987

1. THE PROBLEM : DEMAND FOR FINANCE

In a recent survey of venture capital users[1], two out of three respondents still rated both personal and external finance as a serious or moderate problem when establishing their new business. 41% saw availability of capital as a major obstacle to further growth. The difficulty in obtaining finance is frequently cited as a barrier to small business growth.

The lack of availability of equity capital in particular is often highlighted, especially for new or very small businesses. Many surveys of company finances have been used to support this argument. Table 1 summarises UK research data on financial structures over the 20 year period 1962 to 1982. The broad conclusions to be drawn from these surveys are:

1. Small firms operate with gearing ratios (debt to total funds) similar to or higher than large firms.
2. The proportion of debt represented by long term loans in small firms is significantly lower than for large companies.
3. Small firms are significantly more dependent on creditor finance than large companies.

Insert Table 1 here

Interestingly these conclusions are verified by an international survey covering the UK, USA, Japan, France and Israel conducted by Tamari in 1980[3]. Tamari's research would also seem to suggest that shareholders loans are a significant element in funding small firms, varying between 11% of total assets in the USA, 18% in France, 6% in Japan, 22% in Israel and 3% in the UK. (The Wilson Report put this figure at 11% in the UK by 1975).

This high gearing with a heavy dependence on short term funds is normally seen as inherently risky and unstable. It perhaps goes some way to explain the general lower investment by small firms in fixed tangible assets than large companies, and must mean that small firms are not as well placed to weather economic recession. It is to redress this imbalance that the input of long term equity capital is needed.

2. SUPPLY OF FINANCE : EQUITY

The last decade has seen a mushrooming of institutional sources of equity capital for the new and small firm. The number of venture capital organisations has risen from 20 in 1979 to 126 in 1986. In 1985 they invested some £690 million. Table 2 shows the source of these funds.

Insert Table 2 here

Founded in 1945, 3I dominates the institutional providers and is probably the largest organisation of its kind in the World. As of March 1986 it had long term investments in some 4800 unquoted companies. Table 3 shows the proportion of its investments below £50,000, below £100,000 and in start-up ventures. Whilst 46% of its investments are below £100,000 this represents only 8% of the investments by value. However, significantly 25% by value of its investments have been in start-ups.

Insert Table 3 here

In 1979, venture capital funds (other than 3I) invested under £10 million. By 1985 this had risen to £280 million. In recent years funds have moved towards larger investments, as shown by Table 3. However, once more, 13% by value of investments have been in start-ups and, incidently, a further 6% in 'early stage' finance.

The Business Expansion Scheme (BES) has been particularly successful in encouraging small investments. 64% of investments (representing 10% by value) are in amounts less than £100,000. BES was introduced in 1981 and amended to its present form in 1983. Since then it has seen spectacular growth and has even been copied by the Republic of Ireland. A recent survey of BES by Peat Marwick[4] concluded:

Without BES:

1. 94% of finance invested by individuals would not have gone to particular companies.

2. 93% would not have been invested in UK unquoted companies.

3. 73% would not have been invested in equities in general.

The growth of the venture capital industry in the UK has been spectacular. In the late 70's there was 3I and very little else. Today the industry invests over £690 million, under 40% coming from 3I. In a survey of European small business, Burns and Dewhurst[5] concluded:

> 'The UK seems to lead the other (European) countries in the number of institutional sources of equity for unquoted companies. Institutional providers of venture capital are only just emerging in many of the countries surveyed'.

Table 4 puts the UK industry in an international context showing not only number of firms but also the total venture capital pool. The UK and USA stand out as having by far the best developed markets

Insert Table 4 here

The existence of the 3rd Market, and the Unlisted Securities Market (USM) as well as the share repurchase provisions of the 1981 Companies Act has enhanced the marketability of investment in unquoted companies providing an attractive 'exit route' for outside investors as well as providing valuable 'take-off' stage financing for growth businesses.

Since its creation in November 1980, the USM has seen spectacular growth. It has created over 650 millionaires. Statistics recently produced by accountants Touche Ross chart the spectacular growth in terms of funds raised.

£'million	New Issue	Raised by existing shareholders	Total raised inc. rights issues
First 17 months	**49.7**	**36.3**	**130**
Calender 1984	**NA**	**86.6**	**NA**
Calender 1985	**NA**	**90.3**	**NA**
Calender 1986	**152.2**	**140.6**	**436.8**

The USM now lists about 500 companies with a capitalisation approaching £5 billion and is growing by about 100 new companies each year.

There is some evidence in the UK that the availability of equity funds now exceeds the business opportunities to invest in. Many new issues on the USM are greatly oversubscribed. The launch of the Sock Shop in May was 53 times oversubscribed. A number of venture and BES funds are not fully invested (e.g. the N.C.B. Venture Fund). There is now an established group of Venture Capital managers whose very business existence depends upon them finding a stream of suitable investments, and frequently comment on the difficulty of doing so. In the UK even 'seed' and start-up' equity is becoming more easily available. There are a number of local schemes to 'marry' investors with business needing finance, the best known being run by the London Enterprise Agency and currently being extended outside London. Also The Venture Capital Report, which has been published now for eight years, has raised some £20 million mainly for seed corn investments. The monthly publication carries about a dozen investment opportunities each month giving details of the business, the entrepreneur, the finance sought and whether an active or passive partner is appropriate.

3. THE LIFE CYCLE DYNAMIC AND EQUITY CAPITAL

The nature of long term equity capital which is appropriate and available to small businesses varies as a new venture progresses through its life cycle. Figure 1 illustrates the types of equity capital appropriate to new ventures at various stages of this life cycle. It is adapted from Vickery[6] who based the life cycle stages on work by Churchill and Lewis[7].

Insert Figure 1 here

As can be seen, the nature and variety of equity capital is very wide. Virtually all businesses will have to rely heavily on owners' equity in the early stages of the life cycle. However, not all new businesses will have access to the other forms of venture capital listed.

The vast majority of new businesses grow only in the first few years after start-up and then reach some equilibrium level at which the owner-manager is provided with an adequate, independent life style. The company can stay at this stage indefinitely, provided environmental change does not destroy its market niche or ineffective management reduce its competitive advantage.

Equilibrium businesses of this sort are unlikely to seek additional equity once equilibrium is reached. It is simply not needed. In addition equity involvement at earlier stages will be less attractive to outside backers, even if the owner-manager were to seek it. Firstly, any start-up will be perceived as higher risk than an existing business which has proved the market for its product/service. At the same time the equilibrium business will have limited growth potential and therefore limited exit routes for the investor. Finally, the relatively fixed costs of administration seem extremely high in proportion to the small amounts of equity sought for start-ups of a modest scale. All of these factors add up to the investor seeking a relatively high proportion of the equity of the business at this early stage assuming they wish to invest at all. Add this to the traditional reluctance of the owner-manager to relinquish ownership of their company by bringing in other shareholders and it becomes clear that equilibrium may well be better advised to explore some of the newer instruments of loan finance now available to them.

It is therefore new ventures with growth potential that are most likely to seek, and indeed need additional external equity capital.

4. <u>SUPPLY OF FINANCE : DEBT</u>

There are no published figures on the proportion of commercial bank lending to small firms. However, Table 5 is an attempt to put a value on the loans outstanding to small firms from the major clearers. The figure of £23.5 billion represents approximately £16,000 for each small firm in the UK. The figure is based upon informal research, and should be approached with caution. Midland Bank does not keep records of loans specifically to small firms. That figure is a 'guestimate', albeit consistent with the bank's relative market share. The other three clearers each use different definitions of small firms. Also the figure for overdrafts is only a snapshop at one point of time. It varies widely from one month to another. Finally, it is probable that some overdraft to individuals are in fact being used for business purposes.

Insert Table 5 here

Barclays report loans to small firms up £2 billion from 3 years ago : an annual compound growth of 10%, well in excess of inflation. Nat West also report an increase of 10% over last year, Lloyds an increase of 8%. Both Barclays and Nat West claim to have in excess of 1 million small firm customers each.

Barclays, Midland and Nat West have engaged in a major and continuing programme of rationalisation of their delivery systems for services to small firms. This has mainly taken the form of concentration of professional lending expertise in corporate style branches, but it has also taken the form of a more aggressive marketing effort toward the small firm sector including the emergence of new packaged lending products.

Nat West and Lloyds have been the most prominent in the field of packaged loans. Dating originally from 1971, Nat West's Business Development Loans now total some £1.73 billion and have seen a growth of about 15% per annum since the current scheme was introduced in 1985. Lloyds introduced their Asset and Enterprise Loans in 1979 which was superceded by their Business Loan Scheme in 1984. Barclays have had their Business Expansion Loan since 1980 and Midlands their Small Business Loans and Business Development Loans since 1985. In addition there are a number of other packaged products such as franchise loans, COSIRA loans and European Investment Bank loans from these and other banks.

The Government has also helped by introducing the Small Firm Loan Guarantee Scheme which guarantees 70 per cent of medium term loans now at a premium of 2½ per cent above commercial interest rates. Launched in 1981, the original scheme, which ran until 1984, helped 14,000 businesses with £450 million. However, bad debt claims on the original scheme exceeded income by £37 million. Britain's only national 'subsidised' loan scheme is provided by the European Investment Bank and administered by 3I. There is also a plethora of local and regional schemes directed towards encouraging investment in specific locations rather than in small firms in particular, although there is some evidence that small firms do not make as much use of these schemes as is often supposed.

The evidence would indicate that there is a large and growing provision of loan finance for small firms. This is accompanied by strong competition for business between the clearing banks - certainly a change from a decade ago. A recent NEDC Report[8] observed:

> 'Our interviews have reinforced the view that for several sub-sectors of the market, a borrowers' market is emerging...Branch managers more often than not referred to intense competition for what they termed quality business'.

'Quality business' usually means businesses that have gone beyond start-up and reached a size to demonstrate growth potential. However, the report also points out:

> 'There are far fewer start-ups in which the entrepreneurial element is dominant and which independence is sought....as a precursor to creating an enterprise with growth potential'.

What is more, the bankers themselves would seem to have adequate funds to lend, if the lending opportunities existed. Don Clarke, Finance Director for 3I recently wrote[9]:

> 'Dealing first with long-term debt, I have seen no signs of shortage. Had there been one, we at 3I would have had problems raising money ourselves; and what

> we did raise would have had to be rationed. But, at no time during my 18 years funding 3I has this happened'.

In passing he points out that much of this has come from overseas sources with 3I issuing over £1000 million of debt to foreign investors since 1977. He comments that, given the bouyancy of the European market, they could have issued more 'had there been the opportunity to invest it'.

Is there, then, an unmet demand for finance for viable business projects? A study in Milton Keynes by Robson Rhodes in 1984[10] looked at some 73 local requests for finance (all but 8 for amounts under £100,000 and 30 for amounts less than £10,000) of which 49 were satisfied. It concluded:

> 'Our studies....did not highlight any significant case in which a sound business proposition was unable to attract financial backing through lack of funds....The banks are not unreasonably turning away viable proposals for finance.

In fact 13 of the requests did not even contain sufficient information to assess viability, although 3 requests were later accepted after resubmission.

The problem today would seem to be that too many loan applications are badly presented. There is evidence[11] that most small businessmen in the UK are less well educated in business matters than their counterparts in Europe, and feel in need of additional advice and information, particularly in finance, a view supported by the NEDC Report cited earlier. However, it is not just the presentation of the case, it is also the number of cases where the small business has growth potential. There would seem to be strong evidence that there is more institutional provision of loan and equity finance than there is demand from firms of this sort. The problem in the UK is no longer ensuring an adequate number of start-ups, it is ensuring that those start-ups have growth potential and, more importantly, that the owner-manager is willing to strive to see the business grow.

5. THE COST OF FUNDS

Even if one accepts that there are 'adequate' institutional sources of debt and equity in the UK today, there is always the question of cost. The late seventies saw high rates of inflation which in turn generated high interest rates.

In the UK, since 1972 when 3I raised a 25 year loan stock at $8^7/_8$%, it has only once been able to raise money below 10% until a $9^3/_8$% issue in April this year. The rates of interest on a 20 year debenture over the period 1970-86 are shown in Table 6. they show the steep rise during the late seventies but they also show how, as inflation came down in the eighties, interest rates did not follow.

Insert Table 6 here

Table 6 also gives 'real' interest rates; the difference between the 20 year debenture stock and the inflation rate. The inevitable conclusion is that real interest rates have never been higher. Indeed for most small firms the real costs of finance are even higher. With base rate currently at 10% and many small firms paying premiums of 4%, whilst inflation stands at a little over 4%, this implies a current real cost of borrowing of 10%.

The rate of interest at any time is the result of supply, demand and some government intervention. The prime causes of interest rate levels and fluctuations are often disputed, however, Governments' own borrowing requirements certainly play an important part. The late seventies saw an increase in Government borrowing requirements which probably not only forced up interest rates but also inflation rates. At the same time many companies were very unwilling borrowers as they had to borrow to fill the cash flow gap caused by inflation. The crisis of 1980/81 caused many companies to grasp the unattractive nettle of reducing costs by reducing capacity and improving efficiency rather than accepting the palliative of filling cash flow gaps with borrowed money. Since then, gearing levels for UK companies of all sizes have drifted down and at the same time profitability has improved[12]. Retained earnings and borrowings in the eighties have increasingly been used to finance growth opportunities. Since small firms generally have higher gearing ratios than large firms they are particularly hard hit by these high interest rates and any conclusions about improvements in sources of funds over the period must be tempered because of by the high costs of those funds in the eighties. However, whilst there is some evidence that high interest rates might have affected business stops (see Table 6), there is no evidence that they have affected business start-ups which are currently running at record levels, and as already mentioned, improved profitability has occurred at the same time as this increase in interest rates. Clearly the real effects of high interest rates on small firms may be less than many people suggest.

6. CONCLUSIONS

This paper has shown that the UK is now well provided with institutional sources of equity and debt finance. The situation has transformed itself from the days of the Bolton Report. This paper has also argued that there is adequate finance for new businesses with real growth potential. Indeed the problem would now seem to be that there are insufficient businesses with growth potential coming forward with well prepared proposals. The paper has also argued that it is unrealistic to suggest that more equity finance should be provided for start-ups which do not have growth potential but will instead become 'equilibrium businesses'. These businesses, if viable, are well served by the new range of bank financing instruments, including the Loan Guarantee Scheme, and are being given an increasingly sympathetic hearing from bank managers. The availability of external finance would appear to be no longer a major barrier to small business growth in the United Kingdom.

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   C: 1968-70: R. C. Osborn, ICFC Financing Small and Medium-sized Businesses, IFC 1972 (611 firms subsequently financed by ICFC with medium and mean net assets of £50,000 and £160,000)

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12. P. Burns, Financial Characteristics of Small Companies in the UK, op. cit.

Table 1: Financing of Small Firms in the UK 1962-1982

	Various samples of small companies							Large Companie	
	A	B	C	D	E	F	G	H	G
	1962-63	1964-68	1968-70	1970-71	1971-75	1975	1977-82	1962-75	1977-
	%	%	%	%	%	%	%	%	%
Assets:									
Fixed assets	33	36	37	34	27	32	30	45	3
Current assets	67	64	63	66	73	67	70	55	6
	100	100	100	100	100	100	100	100	10
Financed by:									
Owners interests	58	59	43	53	36	45*	40**	55	4
Current liabilities	29	30	33	31		41	42	26	2
Bank borrowing	11	7	16	12	57	11	15	7	1
Long term loans	2	4	7	3	7	3	3	10	
Minorities	0	0	1	1	0	0	-	2	
	100	100	100	100	100	100	100	100	10

Sources: See reference 2

* includes 11% loans from directors

** excludes loans from directors

Table 2: Sums Invested by Venture Capitalists in 1985

		£'Million
3I (Year ended 31.3.86, including loans)		260*
Venture Capital Funds		280
Business Expansion Scheme		
Funds	46	
Direct Investments (84/85)	101	147
TOTAL		£687

* Includes loans

Source: Venture Economics

Table 3: Proportion of Venture Capital Investments below £100,000 and in Start-Ups : 1985

	3I		Venture Capital Funds*		BES Funds & Direct	
Amounts invested per company	% by number	% by value	% by number	% by value	% by number	% by value
(upper limit)						
£50,000	27%	2%	14%	1%	50%	5%
£100,000	46%	8%	28%	3%	64%	10%
Start up investments	NA	25%**	19%	13%	NA	NA

* Includes BES Funds (but not direct investments)

** Defined as under 3 years old

Source: Venture Economics, May 1986
Inland Revenue Statistics, BES 1984/85
3I Annual Accounts

Table 4: International Venture Capital Markets

	Total No. of VC Firms	Total VC Pool (£m)	VC Pool per head of population
USA	550	13,000	55
UK	126	3,000	54
France	45	500	9
Japan	70	600	5
West Germany	25	300	5
Denmark	14	80	5
Ireland	10	70	4

Source: Venture Economics

Table 5: Bank Loans outstanding to Small Firms 1986/87

	£'Billion
Barclays	8
Nat West	7
Lloyds	5
Midland	3½
	23½

Source: own research

Table 6: Interest Rates in the UK 1979-86

Year	20 years debenture yield %	'Real' Interest %	Business Start-Ups** '000	Business Stops** '000
1970 :	9.9	3.5	-	-
1971 :	9.6	0.2	-	-
1972 :	9.7	2.6	-	-
1973 :	11.4	2.3	-	-
1974 :	16.4	0.4	-	-
1975 :	16.0	-8.2	161	139
1976 :	15.2	-1.3	169	146
1977 :	13.4	-2.4	157	158
1978 :	12.8	4.5	150	156
1979 :	13.2	-0.2	172	125
1980 :	14.2	-3.8	158	142
1981 :	15.4	3.5	152	120
1982 :	14.0	5.4	166	146
1983 :	12.1	7.5	180	146
1984 :	11.8	6.8	182	153
1985 :	11.5	5.4	183	163
1986 :	10.8	7.4	NA	NA

* 'Real' interest is the difference between these 20 year debenture yields and the inflation rate.

** VAT registrations/deregistrations.

Source: Number of businesses : data on Vat Registrations
Employment Gazette, April 1987

FIGURE 1 : EQUITY FINANCE AND THE LIFE CYCLE OF A BUSINESS