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Financing SME Growth in the UK: Meeting the Challenges after the Global Financial Crisis

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Introduction

In the aftermath of the Global Financial Crisis new forms of SME finance are emerging in the place of traditional banking and equity finance sources. This Special Issue has its origins in a conference organised in June 2014 by the Centre for Enterprise and Economic Development Research (CEEDR) at Middlesex University Business School, where all but the final two papers were presented. The Conference was designed to provide a timely forum for leading academics, practitioners and policy makers to disseminate current research and practitioner knowledge exploring finance gaps and how best to address the financing needs of small high growth potential businesses.

The Global Financial Crisis and SME Finance

The global financial crisis, beginning with the sub-prime crisis in the US housing market in August 2007 and culminating in the collapse of Lehman Brothers in September 2008 and the nationalisation or part-nationalisation of a number of major banks across several jurisdictions (Orlowski 2008), reflected a number of factors: the housing boom in the US, which peaked in 2006; the collapse in the sub-prime mortgage market as interest rates and foreclosures rose; and the deregulation of the financial sector and increasingly complex (and not well understood) financial innovations (Almunia et al 2009; Block, Sander and De Vries 2010).

The impact on the SME sector was profound, in terms of restrictions on the supply of capital from financial institutions and constraints on the demand for finance as SMEs faced the trade implications of the resulting economic recession (Cowling, Liu and Ledger 2012; Ogawa and Tanaka 2013). The impact of the GFC was not, however, felt equally across the sector, and bore down most heavily on those SMEs that were already financially constrained and vulnerable before the GFC and thus less able to absorb a credit supply shock (Vermoesen, Deloof and Laveren 2013; McGuinness and Hogan 2014). Furthermore, the GFC had a similarly serious impact on the supply of venture capital, through both a decrease in the supply of money to VC funds and a decrease in the valuation of VC-backed start-ups, with a corresponding negative impact on technological development, innovation and economic growth (Block and Sander 2009; Block et al 2010). In response, policy makers have implemented regulatory and institutional reform in the capital markets in an attempt to improve the supply of capital, and interest has grown in alternative sources of finance.

Review of papers in the double special edition

This double special edition contains a broad and diverse range of papers, written by practitioners (Van der Schans from the British Business Bank and Gill from St John's Innovation Centre) and academics exploring the financing requirements of various types of SMEs in the aftermath of the GFC. Their common unifying theme is the financing addressing gaps and market failures brought about or exacerbated by the GFC. A notable exception is the example of New Zealand, whose relatively sheltered economy provides an interesting contrasting 'control' case (Deakins, North and Bensemann).

The papers span across the contemporary finance escalator (see North, Baldock and Ullah, 2013) from seed and start-up funding through early stage to substantial growth and later stage funding with a particular focus on financing the type of innovative potential high growth SMEs that the current UK government has placed as a cornerstone to policy to rebalance the economy and establish growth drivers in employment, sales and exports (HM Treasury and BIS, 2011). This higher growth oriented policy is called into question in relation to balancing the economic development needs of a wider based economy, notably in terms of addressing the debt financing needs of more modest growth SMEs through government and alternative financing organisations.

Part I: UK Government Policy

The first set of papers focuses on UK Government policy to provide both debt and equity finance in the aftermath of the GFC. The need for a more coherent public policy approach in addressing the SME financing issues brought about by the GFC are highlighted in the key policy papers presented in this issue. These include a practitioner paper by Van der Schans which sets out the unifying vision of the newly established British Business Bank. This paper is particularly helpful in establishing the rationale for a new UK-wide government appointed organisation to address genuine market failure in SME finance.

Jones-Evans, supported by considerable empirical evidence drawn from a recent study of Finance Wales, examines the operation of this Welsh government appointed body in delivering SME debt finance into this devolved UK region. Summarising the problems in raising SME debt finance in the aftermath of the GFC, resulting in increased costs and incidence of refusals for both overdraft and loan finance, allied to depressed demand, the paper raises an important key question as to whether policy should support affordable loans for wider economic development, rather than narrowly focusing on more certain growth oriented and established larger firms.

Both papers suggest the need for these oversight organisations, and perhaps there is a case for a Welsh Development Bank following the lead of the Kreditanstalt für Wiederaufbau (KfW, 2015) domestically in Germany. Such organisations can potentially provide a more coherent approach to policy and more effective post GFC financing escalator, but as Jones-Evans indicates, they need to be clear on their policy objectives.

Developing on the British Business Bank public policy theme, two contrasting papers examine the role of public policy in addressing the equity finance gap facing potential innovative high growth early stage SMEs. Both of the papers, by Gill and Baldock and Mason, note that the equity gap has extended into the £2m to £10m range, as private VCs have continued their retreat, post GFC, to safer later stage funding, exacerbating the Rowlands gap (2009) for more intensive and longer term investments. Gill’s practitioner paper, based on considerable experience of assisting innovative early stage SMEs at St John’s Innovation Centre in Cambridge, presents a compelling case for a refresh of the original 3i approach to providing early stage funding in the UK in the 1970s and 1980s, using core technical expertise whilst also enabling vital outreach to support regional clusters with the substantive investments that are currently lacking outside of the London and Oxbridge triangle. Baldock and Mason draw on recent studies of seed and early stage government equity schemes, focusing on the two key UK flagship VC schemes; the Enterprise Capital Funds (ECFs) and the Angel Co-investment Fund (ACF). They find that they are making a difference, contributing to business and wider economic growth. However, they note that these schemes are evolving and require further monitoring, supporting a key lesson from Lerner’s review of the best practice operation of public VC schemes (2010). This can ensure that they continue to complement each other and address the future equity gap, notably by new super ECFs expanding into the recently extended European Union state aid limit rise from a £2m to a £5m ceiling on initial investments announced in January 2014 (British Business Bank, 2014).

Baldock’s examination of the motivations for UK companies to list on the UK’s Alternative Investment Market (AIM) focuses mainly on growth and expansion funding for smaller cap companies exiting from private equity. Noting that the GFC severely undermined confidence and liquidity in public markets globally and particularly in the case of AIM, the paper finds that this market still has an important role to play, in some cases for earlier stage funding in substitution for private equity. However, it is only likely to provide a more effective exit option for private equity when it is perceived by investors and entrepreneurs as more liquid and stable and therefore a more cost effective alternative to trade sales. Since trade sales may result in the loss of IP, revenue and jobs to foreign buyer economies, following the Kay Review (2011) there would appear to be an important role for government to facilitate an improved AIM and encourage UK based companies to continue their growth.

Part II: International Examples and Alternative Finance for SMEs

Whittam, Talbot and Mac an Bhaird examine the impacts of UK legislation in 2012 designed to increase the lending facilities of credit unions to SMEs. The rationale for this is the reduction in information asymmetries afforded by the perceived local knowledge of credit unions. Using recent evidence from Scottish credit unions, they find that they are reluctant to lend to SMEs because they lack the technical expertise and experience to lend in this perceived high risk market and, as a result, that they are unlikely to offer competitive lending rates. The authors suggest that government needs to have greater understanding of the nuances of delivery organisations like credit unions and the SME lending market in order to design policy which is more effective in targeting support.

Two contrasting papers which examine the financing of potential high growth innovative SMEs are presented by Mac an Bhaird and Lynn who examine Cloud based start-ups in the Republic of Ireland and the study of Deakins, North and Bensemann into the financing of technology based small firms (TBSFs) in New Zealand. In the case of the New Zealand study it is apparent that the country's relatively sheltered and stable economy during the GFC was offset by its small local economy, remoteness and relatively under developed equity finance market, allied to conservative approaches towards using equity. These factors have hindered business growth, but also led to the flight of more successful globally expanding businesses away from New Zealand to substantial growth equity centres in the US or Far East, with the resultant loss of IP, jobs and revenue. Recent moves to tie New Zealand's public equity (the New Zealand Venture Investment Fund, 2012) with public VC in Taiwan may also play an important catalytic role in providing more substantive equity funding in New Zealand, whilst also opening up global market opportunities.

Mac an Bhaird and Lynn call into question the need for public funding to support Cloud tech start-ups in the Republic of Ireland. Their recent study suggests that these essentially low overhead companies are able to adopt Cloud technologies to facilitate rapid expansion using bootstrapping techniques. This involved reducing wages and costs, as well as networking and collaborating with buyers and suppliers for R&D and finance and utilising only relatively small amounts of catalytic grant funding at initial concept stages. The paper concludes that bootstrapping is an essential strategic and financial management approach through which agile and flexible financing solutions can be found.

Lehner, Grabmann and Ennsgraber examine the emerging alternative financing available to entrepreneurs through crowd sources. The authors note that the rapid increase in crowdfunding (CF) has arisen, at least in part, out of the need to find alternative sources of finance for seed and early stage innovation in the aftermath of the GFC. In this highly qualitative study of four ICT business cases seeking CF from the Kickstarter and Indiegogo platforms, the businesses were seeking pledged funds ranging from $100k to $32m in return for innovative product developments and associated rewards. The main focus of the paper is on the various consequences of these campaigns which highlight the complexity of this market. These range from unsuccessful campaigns where funds are returned to highly successful campaigns where considerably more funding is received than originally anticipated. The latter scenario can lead to heightened investor expectations of business performance and scaling up, but which may not be met for a variety of reasons (such as legal, regulatory and technical delays). Whilst CF undoubtedly offers huge global funding opportunities to radical innovation and social improvement projects where there is a collective interest (Drury and Stott, 2011), the authors conclude that considerably more needs to be known and understood about the wider consequences for investors, companies and society.

Finally, Silva and Chávez examine the influence of country institutional and governance characteristics on the performance and resilience of microfinance institutions in a 47-country study. They find, contrary to some previous research, that the microfinance industry was significantly exposed to the global financial shocks of 2008-09. However, it appears that microfinance institutions operating in countries with stronger institutional quality, and where the rule of law imposed constraints on opportunistic behaviour and underpinned confidence in the 'rules of the game', were more resilient to the effects of the GFC. They conclude that given the increased integration of microfinance into the global financial system and its corresponding increased vulnerability to global financial crises, a strong institutional framework for microfinance is more important than ever. This will help to create an enabling environment for MFIs and the microentrepreneurs they serve and to support outreach, economies of scale and the sustainability of the industry.

Conclusion

As a recent World Bank (Ardic, Mylenko and Saltane 2011) report suggests, in the aftermath of the GFC of 2008-2009 there has been an increased interest across developed and emerging economies alike in the role of SMEs in job creation and economic growth. However, based on a major cross-country comparison of SME access to finance this report also demonstrates that performance data shows that access to finance and the cost of credit not only pose barriers to SME financing but constrain small firms to a greater extent than large firms. This confirms other research that suggests that changes in the financial conditions of their banks (notably a decline in equity and Tier1 capital and losses on financial assets) significantly affected firms' access to credit (Popov and Udell 2012). The papers in this Special Issue demonstrate the nature of the government policy response in the UK to the changing market circumstances for SME financing, particularly through institutional evolution, and highlight the impact of the GFC on alternative sources of finance which may become relatively more important across a range of geographies. What is not yet clear, however, is the long-term impact of these innovations and interventions. Given that it is estimated that SME loans represent around 13 per cent of total GDP in developed countries and 3 per cent in developing countries (Ardic et al 2011), any continued constraint in the supply of and effective demand for finance for the SME sector will have significant implications not just for SMEs themselves but for the overall performance of these economies.

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