COLE ASSOCIATES CORPORATE FINANCE
WHITE PAPER
HOW HAS THE FUNDING MARKET FOR SMEs CHANGED SINCE THE CREDIT CRUNCH AND RECESSION?
MAY 2014

In this white paper we assess how the availability of funding for SMEs has changed in the aftermath of the credit crunch in 2008 and subsequent recession, and conclude that there's a slow and patchy improvement at the macro level, and SMEs should be able to find funding if they focus on their unique circumstances.

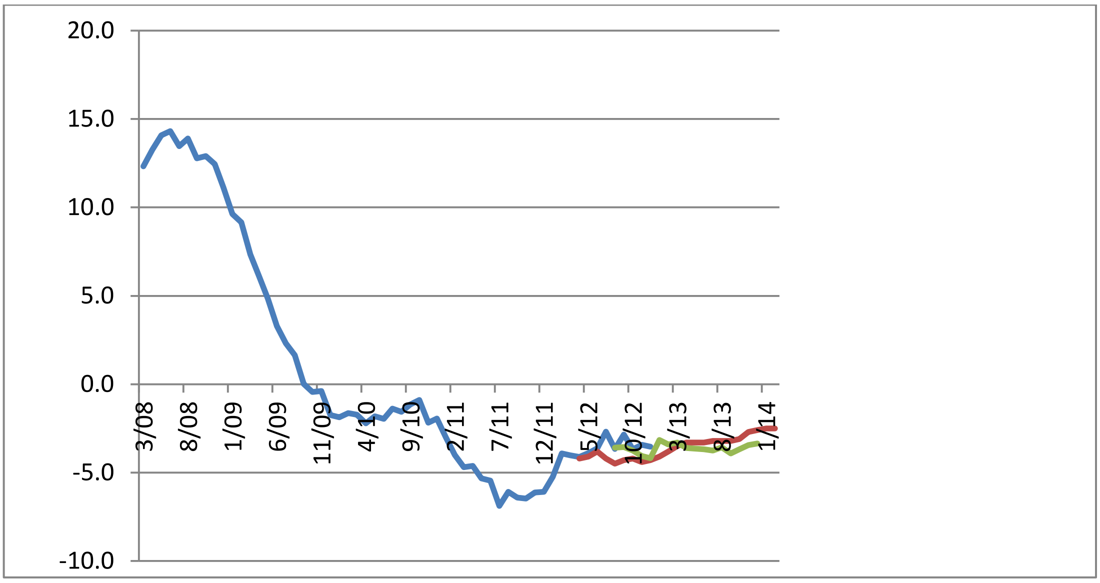
In the immediate aftermath of the credit crunch the banks in particular were largely 'closed for business' as they were either themselves struggling financially and busy planning how to repair the damage to their own balance sheets (mainly the bailed-out banks) or were pausing to assess the fallout from the credit crunch. The wholesale banking market (where banks lend to each other) was effectively paralysed so it is hardly surprising that the banks were unwilling or unable to sanction much new lending to SMEs in 2009 and the first half of 2010.

To compound the damage to the banks themselves, as the recession took hold there was a second problem in that many businesses were themselves adversely affected by the recession, causing the quality of lending proposals to the banks to decline, making positive lending decisions even more unlikely.

The third factor was that a crisis of confidence developed among SME owners in the prospects for obtaining bank approval, so many didn't even bother trying, even the good quality propositions.

This downward spiral of lower supply compounded by lower quality proposals and loss of faith in even trying led to a dearth of new lending to SMEs in 2009-2010.

To put SME lending during the period 2008 to-date into context, the following graph charts the percentage change of lending to SMEs by month from March 2008 to February 2014:

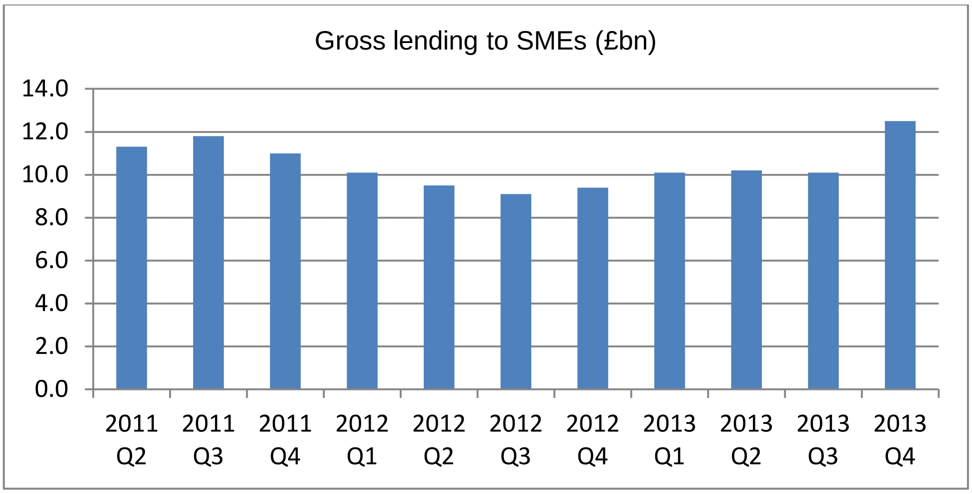


Source Bank of England 'Trends in Lending' report April 2014
http://www.bankofengland.co.uk/publications/Pages/other/monetary/trendsinlending.aspx

However, more recently there has been increasing cause for more optimism:

- The private equity Funds have been well-funded throughout this period, many having raised new funds in the period leading up to 2008. Whilst private equity is a more difficult and sophisticated form of funding to raise than bank debt, and would never be a direct substitute for bank debt, there has doubtless been a degree of private equity funds filling some of the gaps left by the banks. This is particularly true of the mezzanine funds such as Santander's 'Breakthrough Growth Capital' product and, in the North West EV Group's North West Fund for Mezzanine (£750k-£2m).
- Private investors, frustrated with the almost non-existent interest rates on cash deposits have been increasingly looking for 'business angel' opportunities that offer not just a potentially high investment return (albeit quite risky) but also the chance to contribute their skills to the management of the businesses in which they invest, generally in a non-executive capacity. The tax regime for such investing is also very benign in the right circumstances, including EIS and SEIS. Some of these private investors have grouped together into informal 'clubs', often along sector lines, and we believe these can be an excellent form of funding for SMEs, bringing both money and expertise. Alternatively, crowdsourcing has attracted a good deal of publicity but is not yet a significant source of funding and provides the borrowing SME with issues, not least how to communicate with innumerable investors.
- Some SMEs have turned to investment or lending from trade partners (larger corporates) who can take many forms and generally has more 'moving parts' than just a loan, including favourable supply terms etc.
- Some types of funding have remained open for business throughout this period such as invoice finance and other asset-backed lending products, where the borrower has the appropriate unencumbered assets.
- There have been several government initiatives to stimulate lending to SMEs, for example:
    - The Funding for Lending Scheme The Bank of England and HM Treasury launched the Funding for Lending Scheme (FLS) in July 2012. The FLS is designed to incentivise banks to boost their lending to SMEs. FLS was extended in April 2013 to allow participants to borrow from the FLS until January 2015. However, the take up of FLS has been patchy and actually declined in the quarter to April 2014 by £723m compared to a year ago, partly due to the BoE moving the focus from mortgage to business lending.
    - There have been other European and UK national and local government schemes, for example in the North West the Greater Manchester Loan Fund, operated by Maven Capital, offering £100-750k of loans and, in Greater Manchester the Manchester Business Loans offered by Business Finance Solutions (£5-100k loans) – similar schemes are offered by other local authorities. Whilst these initiatives are welcome, part of the challenge is making SMEs aware of their existence.
    - Enterprise Finance Loans, the successor to the Small Firm Loan Guarantee Scheme are always worth considering, although the banks' appetite for them is patchy and can be surprisingly disappointing, often through a lack of internal awareness and training.
- Since 2010, the banks have all, to a greater or lesser extent gradually improved their appetite for new lending to SMEs (with the unfortunate exception of Cooperative Bank) and, even putting aside the hyperbole from the banks' PR departments, there is genuinely a more ambitious attitude among the business development teams and more courage in the credit committees. As the economy has recovered, the performance of SMEs has improved, making them more 'bankable' and SME owners have started to feel more confident about investment in growth and expansion. This virtuous upward spiral is

slower than the corresponding downward spiral described above that followed the credit crunch, but is welcome and is still in progress. The following chart shows the level of banks' gross lending to SMEs from 2011 to 2013 (source: Bank of England):



- The reality is that some sectors and regions are faring better than others and, for many SMEs obtaining new bank lending for expansion remains difficult. There also remains distrust of banks by many SMEs. Phil Orford, chief executive of the Forum of Private Business, said in a report on bank lending to SMEs in May 2014 "At a time when the economy is picking up, the figures remain slightly disappointing." A separate survey to launch the Business Banking Insight (BBI), a new Government-backed website for SMEs to compare bank performances, also found on-going discontent with banks. The survey of 5,000 businesses found 85pc had not approached a bank to apply for credit during the past 12 months. Firms with less than 10 employees gave their banks an average satisfaction rating of just 60pc while with medium-sized firms, the score was 65pc. Firms gave the banks relatively low level ratings for value for money. John Allan, National Chairman of the Federation of Small Businesses, said: "We expect the banks to use these results to up their game and work harder to support their business customers' ambitions. While some are performing well, these results show there is still work to be done in a number of areas. Most important of these are to restore trust, increase transparency and to offer a better value for money proposition to their small business customers." George Osborne said the survey and the website would be a "powerful tool" for firms to judge the different banks "providing them with the means to see who's up for the challenge and who isn't."

So, in conclusion, the picture is improving but, as always the devil is in the detail. It remains the case that, for an SME the prospects for raising finance are improved not so much by the general economic macro factors but more so by the bespoke approach taken by each SME to put forward the best possible proposal to the most appropriate providers of finance in the specific circumstances of each SME. i.e. knowledge of who to approach and how to approach them remains the key.

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