FINANCE FOR SMALL FIRMS

A SEVENTH REPORT

Bank of England **January 2000**

DEFINITION OF A SMALL FIRM

There is no single definition of a small firm. In this report we have drawn on a range of sources of data and consequently have used more than one definition. Therefore, we have included a list of the most commonly used definitions of firm size.

Department of Trade and Industry

	Employees
Micro firm:	0 – 9
Small firm:	0 – 49
Medium firm:	50 – 249
Large firm:	250+

In practice, Government schemes that are nominally targeted at small firms adopt a variety of working definitions depending on their particular objectives.

European Commission

	Micro firm	Small firm	Medium firm
Turnover	not applicable	max €7mn	max €40mn
Balance sheet	not applicable	max €5mn	max €27mn
Employees	max 10	max 50	max 250
Independence criteria*	not applicable	25%	25%

*The independence criterion refers to the maximum percentage that may be owned by one, or jointly owned by several enterprises not satisfying the same criteria.

To qualify as an SME, both the employee and the independence criteria must be satisfied, and either the turnover or the balance sheet total criteria. A large firm is any not satisfying the above criteria.

Companies Act

	Small company	Medium company
Turnover	max £2.8 mn	max £11.2 mn
Balance sheet	max £1.4 mn	max £5.6 mn
Employees	max 50	max 250

A company qualifies as small or medium if it meets two of the three criteria above in any year.

British Bankers Association

For statistical purposes, the British Bankers Association (BBA) define small businesses as those having an annual account turnover of up to £1 million.

Copies of this report are available from Bank of England Public Enquiries 020 7601 4878
For further information please contact Adrian Piper, Victoria Cleland, Caroline Price, Christopher Lewis, Robert Forster or Kelly Young.

EXECUTIVE SUMMARY

Introduction

This is the seventh annual report in the 'Finance for Small Firms' series and includes a special section on equity finance.

Business environment

The wider macroeconomic environment for smaller businesses improved significantly during 1999. This was borne out by surveys of small business activity and a notable increase in small business confidence, particularly towards the end of the year. That said, the continued strength of sterling still impacted adversely on manufacturing SMEs, which have underperformed smaller businesses in the services sector for much of the past five years.

Small firms continue to feature prominently on the Government's agenda. This was reflected in the policies announced in the Budget (March 1999) and the Pre-Budget Report (November 1999). The proposed Small Business Service was one of the key initiatives to emerge during 1999.

Debt finance

Evidence suggests that traditional bank finance still remains the most important source of external finance for small businesses. 1999 saw a continuation in the trend away from reliance on overdraft finance and an increase in use of term loans. The decline in the net bank indebtedness of the small firms sector was very evident through 1999. The report highlighted the gradual shift towards technology-orientated banking delivery mechanisms, such as telephone and Internet banking. Trade credit continues to be an important, though often overlooked, source of finance for all businesses, with stocks and flows of credit being twice the size of bank credit. Asset-based and receivables finance play an increasingly important role in financing small businesses and the proportion of small firms using factoring and invoice discounting doubled between 1991 and 1999.

Equity finance

Venture capital accounted for just 3% of external finance for SMEs between 1995 and 1997. This is in part due to the "equity gap" where the funding requirements of a company are greater than those that can be met by the small scale providers of finance, but not substantial enough to be considered by the large equity providers. Demand side issues are also important and relatively few small businesses are prepared to accept a reduction in ownership and control in return for equity finance.

The formal venture capital industry invested nearly £5 billion in over 1,300 companies during 1998. However, just £288 million was for start-up and early stage investment, with the majority of the money being channelled towards MBO/MBI deals. There are a number of reasons why more money is invested in the latter, the level of available aggregate returns being a key motivator. Issues such as the high transactions costs associated with making an investment and the subsequent monitoring costs can make small-scale investments inefficient.

Business angels - the informal venture capital market - play an important role in addressing the equity gap. Estimates suggest that there are approximately 18,000 business angels in the UK and

that they annually invest in the region of £500 million. In addition to providing finance, many are able to offer managerial and technical support.

Technology-based firms tend to require equity finance, often at an earlier stage than more traditional industries. The role of venture capital (both informal and formal) is crucial for these businesses, many of which require risk capital from the seedcorn stage. The role of public equity is also important for growth-oriented smaller companies. Second tier equity markets enable smaller companies to access public equity at an earlier stage than would otherwise be the case. Such markets not only enable businesses to raise finance, but also offer earlier exit routes to business angel and venture capital investors.

The Alternative Investment Market had a record year in 1999, raising £933 million. SMEs can also consider OFEX and the Official List. Following a notable period of underperformance of their shares, the smaller quoted company sector saw a marked improvement in trading during 1999. There are still concerns over liquidity within the market. The Government is keen to encourage entrepreneurship and has developed a number of initiatives aimed at promoting it within the UK.

The financing of technology based firms

Technology-based firms face a number of different issues to the general small business population. The complexity of the technology, the intangibility of assets and the unpredictability of cashflows, mean that they are perceived as being inherently risky. The banking sector is developing ways of better servicing the high technology sector, but debt finance is rarely the most appropriate form of finance for high growth high technology SMEs. Venture capital is a valuable source of finance and recent data shows average returns from high technology investments of 23%. There are a range of demand and supply-side public policy initiatives targeted towards high technology firms. The Bank aims to produce a second report on technology-based firms in the course of the year 2000.

Ethnic minority firms

Ethnic minority owned firms currently account for around 7% of the small business stock in the UK. While there is little documented evidence that providers of finance discriminate against ethnic minority firms, some ethnic minorities do regard access to business finance as proportionately more difficult for them compared with small firms in general. Possible reasons for such difficulties include the fact that some ethnic minority firms are concentrated in sectors of the economy that are subject to high failure rates, or the lower levels of available collateral. Banks are taking a number of steps to improve relations with ethnic minority firms and are developing strategies tailored towards their specific needs.

Conclusions

Government policy continues to focus on the needs of the SME sector, particularly technology and growth-orientated firms. Relationships between banks and the small business sector continued on a stable basis throughout 1999, although extensive use was also made of asset based and receivables finance. Equity capital is a useful source of finance for high growth SME but there remain a number of supply and demand side issues affecting the further growth of the market.

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SECTION ONE: INTRODUCTION

The Bank of England's objectives

1.1 One of the Bank's Core Purposes is to ensure the efficiency and effectiveness of the UK's financial services. This is reflected in the Memorandum of Understanding agreed between the Bank, HM Treasury and the Financial Services Authority, in October 1997 which, within the Bank's responsibility for the "overall stability of the financial system as a whole", identifies a specific responsibility for the efficiency and effectiveness of the financial sector. Together these provide the basis for the Bank's interest and involvement in issues relating to financing arrangements for small firms.

The Bank's small firms finance initiative

1.2 The Bank's current work on small firm financing issues dates back to 1993, in the aftermath of the last recession. In the late 1980s and early 1990s, the banks' exposures to the small business sector had given rise to substantial losses. There was also evidence of a breakdown in communication and trust between small firms and their finance providers, specifically the clearing banks, which threatened the effectiveness of the provision of finance to this sector.

1.3 The Bank's first Annual report on Finance for Small Firms was published in January 1994. Since that time many structural changes have occurred, improving the provision of bank finance to small businesses. This report is the seventh in this series.

The Bank's work during 1999

1.4 Last year's report was written against a background of concern about the possibility of a further slowdown in the domestic economy. That report concluded, positively, that the small business sector should be less vulnerable to a downturn in the economy than in the last business cycle. This reflected a number of factors:

- Many small businesses were more appropriately financed than in the early 1990s.
- Relationships between banks and small businesses had improved significantly.
- The overall quality of the small business stock was higher than in the late 1980s.

1.5 Notwithstanding these factors, the Bank in 1999 maintained – and, where possible, enhanced – its programme of contact with banks and other finance providers, small business representative organisations, trade associations, professional bodies, academics and relevant Government departments. Such contacts continue to provide the main source of information underpinning the Bank's work in this field, and we welcome opportunities to widen their scope and coverage.

1.6 Alongside this important work on small business finance issues generally, the Bank focused on a number of more specific areas during 1999:

- Our report "The Financing of Ethnic Minority Firms in the United Kingdom" was published in May 1999 and attracted wide interest.

- We undertook further work on the financing of technology-based small firms, focusing particularly on the attitudes of institutional investors towards venture capital targeted at early stage investments in the high technology sector.
- With the publication in November of the Treasury's report on "Enterprise and Social Exclusion", a new dimension was added to the Bank's small firms' work – access to business finance in deprived communities.

All of these subjects are covered in the present report, and all will be carried forward into the Bank's 2000 work programme.

The Report

1.7 The current report covers the customary areas explored by its predecessors. The section on the business environment contains reference to a number of subjects of topical interest, including the Government's new Small Business Service and financial exclusion issues as they relate to small business finance. The section on debt finance in large part reports steady further progress in the positive directions highlighted in last year's report.

1.8 What is new, however, is a greatly-expanded section on equity finance. This reflects the Bank's view that, while much progress has been made during recent years on the provision of debt and asset-based finance to the small business sector, the availability of equity finance (both for start-up and for growth) remains more problematic. This has a clear relevance to the high technology sector, in which the Bank has had a strong interest for some years, but also applies more widely. This section looks at both the demand for, and the supply of, informal and formal venture capital for small firms, as well as examining issues relating to smaller quoted companies and public equity markets. The whole spectrum of equity finance is thus covered – from seed capital and business angels, through venture capital and private equity, to public markets. The report identifies a number of ongoing difficulties in these areas, some of which are already being addressed by UK Government and European initiatives.

1.9 The Bank welcomes comments on this report (addressed, please, to the authors - see page i).

SECTION TWO: BUSINESS ENVIRONMENT

2.1 The financing requirements of small and medium-sized enterprises (SMEs) are influenced greatly by the general macroeconomic environment, including the overall stance of monetary and fiscal policy. This section, therefore, reviews recent macroeconomic developments and summarises the main fiscal and other changes affecting SMEs over the past year.

Macroeconomic developments

2.2 The general macroeconomic environment for smaller businesses has improved significantly over the past year. This has followed a difficult period, especially for SMEs in the manufacturing sector, whose trading position in 1998 was adversely affected by the world economic slowdown induced by the Asian financial crisis.

2.3 Assisted by the relaxation of monetary policy between October 1998 and June 1999, however, GDP rose by a further 0.8% in 1999 Q3. With growing signs of a recovery in the world economy, the performance of and outlook for SMEs in both services and manufacturing, picked up substantially in the course of 1999. That said the continued strength of sterling still impacts adversely on manufacturing SMEs, which have underperformed smaller businesses in the services sector for much of the past five years.

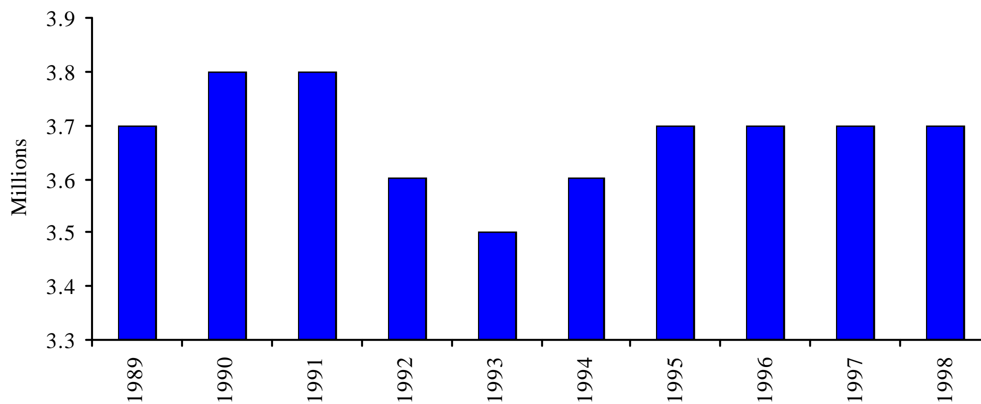
2.4 This general improvement has been borne out by recent surveys of business activity. The CBI/Pannel Kerr Forster Survey for 1999 Q3 reported the first positive balance for small business confidence in two years (the negative balance in Q2 was itself the smallest since October 1997). Furthermore, the Forum of Private Business's longitudinal survey of expanding businesses[1] saw an increase, with the percentage of expanding businesses reaching 41.6%. The NatWest survey[2] has consistently been less promising, but other survey indicators, together with the reports of the Bank's regional Agents, suggest a more positive outlook. This is consistent with expectations of GDP growth, at around 2.5-3% over the next two years.

UK business stock

2.5 DTI data indicates that there were 3.7 million businesses in 1998, the latest year for which figures are available. The total has remained fairly stable for the past 4 years, having recovered from a drop between 1991 and 1993 (see Chart 2.1). The vast bulk of the business population, by number, is accounted for by businesses with less than 50 employees (see Table 2.1). Such firms currently account for over 44% of business employment and 38% of total business turnover, although the proportions have fallen a little in recent years.

[1] Forum of Private Business *Quarterly Survey* (December 1999).
[2] NatWest/SBRT *Quarterly Survey of Small Businesses in Britain* (September 1999).

Chart 2.1
Number of enterprises



Source: "Small and Medium Enterprise Statistics for the United Kingdom, 1998" DTI Statistical Bulletin.

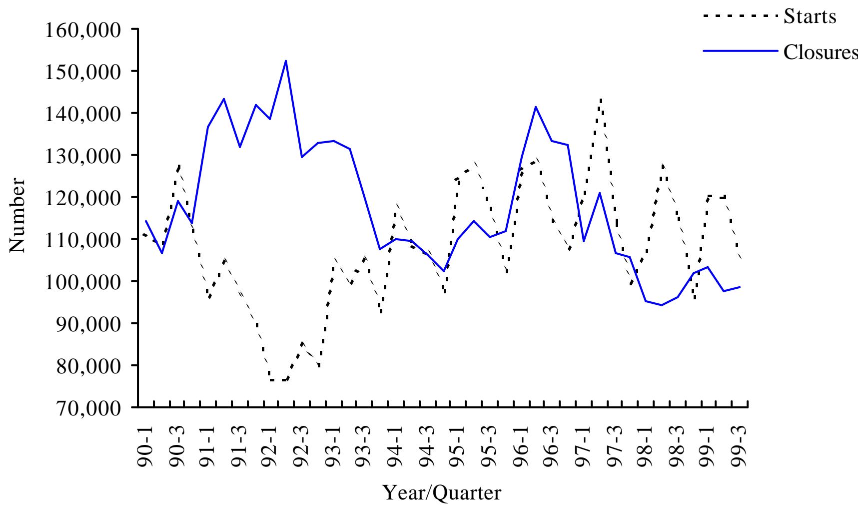
Table 2.1
Composition of the business stock

Number of businesses %	Micro (0-9 employees)	Small (10-49 employees)	Medium (50-249 employees)	Large (250+ employees)
1996	94.70	4.40	0.60	0.20
1997	95.00	4.20	0.60	0.20
1998	94.80	4.40	0.60	0.20
Employment %				
1996	30.60	15.30	12.50	41.80
1997	30.20	14.50	12.10	43.20
1998	30.50	14.20	11.60	43.70
Turnover %				
1996	25.00	17.30	14.00	43.70
1997	23.10	16.40	14.20	46.20
1998	22.10	15.90	13.90	48.10

Source: Adapted from "Small and Medium Enterprise Statistics for the United Kingdom, 1998" DTI Statistical Bulletin.

2.6 Chart 2.2 provides the Barclays Bank data for business start-ups and closures across all businesses. It shows clearly the substantial rise in closures, and fall in start-ups, following the recession in the early 1990s. Notwithstanding the more recent slowdown in the economy, in 1998, the total number of business start-ups has exceeded closures for most of the past two years. The closure rate, having fallen fairly consistently from mid-1996 to mid-1998, has been stable at around 3.5-3.75% since then. Although the recent economic slowdown was much less marked both in terms of duration and severity than in 1989-1991, the closure statistics suggest the business sector might now be more robust in the face of the economic cycle than it was then.

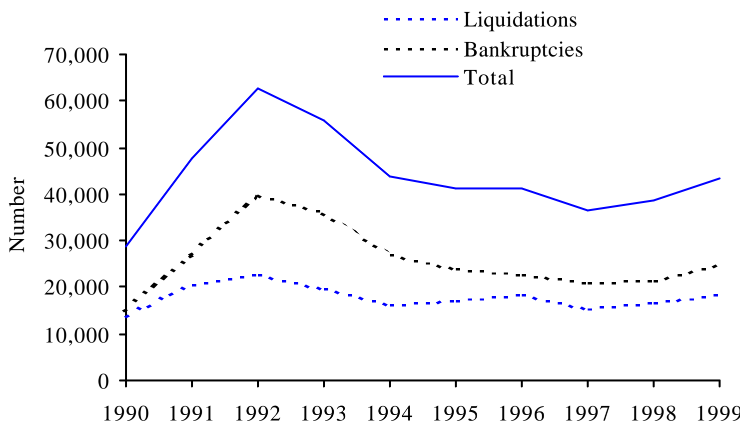
Chart 2.2
Total business openings and closures for all sized businesses 1990 to 1999



Source: "Barclays Small Business Bulletin" Barclays Economics Department.

2.7 The recent attenuation of the trend of a falling closure rate largely reflects a cyclical rise in liquidations and bankruptcies in the SME sector in 1998 and 1999. Indeed the latest Dun and Bradstreet figures show a 12% rise in business failures during 1999, compared with 1998. Again, however, the increase in liquidations and bankruptcies in this cycle has been much smaller than in 1990-1992 and follows a sustained fall in liquidations and bankruptcies between 1992 and 1997 (see Chart 2.3).

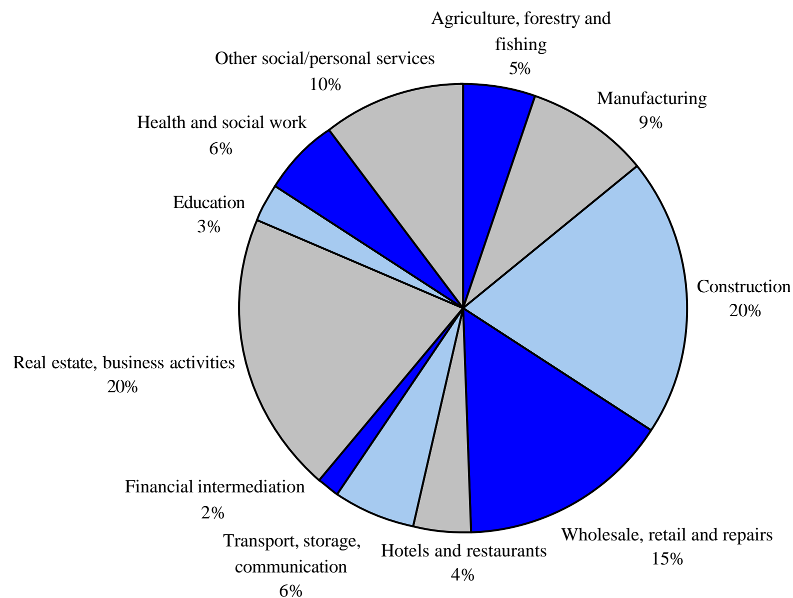
Chart 2.3
Liquidations and bankruptcies



Source: Dun & Bradstreet – January 2000

2.8 The sectoral breakdown shows that a relatively large proportion of smaller firms continue to be located in the construction, real estate/business activities and wholesale/retail sectors – 20%, 20% and 15 % of the 1998 total respectively (see Chart 2.4). Although the relative proportions have altered a little over the past 5 years, the leading areas of SME activity have remained unchanged.

Chart 2.4
Smaller firms by sector 1998



Source: "Small and Medium Enterprise Statistics for the United Kingdom, 1998" DTI Statistical Bulletin.
(Note: Sectors <1% excluded from chart).

Public policy

2.9 Fiscal policy and Government initiatives also have a significant impact on the environment in which small businesses trade. The last two Budgets, and the Chancellor's recent Pre-Budget Report in November 1999, included a range of measures designed to create a more favourable environment for small firms, and to encourage entrepreneurship in the UK. In addition, a number of significant new initiatives, such as the Small Business Service (see box on page 8), were announced in 1999 and will be developed further in the year 2000.

March 1999 Budget

Corporation tax

2.10 Following the reduction, from 1 April 1999, in the small firms' corporation tax rate from 21% to 20% (which applies to companies with taxable profits of up to £300,000), the 1999 Budget announced that companies with profits of up to £10,000 will pay corporation tax at 10% from 1 April 2000. Companies with profits of up to £50,000 will benefit through relief easing the transition from the new starting rate to the 20% rate. It is estimated that the change will benefit approximately 270,000 small companies.

Tax credit on research and development

2.11 The Budget set out proposals, for introduction in the year 2000 Finance Bill, for an R&D tax credit for SMEs based on the total cost of their R&D expenditure. Qualifying companies will be able to offset 150% of the cost of their current spending on R&D, gaining a tax credit of 50% compared to the existing relief. The scheme will reduce the after-tax cost of R&D by 12.5% for tax-paying

companies and by 24% for companies not yet in taxable profit, which will be able to receive payable tax credits from the Inland Revenue in respect of their R&D expenditure.

PAYE

2.12 The measure to increase by two-thirds the limit under which employers are allowed to make quarterly PAYE payments gave an extra 130,000 small employers the option of paying PAYE and National Insurance Contributions in quarterly, rather than monthly, instalments.

Capital allowances

2.13 The enhanced first year capital allowances on plant and machinery for SMEs, introduced at a rate of 40% in the previous Budget, were extended to apply to expenditure incurred up to 1 July 2000. More than 99% of smaller businesses qualify for the enhanced allowances.

Corporate venturing

2.14 The Government announced plans to introduce, in the year 2000 Finance Bill, a new tax incentive to promote corporate venturing. The proposals, which consist of up-front corporation tax relief at 20% for investment in qualifying companies, should contribute to the Government's objective of increasing the availability of venture capital to small companies, and encourage wider corporate venturing relationships between investor and investee companies.

Enterprise Management Incentives and employee share ownership

2.15 The Budget announced that a new scheme, termed "Enterprise Management Incentives" would be introduced. This would provide tax relief for certain forms of equity based remuneration, in order to attract high calibre management into small potentially high-growth companies (see also paragraph 2.24 below, for further details). A new employee share ownership scheme was also announced. In addition to receiving free shares, the scheme will allow employees to buy shares in their employer's company from pre-tax salary. Gains arising on shares held in the scheme will be tax-free as long as they are held in the scheme for a specified period (see also paragraph 2.25 below).

Venture capital

2.16 A £20mn Venture Capital Challenge Competition was announced, aimed at encouraging more investment in young high-technology SMEs with growth potential. This is the high technology element of the DTI's Enterprise Fund initiative. The Enterprise Fund also includes new Regional Venture Capital funds.

Capital Gains Tax and the Enterprise Investment Scheme

2.17 A 'rollover' facility was introduced to enable serial investors to maintain CGT taper relief when the chargeable gain on disposal of one European Investment Scheme (EIS) investment is reinvested in another EIS company. However, CGT roll-over relief for those private individuals who do not wish to invest via EIS has been removed.

University Challenge funds

2.18 A further £15million was allocated to the 'University Challenge', allowing the first round to be increased and making possible a second round of the competition which provides seedcorn funding for commercial projects. Further details of the scheme are provided in Section 5.

Small Business Service

2.19 The Budget also announced that the Government is to establish a new Small Business Service, to overhaul and simplify the current framework for the provision of support and advice to SMEs, and to assist SMEs to comply with regulation. For further information see the box below.

The Small Business Service

The Government published its consultation document on the Small Business Service (SBS) in June 1999. The main objective of the new service is to ensure that the interests of small firms receive a higher priority and greater influence within Government.

Three key tasks are envisaged for the Small Business Service:

- To act as a voice for small businesses at the heart of Government.
- To simplify and improve the quality and coherence of Government support for small businesses.
- To help small firms deal with regulation and compliance, and to ensure that the interests of the small business sector are properly considered in future regulation.

Most of the support services delivered by the SBS will apply to England only, as economic development and "better regulation" functions have been devolved to the new administrations. The exception is where the SBS is responsible for delivering an agreed UK-wide service. In such cases, the SBS will be bound by devolution arrangements to take forward any UK-wide activity, including the representation of small business interests for the UK as a whole, in close consultation with the devolved administrations.

The SBS will be headed up by a Chief Executive (David Irwin) reporting to the Secretary of State for Trade and Industry and with direct access to the Prime Minister and to Ministers in other Government departments. In addition, the Chief Executive will be supported by the Small Business Council. The new Chief Executive's role will include:

- The right to be consulted on proposed Government legislation affecting small businesses and on any proposals for changes to business support services.
- Representing the interests of small firms in policy decisions taken by Government.
- Ensuring that Government services intended to assist small businesses are accessible through local outlets of the SBS. The boundaries for the 45 SBS local areas were announced in October 1999 by Patricia Hewitt, DTI Minister for Small Business and E-commerce.
- Ensuring that local business support delivery arrangements are consistent with overall economic strategies developed by the Regional Development Agencies.

The consultation document proposes that the SBS will be established as a Next Steps Agency within the DTI. The document can be seen in full on the DTI's web site: www.dti.gov.uk/sbs/consult.

Regulation

2.20 Survey evidence has consistently suggested that regulatory burdens bear disproportionately on small firms. They often lack specialised management resources and are unable to benefit from economies of scale in achieving compliance. To mitigate these effects, the Government has established a Better Regulation Task Force to advise the Minister for the Cabinet Office. In addition a Regulatory Impact Unit within the Cabinet Office monitors the costs that new legislation is likely to impose on businesses. The November 1999 Pre-Budget statement also announced new initiatives to help small firms deal with regulation and compliance (see section on the Pre-Budget Report below for further details).

2.21 Research published by NatWest/SBRT[3] in September 1999 assessed how much time was spent by UK small businesses on regulatory requirements. The results showed that the majority of firms with more than one or two workers believed that the time taken to deal with regulation had increased during the past year. For example, over 80% of firms with 25-49 workers indicated that there had been a significant increase in the past year. The study found that tax paperwork – including VAT, self-assessment, PAYE and NIC - was overwhelmingly the most time-consuming element. Interestingly, the Working Time Directive and the Minimum Wage were cited by very few respondents, 5.1% and 3% respectively, as one of the three most time-consuming regulatory requirements.

Pre-Budget Report (November 1999)

2.22 A further range of fiscal and other initiatives designed to support smaller businesses, especially in the high-technology sector, were announced in the November 1999 Pre-Budget Report.

Capital Gains Tax

2.23 Subject to consultation, the year 2000 Finance Bill will determine that CGT on the disposal of business assets for higher rate taxpayers and trusts will be reduced from 40% to 22% for investments over three years and to 10% for investments over five years. The tax liability ranges from 23% to 5.75% for basic rate taxpayers. These reductions will be achieved by shortening the business asset taper from ten years to five years. The definition of business assets to which the taper applies is currently a 5% stake in the company for full-time employees, and 25% ownership for an outside investor. However, the Government is considering substantial reductions in both thresholds.

Enterprise Management Incentives and employee share ownership

2.24 Further details of the EMI scheme were announced by the Chancellor. Under the scheme, small higher risk firms will be able to offer up to ten key employees tax-advantaged options over shares worth up to £100,000 (at time of option grant). These will be taxed under a favourable capital gains tax regime on sale of the shares, rather than taxed as income at exercise of the options.

2.25 Further details of the employee share ownership scheme were also announced. Employee shares held for five years are to be exempt from both income tax and capital gains tax. From April 2000, employees will be able to receive shares worth up to £3,000 in their employer's company free of tax and NICs. These will be known as 'free shares'. Employees will also be able to purchase

[3] NatWest and the Small Business Research Trust, *Quarterly Survey of Small Business in Britain* Vol. 15 No 3 (September 1999).

£1,500 of additional shares from their pre-tax salary, to be known as 'partnership shares'. In addition, employers will have the option to match these 'partnership shares' by giving employees up to two free shares for each 'partnership share' they buy, to be known as 'matching shares'.

Enterprise Fund

2.26 The 1998 Competitiveness White Paper foreshadowed the development of an Enterprise Fund aimed at raising more start-up and early stage finance for the smallest enterprises, especially technology-based firms. This will combine public support and private finance via two new channels for equity investment, as well as absorbing the existing Small Firms Loan Guarantee Scheme (SFLGS). The Pre-Budget Report set out further details of these new initiatives. The highlights are:

- A UK High Technology Fund, combining private finance with £20mn of public sector investment to raise a total of at least £125mn by spring 2000. This initiative, backed by the 1999 Budget investment of £20 million as a Venture Capital Challenge Fund will be structured as a fund-of-funds, providing finance for investment in existing venture capital funds that specialise in the provision of equity-based finance to early stage small and medium sized high-technology firms.

- A network of Regional Venture Capital Funds of at least £10mn each across the English regions aimed at small scale, equity investment. The funds are expected to raise £250mn from the private sector, alongside up to £50mn of Government money.

Enterprise grants

2.27 New plans were announced for £45mn of Enterprise Grants to foster the growth of SMEs. Under the three year initiative, a one-off selective grant of up to £75,000 will be available to high-quality businesses (defined as businesses undertaking sustainable projects which provide skilled jobs) employing up to 250 people. Support will be targeted at those growing SMEs that are covered by the new Assisted Areas definitions. The scheme is subject to approval by the European Commission.

The Phoenix Fund

2.28 The Chancellor also announced a national Phoenix Fund, worth £30million, to promote better access to finance and business support in "disadvantaged" areas. The Fund will include:

- A new development fund to promote innovative ways of supporting enterprise in deprived areas, such as business incubator units.

- A new challenge fund to help resource Community Finance Initiatives (CFIs). These tend to be locally run, non-profit organisations, which lend smaller amounts to businesses which banks consider too risky for reasons such as a lack of business experience or poor credit ratings.

- Loan Guarantees to help co-finance commercial lending to Community Finance Initiatives.

- A national network of mentors to business start-ups through a new Business Volunteer Mentoring Association.

2.29 This Fund addresses some of the issues raised in the Treasury-led Policy Action Team 3 report on enterprise and social exclusion in deprived areas. For further information see the box on financial exclusion (page 13).

Business support and administrative burdens

2.30 The Chancellor has asked Lord Trotman to review the policy environment that the Government has put in place for small firms in areas such as tax and business support. This report is to be delivered to the Chancellor in time for its recommendations to inform the March 2000 Budget. The Inland Revenue will also expand the support it provides to new employers, to help small firms deal with payroll regulations. This will include a new national standard for payroll software.

Other new initiatives

2.31 The Pre-Budget Report announced steps to reform the planning system to facilitate the development of high technology clusters in areas of the countryside that were previously excluded due to planning restrictions. In addition, a £68 million plan, spread over five years, to boost enterprise through partnership with the Massachusetts Institute of Technology (MIT) and Cambridge University was announced.

Other Key Public Policy Issues in 1999

Knowledge Bank

2.32 The DTI is presently consulting on a range of options for the establishment of a 'Knowledge Bank', aimed at helping innovative knowledge-based businesses to secure bank finance. Options under discussion include a Government Fund, loan guarantees and a challenge process. The results of the consultation are expected to be announced in Spring 2000.

National minimum wage

2.33 The statutory National Minimum Wage came into force on 1 April 1999 at a level of £3.60 per hour for all employees over the age of 21. Employees between the ages of 18 and 21 are entitled to a minimum wage of £3 per hour.

2.34 A survey of 8,618 small businesses by the Federation of Small Businesses[4] carried out in April 1999 found that small firms were on average paying their employees amounts well over the minimum wage. The average hourly rate for the lowest paid member of full-time staff was £4.69, and for part-time staff £4.26. Nearly two-thirds of respondents said that the minimum wage would have no impact on the likelihood of their business creating new jobs within the next twelve months, although a third said it had reduced the likelihood. Of the 14% of respondents who indicated that some of their staff were paid less than £3.60 per hour, 77% said that they would raise pay levels to comply with the minimum wage.

UK Banking Review

2.35 Donald Cruickshank launched his review of UK banking services, commissioned by the Chancellor in November 1998. The terms of reference of the review are to:

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[4] Federation of Small Businesses, *Small Firms Paying Above the Minimum Wage Level* (May 1999).

- Examine the banking sector in the UK, excluding investment banking.
- Examine the levels of innovation, competition and efficiency in various sub-markets, including SMEs, and assess how these compare with international standards.
- Investigate whether there are options for change which the industry or Government should consider.

2.36 An interim report by the review team was published in July 1999. This focused almost exclusively on the interaction between regulation and competition in financial services. The key recommendation was that the FSA should be given a primary competition objective, in addition to its regulatory objectives.

2.37 The Government responded to this interim report with a series of changes to the Financial Services and Markets Bill (FSMB) announced in the Pre-Budget Report. Although the FSA will not be given a formal competition objective, the amendments will:

- Strengthen the current 'competition principle' in the FSMB to ensure that the FSA keeps to a minimum any distortionary effects of its regulation on competition.
- Require the FSA to consult on the economic costs of its rules, and to report annually on the effects of regulation on competition.
- Provide for the Competition Commission to take the final decision on whether a rule is anti-competitive.
- Narrow the exclusion from competition law for financial firms.
- Allow the OFT and Competition Commission when investigating complex monopolies to consider and comment on any part played by FSA rules.

2.38 The full report is expected to be published in Spring 2000.

Threshold for statutory audits

2.39 In October 1999 the DTI published a consultative document on 'The Statutory Audit Requirement for Smaller Companies'. This followed an announcement by Stephen Byers, Secretary of State for Trade and Industry, in June that the Government intended to consult widely on raising the threshold for the statutory audit requirement. The current threshold is a turnover of £350,000, and this could possibly rise as high as £4.2 million - the maximum level set by the EU. A rise in the threshold to the maximum legal limit would, according to the DTI, enable 250,000 companies to dispense with audits. The DTI estimates that this would save in the region of £1,000- £5,000 per company. However, an increase in the threshold will reduce the obligation on many SMEs to request an audit and banks, and other creditors, might decide to seek alternative forms of information.

UK Insolvency Review

2.40 In September 1999 the Government's Insolvency Service published 'A Review of Company Rescue and Business Reconstruction Mechanisms'. The document made no concrete proposals but invited suggestions on what might be done to promote a broader 'rescue culture' in the UK, particularly for SMEs. Underlying this document is a concern that the UK insolvency regime may be too "creditor-orientated", with a consequential risk of unnecessary liquidation of viable companies

facing temporary problems. The question is raised as to whether such a regime discourages enterprise and risk-taking, and whether economic efficiency and equity might be served by a shift towards more collective procedures in insolvency. It is anticipated that a further consultation document will be published once the review has reported to Ministers.

2.41 In addition, a detailed proposal has been made by the Insolvency Service for an Insolvency Bill in the next parliamentary session. The proposed legislation would require a company to be given notice before an administrative receiver could be appointed by a secured lender. It would also enable small companies to apply to the court for a moratorium when negotiating a Company Voluntary Arrangement (CVA) with their creditors, although the Bill makes no provision for new funding during the moratorium. Both of these proposed clauses were included in an Insolvency Bill announced in the Queen's Speech.

Financial Exclusion

The Social Exclusion Unit was established by the Prime Minister in 1997 to consider the whole range of Government policies relevant to social exclusion. Eighteen Policy Action Teams were formed, to report on different areas of social exclusion, concentrating particularly on England. Two of these reports focus specifically on financial exclusion, namely:

- Access to finance and support services for small firm start-ups and continuing enterprises operating in deprived areas (Policy Action Team 3);
- Access to personal financial services, including insurance (Policy Action Team 14).

Policy Action Team 3's report 'Enterprise and Social Exclusion' was published by the Treasury on 2 November 1999. The objective of the report is to identify how to generate more enterprise in deprived communities. Key recommendations include:

- Business Support: the Small Business Service should have a clear remit to promote enterprise and business growth in deprived communities.
- Barriers to Enterprise: the Government's aim should be to ensure that the transition from benefits to self-employment is as easy as that from welfare to work.
- Finance: the Government should encourage an innovative and competitive financial market to serve poor areas.
- The Bank of England should report regularly on finance for small business in deprived areas. The Bank has accepted this recommendation and has established a financial exclusion team to carry out the work.

The November Pre-Budget Report took the first steps towards implementing some of these recommendations. For further information see the section on the Pre-Budget Report.

Policy Action Team 14's report 'Access to Financial Services' was published by the Treasury on 16 November 1999. Six initiatives to assist people in disadvantaged communities who may be excluded from mainstream financial services have been announced in response to the report's proposals:

- An improved regulatory framework for credit unions.
- A new central service organisation to support and enhance the role of credit unions.
- Support for more widespread introduction of insurance with rent schemes for home contents insurance.
- Exploring the possibilities of widening the role of the Social Fund to help those in low-paid employment.
- Better access to counselling and refinancing for those in debt.

- Greater disclosure by banks of their provision of services to the socially excluded.

The Credit Unions Taskforce also published its report ‘Credit Unions for the Future’ on 16 November 1999. It recommended several measures to improve the regulatory framework within which credit unions operate. These included increases in the maximum repayment periods for loans, removal of the maximum membership limit, allowing credit unions to charge for ancillary services and greater flexibility in the common bond requirements. As part of this new regulatory regime, it has been proposed that the FSA would be given responsibility for the regulation of credit unions. The aim is that credit unions members will, in the future, have protection similar to that for bank and building society customers.

Year 2000

2.42 The build up to Y2K and the fear that computer systems and other microprocessors might fail or misbehave was a significant challenge for all businesses small and large alike. Research by Action 2000[5], the Government initiative to help companies of all sizes overcome the Millennium date change problem, reported that, as at the end of October 1999, 85% (84%) of the smaller companies[6] surveyed were on course or had completed their preparations for Y2K. These figures represent a significant amount of preparation by UK SMEs, and are substantially higher than in July 1998 when just 4% (9%) of smaller companies believed that they were Y2K compliant.

2.43 The process of becoming Y2K compliant has imposed additional exceptional costs on businesses. On the other hand, dealing with the Y2K issue has had some lasting benefits for SMEs, providing an incentive to update ageing IT systems, and hence giving greater ability to cope with the demands of the Internet and e-commerce. So far the amount of Y2K related disruption appears to have been minimal, but it is still too early to declare complete success. The leap year date of February 29 2000 could pose problems and some believe that Y2K could be used as a pretext for not paying bills on time. Dun and Bradstreet have predicted a rise in business bankruptcies in the first part of 2000, as late payment is a frequent cause of business collapse.

[5] Action 2000, *State of the Nation – Wave Eight Results* (October 1999).
[6] Figures outside brackets refer to companies with 1-9 employees, those in brackets refer to those with 10-249 employees.

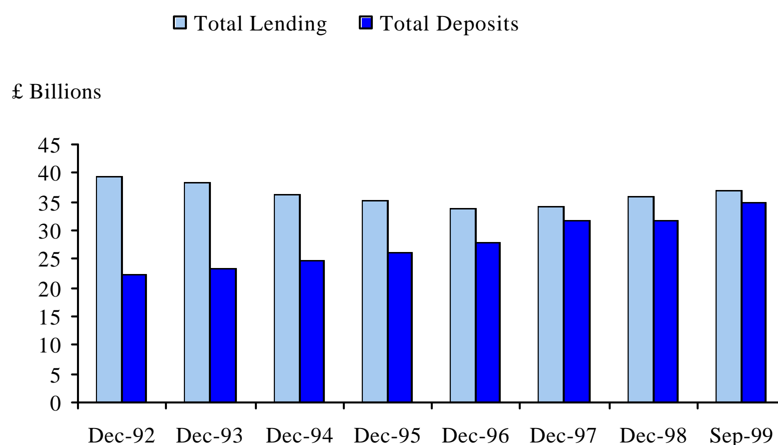
SECTION THREE: DEBT FINANCE

Structure of bank finance

3.1 Traditional bank finance (overdrafts and term loans) remains the most important type of external finance for small businesses, although its importance has declined in recent years as small businesses increasingly diversify their sources of finance. In the period 1995-97 bank finance accounted for 47% of external finance[7], against 61% in 1987-90[8]. Moreover, the characteristics of bank finance have changed considerably during the 1990s. These changes were discussed in greater detail in a special section "The Changing Face of Small Firms Finance" in last year's report. Charts 3.1 and 3.2 of outstanding balances highlight some of the key changes: the decline in the net bank indebtedness of the small firms sector, and the continued growth of term borrowing at the expense of overdrafts.

3.2 The implications of these and other trends for financial stability, and in particular for the quality of the banks' loan books, were considered in detail in last year's report. The conclusion was that improvements in the relationship between small firms and banks had reduced the risks of banks making losses on the same scale as in the early 1990s on their small business loan books. Small firms have a greater understanding of their financing needs, and are less vulnerable to a deterioration of trading conditions than in the early 1990s.

Chart 3.1
Outstanding small business lending and deposits (1992-1999)



Source: BBA

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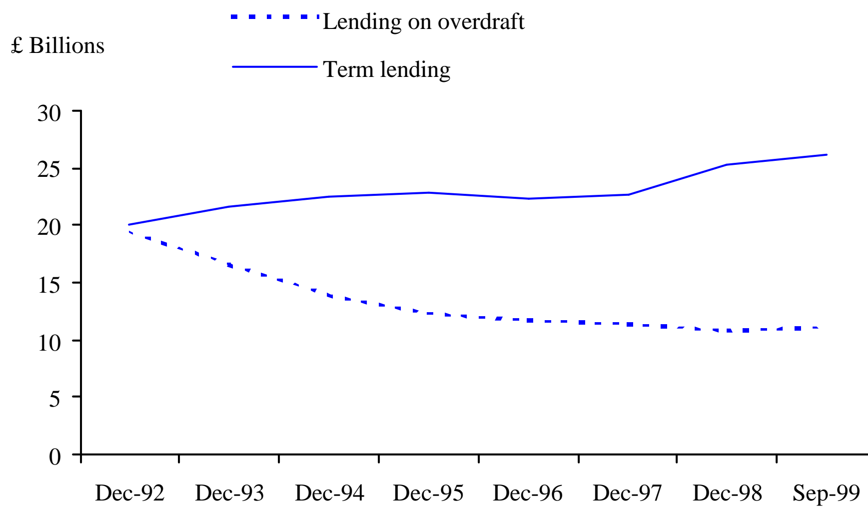
[7] ESRC Centre for Business Research, Cambridge, *Enterprise Britain1994-1997(*1998).
[8] ESRC Centre for Business Research, Cambridge, *The Changing State of British Enterprise* (1996).

Chart 3.2
Small business sector lending (1992-1999)

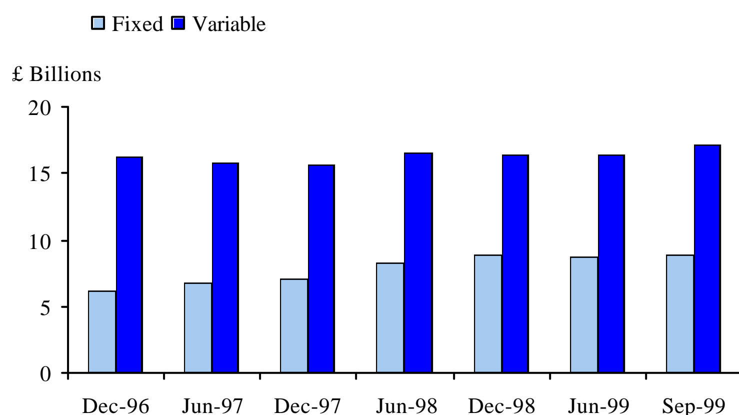


Source: BBA

3.3 Charts 3.1 to 3.4 relate to the stock of lending outstanding at a given point in time. Chart 3.1 demonstrates that bank lending to the SME sector has started to increase again, having fallen consistently from 1992-96. In September 1999 total lending reached £37.1 billion, a record increase of £1 billion since June 1999. Chart 3.2 shows that this increase related largely to term lending. The ratio of overdrafts to term lending has fallen significantly since early 1992 (49:51) and now stands at 30:70. The immediate outlook for bank lending to SMEs could be affected by Y2K issues, because many of the banks are planning to provide extra credit to those customers who experience difficulties, despite having taken precautionary steps for Y2K. This could result in a temporary additional increase in bank lending during January 2000.

3.4 Notwithstanding the renewed rise in bank borrowing by SMEs, the net bank indebtedness of the SME sector has continued to fall. This reflects the marked upward trend in deposits, which reached a record high of £35.0 billion in September 1999. The ratio of deposits to lending was 94% in September 1999, compared with 56% in December 1992; moreover this ratio has continually risen since 1992, except during 1998. As already noted, 1998 was a difficult year for many SMEs, and the figures suggest some shift from internal to external finance in the course of the year, perhaps associated with a decline in profitability. But the recovery of the economy in 1999 has resulted in a re-emergence of the previous trend towards reduced net bank indebtedness.

Chart 3.3
Term lending to small businesses (1996-1999)



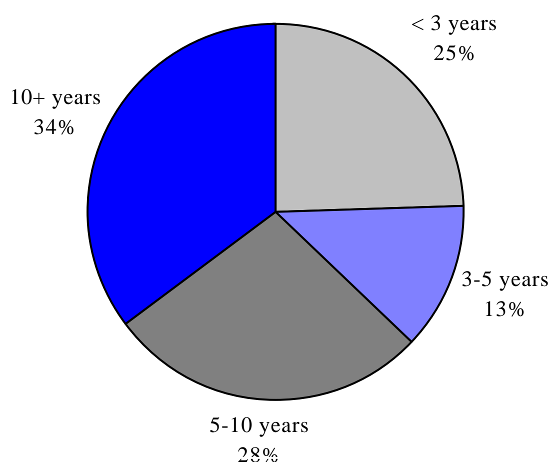
Source: BBA

3.5 Small businesses have, since the mid-1990s, gradually increased their usage of fixed rate loans (see Chart 3.3). In September 1999 fixed rate loans accounted for 34% of term lending, compared with just 28% in December 1996 (24% and 18% respectively of total lending). There has, however, been a slight decline in the importance of fixed rate loans since mid–1998, perhaps reflecting expectations of falling interest rates during a period of slower growth and the tendency for some small businesses to take the form of finance that is cheapest at the time.

3.6 More recently, and looking ahead, the likelihood of higher interest rates, and hence uncertainty, during a period of more rapid economic growth, should lead to a renewed emphasis on the importance of fixed rate borrowing. This should provide SMEs with greater certainty of expenditure streams, assisting business planning and enabling businesses to operate in a more certain financial environment.

3.7 The maturity structure of SME gross banking debt is also important. BBA figures on the maturities of bank loans show that, in September 1999, just over a third of loans had a residual maturity of over ten years, whereas around a quarter had a residual maturity of less than three years (see Chart 3.4). The proportions shown in Chart 3.4 below have remained fairly stable since 1996 (when this data was first published by the BBA), although it is interesting that over 60% of the flow of lending in 1999Q3 was for periods in excess of 10 years. This may reflect increasing bank confidence in the outlook for the SME sector.

Chart 3.4
Residual maturity of bank loans September 1999



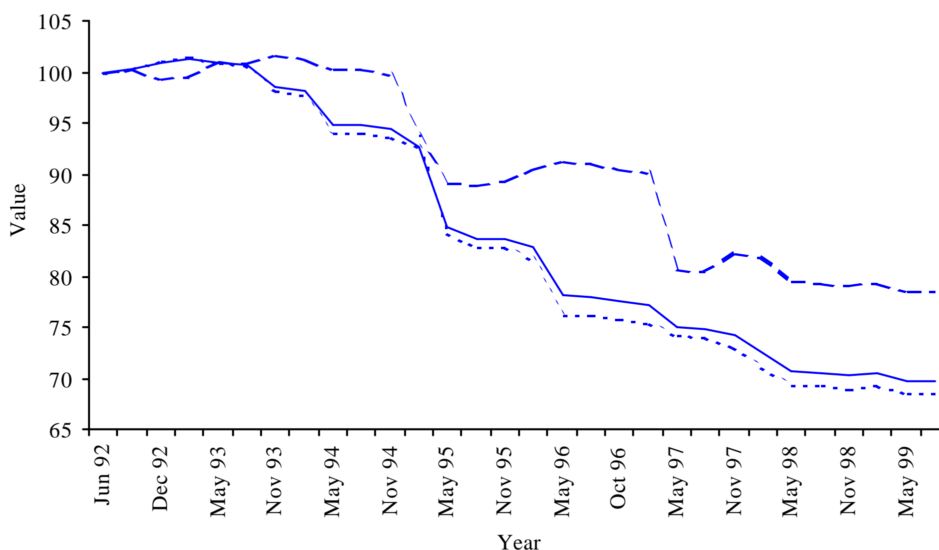
Source: BBA

Cost of bank finance

3.8 Banks derive income from their SME customers not only through margins on borrowing, but also through fees and charges, sales of other products and employment of their non-interest bearing current and deposit accounts. The proportion of total bank income from small businesses attributable to fees and charges varies greatly between the banks, ranging from 20% to nearly 50% in the first half of 1999. Despite an increase in the proportion of income obtained from non-interest sources, however, the Bannock Bank Charges Index[9] of transactional charges has fallen consistently since 1992, as the majority of banks have frozen their fee structure. Taking Q2 1992 as the base year (=100), the index had fallen consistently to approximately 70 by Q2 1998, since when it has been stable (see Chart 3.5). The earlier fall in bank charges was more significant among the major four banks than at other banks. However, although the banks in aggregate have reduced charges, small businesses still cite charges as one of the main driving forces behind bank switching (see paragraph 3.19 on complaints). This could partly reflect the fact that charges appear now to be more rigorously enforced than in the past.

[9] Bannock Consulting *Bank Charges Index*, Q2 1999.

Chart 3.5
Bannock bank charges index



Source: Bannock Consulting

Margins

3.9 The latest data supplied to the Bank suggests that when the mean margins of individual banks were weighted by lending volume, the mean margin over base rate for small business lending was 3.4% in 1999 H1. This has remained fairly stable over the past five years. The bank with the lowest mean margin had one of 2.3% while the highest of any bank was 5.0%, while the margins themselves ranged between 1% and 7.5% over base rate. This was somewhat lower than the corresponding range, of 2% – 8%, in 1998. As noted in earlier reports, the capped distribution of the major banks' margins raises an issue regarding the availability of finance for higher risk businesses. There remains a reluctance on the part of banks to carry out any authorised lending at rates of 7.5% over base rate or above, while only limited amounts of lending occur at rates above 6% over base rate. This situation might be eased as risk assessment techniques improve or other forms of risk sharing develop, although so far indications of greater price discrimination in bank lending to the SME population as a whole are limited.

Loan book and provisions

3.10 The overall quality of the banks' loan books has not altered significantly over the past two years, notwithstanding the slowdown in the economy in 1998-1999. Some banks have experienced an increase in the number of businesses on their watch lists, but others have noted a decrease. The overall quality of bank loan books is significantly better than at the time of the last recession, while the same period has seen a significant decline in the level of bank provisions against small business lending. These improvements reflect considerable efforts on the part of the banks to improve credit scoring and risk adjustment-pricing policies and to develop better early warning mechanisms.

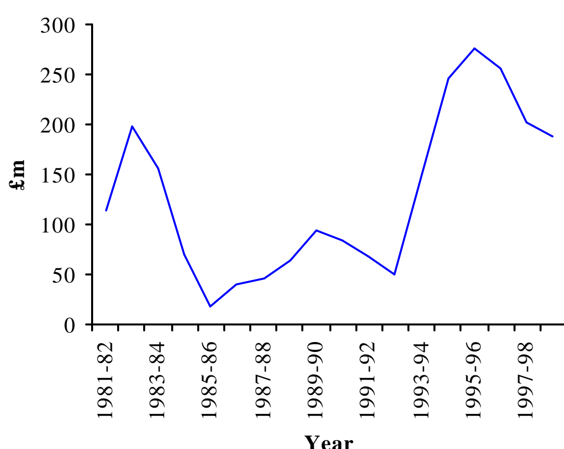
Small Firms Loan Guarantee Scheme

3.11 The Small Firms Loan Guarantee Scheme (SFLGS) was established in 1981 by the DTI. The aim of the Scheme is to improve access to debt finance for viable businesses which are unable to gain conventional finance because of a lack of collateral or trading record, or a combination of both. Since 1981, the SFLGS has been regularly reviewed and amended to ensure that it continues to meet its objectives.

3.12 Since 1993, the scheme has differentiated the treatment of established and start-up firms. Established firms can obtain guarantees for up to 85% of the loan and are charged premiums of 0.5%, while new businesses can only access guarantees for 70% of their loan and are charged a premium of 1.5%. The maximum loan provided under the scheme has increased over time and currently stands at £250,000 for established businesses compared with £100,000 for new businesses. The scheme was modified in 1996, by reducing the number of size definitions and increasing the maximum loan term to 10 years. These changes impacted on both the number of loans taken out and the total volume of lending under the Scheme.

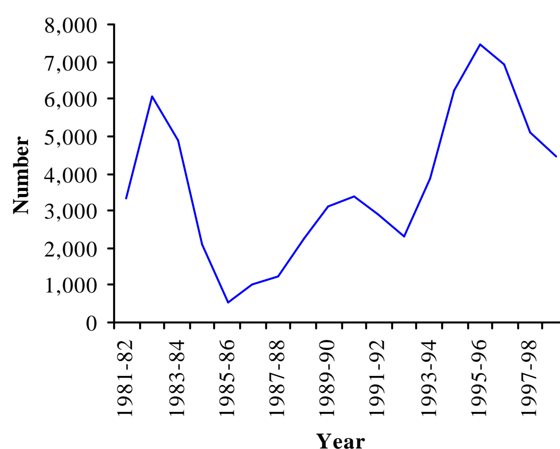
3.13 The most recent DTI figures show that, during the 1998/99 financial year, 4482 loans were guaranteed under the scheme, with a cumulative value of £189 million (see Charts 3.6 and 3.7 below). This is lower than the 5081 loans with a value of £201 million that were guaranteed in 1997/98. During 1998/99, 27% of the loans went to new businesses, with a total value of £37.6 million. The largest number of loans (63%) were for amounts of less than £30,000, although these loans accounted for 27% (£50.8 million) of the total value of the loans made. The largest volume of lending (£84.5 million), which accounted for 45% of the total, was for amounts of between £30,000 and £100,000. During 1998/99, Barclays provided the largest proportion of finance under the scheme (£43.2 million) followed by Lloyds-TSB (£42.3 million), NatWest (£32.7 million) and HSBC (£29.5 million). The remaining £43 million was extended by a range of other approved lenders.

Chart 3.6
SFLGS loans by value (£mn)



Source: DTI

Chart 3.7
SFLGS loans by number



Source: DTI

3.14 The SFLGS remains a useful tool for assisting collateral-constrained small businesses. A 1999 survey by the BCC[10] found that 87% of respondents felt that the Government could do more to assist small businesses, and 35% of these thought that easier access to the SFLGS would be

[10] British Chambers of Commerce, *Small Firms Survey: Finance (* 1999).

beneficial. An independent evaluation of the scheme was carried out by KPMG in December 1998. The central aim of the evaluation was to assess the extent to which the scheme has promoted finance to small firms that would not have otherwise received it. The report concluded that there was a strong case for the SFLGS to continue, alongside other types of support, as a way of meeting the particular needs of SMEs which lack security but nevertheless have sound business propositions. The evaluation did not advocate fundamental change to the scheme but did recommend some specific changes that are currently under consideration. The SFLGS has since been incorporated into the DTI Enterprise Fund (see section 2), so that loans and other forms of finance can be considered within a single framework. The recent Policy Action Team 3's report 'Enterprise and Social Exclusion' suggests that the Government backed loan guarantee schemes, similar to the SFLGS, could have an important role to play in promoting enterprise in deprived areas.

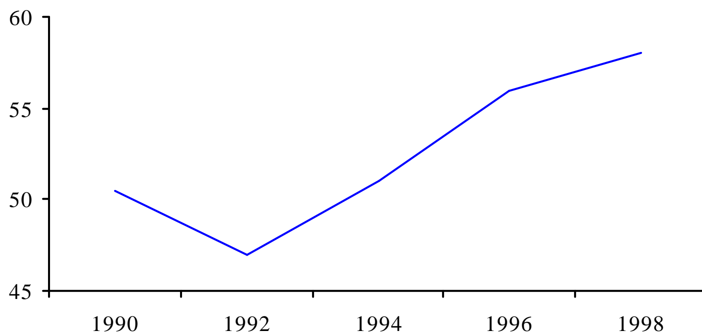
Bank relationships

3.15 Surveys and other evidence suggest that relationship banking is still very important to many small businesses. But the relationship is gradually changing because of the shift from traditional branch banking towards more technology-oriented delivery mechanisms, such as telephone, PC and Internet banking (see paragraphs 3.25 to 3.33). Most recent indicators suggest that relationships between banks and small businesses have improved significantly over the last six years. BCC's Small Firms Finance Survey[11] for 1999 found that 87% of small firms believe that their banks are supportive of their businesses. However, this figure rose with firm size: only 68% of sole traders believe their banks are supportive, compared with 96% for firms employing 50-199 people. The survey also found that fewer respondents had experienced deteriorating relations with their bank, at 10%, compared with previous surveys (23% for 1994, 18% for 1995 and 15% for 1997). However, at the same time, fewer respondents reported improved relations, at 25%, compared with 28% (1994), 37% (1995) and 41% (1997).

3.16 The Forum of Private Business's (FPB) survey "Private Businesses and Their Banks" has been carried out every two years since 1988. The most recent report[12] shows that the aggregate performance index for the banks has improved by 10 percentage points since 1992 (see Chart 3.8). Its research also found that small businesses benefited from having good, participative relationships with their banks, both in terms of lower charges and less stringent collateral requirements. The next FPB survey on bank relationships will be published in 2000. A recent survey by the Federation of Small Businesses (FSB)[13] showed that nearly half of all respondents had remained with the same bank for eleven years or more. The extent to which the improvement in relationships is attributable to the stronger macroeconomic environment of recent years, as distinct from structural changes in the provision of bank finance, is yet to be tested. It also remains to be seen how the trend away from the traditional bank branch will affect small businesses' relations with their banks, and how relationship banking will be affected by the outcome of the merger talks between the UK high street banks. The Institute of Directors (IoD) is currently conducting a questionnaire, focusing on members' relationships with their banks. The results are expected to be published in February 2000.

[11] Ibid.
[12] Forum of Private Business, *Private Businesses and Their Banks (* 1998).
[13] Federation of Small Businesses, *Small Businesses' Finance and the Economy* (1998).

Chart 3.8
FPB aggregate bank performance index



Source: FPB

3.17 This survey evidence reflects the initiatives taken by banks in recent years to ensure that relationships with small business customers have been either maintained or, if necessary, rebuilt. All the main banks have implemented codes of practice and adopted the BBA's *Statement of Principles: Banks and Businesses Working Together* (March 1997) document. The BBA is also currently involved with the Government's Insolvency Review, which is looking at ways to promote a broader 'rescue culture' in the UK, particularly for SMEs (see paragraphs 2.40-2.41 above). The banks have also placed increased emphasis on training their relationship managers to understand the specific issues faced by small businesses. This is in response to research showing that customers value managers who have an in-depth understanding of their business. Examples of specialised managers include healthcare, high technology, legal and franchising specialists.

3.18 The banks are also endeavouring to improve their business relations with ethnic minority businesses. Several have seconded managers to ethnic minority small firms and adopted ethnic minority business awareness training schemes. Examples of schemes currently in operation include the creation by NatWest's "Multicultural Centres of Excellence" and HSBC's South Asian Banking Initiative, which appoints specialist business managers specifically to serve the British Asian business community. Further details of bank initiatives relating to ethnic minority firms can be found in the May 1999 Bank of England report 'The Financing of Ethnic Minority Firms in the United Kingdom', and are summarised in Section 6 below.

Bank complaints

3.19 Chart 3.8 shows that, in aggregate terms, small firms' perception of the banks continued to improve in the two years to 1998, albeit at a slower rate than between 1992 and 1996. Research by the FSB[14] in 1998 reported that 34% of small businesses had considered changing their bank, although only 4% had switched bank in the last year and 15% had switched in the last five years. The most frequently cited reason for changing banks was that charges were too high – 72% of all switchers mentioned this as an important factor. The second most cited factor was unsatisfactory lending agreements, classed as important by 69% of switchers. These findings suggest that, while

[14] Ibid.

general satisfaction with the banks has increased among small businesses, there is still room for further development.[15]

3.20 All the banks have internal complaints procedures either operating on a two-tier or three-tier basis. If a complaint cannot be solved at the local level it will be passed up to the regional level, and if this still does not resolve the issue it will be taken to head office. These internal complaints mechanisms are sufficient for the majority of complaints, with most being resolved at the first level. If the complaint cannot be resolved internally, it is said to have reached "deadlock". At this point the complaint, subject to meeting the other relevant criteria, is eligible for investigation by the Office of the Banking Ombudsman (see below). Some of the banks have also made use of private alternative dispute resolution (ADR) companies. The benefit of ADR companies, compared with the Banking Ombudsman, is that they can investigate any complaint and carry out mediation or arbitration at any stage and the process is often much quicker and therefore less damaging to client relationships.

The Banking Ombudsman

3.21 The Office of the Banking Ombudsman was established in January 1986 to resolve (free of charge) complaints by individuals (including sole traders and unincorporated businesses and partnerships) about their banking services. Since 1986, the number of banks and subsidiaries covered by the scheme has grown from 37 to 126. In January 1993, the service was extended to cover complaints made by small companies, defined as those with a turnover of less than £1 million. The scheme is financed by the banking industry but is accountable to its own Council. The Council is responsible for ensuring the independence of the Scheme and monitoring and reviewing its progress, as well as appointing the Banking Ombudsman, currently David Thomas. The Council consists of eight members – five independent members and three who are appointed by the banks.

3.22 The terms of reference for the scheme are:

- Claims must be for less than £100,000
- Claims must be referred to the Banking Ombudsman within six months of reaching "deadlock"
- The complaint must not have arisen before the member bank joined the scheme
- The complaint must relate to a banking service provided in or from England, Wales, Scotland or Northern Ireland
- Disputes arising from a bank's commercial decisions are not eligible unless maladministration has occurred.

3.23 The latest data from the Office of the Banking Ombudsman, covering the year ended 30 September 1999, showed that a total of 12,713 written complaints were received, an increase of 7% compared with the previous year. Of these complaints, only 6% related to business accounts. The number of complaints regarding deposit accounts fell by nearly 40% to 908 compared with 1,512 in 1997/98. However, the number of complaints regarding current accounts rose by just over 12% to 2,082 compared with 1,856 in 1997/8. Complaints on business accounts are more likely to fall outside the jurisdiction of the scheme because they have often been dealt with by court proceedings or are for more than £100,000. However, business complaints are less likely to be settled by conciliation than complaints on personal accounts, and so a higher proportion (16%) of business complaints went on to investigation than the proportion of written complaints received from

[15] op. cit. Forum of Private Business.

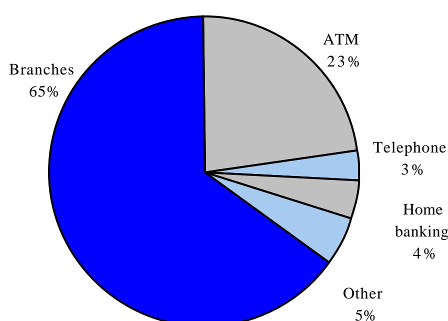
businesses (6%). The average time from beginning an investigation to the issue of the adjudication was just over 27 weeks (an increase of 3 days compared with the previous year).

3.24 In December 1997, the Government decided to amalgamate the five existing ombudsman schemes that relate to financial services, plus three other complaints handling bodies into a new single statutory Financial Services Ombudsman Scheme (FSOS). The FSOS will not come into effect until the Financial Services and Markets Bill is enacted and comes into force – probably in the second half of 2000.

Changes in bank delivery channels

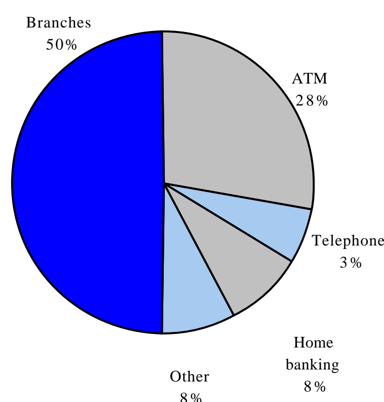
3.25 The traditional branch remains the primary delivery channel for banks providing services to personal and small business customers. However, its dominance is falling, as can be seen in Charts 3.9 and 3.10. This trend raises important questions in connection with trends relating to financial exclusion, as discussed in Section 2 of this report.

Chart 3.9
Bank delivery channels (1995)



Source: The Building Societies Association

Chart 3.10
Bank delivery channels (1998)



Source: The Building Societies Association

3.26 The rationalisation of traditional bank branches has been significant throughout the 1990s, both in the UK and internationally. BBA figures show that over a quarter of bank branches closed between 1986 and 1996. Research by the New Economics Foundation found that the ‘big four’ banks (Barclays, HSBC, Lloyds TSB and NatWest) currently have a network of approximately 8,000 branches; compared with nearly 12,000 in 1990. However, at the same time as branch rationalisation, there has also been rapid growth of new, high-technology delivery channels. The introduction of ATMs in the early 1970s marked the start of the growth of alternative delivery mechanisms, which now include telephone banking, PC banking, Internet banking and even interactive television banking.

3.27 The changes in delivery mechanisms have been driven both by demand side factors, reflecting a desire on the part of personal customers for greater convenience in banking, and supply side forces, through which banks are striving to serve customers more efficiently and at lower cost. However, some commentators believe that the changes, although providing more flexibility to

personal customers, have been damaging to small business customers, who tend to be more reliant on traditional branch services. Many small firms require intensive cash handling services for the day-to-day running of their businesses. They also rely on their bankers having an in-depth knowledge of their business, and desire far more frequent contact with their banks than personal customers. Significantly, research by Midland Bank in 1997 showed that 75% of small businesses visit their branch at least once a week. To the extent that the banks recognise these needs, there seems likely to be a limit to the extent to which traditional branches can be replaced by alternative delivery mechanisms.

ATMs and kiosks

3.28 According to the BBA, there were 11,557 ATMs in December 1988, of which 935 were situated away from branches. This figure has risen significantly and at the end of 1999 reached approximately 26,000, approximately 6,000 of which were situated away from branches. Kiosk self-service centres (which allow customers to withdraw money and deposit cheques and in some cases cash) have also reduced the need for some small firms to visit branches. The further development of these networks may help to reduce small business reliance on traditional bank branches, although future take-up might in part depend on the extent of any charges levied.

Telephone banking

3.29 Telephone banking is also becoming more attractive to some smaller firms, which value the service outside normal working hours. All the major clearing banks now offer telephone banking services to their small business customers. In addition, Girobank operates ‘Girobank Direct’, a telephone banking service specifically developed for smaller businesses.

PC and internet banking

3.30 PC banking, and more recently Internet banking, allows customers instant direct access to their accounts. The Royal Bank of Scotland was the first UK bank to offer its small business customers an on-line banking service. The service has proved to be successful, with a higher than expected take-up. The other major clearing banks have now all either established business banking Internet services or are in the process of doing so. For example, Lloyds TSB launched an Internet banking service for sole traders in March 1999. The Co-operative Bank has recently launched the UK’s first Internet bank, ‘Smile’, which operates in a similar fashion to First Direct, HSBC’s independent telephone banking service. A recent survey by the Small Business Research Trust (SBRT), sponsored by NatWest[16], found that 79% of small businesses now use computers, compared with just 36% in 1985. Internet access and use is also increasing rapidly. Nearly half of small businesses (47%) now have access to the Internet, compared with 14% just three years ago. These rapid increases are encouraging in terms of the potential for small businesses to be able to access services such as PC and Internet banking.

Post Offices

3.31 The Post Office has been offering a basic corporate and personal banking service for a number of years, through the Alliance and Leicester (incorporating Girobank). In addition, Co-operative Bank and Lloyds TSB personal customers are currently able to use over 15,000 post office branches to make deposits and withdrawals. Extension of this initiative to other banks is at present under consideration. Co-operation with the Post Office could be a way for banks to lessen the impact

[16] NatWest/SBRT, *Quarterly Survey of Small Business in Britain* (March 1999).

of branch closures, especially in rural communities, on both personal and business customers. Although the number of outlets has fallen in recent years, there were still nearly 19,000 Post Offices in the UK at the end of 1999, well above the total number of bank branches.

Former Building Societies

3.32 The former building societies also have extensive branch networks and some have begun to enter the small business banking market. Abbey National is a significant new entrant, and is rapidly expanding its number of small business accounts, although overdraft facilities are not available. Its subsidiary, First National Bank, provides commercial mortgages, and a range of business asset finance facilities.

Supermarkets

3.33 Many of the larger supermarket chains now offer personal banking services, but none offer business banking services at present. These schemes tend to be run in association with different clearing banks and accounts are often operated by telephone, by post or via ATMs situated in supermarket branches. The further development of such services could be attractive to small firms that operate their businesses through their personal current accounts.

Impact of the changes on small firms

3.34 The rationalisation of branches and the development of new delivery channels has affected small businesses in several ways. As noted, bank branch closures may have adversely affected small businesses with extensive cash-handling requirements. On the other hand, many small businesses may have benefited to the extent that the remaining branches have become more specialised and focused on the needs of small business customers. Some of the newer channels are undoubtedly more convenient for small businesses - for example, many are available 24 hours a day. But small businesses need to have the IT capability to take advantage of some of these new channels, and the new channels need to provide adequately for the continuation of relationship banking. The key to successful change, as always, is close dialogue between the banks and their small business customers.

Trade credit and late payment

3.35 Trade credit is an often overlooked source of finance for businesses, especially small businesses. Research by the Credit Management Research Group at Bradford University[17] found that stocks and flows of trade credit were twice the size of bank credit in both the UK and US. In the UK corporate sector, more than 80% of daily business transactions are on credit terms, resulting in trade debtors being one of the main assets on corporate balance sheets, accounting for 35% of total assets for all companies. Further data on UK manufacturing companies[18] showed that 96% of sales were on invoice and, on average, less than 50% of invoices were paid on time.

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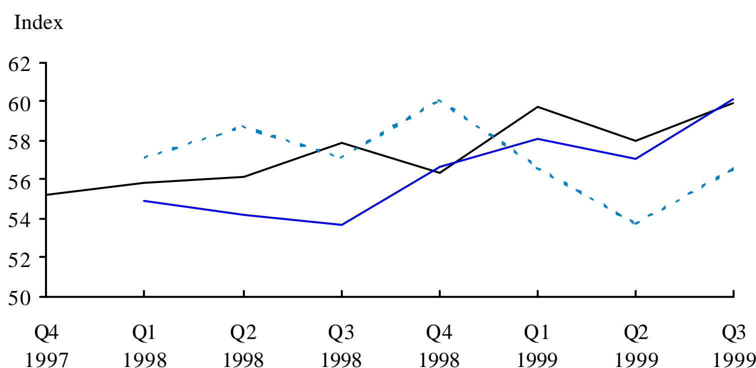
[17] Singleton and Wilson, *Sources and use of external finance: an empirical study of UK small firms*.
[18] Wilson, Watson and Summers, *Trading Relationships, Credit Management and Corporate Performance: A Survey* (1995).

Chart 3.11
Payment delays from UK customers by firm size



Index number of 50 equals no change on previous quarter.

Whole Economy   < £10m (Turnover)

£50m+ (Turnover)

Source: Euler Trade Indemnity

The chart presents the survey results in the form of diffusion indices. These indices are calculated from the percentage of survey respondents stating whether the specified factor (for example, the level of delays from UK customers) had increased, decreased or not changed when compared to the previous quarter. An index reading of 50.0 indicates that there was no change on the previous quarter. Readings above 50.0 indicate an increase and readings below 50.0 indicate a reduction. The greater the divergence from 50.0, the greater the rate of change.

3.36 Statistics collected by Euler Trade Indemnity reported that payment delays from UK customers increased further in 1999 Q3, continuing the trend of rising delays since data was first collected in 1997 Q4. The upward trend in payment delays from overseas customers also continued in 1999 Q3. An Euler index reading of above 50.0 for a quarter represents higher payment delays in that quarter than in the previous quarter. Therefore Chart 3.11 shows that payment delays ran at higher levels in 1999 than in 1998, notwithstanding the introduction of the Late Payment of Commercial Debts (Interest) Act, which took effect from 1 November 1998. It is, however, interesting to note that the quarter on quarter increase in delays is less marked for those firms with a turnover of less than £10 million. Part of the upward trend in 1998-99 may be cyclical, reflecting the effects of the slowdown in the economy in 1998. Small firms suffer disproportionately from payment delays and there has been greater fluctuation in the extent of these delays.

3.37 Although surveys provide some information, it is difficult to quantify accurately the role of trade credit in the provision of finance to small businesses. Businesses define trade credit in different ways and their ability to use it depends on the flexibility of their creditors. Many smaller firms do not regard trade credit as anything other than a means of balancing cash flow - particularly if they are exposed to late payment. But there is some evidence[19] that trade credit is often used as a substitute for bank credit. This is particularly evident in firms that have reached their bank finance limits. Businesses may be prepared to offer trade credit to their customers even when banks are not prepared to extend finance, because they believe they have more information on the customer’s overall standing or future prospects or they think they can gain a competitive advantage by doing so.

[19] Keasey and Watson, *Investment and Financing Decisions and The Performance of Small Firms* (1992).

3.38 The future role of trade credit will clearly depend on the effects of the Late Payments Act (see above). Since 1 November 1998, small businesses (up to 50 employees) have been able to charge interest on any late paid commercial debts due from larger businesses and the public sector**.** From 1 November 2000, small businesses will also be able to charge interest on any late paid commercial debts due from other small businesses. The latest research, however, shows that over 90% of small businesses have not noticed any improvement on late payment since the introduction of the Act[20]. Even after 1 November 2002, business advisers only expect 14%[21] of their small business clients to make use of the Act. Many small firms are still not prepared to exercise their rights partly because of the time, costs and effort involved, and partly for fear of the impact on their relationships with suppliers and customers. These costs, together with the risk of losing future orders, are thought by most small businesses to be likely to outweigh any financial benefit. According to the Lloyds TSB 'Late Payment' Report female entrepreneurs are less likely than male entrepreneurs to pursue late paying creditors under the Act. Two thirds of female business owners are unlikely to pursue late paying customers for interest through the courts, compared to just over half of their male counterparts.

3.39 Firms that give or receive credit in foreign currency are exposed to foreign exchange risk. Many exporters seek to avoid foreign exchange risk by invoicing solely in sterling. So far the introduction of the Euro has had little effect on this tendency. Currently, only 14% of exporters are trading in the Euro and 84% believe that its introduction will have little or no impact on their business.

Trade finance

3.40 Smaller firms active in export markets are generally able initially to support their expansion through normal forms of bank finance. But there may come a stage when gearing rises above the level at which banks feel comfortable with advancing additional funds against the security of fixed assets. In these circumstances, the bank may provide various forms of trade finance, matched to the firm's outstanding receivables.

3.41 Banks are attempting to simplify their trade finance products and the delivery mechanisms by which finance is provided. By utilising technology to reduce both risks and costs, trade finance may soon become available to exporters with a lower turnover than was previously the case. At the moment, however, trade finance products remain almost exclusively available to exporters with turnover of at least £1 million. For exporters with lower turnovers, export factoring may be more appropriate. In the CBI's October 1999 Quarterly Industrial Trends Survey, only 3% (2% in July 1999, 3% in October 1998) of firms with 0-199 employees stated that credit or finance was the most important factor that was likely to limit their ability to obtain export orders over the following four months.

3.42 Given that the provision of specialised trade finance and advice is not relevant to all customers, it tends to be most efficient for banks to pool these resources in regional or central locations. Consequently, the accurate communication of products to relationship managers, who act as the initial 'gatekeepers' for these services, becomes extremely important. Another institutional barrier to efficient referral is managers' perceptions, misconceived or otherwise, that they are losing "their" lending when trade finance schemes are used in place of traditional forms of debt finance. Some banks have rebalanced their incentive procedures in an attempt to develop trade finance usage.

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[20] Comment by Professor John Stanworth, University of Westminster, based on research carried out by the Small Business Research Trust for Lloyds TSB.
[21] Business Planning & Research International (for the ICAEW), *SME Finance & Regulation Research Report* (1999).

Credit insurance

3.43 As noted in paragraph 3.35 above, outstanding invoices can be one of the main assets on a small business's balance sheet. It is, therefore, surprising, that the latest survey suggests that the use of credit insurance has fallen in 1999 for the second year in succession, to 43% of exporters (47% in 1998, 51% in 1997)[22]. To the extent that exporters' profit margins have been squeezed by the strength of sterling, they may have reduced credit insurance to cut costs. That said, credit protection continues to be the main reason for exporters to take out a credit insurance policy, according to 48% of respondents in 1999 (52% in 1998)[23]. The other key reasons are to gain country information (19%) and credit information (26%) from their credit insurers. The Bank of England's report on smaller exporters[24] noted the difficulties faced by credit insurers in providing a commercially viable product to small exporters, which limited the availability and appeal of products. Insurers have responded by marketing new products with relatively low premium rates. The take-up of these products has grown during 1999, as indicated by an increase in exporters in the under £1mn turnover bracket using credit insurance compared with firms with larger turnovers[25]. There still appears to be scope for greater utilisation of credit insurance.

Factoring and invoice discounting

3.44 Factoring and invoice discounting[26] provide businesses with access to finance against their outstanding invoices. Depending on the type and size of business, factors and invoice discounters will immediately advance to their clients between 75% and 85% of the value of invoices. The remainder of the finance is transferred to the business after the invoice has been paid, less the charge for the service (approximately 1-2%) and the interest payment. This type of finance assists a firm's cashflow because it is sales-based.

3.45 Factoring and invoice discounting are particularly appropriate for small growing firms and for exporters unable to draw on further overdraft facilities. They enhance access to cashflow and remove the problems incurred from late payment. Most small businesses continue to choose factoring to invoice discounting. This is partly because factoring allows the business to outsource its financial management controls. Factors also provide expertise and economies of scale in credit risk assessment. This generally enables a factor to ensure payment of debts more effectively and, if required, to provide cover for bad debts.

3.46 However, it is important to note that invoice discounting is normally only offered to businesses with a turnover of over £1 million, because it is not generally possible to provide it on a small scale at a price that would be attractive. This often means that some small businesses are obliged to seek factoring services to access financing facilities, even if they wish to keep credit management in-house.

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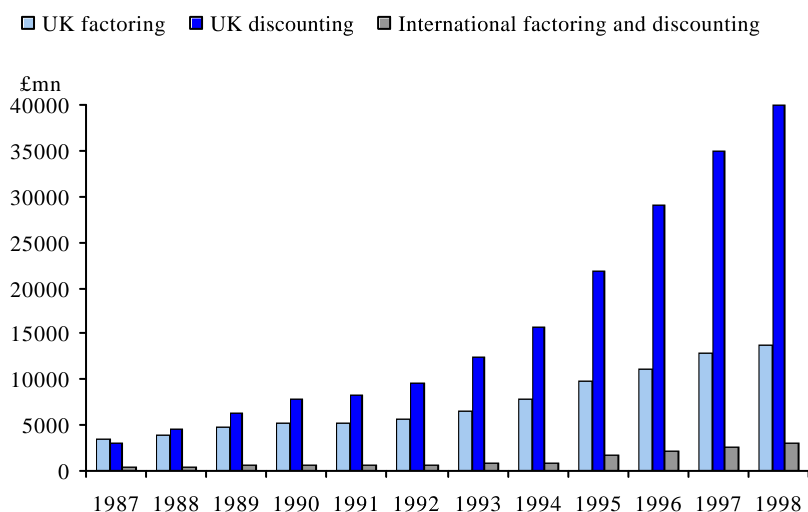
[22] *The Seventh Survey of International Services Provided to Exporters*, undertaken for the Institute of Export and NCM Credit Insurance Limited by Major Issue Limited (1999).
[23] Ibid.
[24] Bank of England, *Smaller Exporters – A Special Report*, (January 1998).
[25] op. cit, Major Issue Limited (1999).
[26] Factoring is the purchase by the factor and the sale by a company of book debts on a continuing basis, usually for immediate cash. The sales accounting functions are then provided by the factor who manages the sales ledger and the collection of accounts under the terms agreed by the seller. The factor may assume the credit risk for accounts within agreed limits (non-recourse), or this risk may be retained by the seller. Invoice Discounting is the purchase by the discounter and the sale by a company of book debts on a continuing basis (occasionally selectively) for immediate cash. The sales accounting functions are retained by the seller, and the arranged facility is usually provided on a confidential basis: credit protection can also be provided if required.

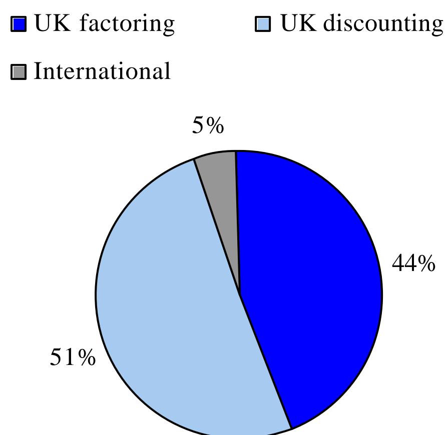
3.47 Factors and Dicounters Association (FDA) figures, covering more than 95% of the market, show that the factoring and invoice discounting industry has grown rapidly over the past decade, with volume growth averaging 20 % per annum. This growth has mainly occurred since 1993, and has been heavily concentrated in domestic invoice discounting (see Charts3.12-3.14). Prepayments (advances against invoices) have also grown rapidly (see Chart 3.15). That said, all categories showed a decline in growth in 1998 compared with earlier years, possibly reflecting the pause in economic activity.

Chart 3.12
Clients' sales volumes for factoring and invoice discounting



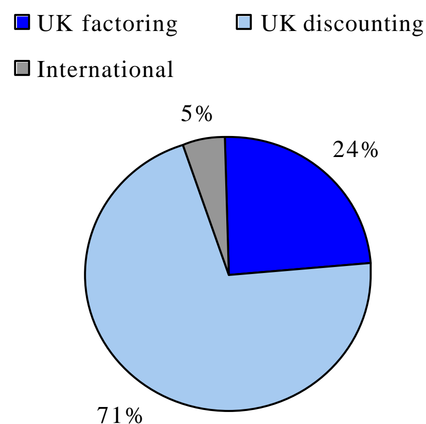
Source: FDA

Chart 3.13
FDA market proportions (1988)



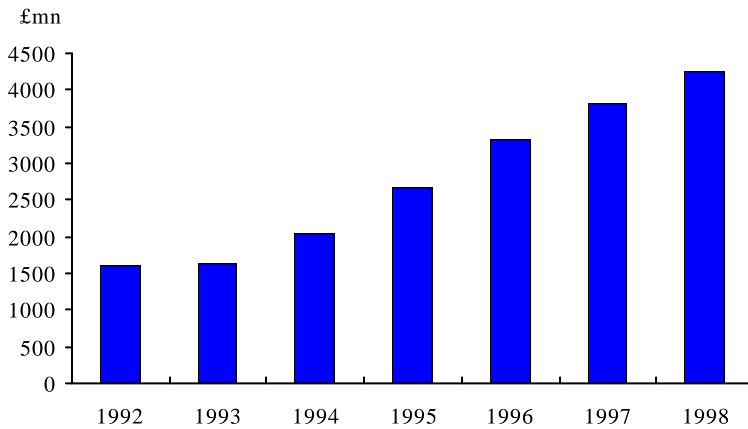
Source: FDA

Chart 3.14
FDA market proportions (1998)



Source: FDA

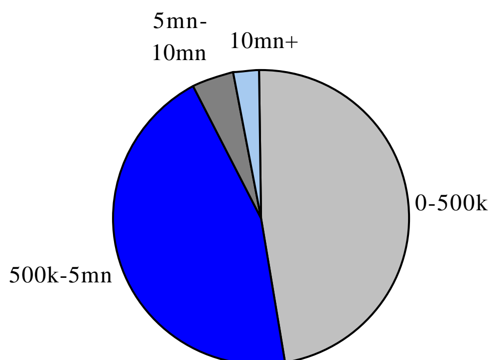
Chart 3.15
Volume of FDA members' prepayments



Source: FDA

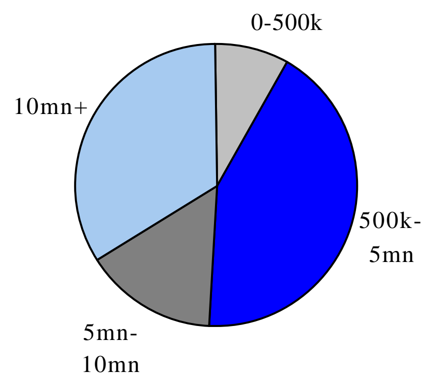
3.48 More recent figures from the FDA show that factoring turnover continued to increase during 1999. Prepayments reached £4.7 billion in 1999 Q3, an increase of 14% on the same period in 1998. Domestic invoice discounting continued to account for over 70% of total clients' sales, showing growth of 15% compared with 1998Q3. Domestic factoring accounted for 22% of total clients' sales, having risen by just 3% on 1998Q3.

Chart 3.16
FDA clients by client turnover (£)
September 1999



Source: FDA

Chart 3.17
FDA advances by client turnover (£)
September 1999



Source: FDA

3.49 The latest statistics also suggest some compositional changes in the provision of advances. As might be expected, while a large proportion of FDA clients have turnovers of less than £500,000

(47% for September 1999), the proportion of advances to such firms was considerably less (8% for September 1999). Moreover, while approximately the same proportion of FDA clients had turnovers of less than £500,000 in September 1999 as in September 1998, the proportion of funds allocated to this group has fallen over the year from 12% in September 1998 to 8% in September 1999. At the same time, the proportion of funds allocated to very large clients (with turnovers in excess of £10 million) has increased to 34% in September 1999, compared with 25% in September 1998.

3.50 Research by the Small Business Research Trust, sponsored by NatWest,[27] found that, in 1999, 4.6% of small firms that used bank finance also made use of factoring and invoice discounting. Although this is a small number, the proportion of small firms that use factoring and invoice discounting has more than doubled since 1991, when just 2% of small firms made use of this type of finance. The SBRT research also found that larger firms are far more likely to use this form of finance than smaller firms. No firms with fewer than five employees used factoring or invoice discounting, while more than 15% of firms with more than 50 employees did use these types of finance.

3.51 A recent report on 'Factoring in the UK' by BCR Publishing[28] shows that the sectors that make the greatest use of factoring and invoice discounting are the service, manufacturing and distribution sectors. In 1998, 34% of FDA business was with the service sector, 33% with manufacturing and 25% with distribution. The transport sector accounts for 6% of FDA clients, leaving just 2% for all other sectors. By comparison, in 1987 manufacturing represented 44% of clients and the service sector only 15%. This change reflects the increase in the number of service sector firms in the UK in recent years and also the growing trend for factors to consider more diverse service sector businesses.

3.52 Figures from Factors Chain International (FCI) suggest that the UK factoring market is currently the largest in the world[23]. In 1998 the UK accounted for 19% of the world's total factoring services, followed by Italy (17%), the US (14%), France (10%) and Japan (9%). However, direct factoring volume comparisons between countries are problematic because the precise definition of the term factoring may differ considerably between countries. For example, the UK's figure of 19% includes invoice discounting while in most other countries invoice discounting is a mainstream banking function and therefore not included in factoring statistics.

3.53 Factoring and invoice discounting activity is highly concentrated in the UK, with 57% of activity (measured by factoring volume) in 1999 accounted for by the top four firms, three of which were owned by UK clearing banks. However, there is evidence of growing competition, especially from the US. In 1999, the Bank of New York's receivables and asset finance business was sold to General Motors Acceptance Corporation, making it the second largest player in terms of market share in the UK.

3.54 Increased competition in the provision of factoring and invoice discounting services has benefited customers, because factoring companies now offer smaller packages and more flexible terms. Advances in IT have also assisted the development of the factoring and invoice discounting industry, allowing businesses to obtain direct access to their account information while enabling the factoring companies to develop substantial databases of company and country information.

3.55 Fraud appears to be a growing concern of the factoring industry. Anecdotal evidence suggests that there has been a significant increase in pre-meditated and sophisticated fraud in recent years.

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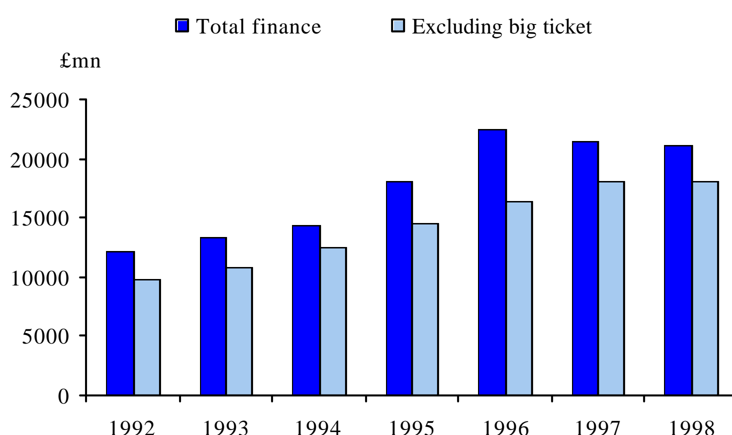
[27] NatWest/SBRT, *Quarterly Survey of Small Business in Britain* (June 1999).
[28] BCR Publishing, *Factoring in the UK* (1999).

The two main areas of fraud are the selling of fictitious debts ('fresh air' invoices) and the collecting and banking of payments, by the client, that should go to the factor.

Asset-based finance

3.56 Asset-based finance includes both leasing and hire purchase, and a range of other products. The leasing industry began its rapid expansion in the 1970s, encouraged by the tax regime. Between 1971 and 1985 buyers of capital equipment qualified for a 100% first year allowance (FYA), while the corporation tax rate stood at 52%. Between 1984 and 1986 FYAs were phased out and corporation tax was cut from 52% to 35%, removing the major tax advantages for leasing. Since then the corporation tax rate has continued to decline and since April 1999 the main rate has been charged at 30%. Despite the reduced taxation benefits of leasing, the leasing and hire purchase industry has continued to grow as more businesses seek greater flexibility in the range and sources of their external finance.

Chart 3.18
Leasing-related business finance 1992-1998



Source: FLA

3.57 The Finance and Leasing Association (FLA) is the major UK representative organisation for the leasing industry. The Association had, as of October 1999, 101 full members and 55 associate members. Figures obtained from the FLA show that business finance (excluding big ticket finance) grew consistently up to 1997, since when it has stabilised at approximately £18 billion. The decline in business confidence during 1998 as the economy slowed helps to explain the absence of further growth in business finance, particularly for commercial equipment. FLA figures show that, in 1998, new business in the commercial sector declined 2% on 1997 to £21 billion.

3.58 Since the last recession, the proportion of external finance to small businesses accounted for by leasing and hire purchase has grown significantly, mainly at the expense of traditional bank finance. Research by the City University Business School (CUBS)[29] found that SMEs used leasing as a substitute for debt finance. The CUBS research reported that 50% of SMEs used leasing, amounting to 19% of their total debt, compared with only 7% for companies of all sizes. The 1998 Grant Thornton European Business Survey showed that a higher proportion of SMEs use asset-based finance in the UK than in any EU country other than Ireland. According to this research 41% of UK

[29] City University Business School, *The Role of Leasing in the Financing of Small and Medium-sized Companies* (1997).

SMEs make use of leasing arrangements, compared with an EU average of 33%. More recent research by the Small Business Research Trust, and sponsored by NatWest[30], has estimated that 36% of small businesses used hire purchasing or leasing in 1999, compared with 32% in 1991. However, this form of finance is used far more by the larger small firms: some 20% of firms with 5-9 employees use hire purchasing or leasing, compared with 47% of firms with 25-49 employees.

3.59 Hire purchase and leasing, although generally grouped together in surveys, are very different financing products. Hire purchase results in the purchaser building up ownership of the good over a pre-determined period, while under leasing contracts the legal ownership of the good remains with the lessor, there may be arrangements under which ownership transfers at the end of the lease period. There are essentially two types of lease, a *finance* (or full payout) lease[31] and an *operating* (or residual risk) lease[32]. Small firms tend to make more use of operating leases, because of the increased flexibility regarding maintenance of the asset and future upgrades.

3.60 The decision by a small business to lease or purchase an asset tends to be less tax sensitive than with larger firms, and more influenced by the available resources of the business. Both leasing and hire purchase provide the business with access to 100% financing without reducing capital reserves or increasing gearing levels. They also allow businesses to spread out payments over the life of the asset, with the payments structured to accommodate the asset's expected pattern of income generation. The flexibility to upgrade equipment in line with the growth of the business is also viewed as advantageous.

3.61 According to research by City University Business School[33], small growing companies are more likely to use leasing than small mature companies. Growth companies are characterised by lower profits than their cash-generative mature counterparts, and consequently need to expand production to meet growth in demand, subject to limited resources. Mature, cash-rich, small companies are more likely to finance replacement or expansion capital out of retained earnings.

3.62 The leasing and hire purchase activity carried out by FLA members is fairly concentrated, with the bulk accounted for by the leasing arms of the clearing banks. According to 1996 figures, 43% of the leasing activity of FLA members is carried out by the five largest market participants. In total, the top 40 companies in the UK account for 95% of all the FLA activity. Breakdowns of overall activity show that leasing activity is more concentrated than hire purchase activity, although a higher proportion of hire purchase activity is carried out by the top five companies than is the case for the leasing industry. The FLA plans to publish more recent figures on market concentration in May 2000.

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[30] NatWest/SBRT, *Quarterly Survey of Small Business in Britain (* June 1999).

[31] A finance lease is defined as a long-term non-cancellable lease, generally requiring the lessee to pay all maintenance costs.

[32] An operating lease is defined as a lease in which the period of contract is less than the life of the asset and the lessor pays all maintenance and servicing costs.

[33] op.cit, City University Business School (1997).

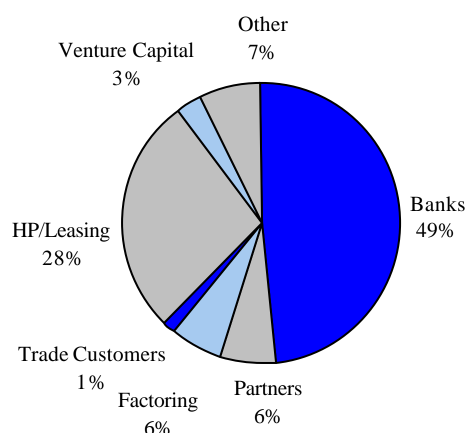
SECTION FOUR: EQUITY FINANCE

4.1 The Bank's previous reports on small firm finance have concentrated primarily on the issues surrounding the provision of debt and asset-based finance. The 1999 report included a special section that reviewed "The Changing Face of Small Firms Finance" and noted the progress that had been made in increasing access to, and providing more appropriate forms of, such finance for these firms. There are, however, many companies that are growing, or expecting to grow, at such a rate that equity based finance is more appropriate for their needs. This section addresses the appropriateness of the forms of equity finance that are currently available to such firms, and considers where improvements could be made. In particular, it does still appear to be true that there are cases where the funding requirements of a company are greater than those that can be met by the small scale providers of finance, but not substantial enough to be considered by the large equity providers – the so called "equity gap".

The take up of equity finance by small firms

4.2 As shown in Chart 4.1 below, venture capital accounted for just 3% of external finance for SMEs in the period 1995-7. Information from earlier ESRC research[34] suggests that the proportion has been stable over the past decade. While venture capital accounts for a very small percentage of total SME financing, however, it plays an important role in financing those high-growth firms that it does support. Moreover, it is likely that there are SMEs which have not received such finance but which would benefit from doing so. The suggestion that such an equity gap exists was first formalised in the 1930 MacMillan Report, although in real terms the size of the gap has reduced significantly and is now mainly believed to affect those firms that wish to raise between £200,000 and £500,000.

Chart 4.1
Sources of external finance for SMEs 1995-97



Source: ESRC

[34] ESRC Centre for Business Research, Cambridge, *The Changing State of British Enterprise* (1996).

4.3 There are two types of equity finance from which SMEs can benefit: private equity and public equity. The former can be obtained from a number of different sources: banks, private equity and venture capital firms, business angels (informal venture capital) and special investment schemes. The term private equity is increasingly used in the UK instead of "venture capital", with the latter being a distinct sub-set of private equity involving the smaller, earlier stage and often more risky deals. In recognition of this the British Venture Capital Association (BVCA) has annotated its logo to include "Representing British Venture Capital and Private Equity". This report reflects the narrowing definition of "venture capital", although this is not always possible when drawing on sources that do not themselves make the distinction. A clear, industry wide position on the correct terminology would be helpful.

Venture capital

4.4 In its simplest form, venture capital involves the long-term commitment of external equity to enable unquoted businesses to grow and prosper. Venture capital investments typically last for between three and seven years, during which finance, expertise, experience and contacts will be provided to help nurture the investee business. In return, the venture capitalist will become an equity partner and will be likely to place greater emphasis on the final capital gain, rather than regular cashflows. Unlike a traditional lender, who has a legal right to receive interest payments and capital repayments, the venture capitalist's returns will be dependent on the success of the business. Venture capitalists take a high level of risk and so demand relatively high returns.

4.5 With venture capital comes not only finance but also managerial expertise and credibility. The venture capitalist's reliance on the performance of the investee company often results in the provision of hands-on support - for example it is common for a member of the venture capital firm to take a seat on the company's board, or at least have observer status. In addition, a venture capitalist's support for a project may indicate to potential customers, creditors and financiers that the company has long term potential: this alone can help to increase the customer base of a business. As well as this indirect impact, the venture capitalist may also provide networking opportunities with some of the other businesses that it finances. To summarise, the business owner receives finance and technical support from venture capital, but surrenders an element of equity and control.

Formal private equity investments

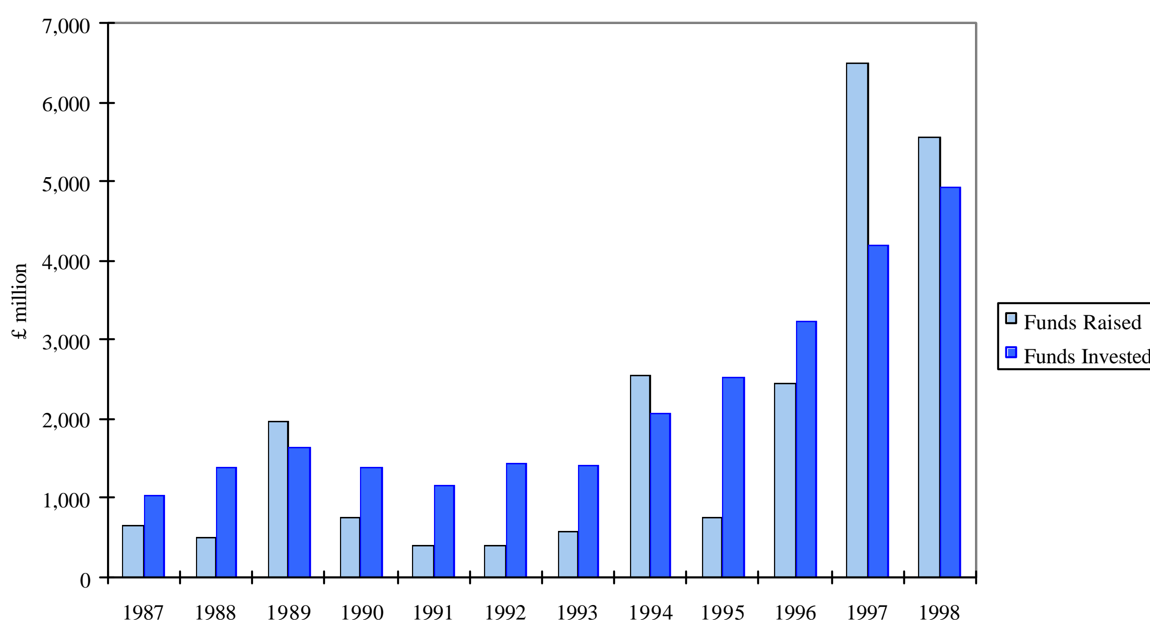
Bank equity products

4.6 The main clearing banks offer a range of equity products for smaller companies, as well as promoting business angels. Barclays, HSBC, Lloyds TSB, NatWest and the Royal Bank of Scotland support the National Business Angel Network (see below). HSBC operates nine HSBC Enterprise Funds, providing investments of between £5,000 and £250,000: catering for start-ups and small businesses. HSBC, the European Investment Bank and others have committed over £45 million to these funds and to a venture fund for technology based firms. Some £18.4mn of this has already been invested in 165 companies. With an average investment value of £112,000 these funds address an important segment of the equity gap. In addition the HSBC Growth Capital Fund is dedicated to investing equity sums of between £250,000 and £1 million. The Bank of Scotland continues to contribute to a number of equity funds including: the West Lothian Venture Fund and Dumbartonshire Venture Fund both of which invest in small businesses. Furthermore, along with a number of the other main clearing banks they invest in the Scottish Equity Partnership.

The size of the industry

4.7 The UK private equity industry continues to be the largest and most developed in Europe, accounting for 49% of total annual European venture capital investment in 1998. The UK market comes second only to that of the US. Between 1983 and 1998, BVCA members invested, in total, over £28 billion across 18,000 companies. As illustrated in Chart 4.2, apart from the reduced level of investment during the recession of the early 1990s, new investment records have been broken each year. In 1998 alone, BVCA members raised nearly £6 billion and there is currently a surplus of funds. This is despite 1998 being a record year for disbursements by members, in total investing £4.9 billion in over 1,300 companies. It is also important to remember that there are suppliers of venture capital who are not members of the BVCA, the impact of which it is difficult to measure.

Chart 4.2
Funds raised and invested by BVCA members



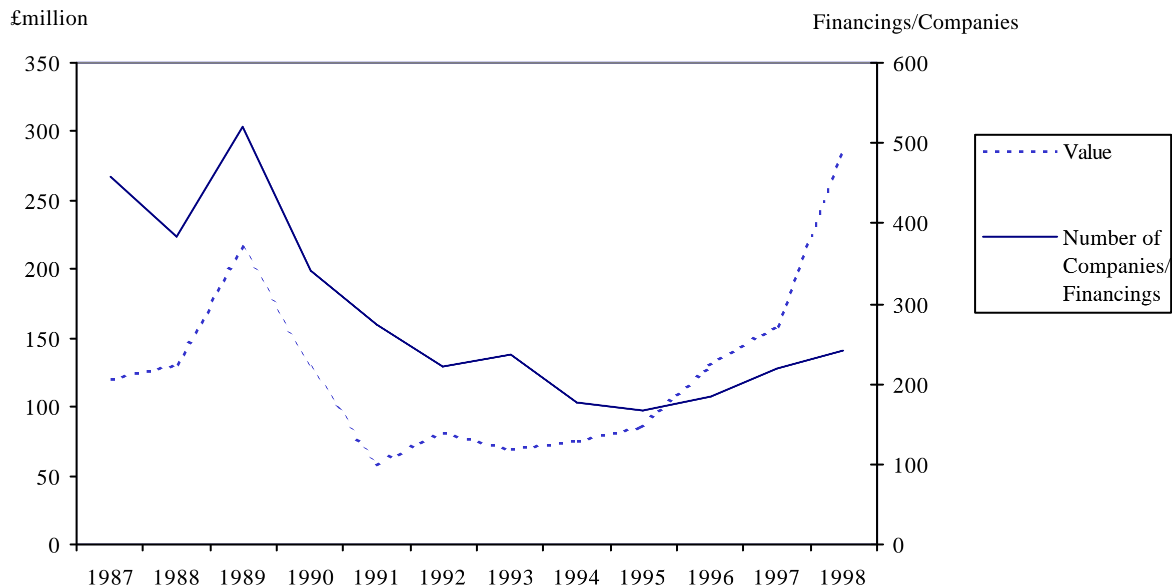
Source: BVCA

4.8 It is, however, important to note that only a small percentage of these funds will be invested in small UK firms. Some of the money will flow out of the UK: in 1998, 17% of the investments made from BVCA members' UK offices financed companies in Continental Europe and 3% went to companies in each of the USA and the rest of the world. Furthermore, figures and survey evidence on the destination of funds by type of financing indicate that the bulk of private equity finance in the UK is targeted towards large MBO/MBI deals. Further, Colin Mason (Southampton University) has noted that while there has in recent years been an increase in the supply of private equity in the regions, classic venture capital remains over-concentrated in the South East and East Anglia.

Deal stage

4.9 As illustrated in Chart 4.3, there has been a steady increase in the value of venture capital investment in start-up and early stage finance in the UK over the past three years, from the relatively low levels that followed the recession of the early 1990s'. Total start-up and early stage investment in 1998, at £288 million, was 2.2 times greater than the level of a decade earlier and 81% higher than in 1997.

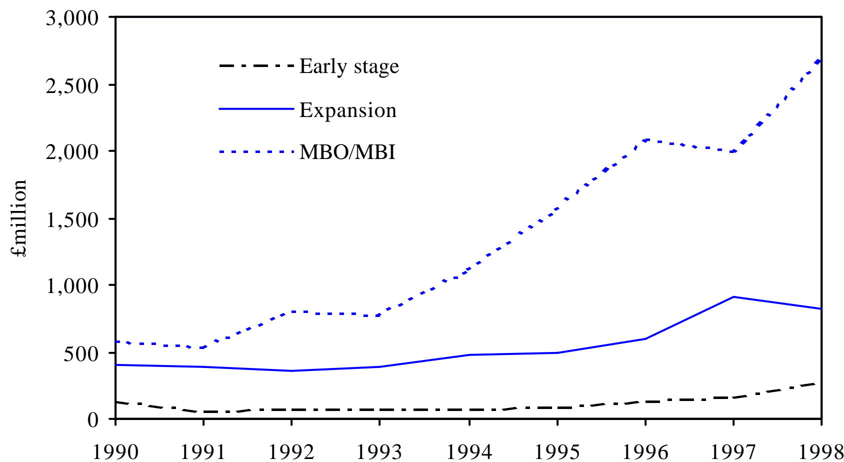
Chart 4.3
Early stage finance in the UK by value and number



Source: BVCA

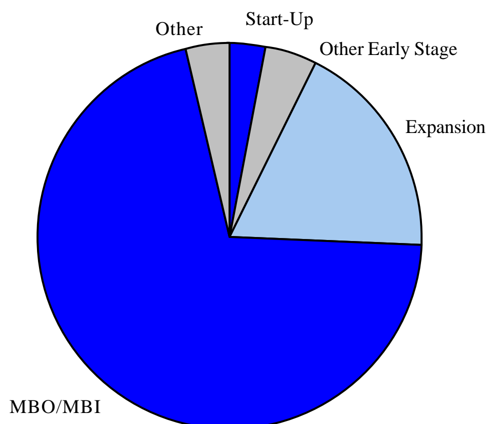
4.10 While the value of early stage investment has recovered and (recently) accelerated, the number of such companies financed has actually decreased substantially, from a fairly low peak of 521 in 1989 to 241 in 1998. Furthermore, although the value of funds available to early stage firms has increased, the proportion of funds invested at the start-up and early stage has fallen from 10% of total investments in 1988 to 7.6% in 1998. Charts 4.4 and 4.5 illustrate this shift more clearly and highlight the dramatic increase in MBO/MBI activity, which now accounts for 70% of total UK investments by BVCA members. In interpreting the figures, it should be noted that not all early stage finance goes to small firms and not all MBO/MBI activity is within large firms. But the figures do suggest that relatively few start-up and early stage smaller businesses receive formal venture capital finance.

Chart 4.4
Value of UK investment by stage 1990-1998



Source: BVCA

Chart 4.5
1998 value of UK investment by stage

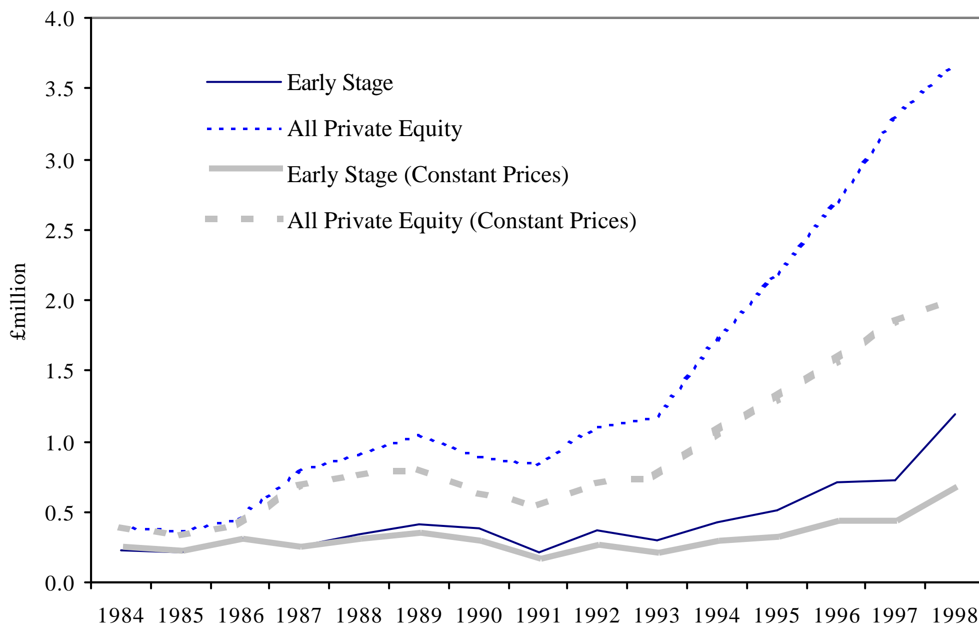


Source: BVCA

Deal size

4.11 These trends can partly be explained by the current preference of the UK private equity industry for larger deals. The average deal size for BVCA members rose from £957,000 in 1988 to over £3 million in 1998 (see Chart 4.6). This not only reflects a move towards later stage deals, which often require larger sums, but also a notable increase in investment size within each financing stage. For instance, in 1988 the average value of early stage financing was £338,000, but by 1998 this had risen to £1.2 million (see Chart 4.6). Even when adjusted for inflation, this rise was nearly three-fold. The dramatic increase in the average size of investments might, in part, reflect the fact that private equity funds do not have the time or expertise to evaluate and monitor a relatively large number of small investments. This issue is accentuated by the recent increase in the value of funds to be invested. The increased need to compete in a global market and to develop up to date technology could be tending to increase the minimum efficient scale of investment for private equity houses.

Chart 4.6
Average deal size of BVCA members, actual and 1984 constant prices



Source: BVCA

4.12 Although approximately 60% of BVCA members stipulate a minimum investment level of below £500,000, the real threshold is likely to be much higher. Many of those members that do give serious consideration to small deals are the smaller, regional funds. Few deals at the minimum level will be undertaken by the larger, national funds and those that are will often demonstrate the scope to benefit from further financing in the near future.

4.13 These figures suggest that there are relatively few opportunities for firms seeking start-up and early stage equity capital of less than £500,000 to raise formal venture capital. Some venture capital firms do, however, invest smaller amounts and the 1999/2000 BVCA *Sources of Business Angel Capital* directory lists 23 venture capital firms that make investments of less than £100,000. The availability of seed capital from the formal venture capital sector should not be underestimated.

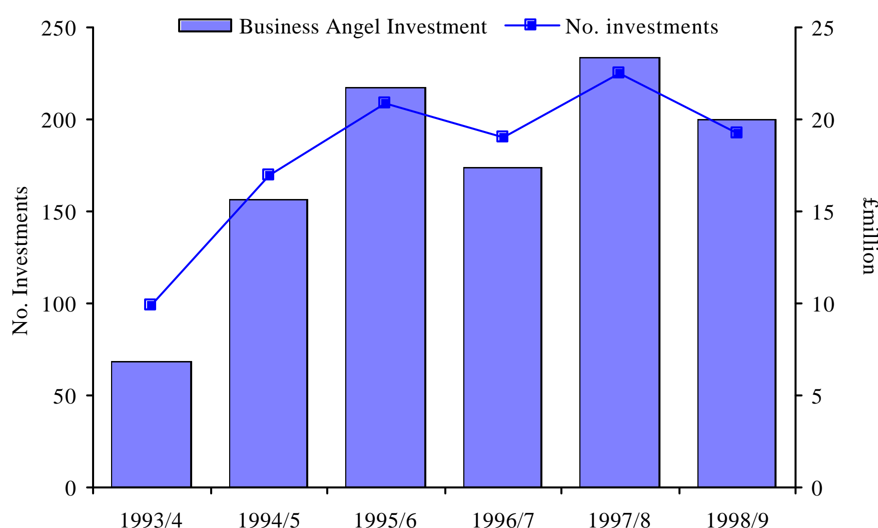
Informal venture capital

4.14 The informal venture capital market (often referred to as the "business angel" market) consists of high net worth individuals willing to invest risk capital in smaller unquoted companies. This market is largely invisible and, while efforts have been made to monitor the activity of business angel networks, they may well account for only a small proportion of the overall activity. Further research into this important market should be encouraged.

4.15 Business angels help to fill the gap between debt finance and the larger formal venture capital investments, because they are more geared to investing in early stage or start-up businesses. Reflecting both a lower cost base and different aspirations, business angels tend to invest smaller amounts than is economic for venture capital funds; they therefore play an important role in reducing the impact of any equity gap.

4.16 The BVCA produces a booklet "Sources of Business Angel Capital". The 1999/2000 directory lists 48 business angel networks and acts as a form of introduction service for entrepreneurs and business angels. Research by Southampton University, on behalf of the BVCA, on the activity carried out through the listed business angel networks, showed that the 1998/9 investment activity fell back slightly from a record amount of investment in the 12 months to June 1998. In 1997/98 the networks made introductions that resulted in 365 registered business angels investing £23.4 million through 225 investments in 221 registered companies, compared to 280 registered business angels investing £20 million through 192 investments in 185 companies in 1998/9 (see Chart 4.7). It is in this context also important to recognise that there are numerous business angels, an increasing number of which work in syndicates (for example PI Capital), that are not members of networks but who provide a significant source of finance. Anecdotal evidence suggests that sentiment amongst many in this group is optimistic in early 2000.

Chart 4.7
Trends in business angel investment 1993-99



Source: BVCA [35]

4.17 The Southampton University survey suggests that despite a recent increase in the average deal size, business angel investments focus on smaller deals than do the formal venture capitalists: some 51% of investments were of amounts of less than £50,000. Most investments were between £10,000 and £100,000, with just 24% of investments over £100,000 – compared with 86% of BVCA investments. Investments were also geared towards start-ups and early stage financing - which together accounted for 60% of all investments - while MBOs and MBIs accounted for only 11% of investments.

4.18 The survey was based on those business angel networks listed in the BVCA directory and, therefore, only covered a small section of the informal venture capital market. Mason and Harrison estimate that the UK has approximately 18,000 business angels and that they annually invest in the region of £500 million[36]: admittedly a small amount when compared with the £4.9 billion of formal

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[35] Statistics for previous years were re-adjusted in the BVCA's 1998/9 report to exclude investments in non-UK companies.
[36] Colin Mason and Richard Harrison, *Public Policy and the Development of the Informal Venture Capital Market: UK Experience and Lessons for Europe*, Editor K. Cowling, *Industrial Policy in Europe* (1999).

private equity. However, a more relevant comparison, and one which emphasises the importance of their contribution, is with formal venture capital investments in seed, start-up and early stage finances - BVCA members invested just £288 million in these categories in 1998[37], suggesting that business angels do help to fill an important gap in the provision of seed and start-up capital.

4.19 Further information on the comparison between formal and informal venture capital is provided by a recent survey of 143 business angels and 119 venture capitalists[38]. This showed that, if one ranked the number of deals by sector by business angels and venture capitalists, the results would be very similar. Technology-based firms received the highest proportion of investment, when broken down by sector. Despite this proportion having increased since 1994/5, business angels still appear to play a considerably less prominent role in the financing of technology-based firms in the UK than in the US. Conservative estimates suggest that there are approximately 250,000 angels in the US investing around $10-20 billion per annum in over 30,000 ventures. The level of investment is broadly similar to the formal venture capital sector.

4.20 A further advantage of business angels is that they can open up other financing opportunities. In 1998/99 the BVCA "Report on Business Angel Activity" found that, in addition to the £20 million invested by those business angels from the surveyed networks, a further £14.1 million was provided by other sources. Banks contributed to 86% of businesses receiving packages of finance and venture capitalists to 25%. It seems probable that a substantial proportion of this additional finance would not have been provided if the business angels had not shown their support for the proposal. This suggests that the impact of business angels exceeds their direct financial contribution. Many business angels play an active role in managing and/or advising those companies in which they have invested. This support can range from general advice to technical expertise. Linked to this is the added credibility that a firm gains once it can show that an independent party is prepared to invest in it. This can assist when seeking trade credit, new customers etc, although the effect is likely to be diluted if the business angel is a connected party.

4.21 Business angels can also work in tandem with the formal market through directorships. It is not uncommon for a venture capitalist to provide a non-executive director place on a company board for an independent specialist. This director may invest some of his own money in the business, thereby increasing his motivation when advising the company. For the company this provides the added benefit that the market will perceive the presence of the non-executive director to be a sign of security. Another example of co-operation is the incidence of co-investments and partnerships between business angels and formal venture capitalists.

4.22 Notwithstanding the growing activities of business angels, this section has suggested that there are SMEs with high-growth potential that do not receive venture capital finance. In particular there is an apparent gap in the provision of amounts between, say, £200,000, where most business angel investment stops, and £500,000 plus, where most formal commercial venture capital begins. It does not follow that all such businesses fall into this equity gap, because there are numerous businesses that do not wish to seek venture capital finance. In assessing the gap we need to consider in more detail the main factors impinging on the demand for and supply of equity.

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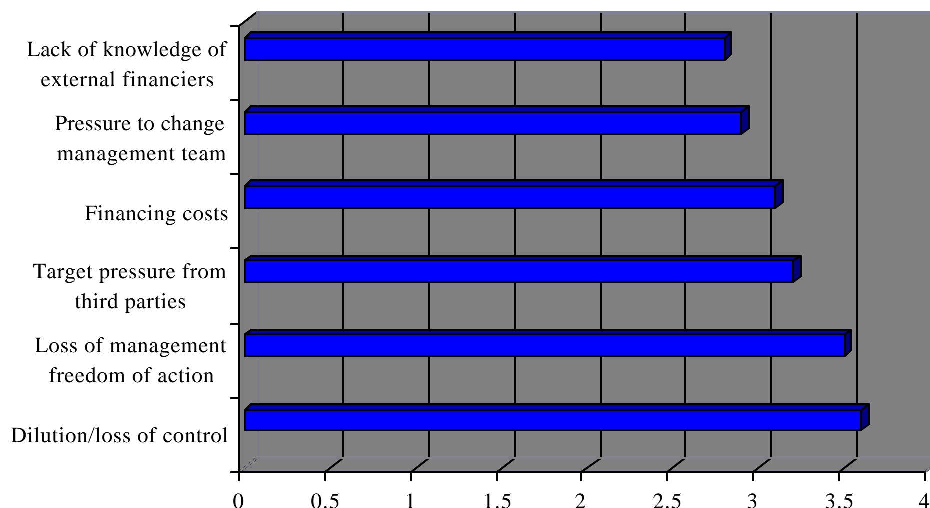
[37] BVCA, *Report on Investment Activity* (1999).

[38] Mark van Osnabrugge, Said Business School, *Comparison of Business Angels and Venture Capitalists: Financiers of Entrepreneurial Firms (1998)*.

Demand for equity finance

4.23 The factors affecting the demand for equity finance by SMEs are complex. According to the pecking order theory of finance[39], firms seek finance in an hierarchical fashion: internal finance, debt and finally equity. Smaller businesses tend to prefer internal finance and only if there is a shortfall will the company turn to external finance. As equity is often issued at a discount, reflecting the investors' difficulty in assessing the viability of the investment, companies will tend to prefer to issue debt first because the discount is lower. In choosing external equity finance, an entrepreneur needs to make a decision regarding the level of control, as well as the cost of finance. A recent survey by Manchester Business School[40] highlighted some of the key issues that deter small businesses from seeking private equity. Respondents were asked to grade on a scale of 1 to 5 (where 1 was not important and 5 was very important) those problems that they perceived to be associated with raising external equity finance. Loss of control was their greatest fear (see Chart 4.8).

Chart 4.8
Problems involved in raising external private equity finance



Source: Manchester Business School

Entrepreneurial drivers

4.24 This loss of control comes about through dilution of the owner-manager's equity stake. Venture capitalists tend to be involved, to varying degrees, in the management of their investee businesses. This will frequently include a 30-40% equity stake and a seat on the board; their remit can often extend to involvement in hiring and firing staff. Owner-managers have to accept that they no longer have total autonomy in the running of the business. This is for many a major barrier, although anecdotal evidence suggests that entrepreneurs are becoming more willing to consider some loss of control, in part due to an acknowledgement of the value that venture capitalists can add in an intensely competitive market place. This could also assist financial stability: the previous reluctance

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[39] Myers, Stewart, *The Capital Structure Puzzle*, Journal of Finance 39, pp. 574-592 (1984).
[40] Poutziouris, Chittenden and Michaelas, Manchester Business School, *The Financial Development of Smaller Private and Public SMEs* (1999).

of small firms to use external equity finance may have resulted in some SMEs becoming over-geared and therefore more vulnerable to changes in the business cycle.

4.25 The process of accepting some loss of control in return for equity finance still has further to go in the UK. Most small businesses are "life style" businesses, where entrepreneurs enjoy the flexibility of independence and are motivated by factors other than financial gain. Grant Thornton Research[41] found that, in contrast to the US where wealth creation was a major driver, many entrepreneurs in the UK regarded independence as a primary motivator when deciding to establish their own business. This is a finding that is strongly supported by many market practitioners. The notion of a "family business" is also very important in the UK. Research by Manchester Business School[42] found that the desire to maintain ownership is particularly strong among family-owned businesses, with little over 40% of those surveyed claiming that they would consider using external equity finance compared with over 60% of non-family businesses.

4.26 Such motives go some way to explaining why venture capital finance, involving the loss of equity and often independence, is not always popular in the UK. Indeed a British Chambers of Commerce Survey[43] claimed that only one third of UK small businesses would even consider using external equity finance. The DTI website makes a distinction between proprietorial and entrepreneurial businesses, suggesting that only the latter will be suited to venture capital investment.

4.27 Small business owners will also consider the longer-term impact of venture capital investments. Trade sales are the most common form of exit route for venture capitalists. This method can result in a loss of jobs at the company that has been sold, hence making it less attractive to certain managers and employees.

Entrepreneurial spirit

4.28 The increased emphasis by the Government on the importance of wealth creation has begun to improve the standing of entrepreneurship. A plethora of ministerial speeches have espoused the virtues of "entrepreneurial spirit". Strong entrepreneurial spirit and the desire to succeed whatever the circumstances is believed to differentiate entrepreneurs in the US from those in the UK. The "sink or swim" culture in the US encourages many more people to prove themselves by becoming entrepreneurs. A former Secretary of State for Trade and Industry, after a visit to Silicon Valley, commented *"They have a business environment that rewards risk, does not unduly penalise failure and above all lauds ambition"*[44]. The current review of insolvency legislation is itself partly motivated by a desire to reduce the stigma attached to business failure in the UK (see paragraphs 2.40-2.41 above). Furthermore, the British Chambers of Commerce announced, in 1999, its commitment to a National Campaign for Enterprise.

4.29 Linked to this is the fact that entrepreneurs have become more business focused. The emergence of a European market place, with its associated threats and opportunities, has required firms to focus more strongly on their aims and objectives. The realisation that they are increasingly competing globally may bring about a greater appreciation by UK entrepreneurs that survival and growth requires external support and finance. If so, the gap between the UK and the US in the take-up of external equity by SMEs may be narrowed.

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[41] Grant Thornton International Business Strategies Ltd, *European Business Survey* (1996).
[42] Manchester Business School, *The Financial Affairs of Private Companies* (1998).
[43] British Chambers of Commerce, *Survey 24: Finance* (1997).
[44] Peter Mandelson, Secretary of State's Address to Foresight/IBB R&D Seminar at Lancaster House (25 November 1998).

Information sources

4.30 Further education and training may also increase the willingness of small firms in the UK to consider venture capital finance. Small business support agencies, such as Business Links, have already helped to provide greater awareness of venture capital. The BVCA has also played a vital part in this education process by providing, free of charge, informative booklets such as "A Guide to Venture Capital". Such publications have alerted businesses to the advantages of venture capital and have highlighted those circumstances in which it might be most appropriate. Furthermore, the emergence of the Internet as a major information source can also help, for example, hot links between the DTI website and that of the BVCA increase the ease with which small business can learn about venture capital. The forthcoming launch of the Small Business Service (see Section 2) should also assist this process.

4.31 Increased availability of information could also help to address the problem whereby some smaller companies are not adequately prepared for venture capital investment and therefore potential investors are required to dedicate significant resources to undertaking due diligence. This increases the cost of investing in smaller companies, making them less attractive. To reduce this barrier, it has been suggested that 'venture catalysts', i.e. advisers that assist smaller companies in their preparations for obtaining venture capital investment, could play an important role. All such developments, to the extent that they reduce the information asymmetries which are at the heart of the equity gap, are to be encouraged.

Supply of formal private equity and venture capital

4.32 In 1998, £5,570 million was raised by BVCA member firms and BVCA estimates suggest that approximately 50% is likely to be invested in UK companies[45]. In addition to this figure, unknown amounts were made available to captive/semi-captive firms from their parent organisations.

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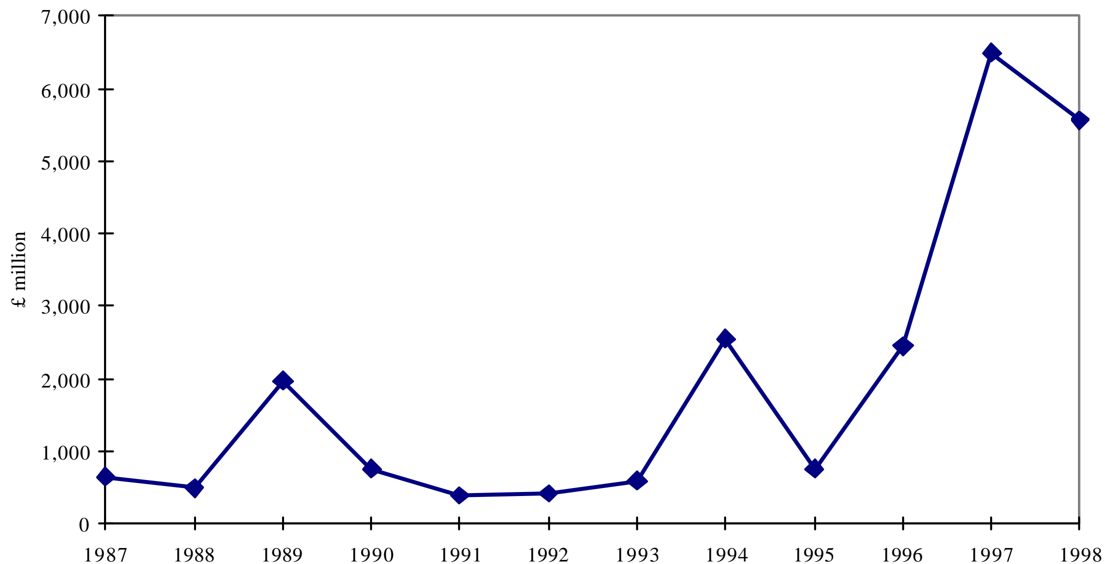
[45] BVCA, *Report on Investment Activity* (1999).

Chart 4.9
Independent funds raised by BVCA members



Source: BVCA

4.33 Chart 4.9 above shows that, despite falling slightly from the 1997 high, the funds raised in 1998 were substantially higher than their level ten years previously. The more than 10 fold increase during the 10 years to 1998 can be attributed to a number of factors. Of great importance is the fact that the UK private equity industry has matured significantly over the period. As a consequence, some institutional investors are more aware of the presence of private equity as an alternative asset class and the number of private equity firms has increased, providing more investment opportunities. Linked to this maturity is the fact that many of the initial closed funds which were set up with a 10 year term have now matured and it has been possible to measure more accurately their final returns and hence to compare them with returns from other asset classes.

4.34 Several factors influence trends in the supply of formal venture capital to the SME sector. As noted above, the most popular explanation for the trend towards larger deals is that the transaction costs associated with a small deal are not significantly less than those incurred on a larger deal. Consultants, legal advice and the venture capitalists' input all benefit from economies of scale, making larger deals relatively more economical. Furthermore, due to the lack of adequate systems and less sophisticated management information at small companies, due diligence work can sometimes take longer and monitoring costs be higher than in their larger counterparts.

4.35 An additional factor explaining the trend towards larger deals is the growth of the size of funds and the time that it can take to invest all the available money. Economies of scale and information asymmetries mean that it is more costly and time consuming to invest in and monitor a large number of relatively small projects than a small number of large projects. In some cases, the original management team's lack of experience can necessitate more rather than less input, relative to their size, from the venture capitalist in the case of small investments.

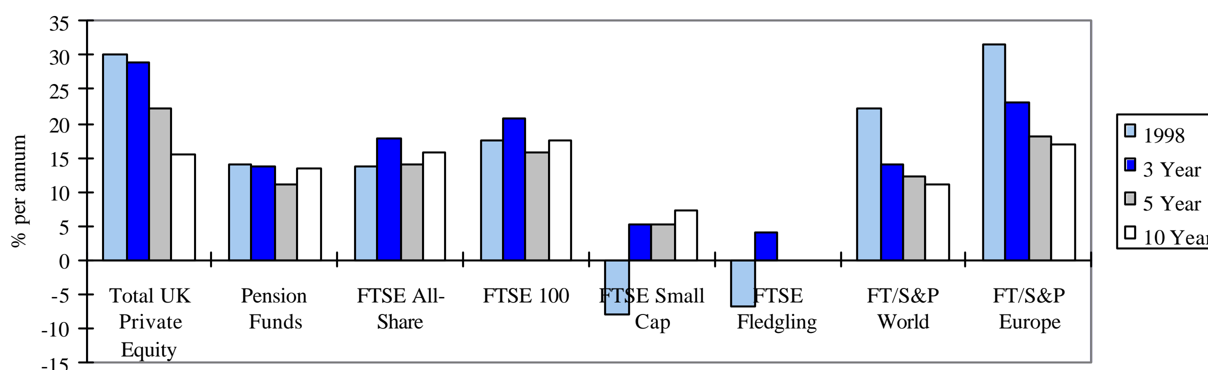
Returns

4.36 The supply of venture capital finance will be mainly influenced by prospective relative returns on investments in relation to the risks. The findings of the BVCA 1998 Performance Measurement Survey, prepared in conjunction with The WM Company[46], covered the vast majority of money raised by their members. The data showed promising net aggregate returns for private equity funds particularly for the more recent investments. The Net Returns of private equity funds raised between 1980 and 1998 measured to the end of December 1998, were:

1 year returns	30.1% p.a.
3 year returns	28.8% p.a.
5 year returns	22.1% p.a.
10 year returns	13.1% p.a.

4.37 Such returns appear high, yet investors are not merely concerned about absolute returns but also returns relative to those achievable from other asset classes. As Chart 4.10 indicates, private equity funds in aggregate outperformed UK pension funds, FTSE 100, FTSE All-Share and other key indicators over periods of 1, 3 and 5 years. However, care should be taken when comparing the performance of private equity funds as reported with indices for other asset classes as calculation methods differ. Furthermore, one year figures are very volatile and affected greatly by the realisation of a few large deals.

Chart 4.10
Comparative returns per annum by asset class, 1998



Source: BVCA/WM Report on Venture Capital Performance Measurement, 1998

4.38 That said, the chart also shows that venture capitalists fared less well, in both absolute and relative terms, over the 10 year period. This is the period over which most investors using closed funds will be asked to commit. Furthermore, it is vital that not only the correct time scale, but also the correct benchmark is used. One would expect the returns on a risky investment, such as private equity capital, to be high compared with the total returns of a pension fund. The latter will be

[46] The WM Company, BVCA *Performance Measurement Survey 1998*, (1999).

required to hold a large proportion of low risk, and hence low return assets, such as government bonds, the inclusion of which will certainly reduce the average returns of the portfolio.

4.39 It is important to note that there is a considerable divergence between the performance of different venture capital funds. As demonstrated by the large gap between the median and the 10th percentile IRRs for the industry, high relative returns are only achieved in the top tenth of private equity funds (see Table 4.1). In Table 4.1 the "all PE" median return of just 3.4% emphasises the strong performance of the most successful firms. Disregarding the argument that private equity may be counter-cyclical and so provide a means of risk diversification for investors, this means that institutional investors may only be interested in investing in a fund if its management team has a solid top tenth or, possibly, top quartile background. However, anecdotal evidence suggests that institutional investment in the funds managed by the better teams is on the basis of invitation only. This usually means that these funds will be fully subscribed almost immediately, shutting out any investors not initially invited. In these circumstances, new investors contacted by private equity funds attempting to market themselves will be very reluctant to invest because of adverse selection.

Table 4.1
Relative performance of private equity funds (10 year returns over period 1989-1998)

Index	Annual Return
All PE – 10th percentile	**20.6**
FTSE 100	17.5
FTSE All-Share	15.9
UK Equities	15.6
All PE – 25th percentile	**13.2**
UK Bonds	12.7
Cash	9.4
Property	7.4
All PE – Median	**3.4**

Source: BVCA/WM Report on Venture Capital Performance Measurement, 1998

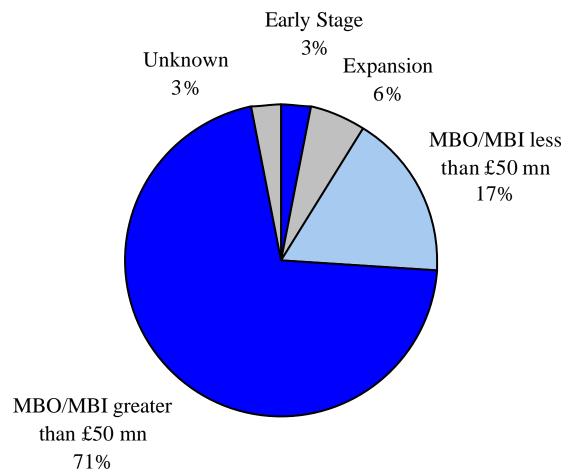
4.40 While the returns are of great importance to all investors, and are indeed the key marketing tools used by private equity houses to attract funds, investors also need to be aware of risks, volatility and, in some cases, lack of liquidity. Venture capital, in its true sense, is considered to be at the more risky end of the investment spectrum, with on average only 2 out of 10 investments meeting their initial targets[47]. However, the investors' risks can be substantially reduced by diversification across a range of assets. Diversification can occur both within the venture capital portfolio and within an overall investment portfolio and allows investors to benefit from the fact that a significant number of private equity investments will exceed their exit price forecast.

Destination of investments

4.41 The switch by private equity houses to larger deals has been accompanied by a move away from early stage investments to the MBO/MBI market. Survey evidence provides further information on this point. The BVCA/MORI Survey[48] found that 59% of respondents intended to maintain or increase their level of investment in MBOs over the next few years but the corresponding proportion dropped to 37% for early stage firms. Chart 4.11 shows the expected destination, by financing stage, of those funds raised in 1998 and emphasises the lack of investments in early stage funds.

[47] Bygrave and Timmons, Harvard Business School Press, *Venture Capital at the Crossroads* (1992).
[48] BVCA/MORI, *Institutional Investors Attitudes to Venture Capital Investment* (1999).

Chart 4.11
Expected destination of funds raised in 1998 by financing stage



Source: BVCA

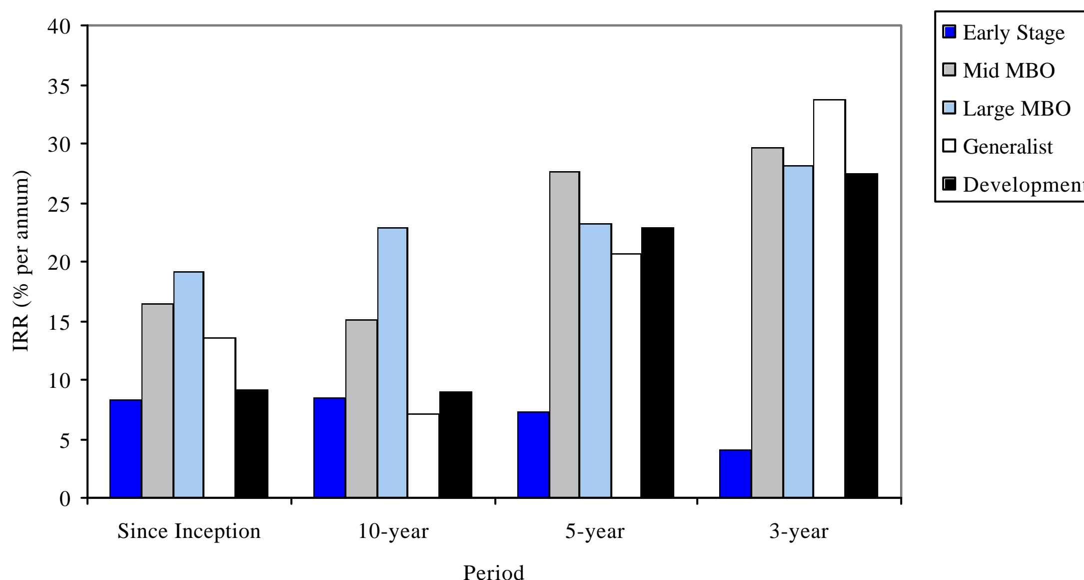
4.42 These trends are reinforced by the fact that over 90% of UK pension fund investment in private equity goes to large MBOs. Important considerations are the range of private equity funds that are open at the time when the pension fund wishes to invest and the size of investments which pension funds are able to make efficiently. With large amounts of money to invest and high transaction costs, the major pension funds rarely find it economical to invest sums of less than £10 million. It can sometimes be difficult to place such amounts in individual private equity funds: as the funds may limit the size of an investment to a certain percentage of the total fund. If, as in the case in some private equity houses, the limit it set at 5%, the fund would need to be in excess of £200 million before most pension funds would even contemplate investing. While such funds are open for MBO style investment, there are few for pure risk capital; this limits an institution's ability to invest at the smaller end of the market even if it had the desire. An alternative is to invest via a fund of funds (see paragraph 4.47) – for example Pantheon.

4.43 The level of returns in relation to risk helps to explain the greater focus of private equity money on MBOs/MBIs compared with early stage investments. Chart 4.12 suggests that MBOs/MBIs generate much greater returns than early stage investments. A possible explanation may be that the UK MBO market largely involves investments in firms with a track record and working in a tested market, hence reducing some uncertainties. Furthermore, the private equity houses are more experienced in conducting such deals and are able to structure them effectively so as to make large returns relative to risks. Indeed, many private equity houses consider the risks from investing in MBO/MBI deals to be less than those associated with start-ups and early stage deals, because the existence of a ready made market and product in the former case reduces the uncertainties that exist in the latter case. There might, over the next few years, be a change in the level of returns relative to risks in the MBO markets, during a time when there is a surplus of funds and when companies are becoming more alert to sophisticated deal structuring techniques. It is, however, interesting to note that the recent BVCA/WM report[49] shows that early stage investments in high technology companies

[49] BVCA/WM Company, *UK High Technology Performance Measurement Survey 1998* (December 1999).

have provided higher returns than have MBO/I high technology investments – 28.3% compared with 19.5% respectively (see Section 5).

Chart 4.12
Returns on private equity by stage focus of fund



Source: BVCA

The availability of information

4.44 An oft-quoted reason for not investing in venture capital was that the returns could not be measured. However, the maturing of funds and the BVCA's move, in 1993, to publish performance data, has made the returns from venture capital more transparent, reducing some of the uncertainty linked to such investments. Moreover, in part due to the switch away from early stage financing to the more lucrative MBOs and MBIs the level of returns has been substantially higher than had previously been expected. The availability of BVCA data is helping to alleviate this problem in the UK, although the data run is still fairly small. There is scope to further improve the quality of the performance data and to ensure that it is more easily comparable with returns from other forms of investment.

Liquidity

4.45 A further factor which may previously have deterred investments in UK private equity funds has been the perceived illiquidity of the market. By its nature, private equity (and venture capital in particular) is a long-term investment, requiring time to nurture a business and generate substantial growth. As a consequence, many private equity funds are closed funds, operating for a set number of years; an investor subscribing to such a fund will be committed for the duration - usually 10 years. Such a structure deters investors who may need to realise their assets at an earlier date.

4.46 On the other hand, the long term nature of the investment ought to be an attraction for pension funds and insurance companies, which by the very nature of their business look for long term investments. In addition, a private equity house seldom draws down all funds at once and likewise returns funds when a particular investment is realised. An investor will, therefore, seldom have more than 60% of its committed monies invested in the fund at any point in time[50]. Furthermore, there has in recent years been an increase in the number of businesses that specialise in buying venture capital portfolios. If, therefore, an individual investor wishes to exit the venture capital market, there may be a number of funds wishing to buy their portfolio. The market for secondary interests is now worth several billion pounds. While the prices are currently heavily discounted, the development of this market, and the increased liquidity which it brings, could open the venture capital market to new types of investors who are wary of committing for the long term.

Fund of funds

4.47 The fact that an investor will not necessarily be asked to invest all that money which has been committed to private equity can also be a disincentive to invest in private equity. In raising a fund, the private equity house will ask investors to make commitments that will be drawn down when suitable companies are found in which to invest. In the meantime the investor retains the money but must have it ready at all times. Such money needs to be invested in a safe and liquid form and as a result is unlikely to be earning significant returns. Furthermore, it is unlikely that all the money will eventually be drawn down. Hence, even if the returns on the invested money are good, they are only on a limited proportion of the investor's commitments to venture capital, thereby reducing the average returns. This problem might be avoided by investing in funds of funds: firms that specialise in investing in numerous venture capital funds. This enables investors to benefit from diversification and is likely to ensure that a greater percentage of money is actively invested in venture capital and hence earning venture capital style returns. Such a concept is relatively less developed in the UK compared with the US. The matured fund of funds market in the US enables investors to select the sectors and the regions in which to invest. It is probable that the further development of such a market in the UK could help to increase the flow of funds into venture capital.

Institutional Investors

Investors by country

4.48 Chart 4.13 shows that in 1998 the value of funds raised from the US, for investment in UK private equity funds, uncharacteristically exceeded those raised in the UK. Indeed, US money accounted for 51% of total investments in UK private equity funds, whereas UK investments fell in absolute terms and accounted for just 27% of investments into BVCA funds. Chart 4.13 also indicates the continued growth of finance from the US. This growth could in part result from the apparently relatively high returns available in the UK, compared to the US, over certain investment periods and particularly in LBO type investments (see Table 4.2). Some 76% of US respondents to a BVCA/MORI Survey[51] claimed that good returns were a major attraction of the UK market. Past experience of the UK market and the number of available opportunities were also cited as important. Perhaps even more significant is the fact that the UK funds are viewed as a gateway into the growing European venture capital market.

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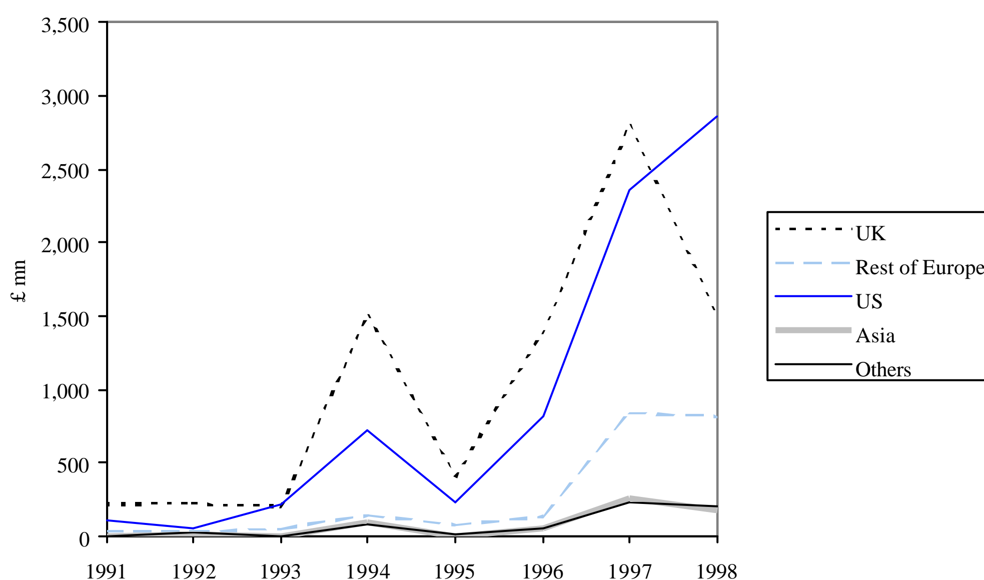
[50] BVCA, *Why you should invest in Venture Capital?* (1998).
[51] op. cit, BVCA/MORI.

Chart 4.13
Value of investments in UK private equity funds by country



Source: BVCA

Table 4.2
Comparison of UK and US 1998 returns

Period of Measurement	UK (All Private Equity)	US (Venture Capital)	US (LBO)
1 year	30.1%	19.7%	10.3%
3 year	28.8%	31.2%	16.5%
5 year	22.1%	32.0%	15.2%
10 year	13.1%	23.8%	15.9%

Source: Venture Economics and BVCA

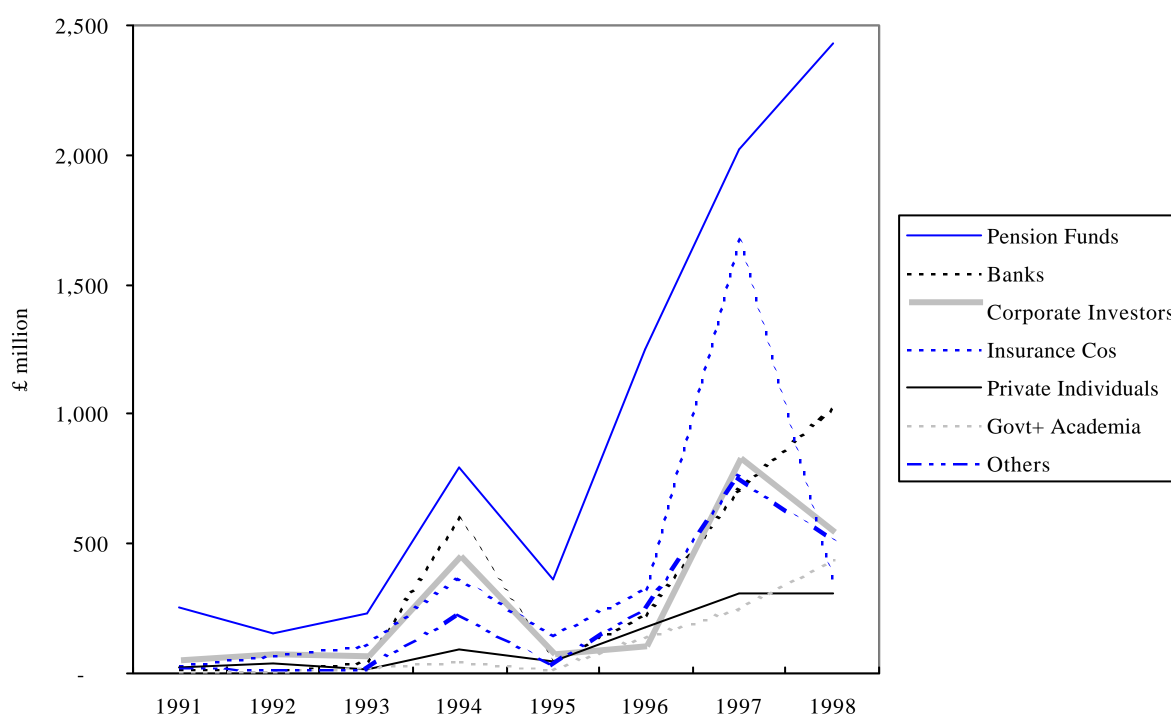
4.49 An additional factor which may help to explain the recent very rapid growth of US investment in UK venture capital could be the uncertainties in the Far East, following the Asian Crisis, leading investors to look for alternative investment opportunities. US investors' interest in the UK private equity market is also demonstrated by the increasing number of US houses moving into the UK (for example, Kohlberg, Kravis and Roberts, and Carlyle Group). There is a possibility that, if such a trend continues, the UK's institutional investors will be unable to regain a foothold in the private equity market in the future.

Sources of funds raised

4.50 As indicated in Chart 4.14, private equity houses raise their funds from a range of different sources. Pension funds worldwide have long been the most important source of finance for private equity funds, accounting for 39% of investment in BVCA members between 1987 and 1998. The

factors that deterred UK institutional investors from placing funds in venture, were the focus of several meetings hosted by the Bank during summer 1999. Representatives from the institutional investors, venture capital funds and the main consulting actuaries contributed to the debate. The key theme which emerged was that while progress had recently been made, in part due to the increased transparency of the market, the process of changing UK investor attitudes was likely to be a slow one.

Chart 4.14
Sources of BVCA private equity raised from investors worldwide



Source: BVCA

Investment by UK pension funds

4.51 In 1987, UK pension funds were the largest single source of investment in UK private equity firms, contributing nearly 35% of all funds. By 1998, this contribution had fallen to less than 10% (see Chart 4.15). Furthermore, the absolute level of contributions from UK pension funds fell by 15% and 11% in 1997 and 1998 respectively. While US pension funds invest an average of 5% of their assets in private equity[52] each year, the National Association of Pension Funds 1998 survey estimates that the corresponding figure for UK pension funds is approximately 0.53%[53]. The Prime Minister's speech to the BVCA in July 1999 further emphasised the importance placed by the Government on the role of venture capital/private equity for small growth firms: *"I cannot make pension funds invest more, but I urge them to look at this issue, to examine whether they and other institutional investors are being too cautious when it comes to venture capital and investing in early stage companies"*. The Prime Minister's speech was followed by a statement by three leading

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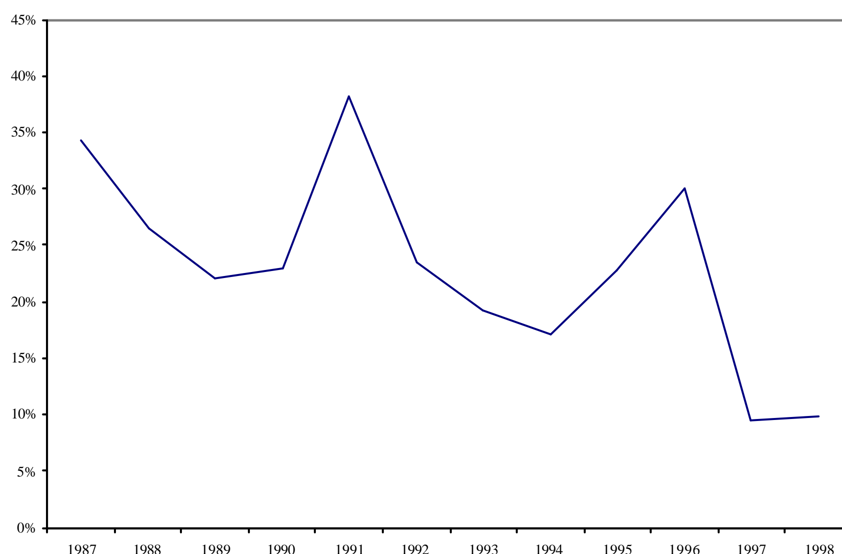
[52] Goldman Sachs & Co/Frank Russell Capital Inc, *Survey of Alternative Investing* (1995 and 1997).
[53] BVCA, *Why you should invest in Venture Capital* (1999).

actuarial consultants, supporting institutional investors making a higher allocation of their funds to unlisted securities.

Chart 4.15
Share of private equity raised from UK pension funds



Source: BVCA

4.52 It could be argued that the relatively small investments made by UK pension funds do not enable them to appreciate fully the advantages of private equity compared with other assets: even if returns on private equity were twice as high as any other asset, the impact on the total fund of, say, a 2% investment would be negligible. Small-scale investments also fail to deliver the full benefits of diversification and incur relatively high transactions costs, due to the inability to benefit from economies of scale. Hence, it is difficult to demonstrate practically the advantages of investing in venture capital. Another important consideration is the method by which the success of the pension funds themselves is measured. Benchmarking plays a vital role in the performance measurement of pension funds and as such there is a tendency for fund managers to replicate the strategies of others: poor performance can be justified if they follow the crowd[54]. With just 26 fund managers controlling 80% of pension funds in the UK, it may be difficult to change this behaviour.

4.53 Of course, pension funds invest in a wide-range of different assets, the most popular being bonds, UK equities, overseas equities and property. A key consideration in pension fund asset allocation decisions is matching assets to their liability profile. The 1995 Pension Act introduced a Minimum Funding Requirement (MFR), which stressed the importance of assets matching liabilities if the fund were to be liquidated immediately. Furthermore, it implied that for clients with less than 10 years to retirement the liabilities should be measured relative to gilts and for those with more than 10 years to retirement they should be valued against equities. The regulations are being phased in and will take full effect in 2002. The Act is inducing funds to aim for a greater match between their assets and liabilities: most notably this has involved a switch from overseas equities to government bonds. It is possible that the need to balance assets and liabilities will lead to a further reduction in

[54] Cliff Pratten and Steve Satchell, *Pension Scheme Investment Policies,* Department of Social Security Research Report 82, Corporate Document Services (1998).

the flows of pension fund money into venture capital, given that the latter is viewed as being more risky than equities.

4.54 Another factor which could have a significant impact on the flow of pension fund money into private equity is the gradual move from defined benefit pensions to defined contribution pensions. Defined contribution pensions provide individual subscribers with the flexibility to choose how to allocate a proportion of their own pension fund. Such members are unlikely to be fully aware of venture capital or how to measure its associated risks. This lack of knowledge, together with the difficulties involved in investing very small amounts of money, will not be conducive to investment in venture capital.

Investment by UK insurance companies

4.55 Insurance companies are also an important source of finance for private equity funds and the Association of British Insurers have recently taken an increased interest in investment by their members in to venture capital. From 1987-1995 the average annual investment from UK insurance companies was £103 million, but this rose to £221 million in 1996, £1,160 million in 1997 and £152 million in 1998. One possible explanation for the dramatic increase in money committed to private equity during 1997 was a change in the valuation rules of unlisted investments. Prior to the 1995 Amendment to the Insurance Companies Regulations 1994, the rules for valuing unlisted investments for the purposes of calculating solvency margins were so restrictive that insurance companies in effect had to value their investments at zero. This reduced the attractiveness of holding such investments. The 1995 Amendments enabled Insurance Companies to value such investments on the basis of the BVCA valuation method (set out in "Guidelines for the Valuation and Disclosure of Venture Capital Portfolios"[55]), hence alleviating that impediment. The BVCA believes that the fall in investment by insurance companies in 1998 is likely to reflect a change in the types of private equity firms raising funds that year, rather than a change in their interest in investing in private equity[56].

Institutional investors' attitudes

4.56 The BVCA commissioned Mori to conduct a survey[57] "Why You Should Invest in Venture Capital?" designed to highlight institutions' attitudes to venture capital. The responses to the question "What are the key factors that most influence whether your organisation invests in UK venture capital?" are set out in Table 4.3 below. ("Venture capital" includes private equity in this context).

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[55] Association of British Insurers, Guidelines for the Valuation and Disclosure of Venture Capital Portfolios, pp 24-26.
[56] The WM Company/BVCA, *Report on Investment Activity* (1999).
[57] BVCA/MORI, *Why You Should Invest in Venture Capital* (1999).

Table 4.3
Factors influencing investment decisions

	Invest in UK venture capital (%)	Do not invest in UK venture capital (%)
Knowledge of UK VC performance	48	14
Experience of previous VC investment	56	36
Fund restriction/policy	26	45
Diversification	41	9
Management time & resource	22	18
Risks	19	64

Source: BVCA/MORI

4.57 The fact that those funds which do invest do so primarily because of past experience of the market and knowledge of venture capital performance, while those that do not invest consider these same factors as a deterrent, further stresses the importance of increasing investors' knowledge of the opportunities associated with venture capital.

Exit routes

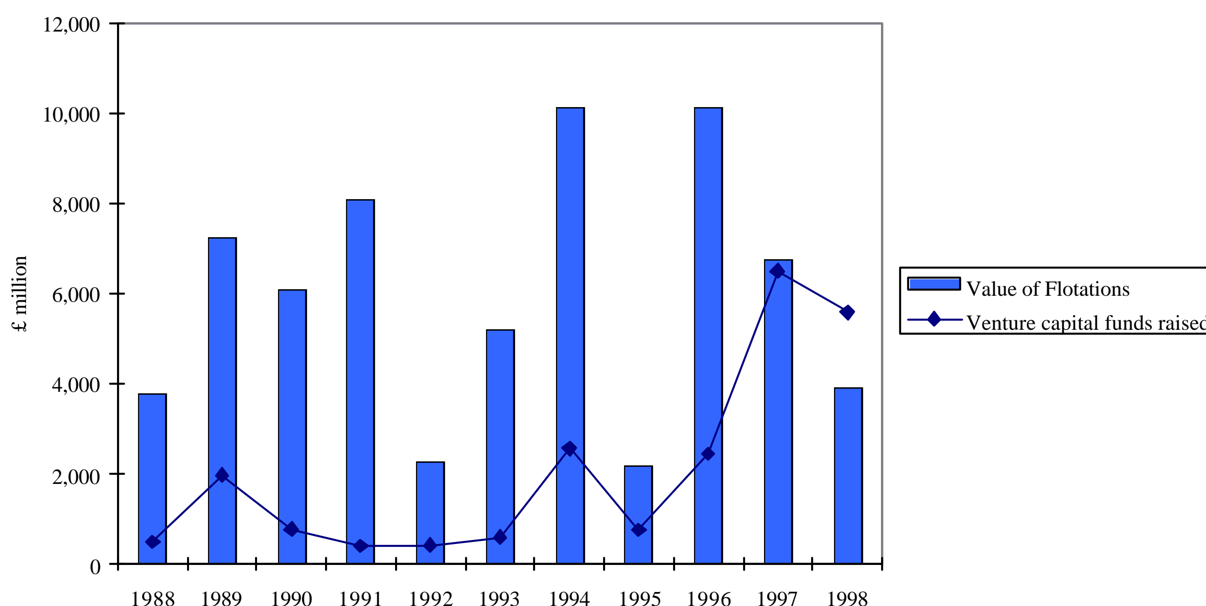
4.58 The success of a private equity investment relies heavily on a successful exit, for this is the stage at which returns are realised. There are a number of different exit routes, the most common of which is a trade sale. Other methods include: flotations, sales to the management, sales to other financial institutions, and sales to other venture capital houses. The latter is becoming an increasingly attractive means of divestment and hence another route by which a private equity fund can realise its value: this should act as an encouragement to further investment. Furthermore, it provides more scope for refinancing investments in companies that are slow to grow, hence providing them with a greater opportunity to develop to their full potential. The public markets, are a vital indication of the health of the venture capital market, for even when divestment is not via flotation, the IPO market is often considered a benchmark for valuing the company. Indeed, the 1987 stock market crash and subsequent reduction in IPOs had a negative, though temporary effect on the health of the US venture capital industry[58].

4.59 Chart 4.16 suggests a link between the level of IPO activity in the UK[59] and the value of venture capital funds raised[60]. Such a correlation can in part be explained by a rise in the IPO market signalling the likelihood of increased returns in publicly traded equities, with spin off effects on private equity. Similarly a downturn in the IPO market could be associated with an economic slowdown and hence increase the risks from private equity investments. It is, however, surprising that there is not a more notable lag between the two movements: the process of raising a private

[58] Bygrave and Timmons, Harvard Business School Press, *Venture Capital at the Crossroads* (1992).
[59] KPMG, *New Issues Statistics* July - December 1998, KPMG Corporate Finance (1999).
[60] BVCA, *Report on Investment Activity* (1999).

equity fund can be slow and the health of the IPO market is likely to have altered by the time that the private equity investments are ready to be realised. It is, therefore, likely that the link stems in part from the funds taking advantage of general levels of optimism within the market. Whatever the precise rationale behind the link, the important fact is that a relationship does exist (and a similar pattern has been found in the US[61]), hence stressing the importance of a healthy IPO market both in the raising of private equity finance and the exit from a deal.

Chart 4.16
Value of funds raised versus IPO activity



Source: BVCA and KPMG

Supply of informal venture capital

4.60 As noted above, business angels have an important role to play in providing small amounts of equity to business and thereby helping to reduce the equity gap. Their ability to invest on a small scale reflects relatively low transactions costs, arising in part from less detailed due diligence than would be carried out by a private equity firm. Business angels may also be prepared to accept lower monetary returns in exchange for non-financial rewards arising from the opportunity to play an active role in the entrepreneurial process. In addition to providing a valuable source of finance, many business angels also offer experience and expertise that are of great benefit to the investee business. Business angels make a vital contribution to the financing of SMEs, but there is potential for many more businesses to benefit from this form of finance. It is also important to recognise the complementarity of business angel investment and formal venture capital investment: more encouragement could be given to business angels and venture capital firms to coinvest in businesses. The rules of EIS which define whether investee businesses are deemed to be "controlled" by venture capital or other investors may be relevant in this context.

4.61 The key barrier to business angel investment, which is generic to all firms, is the lack of information on investment opportunities. Many business angels wish to maintain a degree of

[61] op. cit, Bygrave and Timmons.

anonymity to ensure that they are not inundated with numerous unsuitable requests. It has been estimated that over 50% of the informal venture capital investments arise from recommendations from family and friends[62]. A significant number of business angel networks have been established in order to match business angels more formally to suitable investments. In addition to acting as introduction agencies, the networks are able to offer advice on formulating business plans and making investments.

4.62 These networks are often organised on a regional or local basis, allowing business angels to investigate more fully those business opportunities located in their own area, where hands-on support can most easily be given. However, some locally-based business angel networks have not been able to achieve the critical mass to become viable. Further co-operation and co-ordination between the business angel networks in the UK could remedy this problem and induce an increasing flow of informal venture capital to SMEs. The National Business Angel Network was therefore launched in February 1999. This initiative, which is supported by the major high-street banks, could help to promote business angel investment, to cut the costs involved in finding suitable partners and to make the process quicker and more efficient.

4.63 Such initiatives are welcome, but more remains to be done. Only 10% of those business proposals that business angel networks circulate to their investors receive funding[63], suggesting that there is considerable scope to increase the take-up rate. The rate may reflect a credibility gap between the expectations of potential investors and those of the investee company. Many business angels do not believe that business plans are adequate and many businesses are unconvinced of the benefits of business angel investment. This may partly reflect a failure on the part of some business angels to explain fully the benefits they can offer in terms of expertise and experience, as well as finance. Furthermore, research by Harrison and Mason[64] suggests that business angels could benefit from further technical assistance, for example in the form of an independent technology appraisal service.

4.64 While many business angels have a number of non-financial motives for making investments, financial returns are important. The returns made by business angels are difficult to assess: a recent survey by Mason and Harrison[65] found that while 34% of the 128 business angel investments surveyed were at a total loss, 23% produced IRRs of at least 50%. The greater availability of such performance measurement data, perhaps along the lines of that produced by BVCA members, for informal venture capital investments, might attract a number of new business angels to the market.

4.65 Finally, the regulatory environment within which business angels operate is vital. Section 57 of the Financial Services Act 1986 currently restricts the ability of entrepreneurs to solicit investment from non-professional investors who are not FSA-authorised and thus deemed to lack professional insight. As a result, there are restrictions on the advertising of certain investment opportunities or of unauthorised collective investments schemes to the general public. While the basic aim of this regulation is to protect unwary investors, it may also act as a barrier to the development of business angel networks and other forms of informal equity. The legislation is being modified and the draft Financial Services and Markets Bill provides an exemption for business angels, enabling firms seeking to attract informal venture capital to do so other than via the authorised person route. An

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[62] Coveney, Moore and Nahapiet, Templeton College Oxford, *Business Angels: Tapping the Potential of Individual Investors in Britain* (1996).
[63] BVCA, *Sources of Business Angel Capital 1997/98.*
[64] Mason and Harrison, *Stimulating Investments by Business Angels in Technology-Based Ventures: the Potential of an independent technology appraisal service* (1998).
[65] Mason and Harrison, *Is It Worth It? The Rates of Return From Informal Venture Capital Investments Venture Finance*, Working Paper No 16 (1999)

important issue in formulating the legislation is the definition of "business angels": it is likely that a wealth test will be introduced.

Public equity markets

4.66 Flotations have a number of advantages as a source of finance for certain larger SMEs, particularly where further expansion is planned or as a means of motivating employees. They enable large sums to be raised from a broader investor base and, when the market is thriving, can result in very high returns for business owners and private equity firms alike. Efficient and effective capital markets play a vital role in the provision of finance to smaller quoted companies (SQCs) and in ensuring an exit route for private equity investments. The increased acceptance on public capital markets of loss making companies is also widening the coverage of those markets: for example 40% of companies going public on NASDAQ are loss making companies.

4.67 Prior to the 1980s, UK companies had just two routes through which to raise public equity. One was the main stock exchange, which had strict entry requirements and was highly regulated (and therefore unattainable and inappropriate for many smaller companies). Alternatively, they could gain admission to the OTC market, which was completely unregulated and therefore only attractive to specific investor groups. This gap was subsequently filled, to some extent, by the development of second tier equity markets. Second tier equity markets provide smaller companies with access to public equity at an earlier stage than would occur if the only source of public equity was a full listing. They also result in earlier exit routes for private investors, possibly increasing the liquidity of the private equity market. The development of second tier equity markets means that most European countries now have a three-tier capital market structure: an official list; a semi-official market or section of the official list with less onerous admission and trading requirements for smaller companies; and an OTC market falling outside all formal regulation.

UK second tier equity markets

4.68 The UK's experience of second tier equity markets has been mixed. In November 1980, the Unlisted Securities Market (USM) was established. It was initially successful, attracting most companies formerly traded on the OTC market as well as new entrants. However, the influx of new entrants declined in the wake of the recession of the early 1990s. Furthermore, the Listing Rules of the main market were relaxed, hence reducing the differentiation between it and USM. These factors, coupled with the reduced liquidity of small company shares in the early 1990's, led the London Stock Exchange (LSE)to decide, in 1993, to close the USM (although pressure from investors and issuers meant that the USM was not finally closed until 1996).

4.69 Notwithstanding the closure of the USM, it remained clear to the LSE that the official list alone was insufficient in the provision of finance to smaller companies. The result was that, despite the problems previously encountered by junior markets, the Alternative Investment Market (AIM) was established in 1995 to provide smaller companies with quicker and easier access to public equity (see box).

4.70 There have been concerns recently as to whether the UK equity markets provide an adequate base for smaller quoted companies. A 1998 report to the Paymaster General by a group chaired by Derek Riches, sponsored by HM Treasury[66] (paragraph 4.84), suggested that the London Stock Exchange could do more to provide a supportive market environment and increase the profile of

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[66] *Treasury Working Group Report on Small Quoted Companies* (November 1998).

smaller companies' shares. Recent initiatives, such as the launch of techMARK, could help to improve the situation.

UK equity markets

4.71 Following the establishment of AIM, the UK has a three tier market structure consisting of the official list on the LSE, AIM, and OFEX, the unregulated OTC trading facility. The latter is not a market although its sponsor is subject to Stock Exchange rules.

Official List

4.72 The official list is segmented by market capitalisation. Smaller companies are categorised in the FTSE SmallCap (market cap of £65mn to £400mn) or FTSE Fledgling (market cap of less than £65mn) indices. The LSE has also recently launched the All Small market index, which combines the FTSE Fledgling, SmallCap and techMARK indices.

The Alternative Investment Market

AIM was introduced in June 1995 as a second tier market to target small or young companies whose shares were not publicly traded. It has grown rapidly over the past few years and, at end-November 1999, it consisted of 337 companies with a total market capitalisation of £10 billion. This compares with 313 companies with a combined market capitalisation of £4.4 billion a year previously. Since its introduction, almost £3 billion has been raised on AIM and 60 of its listed companies have subsequently moved to the main market. 1999 was a record year for capital raising on AIM, £933 million was raised – 67.8% more than in 1998.

AIM has no minimum trading record, no minimum assets or profit levels, no minimum capitalisation requirement and no minimum free float of shares. These less stringent entry requirements and continuing obligations were intended to improve smaller companies' access to public equity. However, while the regulatory regime for AIM is much less onerous than that for the Official List, regulations have been tightened since AIM was first established. This was designed partly to encourage more institutional investment, but has caused some businesses to question the benefits of AIM. In 1999, institutional investors owned 19% of AIM companies, compared with 34% for private investors and 40% for directors and founders.

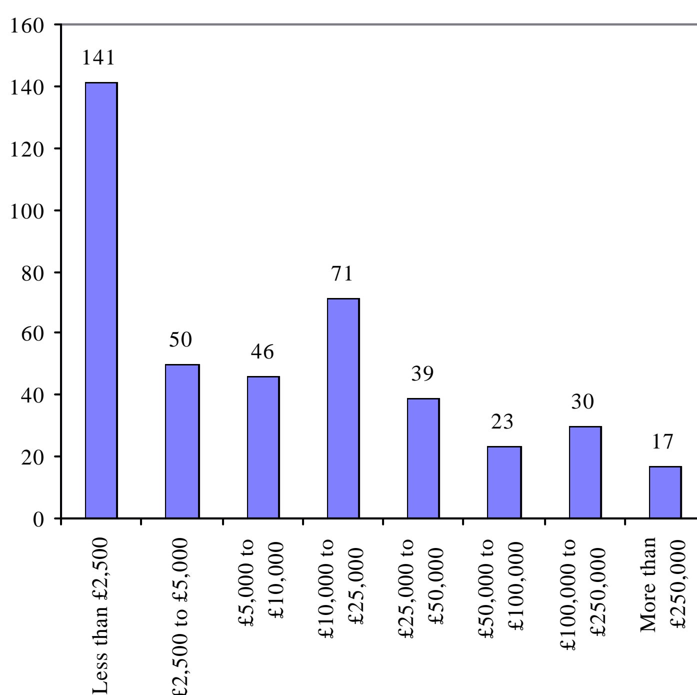
The level of regulation required by AIM means that the costs of listing on AIM are considered by many companies not to be sufficiently lower than those required for a full listing. AIM companies are, for instance, obliged to: produce working capital statements before listing; publish annual accounts and half yearly reports[67]. Easier listing requirements could be introduced, but care would need to be taken to ensure that the subsequent risks did not act as a further deterrent. The balance between enhancing shareholder protection and reducing the burdens of regulation is difficult. While fewer requirements can enable the company to concentrate more on its core business, any such benefits might be offset by a reduction in trading of their shares resulting from reduced investor confidence. The fact that many companies do perceive the regulatory burdens of AIM as a deterrent is demonstrated by their continued presence on OFEX, an off-market trading facility established as a feeder market to AIM, where there are no such regulations.

[67] Tim Steadman, *The Alternative Investment Market: The Regulatory Issues*, Journal of Financial Regulation and Compliance, volume 4 number 2 (1996).

AIM rules require that, if a company has been generating revenue for less than two years, its directors and employees at the time of listing must not dispose of any of their shares for at least a year. This can delay the speed with which private equity houses can realise the full value of their investment. Given that the ease of exit plays a vital role in venture capitalists' returns, this can restrict the supply of venture capital finance at the smaller end of the market. The restrictions may, however, reassure investors about the management's long-term commitment to the company, and hence help to provide credibility to the market.

Another factor which might have restricted AIM's attractiveness to venture capitalists is the lack of liquidity in the market. Chart 4.17 below shows that the average daily trade value for over half of the companies traded on AIM is less than £5,000. One key contributor to the lack of liquidity has been the absence of sufficient published analysis relating to companies quoted on AIM, which has deterred potential investors. This leads to a vicious circle: the fewer analysts' reports available, the fewer shares change hands, and the fewer shares which change hands, the less inclined are analysts to write reports. It is possible that simple moves such as the electronic publication of the company's accounts could assist in this matter.

Chart 4.17
Distribution of AIM securities by average daily value traded (January-November 1999)



Source: London Stock Exchange

OFEX

4.73 As mentioned, OFEX is an off-market trading facility provided by JP Jenkins, a market maker/agency broker that previously specialised in Rule 4.2 stocks. It was established in September 1995 and was intended to replace the Rule 4.2 market for companies that did not wish to join AIM or the official list. OFEX is not regulated, although JP Jenkins is bound by Stock Exchange and SFA rules. It is intended to feed into AIM, although some companies have chosen to remain on OFEX

despite qualifying for AIM, or even the official list, because of the advantages of an absence of regulation.

Recent developments

4.74 It will be interesting to monitor the effect of the recently launched techMARK (see paragraph 5.8), designed as a “market within a market” for companies with a technology bias already on the Official List. In addition, techMARK will have a special listing procedure for other innovative high growth companies, many of which will be technology companies, currently outside the Official List, with less onerous requirements. The planned arrival of NASDAQ Europe in London as a recognised investment exchange could effect the liquidity of the market.

Pan-European equity markets

4.75 An important recent development at the European level has been the progress towards developing a pan-European market. Work undertaken for the European Commission[68] on the financing of technology-based firms identified the need for a substantial pan-European risk capital market, similar to NASDAQ. While EASDAQ (see below) is aiming to fill this gap, it is currently too small and illiquid to attract large numbers of European entrepreneurs, many of which still choose to list on NASDAQ. The main barriers to the development of a deep, liquid pan-European market were identified by the EC as fragmentation, both institutional and regulatory; taxation; paucity of high technology SMEs; human resources; and cultural. There are currently 33 regulated stock markets and 18 regulatory organisations in the EU. Each national market has lower capitalisation and liquidity, and consequently offers less attractive exit routes, than a combined market. The diversity of regulatory and fiscal regimes across the member countries is likely to impede the integration of national exchanges.

Euro.NM

4.76 Euro.NM is an agreement between the Paris, Brussels, Frankfurt, Amsterdam and, since 1999, Milan, stock exchanges to promote the listing and trading of European start-up, high technology and growth companies on member exchanges. From May 1998, trading platforms at the Brussels Euro.NM and the Paris Nouveau Marché have been linked and since July 1998 there has been a common membership between these two exchanges. There has been discussion about widening Euro.NM in the near future. As of November 1999, Euro.NM has 338 companies listed, with a total market capitalisation of just under Euro 100bn – the latter figure being dominated by the success of Germany’s Neuer Markt. This shows considerable growth on the previous years, with the number of companies more than doubling. This perhaps demonstrates the attractions of access to a pan-European investor base.

EASDAQ

4.77 EASDAQ was established in September 1996 as a pan-European market for small and medium sized companies with a bias towards the high technology sector. However, the market, with listing requirements of total assets of Euro 3.5mn (approximately £2.3mn) and capital reserves of Euro 2mn (approximately 1.3mn), is now regarded more as an exchange for high growth mid-sized businesses. EASDAQ was modelled on NASDAQ (which originally took a 5% stake) and is regulated by the Belgian Ministry of Finance and supervised by the Belgian Banking and Finance Commission. It operates across 14 European countries and has just one regulatory system and one

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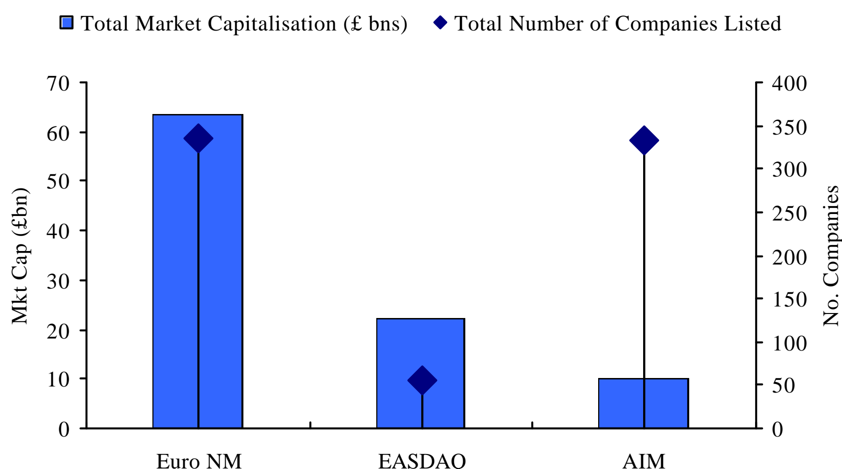
[68] Commission of the European Communities, *Risk Capital A Key To Job Creation In The European Union* (April 1998).

seamless trading and settlement system. As of November 1999, EASDAQ had 56 (1998:37) companies listed, with a total market capitalisation of $32 billion (1998:$13bn). Despite notable growth during the past year, EASDAQ still remains a long way behind Euro.NM (see chart 4.18).

Chart 4.18
Compared market capitalisation and number of companies on Euro NM, EASDAQ and AIM[69]



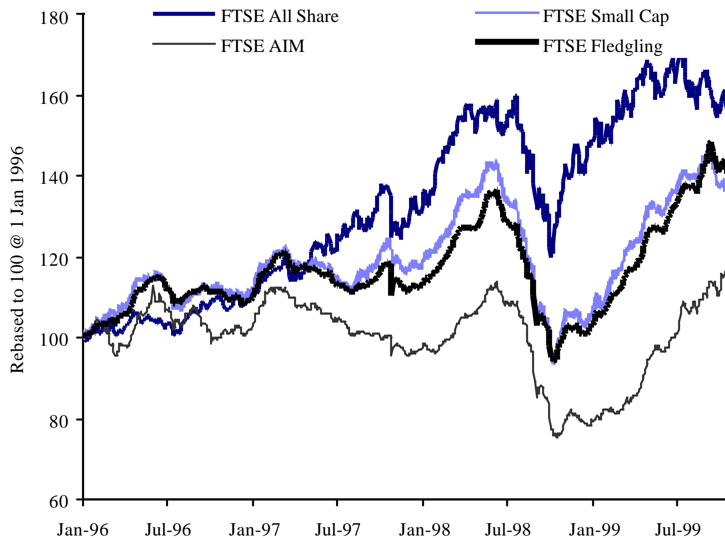
Source: EASDAQ, Euro NM and The London Stock Exchange.

Smaller Quoted Companies (SQCs)

4.78 Turning to the official list, the key factor affecting smaller quoted companies (quoted companies outside the FTSE 350) in recent years has been the underperformance of their shares relative to larger company stocks. The Small Cap Index has under-performed the All Share Index by 40% over the past ten years. Despite a recovery during 1999, particularly reflecting rapid growth in Internet stocks, there is still concern over the functioning of the SQC sector.

[69] Data as of end November 1999.

Chart 4.19
Performance of small company indices (January 1996 - October 1999)



Source: Datastream.

4.79 The mixed performance of the Small Cap market and the possible under-valuation of many SQCs has reduced their ability to raise further finance, increased the cost of the finance that they do raise and may have reduced their ability to attract high calibre staff. For some companies, the difficulties have become so great that there has been an increased trend for public to private deals, often with the assistance of a private equity firm. Some 39 SQCs returned to the private market in the first three quarters of 1999, compared with only 7 in 1997 and 25 in 1998. This should be compared with the 29 companies that joined the main market between January and November 1999. Furthermore, a Manchester Business School survey found that the number of companies that would consider a flotation had more than halved in the 1998/99 period compared with the previous year.

4.80 The relative performance of the SmallCap market may reflect the state of the economic cycle. There is evidence that smaller firms tend to underperform large companies as the economy slows: perhaps partly explaining why SQCs underperformed in 1996-98. This could, for example, reflect the fact that some small firms face greater restrictions in their access to external capital, which tends to bite in an economic slowdown. Other reasons for the underperformance could have been a decline in earnings expectations or a rise in risk premia relative to those associated with large stocks: the latter in particular may have become more marked during the turbulence of the global markets.

4.81 Relatively lower earnings expectations for the SmallCap index may also have been a function of the sectoral composition of the index. During 1998 General Industrials, which made up 23% of the SmallCap index, but 5% of the FT-SE 100 index, fell as a whole by 12%. These companies are, on average, more exposed to overseas markets and consequently suffer more from the strength of sterling. In contrast the Utility sector, which is less exposed to the strength of sterling, and which made up 0.8% and 11% of the SmallCap and FT-SE indices respectively, rose by 21% during 1998. Therefore, the poor performance of SQCs in 1996-98 might have been due to a combination of lower earnings expectations, higher relative risk premia and the cyclical slowdown in the UK economy. The reversal of some of these factors may also help to explain the substantial bounceback in the Small Cap Index in 1999.

4.82 Looking at the longer term the market for SQCs has been underperforming the larger company markets throughout most of the 1990s. There have been a number of structural changes to the UK equity market, which may explain this long-term underperformance of the SmallCap index, through an increase in risk premia, and through suppressed demand. This is partly attributed to the composition of the sector, which has a lower proportion of businesses in the high performance sectors of the 1990s. The SQC market is also less liquid than the FTSE350 and FTSE100, partly as a result of limited institutional interest. Some commentators believe that this problem has intensified as a result of the increased dominance of index-tracker funds, especially those tracking the FTSE100. The consolidation of financial services has also led to fewer fund managers, who now manage larger funds than before. Hence, investment decisions may focus on large, well-known and well-researched stocks, increasing the risk premia on small stocks relative to large stocks.

4.83 These trends in the SQC market have led to the establishment of several working parties, whose work has focused on the performance of the SQC sector and the ways in which the capital markets might be adapted better to serve the needs of SQCs. Among recent reports were the Riches Report[70], and the Waterstone Report *Improving Share Liquidity*[71], *Tomorrow's Giants*[72] and *Creating Quality Dialogue* (DTI).

4.84 The Riches report put forward a case for special treatment of the whole SQC sector. The major recommendations related to taxation, regulation, information, and the London Stock Exchange. To encourage investment in SQCs it was recommended that individuals should be incentivised through tax reliefs on their direct holdings of SQC shares held for a period of time. As regulation has a disproportionate effect on SQCs the issue of whether to exempt 'high net worth' individuals from investor protection was also raised. It was also recommended that consideration should be given to the mandatory submission of information from companies to regulatory authorities in electronic form. The Riches report suggested that the Stock Exchange should create a more favourable environment for nurturing SQCs as they come to market and should support their development thereafter more actively.

4.85 The key message from the Waterstone report was that, in order to grow and to improve liquidity in their shares, SQCs needed to widen their investor base. In particular there was evidence to suggest that they had relied too heavily on institutional investors, which left them with a share liquidity crisis as institutions changed their focus to larger companies. Private investors were seen by the Waterstone Group to represent untapped resources and the route to sustained liquidity. To overcome their liquidity difficulties the report recommended that SQCs should target private investors both at flotation and in the secondary market. Other recommendations included that the FSA should ensure that suitability rules do not inhibit investment in SQCs by private client brokers on behalf of their private investors and the London Stock Exchange should continue to promote the benefits of private investors to SQCs.

4.86 *Tomorrow's Giants* concluded that the SQC sector was suffering due to the volume of the tax-break led flow of funds into larger stocks. The report recommended that the UK should follow the example of the US to combat this problem. Private investors needed simpler products that were cheap to administer, such as the American independent retirement account and 401k plans. In the interests of the economy, the tax playing field should be levelled so that individual investors were given the same privileges as investing institutions. Educating the public on private investment issues was also seen as vital for the long-term success of SQCs. This should include stronger support from

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[70] *Treasury Working Group Report on Smaller Quoted Companies* (November 1998).
[71] DTI report, chaired by Tim Waterstone, *Private Investors Improving Share Liquidity for Smaller Quoted Companies* (1999).
[72] Brian Basham (Equity Development Limited) and Craig Pickering (Finance and Leasing Association), *Tomorrow's Giants* (1999).

Government of organisations such as Proshare and the Guild of Shareholders. The report also sought to encourage share clubs, run by qualified financial intermediaries.

4.87 From the investor's perspective, the comparatively low returns of SQCs in recent years have been just one deterrent. There is also sometimes uncertainty regarding the quality of the management team. Furthermore, the SQC market also suffers from a lack of liquidity brought about by a growing focus on the part of fund managers on large company stocks. This trend reflects various developments, including the consolidation of the fund management industry, the growing popularity of index tracker funds and the increased Europeanisation of funds. The shift towards larger company stocks has resulted in a vicious circle for many SQCs. As interest in the sector reduces, brokers' commissions dwindle, less research is conducted, leading to reduced knowledge of the market and hence even fewer deals. This spiral has proved difficult to break. The Waterstone report suggested that private investors might help to fill the gap which has been left by the institutions. Another alternative would be to consider more actively the suitability of long term debt (including higher yield debt) finance for SQCs.

Corporate venturing

4.88 Corporate venturing has been growing in prominence over recent years. A recent publication[73], co-sponsored by the CBI, DTI and NatWest, defined corporate venturing as: "a formal, direct relationship, usually between a larger and an independent smaller company, in which both contribute financial, management or technical resources, sharing risks and rewards equally for mutual growth". The larger company often makes some form of investment, either in terms of finance, or in kind, in return for a share in the company's future – often relating to a specific product or process. Corporate venturing is most common within the high technology sector (for example, pharmaceuticals and software), where the larger company is keen to access new ideas and skills to enable it to keep ahead of competitors. In return, the smaller company can benefit from access to an established marketing and distribution channel, technical and management expertise and often financial assistance.

4.89 Although corporate venturing is widely used in the US, it is still at an early stage in the UK. One of the key reasons behind the UK's smaller market is the lack of awareness and understanding of the process. The Pre-Budget Report announced that the year 2000 Budget would introduce fiscal incentives for UK companies to undertake corporate venturing. Those companies that undertake corporate venturing will receive up-front corporation tax relief at 20% on investments in small higher risk trading companies, as well as a deferral relief where companies sell shares and reinvest the gain in corporate venturing. This initiative should help to promote awareness of corporate venturing while also giving those companies who have not yet taken part the opportunity to experience the benefits. There is also further scope for the banks to disseminate information relating to corporate venturing opportunities. The ultimate success of corporate venturing will be largely dependent on whether effective individual partnerships can be built between investor and investee companies.

Government and European initiatives

The Role of Government

4.90 The first major public initiatives to promote venture capital style investment in the UK emerged in the aftermath of the Second World War. The most prominent were the launch of the National Research and Development Organisation (to promote the transfer of ideas from British

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[73] CBI, *Connecting Companies, Using Corporate Venturing for Growth* (1999).

Universities to the corporate sector) and the Government's (and the Bank of England's) instrumental role in the formation of the Industrial and Commercial Finance Corporation (now 3i). Government involvement has progressed significantly since then, recognising the potential importance of venture capital to the economy. The current Government has shown a keen interest in venture capital and the ways in which the conditions for securing it can be improved, with particular attention being placed at the smaller end of the market.

4.91 Government involvement aims to provide additionality, encouraging new investment, rather than providing financial rewards for investments which would have taken place anyway. Public intervention is generally justified by potential market weaknesses or failures in the provision of finance to SMEs. The high technology sector is one such example, since the benefits to the economy are great, but the risk return ratios involved (due partly to the large amounts of pre-development investment) do not always make it an attractive proposition for private investors.

Promotion of enterprise

4.92 Michael Porter stresses that *"invention and entrepreneurship are at the heart of national advantage"*[74]. In his speech at the BVCA Conference on 6 July 1999[75] the Prime Minister listed "the encouragement of entrepreneurship" as one the three key building blocks of the Government's economic policy. The intention is to promote an economy in which businesses can prosper and thus indirectly affect the demand for venture capital. It is arguably in these areas that the government can add the greatest value: even government backed supply-side schemes will have little impact if there is inadequate demand for such finance.

4.93 A related area is the extent to which the UK and US differ in their perceptions of failure. It has been argued that there is considerable stigma attached to bankruptcy in the UK, whereas in the US it is viewed more as a sign of experience and is in some ways regarded as a valuable learning point. The recent review of UK bankruptcy and insolvency laws is partly motivated by concerns over the possible stigma attached to business failure in the UK (see paragraphs 2.40 and 2.41).

The supply of management and a skilled workforce

4.94 The supply of management and a skilled workforce to SMEs is a vital factor in determining their growth. This is affected by the determinants of the potential entrepreneur's decisions on whether to leave stable employment and establish a business. The ability to attract employees and hence grow the business to the extent that it is ready for equity finance is also vital. Flexible labour laws and easily transferable pensions will help to promote labour mobility. Furthermore, the expected taxation of the entrepreneur's share of the company on divestment can impact on the decision to seek equity finance.

4.95 Stock options are designed to ensure the retention of key staff in early stage businesses, and played a vital role in the revival of the US venture capital market in the early 1980s. They were slow to take off in the UK, due to the tax on potential gains. The 1984 Finance Act introduced a number of changes which made them more attractive: if the options were held for a specified period they would not be liable for income tax and, if they were part of a formal scheme, CGT would not be payable until the options were exercised. The resulting greater use of stock options helped to increase the flow of labour into new firms[76]. The 1999 Budget acknowledged the need to attract

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[74] Michael Porter, New York Free Press, *The Competitive Advantage of Nations*, pp. 125-126 (1990).
[75] Tony Blair, Speech to the British Venture Capital Association Annual Conference, 6 July 1999.
[76] Commission of European Communities, *Improving Venture Capital Opportunities in Europe* (1985). Proceedings from the symposium held in Luxembourg (October 1984) Kogan Page/Commission of European Communities.

experienced personnel into early stage companies and the Enterprise Management Incentive (see paragraphs 2.24 and 2.25), allowing up to 10 key employees tax-advantaged share options worth up to £100,000 should help to promote and improve the supply of labour to SMEs and venture capital funded firms. In addition, the EMI may facilitate the flow of finance to the company, in a manner similar to that provided by a business angel.

Training and information

4.96 In addition to developing the spirit of entrepreneurship, it is also important for potential entrepreneurs to develop the skills necessary to put this into practice. Linked to this is the need for businesses to understand the advantages and disadvantages of venture capital. The Government can play a vital role in educating small businesses regarding the alternative types of finance, including venture capital, through such agencies as Business Links and the forthcoming Small Business Service.

Clusters

4.97 The US venture capital industry has also benefited greatly from the clustering of business and financiers together, for example in Silicon Valley. This close proximity encourages networking and allows ideas to spread more quickly, with small companies benefiting from the expertise of those around them and also from being able to use the latest products in their own business. The Department of Trade and Industry Biotechnology Means Business Programme provides demand-side support by promoting the importance of business incubation and mentoring for high technology firms. *Biotechnology Clusters*, a report of the findings of a research team, led by Lord Sainsbury, was published in August 1999. While the report focused on biotechnology clusters, it is believed that many of the findings are applicable to a wide range of business sectors. In the US financial support is also vital to clusters, with venture capitalists often opening offices in close proximity to the businesses. The initiative to foster clusters to the UK might, therefore, result in more businesses with the potential to benefit from equity investment.

The Enterprise Fund

4.98 The 1998 Competitiveness White Paper announced the launch of the Enterprise Fund (see Section 2). The Fund will use £180 million over 3 years to stimulate the supply of finance to early stage and high technology SMEs. Two key elements of this are important to the supply of equity finance:

* *A national venture capital scheme to support early stage high technology businesses (see Section 5).*

* *Support for at least 9 regional venture capital funds specialising in the provision of small-scale equity to SMEs.*

While Government money will be important to these schemes it is hoped that public and private partners will also contribute. The involvement of the European Investment Bank is likely to provide further leverage.

4.99 It is intended that the Regional Venture Capital Funds will provide equity sums below £500,000. In addition to assisting those businesses in which they invest, it is hoped that the scheme will demonstrate that it is indeed possible to make good returns from such investments. This could then have a far-reaching effect in encouraging venture capitalists to fund similar businesses in future.

In a similar vein, the Scottish Equity Partnership involves a partnership between Scottish Enterprise and private investors to fund start-up and early stage businesses.

Venture Capital Trusts

4.100 The 1993 Budget announced the introduction of Venture Capital Trusts (VCTs) to encourage investment in small unquoted companies. VCTs are quoted on the London Stock Exchange and attract investment by offering private investors tax-free dividends and capital gains if they commit their investment for at least 5 years. A particularly attractive feature of VCTs has been the ability to roll over CGT. Investors not only benefit from tax incentives but the nature of the Trusts enable investors to spread their risks across a portfolio of companies.

4.101 The first VCT was launched in the summer of 1995, by Murray Johnstone, and others soon followed suit. The scheme had raised £709 million by the end of September 1999, and £312 million had been invested across 341 companies[77]. While this was well below the original official target of £2.5 billion, the money has provided a substantial boost to VCT backed companies. However, those funds raised have tended to finance companies requiring development or expansion capital. Indeed, by September 1999 only 20% of investments were in early stage companies[78]. While the 1998 Budget tightened further the definition of qualifying assets, the high (£15 million) maximum capital base of the companies in which investments can be made means that investments are unlikely to be targeted at the smaller end of the market - that which is least likely to benefit from the formal venture capital market. Guaranteed loans and securities will no longer form part of the fixed proportion of qualifying investments which a VCT must hold, and VCTs will be required to hold a minimum of 10% of their total investment in any company in ordinary, non-preferential shares.

The Enterprise Investment Scheme

4.102 The Enterprise Investment Scheme (EIS) was established in 1994, to replace the Business Expansion Scheme. The EIS offers tax incentives to encourage individuals to invest in the new shares of qualifying trading companies. Such business angel style investors will benefit from income tax relief, relief from tax on disposal and, since the 1998 Budget,[79] the opportunity to defer capital gains arising from investments in qualifying companies. The latter revision is particularly useful as it enables the entrepreneur, as well as the investors, to benefit. However, those private individuals who do not wish to invest via the EIS have been disadvantaged, because their CGT rollover relief has been removed. Participation in the scheme is limited to those companies with gross assets of less than £15 million (or £16 million following the investment). As such, it is aimed at the smaller end of the venture capital market, but not really at those very small businesses who have fallen into the equity gap. The rules governing the definition of qualifying business have been tightened, for example excluding property development and other ventures where the assets of the business mean that any risks taken by investors are substantially reduced.

4.103 The limit on the amount an individual will be able to invest in new shares through the scheme stands at £150,000. Investors also gain unlimited deferral relief from capital gains tax where chargeable gains on disposals are invested in eligible shares. Although the EIS has been welcomed as a useful tool for encouraging investment in small companies, some businesses have expressed concerns that, in practice, the benefits of the EIS are diminished by the complex regulations

[77] PricewaterhouseCoopers, *Venture Capital Trusts*, Issue 11 (1999).
[78] Ibid.
[79] Inland Revenue, *Tax Incentives for Venture Capital*, Press Release 13, 17 March 1998.

surrounding it. A study by Manchester University Business School[80] suggested that investment might be further encouraged if the EIS was extended to provide the business owner's family with the same tax relief as that enjoyed by unconnected people.

Taxation

4.104 A well developed fiscal framework is vital for the development of efficient and effective equity markets. Tax policy has in the past had a considerable impact on the venture capital market. For instance, the incidence of double taxation used to be a problem in the UK as income and gains were taxed when paid to the fund and again when distributed to the shareholders. The issue was overcome in 1987 with the acknowledgement of Limited Partnerships as a tax transparent investment vehicle.

Capital Gains Tax

4.105 Both the BVCA and the Williams Report[81] view CGT as important in influencing the investment decisions of individual investors, financial institutions and the venture capital houses alike. The report, which looked at the main factors impeding investment in high technology companies in the UK, refers to links between the health of the US market and changes in CGT. A sharp increase in CGT in 1969 was followed by a sudden reduction in start-up funding but the 15% reduction in CGT between the late 1970s and 1982 was followed by a rapid increase in commitments to venture capital. There were, however, a number of other influences at the time for example the Employment Retirement and Income Security Act's introduction of the Prudent Man Rule (1979) and the Safe Harbour Regulation (1980), which allowed more risky investments and stated that venture capital funds were not fiduciaries of those pension fund assets invested in them. It is difficult to assess which of these changes had the greatest impact and, therefore, to prove the causal link between venture capital investment and CGT rates. Indeed, regression analysis on this issue by Bygrave and Timmons was unable to demonstrate a statistically significant correlation[82]. However, even if changes to CGT do not directly effect the supply of funds to the venture capital industry, it is likely to impact on the supply of entrepreneurs and hence potential deals.

4.106 Venture capital firms often arrange their investments to be as tax efficient as possible and hence in many cases the impact of changes in CGT is marginal. Furthermore, some of the institutional investors, most notably pension funds, are tax exempt. The same is not true of the smaller private investors or the entrepreneurs, for whom CGT can have a significant impact. Indeed research by Mason and Harrison[83] found that two thirds of those business angels surveyed cited CGT as impacting on their investment decision: it ranked higher than any other variable.

4.107 The 1998 and 1999 Budgets reduced the rate of CGT to 10% for higher-rate taxpayers for long term investments and increased the personal CGT threshold to £7,100. The November 1999 Pre-Budget Report statement announced that the Chancellor intended to increase the incentives to entrepreneurial investment by shortening the CGT taper for business assets from 10 to 5 years. The Government is currently consulting ahead of the 2000 Budget.

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[80] Poutziouris, Chittenden and Michaelas, Manchester Business School, *The Financial Development of Smaller Private and Public Ltd Companies (* 1999).
[81] H M Treasury, The Williams Report, *Financing of High Technology Businesses* (November 1998).
[82] op.cit, Bygrave and Timmons.
[83] Colin Mason and Richard Harrison, *Public Policy and the Development of the Informal Venture Capital Market: UK Experience and Lessons for Europe*, Editor K. Cowling, Industrial Policy in Europe (1999).

4.108 Other tax initiatives, for example the 1999 Budget lowering the small company tax rate to 20% (with a starting tax of 10%) and allowing substantial R&D credits, help to create a tax environment which does not deter entrepreneurship. However, in order to have a significant effect it is important that businesses are confident that such a regime is here to stay. Uncertainties regarding future tax rates and how they will change as Governments change, make business planning difficult and can act as a significant disincentive to establish a business.

European initiatives

4.109 In addition to those funds made available by the UK Government, there are a number of European schemes aimed at promoting equity investment in SMEs. Indeed, the importance placed on the venture capital market was shown by the inclusion of a specific Forum to discuss venture capital related issues, as part of the UK's EU Presidency in 1998.

4.110 Rudy Aeroudt[84] makes a distinction between the two key forms of financial support from European institutions to venture capital funds. The first is to contribute to the funds themselves, while the second focuses on the transaction costs of providing venture capital and helps to cover the operating costs of the funds. Current examples include: the European Technology Facility (ETF) and the I-TEC facility which covers 50% of costs of funds making early stage investment in technologically innovative SMEs (for more details see Section 5).

4.111 Such EU schemes do, between them, provide a useful range of funds available for those companies that have the time and inclination to search for them. However, some funds can prove very difficult to access, and in some cases the costs of advice required to put forward a satisfactory proposal may outweigh the benefit of the award given. There is also the danger that companies will adapt their raison d'être to fit the criteria of the fund, but will in doing so move away from their core competencies.

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[84] Rudy Aernoudt, *European Policy Towards Venture Capital: Myth or Reality?* Editors Colin Mason and Richard Harrison, Venture Capital: An International Journal of Entrepreneurial Finance, vol. 1, number 1 Jan-March 1999.

SECTION FIVE: THE FINANCING OF TECHNOLOGY-BASED SMALL FIRMS

5.1 The Bank's interest in the financing of Technology-Based Small Firms (TBSFs) stems from its core purpose of promoting the efficiency and effectiveness of the UK's financial services industry. Indeed, many commentators have expressed the concern that the TBSF sector suffers from some degree of market failure. This is particularly problematic in light of the role played by TBSFs in driving innovation and future competitiveness for the general economy. The previous Government's competitiveness initiative led to the Bank's collaboration with the Competitiveness Unit of the Cabinet Office, which was working to identify, and lift, barriers to the development of technology-based firms. Combining this work with its own research and a series of interviews carried out by its Agents, the Bank published its Report on the "Financing of Technology-Based Small Firms" in October 1996. This was followed by a conference, hosted together with the Royal Society and the CBI, and more recently by an annual forum, focusing on potential barriers to investment in TBSFs. The Bank has closely followed the subsequent debate and aims to produce a follow-up report during the course of the year 2000.

Barriers to investment in technology-based small firms

5.2 TBSFs have traditionally been perceived by many analysts to face special financing problems that are not shared by the general small business population. This has been reflected in the number of reports published and task forces established to investigate the subject over the past three years, starting with the Bank's own 1996 report. Other studies have been carried out by the CBI[85], the DTI-backed Tech Stars steering group, the House of Lords Select Committee on Science and Technology[86], the Williams Working Group[87], the DTI[88], the Enterprise Panel[89] and DGIII of the European Commission[90]. This momentum has been followed by a combination of public and private measures, for instance those introduced in recent Budgets, details of which are given below.

5.3 This section focuses on the specific nature of the financing problems faced by TBSFs and on the range of responses to them. Recent developments surrounding the provision of technology-focused risk or equity capital at the UK and European levels (for example, the supply-side measures listed in paragraphs 5.15 to 5.18) mean that to a certain extent supply constraints may diminish over the next few years. It is important, however, with the recent move towards Internet based companies, to monitor the re-allocation of risk capital funding away from other technology sectors. There is also a need to assess whether there are adequate human resources to harness the potential of the many technology deals coming to market at the current time, or whether supply constraints of a qualitative nature are present.

5.4 There is also increased recognition that barriers to the provision of finance to TBSFs reflect not only supply-side, but also demand-side problems. The lack of a strong entrepreneurial culture, the absence of management and finance skills in many science graduates, together with the stigma attached to business failure in the UK are all elements adversely affecting both the quantity and the

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[85] CBI, Tech Stars – *Breaking the Growth Barriers for Technology-Based SMEs* (February 1997).
[86] House of Lords, *The Innovation-Exploitation Barrier* (March 1997).
[87] HM Treasury, The Williams Report, *Barriers to the Financing of High Technology Businesses* (November 1998).
[88] DTI, *Competitiveness White Paper* (December 1998).
[89] Enterprise Panel, *Report on Business Incubation* (July 1996).
[90] European Commission, *Benchmarking of Finance for Innovation* (December 1998).

quality of valid business propositions reaching external finance providers. There is growing recognition of the importance of these problems and initiatives are being launched in response[91].

Intrinsic risks

5.5 The main risks associated with the provision of finance to TBSFs include the complexity of the technology, the intangibility of assets and the unpredictability of cashflow. TBSFs are by definition companies with both high and uncertain growth potential. The difficulties, and cost, of protecting intellectual property worldwide, together with frequently long product development times and volatility of returns, are further aspects of this uncertainty. The difficulty of assessing both the technology and growth potential of a TBSF is often reflected in much higher due diligence costs for these firms.

Special financing needs

5.6 TBSFs will not necessarily need more capital up-front than firms in the general small business population, but many will have specific financing needs linked to the type of product under development or their planned rapid rate of growth. An example often quoted to demonstrate the need for equity finance is that of biotechnology businesses, where product inception to market times are traditionally very long. In such cases there are few positive revenue streams for a relatively long period of time, which means that there is generally very little cash available to pay interest on a loan. A counter-example is that of the software company where the product has to be produced and brought to market in a very short time frame, with resulting rapid income generation, if it is to have any shelf-life at all. Most firms will, therefore, have a mixture of the equity and debt finance, with the emphasis on more equity at the outset and more debt as they mature.

Liquidity constraints

5.7 The Williams Report[92] expressed a concern that small technology companies have traditionally not been optimally served by existing public equity markets, mainly because of restrictive listing requirements. The London Stock Exchange itself has been dominated by large manufacturing and services companies, while the second-tier market, in the form of the USM or AIM, has not always fulfilled its potential for smaller businesses. As noted in Section 4, this has partly reflected liquidity constraints in these second-tier markets.

5.8 The Stock Exchange's launch on 4 November 1999 of techMARK, a new market designed to promote existing technology businesses, and attract new ones, can be regarded as a reaction to this issue. Some 180 companies from the technology sectors of the main market have been included in techMARK on a dual-listing basis. The market will also have a special listing procedure for other technology companies with less onerous requirements (for example, no need for a 3-year trading record). This new procedure will, however, be limited to companies of a certain minimum size (£50 million market capitalisation) which are selling a minimum volume of new or existing shares on flotation (£20 million). The new market also has to be seen in the context of the relative success of the continental Euro-NM and Neuer Markt secondary markets (see Section 4).

5.9 A further addition to the list of European markets focusing on technology firms was also announced in November 1999: NASDAQ intends to open up a pan-European market based in

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[91] For instance, Lloyds TSB have recently agreed to support two initiatives supporting student placements with technology SMEs in London and Cambridge.

[92] Op Cit, HM Treasury, *The Williams Report* (November 1998)

London. Although these developments do increase the range of options available to technology firms seeking external finance, there is also a danger of fragmentation, with thinly-spread investors causing markets to be less liquid. US experience does, however, indicate that easier and cheaper stock trading, mainly in the form of Internet trading, might counteract this fragmentation and serve to deepen the various markets.

The challenge for the banking sector

The banking sector's response

5.10 The banking sector has taken steps in recent years to improve its servicing of the technology market in the UK. For instance, the NatWest Innovation and Growth Unit currently has 243 Technology Business Managers operating in the field, assisted by the Technology Service Business Appraisal reports offered by the bank. Lending activities are targeted at companies either already in the market place or on the verge of entering it. HSBC has more recently established its own Innovation and Growth Unit and Barclays has set up 15 Technology Centres across the UK. It appears that the banks are, in a number of cases, working with business angels and other equity providers to supply TBSFs with a more flexible financing package, according to their stage of development.

The suitability of debt finance

5.11 Although the major UK banks are raising their profile in the TBSF sector, not only through their own schemes but also through their participation in the Government's various initiatives in this area (for example, UK High Technology Fund and Regional Venture Capital Funds), debt finance is rarely the most appropriate instrument for high growth, high risk SMEs. The risk:reward ratio does not work in favour of the banks for a variety of reasons. The long time horizons, intangibility of assets, etc tend to increase the perceived risks of lending to TBSFs. Because of this increased risk, the associated interest rates often make loans unattractive.

The special role of venture capital

5.12 Given the difficulties associated with debt finance, equity capital is regarded by many observers and policy-makers, both at the national and European levels, as more appropriate for the financing of technology-based small companies. These expectations are supported by the well documented US experience, particularly in relation to IT based companies. The UK venture capital industry similarly to others in Europe, has typically been viewed as being less successful in replicating the US combination of high returns from technology investments and a consistent track record of nurturing these promising young businesses to success.

5.13 However, a recent survey[93] of high technology investments by 17 UK technology funds showed an average overall return (from inception until 1998) of 23% per annum before venture capital management fees. Furthermore, the survey suggested that early stage investments returned 28.3% per annum on average, more than investments in either the expansion or MBO/MBI categories (Chart 5.1).

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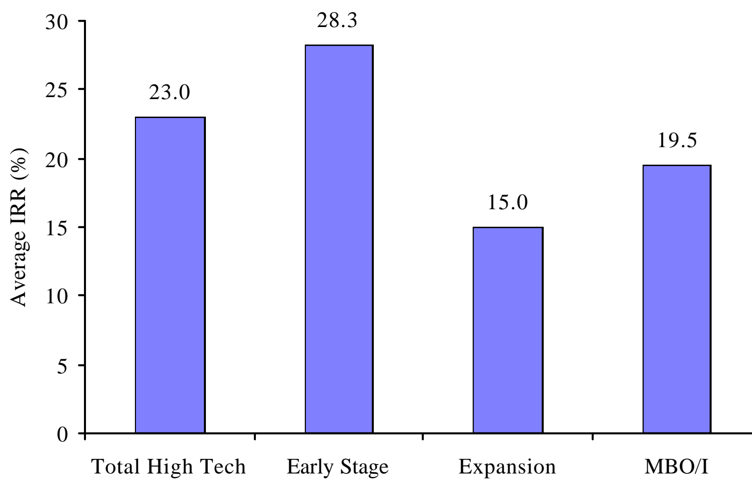
[93] The WM Company/BVCA, *UK High Technology Performance Measurement Survey* (1998).

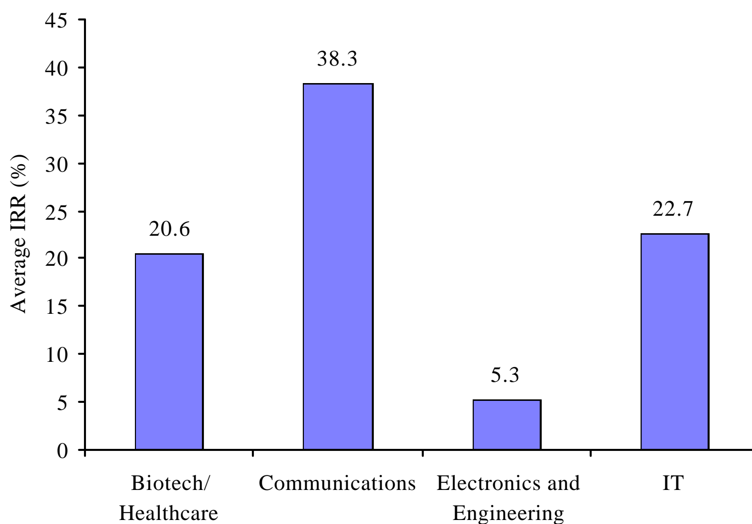
Chart 5.1
High technology investment returns by investment stage



Source: BVCA/WM Company

5.14 The absence of any specific measure of volatility, however, means that caution should be used when interpreting these promising average internal rates of return. Some idea of the range of returns that have been achieved from investments in high technology companies can be gained from the differences in performance between the individual sectors that are included in the general high technology category (Chart 5.2).

Chart 5.2
High technology investment returns by sector



Source: BVCA/WM Company

Public policy – supply-side measures

5.15 A number of initiatives have been launched over recent years, both at the national and at the European levels, which aim to improve the supply of risk capital to TBSFs. The recognised "gap" in private sector risk capital supply is both at the seed and start-up stages, hence the need for public intervention in both markets. However, the scale of public intervention is relatively greater in the seed capital area where the majority of the funds have been provided by Government. For the initiatives detailed below aimed at start-ups or other early stage firms, the model adopted is essentially that of the public sector acting as "cornerstone" investor, but with the bulk of the funds being raised from the private sector.

Seed capital

The University Challenge Fund

5.16 As part of the 1998 Budget, the Chancellor announced the creation of the University Challenge Fund. The aim of the fund is to encourage the transfer of science and technology from universities into the commercial world. The Government, together with major charities, will provide over £50 million (increased to £65 million in the 1999 Budget) for seedcorn venture capital funds, enabling the universities to develop their business proposals and start-up companies. This Fund helps to fill a market gap, by providing finance at the very early stage, where formal venture capitalists are reluctant to become involved due to the high risks. More importantly, if those projects that are funded are successful, it could at a later stage demonstrate that seedcorn investments can be profitable. The first round winners have now been selected, one of which is the £6 million White Rose Technology Seedcorn Fund, formed by a consortium of Leeds, Sheffield and York universities and managed by Murray Johnstone. The fund has attracted £4.5 million from the Challenge Fund itself and a further £1.5 million from the university consortium. A second round of University Challenge is now expected.

High technology venture capital

The UK High Technology Fund

5.17 The new UK High Technology Fund, formally launched by the Secretary of State for Trade and Industry in November 1999, is intended to be structured as a £125 million "fund of funds", investing in those venture capital funds which specialise in high technology investments. By January 2000, the Government had committed £20 million to the Fund and £25 million had already been raised from external investors. It is hoped that a further £75 million will be raised from external investors. A "fund of funds" manager has been appointed to help achieve this objective and he will have sole responsibility for investment selection. The main aim of the Fund is to demonstrate to institutional investors that good returns can be achieved from investing in specialist early stage technology funds. A number of the major banks have expressed interest in the Fund, as have the European Investment Bank and European Investment Fund.

EU-level initiatives

5.18 There are four main European initiatives supporting venture capital funds specialising in early stage technology investments:

- The European Investment Fund (EIF) launched a €75 million equity programme in 1996, designed to support investment in technologically innovative SMEs. The EIF does not invest directly in individual companies but invests instead in specialist venture capital funds.

- The European Investment Bank's European Technology Facility (ETF), launched in November 1997 with a budget of €125 million over three years, and managed by the EIF. This is one of the initiatives to arise out of the EIB's "Amsterdam Special Action Programme (ASAP)", which allows for the financing of initiatives to support technology-related and high growth SMEs. ASAP will be funded by EIB surpluses to a maximum of €1 billion over three years.

- The Commission-funded ETF Start-up facility, also managed by the EIF, which was launched in 1998 and has an indicative budget of €150-190 million over three years.

- The Commission's I-TEC scheme, launched in July 1997, which offers venture capital funds a 50% cost subsidy for qualifying investments (up to a maximum of €500,000) in exchange for a commitment on the part of the management company to invest at least 25 per cent of the fund in technology-focused, high growth SMEs.

Specialist UK venture capital operators feature prominently in the take-up of all of these facilities.

Public policy – demand-side measures

5.19 Improving the supply of equity finance to TBSFs is only one side of the equation. In order for the UK to develop a healthy TBSF sector, there also needs to be a stronger core of highly skilled entrepreneurs to provide the business credibility that will attract the finance in the first place. Government initiatives are being launched in response to concerns about the need to further encourage entrepreneurship and hence TBSFs. Initiatives include the reduction in capital gains tax and the Enterprise Management Incentives (EMI): measures announced in the November 1999 Pre Budget Report that were suggested as options in the Williams Report[87].

Enterprise centres

5.20 The Chancellor announced in the November 1998 Pre-Budget Report the Science Enterprise Challenge, which is designed to promote the development of entrepreneurial skills among university scientists and engineers. Eight centres of enterprise in universities are to be established around the country with the help of a £25 million contribution from the Government. The Enterprise Challenge winners were announced on 14 September 1999 and are in the process of implementing their plans. To add to this national network of enterprise centres, the Chancellor announced in his November 1999 Pre-Budget Report that the Massachusetts Institute of Technology (MIT) is to establish an Institute jointly with Cambridge University. The Government will contribute up to £14 million a year from the Capital Modernisation Fund for the next five years towards the costs of establishing the Institute, amounting to a total contribution of up to £68 million. It is hoped that a further £16 million will be found from private investors. The main objectives of the Institute will be to:

- Stimulate the development of technology based business out of the University's academic base.

- Develop a research programme in fields likely to have a substantial impact on the future evolution of technology.

- Undertake education and research designed to improve the UK's entrepreneurship, productivity and competitiveness.

UK Business Incubation

5.21 UK Business Incubation (UKBI) was established in 1998 to promote the concept of business incubation and to encourage the dissemination of best practice. UKBI has funding of £600,000 for three years, derived from HSBC, the Prudential, Aston University, Aston Science Park, the Securities Institute and the DTI. Continuation after the initial three years will be dependent on proven worth and the availability of funding. The UKBI Centre, based at Aston Science Park, aims to work in partnership with, and complement, existing related business support organisations and the new English Regional Development Agencies. The first National Business Incubation Conference, organised by UKBI, was held at the Royal Society on 29 November 1999. According to research carried out by UKBI in the summer of 1998 and in August 1999, there are 68 incubation units currently in operation in the UK and another 16 plan to open over the next few months. The latest research by UKBI has shown that beyond these numbers there are around half a dozen specifically focused on Internet incubation projects currently being established and more are under development. Other sources suggest that this number is much greater, possibly as high as 100[94].

SMART
SMART is a DTI scheme, that provides grants to help individuals and SMEs to review their use of technology, to access technology and research, and to develop technologically innovative products and processes. It provides assistance in the following areas: **Technology Reviews**: grants of up to £2,500 are available for SMEs to help them to meet the costs of expert reviews against best practice.
Technology Studies: grants of up to £5,000 for SMEs to help identify technological opportunities leading to innovative products and processes.
Micro Projects: grants of up to £10,000 are available to help individuals and micro-firms with the development of low-cost prototypes and processes involving technical advances and/or novel applications.
Feasibility Studies: grants of up to £45,000 are awarded to individuals and small firms undertaking feasibility studies into innovative technologies.
Development Projects: grants of up to €200,000, awarded through competitions, for SMEs.

[94] Financial Times, *The Generation Game*, p.21 (16 December 1999).

SECTION SIX: ETHNIC MINORITY FIRMS

Background

1.1 The Bank has, over recent years, devoted considerable attention to issues relating to the financing of small firms in the United Kingdom. The improvements in small business finance since the last recession have allowed the Bank, more recently, to focus on areas of specific interest in a series of reports. The most recent in this series looked at the financing of ethnic minority small businesses. The report, 'The Financing of Ethnic Minority Firms in the United Kingdom,' was published in May 1999; it sought to compare the experiences of ethnic minority small firms with those of small firms in general. Following the report we have maintained an active interest in this area, Bank personnel have delivered a number of related speeches and our contact base has been extended.

Ethnic minority businesses in the economy

6.2 The contribution of ethnic minority firms to the UK economy as a whole is considerable and represents a growing part of the small business market. In 1997 people from ethnic minority backgrounds represented 5% of the population of the United Kingdom, yet entrepreneurs from ethnic minority backgrounds were responsible for 9% of new business start-ups. It is estimated that ethnic minority businesses currently represent about 7% of the total small business stock in the UK.

6.3 According to a recent study[95] of London's ethnic minority community, in 1997, 1.8 million people living in Greater London were from ethnic minority backgrounds (and accounted for almost 45% of the country's total ethnic minority population). The study found that 19% of all businesses in London were owned by people from ethnic minority backgrounds. However, this number was unevenly distributed across London (32% of businesses in north west London were owned by ethnic minorities, compared with only 11% in south east London).

Key findings of the Bank's report

6.4 We have seen that some small firms encounter difficulties in seeking to raise external finance, particularly at the start-up stage. There is some evidence that these problems can be more acute for ethnic minority firms. Surveys carried out in the early 1990s suggested that some ethnic minorities (particularly the African-Caribbean community) regarded access to business finance as disproportionately difficult for them compared with small firms in general. On the other hand many Asian business owners, in particular, did not perceive there to be a great difference between their experiences in raising finance and those of the general small business population.

6.5 There is little documented evidence that providers of finance discriminate against ethnic minority businesses, although in some cases perceptions can be as important reality. However there are a range of other possible explanations for the survey findings. A number of commentators have suggested that some ethnic minority businesses are concentrated in sectors of the economy that are subject to historically high failure rates, for example catering, retail and transportation. Others have noted the disproportionately high representation of economically active ethnic minorities in inner-

[95] London Skills Forecasting Unit, *Strength Through Diversity – Ethnic Minorities in London's economy (*September 1999).

city areas and in rented accommodation: this in turn reduces the level of available collateral and can in some circumstances make businesses in these communities less attractive to banks.

6.6 Evidence suggests that Asian business start-ups, despite strong family networks, appear to be less dependent on informal sources of finance than other ethnic groups, perhaps reflecting a better relationship with banks. Some Asian business organisations suggest that business survival rates are higher in their communities. Although there is no evidence available to confirm this, the perceived above-average survival rates could explain the success that some Asians have in raising finance.

The role of banks

6.7 Banks are increasingly recognising the significant contribution made by ethnic minority businesses to the economy, and have taken a number of active steps to help improve business relations. Many high street banks have, for instance, issued 'internal guides on ethnicity' to increase awareness of cultural issues that might affect banking practice. Other schemes include management secondments to small businesses and training courses to raise awareness of the key aspects of ethnic businesses: Lloyds TSB, for example, have begun training managers in cross-cultural awareness.

6.8 Furthermore, all the larger clearing banks have developed strategies tailored towards the needs of ethnic minority business customers, and NatWest and Barclays have been involved in commissioning surveys on such businesses. HSBC has established a South Asian Banking Initiative, which keeps such businesses in mainstream banking. These measures have tended to be well received by most business customers.

Other sources of finance

6.9 Attention has been drawn to the low take-up of venture capital by ethnic minority businesses. It has been suggested by the Commission for Racial Equality that ethnic businesses should be made more aware of financing options available to them. Sources have also indicated that ethnic minority businesses cannot easily overcome the information and search costs associated with venture capital. This would, for example, make it harder for an ethnic business to find a business angel to provide risk capital. There is also evidence to suggest that some ethnic minority business owners, in particular those from the South Asian communities, are reluctant to seek external equity on account of perceived (or actual) loss of control.

6.10 Many ethnic minority businesses tend to rely heavily on their own community finance schemes. These might be used in addition to, or as substitutes for, bank finance. For instance 'partnering schemes', which involve members paying a pre-specified amount of money into a mutual savings fund, have traditionally been an important source of finance for African-Caribbean businesses. The Birmingham Partner Fund, established in 1994, is an example of a traditional partnering scheme that has been adapted to provide investment capital for African-Caribbean businesses and community initiatives. Formal partnerships and Stockvelds, family co-operatives of mutual savings funds that work in a similar way to partnering schemes, are becoming increasingly popular within the ethnic minority communities.

6.11 Self-help among ethnic groups has also proved to be important. This can either take the form of finance or practical support and assistance. The first 'UK Black Links Business Directory' was launched in April 1999 along with an accompanying website. The publication, a directory of African-Caribbean businesses in London, has gained wide support.

Support for ethnic minority businesses

6.12 Anecdotal evidence suggests that the take up rate of official business support among ethnic businesses is proportionately lower than among small businesses in general. Explanations include a lack of awareness of the existence of the various disparate agencies and cultural reluctance to make use of them. Some research continues to suggest that official enterprise support agencies are not sufficiently tailored towards the needs of ethnic minority businesses. Steps have been taken by some support agencies, especially Business Links, to increase ethnic groups' representation on boards and to ensure their composition reflects the ethnic mix of the local community.

6.13 The London TEC's recent study (referred to in paragraph 6.3) draws on national data sources and annual data collected by London TEC. This suggests that local support agencies have started to focus more on ethnic minority business to help tailor their services towards such businesses.

6.14 One of the stated objectives of the forthcoming Small Business Service (SBS) is to "provide a voice for small business". A recommendation of Policy Action Team 3 is that the DTI/SBS should try to gain a good understanding of enterprise in ethnic communities and across different dimensions of society. This could be achieved by commissioning research into the survival rates of businesses across different social groups. It was also recommended that a centre of expertise should be established in the SBS on enterprise in disadvantaged groups and more generally in a diverse society.

Further Research

6.15 The desirability of further research into the relationships between ethnic minority businesses and banks was a recurrent theme of the Bank's report. Much of the available data was based on a small sample of respondents and many of the surveys were conducted either before or during the last recession. Small business finance has improved in many ways since then, but there is very little comparative evidence on the extent to which the financing issues faced by ethnic minority firms have changed during this period. The BBA announced, in October 1999, the launch of an extensive study of ethnic minority businesses in the UK[96]. The study is being supported by the Bank of England, the DTI and the Commission for Racial Equality. It will focus on ethnic minority businesses over a two year period and examine the key issues that they encounter, with particular reference to the provision of finance and business support. The study should reinforce understanding of the contribution made by ethnic minority businesses and help both providers of finance and business advisors to tailor their products to help meet further the needs of the ethnic minority business community.

6.16 In addition to supporting this major long-term research initiative, the Bank will continue to pursue its own interests in this area. Involving the Bank's regional Agents in the work we will be able to further strengthen our contact base and to provide a more comprehensive view of the issues involved.

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[96] British Bankers' Association News Release, *Banks Launch Ethnic Minority Business Investigation* (21 October 1999).

SECTION SEVEN: CONCLUSIONS

7.1 The general economic environment for smaller firms during 1999 was more benign than might have been expected at the time of the Bank's sixth annual report on Finance for Small Firms (published in January 1999). Final domestic demand accelerated, following the uncertainties caused by global economic turbulence during 1998. Nonetheless, as 1999 progressed, surveys of business activity provided mixed evidence for the SME sector: some pointed to strongly rising confidence, while others were less positive. The trading environment for many SMEs, not least in the manufacturing sector, continued to be competitive and challenging. More generally, however, the Bank's regional Agents reported a positive near-term outlook for most business sectors, and GDP growth forecasts for the next two years were 2.5-3%.

7.2 Government policy, both fiscal and other, continued to focus on the needs of the SME sector, particularly technology-based and other growth-oriented businesses. There was a strong emphasis on the development of a more entrepreneurial business culture. The new Small Business Service, the likely shape of which began to emerge during the year, is an ambitious attempt to improve the delivery of Government support and advice for the small business sector, working closely alongside the new Regional Development Agencies. There was increased focus during 1999 on financial exclusion issues as they relate to self-employment and the development of micro-enterprises and small businesses in deprived areas, and this is set to continue over the next year.

7.3 Relationships between banks and the small business sector generally appeared to continue on a stable basis in 1999, building on the changed approaches of finance providers and the small business sector since 1993 – a key theme of last year's report. Further developments by the banks of alternative delivery mechanisms in the small business market (including telephone and internet banking) provided new opportunities, as well as challenges, for both banks and SME customers. While the Treasury's Banking Review, chaired by Donald Cruickshank, may shed some new light on the banking market for small firms, it will no doubt also reflect the considerable progress made since the last recession.

7.4 Bank lending to small businesses (predominantly in the form of term loans) increased during 1999, as did the credit balances and deposits placed with banks by their small business customers. The SME sector continued also to make extensive use of asset-based and receivables finance. Banks anticipated adopting a generally supportive approach to small business customers who experienced cash flow difficulties over the Millennium holiday period .

7.5 Equity finance continued to be a more problematic area, and there was considerable focus on both supply and demand issues during 1999. While there have been helpful initiatives from both public and private sectors, particularly for technology-based firms, there continue to be issues to be addressed across the whole spectrum of equity finance provision. For example, options for raising seed finance have increased, but the process is still challenging for many; the business angel market in the United Kingdom is still under-developed compared to the United States; many large investing institutions are still reluctant to allocate funds to venture capital; and, despite improved performance by smaller companies on public markets in 1999, there are still issues about liquidity, depth of markets and valuations. The Bank will continue to examine these issues carefully in 2000, particularly (but not exclusively) as they relate to the high technology sector.

7.6 The publication of the Bank's report on the financing of ethnic minority firms in May 1999 coincided with a much-enhanced level of attention by Government and others to the actual and

potential contribution to the economy of such firms. The Bank's work identified perceptions of adverse treatment by banks, particularly on the part of some African-Caribbean businesses. The Bank will continue to work with Government, the banks and the ethnic minority business community to address these issues in the years ahead.

The Bank's work in 2000

7.7 During 2000, the Bank will continue to monitor the issues covered in this report, in relation to equity as well as debt and asset-based finance.

7.8 More specifically, the Bank will carry out further work on:

- The financing of technology-based small firms, with a view to publishing a second report on this subject during 2000.
- Equity finance for the SME sector, including the needs of smaller quoted companies.
- Access to business finance in deprived communities, leading to the publication of our first report in this area.
- The financing of ethnic minority firms.

7.9 The range of issues examined by the Bank in the course of its initiative on finance for small firms, launched by the Governor in 1993, has expanded significantly over the years. New challenges lie ahead in 2000, and the Bank looks forward to continuing to work with banks and other finance providers, and the small business community, to address these.

> *"There is no doubt that the importance of the SME sector to the supply side of the economy is much more widely appreciated now than it used to be; it has moved up the policy agenda, and there are a whole host of initiatives in train to provide more encouragement to the sector, including initiatives to improve the provision of SME finance. But Rome was not built in a day. The problems facing the sector, including the problems of access to finance, are as varied and diverse as the sector itself. I have touched upon some of the current priorities in relation to SME finance, which we at the Bank, working with the Government and with private sector financial institutions, will be seeking to address over the period ahead. But it is a continuing incremental process, through which we need to look for continuous improvement across the board. To the extent that we can strengthen the supply side in this way, it will make for a more robust economy and make our monetary policy job on the demand side that much easier."*
>
> **The Governor of the Bank of England, Mr Eddie George, addressing the KPMG Profitability Seminar on 1 March 1999.**

SECTION EIGHT: 1999 DIARY OF SMALL FIRMS EVENTS

1 January	Introduction of the Euro.
15 January	Bank of England's annual seminar on Finance for Small Firms.
21 January	At the annual conference of the National Council for Voluntary Organisations (NCVO), NatWest announces the launch of a Community Bond to assist local community groups who have difficulty in accessing appropriate finance.
25 January	Donald Cruickshank launches a consultation document for the independent review of UK banking services.
9 February	Launch of the National Business Angels Network.
February	'Creating Quality Dialogue between Smaller Quoted Companies and Fund Managers' report published by the DTI.
9 March	The Budget – see Business Environment section.
25 March	Publication of BVCA/MORI survey into 'Investor Attitudes to Venture Capital Investment'. The aim of the research was to help market the venture capital industry to UK investors and the Government, and the report compared US and UK investing institutions.
1 April	Statutory national minimum wage came into force at £3.60 per hour for employees over the age of 21, and £3 per hour for those aged between 18 and 21.
9 April	Bank of England's forum on 'The Financing of High Technology Businesses'.
13 April	Cruickshank team announces that electronic commerce and money transmission issues will be added to the scope of the independent review of UK banking services.
April	KPMG launches report on 'Investment in Smaller Capitalisation Companies'.
20 April	BBA publish 'Micro Credit in the UK: An Inventory of Schemes for Business' Supported by Banks'.
25 April	Launch of UK Black Links, a business directory of black businesses in London.
20 May	Bank of England publishes 'The Financing of Ethnic Minority Firms in the United Kingdom'.
24 May	Small Business Research Trust (SBRT) publishes 'The Role of the Small Firm in the UK Economy' by Professor James Curran.

May	British Trade International (BTI) established. BTI is a Government organisation that brings together the work of the Foreign & Commonwealth Office and the DTI in support of British trade and investment overseas. (www.brittrade.com)
30 June	DTI publishes Consultation Document on the new Small Business Service (see Budget entry).
30 June	DFEE White Paper 'Learning to Succeed: A New Framework For Post-16 Learning' published – creation of a new learning and skills council that will finance and co-ordinate post-16 further education and training. As part of this, TECs and the Further Education Finance Council are to be dismantled.
6 July	Consultation Document 'Addressing the SME Equity Gap – Support for Regional Venture Capital Funds' released by DTI.
22 July	Interim report on competition and regulation in financial services markets published by the Cruickshank team.
27 July	'Micro Credit for Micro Enterprises' report published by the New Economics Foundation.
5 August	**'**SME Statistics for the UK – 1998' published by DTI.
9 September	Barclays announces plans to set aside £100m to support the development of regional investment funds in England and Wales. The aim is that this money should be matched equally by £100m of public money. The initiative is partly in response to the DTI Consultation Document of 6 July.
16 September	London Stock Exchange announces plans to launch a new technology market in November, techMARK. It also publishes a consultative document outlining proposed changes to the listing rules and anticipates that these will become effective in early 2000.
20 September	Patricia Hewitt, the Minister of State for Small Firms and E-Commerce at the DTI, announces that more than £3m will be made available to develop a mentoring scheme for people looking to start up their own business or running a new business, especially in deprived areas.
28 September	'The Financial Development of Smaller Private & Public Limited Companies (SMEs)' report published by the Manchester Business School and sponsored by Tilney Fund Management.
September	The Insolvency Service published "A Review of Company Rescue and Business Reconstruction Mechanisms" (see Business Environment Section).
21 October	BBA announces research programme on ethnic minority businesses in the UK. The study will commence in January 2000 and is to be carried out in conjunction with the DTI and the Bank of England, and in association with the Commission for Racial Equality.

28 October	DTI announces the boundaries for the 45 Small Business Service local areas.
29 October	DTI produce a summary of the responses to their Consultation Document, 'Addressing the SME Equity Gap'.
October	'The Statutory Audit Requirement for Smaller Companies' DTI Consultation Document published. The DTI has proposed that the audit threshold should be increased from a turnover of £350,000 to a higher level, possibly up to the maximum of £4.2m permitted by EU law.
1 November	Princes Trust granted Royal Charter, recognising the Trust's work helping young people to develop skills and self confidence, and set up their own businesses.
1 November	Publication of 'National Strategy for International Trade Development and Promotions' by British Trade International. The report gives a special emphasis on helping smaller companies develop their exporting skills.
2 November	Publication of the Waterstone report 'Private Investors Improving Share Liquidity for Smaller Quoted Companies'.
2 November	Publication of Policy Action Team 3 report 'Enterprise and Social Exclusion'.
4 November	TechMARK (announced 16 September) goes live.
9 November	Launch of Small Firms Equal Opportunities leaflet by Commission for Racial Equality. An easy to read leaflet providing details of the key equal opportunity issues which might impact on a small businesses.
9 November	Pre-Budget Report published (see Business Environment Section).
16 November	Publication of Policy Action Team 14 examining access to financial services in deprived communities.
29 November	1st National Incubation Conference (organised by UK Business Incubation).
November	Inaugural AGM of the All Party Parliamentary Small Firms Group: an all party body aimed to address specifically small business issues.
9 December	Final event in the Treasury's Lloyds TSB sponsored "Start Small, Think Big" Enterprise tour, aimed at alerting students of the values of business enterprise. The Chancellor used the event to launch the National Enterprise Campaign, co-ordinated by the British Chambers of Commerce and aimed at creating a cadre of business "heroes".
19 December	It was announced that David Irwin, Director Project NorthEast, would be the first Chief Executive of the Small Business Service.

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