

# Small Business Finance Markets 2020/21





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# Foreword

The British Business Bank's mission is to make finance markets work better so smaller businesses across the UK can prosper and grow.





Our unique position at the intersection of government and financial markets enables us to identify and reduce imbalances in access to finance; create a more diverse market; and increase the supply of finance for the entrepreneurs and business owners at the very heart of the British economy.

Now in its seventh year, our Small Business Finance Markets report gives an independent and comprehensive assessment of the market. It continues to be a vital resource for both our own policy making and in our role as a centre of expertise to government. This year's report provides not only a look back at the impact of the Coronavirus pandemic on smaller businesses and the finance market, but also a forward look at the role finance will play in supporting economic recovery and future growth.

Covid-19 has had a devastating effect on the UK economy, particularly on the all-important small business sector that accounts for 61% of private sector employment. It has also had a profound influence on the operation of the finance markets serving small businesses. We have seen record values of lending, primarily working capital provided through the government's emergency schemes. However, there has been an overall fall in demand for repayable external finance, in part because of extra support provided by non-debt government schemes such as furlough and grants.

The pandemic has not affected businesses in a uniform manner. Many businesses in the worst affected sectors find themselves with substantial debts - perhaps for the first time - and enabling them to manage those debts will continue to be a key priority. On the other hand, record cash balances indicate that there are also a sizeable number of smaller businesses well positioned to take advantage of opportunities as the economy begins to recover.



Although our Business Finance Survey showed in late 2020 a third (33%) of businesses expected to shrink over the next year, over a fifth (21%) of businesses still expected to grow in the next 12 months. Small and medium-sized businesses showed most positivity, with 35% and 38% respectively expecting to achieve annual growth.

There are also positive indicators that, unlike in the period following the credit crunch in 2008-9, there will be sufficient supply of finance to meet the expected demand. Banks look to have sufficient capital available, and therefore could be well placed to provide the growth finance that will play a key role in the recovery. Many non-bank lenders and their investors show signs that they are ready to resume a greater level of activity in 2021, having been less active in 2020 due to the dominance of the government's emergency schemes. Record fundraising in 2020 suggests venture capital funds also have sufficient capital to invest in high-growth companies in 2021 and beyond.

This has been an especially challenging period for smaller businesses with external finance playing a vital role in business survival in the face of the Covid-19 pandemic. The British Business Bank has played an important role during the crisis and we will continue to support smaller businesses as they steer a path towards a sustainable recovery. In doing so, we will also be tackling the government's longer-term priorities of growing the UK as a science superpower, levelling up the regions of the UK and moving to a net zero economy.

Our Start Up Loans programme has seen a record £126m of funding drawn down in 2020, the highest level since the programme's inception in 2012 and is able to support more entrepreneurs in 2021.

We also have a wide range of interventions aimed at supporting venture and growth capital. This type of finance is vitally important to high-growth firms which have the potential to provide jobs and economic growth. Our British Patient Capital programme has the capacity to deploy an additional £1.5bn available to support investment in these types of businesses.

At this crucial time for the economy, it has never been more important to have a deep understanding and knowledge of the finance markets which support UK businesses. I hope this report will provide anyone with an interest in supporting smaller businesses with useful and valuable insight into what is required for their future success.

**Catherine Lewis La Torre**  
**CEO, British Business Bank**



# Executive summary

Small business finance markets have always had a key role to play in supporting small businesses, whether that be helping start and grow new businesses or supporting the activities of established SMEs.



While business finance has been a key pillar in supporting businesses through 2020 it will be even more important as the UK economy seeks to recover after the Covid-19 pandemic and refocuses on challenges such as transitioning to a net zero economy, levelling up in the UK and adapting to life outside of the EU.

This report combines a look at the extraordinary impact Covid-19 has had on smaller businesses and the finance providers that support them, prospects for 2021 and the role finance needs to play to help achieve key government objectives. Five key findings stand out.

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### **The economy experienced a record contraction as a result of the Covid-19 pandemic and resulting public health measures**

The UK suffered a record 18.8% quarter-on-quarter fall in GDP in Q2 2020 and while the economy showed signs of recovery in second half of the year official forecasts suggest it will not return to pre-pandemic levels until 2022. In response, the UK government unveiled the most significant package of peacetime interventions to support smaller businesses. Without these interventions, the impacts of Covid-19 on the economy would have been much greater.

Smaller businesses have been particularly impacted by the pandemic. Many reported significant falls in revenue with several industry sectors experiencing notably worse outcomes on measures such as redundancies, trading status, and turnover. Across all sectors, the smallest businesses were the most likely to report negative impact from the pandemic and the least likely to have resources to help them through.

The 22.1% quarter-on-quarter fall in business investment in Q2 2020 was the largest quarterly fall on record and a result of many companies switching from investment to survival mode, utilising available funds for cashflow.

As the year drew to an end, the SME confidence was low, with the FSB Small Business Index (SBI) confidence measure stood at -49.3, the second lowest reading in SBI history, second only to that recorded in Q1 2020. However, since then the UK has concluded a trade agreement with the EU and rolled out a Covid-19 vaccine programme reducing uncertainty for many businesses.



## **SME lending values have reached record levels but use of other traditional forms of finance is down**

Working capital, to cover short-term funding gaps or to help during difficult trading conditions, was the dominant driver of funding needs in 2020, with many smaller businesses facing heightened cashflow issues. Of those identifying a need for funding, 78% said cashflow support was the reason for requiring funding in 2020, up from 49% in 2019.

Following the introduction of the government guaranteed loan schemes, our Business Finance Survey reported usage of loans increased to 25% of SMEs, up from around 10% in previous years. This is in line with official BBLs and CBILS data which showed around 1.5m facilities approved by the end of 2020. In large part driven by government loan schemes, Bank of England data shows SME lending surged to a record level in 2020. Gross bank lending (excluding overdrafts) to SMEs was £103.7bn, 82% higher than in 2019.

Equity Investment values also reached record levels in 2020, up 9% on 2019. Furthermore, the number of deals was up 5%. While the headline figures appear to show UK equity finance had a strong year in 2020 with higher deal and investment figures, equity finance has been affected by the pandemic. The Future Fund has contributed to the continued functioning of UK equity finance markets, as of 21st January 2021, 1,140 convertible loans have been approved to the value of £1.1bn.

Despite the challenges faced in 2020 and the record values of lending and equity investment, overall, the demand for traditional forms of external finance by small businesses declined to 37% in 2020 from its peak of 45% in 2019. This likely reflects the significant use of non-debt government support schemes alongside, or instead of, the guaranteed loan schemes.

## **SMEs' balance sheets have diverged, both cash balances and debt have risen**

The disproportionate impact on SMEs by size and sector has left a varying imprint on balance sheets. A continued reduction in operating expenses combined with significant government financial support has led to a 20% rise in deposit holdings since the start of the year to a record £252 billion according to UK Finance data.

Despite this, while smaller businesses in aggregate do not appear overindebted, many individual businesses and some specific sectors have been significantly impacted and may be facing financial difficulties in 2021. In addition, the longer the pandemic and restrictions continue into 2021, the more debt repayments will likely become an issue for smaller businesses, potentially increasing the need for SMEs to refinance and take on additional debt where possible.





However, the government loan schemes include provisions to support businesses to repay, such as extending the loan term to ten years. In February the Chancellor also announced further support by allowing businesses to pause BBLs repayments for six months before their first repayment is due. This will offset some of the negative impacts of current and new debt on affordability.

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### **Finance providers remain well placed to support demand for finance in 2021**

There will be significant demand for finance from viable SMEs in 2021. Importantly, banks have sufficient capital to support further lending. While there are serious concerns around SME indebtedness and ability to service the debt they already have, the December 2020 Bank of England Financial Stability Report suggested banks could absorb losses far exceeding even the most pessimistic of forecasts.

Furthermore, many non-bank lenders, including longstanding providers of non-term loan finance, and their investors have had to bide their time. Market contacts suggest they are likely to return to the market as demand for their products returns to more normal levels and government guarantee schemes become less dominant in the market.

The exception to this may be those finance providers, and in particular non-bank lenders, who for various reasons have struggled during 2020. Some have had funding issues of their own while others have seen their usual markets serviced almost exclusively by government guaranteed lending.

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### **Greater use of growth orientated finance will be needed to help the UK achieve its stated aim of building back better**

Increasing business investment is essential for seizing opportunities and delivering government priorities such as enhancing the UK as a scientific superpower, levelling up the UK and accelerating the transition to a net zero economy.

External finance can empower businesses to invest in changes that will reduce their environmental impact. It can also fuel the innovating researchers and smaller businesses that develop new technologies, including green solutions, for others to adopt.

We have seen this throughout 2020 with examples across the Bank's portfolio including sustainable energy providers, medical diagnostics companies and digital connectivity providers all using external finance from the Bank and others in ways that will help their businesses as well as contributing to wider challenges. These examples are only the tip of the iceberg, but they demonstrate how important external finance will be in our recovery.

The British Business Bank's strategy has evolved to both reflect, and to shape, the market developments we have witnessed since our founding. 2020 has further increased our capabilities and alongside our existing programmes the newly announced Recovery Loan Scheme and Future Fund: Breakthrough will enable us to continue to support UK smaller businesses.



# Introduction

This is the seventh annual British Business Bank Small Business Finance Markets report, setting out the latest evidence on the ways in which finance markets support smaller business and help them contribute to improving productivity and growth in the UK economy.



Our understanding of smaller business finance markets, both in terms of the latest available data on SMEs and their financing needs, and the intelligence we obtain as an active participant in the finance markets, is central to delivering on our objective to be the centre of expertise on these markets for government. It is also used to shape our business plan and in the design of our programmes and products.

### **New evidence and analysis**

The British Business Bank has continued to develop evidence and analysis to deepen our understanding of smaller business finance markets. In particular:

- We have upgraded our annual small business finance survey to give greater insight into the impact of Covid-19 on UK SMEs
- We have continued to evolve Part B of the report to give more insight into individual smaller business finance markets
- We draw on our own Management Information (MI), the contacts of our UK Network and experience as a market participant to gain insights into use of Bank-supported programmes. This has been enhanced by our role delivering government guaranteed schemes launched in response to the Covid-19 pandemic

This report also references a wide range of evidence drawn from government, market and academic research. We are keen to further increase the range of researchers we work with.

### **Structure of the report**

As usual the report is split into two sections to allow both consideration of broader trends and issues in SME finance markets, and to explore specific segments of the market in detail.

Part A provides a thematic overview looking in turn at how SMEs and SME finance markets have been impacted by the Covid-19 pandemic and the associated public health measures, the outlook for demand and supply in 2021 and the important role finance will need to play in achieving the governments stated aim of building back better. Finally it discusses the importance of and challenges faced by alternative finance providers in 2020.

Part B examines in more detail developments in the macroeconomy and small business population. It then considers in more depth the market for different types of debt and equity finance most widely used by smaller businesses, identifying the drivers of the latest trends in the market.



# Aggregate flow and stock of finance to smaller businesses

- Gross bank lending surged to a record high in 2020
- Equity finance values and volumes increased while alternative finance lending decreased
- Small business use of traditional forms of external finance fell despite the challenges they faced in 2020



This section brings together the latest data from a range of sources on the volume and value of various types of external finance provided to smaller businesses. Consistent and comprehensive data outlining the value of the aggregate stocks and flows of all forms of external finance is not readily available. However, the summary table below provides a reasonable snapshot.

While flows of different types of finance are not directly comparable, the data shows that bank lending remains the single largest form of external finance for smaller businesses.

### Estimates of the flow and stock of external finance for UK SMEs (£ billions) (a)

		2015	2016	2017	2018	2019	2020
<b>Bank lending stock</b>	Outstanding Amount (b)	164	166	165	166	168	<b>213</b>
Source: Bank of England							
<b>Bank lending flows</b>	Net flows (c)	2.2	3.3	0.7	0.6	2.1	<b>46.6</b>
Source: Bank of England							
	Gross flows (d)	57.9	59.2	57.3	57.8	56.9	<b>103.8</b>
Other gross flows of SME Finance							
<b>Private external equity investments</b>		4.1	3.9	6.8	7.1	8.1	<b>8.8</b>
Source: Beauhurst (e)							
	Number of reported deals	1592	1588	1825	1846	1941	<b>2044</b>
<b>Asset finance flows</b>		16.3	17.0	19.0	19.4	20.1	<b>15.9</b>
Source: FLA (f)							

- (a) The information contained in this table should be viewed as indicative as data and definitions are not directly comparable across different sources. There can be some double counting across estimates in different parts of the table. Flows data are cumulative totals for the year or to the date stated. Non-seasonally adjusted. All numbers are in billions, except number of reported equity deals, and have been rounded appropriately.
- (b) Movements in amounts outstanding can reflect breaks in data series as well as underlying flows.
- (c) Net flows does not always reconcile with change in stock due to differences in statistical reporting. The reported stock can include other adjustments made by banks but not detailed when reported, whereas flows data does not include these adjustments.
- (d) Data exclude overdrafts and covers loans in both sterling and foreign currency, expressed in sterling. The total may not equal the sum of its components due to rounding.
- (e) Beauhurst is a market data provider that records visible equity deals including crowdfunding deals.
- (f) The Finance and Leasing Association (FLA) whose members make up 90-95% of the market.



## Gross bank lending surged to a record high in 2020

Gross bank lending (excluding overdrafts) to smaller businesses surged in 2020 to a record high. The series peaked in May at a record £25bn. Repayments rose only slightly meaning net lending also recorded record values.

The value of deposits held by SMEs rose to a record high 2020 and are up 20% on 2019. At the same time there has been a continued reduction in the usage of overdrafts and other traditional forms of short-term funding.

## Equity finance values and volumes increased while alternative finance lending decreased

A record £8.8bn of equity was invested in UK SMEs in 2020, up 9% on 2019. There was also a 5% increase in the number of deals completed. This is the third year in a row equity investment was above £7bn.

Data from the Finance and Leasing Association suggests that new asset finance volumes to smaller businesses was around £15.9bn by the end of 2020, a decrease of 21% on 2019. This is the lowest annual total since 2014. UK Finance estimates suggest total invoice and asset-based lending outstanding advances to smaller businesses also fell, averaging £6.1bn in 2020, down from £9.1bn in 2019.

Gross flows of lending to businesses via marketplace lending were not available at the time of publishing this report. However, with many of the larger lenders concentrating on lending via government Covid response schemes rather than marketplace lending it is likely volumes fell significantly. Part B provides a detailed discussion of the trends in volumes for different types of finance.

## Small business use of traditional forms of external finance fell despite the challenges they faced in 2020

Demand for traditional forms of external finance by UK smaller businesses declined in 2020. Just over a third (37%) of smaller businesses reported using external finance in 2020, down from 45% in 2019. The use of finance increased in the second half of the year after a record low in H1. This increase was seen most prominently in the smallest businesses.

Credit conditions remain broadly favourable despite some signs of tightening, particularly in sectors that had been most affected by the pandemic and where insolvencies were expected to rise. Despite this, the FSB's Voice of Small Business survey for Q3 2020 reported that the credit availability index moved into positive territory for the first time since it was introduced in 2012. Furthermore, credit affordability picked up by 1.6 points, reaching an all-time high of 6.6. This is supported by BoE data which indicates that credit is still affordable by historical standards.

## Part A

# The impact of Covid-19 on small business finance markets and the implications for 2021

2020 has been an extraordinary year for the UK's smaller businesses and the finance providers that support them. Part A looks to put into context how the Covid-19 pandemic, the public health measures and the resulting government loan guarantee schemes shaped the finance landscape in 2020 and sets out the implications for the demand and supply of finance in 2021.

The section concludes by analysing the role external finance can play in building back better from the Covid-19 pandemic through contributing to government priorities including enhancing the UK as a scientific superpower, levelling up the UK and accelerating our transition to a net zero economy.





1.1

# Demand and supply of SME finance during the pandemic

- The Covid-19 crisis saw the UK economy in lockdown creating cashflow pressures with some sectors impacted much more than others
- The government introduced an unprecedented financial support package including guaranteed lending schemes supporting the supply of debt
- Lending values hit record levels with government-backed debt used predominately to maintain liquidity and manage cash flow
- A significant proportion of finance facilities remained unspent at the end of 2020
- Non-debt government schemes have been used extensively
- There has been strong take-up of the Future Fund by innovative high-growth potential companies





The UK and much of the world spent 2020 battling the Covid-19 pandemic. Every aspect of normal life was dramatically impacted including for small businesses. In the UK there were three national lockdowns which placed significant restrictions on UK smaller businesses' ability to operate and trade as normal.

**The Covid-19 crisis saw the UK economy in lockdown creating cashflow pressures with some sectors impacted much more than others**

The UK suffered a record 20% quarter-on-quarter fall in GDP in Q2 2020 with the first lockdown in full force. The scale of the economic impact was apparent in take-up of the Coronavirus Job Retention Scheme which resulted in 30% of the workforce being put on furlough by May while around 40% worked from home.<sup>1</sup>

As a result of the pandemic and associated public health measures, many SMEs saw significant falls in revenue with June fieldwork for the ONS Business Impact of Covid-19 Survey (BICS) finding that around 45% of SMEs had seen turnover fall by at least 20% compared to prior years.<sup>2</sup> The Q2 SME Finance Monitor painted an even bleaker picture with 87% of SMEs reporting being impacted by Covid-19 and two thirds (67%) saying their sales were already down by 50% or more. Smaller SMEs were the most likely to report having been impacted by the pandemic and the least likely to have resources to help them through.

Fig A.1  
**2020Q3 share of SMEs reporting a 12 month decline in turnover, by sector**

Source: BVA BDRC SME Finance Monitor Q3 2020





Several sectors experienced notably worse outcomes on measures such as redundancies, trading status, and turnover. Regarding the latter, SME turnover decline rates increased sharply in 2020 relative to prior years. The SME Finance Monitor (Q3 2020) found that the Hospitality (59%), Transport (58%), and Health (51%) sectors were amongst the worst hit with the Other Community (49%) and Wholesale/Retail (48%) sectors just behind (figure A.1).

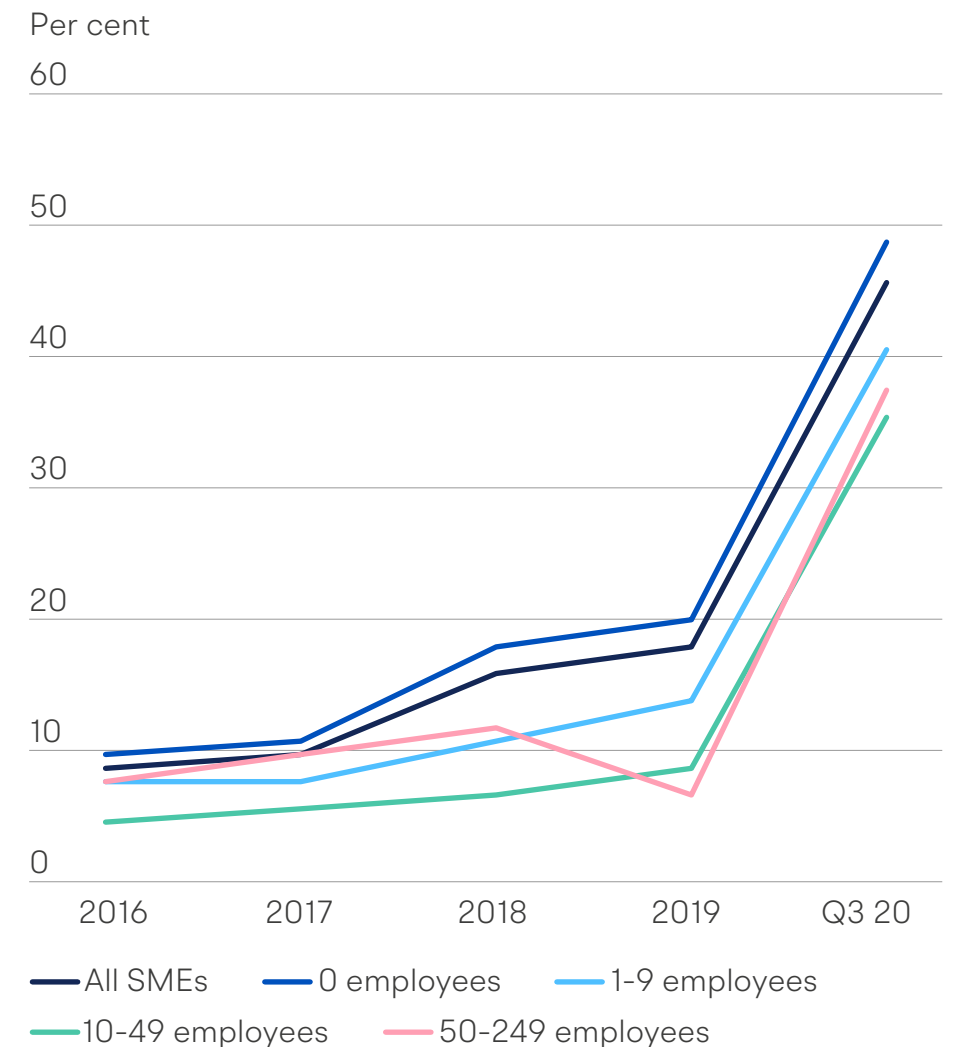
Analysis from Xero showed the hospitality sector (54% revenue fall in May) and the arts and recreation industries (41%) recorded the largest falls in their dataset. Other measures of Covid-19 impact also pointed to sectoral differences. For example, the SME Finance Monitor found redundancies at SMEs with 10-249 employees were most often reported by Hospitality (30%) and Wholesale/Retail (21%) sectors.

Turnover decline rates in Q3 for business of all sizes were over three times their respective prior five-year averages – illustrating the scale of disruption across all businesses. Breaking down the data we find that the smallest SMEs have experienced the most widespread declines in turnover (figure A.2). Around 49% of zero employee firms reported a fall in turnover over the previous 12 months compared to 38% of businesses with 50-249 employees.

As a result of the unfolding crisis, while many SMEs were able to use a combination of non-debt government support schemes and their own internal funds to carry on, Bank of England analysis over the summer suggested smaller businesses faced an aggregate cash-flow deficit of around £40-£70bn.<sup>3</sup> This estimate took into consideration the impact of the substantial package of fiscal measures put in place by the government, but not the government-backed lending schemes.

Fig A.2  
**Annual trends in share of SMEs reporting a 12 month decline in turnover, by size**

Source: BVA BDRC SME Finance Monitor Q3 2020





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## The government introduced an unprecedented financial support package including guaranteed lending schemes supporting the supply of debt

Given the rapidly worsening economic environment the government took the decision to quickly roll out several loan guarantee schemes, delivered by the Bank, to help businesses impacted by Covid-19. The loan guarantee schemes were part of a wider package of business support, also including the Bank's Future Fund scheme. This scheme was designed to support innovative UK companies with good potential that typically rely on equity investment and is covered in detail in later in this chapter.

For companies better suited to debt products, the three loan guarantee schemes utilised the UK financial system, including its banks and alternative finance providers, to originate and manage the loans rapidly and on a large scale.

The Coronavirus Business Interruption Loan Scheme (CBILS) was launched in March followed by the Bounce Back Loan Scheme (BBLs) in May 2020.<sup>4</sup> These schemes offered finance providers a government guarantee as, given the worsening economic conditions and uncertainty, it was unlikely that smaller business finance markets would have been able to support the huge demand for finance from smaller businesses without a guarantee to support lending.

### Box 1 - Government Coronavirus debt guarantee schemes

The UK government announced the first of three debt guarantee schemes on the 23<sup>rd</sup> March 2020 with the Coronavirus Business Interruption Loan Scheme. Two subsequent products were launched in April and May aimed at supporting different segments of the lending market following feedback from businesses regarding the scheme's suitability. The principle objective of each scheme was to ensure finance was accessible to those businesses that needed it throughout the pandemic.

Favourable terms were included to allow businesses to use finance to help them meet cashflow needs and maintain liquidity during the downturn. Businesses were, however, limited to use only one scheme. To make the choice easier for businesses, each product was designed with distinct eligibility criteria and facility parameters to attract different types of businesses based on their needs. These eligibility and scheme features are summarised in figure 1.1.



Figure 1.1

**CBILS, CLBILS, BBLS eligibility and key scheme features**

	<b>Coronavirus Business Interruption Loan scheme</b>	<b>Coronavirus Large Business Interruption Loan scheme</b>	<b>Bounce Back Loan scheme</b>
<b>Launch date</b>	23 <sup>rd</sup> March	20 <sup>th</sup> April	4 <sup>th</sup> May
<b>Eligibility</b>			
<b>Turnover</b>	Maximum £45m	Minimum £45m	No minimum or maximum
<b>Performance</b>	Business must have borrowing proposal which, were it not for the current pandemic, would be considered viable	Viable business were it not for the pandemic; loan will enable them to trade out of short-term to medium-term difficulties	Adversely impacted by Coronavirus and not a business in difficulty on 31 <sup>st</sup> Dec 2019
<b>Government guarantee</b>	80%	80%	100%
<b>Underwriting</b>	Subject to lenders' lending criteria	Subject to lenders' lending criteria	Businesses self-certify their need for the finance to support them during the pandemic
<b>Facility</b>			
<b>Size</b>	£50,001 - £5m	Up to £200m	£2,000 - £50,000 subject to a cap of 25% of turnover
<b>Type</b>	Term loans, overdrafts, invoice finance, and asset finance	Term loans, overdrafts, invoice finance, and asset finance	Term loan
<b>Interest rate</b>	Lender determined with government paying first year interest and fees	Lender determined	2.5% per annum with government paying first year interest
<b>Repayment period</b>	Up to six years	Up to three years	Six years with option to extend to ten years and repayment holidays available



The totality of lending involved through these schemes explain the record levels seen in 2020. As of 21<sup>st</sup> February the schemes have approved c.1.6m loans to businesses worth c.£73bn. BBLs makes up the vast majority of these loans, as measured by approval numbers, contributing to just under 95% of all loans underwritten by the schemes. As measured by loan value, just over 60% has been provided through the BBLs scheme, with CBILs and CLBILs making up c.30% and c.7% respectively (figure 1.2).

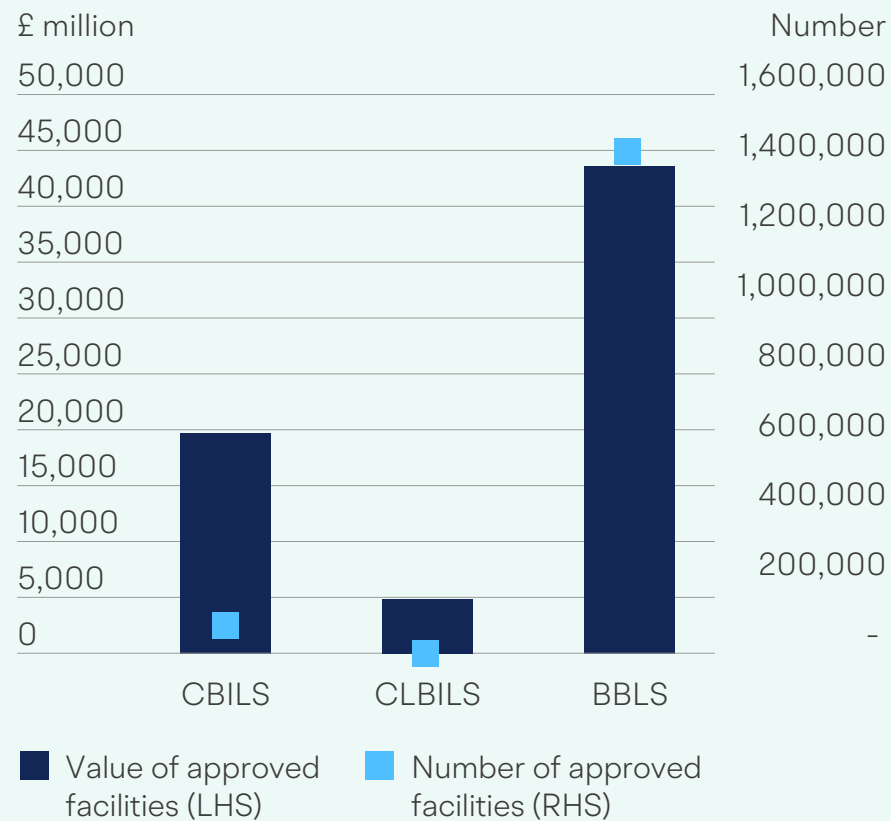
Borrowers can borrow much more easily and quickly through the BBLs scheme thanks to the simplicity of its self-certification application process, enabled by the 100% government guarantee. Whilst CBILs is focused on SMEs that have larger financial needs (average loan of c.£240k) than BBLs (average loan of c.£30k), CLBILs is catered for the mid-cap market and those businesses that need finance but can take the time to structure more complicated deals (average loan of c.£7.5m). This complexity, alongside dividend restrictions, loan seniority conditions and availability of other commercial loans, resulted in limited demand for finance through the scheme with just over 700 loans approved. The Bank is currently

commissioning an in-depth evaluation of each of these schemes to assess their effectiveness. Initial results are expected towards the end of the year.

Fig 1.2

**Number and value of facilities approved as of 21<sup>st</sup> February 2021**

Source: HM Treasury



In contrast to the previous recession where SME finance markets, and in particular the banking sector, were part of the problem, this time they have been part of the solution. This for the most part reflects that unlike during the financial crisis, this was not a banking or liquidity crisis and as such a lot of banks have retained the ability to lend (figure A.3). As a result, there was a significant supply of debt finance available to smaller businesses once the schemes went live.

It should be noted however, this was not the case for some alternative finance providers, not at the beginning of the schemes at least. A range of issues around the way the government guarantee worked meant many non-bank lenders were unable to access wholesale funding markets or institutional investors for the purposes of CBILs or BBLs lending. In addition, pricing limits meant the BBLs in particular was not economically viable for many non-bank lenders (see chapter 1.4 for a more detailed discussion).



As a result, their participation in these schemes was mostly limited in the early weeks, even for those already accredited for the schemes. However, over the summer several non-bank lenders arrived at solutions that allowed them to lend via the schemes and have since made a significant difference to both the volumes lent and to the profile of the smaller businesses able to access the finance.

**Lending values hit record levels with government-backed debt used predominately to maintain liquidity and manage cash flow**

Government intervention in the lending markets and the huge demand for working capital from struggling smaller businesses has resulted in 2020 being a record year for SME borrowing, albeit mostly via government guaranteed term lending (see Part B for the individual market breakdowns). Total gross SME term lending in 2020 was estimated at £104bn, driven by £57bn of BBLs and CBILs lending. This compares to an average £58bn of gross term lending over the prior 5 years. Net term lending reached £46.8bn in 2020, up from £1.9bn the previous year.

Businesses across the country have had to deal with national and regional tiered restrictions leading to extensive use of the schemes across the UK. Figure A.4 looks at the spread in SME demand for government-backed loans from a regional perspective using the number of SMEs in each region with either a BBLs or CBILs facility as a percentage of the estimated SME population in that region. This measure is a useful indicator for how accessible the schemes have been for SMEs across the UK as it controls for regions with different business populations. This measure shows that demand for finance through the schemes has been evenly spread.

Though usage is broadly even there are some minor differences. For example, the North West and North East are at the higher end of regional uptake with 28% of their respective SME population. The South West saw the smallest share of its SMEs access the scheme, albeit with a small difference to the overall average, with 21%.

The slightly higher uptake in the northern regions could reflect greater business impact in those regions, especially given tiered restrictions, or the sectoral composition of regional economies - although these cannot be concluded with any certainty until studies and evaluations assessing these questions are produced.

Fig A.3

**Aggregate CET1 capital ratio of major UK banks**

Source: PRA regulatory returns, published accounts, Bank analysis and calculations.

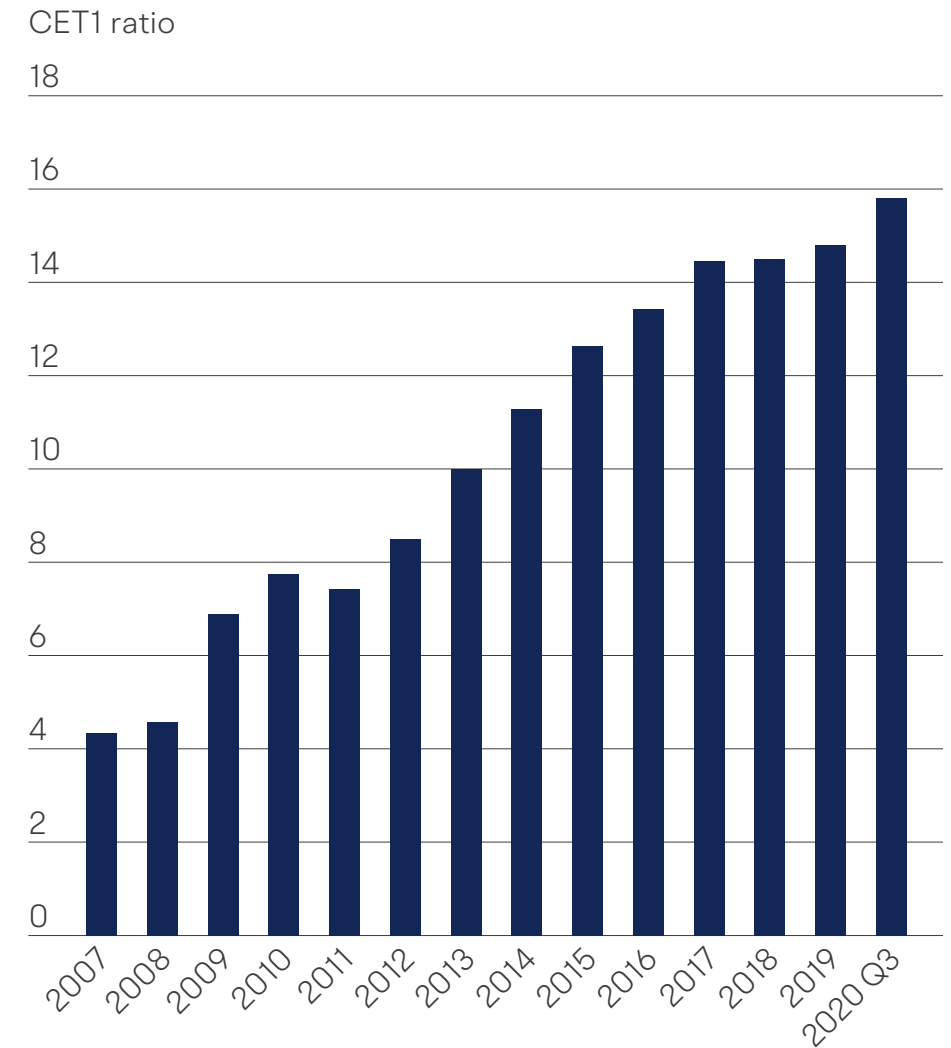




Fig A.4

**Share of SMEs in each region with an approved BLS or CBLS facility**

Source: BBB scheme portal data as at December, 2020; BEIS Business Population statistics 2020

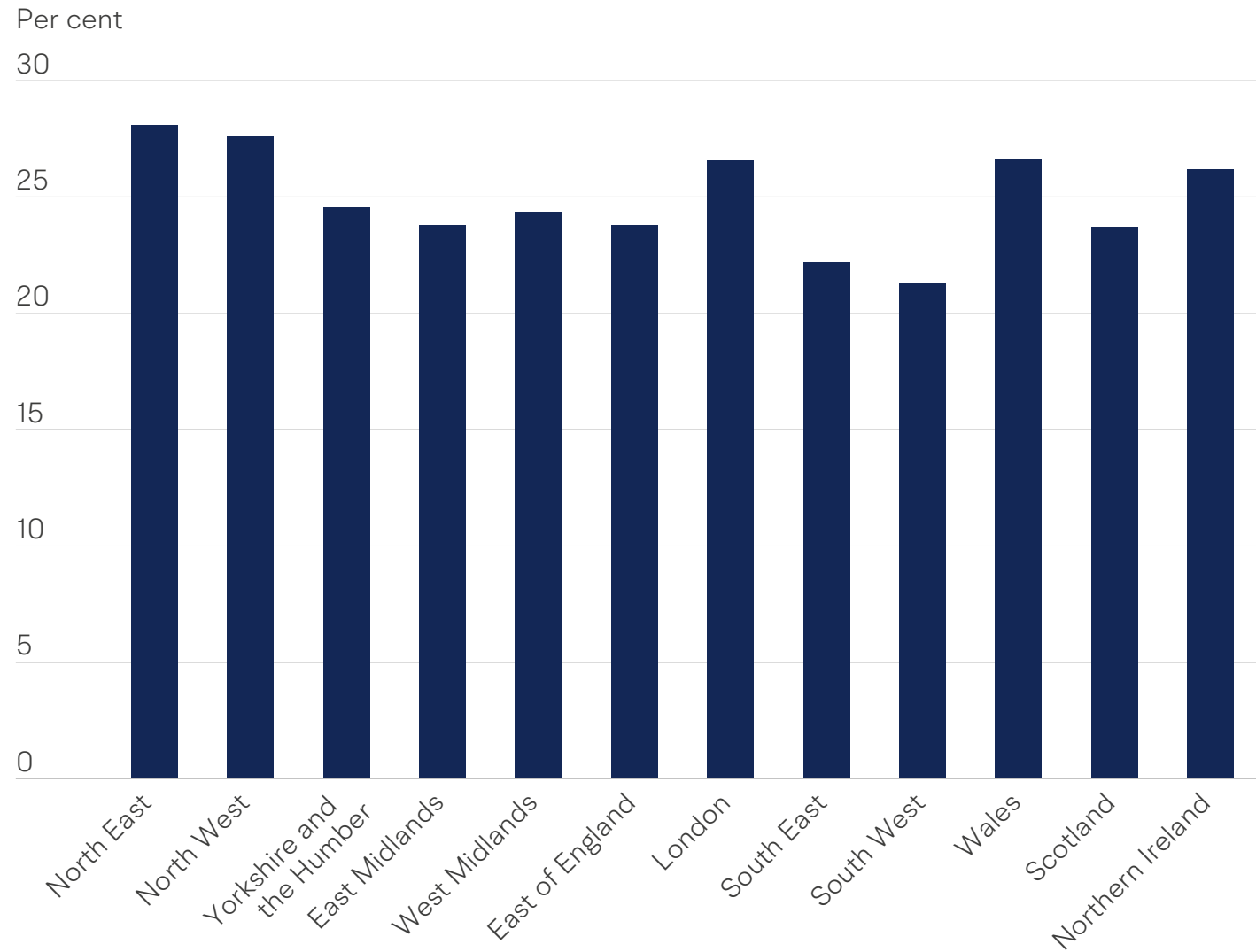
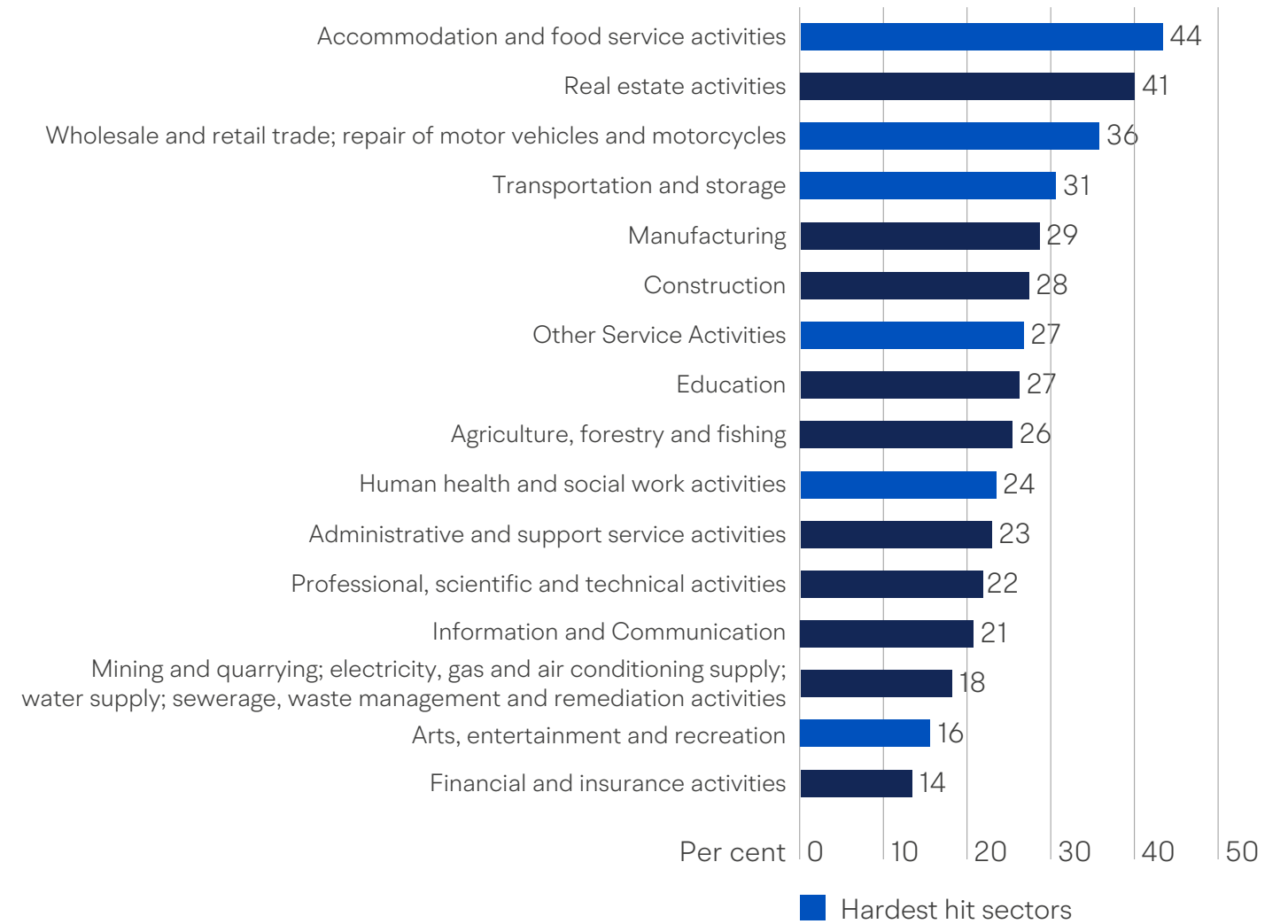


Fig A.5

**Estimated SME scheme uptake as a proportion of sectoral population**

Source: BBB scheme portal data as at December, 2020; BVA BDRG SME FM Q3; ONS BICS; BEIS Business Population statistics 2020





Demand for government-backed finance varied more across sectors than it did for regions. The majority of sectors saw between 20% - 30% of their SME population take up a loan during the pandemic. However, Figure A.5 shows that those sectors most affected by Covid-19 restrictions typically exhibited a higher propensity to receive government-backed finance. The lighter blue bars highlight those SME sectors which have been hit the hardest based on the findings on turnover impact discussed above.

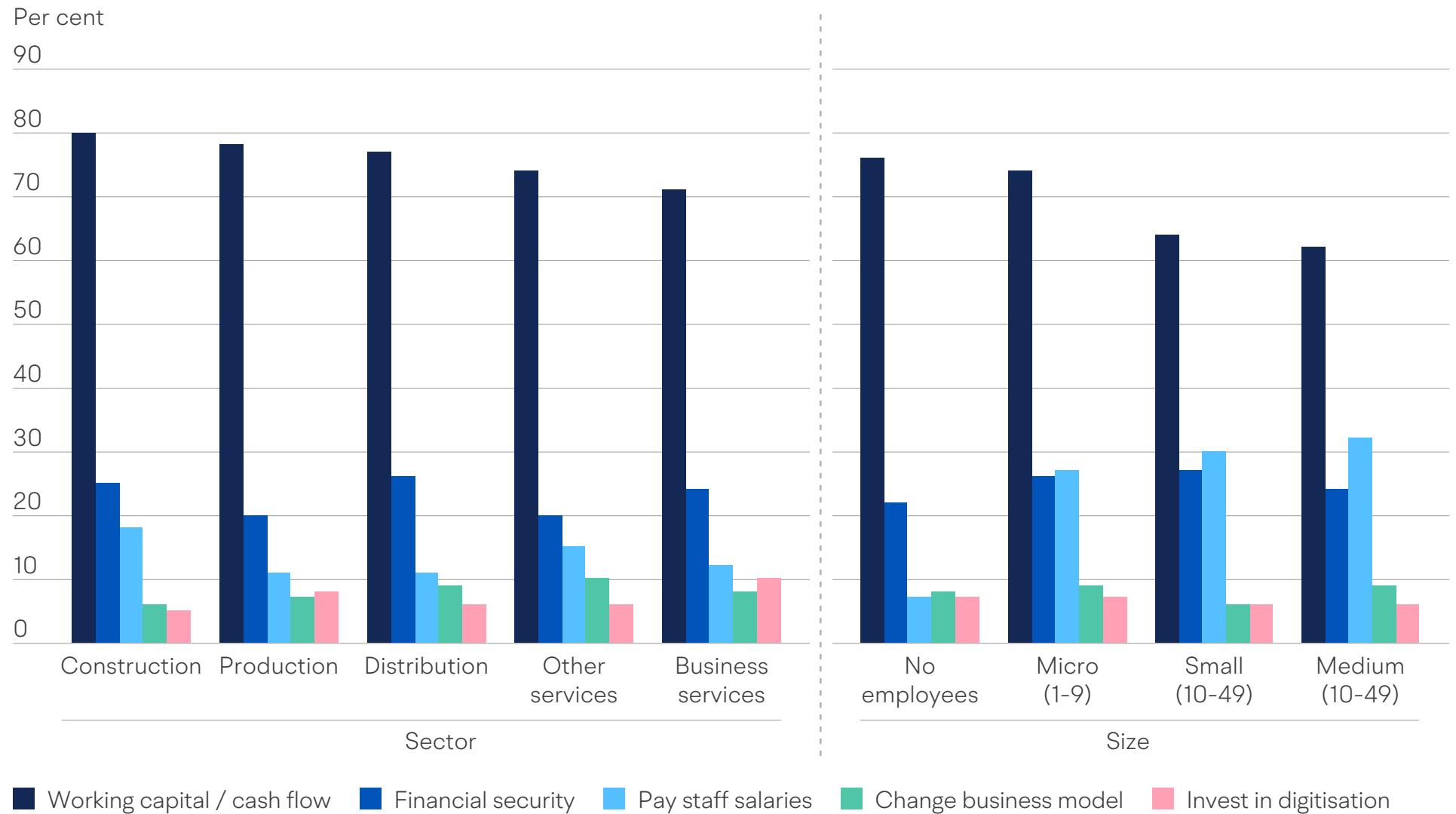
The sectors with the five highest uptake rates contain three of the most affected sectors with Accommodation and Food Services (44%), Wholesale and Retail (36%) and Transportation (31%). Real Estate (41%) and Manufacturing (29%) make up the remainder of the top five.

Some of the hardest hit sectors are also found at the lower end of demand, notably the Arts and Health sectors. Whilst finance was used across the board, this suggests that not all sectors prioritised finance as a solution to their needs during the pandemic. This could be due to external factors, such as alternative support schemes available, or internal factors such as sectoral behaviours towards finance in general and a lack of experience or relationships with finance providers.

Fig A.6

**Intended use of Covid-19 finance, by sector and size**

Source: British Business Bank 2020 Business Finance Survey – Ipsos MORI







A key area of interest has been how SMEs have used, or are intending to use, this new borrowing and whether those with limited cash flow issues would seek to use it for other purposes.

Across all sectors and firm sizes, as aggregated by the Bank’s Business Finance Survey (BFS), SMEs’ intentions were largely focused on using Covid-19 related finance for working capital and cash flow requirements (figure A.6). This peaks at 80% for Construction and 76% for zero employees from sectoral and firm size perspectives respectively. Overall, across both sector and size, medium-sized businesses had the lowest proportion planning to use their finance for working capital at just over 60%.

Unsurprisingly, given the increased levels of uncertainty, financial security was a strong driver of demand for pandemic-related finance, no matter the size or sector of the business, with around 20% of SMEs stating this as their reason for borrowing. While paying staff salaries was not a key driver noted by many sectors it increased in importance as firm size increased, peaking at 30% for medium sized businesses.

A smaller share of SMEs reported borrowing to change their business model (average 8%) and to invest in digitalisation (average 7%). This likely reflects businesses adapting to be able to carry on serving their customers, or indeed reaching new customers and markets, during the public health restrictions.

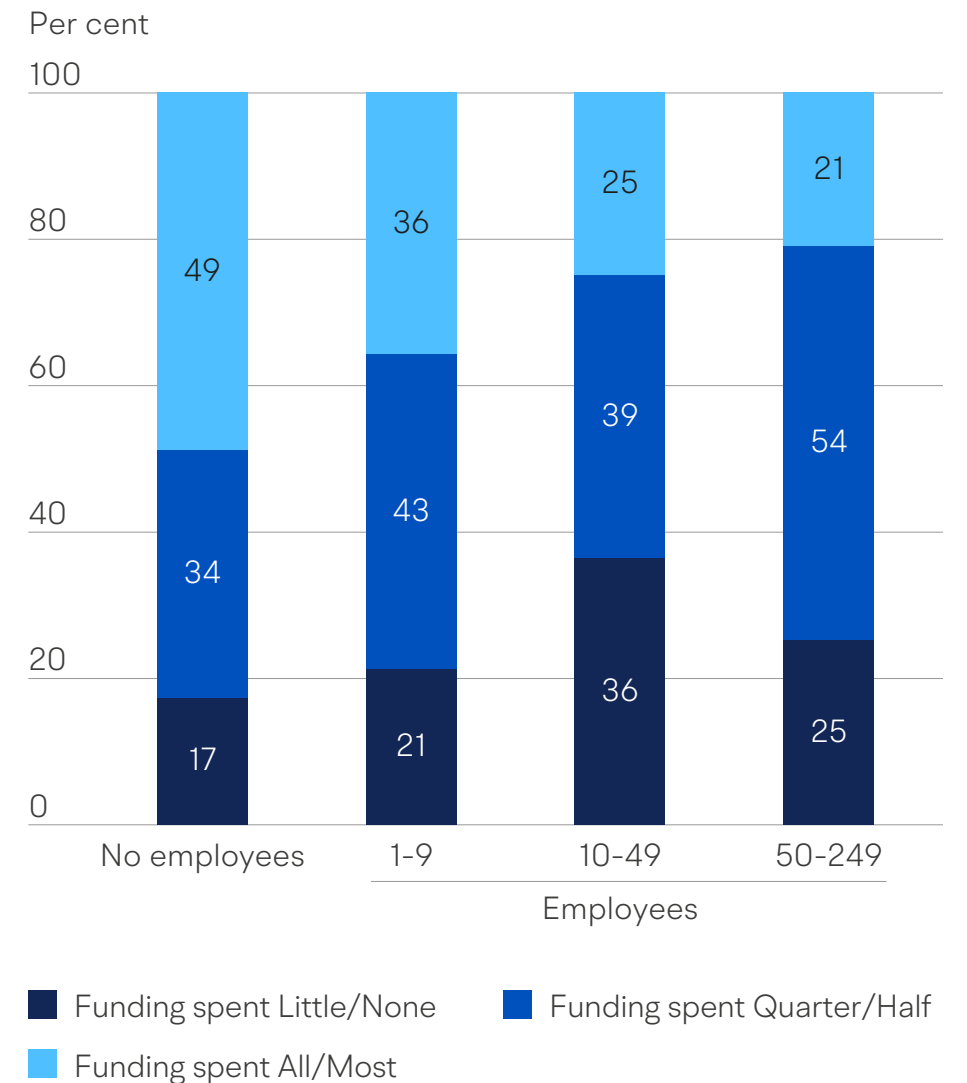
### A significant proportion of finance facilities remained unspent at the end of 2020

Of the SMEs responding to the Q3 SME Finance Monitor, 19% reported they had spent none of their government guaranteed finance facilities. A further 38% had spent no more than half of their facilities. However, 23% had spent all of their facilities. Figure A.7 shows that as firm size increases, so does the proportion of businesses who have spent no more than half of facilities. At the smallest end an estimated 49% of zero employee SMEs have spent all/most compared to 21% for medium businesses.

Fig A.7

### Share of facility spent by firm size, 2020 Q3

Source: BVA BDRC SME Finance Monitor Q3 2020





### Non-debt government schemes have been used extensively

A further reason why a significant proportion of available finance facilities were not drawn down is likely to be the range of non-debt options the government launched to support smaller businesses. These included the Self-employed income support scheme, the Coronavirus Job Retention Scheme (CJRS), VAT deferrals, Self-Assessment deferrals, and business rate holidays.

The BFS looked at the extent to which five broad groups of SMEs used these other support schemes.

Demand for non-debt government support was up to four times higher than government-backed debt finance (figure A.8). The Distribution sector, consisting of Accommodation and Food Services, Transportation, and Wholesale and Retail Services, has the highest percentage of its SMEs reporting use of any non-debt scheme (80%). At the lower end Other Services, made up notably of Arts and Recreation and Health, still saw 64% utilising non-debt support. These results suggest non-debt support was the preferred solution for SMEs in all sectors to mitigate the impacts of Covid-19 in 2020 and undoubtedly played a key role in reducing the finance needs for many smaller businesses.

### There has been strong take-up of the Future Fund by innovative high-growth potential companies

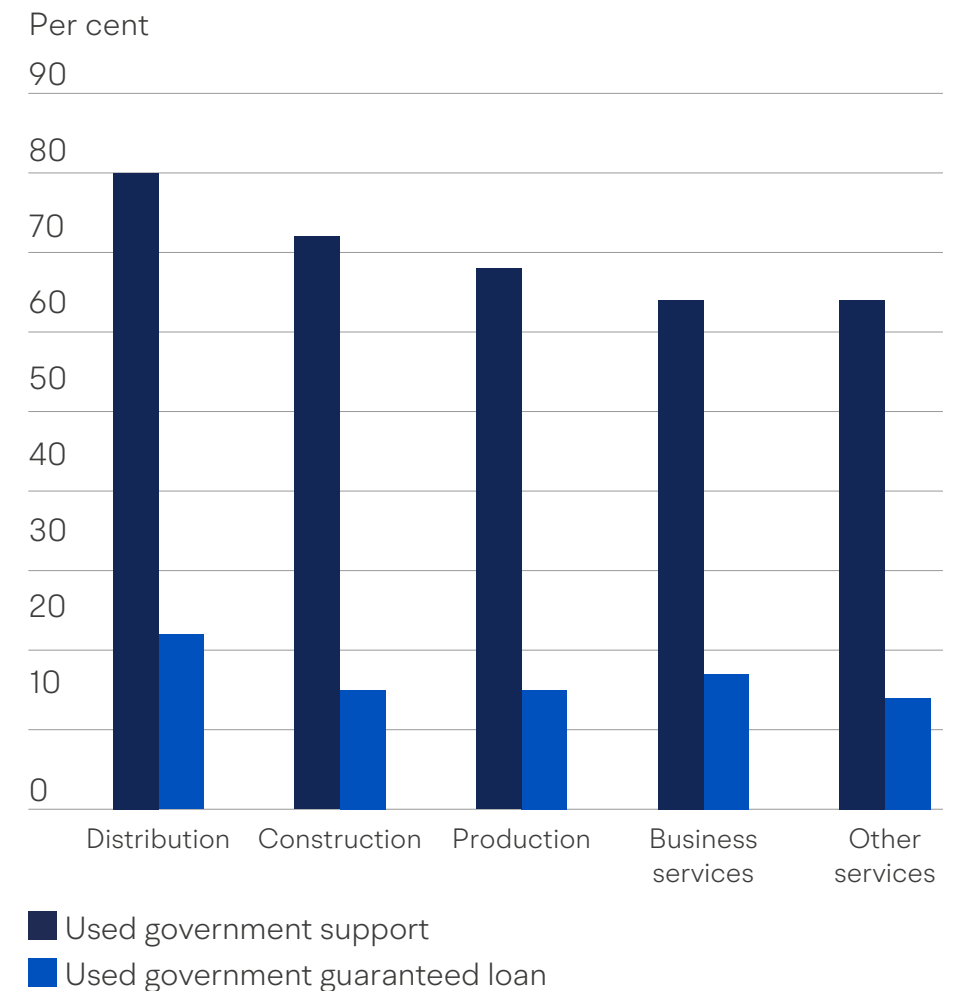
Debt finance has been the focus of this chapter so far but equity finance is an important funding source for businesses with high growth potential that offer innovative products and services. Many such businesses are unsuitable for debt finance due to their high levels of risk, lack of security and cashflows which may be insufficient to service interest payments.

For this group of businesses, the government along with the Bank worked to introduce the Future Fund scheme in May 2020. The Future Fund provides Convertible Loan Agreements (CLAs) of between £125,000 to £5 million to equity-backed businesses alongside at least equal matched funding from private investors.

As of 21<sup>st</sup> February 2021, 1,140 convertible loans have been approved to the value of £1.1bn.<sup>5</sup> This is a relatively large number of companies receiving equity funding in a single year and has clearly played substantive role in maintaining UK SME equity activity at record levels.

Fig A.8  
**Sector take up of non-debt government support and government guaranteed finance**

Source: British Business Bank 2020 Business Finance Survey – Ipsos MORI





Beauhurst data shows there were 2,044 announced equity deals in UK SMEs in 2020, which is 5% higher than 2019. Figure A.9 shows the profile of investment and deals during the year, highlighting that the second quarter was the only period where deal volumes fell below 2019 levels. The decline in Q2 was relatively mild with deals just 6% below the equivalent period in 2019, though some of this could reflect the conclusion of deals already in progress.

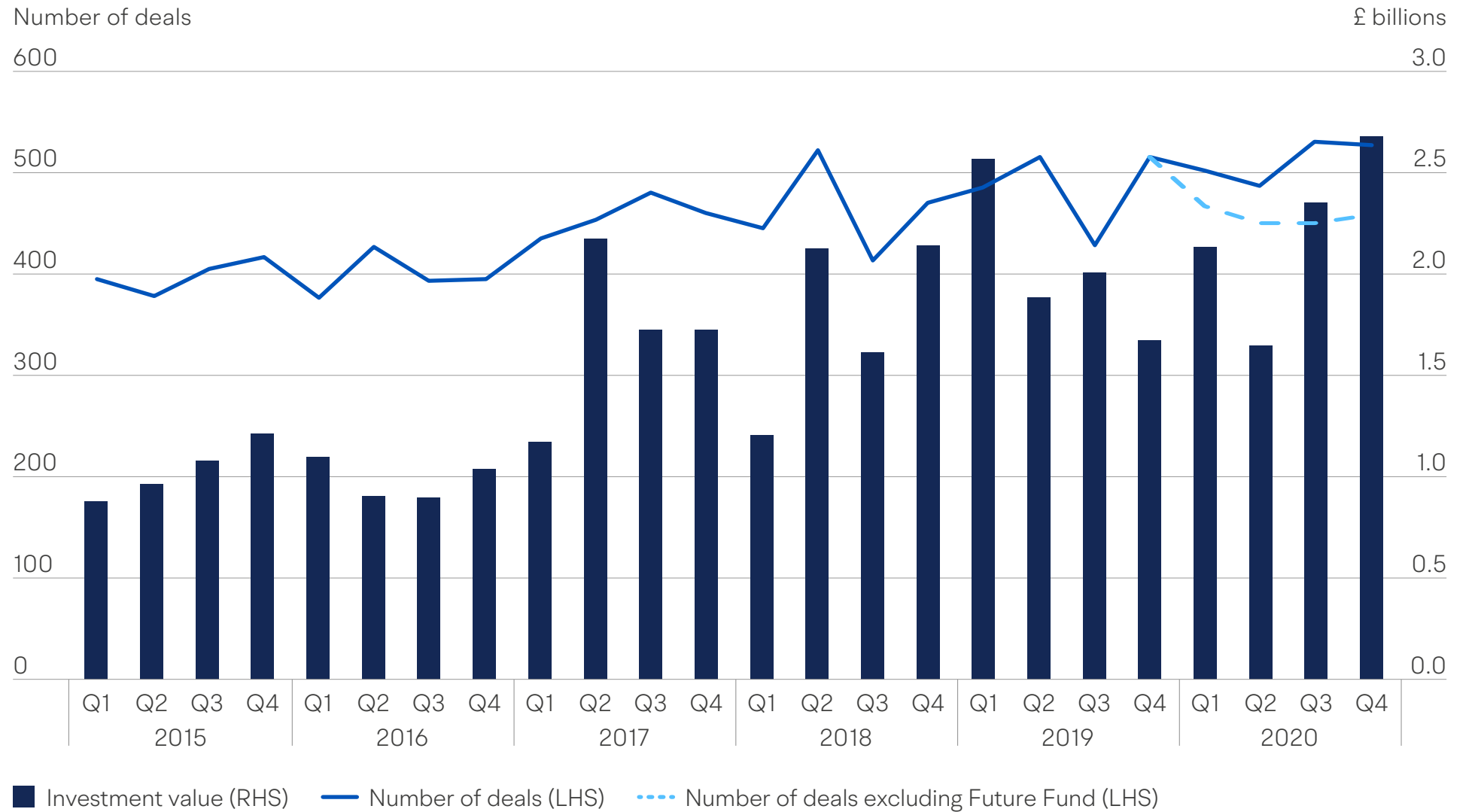
Investment values also reached record levels in 2020, rising by 9% on 2019 levels to £8.8bn. 2020 was another record year for UK equity investment and the third-year annual equity investment was above £7bn.

Disentangling the exact contribution of the Future Fund to the consistent time-series of announced SME equity activity maintained by Beauhurst requires matching the details of Future Fund deals into the dataset. Our analysis<sup>6</sup> has identified 223 Future Fund deals within the Beauhurst announced deal dataset.<sup>7</sup> Overall, these deals account for 11% of announced deals in the Beauhurst dataset in 2020, but this was as high as 15% in Q3 2020.

Fig A.9

**Number of equity deals and value of investment per quarter**

Source: British Business Bank analysis of Beauhurst data





Deals involving business angels and other private investors are unlikely to be formally announced which will explain why the number of Future Funds deals identified is relatively low compared to the total number of Future Fund CLAs drawn down.<sup>8</sup> This also applies to the wider market where crowdfunding and VC deals are more likely to be formally announced than deals involving business angels.

It is difficult to estimate what the market would have looked like without the Future Fund as some deals may have still gone ahead in the absence of the programme. Excluding deals involving the Future Fund from the aggregate market figures shows the number of announced SME equity deals would have declined by 6% in 2020 to 1,821 deals. In particular, the number of deals in Q2 2020 (449) would be 13% lower than the same quarter in 2019, suggesting a noticeable decline in deal activity in spring 2020. Lower deal activity was then maintained in Q3 2020 at 449 deals per quarter (although this is 5% higher than the same quarter in 2019 as the usual summer dip in deal activity did not occur in 2020), before a slight (2%) quarter on quarter increase in Q4.

Of the £8.8bn invested into UK SMEs in 2020, the Future Fund contributed £205m to the deals identified in the

Beauhurst dataset (which is a subset of all Future Fund deals) which was matched by £286m of private sector investment. It is not possible to determine how much of the private sector funding would have been allocated to the equity ecosystem in the absence of the Future Fund. Removing deals involving the Future Fund funding still indicates total investment activity grew by 3% in 2020, which is consistent with wider UK and European market trends of higher investment amounts.

Investment figures are volatile on a quarterly basis, 2020 was a year of two halves. £3.8bn was invested in the first half of 2020, down 15% from the first half of 2019. Some of the decline is due to the inclusion of a single very large equity deal in Q1 2019 (£940m invested in OneWeb), which helps to explain some of the year-on-year decline. However, the second half of the year finished strongly with £5.0bn invested, 37% higher than H2 2019.

In particular, Q4 2020 finished the year strongly with £2.7bn of investment. This is the largest ever single quarter, driven by several large equity deals in unicorn companies including £240m into Cazoo, £224m into OneTrust and £95m into Hopin.<sup>9</sup> Ending the year with record investment shows equity investors retain confidence in the prospects of these companies and

the continued strong performance of the equity ecosystem. This suggests investor optimism increased in the second half of the year, once the effects of the pandemic were more widely known, with increased confidence to undertake larger investments in later stage companies. In addition, by the second half of the year, equity investors had adjusted their due diligence processes and become accustomed to undertaking deals remotely.

Whilst the headline figures appear to show UK equity finance had a strong year in 2020 with higher deal and investment figures, equity finance has been affected by the pandemic. The Future Fund has contributed to the continued functioning of UK equity finance markets in 2020. It has helped to ensure innovative equity backed companies are able to weather the current period of economic disruption and continue their long-term growth trajectory to reach their full potential. Without the programme, deal numbers in 2020 are likely to have declined.

The UK SME equity market has been very resilient to the challenges Covid-19 has brought, and higher levels of investment in 2020 demonstrate investors continued to have the confidence to invest in high growth potential businesses at all stages of their development.



1.2

## Expectations for demand and supply in 2021

- Economic uncertainty is likely to weigh on attitudes to borrowing
- Both cash balances and debt have risen
- SME finance providers remain well placed to service demand for finance
- Pricing and availability of lending will likely change as government schemes are replaced
- Record fundraising in 2020 suggests VC funds have sufficient capacity to invest in high growth companies in 2021 and beyond



The uniqueness of the disruption seen in 2020 gives rise to a multitude of long-term questions about when the UK may get back to business as usual and how the various support measures will have impacted both smaller businesses and the finance markets that support them.

**Economic uncertainty is likely to weigh on attitudes to borrowing**

2020 has been an incredibly challenging year for the people and businesses of the UK. The level of economic uncertainty created by both the pandemic and EU trade negotiations has made even short-term business plans difficult to formulate and follow. While the Brexit transition period has now ended with a trade deal the pandemic continues to drive uncertainty.

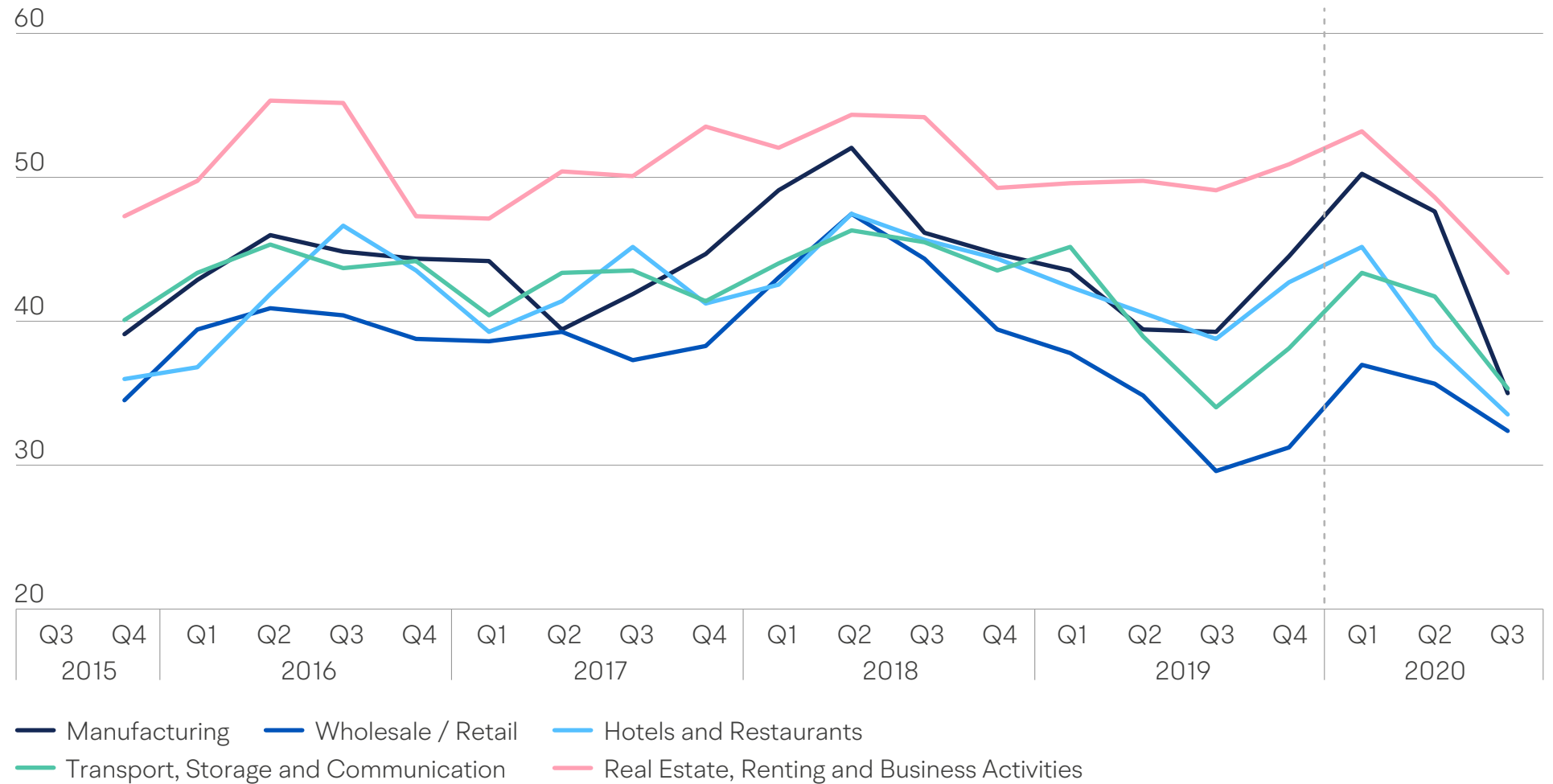
How this uncertainty will ultimately impact demand for finance in 2021 is not yet clear, both for those looking to use finance to support survival, and those looking to recover and grow. For some, necessity or opportunity will win out and lead them to seek finance but for others

Fig A.10

**Permanent non-borrower rates for sectors with the highest share of SMEs accessing guarantee schemes, two-quarter moving average**

Source: BVA BDRC SME Finance Monitor Q3 2020

Per cent





it is likely it will further entrench their desire to avoid taking external finance if at all possible.

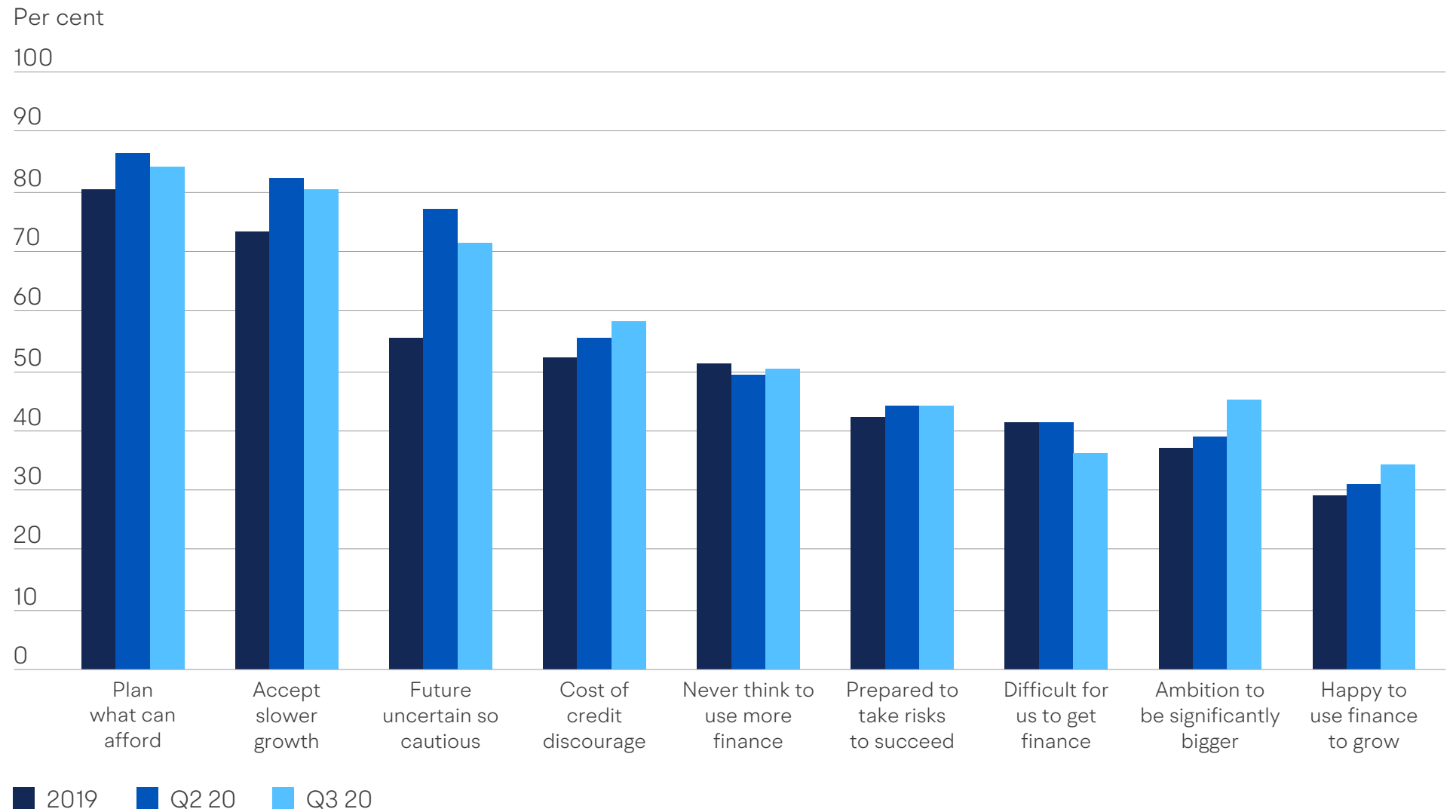
Those sectors with the highest concentration of SMEs accessing the government schemes all saw declining Permanent non-borrower (PNB)<sup>10</sup> rates in 2020 Q2 and Q3 (figure A.10). Whilst it is not unexpected to see PNB rates fall given the scale of borrowing, whether this reflects a fundamental shift in SMEs' attitudes to borrowing is a different and more difficult question to answer. The extent to which this trend persists into 2021 and beyond is something that the Bank will closely monitor.

The Q3 2020 SME Finance Monitor (figure A.11) saw many attitudes change as economic conditions improved or deteriorated. Despite the challenges faced by smaller businesses during Q2 and Q3, the majority of SME respondents remained reticent about using finance with over 80% planning only for what they could afford and those who said they were being cautious due to an uncertain future recording the largest increase from 2019 (55% to 77% in Q2).

Fig A.11

**Attitudes to borrowing for different purposes**

Source: BVA BDRG SME Finance Monitor Q3 2020





While the more negative attitudes to the use of external finance saw the largest quarterly increases only three options saw increases throughout the year, those who thought the cost of credit was a discouragement, those with ambitions to be significantly larger and those happy to use finance to grow.

With lockdown measures tightening late in Q4 and early Q1 2021 the economic environment will increase demand for finance for survival related needs. This is backed up by OBR and Bank of England business investment forecasts. As such, individual firm or sector dynamics are likely to be the key drivers of demand for finance, at least at the start of 2021. However, when the lockdown is relaxed, market contacts suggest there is significant pent-up demand for finance and the balance of demand will move from survival to recovery.

### Both cash balances and debt have risen

The disproportionate impacts on specific subsets of businesses have left varying imprints on balance sheets. A continued reduction in operating expenses and significant financial support through government schemes has led to a 20% rise in deposit holdings since the start of the year to a record £252 billion according to UK Finance data.<sup>11</sup>

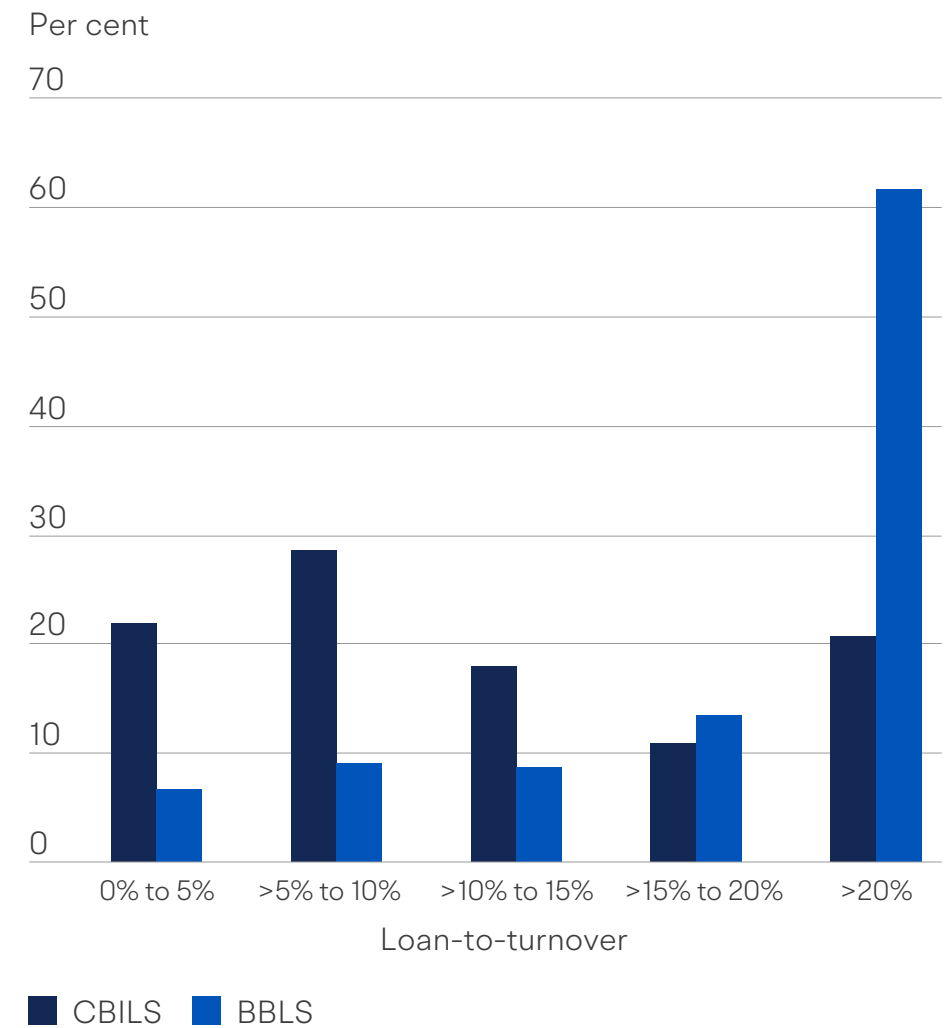
Despite this, UK Finance have said “While the business community in aggregate does not appear overindebted, with liquidity reserves and capacity to provide finance strong overall, many individual businesses and some specific sectors are facing significant and much more extended disruption and may find themselves in financial difficulty in 2021... widespread restructuring and recovery situations are expected.”

This is corroborated by a Federation of Small Businesses (FSB) report that found firms with pre-existing debt were more likely to take up a CBILS or BBLS loan thereby increasing overall debt levels. It suggested that more than half (56%) of small firms had some form of existing debt before the Covid-19 crisis with this rising to 69% in August.<sup>12</sup>

Fig A.12

### Distribution of BBLS and CBILS SME recipients, split by loan-to-turnover

Source: BBB scheme level data as at December 2020







British Business Bank data shows that across both CBILS and BBLs, the majority (59%) of SMEs accessing government-backed finance schemes have borrowed more than 20% of their reported turnover (figure A.12) with the vast majority of this group borrowing no more than 25%. This is a result driven by BBLs with its cap on borrowing set at 25% of turnover.

What this means for an SME's potential demand for finance in 2021 will vary widely depending on a range of factors, including their own specific financial position, the sector they operate in and the senior management or owner's attitude to external finance.

High levels of debt, and in particular the number of businesses with higher debt-to-turnover ratios suggests a potential drag on viable demand from over indebtedness. Record cash balances on the one hand and increasing debt levels on the other would suggest that there are both a sizeable number of SMEs in a position to borrow further in 2021 and a sizeable number of SMEs likely to struggle with debt repayments, however it is simplistic to split all SMEs into one of those two categories.

As of Q3, the SMEs with the largest share of loans worth more than 20% of turnover included Other Service Activities, Transport, Education, and Professional and Scientific Activities, each with at least 65% of borrowers taking out 20% - 25% of their turnover (figure A.13). Perhaps surprisingly, Accommodation and Food Service, and Wholesale and Retail Trade, two of the hardest hit sectors, are lower down the list with 50% and 44% of respective facilities in the 20-25% of turnover band. Loans worth no more than 10% of turnover are most prevalent in Manufacturing (29%), and Wholesale and Retail Trade (28%).

Most sectors have expressed a marked increase in concern regarding repayment ability between 2020 Q1 and Q3 (figure A.14). However, the sectors with higher loan-to-turnover ratios in figure A.12 do not consistently appear to be those expressing the largest increases in concern over repayments since the start of the year. Notable percentage point increases can be found in the Construction (20), Transportation and Storage (20), and Manufacturing (14). Of these, only Transportation was in the top three loan-to-turnover sectors.

Hospitality has the largest absolute share of Q3 SMEs concerned about repayment at 37%, however this represents a more moderate 12 percentage points increase on their Q1 concerns. This may reflect that the sector was already anticipating concerns in Q1 prior to the first announced lockdown in March, or, that sentiment improved in Q3 as restrictions were still lifted at the start of the period.

A further potential indicator of over indebtedness is the use finance has been put to. As noted earlier, finance has predominantly been used to meet liquidity and cashflow needs and whilst this can support business survival, it does not always directly add to the productive capacity of a business. Increasing debt levels without the benefit of return can contribute to a debt overhang problem. Such risks materialise when debt repayments make up an excessive share of annual costs such that borrowing more for other purposes becomes unaffordable.



Fig A.13

**Scheme debt as a share of firm turnover, by sector**

Source: BBB scheme level data as at December 2020

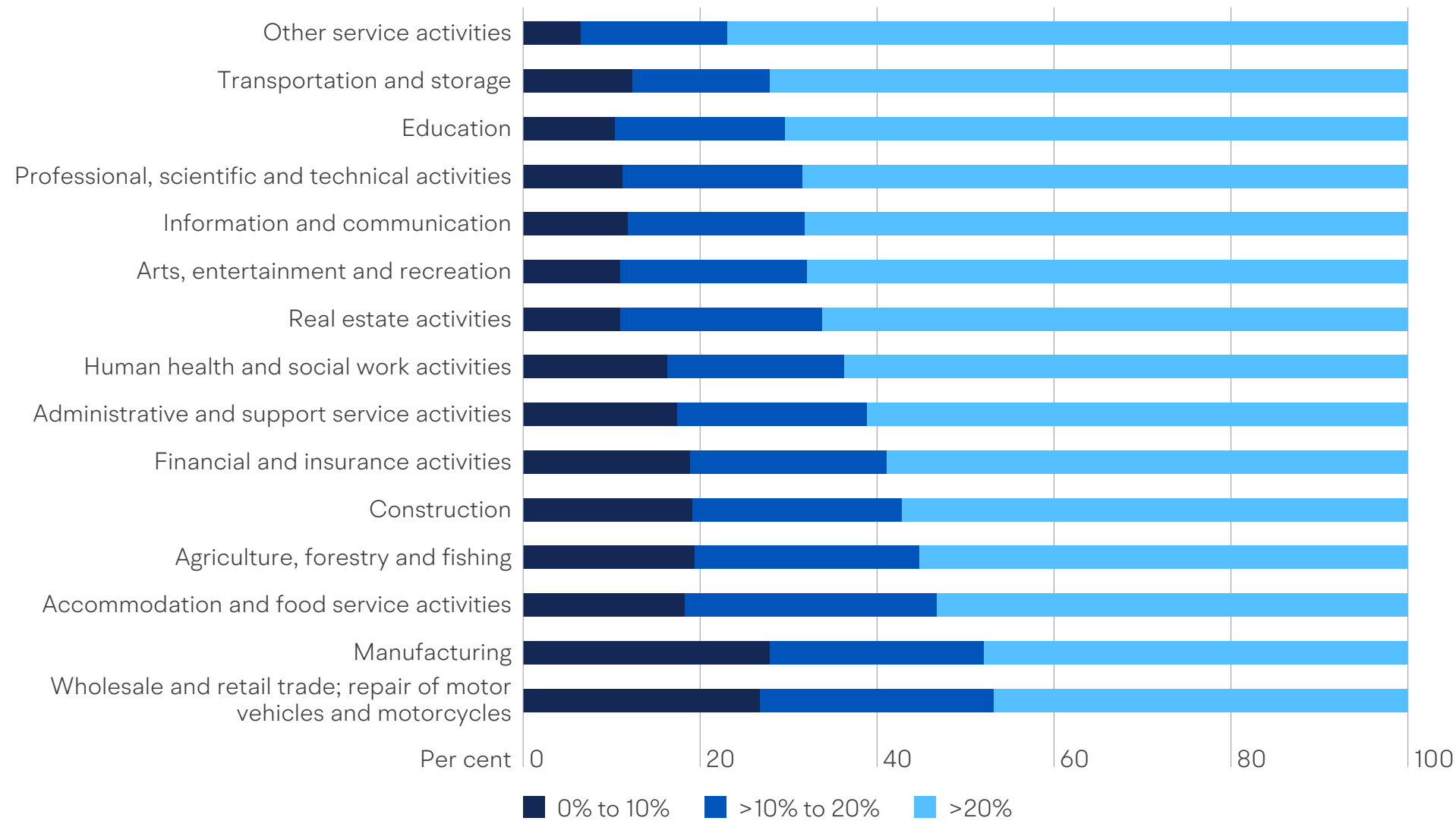
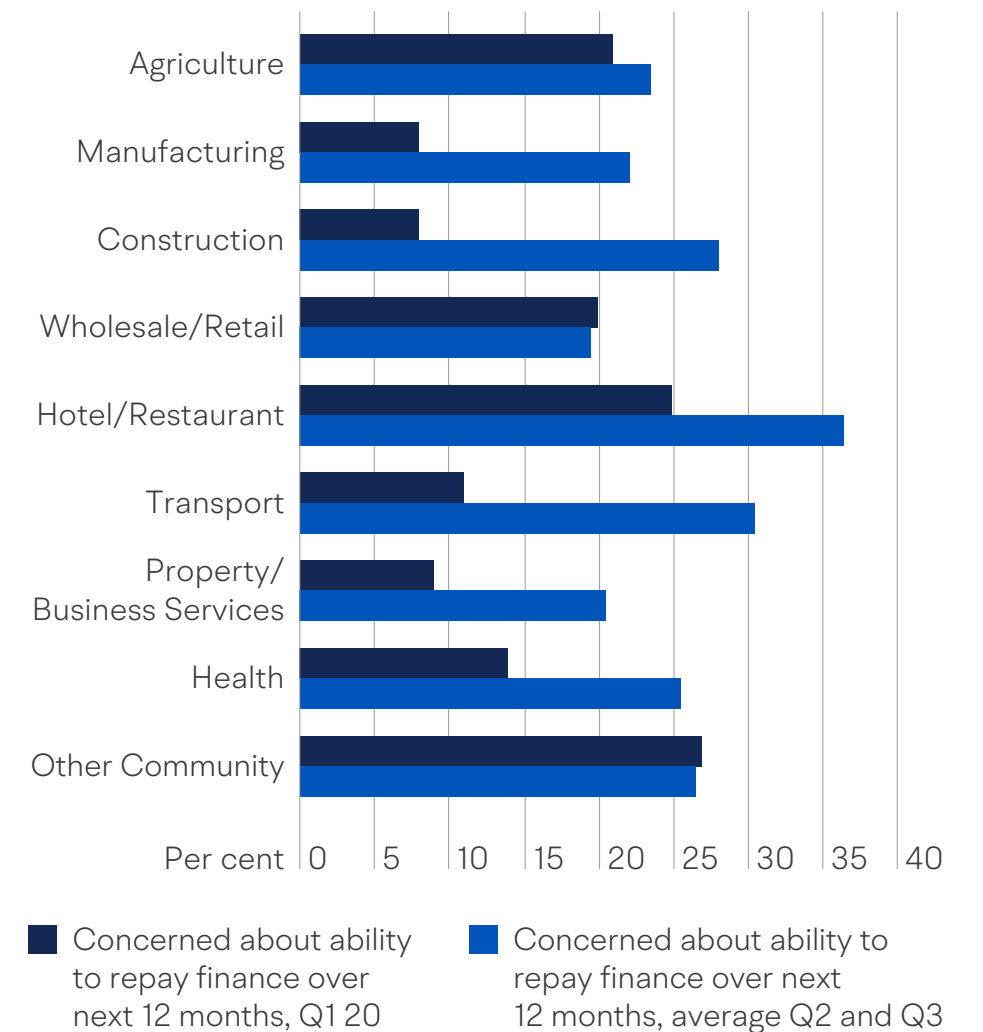


Fig A.14

**Concern about ability to repay finance over the next 12 months**

Source: BVA BDRC SME Finance Monitor Q3 2020





The above could be a particular issue for the smallest businesses. As noted previously, a higher proportion of the smallest businesses have already spent a larger share of their facilities. Given we know finance has been used mainly for liquidity needs to keep businesses going rather than investment, smaller businesses may find themselves requiring more finance or support in 2021. Should the economic environment insufficiently improve, however, they may be unable to take on more debt to service existing liabilities without severely affecting their viability, especially given they tend to lack collateral.

The initial interest-free period on existing government-backed finance schemes is soon coming to an end for the earliest borrowers, but the schemes include provisions to support businesses to repay, such as extending the loan term to ten years. In February, the Chancellor also announced further support by allowing businesses to pause BBLs repayments for six months before their first repayment is due. This may offset some of the negative impacts of current and new debt on affordability.

However, the longer the pandemic and restrictions continue into 2021, the more debt repayments will likely become an issue for SMEs, potentially increasing the need for SMEs to refinance and take on additional debt where possible.

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### **SME finance providers remain well placed to service demand for finance**

There will be significant demand for finance from viable SMEs although the exact amount will be impacted by the on-going economic uncertainty. Importantly, banks have sufficient capital to support further lending. While there are serious concerns around SME indebtedness and ability to service the debt they already have, the December 2020 Bank of England Financial Stability Report suggested banks could absorb around £200bn of credit losses.<sup>13</sup> Currently they have provisioned for £20bn of losses.

Furthermore, many non-bank lenders, including longstanding providers of non-term loan finance, and their investors have had to bide their time. However, market contacts suggest they are likely to return to the market as demand for their products returns to more normal levels and government guarantee schemes become less dominant in the market.

One example of this is asset finance, a market that has shown significant decreases in lending in 2020 (see chapter 2.8), but as SME investment increases asset finance will be crucial to the growth of the economy. Invoice finance will also play a significant role as the economy recovers. It is likely many SMEs will be looking to initially shorten their credit cycle as they get back to business and invoice finance is suited for this role.

In addition to capacity held by private sector finance providers, the Bank's programmes remain well placed to service demand for finance. This now includes the Recovery Loan Scheme, announced in the March 2021 Budget. Accredited finance providers will be able to offer loans and overdrafts of between £25,001 and £10 million per business and invoice finance and asset finance facilities of between £1,000 and £10 million. The scheme launches on 6<sup>th</sup> April and is open until the 31<sup>st</sup> December.



### Box 2 - Start Up Loans

The Start Up Loans programme offers loans, alongside business support and mentoring, to individuals across the UK looking to start a business or to develop a recently established business. From its launch in 2012 to December 2020, the programme has lent over £685m, through over 79,000 loans.

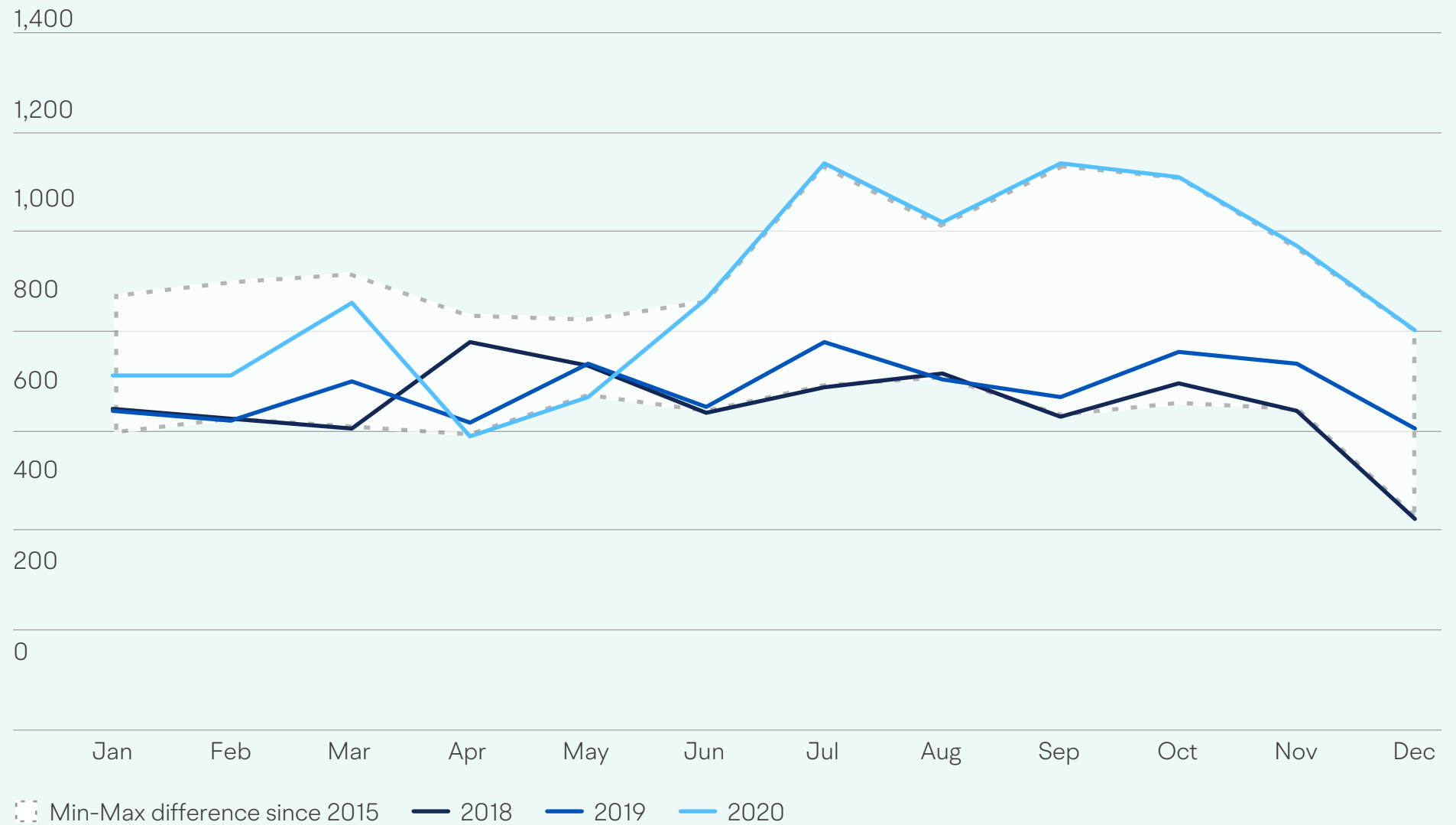
#### Start Up Loan volumes hit record highs in the second half of 2020

At the beginning of the lockdown in mid-March Start Up Loans drawdowns declined sharply, reaching their lowest ever levels in April and May since start of the scheme. However, with the ease of restrictions in June allowing businesses to start re-opening their doors to customers, demand for Start Up Loans appeared to rise and there was a significant increase in volumes. Notably, the number of successful applicants increased rapidly from June and reached a record high since peak delivery in 2015 (figure 2.1). The total funding drawn down in 2020 was £126m, the highest since the scheme began and 41% above the £89m drawn down in 2019.

Fig 2.1

#### Number of monthly Start Up Loan drawdowns

Source: Start Up Loans data





### Demand could rise further in 2021

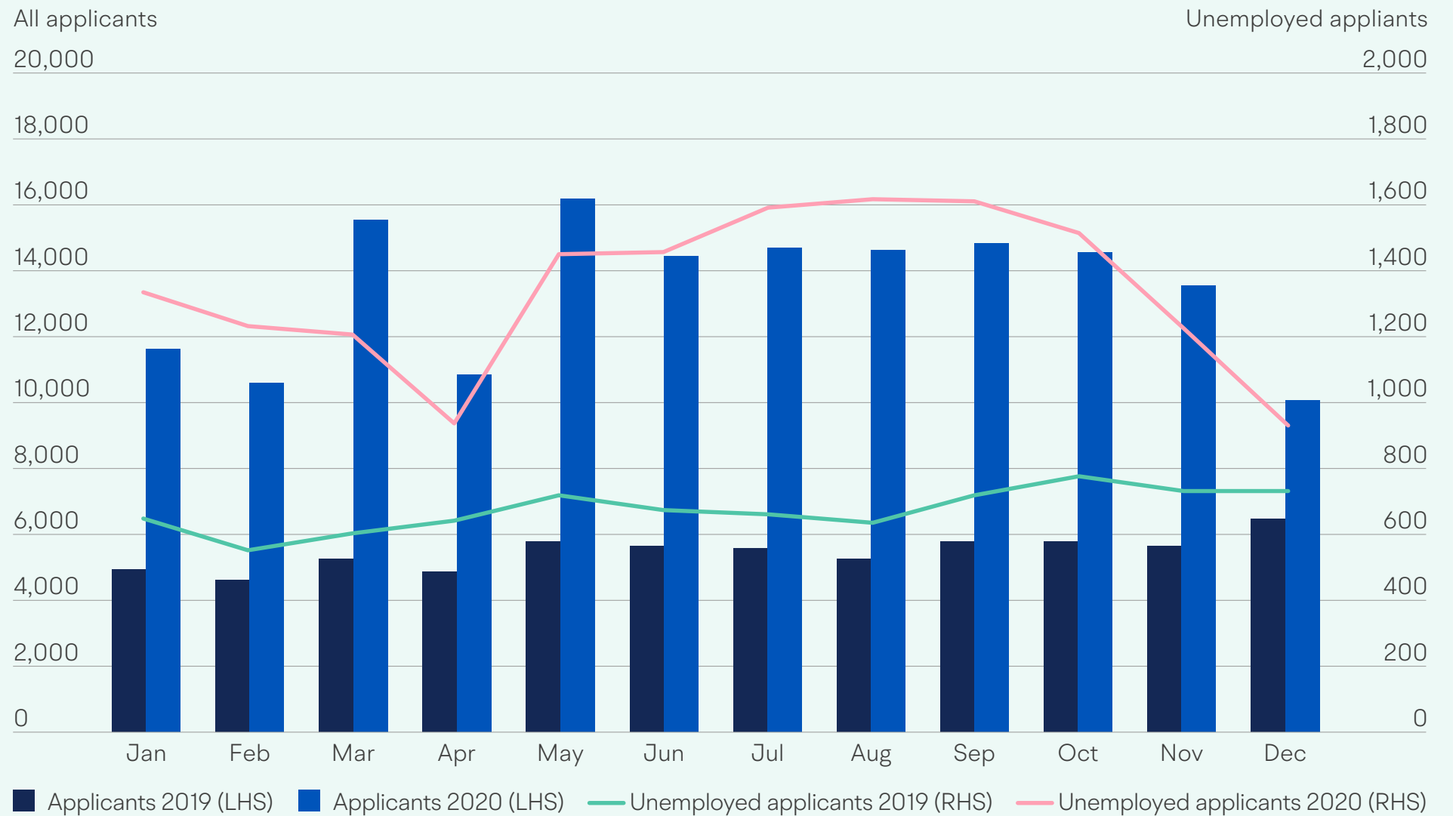
Chapter 1.2 has highlighted the likely significant demand for finance in 2021 as the economy begins to recover. Start Up Loans provide loans not just to those who are looking to start a business but also to eligible existing businesses that fall within the scheme’s definition of a start-up.<sup>14</sup> For those smaller businesses looking for a relatively small amount of finance and the option of free mentoring Start Up Loans can be an attractive proposition.

Furthermore, while the Coronavirus Job Retention Scheme has limited job losses in 2020, unemployment has still risen since the start of the pandemic and is predicted to rise further in 2021 (see chapter 2.1 for more details). Being unemployed or inactive in the labour market is a common starting point for individuals establishing their own business. Evidence from the IFS suggests that more than 50% of the newly solo self-employed were either inactive or unemployed immediately before starting their business.<sup>15</sup>

Fig 2.2

### Number of monthly Start Up Loan applicants and employment status

Source: Start Up Loans data





A possible early indicator of the potential impact this could have on Start Up loans demand can be seen in expressions of interest. 2020 showed strong increases, rising by 146% on an annual basis and reaching a record high. Perhaps tellingly, the total number of loan applicants who were unemployed also doubled in 2020 (figure 2.2). Historically, one third of successful Start Up Loans applicants were unemployed or economically inactive when they applied for a loan.

In addition, according to the Global Entrepreneurship Monitor report, young people, defined as between 18 -34, have been hit hardest by unemployment during pandemic.<sup>16</sup> This likely reflects some of the industries hardest hit by the pandemic such as hospitality (see 1.1 for a fuller discussion). Since the start of the Start Up Loans programme, almost a quarter (23%) of loan recipients are in the 18 and 24 age group, and were not in education, employment, or training.

Finally, The Resolution Foundation found in its survey that people from ethnic minority backgrounds, together with 18-24-year-olds, are likely to lose their jobs faster than the rest of the population when the government's financial support comes to an end.<sup>17</sup> The Start Up Loans program historically provided 20% of its loans to people from ethnic minority backgrounds. This latter point is particularly important given that the Bank's recent research on entrepreneurship and diversity found that access to finance appears to be a major barrier for Black, and Asian and Other Ethnic Minority entrepreneurs and the reason why 39% and 49%, respectively, stop working on their business idea.<sup>18</sup>

### **The British Business Bank has secured further funding to ensure Start Up Loans can support the economic recovery**

Given the historical role Start Up Loans has played supporting start-ups and in particular entrepreneurs who have struggled to get the finance they need from other sources the above findings suggest the demand for and importance of will only increase in 2021.

The Chancellor of the Exchequer announced at Budget 2020, that the government would be extending funding for the British Business Bank's Start Up Loans programme until March 2022. The extension of funding will enable the programme to provide up to 11,000 more loans to ambitious new and early-stage businesses that form and grow in the wake of the Covid-19 pandemic.



### **Pricing and availability of lending will likely change as government schemes are replaced**

The biggest challenges to successfully supporting SME lending in 2021 are likely to lie in three places. Firstly, as finance providers start to lend outside of such generous government guarantee schemes it is possible, in fact likely, they will lend at higher rates or in less markets as banks and alternative lenders return to lending on their own criteria.

As noted, banks in particular are well capitalised, but they have lent via the government schemes in sectors of the market, such as sub £25k, and at pricing they have previously been unprepared to fund prior to Covid-19.

Furthermore, the Bank of England's Q4 Agents Summary noted there have been some reports of bank credit conditions tightening, particularly in sectors that had been most affected by the pandemic, and where insolvencies were expected to rise.<sup>19</sup> This was supported by their Q4 Credit Conditions survey which said lenders had reported that spreads on corporate lending to small businesses widened in Q4 and were expected to widen slightly over the next quarter.<sup>20</sup>

Secondly, for some finance providers, and particularly some non-bank and newer lenders who were unable to lend via government schemes or access cheap funding, the future is less clear. These finance providers have become significant players within SME finance markets, but many have had their target market largely served by government lending schemes and in particular by BBLs (see chapter 1.4 for a more detailed discussion).

For those alternative finance providers that have managed to lend through the crisis some have potentially gained new customers, experience and links with institutional investors. This could accelerate their development and growth. It also may have, in the minds of potential customers and investors, removed the question of whether can they survive a full credit cycle. However, for others this may well have put back their plans and the markets they targeted pre-pandemic may not be as large for a few years to come.

Finally, how smaller business indebtedness is managed will be crucial to both the demand and supply of debt finance in 2021 and beyond. Indebtedness has risen during 2020 and will continue to increase going into 2021, but government schemes and finance providers have also worked hard to support their borrowers through a range

of measures. An OECD review of international evidence suggests schemes have been effective in reducing bankruptcies, but with a risk of creating zombie businesses.<sup>21</sup>

There will be difficult decisions to be made for both smaller businesses and the finance providers that support them, but successfully managing this indebtedness, and in particular how financing or refinancing needs are addressed, will be key to making sure viable businesses are able to recover and begin to invest again.

### **Record fundraising in 2020 suggests VC funds have sufficient capacity to invest in high growth companies in 2021 and beyond**

The picture for the supply of equity finance seems much clearer. Preqin data shows that in 2020 44 UK-based VC funds reached their latest close, up 26% from 2019 when 35 funds closed (figure A.15). This is a continuation of the upward trend seen since 2012, when just three funds closed in the aftermath of the Financial Crisis.

The total value of VC funds closed in 2020 was £4.8bn, the highest amount raised by UK VC funds in a single year.<sup>22</sup> This is 39% higher than the £3.4bn raised in 2019, showing continued confidence in the UK VC industry.



Global VC fundraising conditions have been strong in recent years, with the current low interest rate environment being one explanatory factor. Low interest rates increase the amount of capital available to invest in alternative asset markets as LPs increase their allocation to alternative strategies, including VC, seeking higher returns. Preqin forecast increased capital allocation to alternative assets in the next five years, in part due to Covid-19 prolonging the low interest rate environment.<sup>23,24</sup>

There is continued strong interest in UK and European VC markets from institutional investors. For instance, 94% of LP respondents to a 2020 survey have either increased or maintained their appetite to invest in the European venture asset class. Just 6% of LPs stated their appetite has decreased since the onset of the pandemic. 70% of LPs investing in venture capital thought the European technology sector will gain ground compared to the US and China in the next decade.<sup>25</sup>

Whilst 25% of funds raised in 2020 are small (less than £50m in size), in recent years an increased number of very large VC funds, funds above £250m, have been established, with four such funds closing in 2020, up from one fund in 2011. These large VC funds raised the most capital, accounting for 52% of total VC fundraising in

2020. Of these large funds, three were greater than £600m in size. These very large funds have led to a 13% increase in the average fund size to £111m in 2020.

Average fund sizes have been increasing in recent years from a low of £44m in 2013. This confirms the UK equity ecosystem is maturing as the size of UK VC funds continues to scale up, so that they are better able to support companies at all stages of their development.

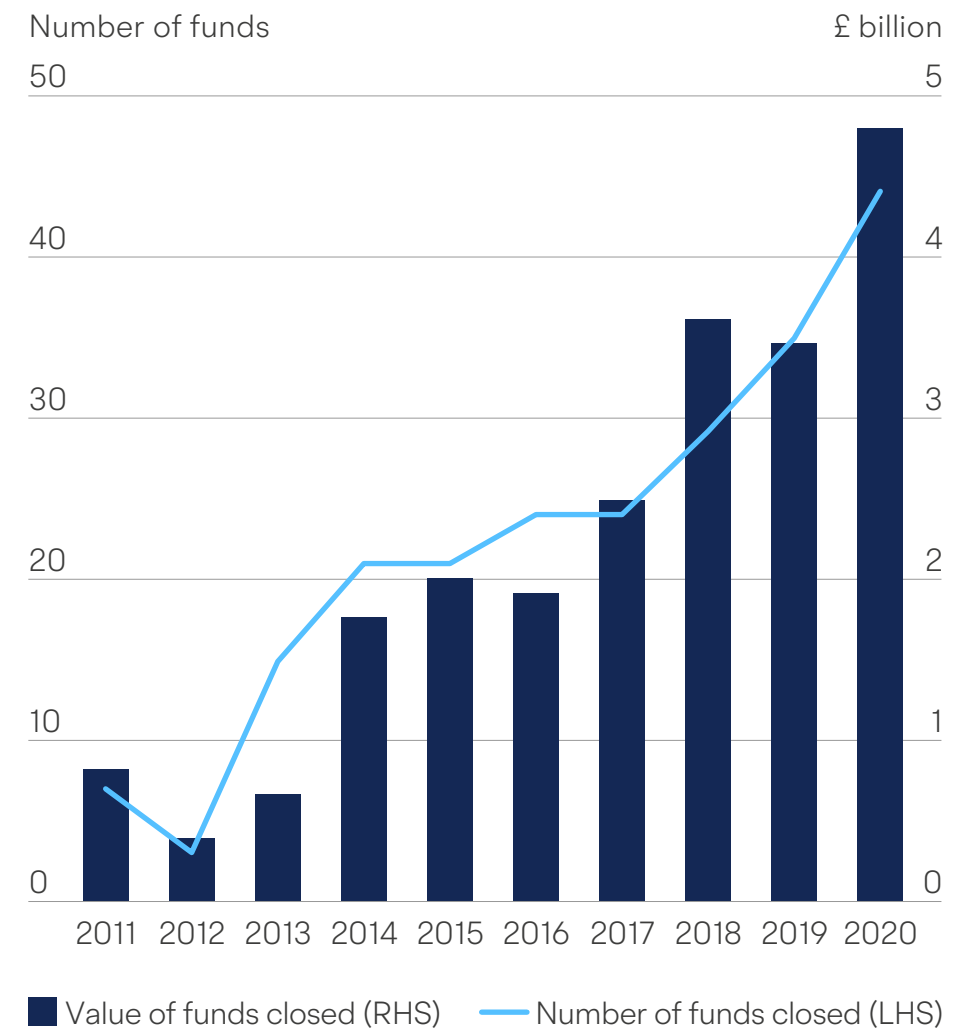
Whilst fund sizes have been increasing overall, this has not been at the expense of smaller funds. 2020 was also a strong year for fund managers at the smaller end of the spectrum. 2020 saw eight funds closed that were smaller than £50m in size and 14 funds closed that were between £50m and £100m in size. 69% of funds closed in 2020 were in these size categories compared to 61% in 2019.

While the Future Fund is now closed to new applications, the record fundraising in 2020 suggests VC funds have sufficient capacity to invest in high growth companies in 2021 and beyond. Furthermore, the continued support from angel investors seen throughout 2020 and the speed at which they adapted their ways of working suggests funding will remain available at the earliest stages too.<sup>26</sup>

Fig A.15

**Number and value of UK VC funds reaching final close, per year**

Source: Preqin data as at 21/01/21







**1.3**

# **Finance can help the UK build back better**

- Boosting investment will be a key focus of the recovery effort
- Evidence shows finance can fuel the investment we need
- Though the outlook for finance flows is mixed in the short-term, there are reasons for optimism
- The British Business Bank is committed to using our full suite of activities to help the UK build back better



The previous sections have outlined how finance has played a vital role in business survival during the Covid-19 pandemic. That role will broaden as we move into a recovery phase, with business leaders increasingly able to focus on opportunities rather than threats and, in doing so, help create a brighter economic future.

**Boosting investment will be a key focus of the recovery effort**

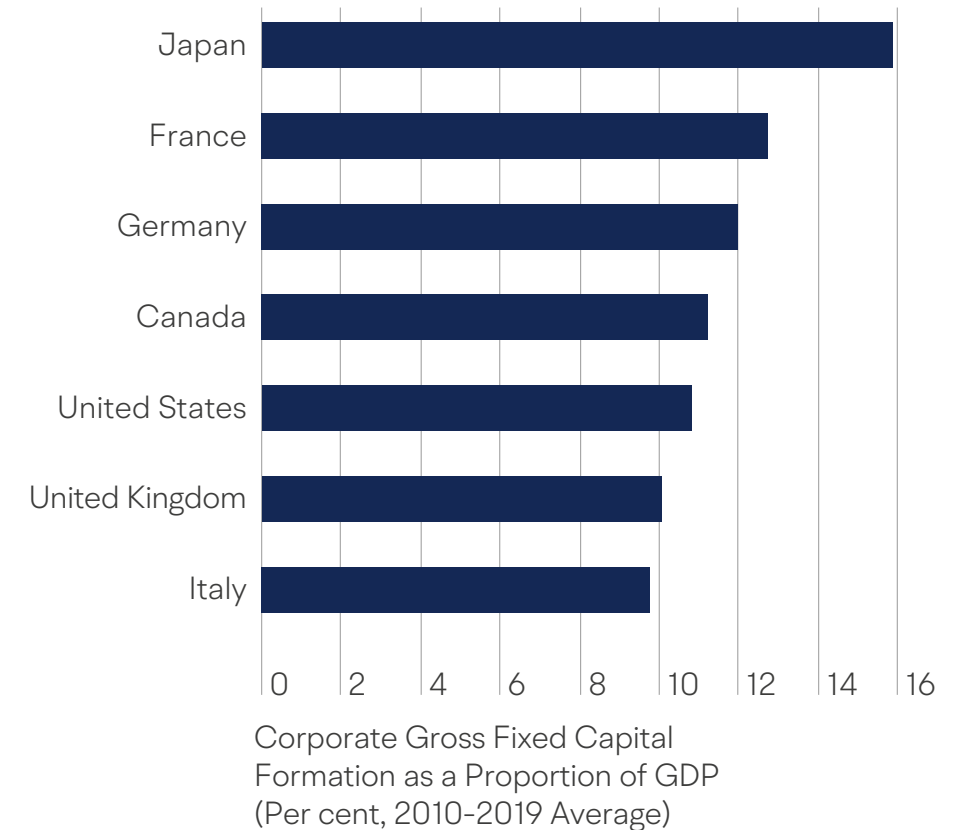
At the business-level, investment can be essential for seizing opportunities and it is equally important at the aggregate level. Government priorities such as enhancing the UK as a scientific superpower, levelling up the UK and accelerating the transition to a net zero economy all require substantial investment to meet the goals being set.

Data from 2019 and before show that the UK has scope to catch up to our peers on this front. Annual UK business investment as a share of GDP has sat close to two percentage points below France and Germany over the past decade (figure A.16). This amounts to billions of pounds of missing investment over the period.

Fig A.16

**Business Investment in the G7**

Source: British Business Bank analysis of OECD data





This missing investment has likely contributed to a disappointing decade of productivity growth across the UK (figure A.17). Although most advanced economies have experienced reduced productivity growth following the financial crisis, international comparisons by the OECD suggest the UK is in the bottom five of the 36 member states for labour productivity performance.<sup>27</sup> This is a finding echoed by the UK-based Enterprise Research Centre whose 2020 State of Small Business Britain report suggested “business dynamism on the eve of the pandemic was much weaker than in the period before the Global Financial Crisis”.<sup>28</sup>

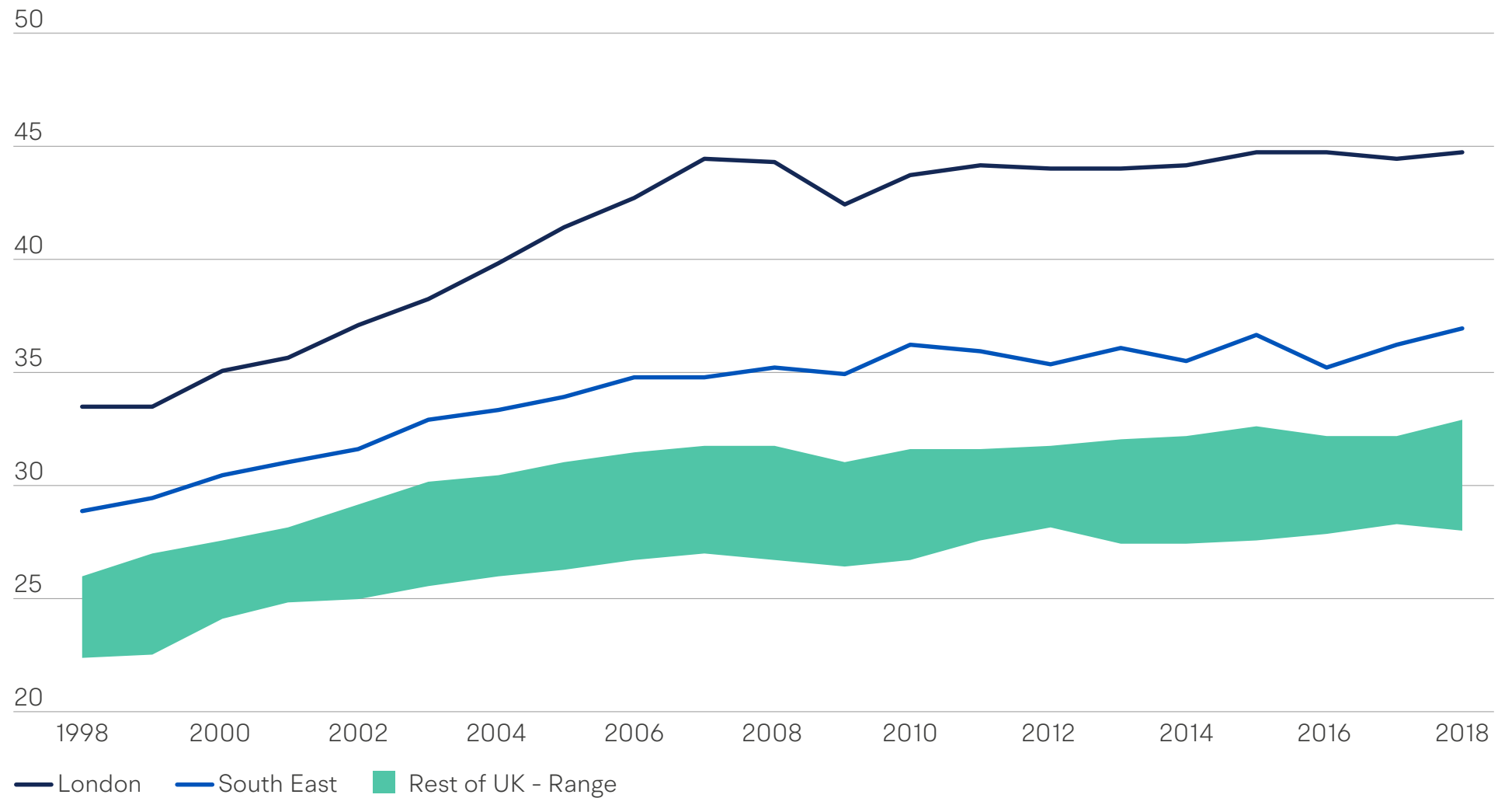
Boosting investment to reinvigorate productivity growth is doubly imperative for the UK. Not only has our national productivity performance been on the lower end of the international scale, the UK continues to have wide regional productivity divergences which have contributed to the UK being regarded as the most inter-regionally unequal advanced economy in the world.<sup>29</sup>

Fig A.17

**Labour Productivity in the UK**

Source: British Business Bank analysis of ONS data

Output per hour (£, 2016 prices)





Beyond improving productivity, an acceleration in business investment would also benefit our scientific and environmental ambitions. Furthermore, it would help businesses seize the opportunities presented by the UK's recently established trade deals with partners all over the globe and the boost to climate protection innovations that COP 26 will bring.<sup>30</sup>

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### **Evidence shows finance can fuel the investment we need**

Making investments in fixed assets and pursuing productivity enhancements are among the top reasons for securing external finance. Whether SMEs are using finance to develop new-to-market innovations or simply adopting the latest innovations in their sector, new equipment, processes and skills can make a meaningful impact to firm-level productivity.

At the top end of that scale, companies at the leading-edge of productivity growth and innovation, the UK is already relatively strong. UK companies in the top decile of the productivity distribution are more than twice as productive as the median UK firm while in France and Germany the ratio of top decile to median productivity is lower at 1.6 and 1.8, respectively.<sup>31</sup> The story changes at the lower end of the scale with the bottom quartile of UK companies operating at just 20% of median productivity compared to 40% for French and German companies.<sup>32</sup>

Taken together, these datapoints imply that the UK's leading-edge companies are further ahead of the middle-ranking firms than equivalent French or German firms, but that our least productive firms are further behind. At both ends of the scale, however, evidence shows how finance can make a difference. For leading-edge companies with global potential, venture capital backing can help companies accelerate away from comparable unbacked companies on several metrics, including productivity.<sup>33</sup>

Companies with slower growth potential can also use finance to boost their productivity. Evidence from the Bank's own programmes confirms this, with high proportions of debt recipients under the Bank's regional funds using their finance for productivity enhancements such as process improvements, staff training and capital equipment.<sup>34</sup>

Finance doesn't just help investment and productivity at the firm level, it can make an impact at the aggregate level too. Leading academics view addressing regional imbalances in finance as part of the solution for narrowing gaps between London and the South East, and the rest of the UK.<sup>35</sup>

The role of finance in facilitating the business investment that drives productivity improvements is mirrored in the environmental and scientific space. External finance can empower businesses to invest in changes that will reduce their environmental impact and it can also fuel the innovating researchers and smaller businesses that develop new technologies, including green solutions, for others to adopt.<sup>36</sup>



We have seen this throughout 2020 with examples across the Bank's portfolio including sustainable energy providers,<sup>37</sup> medical diagnostics companies<sup>38</sup> and digital connectivity providers<sup>39</sup> all using external finance from the Bank and others in ways that will help their businesses and contribute to wider challenges. These examples are only the tip of the iceberg, but they demonstrate how important finance will be in our recovery.

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### **Though the outlook for finance flows is mixed in the short-term, there are reasons for optimism**

Given the role finance plays in addressing economic challenges like levelling up and environmental challenges like climate change, the outlook presented in the previous section warrants further consideration.

Both the demand and supply of finance are predominately focused on working capital and survival at present. This raises doubts over whether we will see the flows of finance needed to stimulate the business investments we require in the very short-term. These doubts are supported by data on investment intentions which remain very weak, even using data collected before the announcement of a national lockdown in January 2021.<sup>40</sup>

Historical experience provides another basis for concern as there is evidence that past recessions trigger reductions in investment and productivity alongside output.<sup>41</sup> The UK's experience following the global financial crisis appears to have followed this path with innovation activity dropping substantially and recovering very slowly.<sup>42</sup> This already appeared to be happening again in 2020 with around four in ten Innovate UK award winners reporting that they had reduced or stopped their research and development activity in the three months to October 2020.<sup>43</sup>

There are, however, reasons for optimism both in the short and longer-term. In the short-term, as noted in chapter 1.1 there are a considerable number of SMEs that hold significant unspent proportions of their BBLS and CBILS facilities. While it is likely that firms in this position will continue to hold some level of precautionary balances it is possible that these firms will increasingly consider using their balances for investment as the vaccination roll-out continues and uncertainty over business prospects gradually recedes. Companies supported through the 1,140 convertible loan notes issued by the Future Fund also offer cause for optimism in the short-term as these companies will have been able to continue their ambitious growth plans towards their next funding round.

Beyond the immediate short-term, causes for optimism increase. Firstly, as the previous section has explained, banks have the capital to lend further and there is improving sentiment among non-bank lenders. Similarly, there is evidence that equity investors remain open to building their portfolios with new investments.<sup>44</sup>



Secondly, the conclusion of a trade and cooperation agreement between the UK and the EU in December 2020 will alleviate one of the key sources of uncertainty that business leaders have faced in recent years. This is likely to have a positive impact on finance demand given the well-documented dampening effect of uncertainty on investment.<sup>45</sup>

Thirdly, there have been a range of pandemic-prompted changes to business practices that could support finance demand during the recovery. There has been a huge expansion of homeworking with upwards of 40% of employees working from home during lockdowns relative to 5% in 2019.<sup>46</sup> Many firms have also adapted their business models and introduced new processes which, alongside enhanced digital capabilities spurred by homeworking, may strengthen the business case for future investments funded through external finance.<sup>47</sup> This dynamic is likely to be further enhanced by the introduction of the super-deduction capital allowance at Budget 2021.

The experience of using finance through BBLS and CBILS could also foster subsequent finance usage among SMEs that may previously have been averse to using finance or lacking in confidence. There is some tentative evidence of such changing attitudes in the Q4 2020 SME Finance Monitor data with 37% of SMEs now happy to use finance to grow, 8 percentage points up from the 2019 figure.<sup>48</sup>

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### **The British Business Bank is committed to using our full suite of activities to help the UK build back better**

The British Business Bank is determined to use our products and expertise to help businesses navigate out of survival mode and into a sustained recovery. Together with government colleagues we are launching a successor to our Covid-19 loan guarantee schemes that will unlock finance for SMEs looking to forge a brighter, greener, more productive future for themselves and for the UK.

The Recovery Loan Scheme will launch on the 6<sup>th</sup> of April and will complement our existing suite of both national and regional programmes and activities. Our diversity of actions helps us make a difference to the UK's economic priorities from multiple angles. Many of our programmes are designed to help at the leading-edge through supporting some of the world's most innovative companies, but we know the UK cannot build back better without every one of our six million SMEs playing a role.

Whether smaller businesses need funding to start up, scale up or stay ahead we will continue to be here for them as we move on from a uniquely challenging period.



1.4

# The importance of and challenges faced by alternative finance providers in 2020

- Since the Global Financial Crisis alternative finance providers have become significant players in traditional finance markets whilst also creating entirely new markets
- Alternative finance providers have been accredited for the government-guaranteed loan schemes, but funding and pricing challenges have limited the involvement of some non-bank lenders



This section covers the role alternative finance providers have played in making UK smaller business finance markets more diverse since the Global Financial Crisis. Most alternative finance providers, with a few notable exceptions, do not compete with the traditional banks but complement their offerings. As such they have not only increased the options available to smaller businesses but have also increased the accessibility and appropriateness of finance available. While this has been beneficial both before and during the Covid-19 pandemic, many non-bank lenders have faced their own challenges during 2020.

### **The smaller business lending landscape has changed substantially since the last Global Financial Crisis**

The smaller business lending landscape has changed substantially since the last financial crisis and the long-perceived wisdom that bigger banks have around 85% of the SME lending market no longer holds.<sup>49</sup> Alternative finance providers, defined as non-bank providers of products such as asset finance, invoice finance, marketplace lending, venture debt and private debt have greatly increased their share of SME finance markets. Furthermore, challenger banks and specialist banks have also eroded the market share of the biggest banks.

This has been achieved not only by attracting businesses traditionally served by high street banks but also by being able to offer services to viable smaller businesses that were previously unable to access funding at all. By 2019, EY estimated 30% of SME finance was being supplied by non-bank lenders.<sup>50</sup>

### **Alternative finance providers are significant players in traditional finance markets while others have created new markets altogether**

Looking at individual finance types we can see the important and varied offerings of alternative finance providers. We have previously estimated that within the asset finance market, the third most used type of finance by SMEs prior to 2020, non-bank lending accounted for around a third of the market in 2019.<sup>51</sup> The Finance and Leasing Association has since confirmed that of the £20.1 billion of new lending provided to SMEs by its members in 2019, £7 billion came from non-bank lenders.<sup>52</sup> In addition, we estimated a further fifth (approximately £2bn) was provided by challenger and specialist banks. Similarly, in the invoice finance and asset-based lending market, a key tool in cashflow constrained times for many, around 20-30% of finance was provided through non-bank lenders in 2019.





Finally, Venture debt funds and Debt funds now play a significant role in supporting growth-orientated companies of all sizes while marketplace lenders lent £2.9bn to SMEs in 2019, around 5% of the Bank of England bank gross lending number.<sup>53</sup> Importantly, marketplace lending is mostly net positive, given the young age of the industry, whereas net bank lending is only a fraction of gross bank lending.

These vibrant and often world-leading UK alternative finance markets, including FinTechs, have attracted significant expertise from the big banks in recent years. They have brought ideas to finance providers that have changed the finance experience for hundreds of thousands of smaller businesses for the better. This is rightly something the UK is proud of and judging by their growing number of business customers this is valued by the smaller business community.

The Bank's work to increase diversity, an original and longstanding objective, has had a very real impact on smaller businesses. As of the 31<sup>st</sup> March 2020, 92.8% of the stock of our finance was supported through non-Big Five banks.<sup>54</sup> Not only has greater diversity

brought new providers and products to the market for those who could not previously get finance from the big banks, but it has also opened up finance to smaller businesses who previously could not get finance at all despite being viable propositions.

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### **Alternative finance providers have been accredited for the government guaranteed loan schemes, but funding and pricing challenges have limited participation**

The Bounce Back Loans Scheme (BBLs) only covers term loans up to £50k with a low fixed interest rate of 2.5%. There are only 28 accredited lenders and within this scheme six are non-bank lenders. In comparison, the Coronavirus Business Interruption Loans Scheme (CBILs), allows lenders greater flexibility on price, covers lending up to £5 million in the form of term loans, overdrafts, invoice finance or asset finance.

As such a larger number and range of finance providers have been accredited to provide these various CBILs products. By the end of 2020 there were over 100 accredited CBILs lenders. Of these, roughly two thirds are non-bank lenders. Despite there being four variants within CBILs, the vast majority (92% by value) of CBILs by the end of 2020 had been written as term loans, predominately providing working capital (84%) or support by way of refinanced existing facilities (8%).

The accreditation of the alternative finance providers, challenger and specialist banks has been particularly important for those smaller businesses that did not have existing relationships with the bigger banks and those who were asking for smaller amounts before the launch of BBLs. This is because larger banks, due to resource constraints and the unprecedented demand, prioritised existing customers and several did not accept applications for CBILs below £25k. Many alternative finance providers were willing and more able to provide finance to eligible applications regardless of existing relationships or the amount requested.



## Funding has proved a challenge for many non-bank lenders, but some have found solutions

While some individual alternative finance providers have written significant CBILS lending volumes, the vast majority of the remaining BBLs and CBILS lending has come from banks. This in part reflects funding and pricing challenges faced by non-bank lenders, which have either prevented them from becoming accredited or limited their capacity to lend via the guaranteed schemes.

Non-bank lenders, unlike banks, do not have access to retail deposits to fund their lending and this is often one of the cheapest forms of funding with limited 3<sup>rd</sup> party restrictions, outside of banking rules, placed on their usage. Wholesale funding facilities from larger financial institutions are most alternative finance providers main source of funding.

When the loan guarantee schemes launched these facilities were restricted by funders, while covenants on existing facilities often limited their use for the guaranteed schemes. This was despite there being significant liquidity within the banking system, and within the larger banks in particular, and the availability of the government guarantees.

Bank contacts initially reported these restrictions were placed on both business-as-usual lending and government-guaranteed lending. The former was driven by concerns around the creditworthiness of SMEs and some of the non-bank lenders themselves as the crisis unfolded. The latter was largely because initially, though this is no longer the case, the government guarantee was not assignable. As such, were lenders to fail, the providers of the wholesale funding facilities would not have been able to directly benefit from the guarantees to recover losses on loans that subsequently default.

For those who have been accredited to lend via the government Covid-19 schemes, to overcome this latter issue, some lenders put forward proposals designed to give their investors comfort that their funding would benefit from the guarantee without the need to transfer the guarantees to them. Often these have involved structured finance techniques, such as equitable assignments or declarations of trust. This has particularly been the case for some marketplace lenders as while they originate the loan, they do not, at least for the greater percentage of lending, use their own funds.

A further funding challenge for non-bank lenders has been the lack of direct access to the Bank of England's Term Funding Scheme with additional incentives for Small and Medium-sized Enterprises (TFSME). The TFSME allows eligible banks and building societies to access four-year funding at rates very close to Bank Rate.

This could have been partly offset by funding from another of the Bank of England's schemes, the Covid Corporate Financing Facility. However, while non-bank lenders may have been allowed to access this scheme, the required scale, complexities and costs of doing so have meant in practice this has not been a widely used option either.

The lack of access to the cheaper funding available to banks via the Bank of England has been raised by numerous industry participants and commentators, with EY estimating at the start of the crisis that, without government or Bank of England support, specialist SME funding could drop by more than 50% within weeks.<sup>55,56</sup> If alternative finance providers are to play their role to the fullest in supporting SMEs during future crises a solution to level this particular funding playing field will be required.



### **Pricing has also limited the involvement of some non-bank lenders**

BBLS provides term loans with a set interest rate of 2.5% per annum. This limit was put in place to ensure availability to as many smaller businesses in need of finance as possible and as a result has had a significantly positive impact on the supply of SME finance during the pandemic. However, the scheme has been beyond reach for most non-bank lenders as the rate is below the combined cost of funding and other costs they incur, to be able to operate the scheme viably.

For CBILS, some finance providers have not become accredited due to the need for a case-by-case government approval for any applicant wishing to charge more than 14.99% per annum for fees and interest. Some business models offer finance above this rate due to either the risk profile of the businesses they lend to, and the additional costs associated with underwriting and funding such lending, or the additional flexibility offered by the product.

### **Alternative finance providers have lost some customers to government guarantee schemes, but many have adapted**

Bank and non-bank finance providers alike have been supporting their existing borrowers. For example, there have been numerous reports of receiving and accepting requests for payments holidays which have been a great help for many SMEs. However, along with potential defaults, this can be a challenge for lenders, impacting their own revenue and cashflow. On top of this, many alternative finance providers have seen their target markets almost exclusively served by government-guaranteed lending since the introduction of BBILS and CBILS.

Most alternative finance providers do not compete with traditional lenders such as the high street banks and instead target niche or specialist markets including, for example, lower value business loans across a range of products. Larger, traditional lenders have not only restricted lower value loans via CBILS but have had limited offerings in this space since the financial crisis, often citing the fixed costs of due diligence as a barrier.

Alternative finance providers had been very active in this space in recent years. However, the introduction of BBLS with its lower limit of £2k, streamlined application and 100% guarantee has meant that accredited bank lenders have funded the majority of lending under £50k in 2020. This has included the larger traditional lenders who had previously vacated this area of the market.

While data split by loan value is limited, especially for alternative finance providers, one indicator that shows this impact is the average loan size funded via the government's Bank Referral Scheme (BRS). The BRS offers SME's who were unsuccessful in getting the finance they requested from a designated bank the opportunity to be referred to three finance platforms who attempt to match them with their finance provider panels. These panels are almost exclusively made up of alternative finance providers.

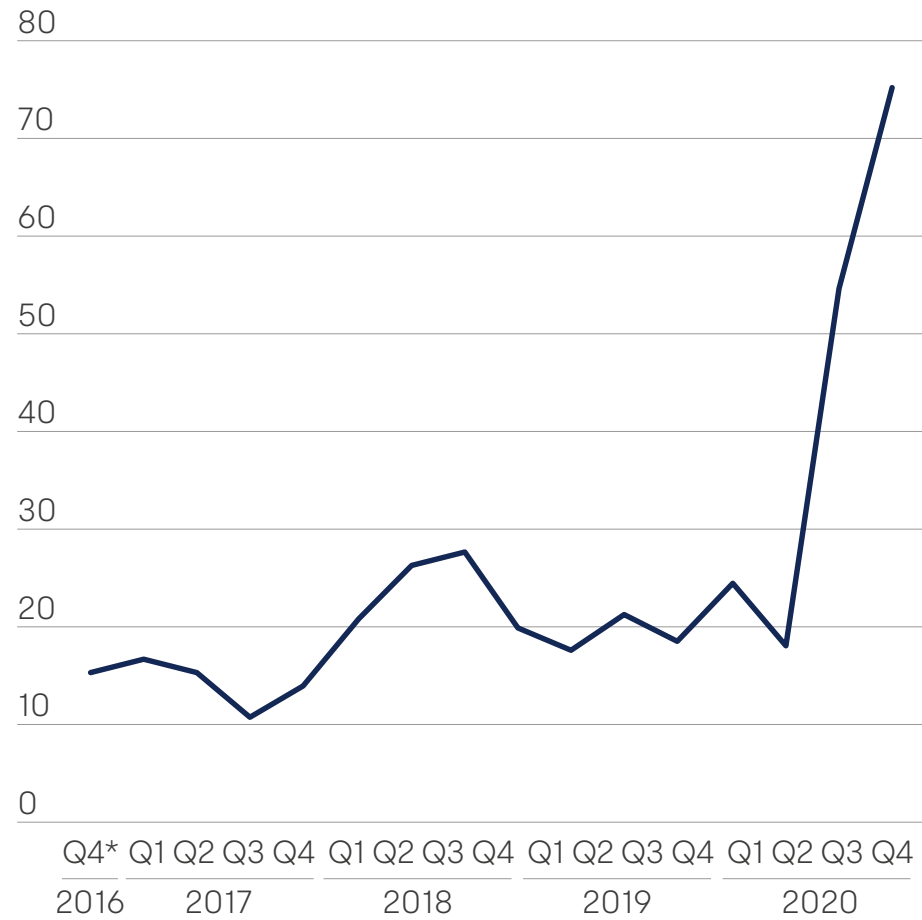
Prior to the onset of Covid-19, the average loan size was around £20k with the highest quarterly average recorded being £27k (Q3 2018). In Q2 2020, the number of deals dropped significantly and the average loan value leapt to £54k. In Q3, probably reflecting that BBLS was introduced later than CBILS and would not have impacted the Q2 lending to the same degree, the average loan size jumped again to £75k (figure A.18).



Fig A.18  
**Average Bank Referral Scheme deal size**

Source: HM Treasury

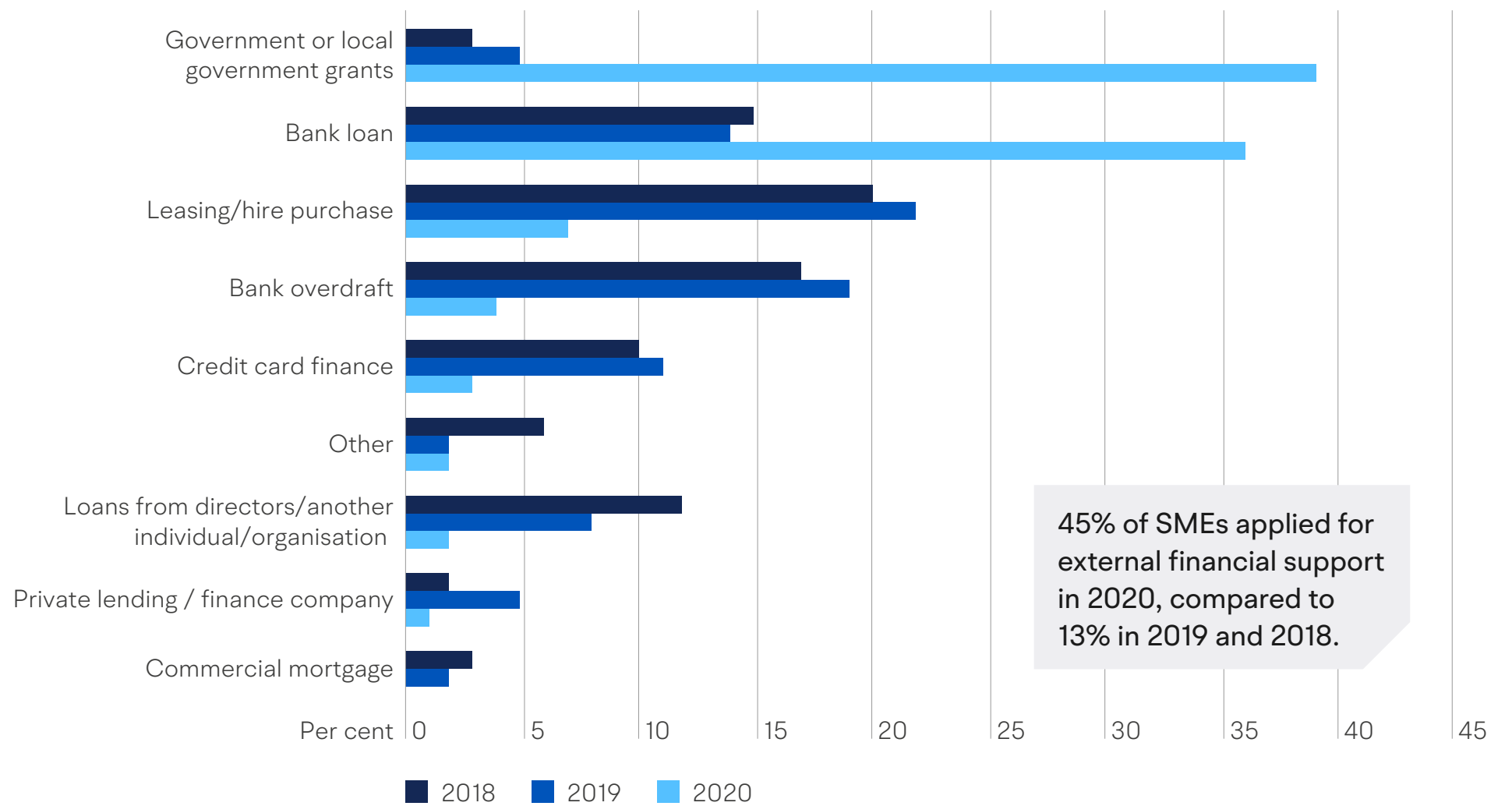
£ thousands



\*Q4 2016 covers only 2 months, November and December due to the scheme going live November 1st 2016.

Fig A.19  
**Financial support sought on last occasion by SMEs, percentage of SMEs who applied for financial support in the last 3 years**

Source: Business Finance Survey 2020



45% of SMEs applied for external financial support in 2020, compared to 13% in 2019 and 2018.



A second impact we can see is that, due to the simplicity, covered interest payments for the first 12 months and pricing of both BBILS and CBILS, many smaller businesses appear to have chosen them over other finance products, such as asset finance. Furthermore, in some cases BBLS and CBILS have been used to pay down existing finance. This can be seen in the latest SME Finance Monitor and in our Business Finance Survey where the use of bank lending has increased dramatically and become the most sought after repayable finance type in 2020 (figure A.19).<sup>57</sup>

The result has been that when combined with the funding challenges many non-banks have faced, the government support schemes and lower business investment, many SME finance markets have experienced reduced year-on-year lending volumes in 2020. In most cases these are the first reductions in lending volumes since the financial crisis and represent an erosion of the client bases built up before the pandemic (see Part B).

Some alternative finance providers have chosen to consolidate and manage their existing customers, but others have adapted or evolved. Reports suggest many providers have hastened their digital offerings and improved internal systems. Others have diversified their product lines, both within and outside government-guarantee schemes.

What this means for alternative finance providers will vary considerably, and to some extent upon the continuing appetite of financial institutions to provide funding outside of the government-guaranteed schemes. Some will emerge stronger having adapted, extended themselves operationally, gained new customers or greater exposure to potential investors. Others may face more challenging times to come, whether they have yet to scale in the same way or perhaps find they will need to scale back. One way or another they will now be able to answer the question many have been asking of the newer providers and business models: how will they hold up through a complete credit cycle?



**Part B**

**Market  
developments**





## 2.1

# Macro-economic developments

- The UK economy went into recession in 2020 as the Covid-19 pandemic led to restrictions throughout the year
- The pandemic has caused significant job losses, but it would have been worse without the government support schemes
- Business investment fell as cashflow became key
- Forecasts suggest GDP will not return to pre-pandemic levels until 2022 and unemployment will increase significantly in 2021
- SME confidence surveys recorded new lows in 2020 and remain downbeat
- Credit conditions have tightened for some sectors, particularly those most exposed to the impact of the pandemic
- The trade agreement with the EU has reduced uncertainty for many



**The UK economy went into recession in 2020 as the Covid-19 pandemic led to public health restrictions throughout the year**

2020 began and ended with the UK leaving the EU and then exiting the transition period with a trade deal, but the Covid-19 pandemic dominated economic events for most the year.

The UK entered lockdown after the first wave of Covid-19 infections hit in late Q1. As a result, 2020 has seen several unwanted economic records broken and the UK government unveil the most significant package of peacetime interventions of this or any generation (see chapter 1.1 for more detail on the support packages).

With Brexit related uncertainties as we entered the EU exit transition year weighing on business confidence and investment, the UK economy was already somewhat on the backfoot. In Q1, as the first direct effects of the Covid-19 pandemic, and the government measures taken to reduce transmission of the virus started to impact the economy, GDP contracted by 3.0%. This was one of the largest falls in GDP in recent times and larger than any quarter-on-quarter fall seen during the financial crisis (figure B.1).

Fig B.1  
**UK Headline GDP, quarter on quarter to Q1**

Source: ONS

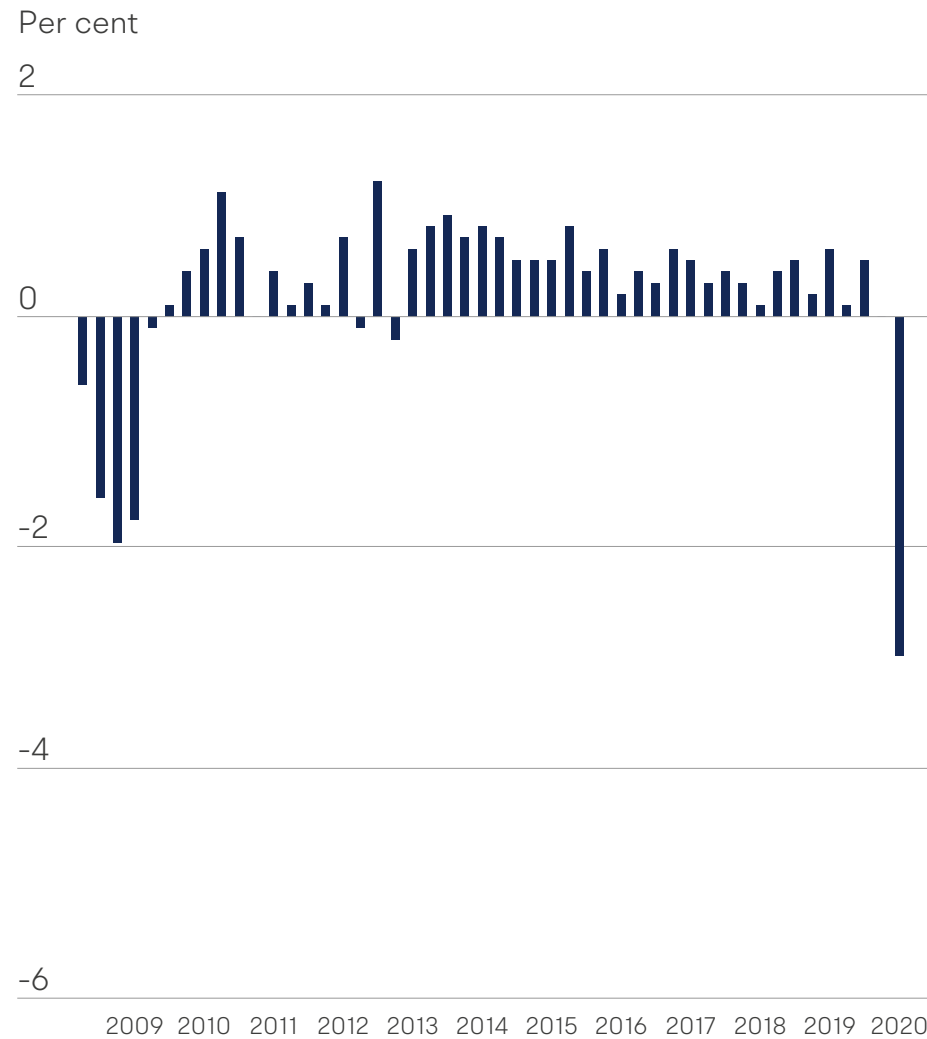
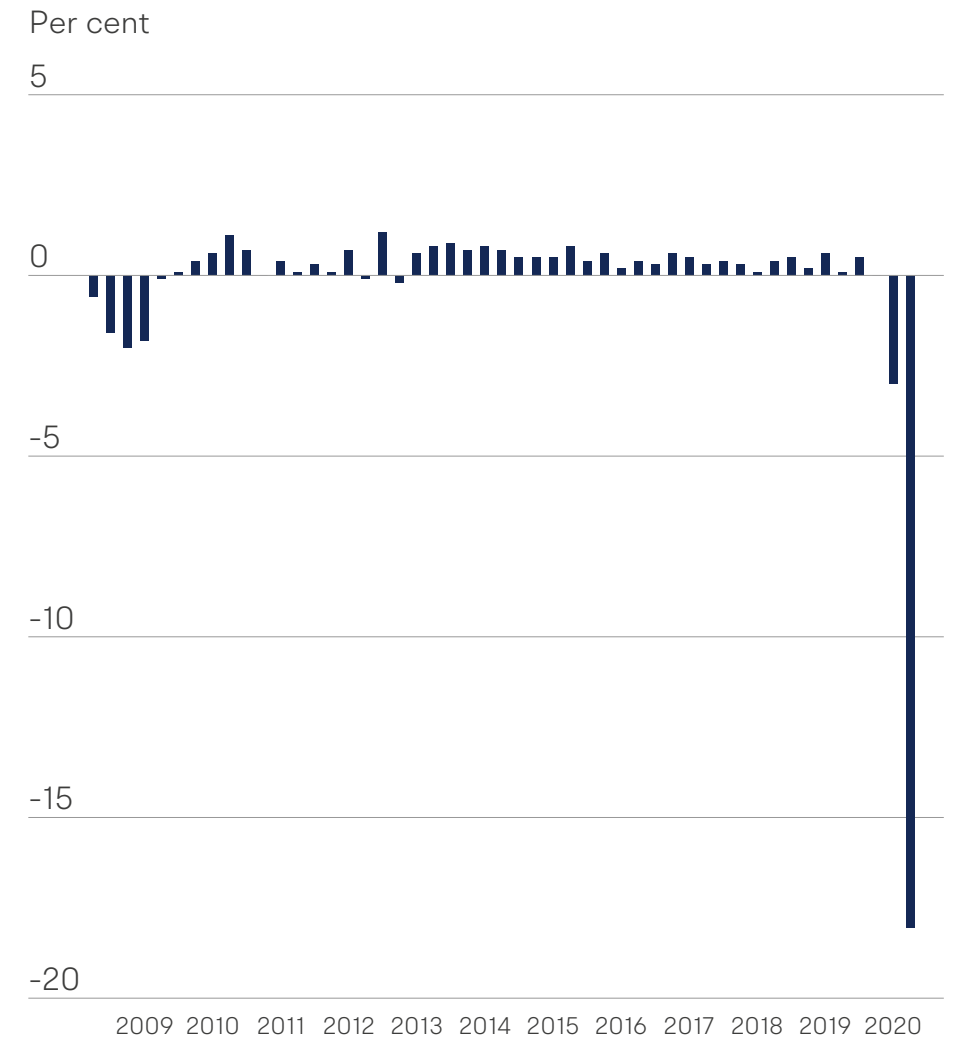


Fig B.2  
**UK Headline GDP, quarter on quarter to Q2**

Source: ONS







This was soon to be eclipsed. When the UK went into lockdown in the second half of March the impact on the economy was immediate. National output dropped by almost a fifth in April. By the end of Q2 GDP had fallen by 18.8%, with the UK officially in recession (figure B.2). This is the largest quarterly contraction in the UK economy since Office for National Statistics (ONS) quarterly records began in 1955.

With lockdown easing later in Q2 the economy began to recover. UK GDP is estimated to have increased by 16.0% in Q3 2020, a record itself. Despite a second successive quarter of growth in Q4 (1.0%), the level of GDP in the UK remained 7.8% below where it was at the end of 2019. Over the year 2020 as a whole, GDP contracted by 9.9%, marking the largest annual fall in UK GDP on record.

The Q4 data suggests the November UK lockdown did not have the same impact on GDP as the first one. This partly reflected that more of the economy remained open than did during the first lockdown, either due to looser restrictions or via learning from the first lockdown and finding a way to continue trading. Furthermore, less of the workforce was on furlough or looking after housebound school children.

There were additional factors too. Firstly, there was a delay between the announcement and enactment of the lockdown meaning people could bring forward spending, possibly with Christmas in mind, and businesses could better prepare. Finally, with negotiations going down to the wire with the EU, there was something of a repeat of 2019 with some firms stockpiling in case a no-deal outcome significantly impacted supply.

### **The pandemic has caused significant job losses, but it would have been worse without the government support schemes**

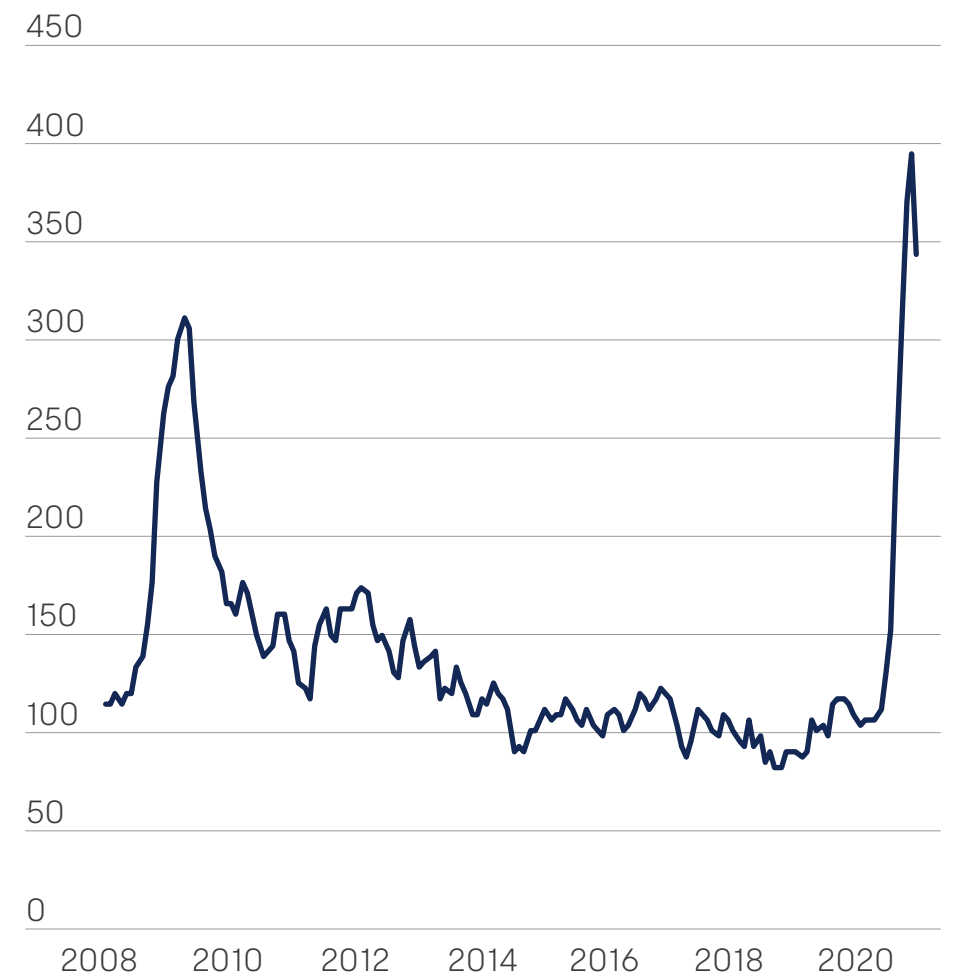
With much of the economy in lockdown at various points through 2020 and reduced economic activity in general, job losses have been significant. Early estimates for December 2020 suggest that since February 2020, the number of payroll employees has fallen by 809,000. Despite the fact that larger output falls were seen at the start of the Covid-19 pandemic, the number of redundancies reached a record high (395,000) in September to November 2020 before falling back slightly at the end of the year (figure B.3).

Fig B.3

### **The number of people reporting being made redundant in the three previous months**

Source: ONS Labour market overview, UK: February 2021

Redundancies, thousands





During the three months to December, the UK employment rate was estimated at 75.0%, 1.5 percentage points lower than a year earlier and 0.3 percentage points lower than Q3. The UK unemployment rate in Q4 was estimated at 5.1%, 1.3 percentage points higher than a year earlier and 0.4 percentage points higher than Q3.

Throughout the year, unemployment would have almost certainly been higher had it not been for government support and most notably the Coronavirus Job Retention Scheme (CJRS). In March, to support employers and reduce the number of job losses, the government introduced the CJRS which paid 80% of forgone wages, capped at £2500 per month, for staff placed on furlough.

At its peak in May, 30% of the workforce across the UK were furloughed. Since then, the number of people temporarily away from work has fallen despite subsequent lockdowns and the extensions to the CJRS as staff have either returned to work or left permanently.

Despite the falling employment rate, annual growth in employee pay continued to strengthen as more employees returned to work from furlough, but the

estimated growth in average pay was also driven by the compositional effects of a fall in the number and proportion of lower-paid employee jobs. This likely reflects that lower-paid jobs are prevalent in some of the sectors most impacted by Covid-19 and the lockdowns such as retail and hospitality.

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### **Business investment fell as cashflow became key**

After a largely flat start to the year, quarter on quarter business investment fell by 22.1%, in volume terms, in Q2 2020, the largest quarterly fall on record. The driver of this fall was the increased economic uncertainty created by Covid-19 leading to many companies switching from investment to survival mode, utilising available funds for cashflow. By comparison, the largest fall in business investment during the 2008 global economic downturn was 9.6%.

Business investment did bounce back somewhat in Q3, 14.5% in volume terms, the largest quarterly increase on record. Despite a further increase of 1.3% in Q4, business investment fell 10.7% between 2019 and 2020.

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### **Forecasts suggest GDP will not return to pre-pandemic levels until 2022 and unemployment will increase significantly in 2021**

The latest OBR forecast expects GDP to grow by 4% in 2021 and to regain its pre-pandemic level in the second quarter of 2022, six months earlier than forecast in November. Unemployment is expected to peak at 6.5% at the end of 2021, but the peak is less than the 7.5% assumed in the previous forecast, thanks partly to the latest extension of the CJRS.

The OBR's expectation that real GDP recovers to its pre-virus level by the middle of 2022 is still slower than the February 2021 Bank of England forecast. In the MPC's central projection, GDP reaches its 2019 Q4 level in 2022 Q1. Despite the quicker recovery, unemployment is elevated in the Bank of England's forecast, peaking at around 7¾% in the middle of 2021, before declining gradually over the forecast period. However, this forecast was published before the extension of the CJRS was announced.



The OBR forecast has a further decline in business investment of 9.5% in the first quarter of 2021, in part due to the national lockdown. It is then expected to gradually recover as the impacts of the pandemic and Brexit recede.

While the higher levels of debt some businesses are now carrying is expected to weigh on spending, the large temporary uplift to capital allowances announced in the Budget should boost investment spending materially in the first half of the forecast. Despite this, business investment is expected to fall 2.2% in 2021. The forecast returns to positive territory in 2022 (16.6%), with business investment reaching its pre-virus peak in the first half of 2022.

### SME confidence surveys recorded new lows in 2020 and remain downbeat

In Q4, the FSB Small Business Index (SBI) confidence measure stood at -49.3, down 27 points year-on-year. The reading is the second lowest in SBI history, second only to that recorded in Q1 2020 (figure B.4). The vast majority of those surveyed in Q4 (80%) did not expect their performance to improve over the next three months. 58% actually expected profits to fall in the next three months, a record high.

This was corroborated by our Business Finance Survey conducted during the Autumn which found that 58% of SMEs had falling turnover and only 9% had grown over the previous 12 months. Looking ahead, only 21% of SMEs expected to grow in the coming 12 months.

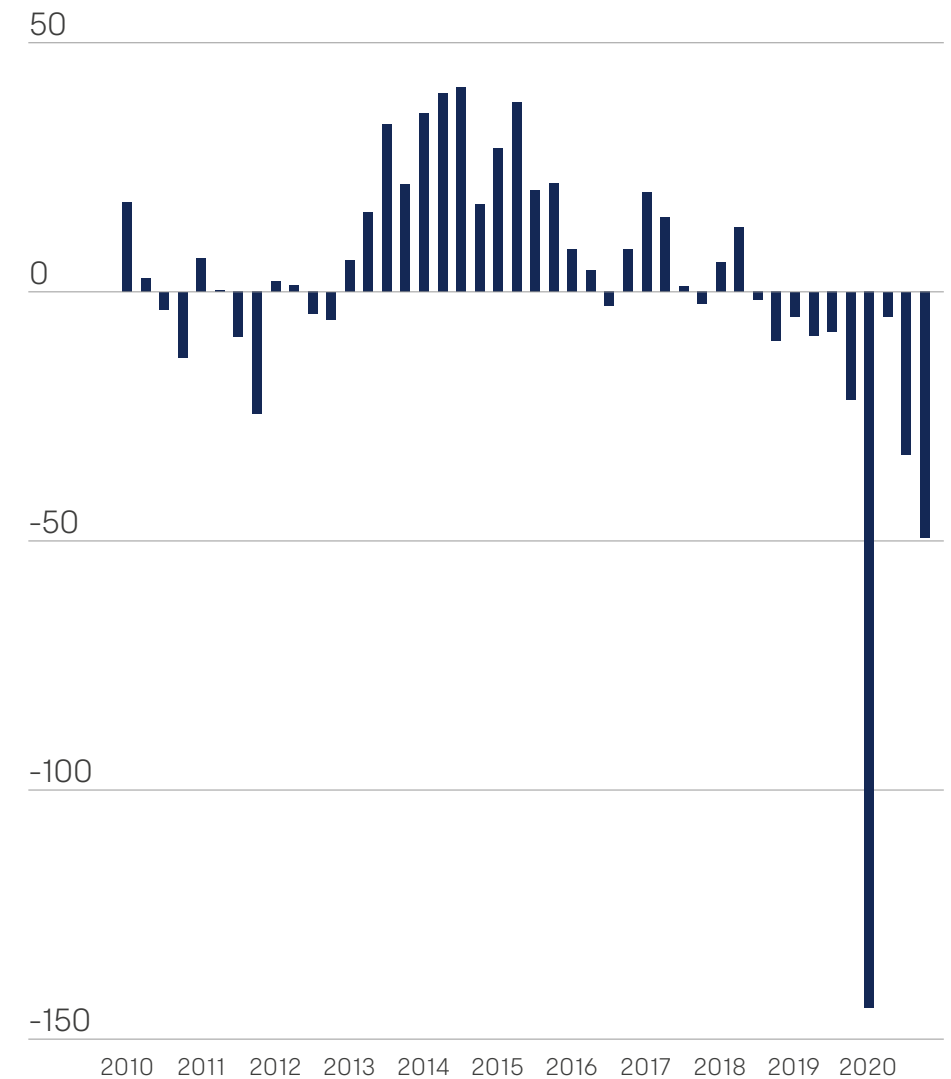
Furthermore, while SME manufacturing output stabilised in the three months to January, the expectation was for a decline in the coming quarter (Q1 2021) for the first time since April 2020, according to the CBI’s quarterly SME Trends survey. Output in the three months to January was down 2%, this followed a fall of 15% in October and July’s record decline of 53%.

The CBI also found investment intentions for the year ahead remained weak, with SME manufacturers set to cut back capital expenditure on buildings and plant and machinery, albeit to a lesser extent than in 2020. Orders or sales continued to be the key factor limiting output, while uncertainty around demand remained the leading factor limiting capital expenditure. Concerns around the availability of materials and components (+37%) rose to the highest on record at the end of 2020.

Fig B.4

### FSB Small Business Index, business confidence

Source: FSB Small Business index Q4





Perhaps more worryingly, the SBI, conducted in late December and before the third lockdown, showed that 5% of small businesses plan to close in the coming 12 months. This is the highest since the index began in 2010 and more than double that in Q4 2019.

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### **Credit conditions have tightened for some sectors, particularly those most exposed to the impact of the pandemic**

As the pandemic started to impact businesses Bank of England contacts reported that some banks were tightening lending conditions on new borrowers across all sectors.<sup>58</sup> Unsurprisingly, with high demand for finance, and in particular cashflow finance, some banks were said to be taking longer to approve loans due to the high volume of applications. There were only a few reports of banks withdrawing existing facilities, but some contacts reported that banks were reluctant to renew revolving credit facilities.

For the middle part of the year, with the majority of 2020 lending being supplied via the government guaranteed loan schemes, many finance providers offered flexibility on covenants, payment holidays and rolling over of

existing facilities. However, banks were reported to be wary of increasing their own exposure by extending new loans to companies in vulnerable sectors.<sup>59</sup>

By Q4, the Bank of England's Agents summary noted a reported increase in demand from smaller businesses. However, it also noted reports of bank credit conditions tightening again, particularly in sectors that had been most affected by the pandemic, and where insolvencies were expected to rise. Contacts thought credit demand could rise further in the coming quarters as deferred payments, such as rent and tax, fall due in the first six months of 2021.

Throughout the year there were also reports of trade credit insurance being withdrawn or reduced. As the year progressed the Bank of England's Agents reports became more specific, noting restrictions on those sectors most impacted by the pandemic. For example, in Q3 the casual dining and construction sectors were finding it hardest to access trade credit, but the report also noted that while the availability of new cover was constrained, this was less the case for companies that could demonstrate strong cash flow.

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### **The trade agreement with the EU has reduced uncertainty for many**

Despite the Covid-19 pandemic, the ongoing economic uncertainty, in part caused by UK-EU negotiations, was a concern for many SMEs throughout 2020.<sup>60</sup> Sentiment fluctuated as hopes of a deal rose and fell throughout the year before the agreement brought some clarity, albeit it with limited time to digest the consequences for UK smaller businesses ahead of the transition period ending.

While the agreement allows for tariff and quota free trade for the majority of goods there are some new non-tariff barriers to trading with the EU and indeed Northern Ireland. Furthermore, the picture is still unclear for services, the declarations released in late December included an agreement to try and reach a memorandum of understanding on services by March 2021.

It is too soon to understand what the full implications of the deal will be for smaller businesses. As with the Covid-19 pandemic, the implementation of the deal will continue to impact businesses for some time to come, but with the vaccine rollout well underway and the trade deal agreed both should give smaller businesses a firmer footing to move forward in 2021.

## 2.2

# SME business population

- The UK business population increased to 6 million firms at the start of 2020, driven by growth in zero employee firms
- VAT data suggest there was a temporary dip in business formation during 2020
- Insolvency rates remain low as a result of government support, but redundancy notification volumes show the scale of the challenges businesses have faced





### The UK business population increased to 6 million firms at the start of 2020, driven by growth in zero employee firms

According to BEIS business populations estimates, there were 6 million private sector businesses in the UK at the start of 2020, an increase of 1.9% on 2019. This is slower than the 2.3% average annual growth rate recorded over the previous 5 years. Moreover, it is also important to note that these estimates do not factor in any impacts of Covid-19 on the business population throughout 2020 (Figure B.5).<sup>61</sup>

Zero employee firms accounted for 4.6 million or 76% of the total business population and 1.4 million firms (24%) were employers, proportions that have remained fairly constant since 2014. These employers were comprised of: 1.2 million micro firms (1-9 employees), 0.2 million small firms (10-49 employees), 36,100 medium-sized firms (50-249 employees); and 7,800 large firms (250 or more employees).

Growth in the stock of businesses continues to be driven by firms with no employees, the majority of which are unregistered.<sup>62</sup> In the year to 2020, zero employee firms grew by 2.5%. This was considerably higher than the rate for firms with employees which fell to 0.2%, the lowest growth since the number of employers decreased in 2013. This has been a long-term trend, with 2018 the only year in recent times where employers have had the higher growth rate. Over the preceding five years, the average annual growth rate for zero employee firms was 2.4% compared to 2% for employers (Figure B.6).

Amongst employers, micro firms (1-9 employees) and small firms (10-49 employees), which comprised 82% and 15% of private sector employers respectively, recorded the slowest annual growth rates of just 0.1% and 0.2% in the year to 2020. Medium-sized firms (50-249 employees) and large firms (250 or more employees), which collectively comprised just over 3% of private sector employers, recorded higher growth rates of 1.4% and 1.3% respectively. For all size cohorts the growth rates in 2020 were below those seen in 2019 and below the average of annual growth rates reported in the previous five years (Figure B.7).

Fig B.5  
**UK business population, 2011 to 2020**

Source: BEIS Business population estimates 2020

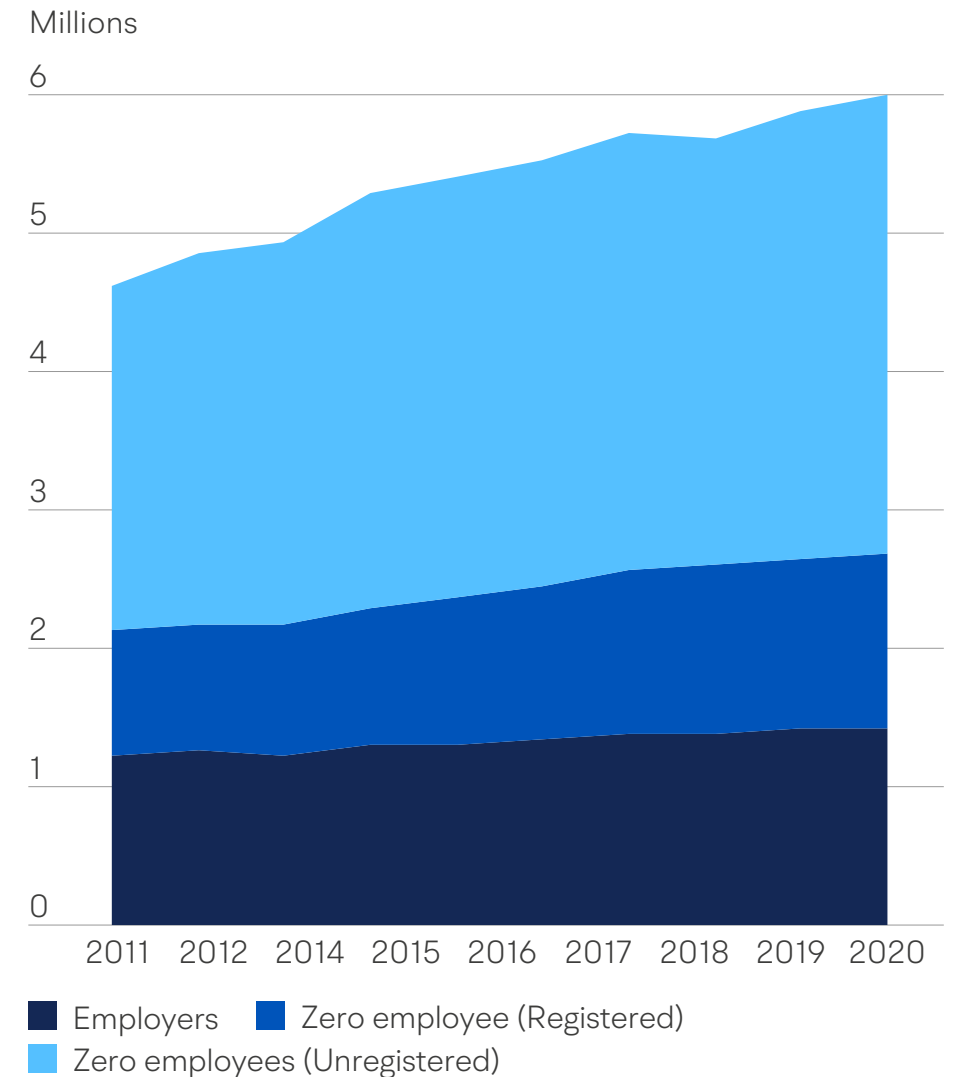




Fig B.6  
**UK business population, number of firms and growth**

Source: BEIS Business population estimates 2020

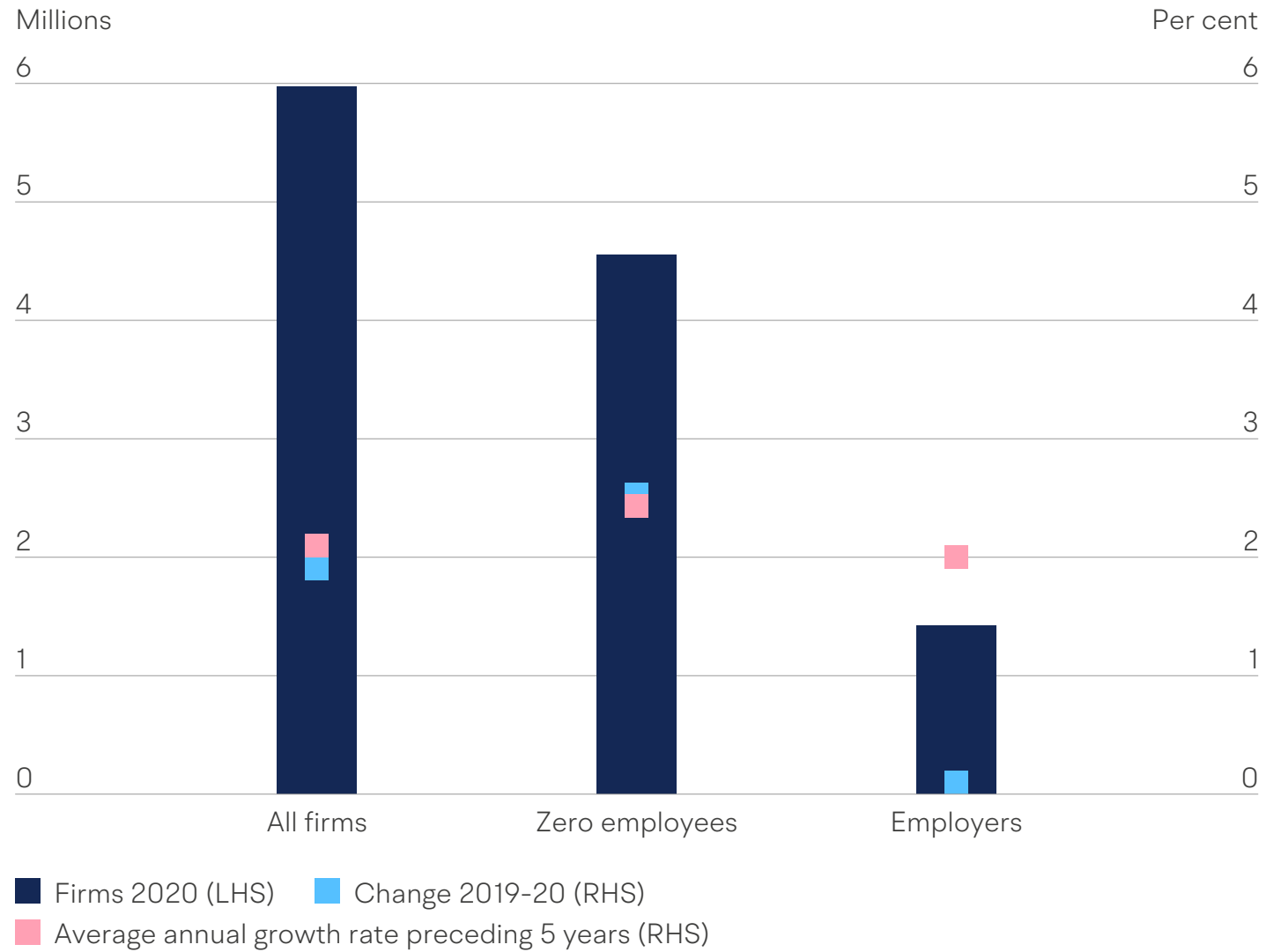
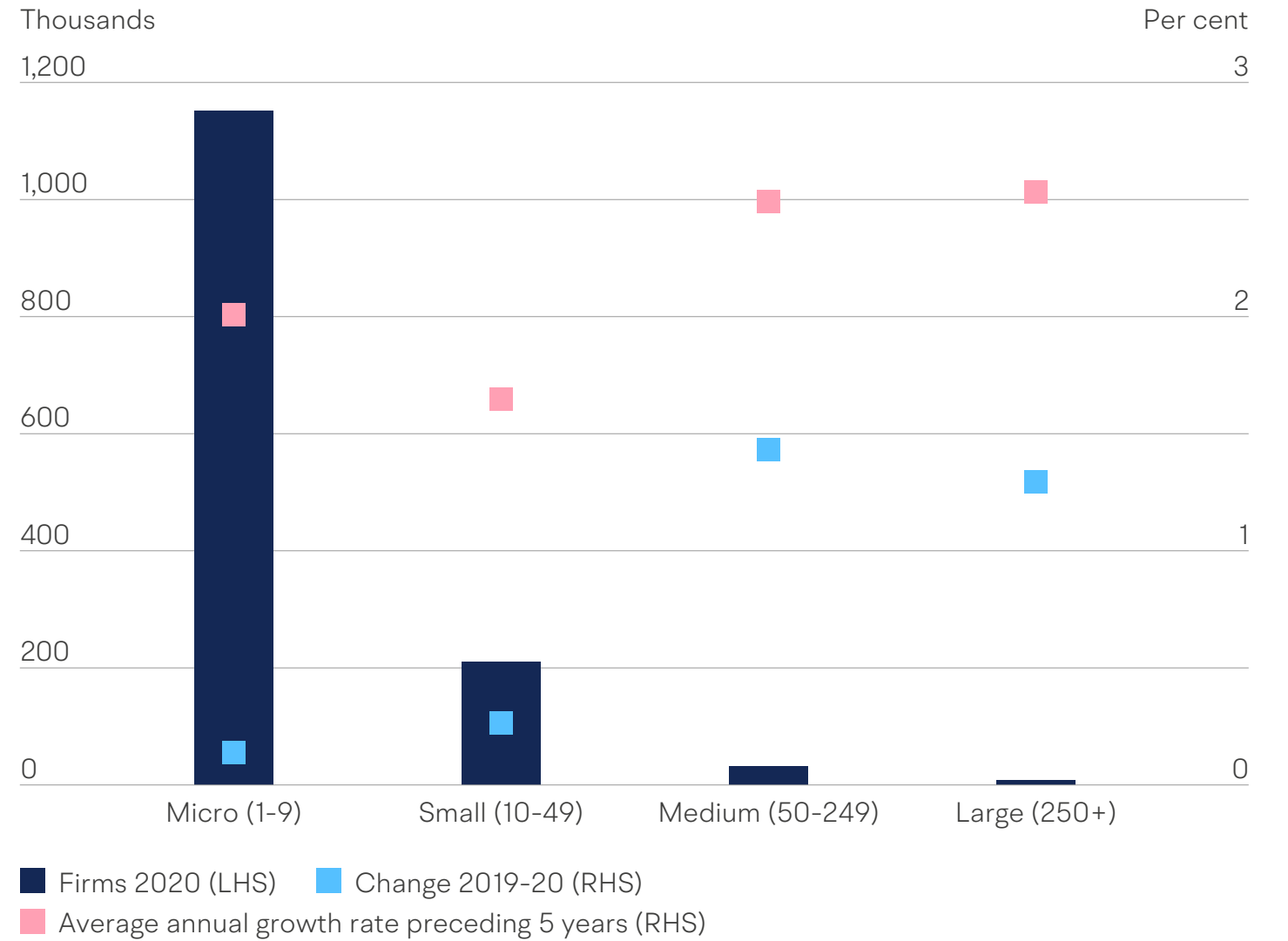


Fig B.7  
**UK employers, number of firms and growth**

Source: BEIS Business population estimates 2020





### VAT data suggest there was a temporary dip in business formation during 2020

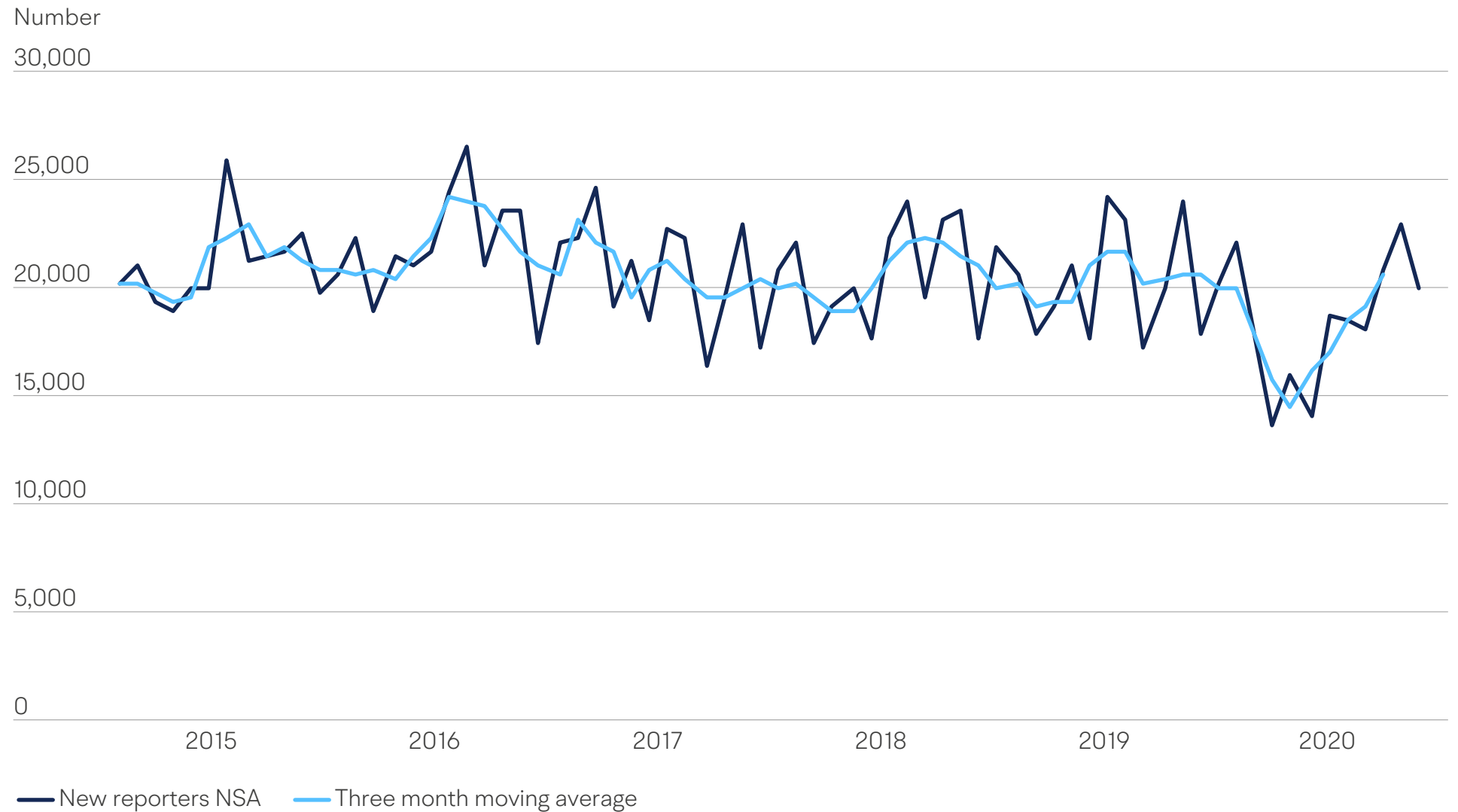
The ONS publishes the number of firms reporting for VAT for the first time. While not a comprehensive measure of start-up activity, given some firms register for VAT upon starting while others may wait until reaching the mandatory registration annual turnover threshold of £85,000, it is a useful indicator of enterprise creation.

The data point to a dip in activity in Q2 2020 although, by the start of Q4, the number of new VAT reporters had recovered to a level roughly consistent with the average reported for this data series since 2015 (Fig B.8).<sup>63</sup>

Fig B.8

### UK new VAT reporters

Source: ONS, Coronavirus and the latest indicators for the UK economy and society







**Insolvency rates remain low as a result of government support, but redundancy notification volumes show the scale of the challenges businesses have faced**

Company incorporation and dissolution statistics also go beyond the start of 2020, shedding some light on business dynamics following the onset of the Covid-19 pandemic. The data show that incorporations dipped sharply during lockdown, but since May 2020 have tracked above 2019 levels (Figure B.9).<sup>64</sup> Voluntary dissolutions have generally been marginally below 2019 levels, likely driven by the range and scale of enhanced government financial support for companies and individuals.

Data from the Insolvency Service paint a similar picture with the number of company insolvencies in 2020 lower than in the previous year (Figure B.10). The Insolvency Service report this trend is “at least partly driven by government measures put in place in response to the coronavirus pandemic” alongside limitations imposed on court proceedings, and reduced HMRC enforcement activity, following the implementation of UK lockdown from 23 March 2020. Whilst there was a rise in the

Fig B.9  
**Weekly UK company incorporations and voluntary dissolutions**

Source: ONS, Coronavirus and the latest indicators for the UK economy and society

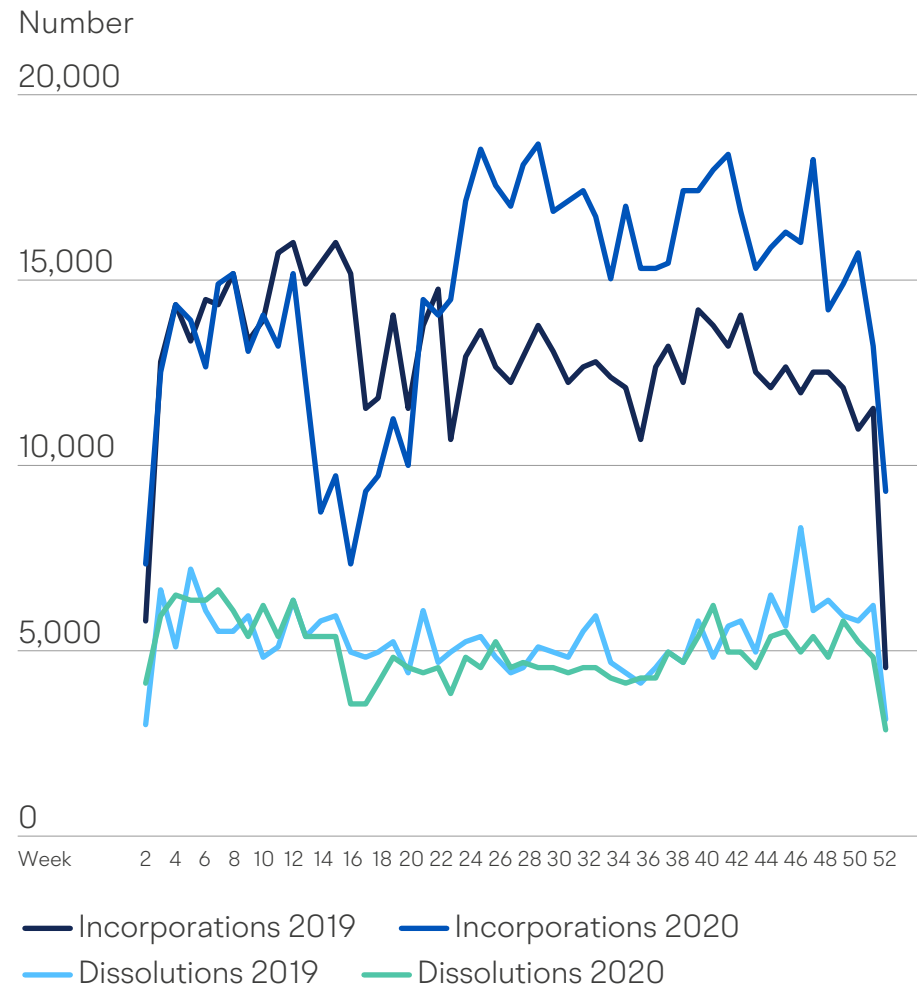


Fig B.10  
**UK company insolvencies**

Source: The Insolvency Service





absolute numbers of company insolvencies between to Q4 2020, they remain lower than Q4 2019.<sup>65</sup>

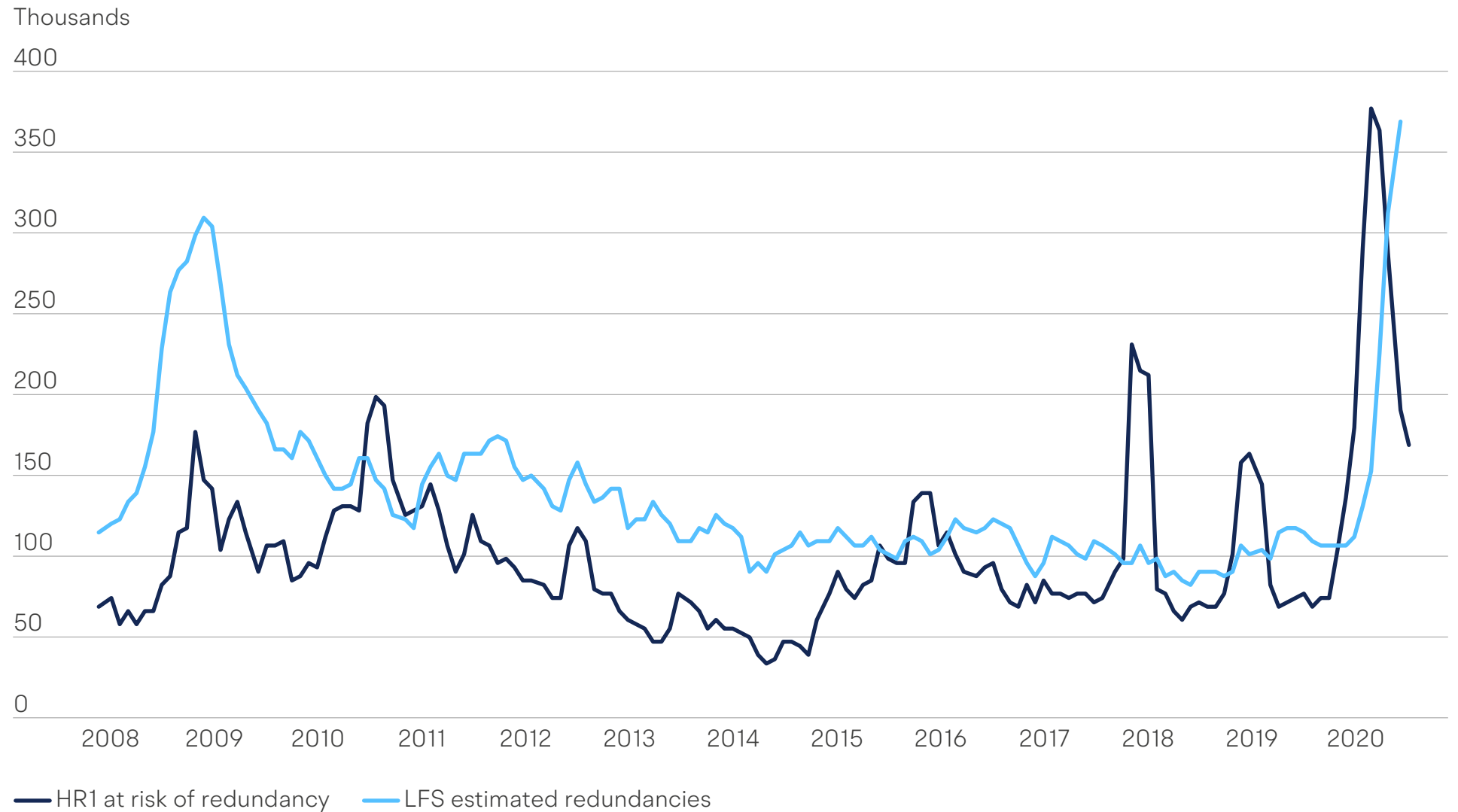
While government support has helped businesses survive 2020, it is apparent when looking at the level of notified redundancies in official returns to the Insolvency Service this does not tell the full story. In contrast to the relatively benign profile for insolvencies, redundancy notifications rose to elevated levels through much of the year.<sup>66</sup> Analysis by the Institute for Employment Studies showed that the level of employer notified redundancies in 2020 was substantially above that witnessed in 2008-2009 (Figure B.11).<sup>67</sup>

These timelier data would suggest the true impact of the Covid-19 pandemic on the business population has not been seen yet. Furthermore, given the 2021 BEIS business population estimates to be published later this year are a snapshot taken at the start of 2021 and with multiple government support schemes still active, we may not start to see the impact in the official business statistics until the 2022 figures are released.

Fig B.11

**GB employees at risk of redundancy and estimated redundancies**

Source: The Insolvency Service, Labour Force Survey (LFS)



## 2.3

# Use of external finance

- More than two in five (44%) SMEs were using external finance in Q4 2020 and just one third (32%) were Permanent non-borrowers
- The proportion of SMEs using loans almost doubled in 2020
- Many smaller businesses rely on established relationships when considering finance options
- Over a third (37%) of SMEs currently use trade credit, reducing the need for external finance for some businesses





This section highlights current usage of external finance, attitudes to finance and trends in debt applications during the pandemic. It draws on data from BVA BDRC's SME Finance Monitor, the British Business Bank's Business Finance Survey and the ERC's Business Futures Survey. External finance covers a wide range of products including overdrafts, credit cards, bank loans, commercial mortgages, leasing or hire purchase, loans or equity from family and friends or directors, invoice finance, grants, loans from other third parties, export or import finance, crowd funding, asset-based lending, or any other loan or overdraft facility and government or local authority finance. This definition excludes trade credit, which is discussed separately at the end of the chapter.

### **More than two in five (44%) SMEs were using external finance in Q4 2020 and just one third (32%) were Permanent non-borrowers**

More than two in five (44%) smaller businesses were currently using external finance in Q4 2020, a significant increase from 31% in the first half of 2020, which was the lowest level since the launch of the SME Finance Monitor survey in 2011. In the same quarter the number of 'Permanent non-borrowers' (PNBs)<sup>68</sup> declined to 32%, the lowest figure since the start of the survey (figure B.12). A further one in four (24%) small businesses, that are not currently borrowers, are not entirely averse to using external finance, down from a peak of 29% in Q2 2020.

Working capital, to cover short-term funding gaps or to help during the often difficult trading conditions, was the dominant driver of funding needs in 2020, with many smaller businesses facing heightened cashflow issues because of the Covid-19 pandemic. Of those identifying a need for funding, 78% said cashflow support was the driver in 2020, up from 49% in 2019, with a peak of 91% in Q3.<sup>69</sup>

This can also be seen in our Business Finance Survey. Nine in ten respondents (89%) said they were seeking finance in the past year because of the impact of Covid-19. Of those, 75% said it was to help with cashflow.

The increase in the use of finance over the second half of 2020 was seen most prominently in smaller businesses (those with fewer than 10 employees). The share of zero employee businesses and those with 1-9 employees using finance rose to 39% and 55% respectively in Q4 2020, from 25% and 45% in Q2 2020.<sup>70</sup>

Despite the challenges faced in 2020, overall, the demand for finance by small businesses declined to 37% in 2020 from its peak of 45% the year before to levels last seen in 2016. This likely reflects the significant use of non-debt government support schemes by many smaller businesses. The yearly figure also hides large within year variations. Use of finance fell to 30% in the first half of 2020, the lowest response since the launch of the SME Finance Monitor survey, before returning to near 2019 levels in the second half of the year.



As the first UK lockdown started to impact smaller businesses in Q2 2020, three in ten (29%) businesses using finance were concerned about their ability to repay. The Hotels and Restaurants sector was particularly impacted by lockdown measures in Q2. Likely reflecting this, two in five (44%) had concerns about their ability to repay, the highest in comparison to other sectors.

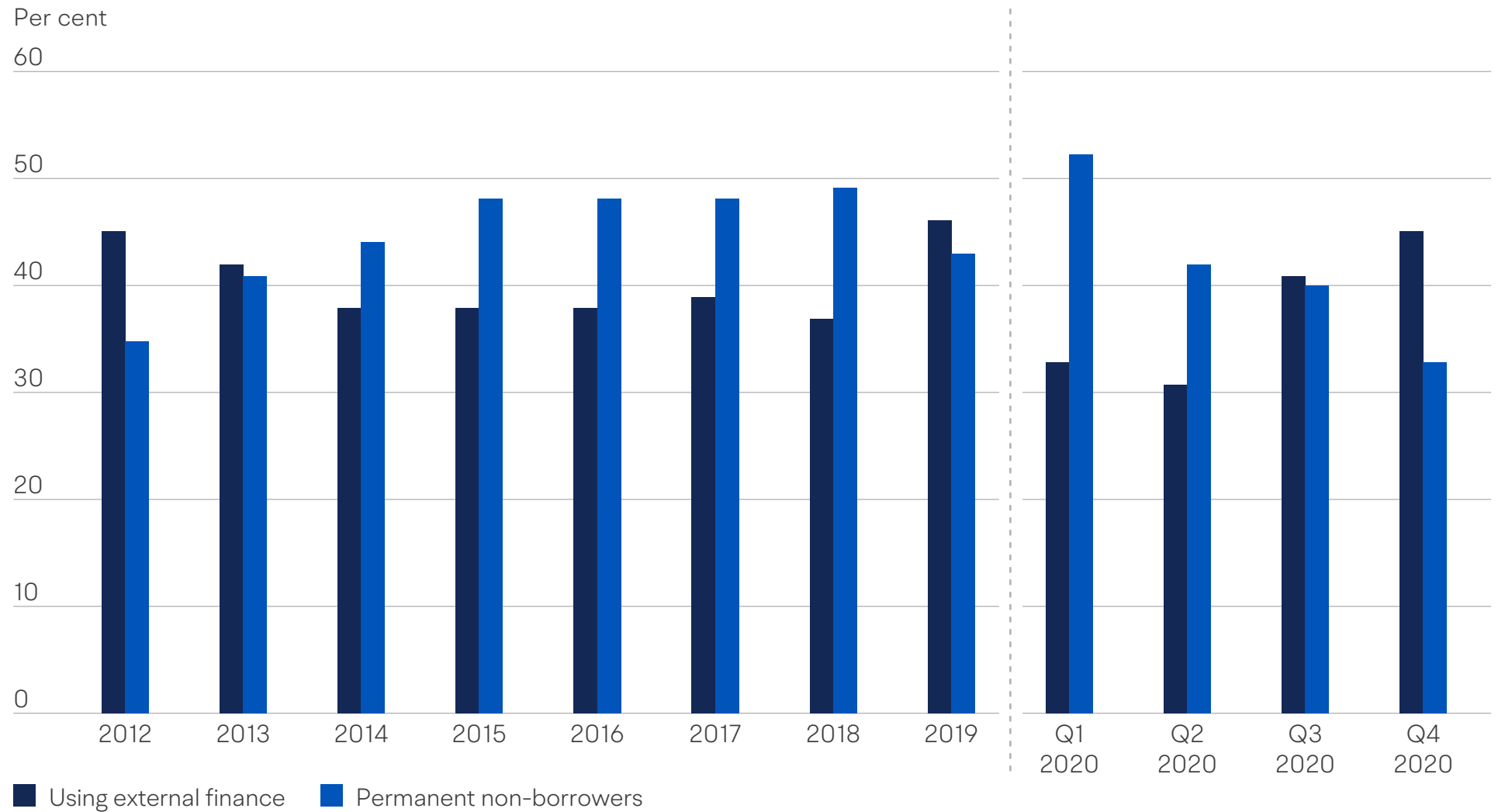
However, with lockdown measures easing and a significant volume of finance provided via BBLs and CBILS this concern decreased in Q3 to 21%. This did somewhat increase again in Q4 (24%) as the second wave of Covid -19 infections resulted in the introduction of a tier system and eventually a UK-wide lockdown.

Overall, all sectors apart from Transport and Health saw a decline of repayment concerns from the first half of the year to the second half. The Transport sector's concern grew by 12 percentage points to 41% in Q4 and the Health sector increased by 3 percentage points to 25%.

Fig B.12

**SMEs using external finance and Permanent non-borrowers**

Source: BVA BDRC SME Finance Monitor Q4 2020.  
2011 data not shown consistent with BVA BDRC reporting





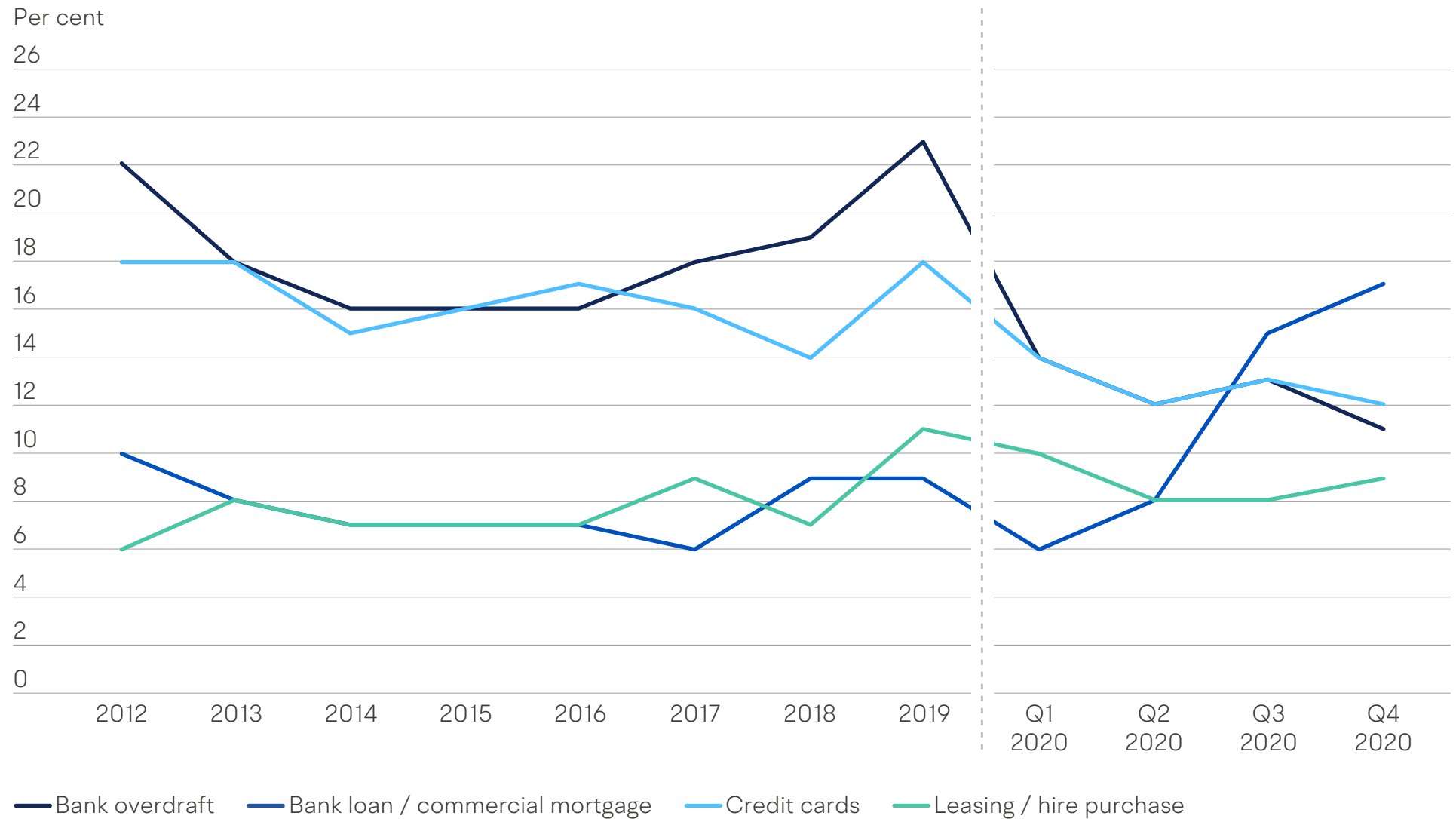
### The share of SMEs using loans almost doubled in 2020

Use of ‘core’<sup>71</sup> forms of finance increased 6 percentage points in the second half of 2020 to 31% after a record low in Q2. However, this was still down on the 2019 average (39%). The H2 increase was driven by take up of the government guaranteed loan schemes, reflected in an increase in the use of term loans which more than doubled from 9% in 2019 to 17% in Q4 2020, their highest levels since the series began (figure B.13). Take up of ‘other’ forms of finance increased throughout the year, reaching a record high in Q4 (26%). This was an increase of 10 percentage points when compared to 2019 and was down to the increased use of grants which increased from 4% in Q2 to 14% in Q4 2020.<sup>72</sup>

Fig B.13

### Share of SMEs using forms of core finance and leasing/hire purchase products

Source: BVA BDRC SME Finance Monitor Q4 2020





The Bank’s Business Finance Survey, undertaken in the second half of 2020, provides further colour on the current use of external finance. Two thirds of firms (67%) were currently using some form of repayable external finance or grant funding.<sup>73</sup> Of these firms, 37% were using one or more forms of repayable external finance only, 21% a combination of repayable external finance and grant funding, and 10% grant funding only (figure B.14). In 2019 only 2% of SMEs were using some form of grant funding compared to almost a third in 2020.

Of the respondents in the Business Finance Survey who reported applying for finance in the previous three years, just 11% of applications were made in the three months to the end of March (Figure B.15).<sup>74</sup> During this time, the demand for bank loans, bank overdrafts and credit cards was roughly in line with reported demand in 2019. However, post March the demand for bank loans increased to a record high of 42%, up from 25% in 2019.

Reflecting this, the current use of bank overdrafts and asset finance fell while the greatest increase in the usage of external finance was seen in loans, up from around 10% in previous years to 25%. This is in line with official BBLs and CBILs data which showed around 1.5m facilities approved by the end of 2020.<sup>75</sup>

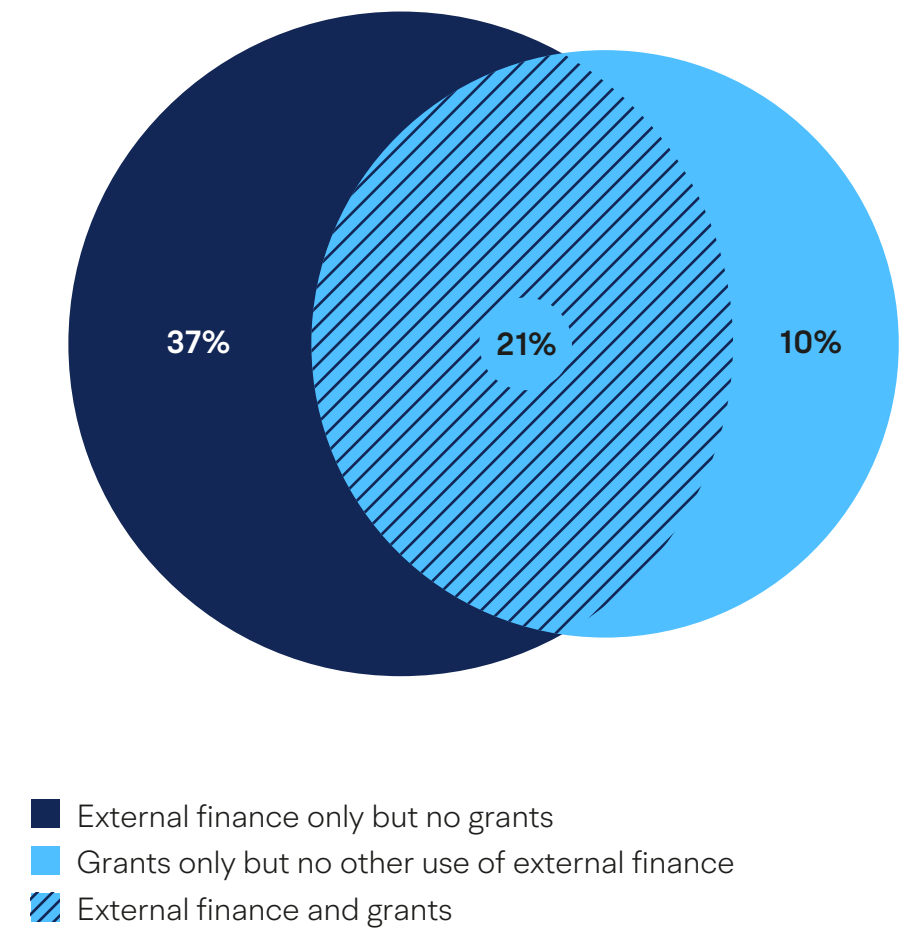
Outside of the use of external finance there were two other significant trends. Firstly, the use of personal funds increased to 32% in 2020, up from 24% in 2019. This peaked in Q4 at 38%, back to levels last seen in 2013.<sup>76</sup> This was driven by respondents who felt they had to inject funds, rather than those who chose to, which almost doubled in 2020 and peaked at 25% in Q4 and likely reflects either an aversion to using external finance or an inability to access it for some.

Secondly, there was significant growth in SME cash balances. UK Finance data shows this reached a record high value of £252 billion in 2020, an increase of 20% on 2019.<sup>77</sup> SME Finance Monitor data also shows the share of SMEs with cash balances over £10,000 increased from an average of 23% in 2019 to 28% in 2020.

Fig B.14

**Firms use of external finance and grants, as a proportion of all SMEs**

Source: British Business Bank 2020 Business Finance Survey – Ipsos MORI





The rise in deposits likely reflects a combination of cost cutting, possibly with the help of government support schemes such as the Coronavirus Job Retention Scheme, and precautionary savings. Indeed, market contacts have reported some of the businesses who have taken out BBLs or CBLLs have retained at least a part of their facilities as cash balances (see chapter 1.1 for more information).

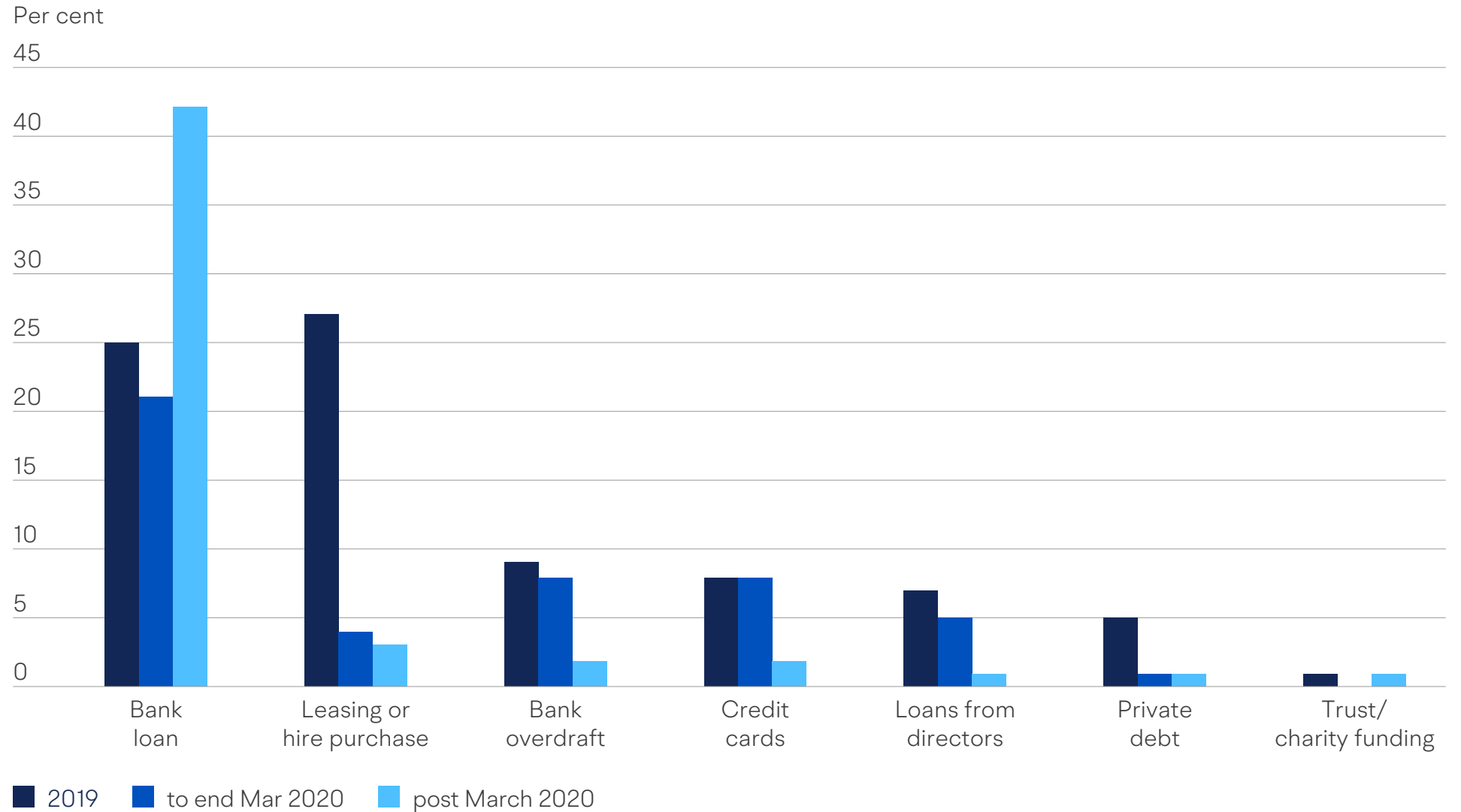
**Many smaller businesses rely on established relationships when considering finance options**

Smaller businesses have been increasingly self-reliant when considering the type of finance to apply for and who to apply to. The availability of government loan schemes, with their simple design, would appear to have affected SME attitudes and behaviour with 75% of SMEs only considering one provider in 2020, an increase of 16 percentage points in comparison to 2019.<sup>78</sup>

Fig B.15

**SME demand for finance in 2020, pre and post pandemic compared to 2019**

Source: British Business Bank 2020 Business Finance Survey – Ipsos MORI







This behaviour could reflect the immediacy of funding needs for businesses, with limited time to consider a range of potential sources. However, one in five SME (21%) reported seeking advice before borrowing, a substantial increase on the 13% reported in 2019.<sup>79</sup> In H2 2020, six in ten (58%) reported speaking to an advisor or informally to their main bank, an increase of 15 percentage points since 2019.<sup>80</sup>

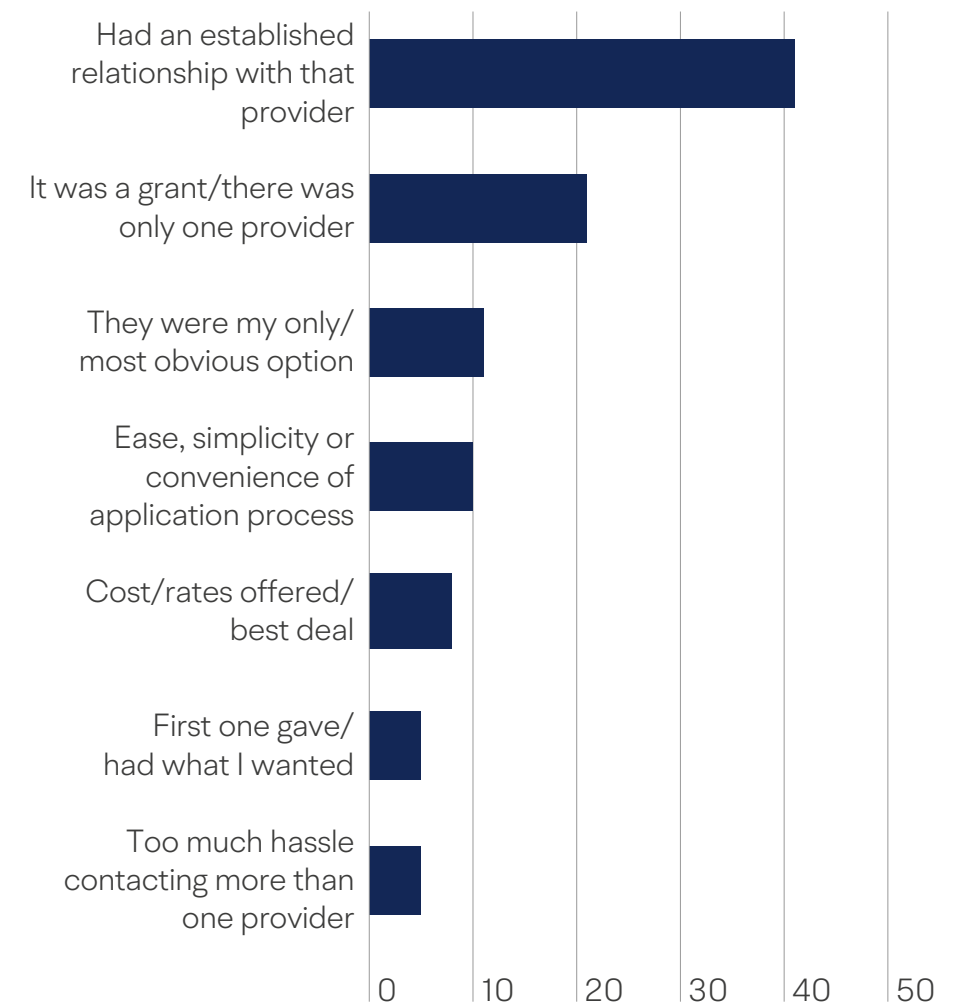
The most common reason for contacting just one provider was having an established relationship with that provider (41%) (figure B.16).<sup>81</sup> This likely reflects that many smaller businesses were seeking BBLS, a generic product only available from accredited lenders. Furthermore, whether a smaller business was seeking BBLS or CBLS, due to resource constraints and high demand, relatively few lenders were providing loans to businesses they did not already have a relationship with. As such this would have limited the options for smaller businesses for who they could approach.

As discussed, the demand for finance observed in 2020 was predominantly for working capital purposes to soften the impact of the pandemic rather than funding long-term growth ambitions or expansion. This short-term focus of businesses during the Covid-19 pandemic is reflected in the ERC’s Business Futures Survey. It found that in order to stay liquid, businesses reduced their costs and changed their investment priorities with the introduction of new processes playing a greater role in their strategic decision making. Almost three quarters (74%) of businesses identified reducing cost as a priority and a similar proportion (72%) stated that the introduction of new process is a business priority.<sup>82</sup>

FIG B.16

**Share of SMEs’ reason for only approaching one provider**

Source: British Business Bank 2020 Business Finance Survey – Ipsos MORI. Base = all businesses (n=890)





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### **Over a third (37%) of SMEs currently use trade credit, reducing the need for external finance in some businesses**

The definition of external finance used by SME Finance Monitor excludes trade credit. Trade credit is an agreement between a buyer and seller, whereby the buyer of the goods or service does not need to pay for those goods or services immediately but can delay the payment for an agreed period of time. This can help the buyer to manage their cashflow.

Almost a quarter (24%) of all SMEs said trade credit reduced their need for finance. However, trade credit and external finance are increasingly being used as complements: almost half (48%) of smaller businesses using trade credit also use external finance.<sup>83</sup>

The Bank of England's Agents' summary of business conditions (based on consultations with companies including SMEs) noted trade credit conditions tightening in 2020.<sup>84</sup> The Agents' summary indicated that businesses in sectors most affected by the pandemic had experienced a reduction in the usage of trade credit, but less so for companies that could demonstrate strong cash flow.

While the SME Finance Monitor showed the use of trade credit overall has remained stable with no change in 2020 (37%) to the previous year this hid variations by size of firm. Medium sized firms (50-249 employees) increased their trade credit usage in 2020, by 13 percentage points to 72%, while the smallest firms' usage remained flat at 30%, perhaps reflecting the differences in cashflow.

## 2.4

# Bank lending

- Gross bank lending surged to a record high in 2020, driven by the government loan schemes introduced in response to the Covid-19 pandemic
- Repayments rose slightly in 2020, as some SMEs paid off pre-existing loans and replaced them with government guaranteed debt
- Demand for traditional forms of working capital finance waned as some SMEs used term lending or government support schemes instead
- Credit conditions tightened somewhat towards the end of 2020, particularly in sectors most affected by the pandemic, but remained relatively loose
- The value of deposits reached a record high in 2020 as uncertainty about the outbreak and Brexit led some SMEs to set money aside
- 





This section focuses on key trends in the UK banking market for small and medium-sized businesses (SMEs) in 2020. It covers developments in the demand for, and supply of, SME credit and how these affected aggregate measures including gross lending and repayments. The section draws on the latest data from a range of sources including the Bank of England (BoE), UK Finance and the British Business Bank.

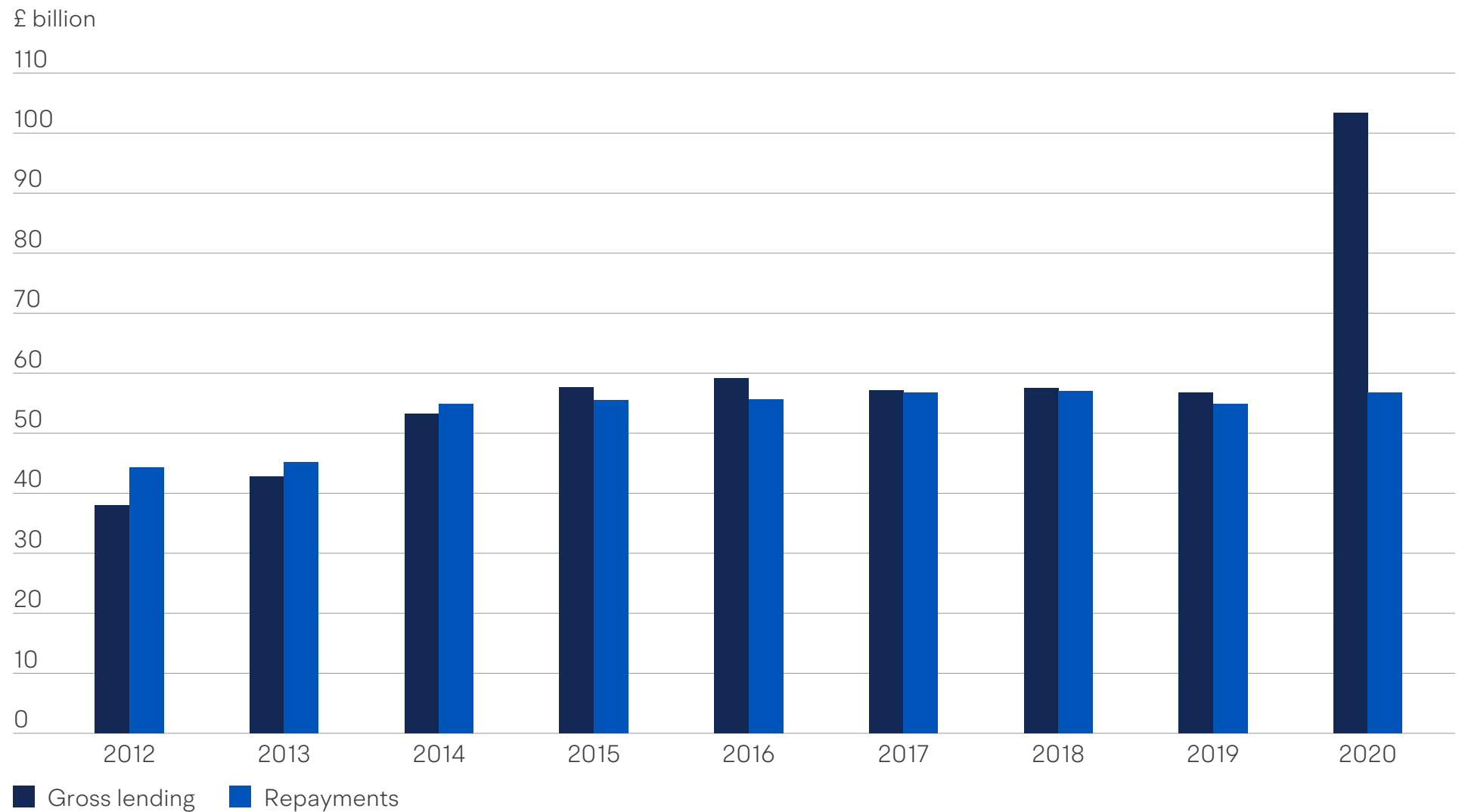
**Gross bank lending surged to a record high in 2020, driven by the government loan schemes introduced in response to the Covid-19 pandemic**

Gross bank lending (excluding overdrafts) to SMEs in 2020 was £103.7bn according to BoE Bankstats data.<sup>85</sup> This was the highest value since the data series began in 2012 and 82% higher than in 2019 (figure B.17). The surge in gross lending was driven by the usage of the government guaranteed loan schemes introduced in response to the pandemic.

Fig B.17

**Gross bank lending to, and repayments by, SMEs**

Source: Bank of England Bankstats, British Business Bank calculations





The schemes most relevant to SMEs were the Bounce Bank Loan Scheme (BBLs) and Coronavirus Business Interruption Scheme (CBILs). The total value of BBLs and CBILs facilities drawn down from banks was £56.7bn at the end of December 2020, according to British Business Bank data, of which 99% was term lending.

At the end of 2020, the total value of BBLs and CBILs facilities drawn down was equivalent to around 55% of the BoE’s total drawn down gross bank lending. However, the reporting populations and products covered by the British Business Bank data on BBLs and CBILs facilities drawn down, and the BoE on gross lending, are not identical so exact comparisons are not possible.

Gross bank lending peaked in Q2 2020. Seasonally adjusted gross lending rose 13% in April to £5.9bn, the highest on record at the time. This followed applications for CBILs opening in late March. Gross lending subsequently surged by more than 320% in May to £25bn, with both the rise and value the largest on record. This was the same month BBLs applications opened.

Gross lending then fell sharply from June to August before stabilising at around £6.5bn in the three months to November as the value of BBLs and CBILs approvals eased and then levelled off. However, gross lending fell again in December to £5.2bn, as BBLs and CBILs lending eased. This was still above the pre-Covid-19 average of £4.4bn (figure B.18).

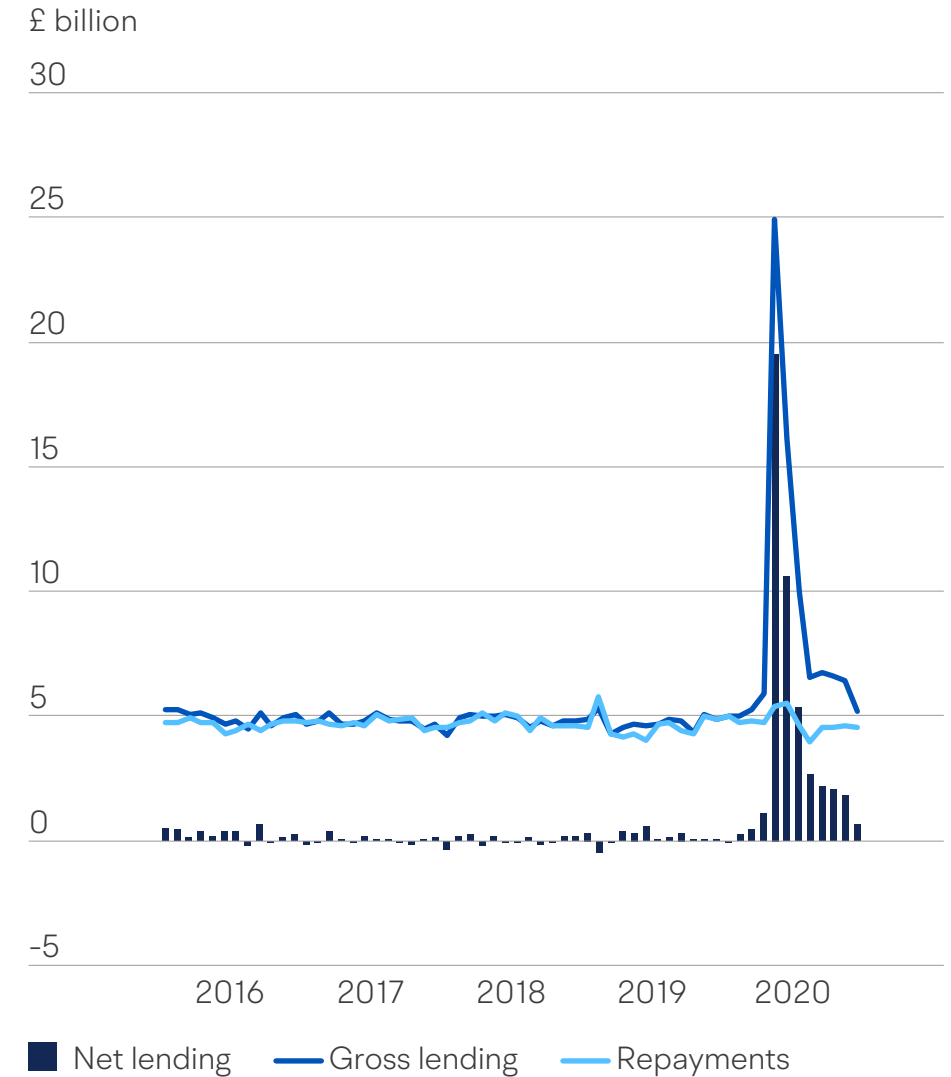
The alternative UK Finance measure of new lending to SMEs, covering the seven largest banks in the UK, shows a similar trend to the BoE data.<sup>86</sup> November 2020 data shows that total new lending in the first 11 months of that year was £61.2bn. This was up 173% from £22.4bn in the same period of 2019.

The BoE Agents’ summary of business conditions for Q4 2020 (based on consultations with companies including SMEs) noted that businesses reported their demand for credit could rise further in the coming quarters as deferred payments, such as rent and tax, fall due in the first six months of 2021.<sup>87</sup>

Fig B.18

**Gross and net flows of bank lending to SMEs**

Source: Bank of England Bankstats





**Repayments rose slightly in 2020, as some SMEs paid off pre-existing loans and replaced them with government guaranteed debt**

Repayments of bank loans by SMEs in 2020 totalled £56.9bn according to the BoE Bankstats data. This was up 4% from £55bn in the previous year but still slightly below the record high of £57.2bn in 2018 (figure B.17).

The monthly breakdown shows that repayments rose 14% in May to £5.4bn, the highest in more than one year. This coincided with the opening of applications for BBLs. In June repayments climbed another 2% to £5.5bn (figure B.18). Our market contacts reported that some SMEs borrowed via the BBLs and repaid pre-existing loans.

However, repayments fell sharply in July and August before becoming broadly steady at around £4.6bn. A probable explanation for the weaker trend in the second half of 2020 is that under BBLs no repayments are due during the first 12 months, while many banks have offered loan repayment holidays to business customers adversely affected by Covid-19.<sup>88</sup>

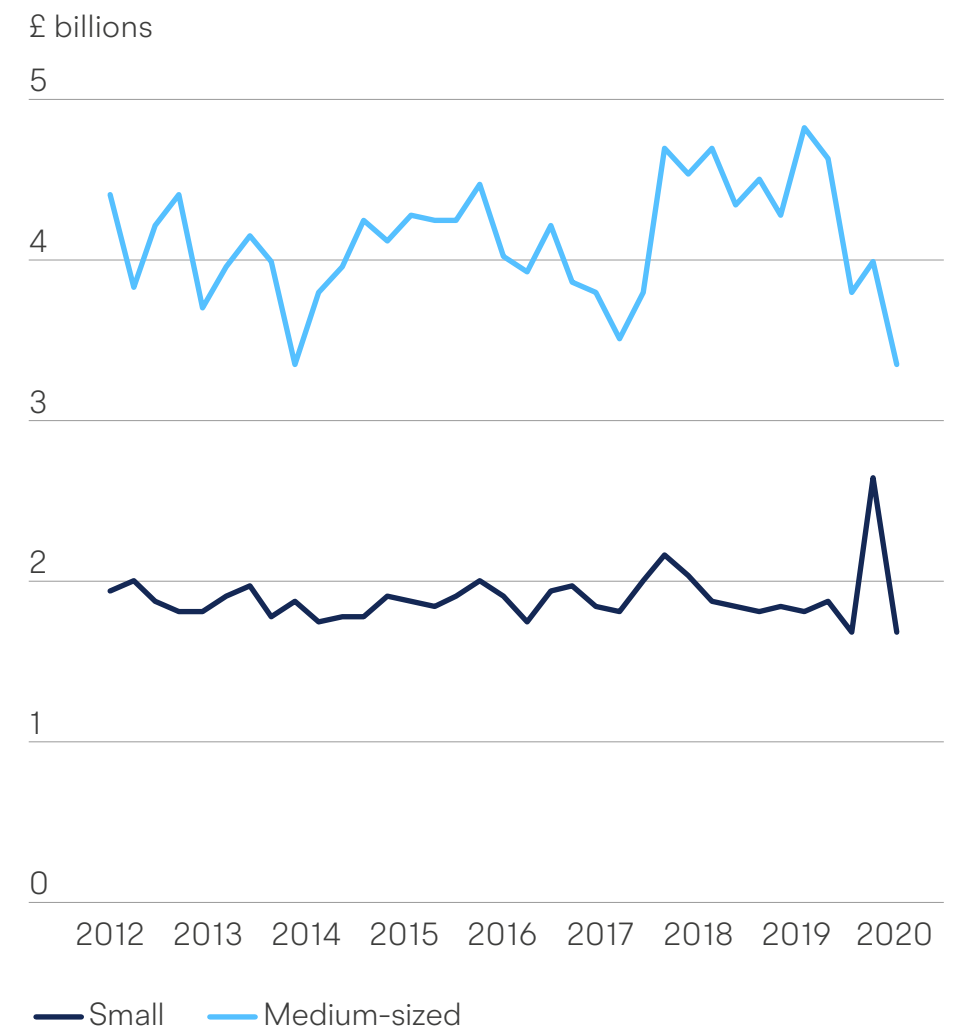
The UK Finance measure of repayments shows a different trend to the BoE data. Repayments between January and November 2020 was £21.3bn, this was down 9% from £23.4bn in the same period of 2019 (figure B.19). There are two likely explanations for this. Firstly, as the largest UK banks have accounted for a significant amount of BBLs approvals, the impact on them of no repayments for the facility being due for a year is greater than on smaller banks. Secondly, it may reflect that a higher proportion of the facilities being paid off using new BBLs borrowing was lending by providers outside of the seven largest banks.

Despite the increased levels of repayments recorded in the BoE Bankstats data, net lending reached £46.8bn in 2020 (figure B.18). This was the largest on record and compares to net lending of £1.9bn in the previous year.

The equivalent UK Finance measure tells a similar story. The latest data shows positive net lending of £39.9bn in the first 11 months of 2020. This was the largest on record and compares to negative net lending of £1bn in the same period of 2019.

Fig B.19  
**UK Finance repayments, small and medium-sized businesses**

Source: UK Finance





**Demand for traditional forms of working capital finance waned as some SMEs used term lending or government support schemes instead**

While the latest UK Finance data shows that the total value of SME overdraft facilities approved or increased from January to November 2020 (£5.1bn) was broadly unchanged from the same period a year earlier, this hides a varied year (figure B.20).

The monthly breakdown shows that the value rose significantly in February and March before reaching a record high in April. However, it then fell sharply to a record low in September. The large increase from February to April likely reflects SMEs arranging or increasing facilities to cover their working capital needs as the pandemic escalated in the UK. Following the launch of government guaranteed loan schemes and support schemes, such as the Coronavirus Job Retention Scheme, SMEs appear to have then moved away from overdraft facilities and other traditional forms of working capital finance such as invoice finance (see section B 2.9 for further details) to cover their cashflow needs.

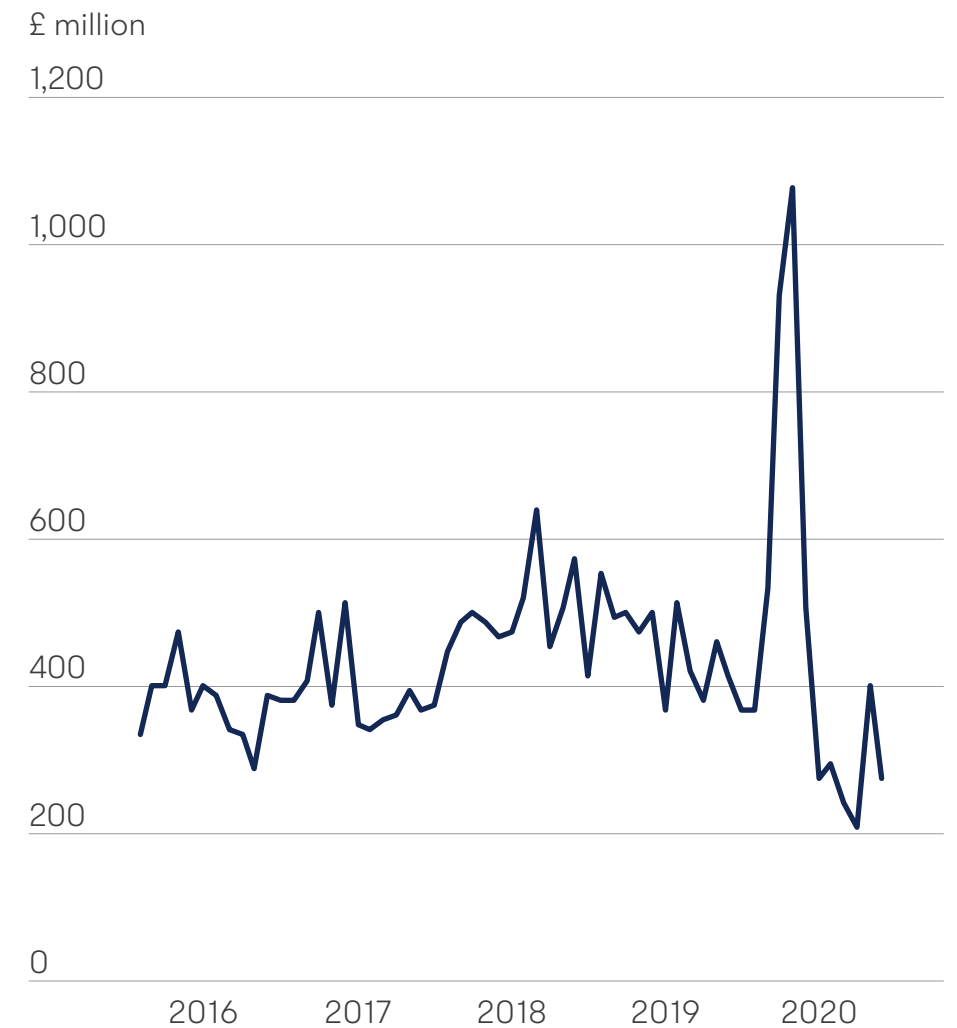
**Credit conditions tightened somewhat towards the end of 2020, particularly in sectors most affected by the pandemic, but remained relatively loose**

The BoE Agents Summary for Q4 2020 noted that although the government loan schemes are supporting credit availability, especially for the smallest companies, there have been some reports of bank credit conditions tightening. This was particularly in sectors that had been most affected by the pandemic, and where insolvencies were expected to rise.

Similarly, the BoE Credit Conditions Survey for Q4 2020 showed that lenders reported a net fall in the availability of credit provided to small businesses (figure B.21). This followed net increases in the previous two quarters, with the increase in Q2 the largest since the data series started in 2009. In contrast, lenders reported a small net increase in the availability of credit to medium-sized businesses in Q4 2020.

Fig B.20  
**UK Finance value of overdraft facilities approved or increased**

Source: UK Finance





The BoE Bankstats data also indicates that credit remains very affordable for SMEs by historical standards. Interest rates on a range of SME loans in late 2020 were much lower than at the same time a year earlier (figure B.22). The effective interest rate on all SME loans declined from 3.29% in December 2019 to 2.32% in December 2020. The effective floating rate, which broadly tracks the BoE Bank Rate, is slightly higher than that for all loans while the effective fixed rate is somewhat lower. The BoE cut the Bank Rate by 65 basis points to a record low of 0.1% in March 2020 to support the UK economy as the Covid-19 pandemic escalated.

Fig B.21

**Availability of credit, small and medium-sized businesses (net balance)**

Source: Bank of England Credit Conditions Survey

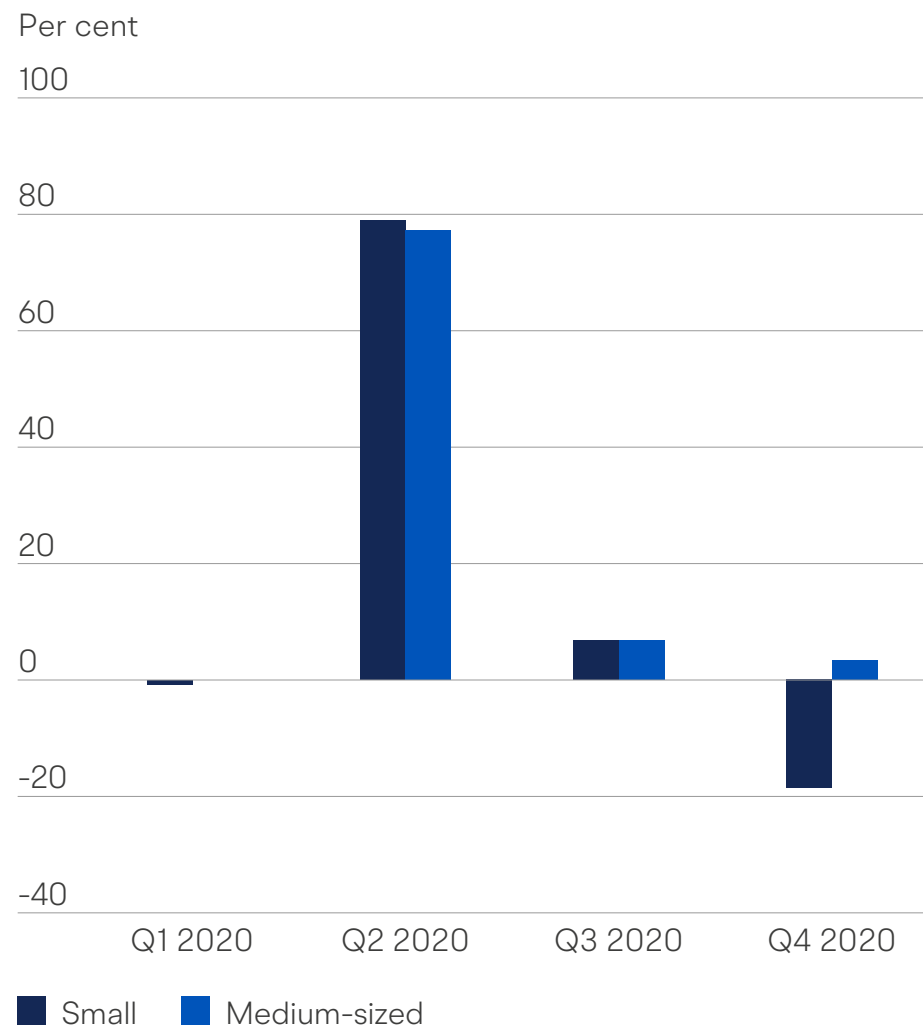
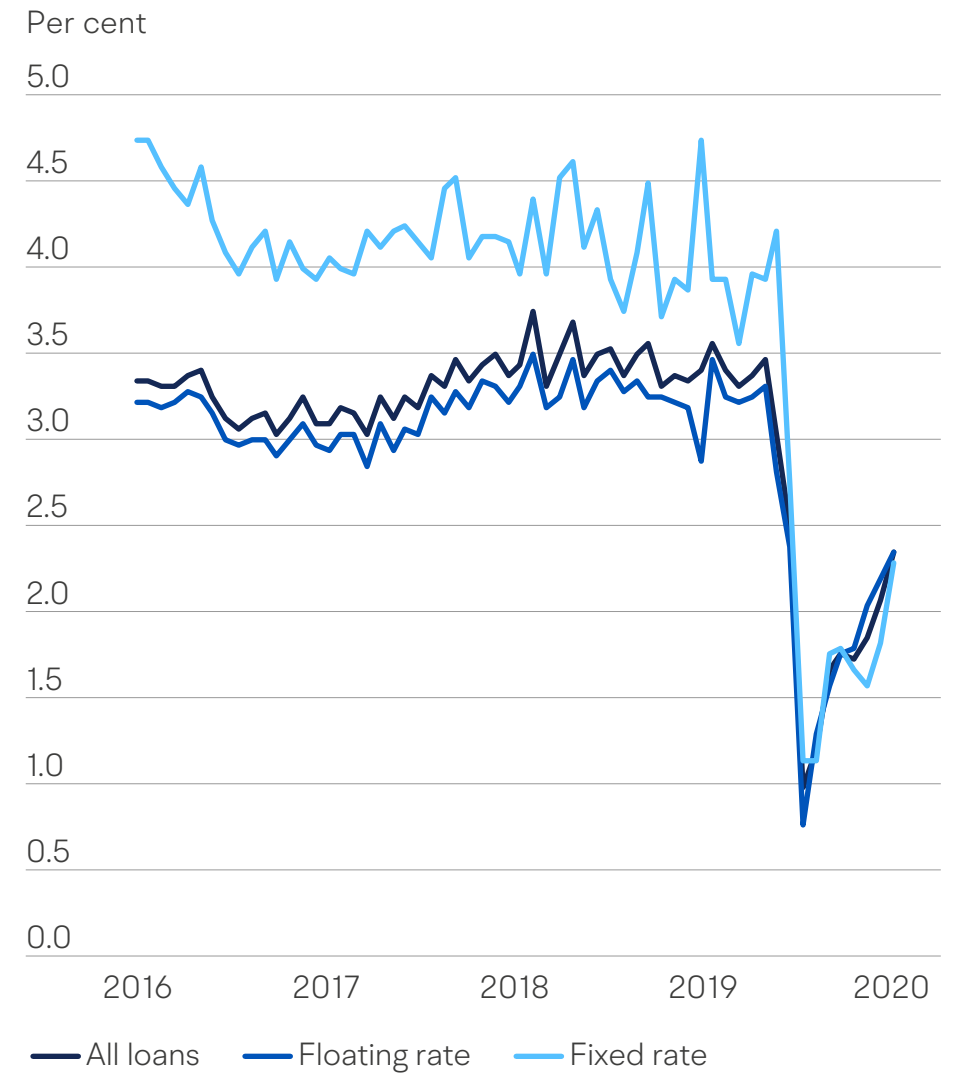


Fig B.22

**Effective interest rates (new business) for SMEs**

Source: Bank of England Bankstats







**The value of deposits reached a record high in 2020 as uncertainty about the outbreak and Brexit led some SMEs to set money aside**

The latest UK Finance data shows that the total value of deposits held by SMEs rose to £256.2bn in November 2020. This was a record high and up 30% from its pre-pandemic level in February. The value has risen by 123% since the series started in July 2011 (figure B.23). Likewise, the latest SME Finance Monitor (December 2020) showed that the share of SMEs holding more than £10,000 of credit balances was 33% in Q4 2020. This was the third consecutive quarterly rise from 23% in Q1 2020.

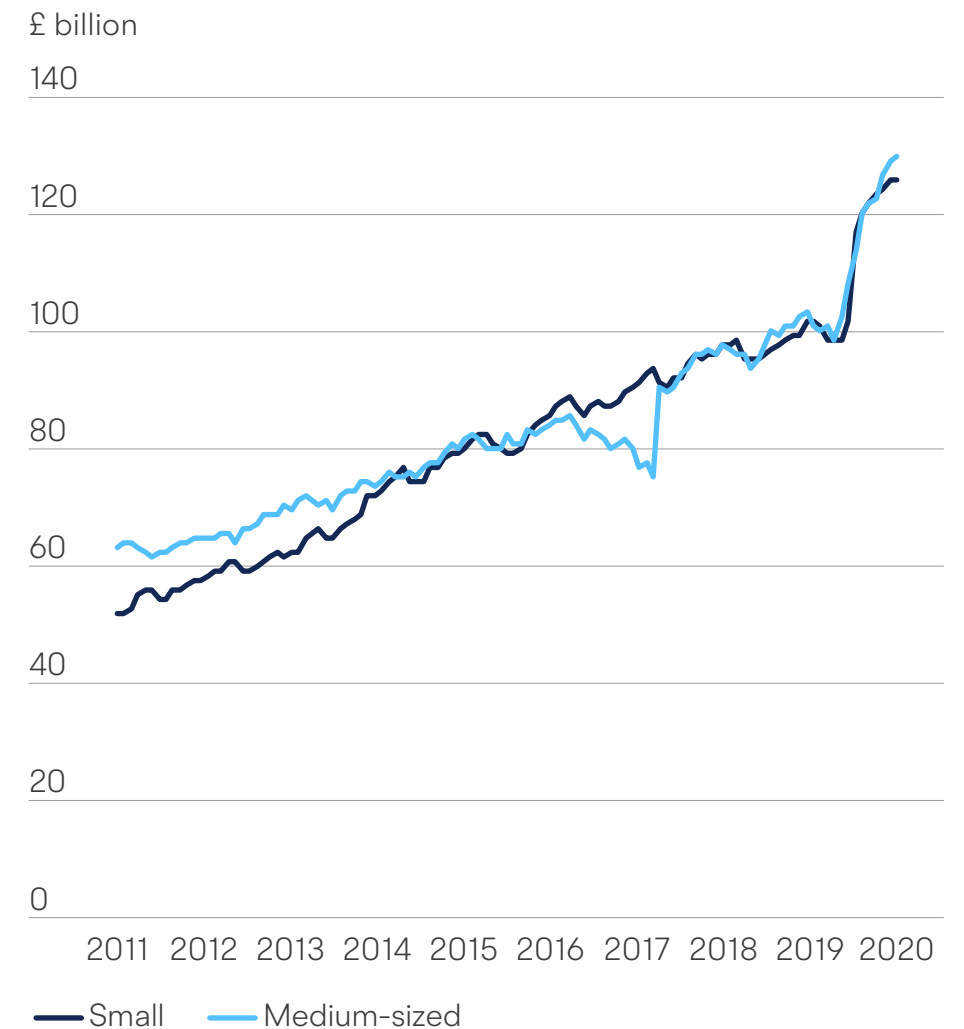
Our market contacts report that the uncertainty associated with the pandemic and the UK’s future trading relationship with the European Union led to precautionary behaviour among some SMEs. They also report that some of the SMEs accessing BBLS have put the loans on deposit, at least initially, with UK Finance data showing the monthly total value of deposits rose in May by 10%. This was the largest increase on record.

The impact of the pandemic highlights that it is more important than ever for the UK banking sector to support SMEs. While the current Covid-19 government guaranteed loan schemes are due to close for new applications in the first half of 2021, the British Business will continue to support bank lending to SMEs through existing programmes including ENABLE Guarantees and via the Recovery Loan Scheme which was announced at the March 2021 Budget and is set to launch on the 6<sup>th</sup> April.

Fig B.23

**UK Finance value of deposits, small and medium-sized businesses**

Source: UK Finance



2.5

## Challenger and specialist banks

- Challenger and specialist banks' share of total gross lending fell significantly in 2020, a reversal of the post-financial crisis trend
- Some challenger and specialist banks have reported lending growth in 2020
- Market contacts reported several reasons why some banks chose not to seek accreditation for CBILS or BBLs lending
- Two awardees each returned £50m to the Capability and Innovation Fund
- In 2020 six challenger and specialist banks were granted UK banking licences, four focus on SMEs





Challenger and specialist banks play a key role in increasing the diversity of smaller business finance markets in terms of both supplier and products offered.<sup>89</sup> New providers, products and business models can improve who can access finance, where it is accessed, when and on what terms the access is arranged, and how it is delivered.<sup>90</sup>

The focus of this section is on challenger and specialist banks that serve SMEs. It covers the main developments in 2020, particularly the impact of the Covid-19 outbreak. The section draws on data from a range of sources including the Bank of England (BoE), the financial reports of challenger and specialist banks, and the British Business Bank.

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### **Challenger and specialist banks' share of total gross lending fell significantly in 2020, a reversal of the post-financial crisis trend**

Gross bank lending to SMEs reached a record total in 2020 (see section 2.4 for further details). Similarly, gross lending to SMEs by challenger and specialist banks was £32.5bn, a rise of 18% compared to 2019 and the highest since the data series started in 2012.

However, challenger and specialist banks' share of total gross lending fell to 31% in 2020 from 48% in the previous year, the lowest on record. This reversed the post-financial crisis trend which had seen the challenger and specialist banks go from providing a third of gross bank lending in 2013 to around a half in 2017-2019 (figure B.24).

The driver of gross bank lending in 2020 has been the government guaranteed loan schemes, with the Bounce Back Loan Scheme (BBLs) and the Coronavirus Business Interruption Loan Scheme (CBILs) providing around 55% of total bank lending.

Challenger and specialist banks have so far provided a significantly smaller proportion of loans made under these schemes compared to the Big 5 banks. At the end of December 2020, the total value of BBLs and CBILs facilities drawn down from UK banks was £56.7bn. Of this, challenger and specialist banks comprised £6.9bn (12%) while the Big 5 banks provided £49.8bn (figure B.25).



Fig B.24

**Share of total gross bank lending to SMEs**

Source: Bank of England

Per cent

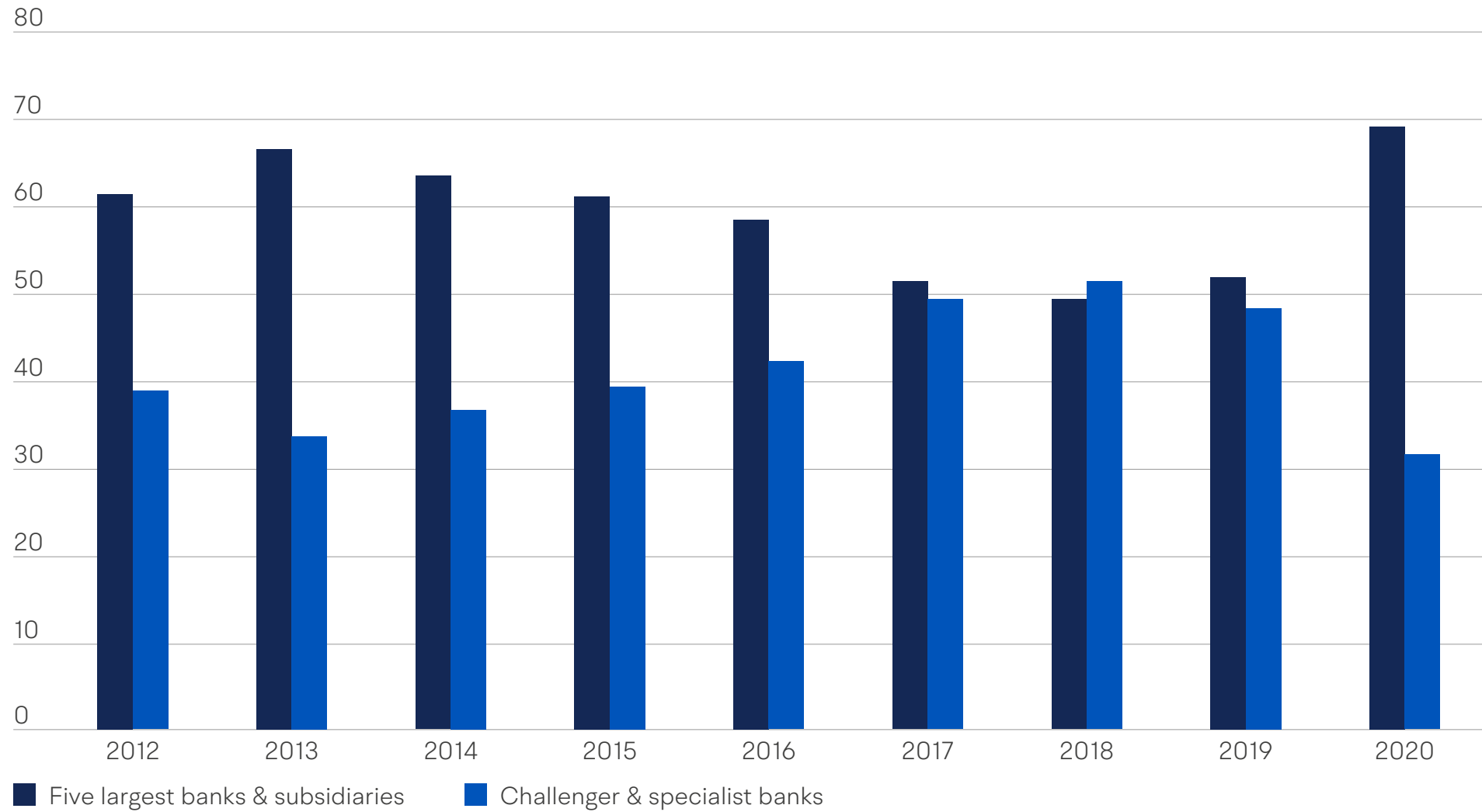
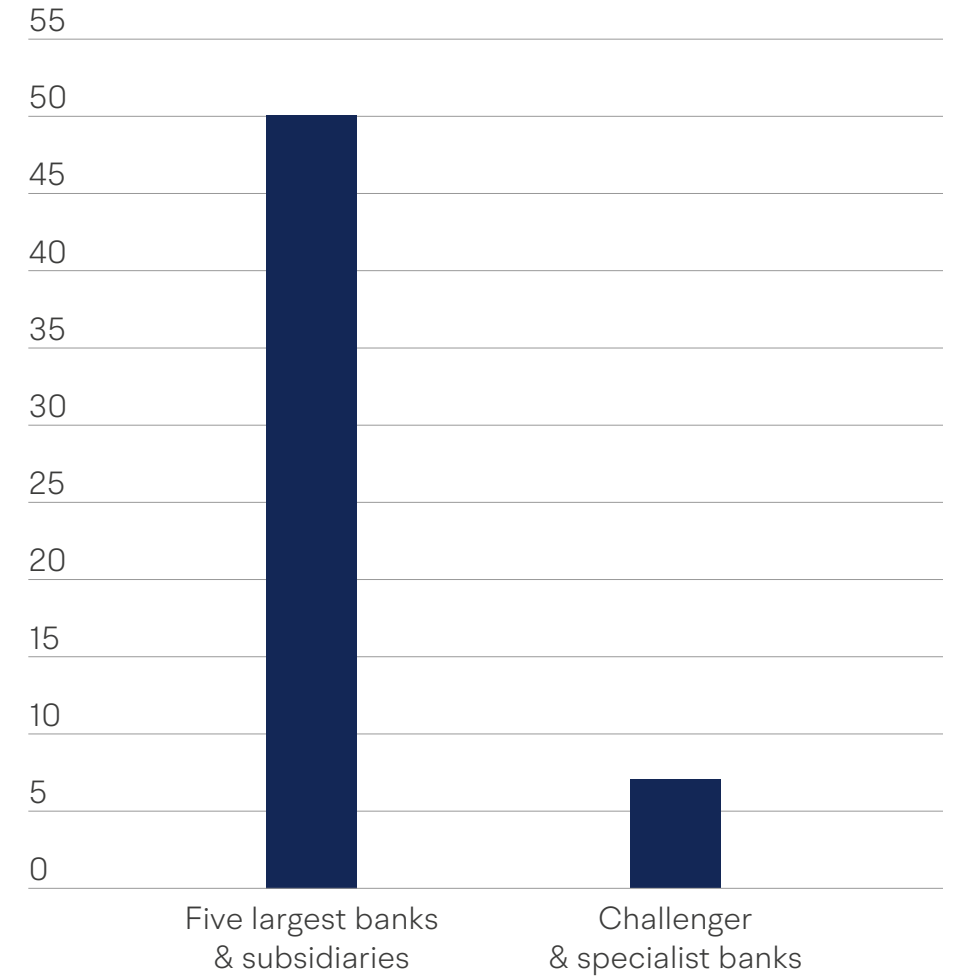


Fig B.25

**BBLs and CBILS facilities drawn down from banks at end-2020**

Source: British Business Bank

£ billion





### **Some challenger and specialist banks have reported lending growth in 2020**

Our market contacts report that many challenger and specialist banks have shown resilience amid the Covid-19 crisis. While the volume of their new business dropped in early 2020 as the pandemic emerged, it subsequently recovered.

This is broadly backed up by those challenger and specialist banks that have published financial reports. At the time of writing, only a handful have published trading updates or mid-year or annual reports that contain SME lending information and only covering part of 2020.

Among the published accounts, Starling Bank experienced the strongest growth in its loan book in both absolute and percentage terms. The digital bank's stock of SME lending was £1.4bn at the end of October 2020.<sup>91</sup> This was up around £1.3bn from less than £40m prior to the pandemic. Starling Bank have stated that the increase was solely driven by BBLs and CBILs.

Virgin Money UK's loan book also grew strongly. The full-service bank's stock of business loans stood at £8.9bn at the end of September 2020.<sup>92</sup> This was around £1.1bn higher than in September 2019. Virgin Money UK said it had provided BBLs and CBILs totalling £1.1bn as of September 2020.

Of the other reports available, the majority indicated that their loan books had grown in 2020, by amounts ranging from £0.1bn to £0.5bn. These included Metro Bank, Close Brothers Group's banking division and Paragon Banking Group.

For those that reported growth, it largely reflected lending via BBLs and CBILs. However, while the BoE data showed an aggregate rise in lending by challenger and specialist banks in 2020, there are signs that for many who are yet to report, and particularly those which are not accredited to lend via BBLs or CBILs, it may have declined. When the BBLs and CBILs facilities drawn down from challenger and specialist banks at the end of that year (£6.9bn) are removed from gross lending by challenger and specialist banks in 2020 (£32.5bn), it leaves £25.6bn of market-based lending.

This compares to around £27.5bn in 2019, a fall of 7%. This is in line with our market contacts noting that SME demand for lending from non-accredited challenger and specialist banks was weaker in 2020.

### **Market contacts reported several reasons why some banks chose not to seek accreditation for CBILs or BBLs lending**

Banks made up around one third of all accredited lenders by the end of 2020. However, given the number of banks that traditionally lend to SMEs, this suggests a proportion have chosen not to pursue accreditation.

Market contacts have noted a range of reasons for challenger and specialist banks not to seek accreditation. For some this was simply because they saw an opportunity to provide non-government guaranteed facilities and, rather than participate in BBLs with its low interest rate, preferred to wait until demand for commercial lending picked up again.



For others, it is a result of something more fundamental. For example, some challenger and specialist banks with relatively small balance sheets did not seek accreditation because they lacked the capacity to meet potentially large enquiries for BBLs and CBILs. In other cases, particularly some of the newer banks, it was more because BBLs lending was not financially viable for them given the 2.5% per annum fixed rate mandated for the scheme.<sup>93</sup>

This later point highlights that newer banks often compete for deposits at a higher cost than their established counterparts, ie they offer relatively high interest rates to attract deposits. In addition, their access to wholesale markets (if indeed they have such at all as banks need to be established for several years before they can access wholesale markets) can be limited or expensive.

### **Two awardees each returned £50m to the Capability and Innovation Fund**

In early 2020, two awardees, Metro Bank and Nationwide Building Society, each returned £50m of grants from the Capability and Innovation Fund (CIF) after their own internal strategic reviews indicated a change in business direction. The purpose of the £425m CIF is to encourage greater competition in the provision of banking services to SMEs and to develop and improve the financial products and services which are available to SMEs.

Nationwide, the largest building society in the UK, returned its £50m grant after deciding not to expand its business banking offer. The building society said that the BoE's emergency cuts in the Bank Rate meant its business plan was no longer viable, and the benefits of offering fee-free current accounts would no longer be enough to cover the costs of providing the service.<sup>94</sup>

Following a challenging 2019, Metro Bank carried out a strategic review. This led the bank to submit a revised business case to Banking Competition Remedies, the administrators of the CIF, and return £50m of their original £120m grant. Metro Bank has deployed the remaining £70m of the grant to further their SME offering.

While these returns are both significant, others have announced plans to expand or improve their offerings to SMEs. One example is Virgin Money UK. The bank won £35m from the CIF in September 2020 to fund its SME lending expansion.<sup>95</sup>

Similarly, both TSB Bank and The Co-operative Bank announced plans to enhance their digital offering for customers including SMEs. These plans were announced in the months preceding the Covid-19 outbreak but have now been sped up because of pandemic-driven changes in customer behaviour.<sup>96,97</sup>

Overall, our market contacts report that the Covid-19 crisis has not prevented challenger and specialist banks from remaining innovative. They have maintained their development plans, which have included improved digital offerings and building new capabilities to explore other markets or asset classes.



### In 2020 six challenger and specialist banks were granted UK banking licences, four focus on SMEs

The Prudential Regulation Authority (PRA) authorised six new banks in 2020. This was the lowest number in five years. Since the PRA introduced reforms in 2013 that lowered the barriers to entry to the UK banking sector, 53 banks have been authorised (figure B.26).

The six banks authorised in 2020 were all UK start-ups. This was the highest number of start-ups since 2016 and double the average from 2013 to 2019. For the first year since the reforms, in 2020 no overseas banks were authorised. This followed a higher than usual number of overseas bank authorisations in the three years to 2019 (figure B.27).

Of the six UK start-ups authorised by the PRA in 2020, four focus on SMEs. This was one less than in the previous year but broadly in line with the average from 2013 to 2019 (figure B.28). The four that serve SMEs were all specialist banks. One of these, Oxbury Bank, is the first new bank in around 100 years to focus on providing products and services to SMEs in the agricultural sector.<sup>98</sup> Overall, we estimate that around

Fig B.26  
**Banks authorised by the Prudential Regulation Authority, 2013-2020**

Source: Bank of England, British Business Bank calculations

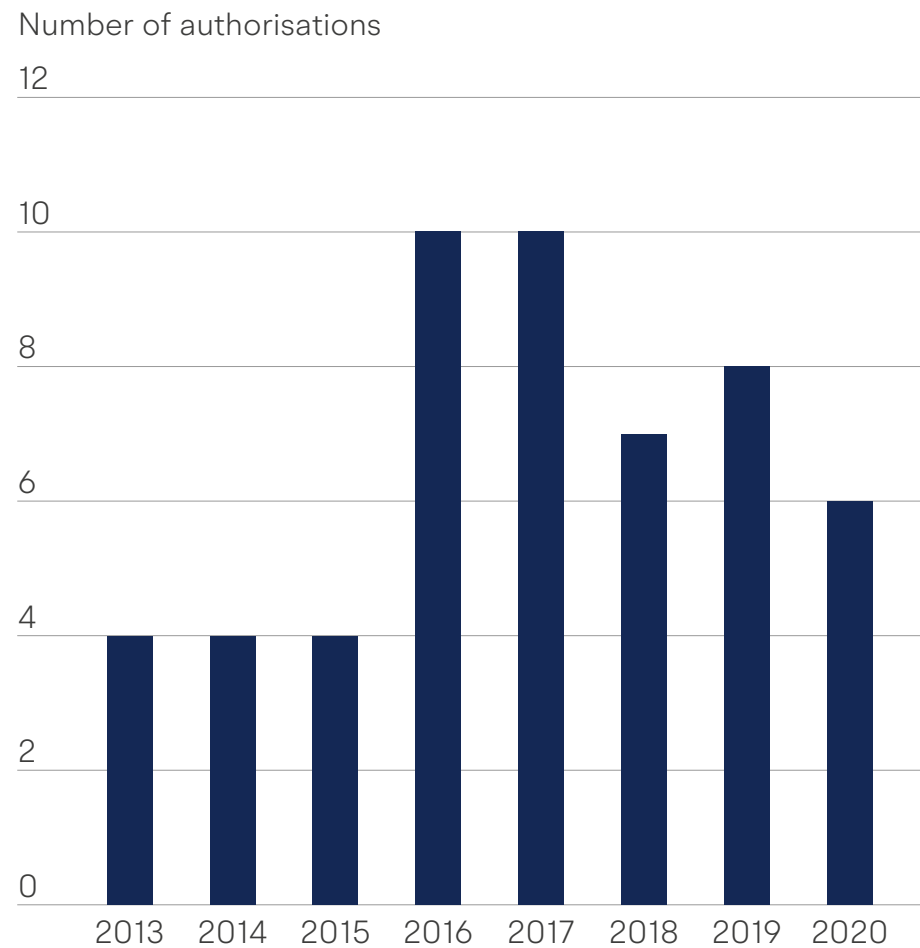
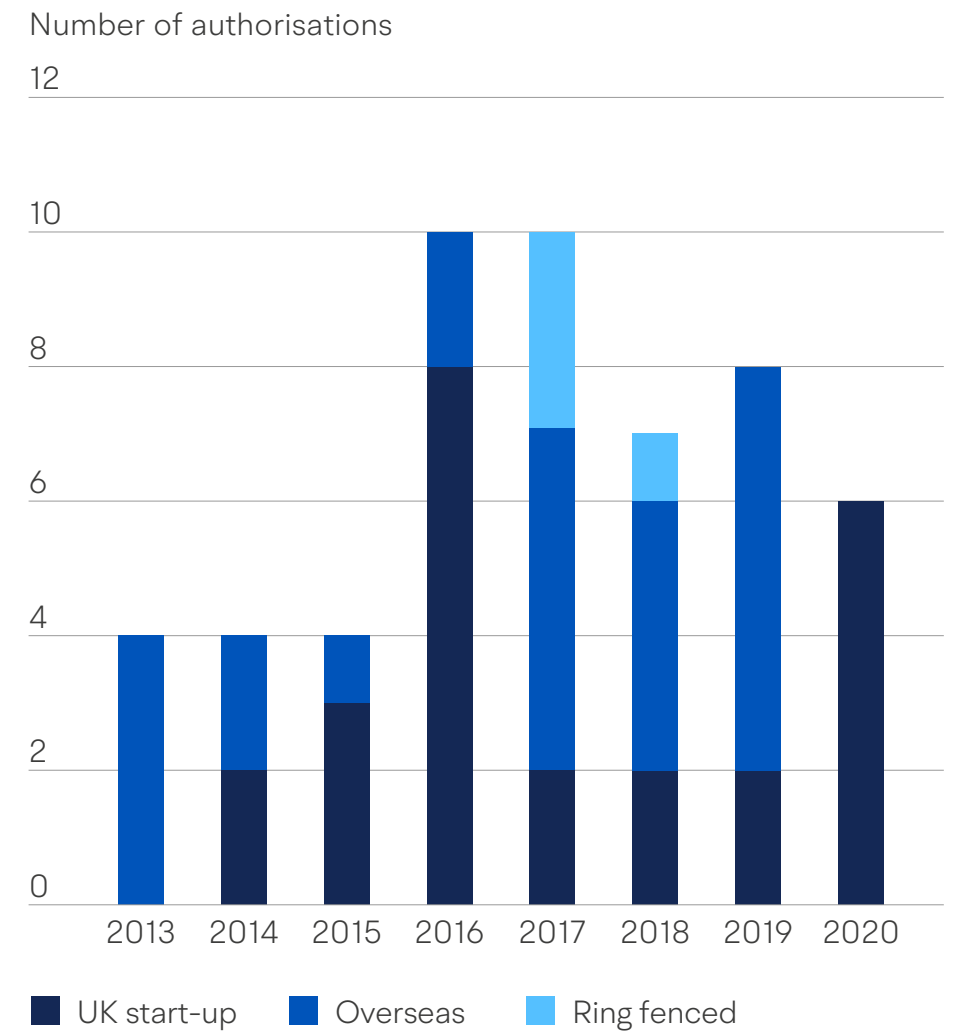


Fig B.27  
**Split of banks authorised by the Prudential Regulation Authority, 2013-2020**

Source: Bank of England, British Business Bank calculations





30 of the challenger and specialist banks that have been authorised since 2013 serve SMEs.

Publicly available information indicates that there are a handful of applications for authorisation pending. These include B-North (a specialist SME lender in Manchester), GB Bank (a Newcastle-based regional SME property lender) and Revolut (a digital bank).<sup>99,100,101</sup>

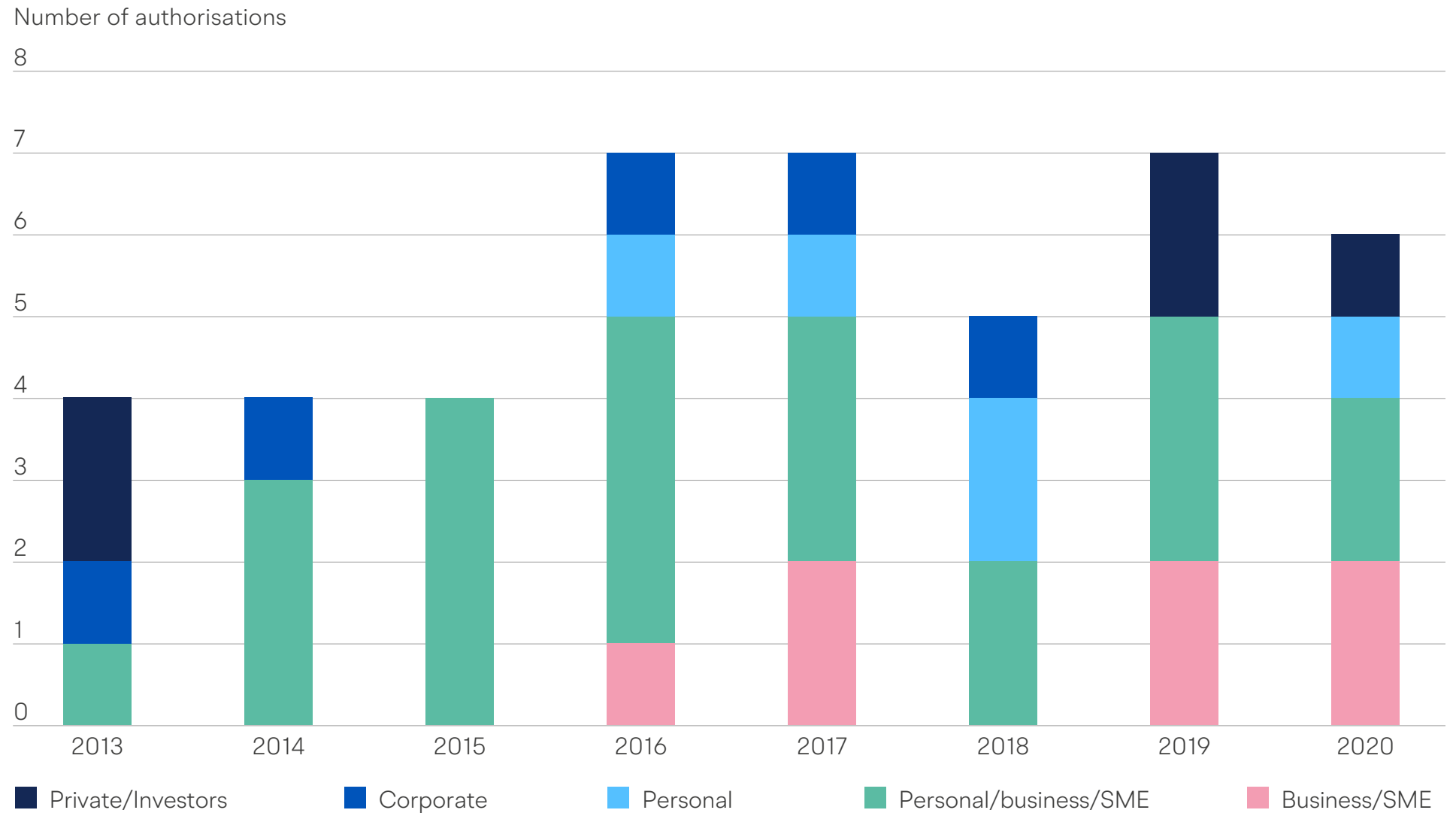
Our market contacts report that several applicants have found that it has become more difficult and it is taking longer to obtain information from the PRA and progress through the authorisation process. This reflects that the PRA has recently needed to focus on the pandemic and the UK leaving the European Union. The implication is that it will take longer for applicants to get to the point where they can start to take deposits and lend.

The government loan schemes, particularly BBLs and CBILs, supported accredited challenger and specialist banks that lend to SMEs during 2020. While applications for these schemes are due to close during 2021, the British Business Bank will continue to support challenger and specialist banks via the successor Recovery Loan Scheme, through various existing programmes including ENABLE Guarantees and via our commercial arm British Business Investments.

Fig B.28

**Customers served by Prudential Regulation Authority authorised banks, 2013-2020**

Source: Bank of England, British Business Bank calculations





2.6

## Equity finance

- Equity finance has played an important role for innovative companies seeking finance in 2020
- Deal numbers have increased across most investor types, in part supported by the Future Fund
- Equity investors have responded to Covid-19 with smaller size deals at the seed stage but larger size deals at later stages, and more considered valuations at the venture stage
- Equity activity remains concentrated in London, but there are signs of increased investment outside of the Capital
- British Business Bank programmes have had an important role in increasing the availability of equity finance to SMEs during the pandemic





Equity finance is an important source of funding for businesses with the potential for rapid growth. Equity finance can be used by early stage businesses that are unable to secure debt finance due to their risk profile, lack of collateral or unstable cash flows. Established businesses looking to expand into new markets or develop new products may also utilise equity finance. These businesses may not be able to obtain debt finance due to their existing leverage or risk profile.

### **Equity finance has played an important role for innovative companies seeking finance in 2020**

Section A of the report identified UK equity finance has had a strong year in 2020, albeit at least in part supported by the government's Future Fund. Reported equity investment reached £8.8bn, an increase of 9% on 2019, and a record high. Announced deals also increased 5% to 2,044.

Equity finance supports companies with innovative operating models and products, who can quickly respond to new opportunities created in the market. This has been particularly important in 2020 given the unprecedented disruption and continued macroeconomic uncertainty created by the Covid-19 pandemic.

One example of a sector adapting to the current opportunities and challenges comes from the life sciences sector which has been at the forefront of the pandemic response as well as benefitting from the increased investor appetite for the broader healthcare sector.<sup>102</sup> Equity fundraising is important to the health of the life sciences sector as it can take many years for

these companies to develop their products and bring them to market. The number of deals in the life sciences sector increased by 26% to 102 and investment increased by 70% to £631m in 2020.<sup>103</sup>

Continued investment in life sciences and other sectors at the forefront of the pandemic response will therefore be important in the UK's recovery from the current health and economic crises. It can take many years to build up a strong equity ecosystem, and the UK's current market is the result of growth over the last decade. Despite cyclical factors including Covid-19, new research and ideas continue to arise, and existing early-stage companies are still looking to raise initial or follow-on funding rounds.

On average early-stage equity-backed companies raise a funding round every 18-24 months. The latest data shows the average gap between equity rounds was 18.5 months for deals in 2020, which is lower than for deals completed in 2019 (19.7 months). This is mainly driven by the seed stage where the average time between funding rounds fell from 17.3 months in 2019 to 15.4 months in 2020.



Equity backed businesses affected by pandemic-induced disruption may have found themselves forced to raise earlier than expected due to lower sales to extend their runways and avoid business failure. Given the uncertainty around how long the pandemic will last, some businesses may have also chosen to bring forward the date of their funding rounds whilst funding is currently available. CB Insights suggests that even in normal times around 30% of company failures are due to the company running out of cash.<sup>104</sup> It is therefore a positive sign that early-stage equity-backed companies were able to access the finance they needed to get through the pandemic.

British Business Bank analysis of Beauhurst suggests deal sizes increase by an average factor of 1.6 between funding rounds.<sup>105</sup> Therefore, significant shares of the future demand for equity finance come from companies already in the pipeline looking for their next funding round, as well as the new companies and entrepreneurs looking to raise equity for the first time.

The next few sections use data from Beauhurst to provide an overview of recent trends in equity finance for UK SMEs. This year we are able to analyse data up to the 31<sup>st</sup> December 2020 instead of our usual Q3, end of September, cut-off. The data is based on numbers extracted from the Beauhurst platform on the 31<sup>st</sup> January 2021 (one calendar month after the end of the year), and so provides a good indication of equity activity in 2020. In the summer we will publish the next edition of our Equity Tracker report which will provide a more detailed picture of equity deals.

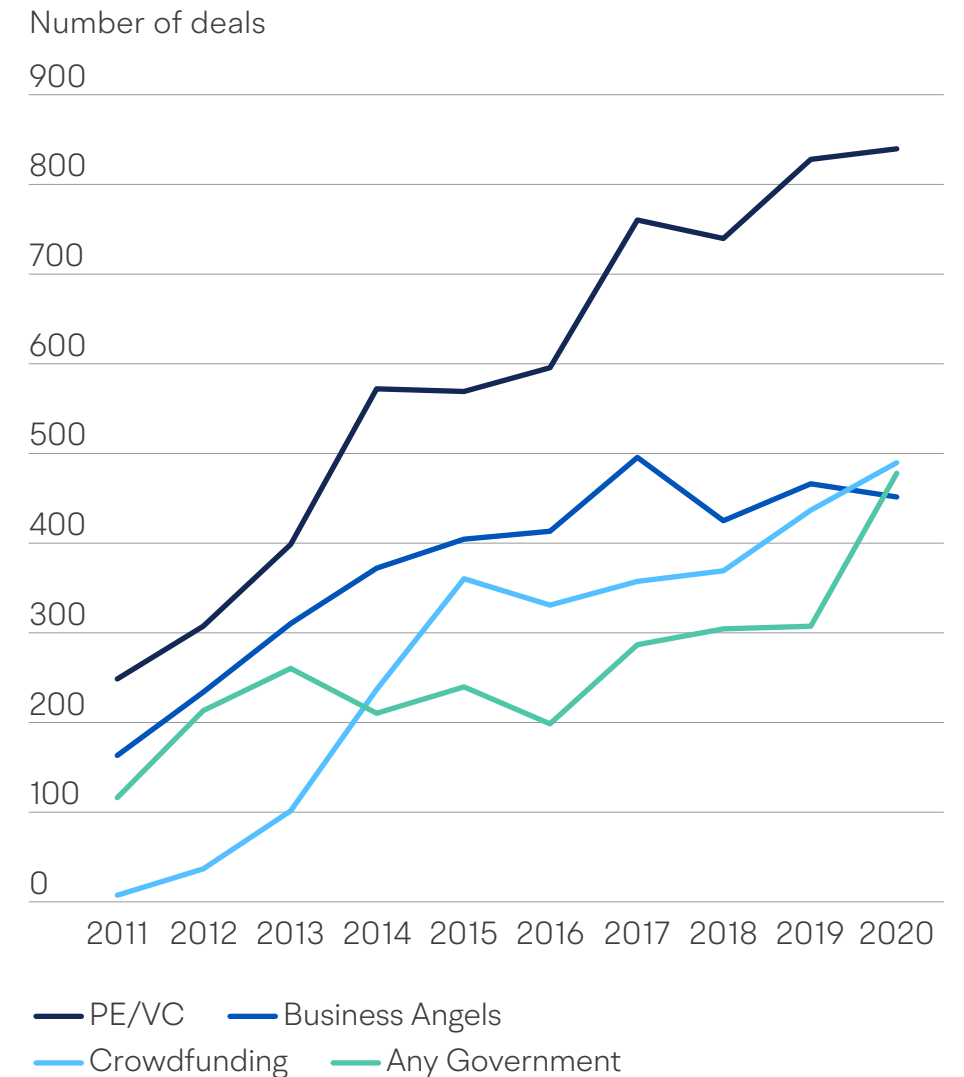
**Deal numbers have increased across most investor types, in part supported by the Future Fund**

The Future Fund has contributed to the continued functioning of UK equity finance markets in 2020, as without the programme, the number of equity deals would likely have declined. Figure B.29 shows the important role the Future Fund played in 2020, which is illustrated by the increase in the number of deals involving government investors. The number of deals involving government investors increased by 56% to 477 deals in 2020.<sup>106</sup>

Fig B.29

**Number of equity deals per year by investor type**

Source: British Business Bank analysis of Beauhurst data





Deal numbers increased across most types of equity investor, with the number of deals involving PE/ VC funds increasing slightly by 2% on the previous year and crowdfunding platform deals increasing by 12%. It is important to note that equity deals can involve multiple investor types, so the increase in deals seen in other investor types may be alongside the Future Fund. Business angel deals showed resilience but declined 3% in 2020. Angel deals are less likely to be announced compared to other investor types, and business angels may also be less able to co-invest alongside the Future Fund.<sup>107</sup>

In terms of known co-investing alongside the Future Fund, crowdfunding platforms were the most likely to be identified as the co-investor in the Beauhurst dataset. Of the 223 announced deals identified as involving the Future Fund, 84 (38%) were identified as receiving the matched investment from a crowdfunding platform, closely followed by 73 deals (33%) with support from PE/VC funds and 28 (13%) were supported by angels.

Figure B.30 shows PE/VC funds remain the most active type of equity investor in UK SME finance, forming 41% of deals, which is lower than their 43% share of all announced deals in 2019. Crowdfunding platforms were the second most prevalent type of equity investor

behind VC/PE funds involved in 24% of deals, just ahead of business angels (22%). Nearly half (49%) of crowdfunding deals went to seed companies, again showing their importance to the early-stage equity ecosystem.

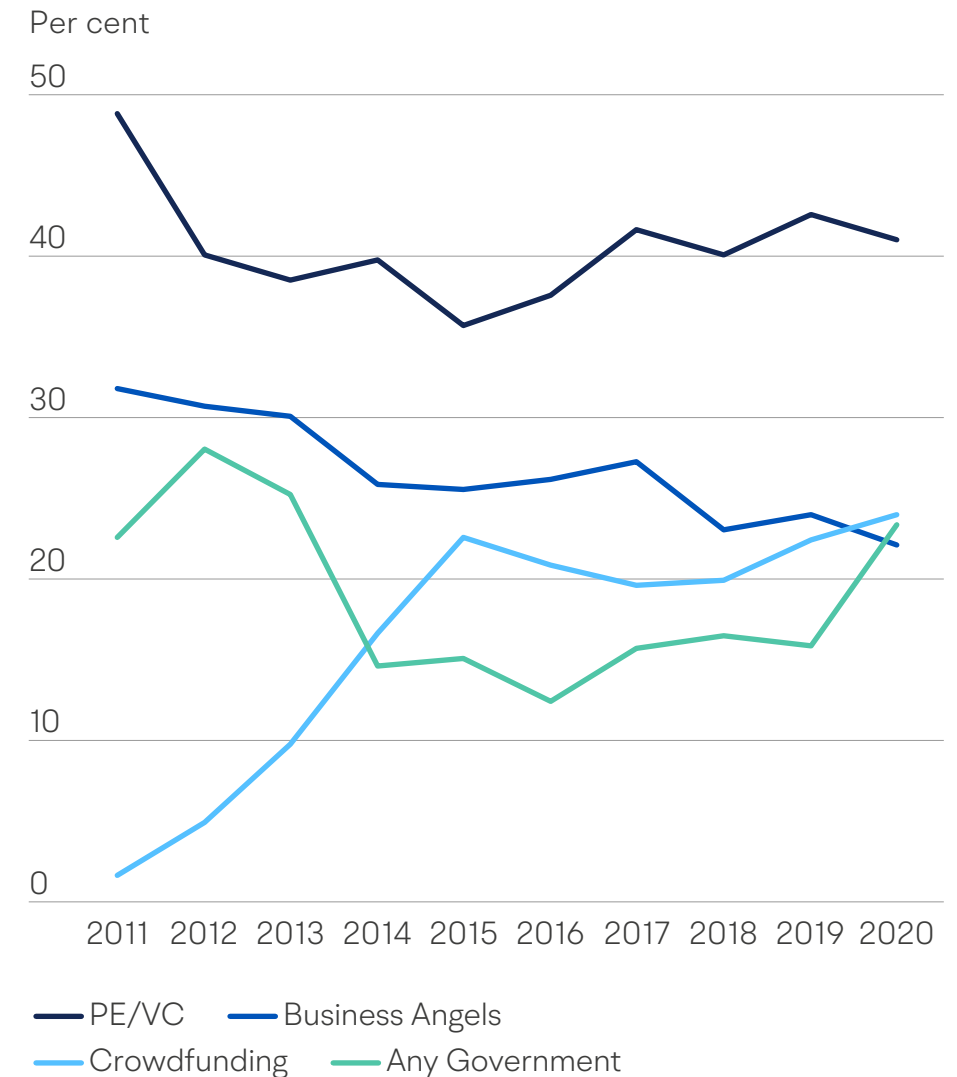
It is important to recognise that Beauhurst underestimates the number of deals involving business angels, as business angel deals are less likely to be formally announced than deals involving other equity investors, e.g. crowdfunding platforms. Business angels formed 22% of all deals in 2020 but were involved in 28% of seed stage deals in 2020, showing their importance to the early-stage equity ecosystem.

The recent Business Angels Market report revealed UK angel investors are continuing to invest in early-stage businesses and are optimistic about the future despite current economic uncertainty.<sup>108</sup> At the time of the survey (July 2020) over half of the angel respondents had made at least one investment with the sample average being 1.5 investments. Pro rata this was above the 2018/19 rate and similar to 2019/20 levels suggesting angels remain active in the market. However, the survey did reveal angels were investing lower amounts and this will be explored in the next section.

Fig B.30

**Proportion of equity deals per year by investor type**

Source: British Business Bank analysis of Beauhurst data





### **Equity investors have responded to Covid-19 with smaller size deals at the seed stage but larger size deals at later stages, and more considered valuations at the venture stage**

Beauhurst classifies equity deals into four distinct stages; seed, venture, growth and established, which reflect the recipient company's underlying position in terms of product development, commercialisation, sales, and profitability. The British Business Bank has combined the Beauhurst growth and established stages together for simplicity, which we refer to as the 'growth' stage.

#### **Both deal numbers and investment grew at seed and venture stages**

The previous 2020 Equity Tracker report identified equity deals at the seed stage were disproportionately affected during the Financial Crisis in 2008 – declining far more sharply than those at either the venture or the growth stage. As the Covid-19 pandemic developed, there was widespread industry concern that the seed stage would face a similar fate because of investors reducing their risk appetite and shifting away from new and early-stage investments towards supporting their existing portfolios.

Investment activity at the earliest seed stage is an important leading indicator for the wider equity ecosystem. The companies raising small amounts of funding currently are the future companies raising several hundred million pounds years to come. Therefore, any disruption to the funding of seed stage companies from Covid-19 will have long term implications for the equity ecosystem.

Covid-19 has also created some additional barriers to investment at the seed stage, with investors currently unable to physically meet founders. As seed stage companies are the least likely to have existing relationships with equity investors, there were concerns that this would also further exacerbate the existing long-run trend of softening at the seed stage.

The data shows this has not been the case, and early-stage seed companies were able to raise equity finance and have not been disproportionately affected by the economic turbulence caused by Covid-19.

Figure B.3 appears to show only the growth stage showed a decline in deal numbers in 2020, declining by 12% to 319 deals. The number of deals in earlier equity stages appear to have increased in 2020 with seed stage deals growing by 10% to 863 deals, and venture stage by

9% to 862. The proportion of equity deals going to seed stage companies in 2020 has therefore increased to 42%, up from 40% in 2019.

Some of these trends are obscured by deals involving the Future Fund. Figure B.31 shows excluding these deals shows seed deals increased by 2% but the venture and growth stage declined by 7% and 22% respectively. This decline in deal numbers across these stages is consistent with investors being more cautious in making deals. The Future Fund has particularly helped fund companies at the venture stage that are scaling up their activities.

Although fundraising conditions for first time companies are more difficult in 2020, concerns that investors would only focus on their existing portfolio and not make any new investments have not fully materialised in 2020. The number of companies raising funding for the first time fell 2% in 2020, although there was a much greater decline by value (19%).<sup>109</sup> Whilst figure B.32 shows the proportion of deals for companies raising equity finance for the first time decreased from 48% in 2019 to 44% in 2020, the lowest percentage since Beauhurst started collecting data, the decline is largely the result of the impact of the Future Fund.



Fig B.31

**Number and value of equity deals by stage**

Source: British Business Bank analysis of Beauhurst data

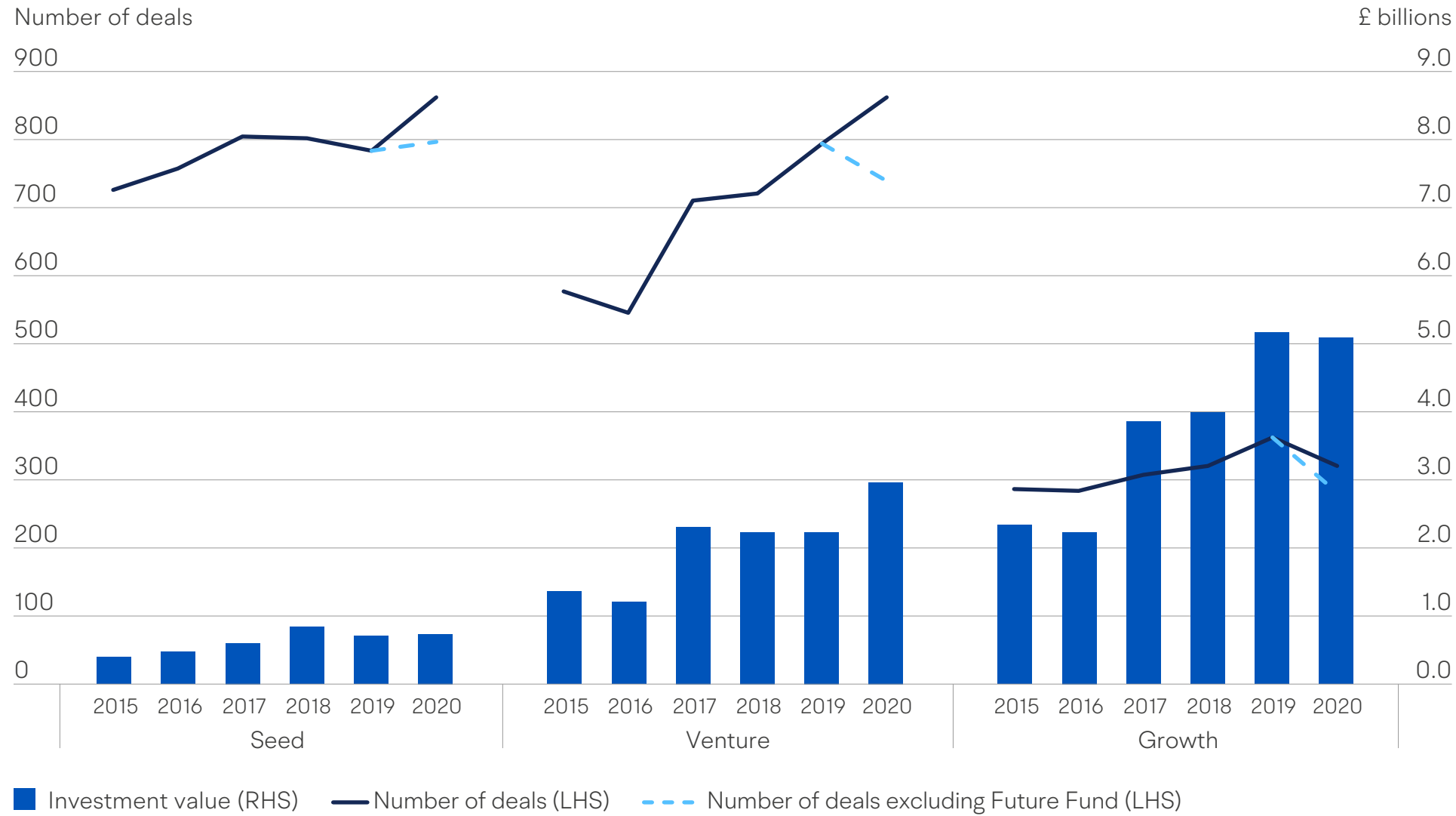
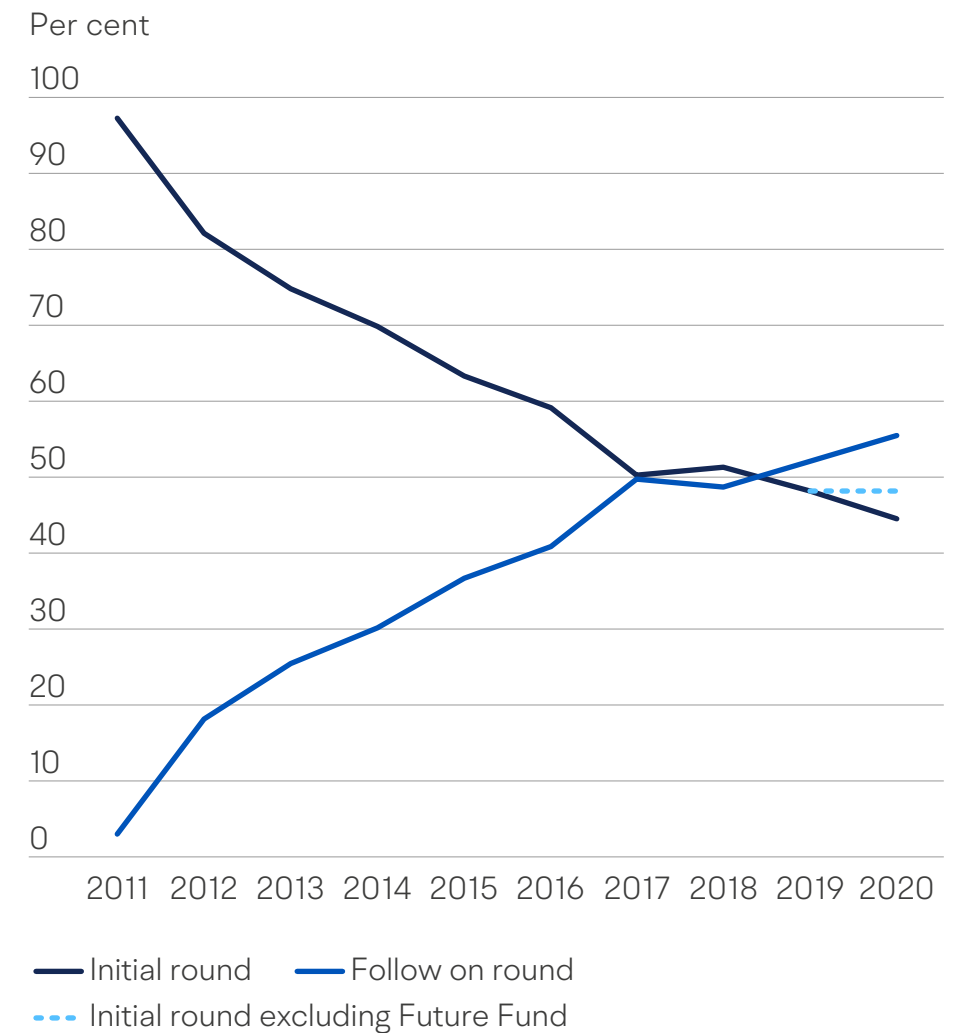


Fig B.32

**Proportion of equity deals, first time companies compared to companies raising follow on funding**

Source: British Business Bank analysis of Beauhurst data





The Future Fund requires companies to provide evidence of having raised at least £250,000 over the last five years, and so by its nature can only fund companies raising follow on funding rounds. Removing deals involving Future Fund backed companies suggests 48% of deals were first time deals in 2020, the same proportion as in 2019. There is a long run trend for a greater proportion of companies raising following on rounds rather than initial rounds as the UK equity market matures, but Covid-19 does not appear to have accelerated it in 2020. However, the proportion of seed stage companies raising funding for the first time fell from 70% in 2019 to 65% in 2020.

Although equity investment was up 9% overall in 2020 (3% if companies raising a Future Fund round are excluded), there are some differences by stage.

Investment in early-stage seed companies increased by 4% from £724m to £751m, although this is still lower than the level it was in 2018 (£841m), which confirms seed funding conditions are tighter than previously.

Investment in venture stage companies grew 33% from £2.2bn in 2019 to £2.9bn in 2020. In contrast, investment in growth stage companies fell 1% in 2020 to £5.1bn, although this is distorted by the inclusion of the £940m

deal raised by OneWeb in 2019. If the investment in OneWeb is excluded from the 2019 figures, investment at the growth stage grew 21% between 2019 and 2020 showing strong growth.

**Average deal sizes increased by 3% overall but fell at the seed stage**

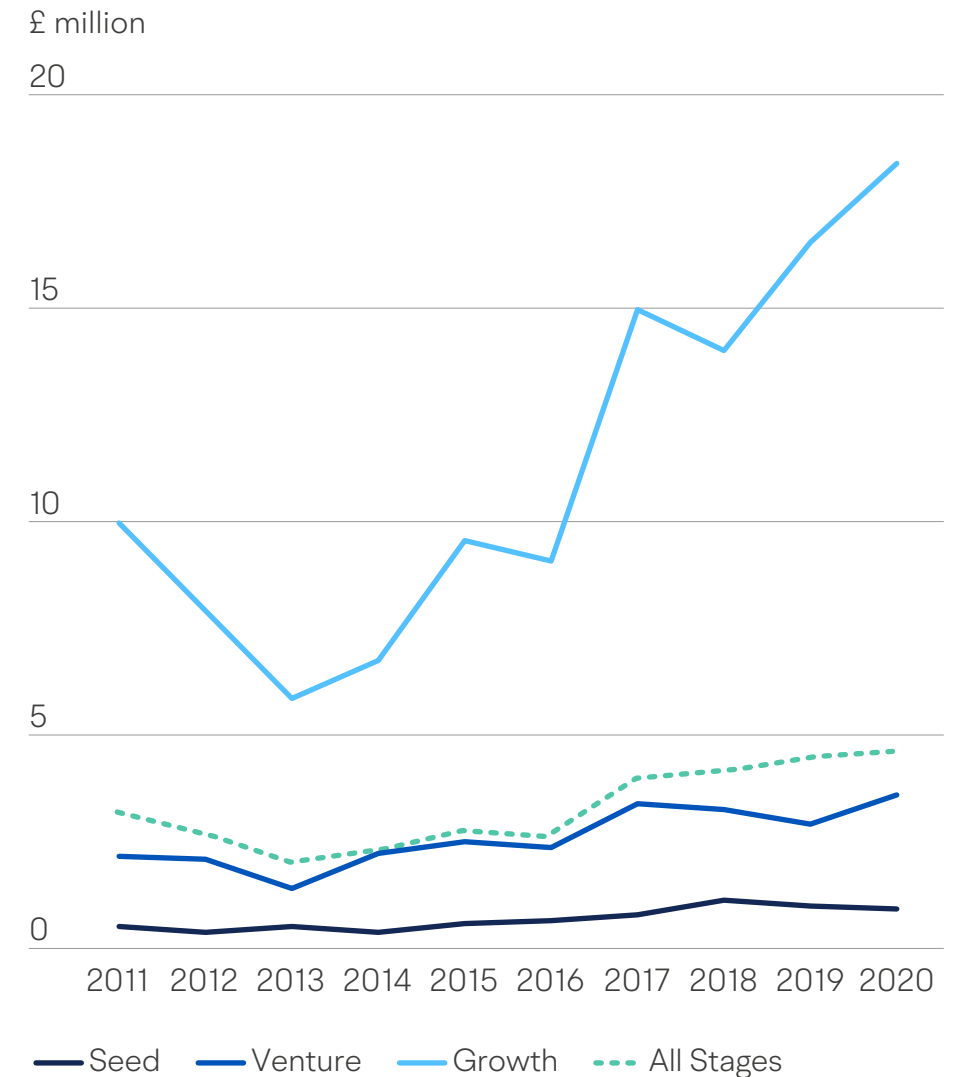
Equity deal sizes have increased over the last few years and continue to do so in 2020, albeit at a lower rate, increasing by 3% in 2020. This is driven by a small number of very large deals. The number of deals greater than £10m increased in 2020 from 173 in 2019 to 176 2020, although as a proportion of overall deals it remained the same at 9%. However, the proportion of total investment coming from these deals rose from 68% to 71% in 2020. There were 11 SME deals larger than £100m in size in 2020, up from 5 in 2019 showing outsized deals continue to be a feature of the UK market.

There are clear differences by stage of business. Figure B.33 shows average deal sizes for later stage companies at the venture and growth stage increased in 2020, whilst deal sizes for the seed stage have declined. These are the highest recorded average deal sizes for the growth and venture stages.

Fig B.33

**Average deal size over time, by business stage**

Source: British Business Bank analysis of Beauhurst data





Average venture stage deal sizes increased 25% to £3.6m, although the increase was mostly driven by a small number of very large deals. For instance, in 2020, there were 2 venture stage deals larger than £100m in size and 26 deals larger than £20m. Outside of these outlier companies, the median venture stage deal size decreased by 4% to £1.3m. The fall in the median deal size is due to the inclusion of Future Fund deals. Average non-Future Fund deals at venture stage are 38% larger (£3.8m) than Future Fund deals (£2.4m). Therefore, the median deal size at the venture stage without the inclusion of Future Fund deals is flat at £1.4m.

The average growth stage deal size increased by 11% to £18.3m in 2020. The size of the increase is obscured by OneWeb, which received £940m of funding in Q1 2019. Excluding this single OneWeb deal shows growth stage deals increased by 35% in 2020 from 2019. The median growth stage deal increased by 31% to £6.9m showing the confidence that investors have in the performance of late stage equity backed companies, and their willingness to invest larger amounts of funding into those companies which are in the process of scaling up their activities.

In contrast to increasing deal sizes at later stages, the average size of seed stage deals declined by 7% in 2020 from £1.0m in 2019 to £0.9m. This is also lower than in 2018 (£1.1m), showing that the seed stage was already showing signs of softening in 2019. The median deal size at the seed stage was flat in 2020 at £350k. The recent Business Angels Market report also confirms angels are more cautious in 2020 and have been making smaller investments. The value of initial and follow-on investments during 2020/21 to-date is considerably lower than previous years, sitting at an average of £69k and £46k respectively.<sup>110</sup>

This indicates that while investors were still willing to make deals in seed stage companies, they are rationing their capital for these early-stage companies and are being more cautious, especially for high growth potential outlier companies. This is especially seen in the divergence in average deal sizes between initial and follow-on rounds for seed stage companies. The average deal size of a follow-on round of funding in a seed stage company declined by 3% to £1.1m in 2020. This is much smaller than the decrease of 12% to £0.8m seen in the average size of initial seed funding rounds.

This has led to a divergence in the average deal size between first time funding and subsequent seed rounds compared to 2019.

This is also seen in Europe with PitchBook data showing 93% of VC in Q3 2020 went to follow-on rounds. PitchBook suggests if these trends continue there will be the largest divergence between first time funding and follow-on VC investment value for a decade. Part of this is down to growing sources of non-traditional sources of capital from overseas investors like corporate venture capital and sovereign wealth funds all looking to undertake larger follow-on deals.<sup>111</sup>

### Company valuations increased

Pre-money valuations show how much a company is worth before it receives any equity investment. Company valuations will increase over time as the company grows, or due to changes in investor appetite and competition amongst investors for deals.

Average pre-money valuations have shown long run increases over the last decade but have fluctuated in recent years due to volatile valuations in later stage growth stage companies. A couple of large outlier





companies may have an outsized effect on the average in 2020 as occurred previously in 2018. In 2020, the average pre-money valuation grew by 47% with increases in the average valuation at all stages (Figure B.34). The growth stage saw the largest increase at 92% with average company valuations now over £100m. Pre-money valuations at the seed and venture stage increased by 14% and 25% respectively.

Some of the increases in valuations are due to the impact of outlier companies, especially as there has been some very large deals in 2020. However, the median valuations at the seed and growth stages, saw increases of 17% and 40% respectively, which shows valuation increased across the wider population of equity backed companies. Meanwhile the median pre-money valuation of a venture stage company was flat at £7.1m in 2020. This might reflect investors becoming more cautious about investing in some venture stage companies, as well as investors having less competition for deals.

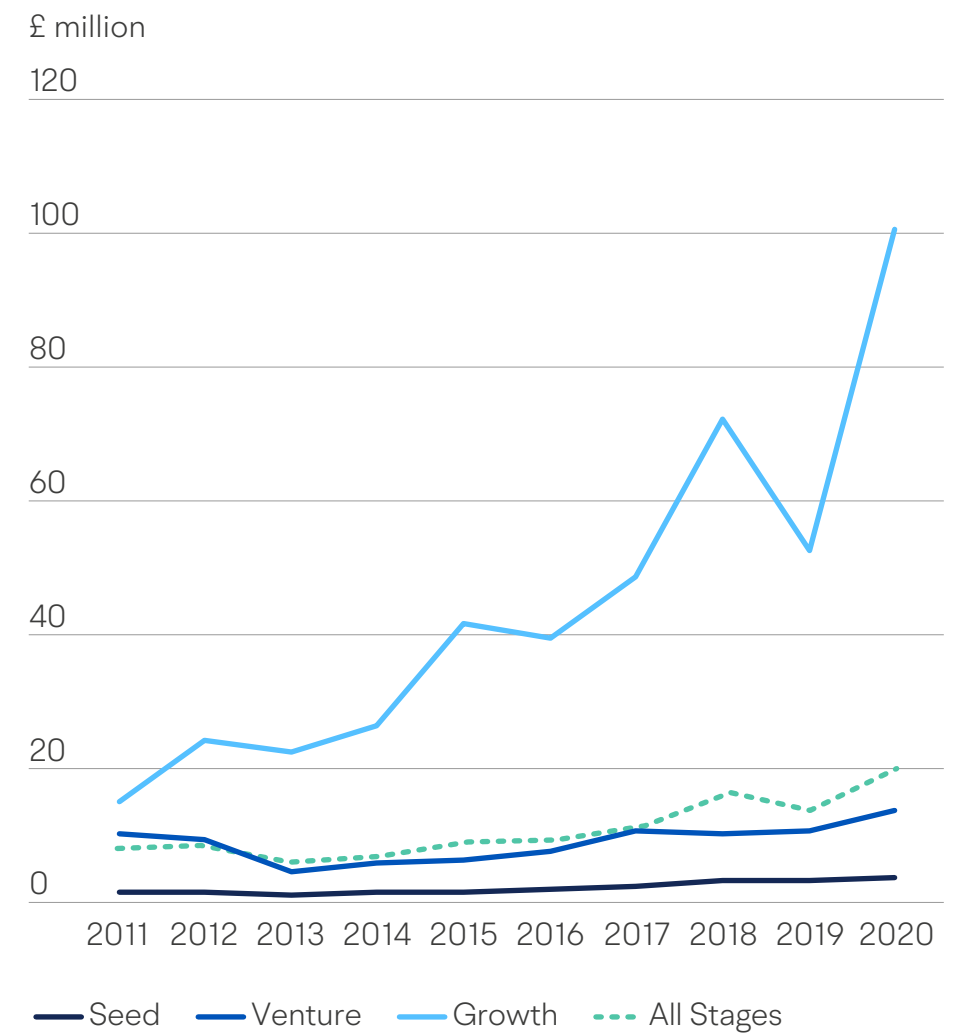
The significant increase in growth stage valuations have been driven by strong capital inflows into the ecosystem, as outsized rounds have closed despite the macroeconomic uncertainty.<sup>112</sup>

More companies than ever before are reaching unicorn<sup>113</sup> status, and there is a strong media and industry interest in companies reaching this coveted status. However, reaching unicorn status is a measure of developing a successful scale up company, rather than the ultimate objective. As of 12th February 2020, the UK had 22 unicorn status businesses. Five new companies gained unicorn status in 2020 including Snyk, Arrival, Cazoo, Gousto and Hopin. This is one more than in 2019, showing later stage VC funding conditions are strong despite the global uncertainty.<sup>114</sup> The time taken for some companies to achieve unicorn status is reducing in 2020.<sup>115</sup> Beauhurst<sup>116</sup> estimates the average age of all companies gaining unicorn status was 7 years, but Hopin gained unicorn status only after one year and Cazoo after 2 years.

Fig B.34

**Average company pre-money valuation over time, by business stage**

Source: British Business Bank analysis of Beauhurst data





British Patient Capital has had an important role in increasing the number of VC funds with sufficient scale and firepower to support larger, later-stage funding rounds in UK companies. This is demonstrated by the recent unicorns Cazoo and Hopin who are both funded by VC funds supported by British Patient Capital.

Whilst the increase in valuations is positive, there are some differences depending on whether the deal is an initial or follow-on deal. This is especially seen at the growth stage where the average pre-money valuation of a follow-on round increased by 97% to £122m compared to an increase of only 1% in the average pre-money valuation of an initial round in a growth stage company to £24.3m. This shows that the strong capital inflows into the equity ecosystem were mainly directed towards those later stage companies already within the equity ecosystem.

This dynamic is also seen at the seed stage where the average pre-money valuation of a follow-on round rose by 33% in 2020 to £4.6m compared to 2019. This contrasts with a much smaller increase of 4% to £2.8m seen in the average pre-money valuation of a company raising an initial round of equity. This shows investors

were more confident in making investments in early-stage companies that had previously raised equity finance, illustrating the challenge facing companies raising funding for the first time.

The venture stage presents a contrasting picture, with the average pre-money valuation of an initial round growing by 63% to £12.1m, much stronger than the 15% growth to £13.9m seen in the average pre-money valuation of a follow-on round.

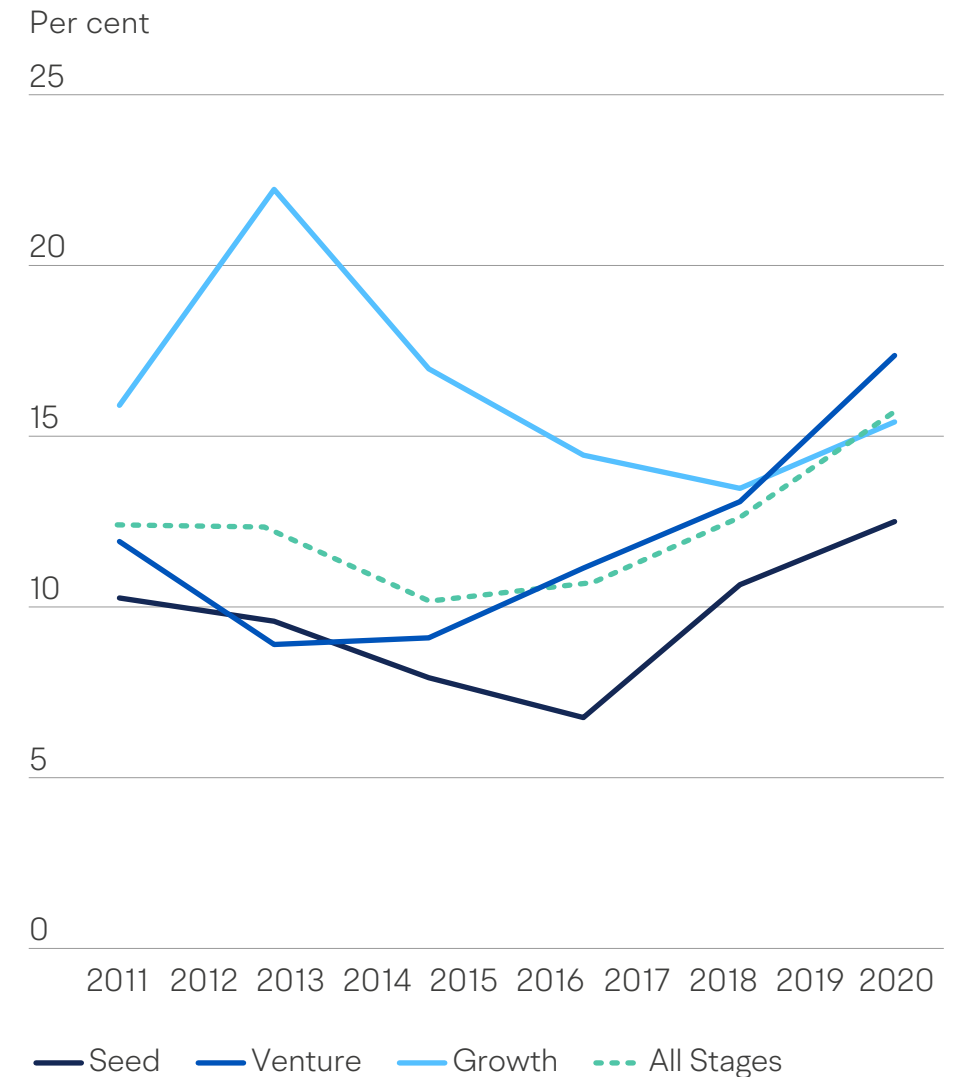
Another indicator of changes in investor appetite is the prevalence of down rounds in follow on deals. A ‘down-round’ is when a company raises an equity round at a lower valuation than previously achieved. Figure B.35 shows since 2015, the proportion of follow-on rounds classified as down rounds has stayed between 10% to 13%. In 2020, this proportion increased by 3 percentage point to 16% suggesting that while the market has been relatively robust, some companies’ valuations have been adversely affected by Covid-19.

The proportion of down rounds increased at all stages, with the venture stage seeing the largest increase from 13% in 2019 to 17% in 2020. This helps to explain the muted growth in the average pre-money valuation of a

Fig B.35

**Proportion of follow-on down rounds, by stage**

Source: British Business Bank analysis of Beauhurst data





follow-on round in a venture stage company compared to those at the seed and growth stages, as well as the flat median average pre-money valuation for all venture stage companies. The proportion of down rounds at the seed stage increased from 11% in 2019 to 12% in 2020 and the proportion of down rounds at the growth stage increased from 13% to 15%. Despite the increases, these are similar proportions to historical levels showing that investors generally maintained confidence in investing in early and late stage companies.

There are multiple factors that may have led to the decreasing valuations that result in a down round including failure to hit planned milestones, uncertainty on revenue and viability, and potential weaknesses in both the fundraising and exit environment. It is possible that venture stage companies were more exposed to market uncertainty as these companies are beginning to generate sales and are scaling up within the market. Nevertheless, valuations overall have defied expectations, mirroring the recovery seen in public market share prices seen over 2020.

To summarise, there is some evidence to suggest investors became more cautious at the earlier stages in 2020, as demonstrated by smaller deal sizes at the seed stage, especially for companies raising equity for the first time. Investors have also become more cautious at the venture stage shown by declining valuations and an increased prevalence of down rounds.

### **Equity activity remains concentrated in London, but signs of increased investment outside of the Capital**

Previous Small Business Finance Markets and Equity Tracker reports identified that the UK's equity deals and investment activity are highly concentrated in London. The Capital city's proportion of total UK equity deals and investment is greater than its proportion of high growth businesses. Figure B.36 shows in 2020 London accounted for 47% of all deals and 66% of all investment. This is flat on the 47% of deals and down on the 68% of investment value that went to London in 2019, showing that concentration did not increase in 2020. London accounted for 21% of the UK's high growth business population in 2019, suggesting equity activity is under-represented in areas outside of the

Capital.<sup>117</sup> This shows the existing structural challenges for entrepreneurs outside of London to access capital continue to occur under a Covid-19 environment, despite the greater movement towards investors using remote networking and due diligence.

Future Fund supported deals were slightly more likely to be in London, with 51% of deals in London compared to 49% of non-Future Fund deals. Published Future Fund programme statistics shows on a values basis, a lower proportion of Future Fund funding goes to London.<sup>118</sup>

The increase in the number of deals seen in 2020 was relatively evenly distributed across the country with only two regions – Northern Ireland and the South West – seeing a noticeable decline in the number of deals in 2020. Despite the number of equity deals in London increasing by 6% to 965 deals, London's concentration remained flat at 47% due to increases seen in other parts of the UK.



The average size of an equity deal in London increased by 1% to £6.4m in 2020. This means that the 2% decline in the concentration of investment is driven by increases in equity investment in areas outside of London. The amount of investment outside of London increased by 15% to £3bn, driven by an 8% increase of the average deal size in these regions to £3m. Equity investment in the West and East Midlands and Yorkshire and the Humber saw the strongest increases in 2020, increasing by 277%, 167% and 145% respectively.

This section suggests that there does not appear to be large geographic differences in the impact of Covid-19 on UK equity finance markets. Companies across the UK have been able to access equity funding, with some regions seeing particularly strong growth in investment. This will be explored in more detail in the forthcoming Equity Tracker report.

Figure B.36

### Number and value of deals in 2020, by English region and Devolved Administration

Source: British Business Bank analysis of Beauhurst, ONS and BEIS data

Region	Number of equity deals (2020)	Proportion of deals (2020)	Investment value (2020)	Proportion of investment (2020)	Proportion of High Growth businesses (2019)
London	965	47%	£5.8bn	66%	21%
Scotland	242	12%	£283m	3%	6%
South East	188	9%	£792m	9%	15%
East of England	130	6%	£595m	7%	9%
North West	117	6%	£270m	3%	11%
South West	80	4%	£185m	2%	8%
Wales	77	4%	£78.6m	1%	4%
North East	69	3%	£123m	1%	3%
Yorkshire and the Humber	68	3%	£146m	2%	7%
West Midlands	52	3%	£382m	4%	8%
East Midlands	32	2%	£76m	1%	7%
Northern Ireland	24	1%	£20m	0%	2%



### **British Business Bank programmes have had an important role in increasing the availability of equity finance to SMEs during the pandemic**

UK equity finance finished 2020 with a 5% increase in deals compared to 2019, with the increases partly driven by the Future Fund programme. The impact of the Future Fund is seen in the aggregate data with the Future Fund involved in 11% of all announced deals in 2020. Without the programme, the number of equity deals in 2020 is likely to have been lower.

Not only have the Bank's equity programmes responded to cyclical needs, but they also address long term structural issues in the market.

Funding conditions for early-stage companies remains difficult. These companies raising small amounts of finance are likely to be affected by market failures. The decline in seed stage funding seen in 2019 and continued low level of investment in 2020, which remains lower than 2018 levels show the continued need for the ECF programme. The ECF programme remains targeted at supporting early-stage companies raising their first round of VC. The Bank's Regional Angel Programme is also supporting early-stage businesses. In 2020, Newable Ventures and Bristol Private Equity Club (BPEC) secured £10m<sup>119</sup>, and SFC Capital<sup>120</sup> also secured funding.

London's continued high share of UK equity deals in 2020 shows the continued need for geographically targeted programmes for companies outside of London. The British Business Bank is committed to supporting equity activity throughout the UK with the Midlands Engine Investment Fund, the Cornwall and Isles of Scilly Investment Fund and the Northern Powerhouse Investment Fund dedicated to increasing the availability of both equity and debt finance in these areas.

The British Business Bank equity programmes support both early-stage investment and regional equity activity, and they also fund companies scaling up. In 2020 Gousto, which is backed by the Angel Co-fund, as well as Cazoo and Hopin, which are funded by BPC-backed VC funds all reached unicorn status showing how our programmes support successful ambitious scale up companies.

The British Business Bank will launch in early summer Future Fund: Breakthrough. This new £375m scheme will encourage private investors to co-invest with government in high-growth innovative firms. These R&D intensive companies accelerate the deployment of breakthrough technologies which can transform major industries, develop new medicines, and support the UK transition to a net zero economy.

2.7

## Private debt

- UK private debt deal numbers declined significantly in 2020, particularly for smaller businesses
- Fundraising markets were challenging, the number and value of private debt funds closing halved in 2020
- BBB research indicates over £9bn of private debt capital is invested annually in SMEs and lower mid-market companies
- Private debt deals are geographically diverse, with 82% of deals in 2018 and 2019 occurring outside of London
- Private debt will play an important role in the economic recovery





Private debt is a broad finance type, involving loans made by non-bank lenders to firms. The sector, sometimes also referred to as direct lending or private credit, covers products ranging from growth-focused deals worth below £250,000 to Private Equity-backed leveraged buyouts of large corporates. The Bank's focus in this market is on private debt deals in SMEs and mid-caps which do not involve a Private Equity (PE) sponsor and aim to unlock growth in recipient businesses.

Private debt funds generally target established, profit-generating companies seeking finance to implement step-change growth plans. These companies typically fall outside of bank lending risk appetite and benefit from the tailored lending products private debt funds specialise in. This tailoring can include bullet repayment where the loan is repaid in full at maturity, rather than on an ongoing basis throughout the term. Recipients are then free from regular repayments, allowing them to focus on investing in growth.

Private debt markets are dominated by large scale funds undertaking sponsored, mostly buyout, transactions in large corporates.<sup>121</sup> This is reflected in much of the market data. Leading industry publications (e.g. Preqin's Global Private Debt Report,<sup>122</sup> Deloitte's Alternative Lender Deal Tracker,<sup>123</sup> or the Alternative Credit Council's Financing the Economy report<sup>124</sup>), focus on mid-market deals and tend not to be UK-specific. The SME end of the private debt market has therefore been relatively opaque historically. Consequently, to add to our understanding of the smaller end of the UK private debt market, the Bank undertook a primary research project in 2020. The UK Private Debt Research Report's<sup>125</sup> findings are used at the end of this section to provide a more SME-focussed overview of the UK private debt market.

### **UK private debt deal numbers declined significantly in 2020, particularly for smaller businesses**

Preqin and Deloitte Alternative Lender Deal Tracker data show a large fall in private debt deal numbers in 2020 (figure B.37). According to Deloitte, 69 private debt deals took place in the UK in Q1-3 2020 compared to 118 over the same period in 2019, a 42% decline. Preqin data shows a similar story, with deal numbers dropping 38% from 89 in Q1-3 2019 to 55 in Q1-3 2020.

Barring an exceptional Q4, 2020 will be the first year in which annual UK private debt deal numbers have fallen in the Deloitte dataset. Prior to 2020, Deloitte reported the UK private debt market had been on a strong growth trajectory, with deal numbers increasing from 68 in 2013 to 162 in 2019. Whilst Preqin data also shows strong growth between 2013 and 2017, the trend had begun to reverse slightly in 2018 and 2019, where deal numbers fell from their peak of 144 in 2017 to 109 in 2019.



Dividend recaps were the most affected deal type in 2020, falling 82% from 11 deals in Q1-3 2019 to just two deals in Q1-3 2020. Refinancing and Bolt on M&A deal numbers also fell significantly, by 58% and 47% in Q1-3 2020 compared to Q1-3 2019 respectively. Leveraged buyout and growth capital deals in the UK were less affected, with the number of leveraged buyouts falling 30% in Q1-3 2020 compared to Q1-3 2019, and the number of growth capital transactions increasing slightly.<sup>126</sup>

Market data sources also indicate that the UK private debt market may have been more severely affected by Covid-19 than other countries. For instance, both Preqin and Deloitte data suggest that the German market has been much more resilient, with deal numbers falling by 9% and 17% in Q1-3 2020 according to each data source respectively. This may be due to Germany's low historic activity in highly affected sectors such as retail, leisure and real estate, and relatively higher concentration in less cyclical sectors such as TMT and Healthcare. The US mid-market also appears to have been slightly more resilient than the UK through the pandemic, with deal numbers falling by 31% in Q1-3 2020 compared to Q1-3 2019.<sup>127</sup>

Fig B.37

**Number of UK mid-market private debt deals per quarter, 2013-2020**

Source: British Business Bank analysis of Preqin and Deloitte Alternative Lender Deal Tracker

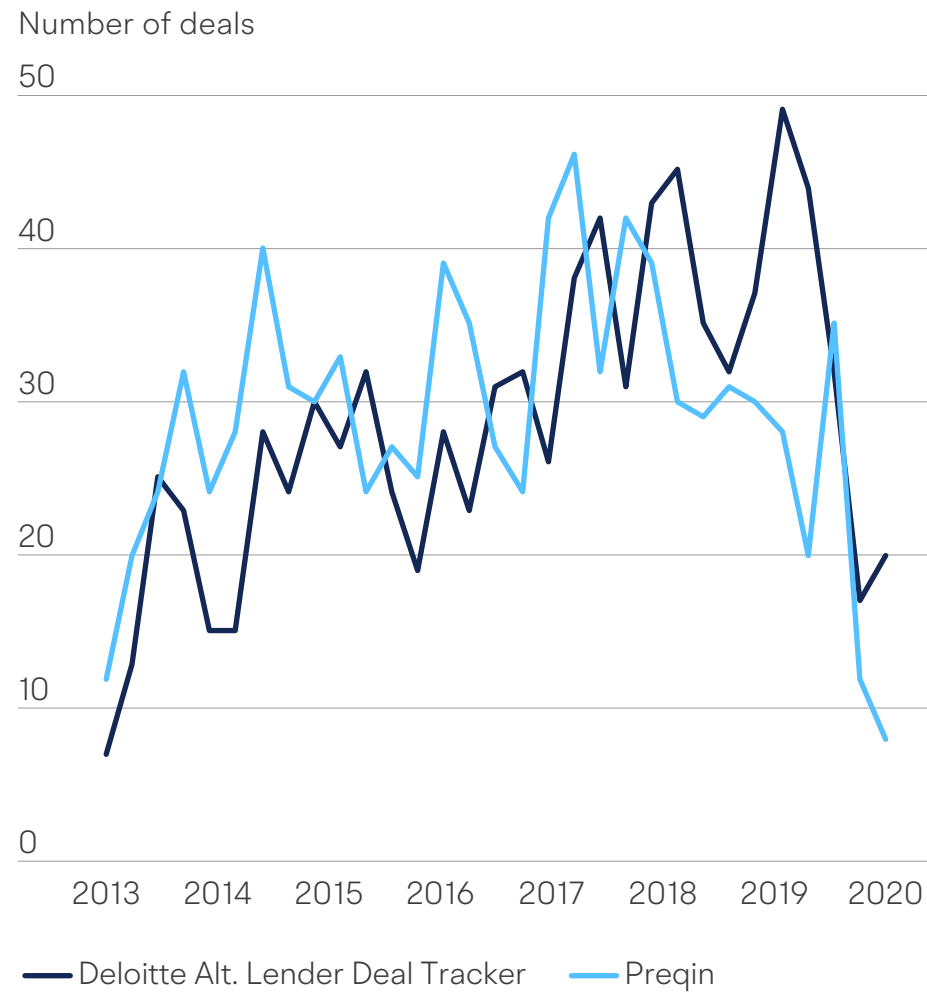
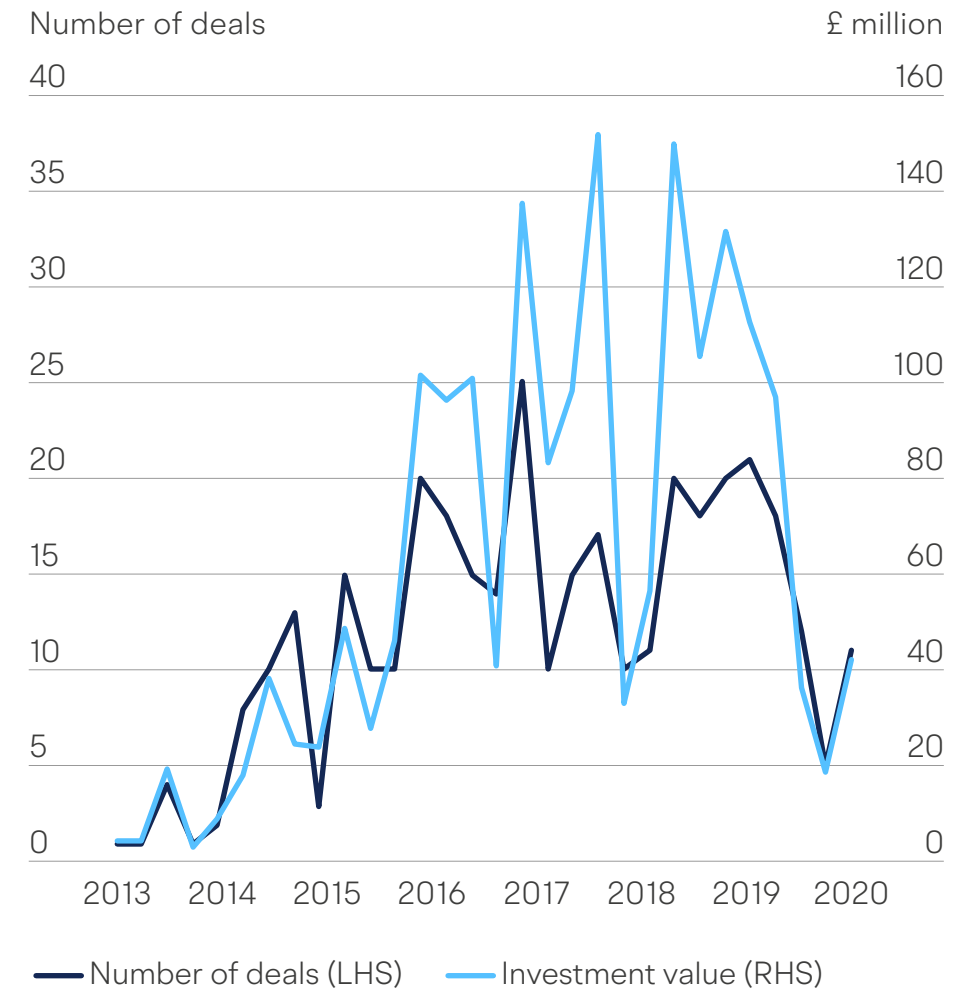


Fig B.38

**Number and value of UK deals undertaken by BBB-backed small-cap private debt funds**

Source: BBB MI data







Analysis of both the Deloitte and Preqin datasets shows they mostly cover mid-market deals with limited coverage of deals in SMEs and smaller mid-caps. BBB data on the activity of the small-cap debt funds in the Bank’s private debt portfolio has also been analysed to assess whether these predominately mid-market findings translate to trends at the smaller end of the market.

Figure B.38 shows that the activity of these small-cap private debt funds has been hit even harder in 2020 than the mid-market. Deal numbers declined by 53% from 59 in Q1-3 2019 to 28 in Q1-3 2020. Investment value dropped even more sharply, from £350m in Q1-3 2019 to £98m in Q1-3 2020, a 72% decline.

Clearly the Bank’s portfolio does not cover the whole market, but these sharp declines are likely to have been mirrored elsewhere, suggesting that the impact of Covid-19 on UK private debt deal flows is most pronounced for smaller companies. Distressed debt and special situations lending deals tend to perform well during economic downturns, and therefore support overall private debt deal flows. However, they are relatively rare at the smaller end of the market, which may have contributed a greater decline in SME private debt deals compared to the mid-market in 2020.<sup>128</sup>

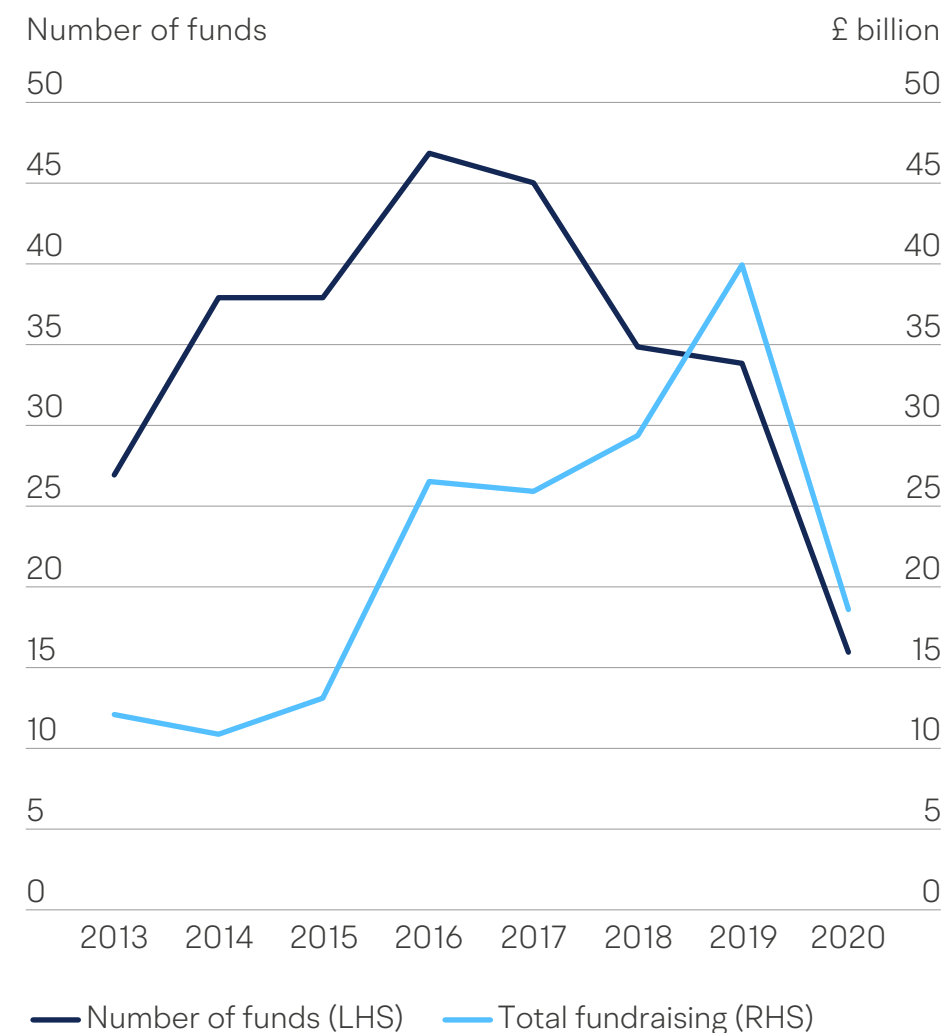
It is likely that the introduction of the Coronavirus Business Interruption Loan Scheme (CBILS) has impacted activity too. For many businesses at the smaller end of the private debt space, CBILS provided a financing option which was both cheaper and more accessible. CBILS was largely delivered through the main banks, with few alternative finance providers being accredited. Section 1.4 provides more detail on this issue.

**Fundraising markets were challenging, the number and value of private debt funds closing halved in 2020**

Fundraising markets for private debt funds have been similarly affected by Covid-19. In 2020, a total of £19bn was raised across 16 UK mid-market private debt funds, compared to £40bn across 34 funds in 2019. This represents a decrease of 53% in both the number of funds closing and the total raised. However, as figure B.39 shows, the number of UK mid-market debt funds closing per year has been trending downwards since 2016, whilst total fundraising has continued to increase. Average mid-market fund sizes have therefore been trending upwards, increasing from £290m in 2014 to £1.2bn in 2020.

Fig B.39  
**Number and value of UK-based Private Debt funds closing per year, 2013-2020**

Source: PitchBook





Difficult private debt fundraising conditions are not unique to the UK as global private debt fundraising declined substantially in 2020.<sup>129</sup> The total number of mid-market private debt funds in the US and the Rest of Europe fell by 40% and 39% respectively. Whilst this is only marginally lower than the decline in the UK, the total amount raised only dropped by 13% in the Rest of Europe and increased by 6% in the US.

Fundraising for SME-focussed debt funds has been particularly difficult in 2020. It is likely that, amidst this period of economic uncertainty, LPs are concentrating their capital in larger funds and established fund managers, at the cost of small-scale fund managers.

The British Business Bank has played a catalytic role in supporting the development and growth of SME-focused private debt funds in the UK through the Small Cap Business Finance Partnership and the Investment Programme. These programmes have been especially important this year in supporting small-scale private debt fund managers raise capital in a challenging environment. In 2020 British Business Investments made a record six commitments worth £190m to small-cap private debt funds, up from two commitments worth £75m last year.

### BBB research indicates over £9bn of private debt capital is invested annually in SMEs and lower mid-market companies

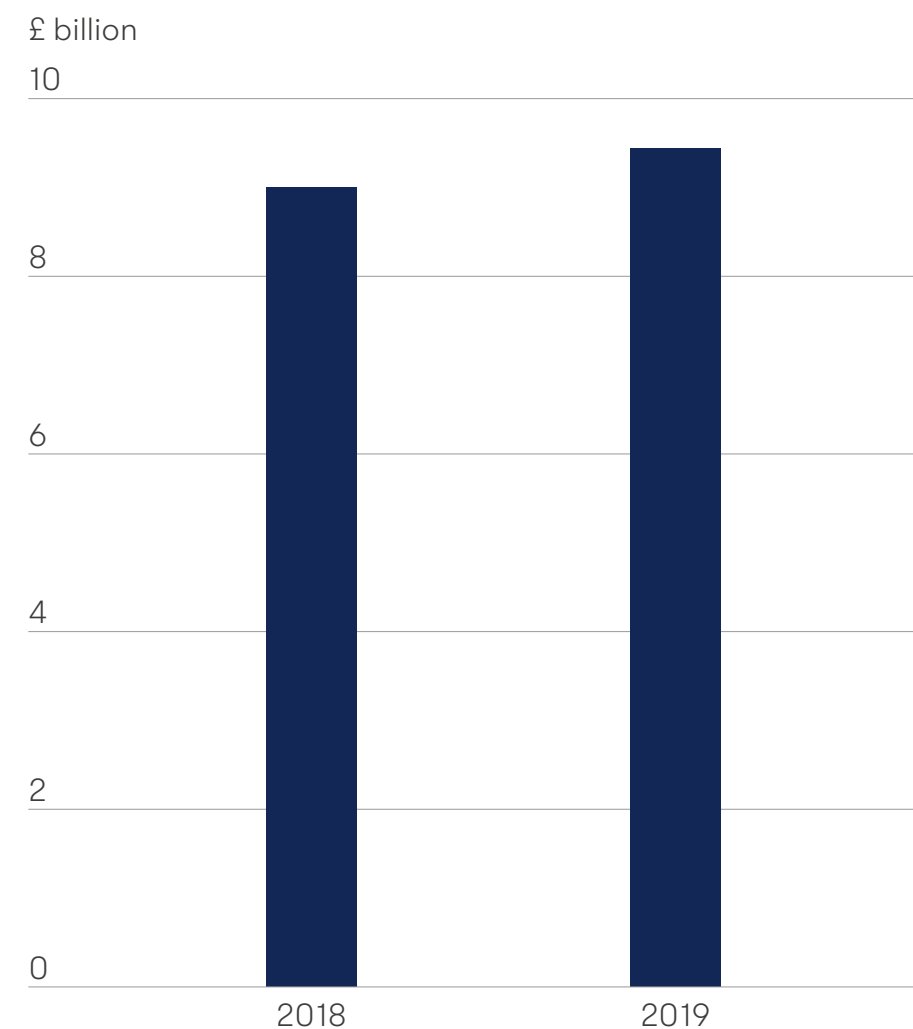
Given both the Deloitte and Preqin datasets predominantly cover mid-market activity the Bank's UK Private Debt Research Report focussed on increasing visibility of the SME end of the UK private debt market. The fieldwork was completed in mid-2020 and as such the analysis looks at 2018 and 2019 data.

Figure B.40 shows the total value of the deals undertaken by the 37 responding managers in 2018 and 2019. In total £9bn was invested in 2018, increasing to £9.4bn in 2019, in line with the pre-2020 market-wide growth reported by Deloitte and demonstrating the scale and importance of private debt to the UK SME finance ecosystem.

Figure B.40

#### Total value of UK private debt deals captured (2018-2019)

Source: BBB Private Debt Research Report 2020,<sup>130</sup>





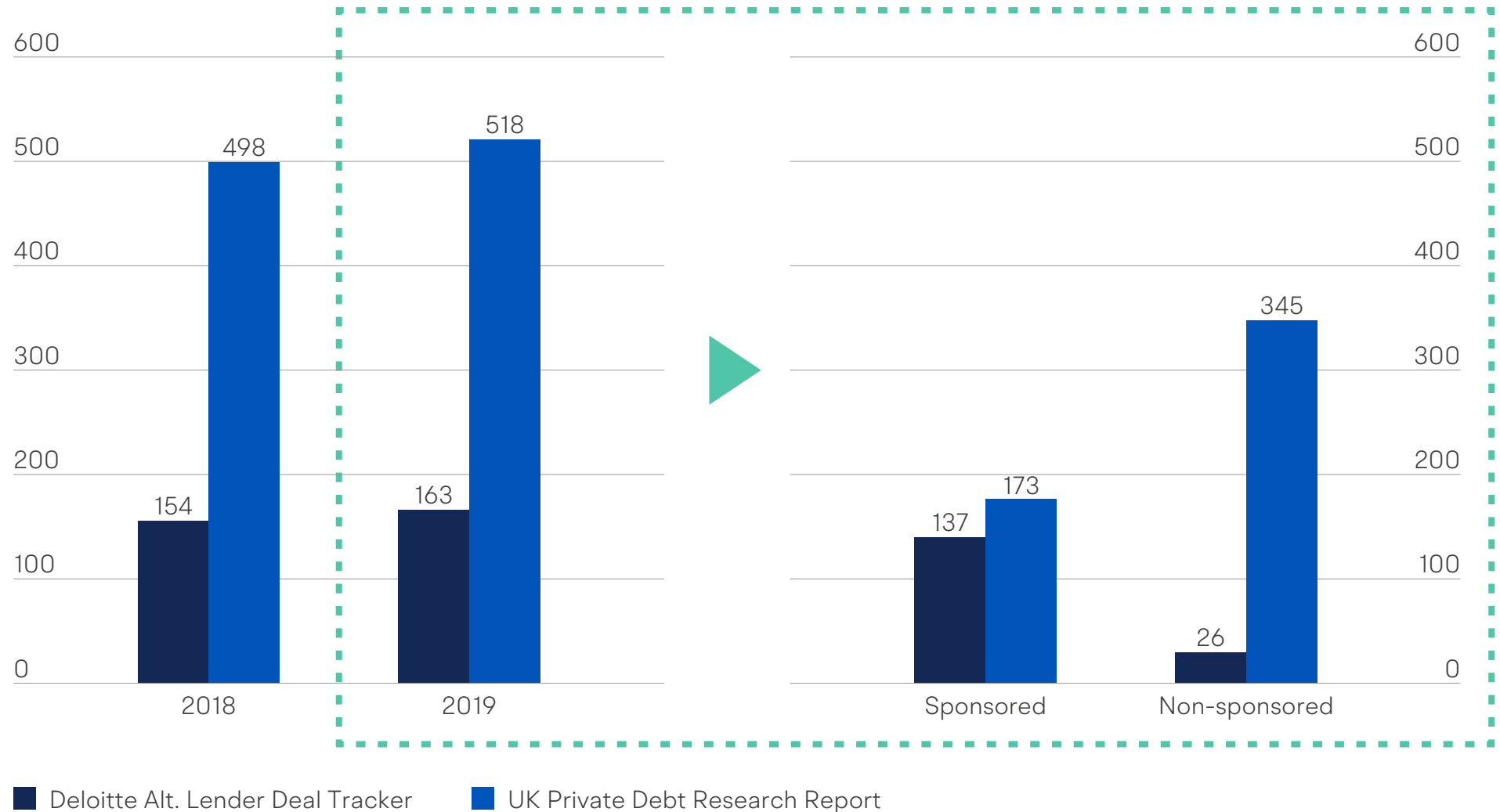
A total of 498 transactions were completed by responding funds in 2018, increasing to 518 in 2019 (figure B.41). Figure B.41 also compares the coverage of the Bank’s report with the Deloitte Alternative Lender Deal Tracker, showing that the Bank’s data captures a much larger number of deals in each year. This is driven by far greater coverage of non-sponsored transactions, which only make up around 20% of the Deloitte Alternative Lender Deal Tracker dataset but comprise around two thirds of deals in the Bank’s data.

Figure B.42 shows the split of reported deals and investment by finance use.<sup>131</sup> The majority of deals are classified as “growth”,<sup>132</sup> with buyouts and acquisitions constituting less than 20% of deal numbers. Conversely, buyout and refinancing deals are comfortably the largest components of capital invested, contributing 74% between them.

Fig B.41

**Total number of UK private debt deals captured (2018-2019)**

Source: BBB Private Debt Research Report 2020, Deloitte Alternative Lender Deal Tracker





This demonstrates that growth deals are much smaller on average, with a mean size of £2m compared to £24m for other deal types. Although this is partly driven by microfinance transactions undertaken by government-backed lenders, the size differential persists even without these deals. The prevalence of growth deals in the Bank’s dataset demonstrates the report’s focus on the smaller end of the private debt market, with buyouts and acquisitions representing a much larger proportion of deals in datasets focussing on the mid-market segment.<sup>133</sup>

Figure B.43 breaks down the deals and investment by deal size.<sup>134</sup> Deals below £1m are most common, accounting for 53% of deals in the dataset, however, deals within this category only represent 1% of capital invested. Over 50% of investment value comes from deals above £50m in size, again demonstrating the variety in the transactions captured by this project.

Fig B.42

**Finance use by number of deals and capital invested (2018-2019)**

Source: British Business Bank Private Debt Research Report 2020

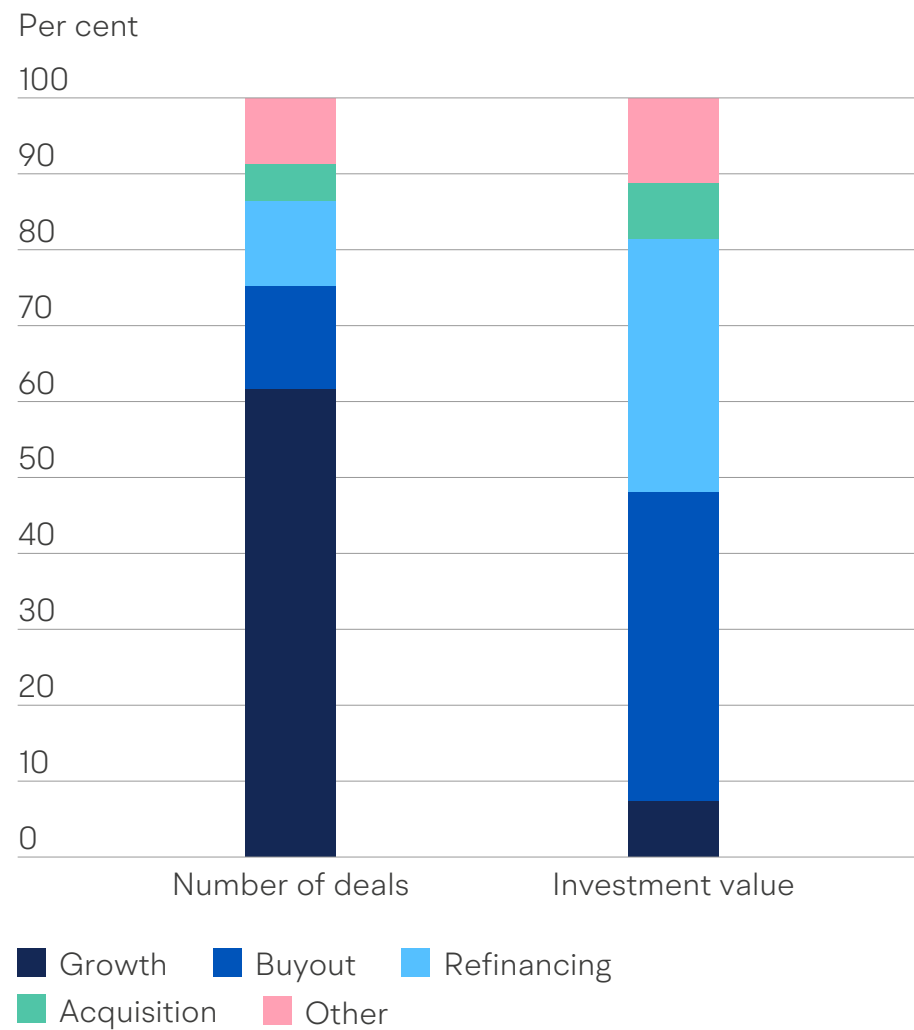
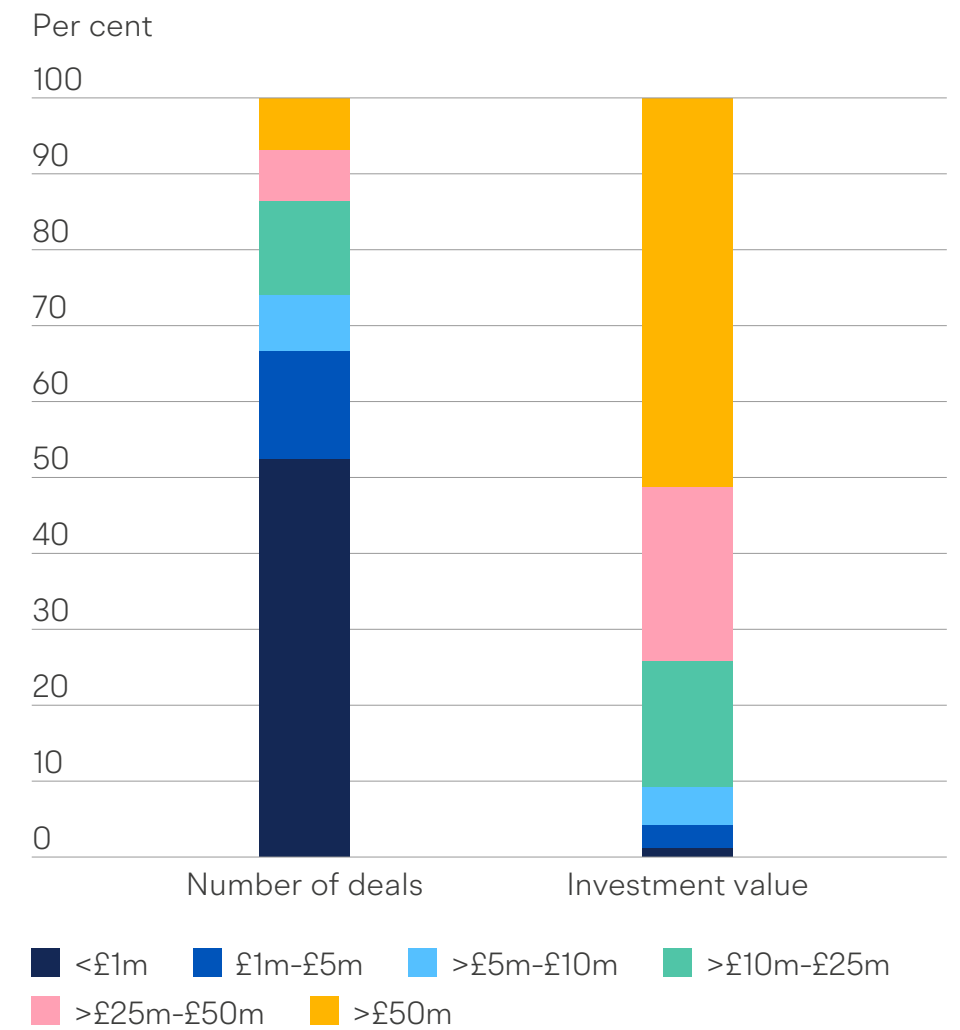


Fig B.43

**Deal size by number of deals and capital invested (2018-2019)**

Source: British Business Bank Private Debt Research Report 2020





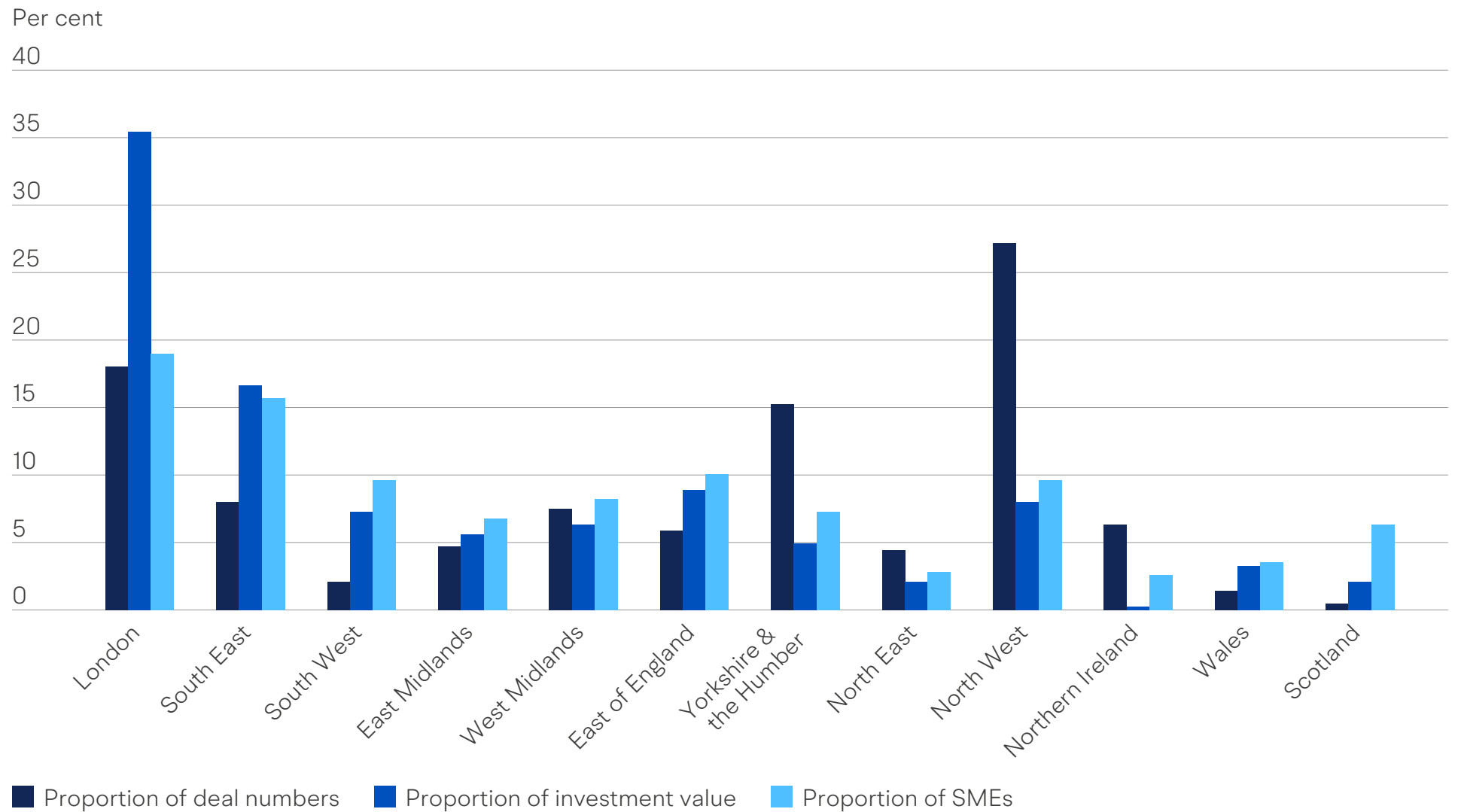
**Private debt deals are geographically diverse, with 82% of deals in 2018 and 2019 occurring outside of London**

Figure B.44 shows the regional distribution of reported private debt deals and investment compared to the distribution of the business population.<sup>135</sup> Private debt is clearly a geographically diverse finance product, with 82% of deals between 2018 and 2019 occurring in companies outside of London. This reflects that high-growth investment opportunities can be found across the country. Despite strong clusters existing outside of London, 35% of capital invested between 2018 and 2019 went to London-based businesses. Although this is greater than London’s 19% share of the UK SME population, demonstrating a degree of concentration, private debt is more regionally diverse than other high-growth risk capital finance types such as Venture Capital.<sup>136</sup>

Fig B.44

**Regional distribution of deals and capital invested compared to business population (2018-2019)**

Source: British Business Bank Private Debt Research Report 2020, BEIS Business Population Estimates (2020)





There are some differences between the characteristics of deals in London and those in the rest of the UK. Growth capital transactions are much more prevalent outside of London, where 69% of all deals were classified as growth compared to 39% in London. Growth deals tend to be much smaller, which may explain why the average value of deals involving London-based companies is larger (£21m) than those involving companies outside of London (£9m).

Transactions undertaken by private debt funds with government support represent 60% of the non-London deal sample but just 1% of London deals. We believe that this is the key driver of the discrepancy in transaction sizes, as these government-backed investors appear to make smaller, more often growth-focused, investments than the overall population of investors in the dataset. When considering the transactions undertaken solely by sector players, there is no material difference in either the size or type of deal in London-based companies compared to the rest of the country.

### **Private debt will play an important role in the economic recovery**

The UK Private debt market had a challenging year in 2020, with funding markets for both companies and funds being hit hard by the Covid-19 pandemic. Funding conditions for SMEs have been particularly poor, as many fund managers and LPs have focussed on larger, lower risk, investments and supporting their own portfolios.

Furthermore, longstanding structural market issues mean there are barriers to entry for new fund managers looking to enter the private debt market and create incentives for larger ticket investments. As a result, smaller fund managers, and by extension SMEs in the space, find it relatively more difficult to raise capital.

The flexibility of private debt is particularly important at present. Covid-19 has disrupted the revenue streams of many SMEs and mid-caps, and private debt lenders are well placed to support their portfolios through flexible repayment schedules. Private debt will play an important role in the economic recovery, particularly once government guarantee schemes become less dominant

in the market. The role of private debt lenders in post-recessionary periods was clear following the Global Financial Crisis when the greater prevalence of alternative lenders in the US supported faster recovery than in the UK where the market was still relatively immature.<sup>137</sup>

Recognising this importance, and following the record number of commitments in 2020, the Bank's Investment Programme will continue to help smaller fund managers navigate through this period of uncertainty and beyond.

2.8

## Asset finance

- Asset finance volumes fell significantly in Q2 2020, but returned to more normal levels as the year progressed
- Accredited asset finance companies provided £1 billion through the government guaranteed lending schemes in 2020
- While many finance providers have chosen to ride out the storm, for some Covid-19 has accelerated changes in business models and technology
- Green asset finance continues to gain momentum





This section provides an update on developments in the asset finance (leasing and hire purchase) markets in 2020, highlighting the first fall in the level of annual new business since the financial crisis. Asset finance continues to be the alternative finance instrument used by the largest proportion of smaller businesses surveyed in the Business Finance Survey (13% in 2020) but this is below the 15% recorded 2017-2019 and, following the unprecedented uptake of government guaranteed loans, it has dropped from third to the fourth most used external finance type behind term loans, bank overdrafts and credit cards.

The asset finance market, through the provision of leasing and hire purchase, helps businesses invest in vehicles, equipment and plant and machinery. Leasing allows businesses to obtain new equipment by renting it for a contracted period without owning it. If a business wants to own the equipment at the end of the contract period, then hire purchase is the appropriate finance option. In both cases, businesses avoid paying the full cost of the equipment upfront, easing pressures on cash flow.

**Asset finance volumes fell significantly in Q2 2020, but returned to more normal levels as the year progressed**

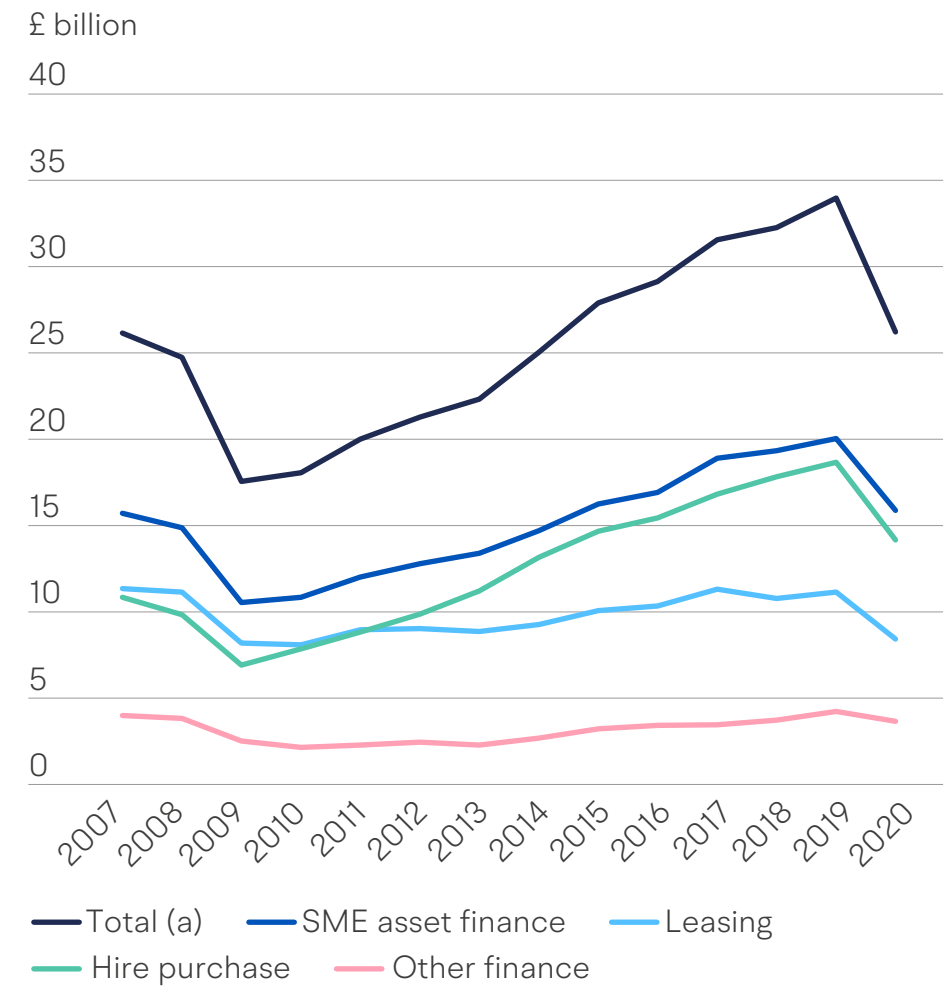
Weak business investment figures, driven by both the Covid-19 pandemic and continued economic uncertainty in the run up to the end of the EU transition period, have been a major driver in the reduction in asset finance in 2020.

The SME asset finance market reported a fall in new business of 21% in 2020 to £15.9 billion, the lowest annual total since 2014 (figure B.45). The IT equipment finance sector reported the smallest rate of contraction in 2020, with new business only 12% lower than in 2019.

Fig B.45

**Size of UK asset finance market for businesses, new business (a)**

Source: Finance and Leasing Association (FLA)



a. Asset finance new business for deals of up to £20 million.





Over the same period, the commercial vehicle finance and business equipment finance sectors each reported a fall in new business of 24%, while the plant and machinery finance sector reported a decrease of 20%.

With changing Covid-19 restrictions and ongoing Brexit negotiations, each quarter had its own story. Despite subdued business investment in Q1 the share of UK investment in machinery, equipment and purchased software in Q1 2020 financed by FLA members fell to 32% from 36% in Q4 2019. This was largely driven by a 28% fall in lending in March compared to the previous year.

Q2 saw larger falls with lockdown restrictions reducing lending volumes considerably and in May the asset finance market reported its lowest level of new business for more than 13 years, down 60% on the same month in 2019. Vehicle finance sectors were the hardest hit by the lockdown restrictions during a quarter that saw record falls in UK business investment (26%). The IT equipment finance sector was the only sector to report growth in the first five months of 2020 as employers supported the transition to home working.

In addition to the impact of falling business investment, market commentary has suggested some SMEs may have utilised government guaranteed term lending in place of asset finance. Looking at asset finance loans written in 2019, 37% by value were for deals of up to £50k, the upper limit of the Bounce Back Loans Scheme (Figure B.46). A further 36% were loans of between £50k and £1m which could qualify for the Coronavirus Business Interruption Loan Scheme (CBILS) and significant share of the remaining 27% would also fall within the £5m upper limit for CBILS. In Q2 2020, the share of total new business accounted for by deals of up to £50k fell to 29%, before recovering to more normal levels in Q3 and Q4 2020.

Asset finance for ‘soft assets’ was thought to have been the most likely replaced with government guaranteed term loans as this is typically more expensive than hard asset finance due to the higher loss given default on such assets.

In Q3 the asset finance market gradually returned to more normal levels of new business with values down 17% on the same quarter in 2019. FLA data showed that the industry provided finance for around 38% of UK investment in machinery, equipment and purchased

Figure B.46

### Asset finance new lending, by value in 2019

Source: Finance and Leasing Association (FLA)

	£m
<b>Loans up to 50k</b>	13,186
<b>Loans between 50k to £1m</b>	13,001
<b>Loans between £1m to £20m</b>	7,955
<b>Loans over £20m</b>	1,492
<b>Total</b>	35,634



software in Q3, with broker contacts suggesting SME clients had started to return to using non-government guaranteed finance.

Asset finance will be key to helping businesses recover post Covid-19. It took until around 2015 for business investment and asset finance values to return to pre-financial crisis levels, should it take a similar amount of time after this similarly sized fall, the UK would be at risk of ‘rusting’ with assets being pushed long past traditional replacement cycles and the resulting loss of productivity impacting smaller businesses’ competitiveness.

The asset finance market does see opportunities for growth in 2021. Commenting on the FLA’s Q1 2021 Industry Outlook Survey results, Geraldine Kilkelly, Director of Research and Chief Economist said “The vaccine rollout in the UK has improved the outlook for the UK economy in the second half of 2021. Almost three-quarters of asset finance respondents to the FLA’s Q1 2021 Industry Outlook Survey expected some growth in new business over the next year if uncertainty reduces.”<sup>138</sup>

### **Accredited asset finance companies provided £1 billion through the government guaranteed lending schemes in 2020**

At the end of 2020 there were 28 finance providers accredited to provide the asset finance variant of CBILS. This compares to over 100 who are accredited in total across the four CBILS variants with nearly all accredited to provide term loans. As discussed in chapter 1.4, this relatively low number of accredited asset finance providers, and in particular non-bank lenders (18), could reflect challenges in securing funding for CBILS lending.

FLA asset finance accredited lenders provided just over £1 billion through CBILS in 2020, with around three-quarters provided through the asset finance variant and the rest mostly via unsecured term lending. Interestingly, some asset finance providers have also increased their offerings on unsecured lending outside of the government guaranteed schemes.

It is likely some of this guaranteed term lending will be to smaller businesses without existing relationships with traditional term loan providers, such as the larger banks, and as such could create new, loyal customers they didn’t previously serve. While some asset finance providers may continue to offer this type of loan in 2021, or if they already did, in greater quantum, market contacts largely felt for many this was a short-term approach until demand for asset finance returned to more normal levels.

### **While many finance providers have chosen to ride out the storm, for some Covid-19 has accelerated changes in business models and technology**

Existing strong liquidity has allowed some asset finance providers to concentrate predominately on managing their existing book without the pressure of needing to increase lending. Historically, loss given defaults have also been low for asset finance lending though secondary values could be an issue if we have a rash of defaults, particularly for those lending to industries hardest hit by Covid-19, such as hospitality.



For some, the Covid-19 crisis has led to lenders either reprioritising or fundamentally changing investment plans and as such a lot has been achieved during 2020 that probably would have taken a lot longer or that finance providers wouldn't have been brave enough to do had these been more normal, office-based times.

Asset finance is considered very much about relationships with clients rather than a more transactional industry. It often requires specialist knowledge and working with clients to deliver tailored solutions. However, many have now realised changes can enhance that, reducing the manual burden of many tasks and leaving companies with more time to be able to manage relationships.

Asset finance providers, as with other finance providers, have sought to improve their digital offerings and processes. Market participants have suggested that institutions that either already had or quickly developed digital offerings and processes, have been able to increase their business during 2020. Furthermore, those without digital processes, and who were trying to stick to their traditional approach, were suffering and for many their business volumes fell substantially.<sup>139</sup>

### **Green asset finance continues to gain momentum**

As noted in last year's report, there was growing discussion in 2019 around the role asset finance providers could and need to play in helping the UK achieve decarbonisation goals. This has intensified in 2020 with talk often framed as 'building back better' as a result of the heightened focus on environmental issues that arose during the onset of the Covid-19 pandemic in the UK.

One approach suggested is via a circular economy approach. This is based around sustainability, promoting repair, refurbishment, and recycling above the 'take, make, waste' approach and it has been suggested asset finance providers are particularly suited to a circular economy model.<sup>140</sup> For example, in a leasing environment, for resources such as machinery, they have expertise in providing use of an asset for a specific period, managing the delivery and collection process and accurately estimating its value on return.

While there is a growing desire amongst many business owners to lessen their carbon footprint, many do not know how best to achieve this. Leasing companies will need to play a key role in educating the market about the benefits of investing in pre-owned assets to promote service-based solutions, such as pay per use. With many assets laying idle currently due to Covid-19 lockdowns, including 34% of UK office desktop PCs, and the potential permanent switch to greater homeworking, now seems an opportune time to pursue such models.<sup>141</sup>

A range of finance providers and manufacturers are currently exploring products and partnerships to deliver circular economy solutions ranging from subscription services for IT equipment to recovery and recycling programmes for electric cars. While the environmental imperative is clear, the fact estimates have suggested the worldwide circular economy could be worth several trillion US dollars by the end of the decade may mean asset finance providers can't afford to ignore the opportunity either.<sup>142</sup>



2.9

## Invoice finance and asset-based lending

- The outstanding value of advances to SMEs fell in 2020
- The smallest businesses continue to buck the trend
- Invoice finance will play an important role in helping smaller businesses recover



Invoice finance and asset-based lending (IFABL) is a term used to describe funding against a range of business assets including accounts receivable (the debts owed to a business by its business customers, often represented by its invoices), stock and inventory, plant and machinery, real estate and even (sometimes) intellectual property and brands. In various forms, the principles underpinning invoice finance and asset-based lending have enabled funding to British businesses for centuries.

### The outstanding value of advances to SMEs fell in 2020

As with almost every finance type, SME IFABL volumes and values fell in 2020. UK Finance estimates suggest that SMEs outstanding advances averaged £6.1bn in 2020, down from £9.1bn in 2019 (Figure B.47). As with other alternative finance types, this likely reflects smaller businesses switching to term lending, predominately via the government guaranteed schemes, and in some cases the challenges lenders have found in reconciling their own funding models with the operation of the government schemes (see chapter 1.4 for a more detailed discussion). While there was an invoice finance Coronavirus Business Interruption Loans Scheme (CBILS) variant, this accounted for less than 1% of drawn down funds lent via the scheme.

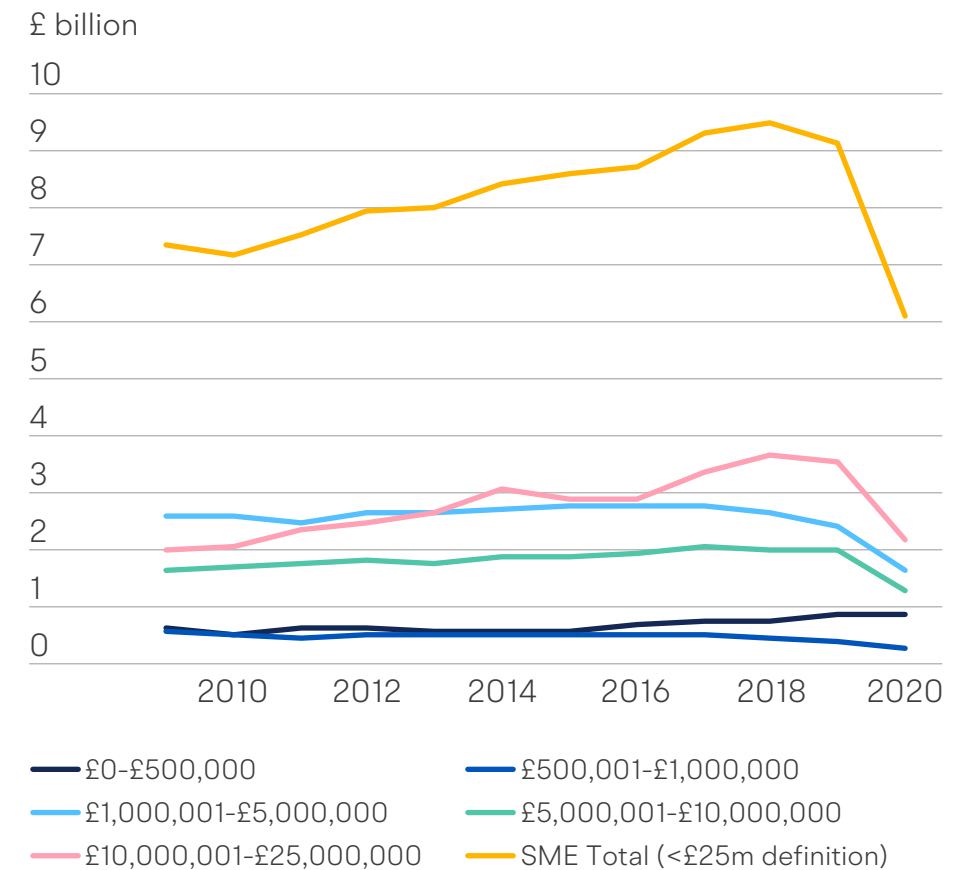
Additional challenges faced by IFABL providers, such as the lower economic activity reducing the number and value of invoices being created and thus available for invoice finance purposes, will have added to the reduction in lending. This is because the value of invoice finance and asset-based lending that can be advanced is essentially determined by the value of the underlying asset base. With client turnover and order books down

Fig B.47

### Levels of quarterly average stock of advances, by size cohort

Source: UK Finance, Bank of England and British Business Bank calculations

Notes: 2020 full year data points are UK Finance estimates projected from monthly figures supplied by a representative sample of UK Finance’s IFABL members.





during the lockdown period, advance levels were automatically restricted. However, despite this, invoice finance providers continue to report significant headroom within existing facilities and capacity for new facilities.

The year started with the first increase in the value (2%) of IFABL advances to SMEs for four quarters. This likely reflected that for many smaller businesses, their first response to the building economic uncertainty was to make more use of their existing finance arrangements.

Q2 was a different story entirely. The range of government interventions to support businesses began to significantly reduce businesses' immediate working capital requirements. While the number of SMEs utilising IFABL decreased by only 2%, the value of advances fell by 44%. This was the largest fall since the series began (2006), and comfortably eclipses the 10% fall seen in Q1 2009 during the financial crisis.

Levels of advances were little changed in Q3 with a small increase of 2% across all SMEs despite the economy starting to reopen after the first lockdown was eased. Q4 estimates suggest further recovery with an increase of 8%, but this still leaves the average advance in 2020 around 33% lower than in 2019.

Throughout the year the overall number of SMEs utilising IFABL has continued to fall, with growth in the sector predominantly seen amongst larger businesses, a pattern we have seen since the end of 2018. While the pace of the reduction quickened marginally, it remained slower than the declines seen during the financial crisis (figure B.48).

Given the relatively small decline in the numbers of SMEs using invoice finance and asset-based lending, the fall in average advances, 43% in Q2 and 32% for the year, likely reflected a combination of SMEs reducing their use of facilities or putting them into abeyance, or a reduction in qualifying invoices due to the decreased economic activity.

### The smallest businesses continue to buck the trend

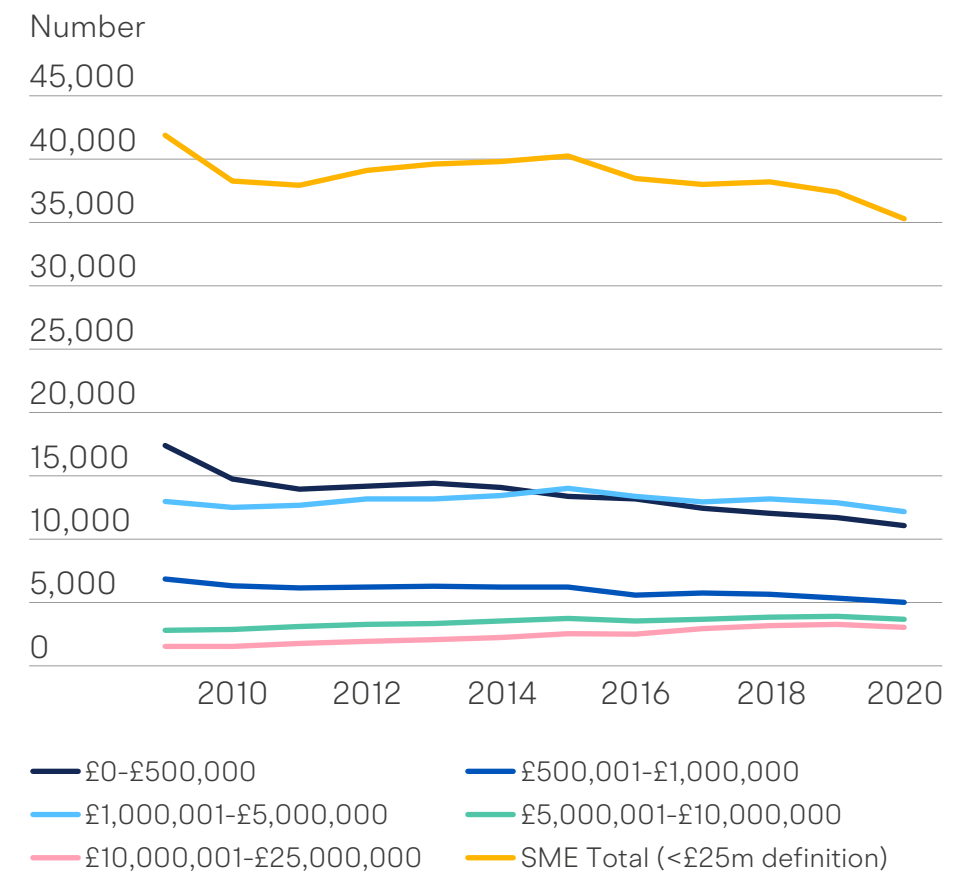
Pre-pandemic, the increase in advances in Q1 was seen across the SME size brackets with the one cohort registering a decline being the largest SMEs (turnover of £10m-£25m). For the smallest businesses (£0-500k) this was a continuation of a recent trend and marked growth for the sixth successive quarter and a new record high for the series at £933m.

Fig B.48

### Number of SMEs using invoice and asset-based finance, by size cohort

Source: UK Finance, Bank of England and British Business Bank calculations

Notes: 2020 full year data points are UK Finance estimates projected from monthly figures supplied by a representative sample of UK Finance's IFABL members.





In comparison, for the next smallest cohort (£500k-£1m) this was the first positive quarter since the SME series peaked in September 2017 and followed nine quarters of decreasing advances. The other cohorts had also decreased more often than not over the same period.

The picture changed again in Q2 with most size cohorts experiencing significant declines in the value of advances ranging between 46% and 53% and record series lows (figure B.49). However, for the smallest cohort, advances only decreased by 2%. Furthermore, despite the fall this was still the second highest value on record (£917m).

This variation by size cohort would suggest that, at the outset of the pandemic at least, the smallest companies were either less able or less willing to access government guaranteed loan schemes to replace invoice finance. Alternatively, or alongside this, it could be that they did not benefit sufficiently from the first waves of government support through other schemes, such as the Coronavirus Job Retention Scheme, and thus needed further external finance.

One example of an inability to access CBILS could be that many of the smallest businesses would possibly be looking for loans smaller than £25k, the level below which most the big banks were unwilling to lend via CBILS, while they could also have found it harder to be approved even if they were looking for more than £25k.

As Bounce Back Loans Scheme (BBLs) did not launch until May, it is likely many smaller businesses were only able to access the government guaranteed schemes in the second half of Q2 and often then only if they had existing relationships with accredited lenders. Given their size and limited borrowing needs it is probable a smaller proportion of these smaller businesses would have had qualifying relationships with those finance providers accredited from the start and thus may have had to wait for the wider pool of lenders, open to new customers, to begin to offer BBLs.

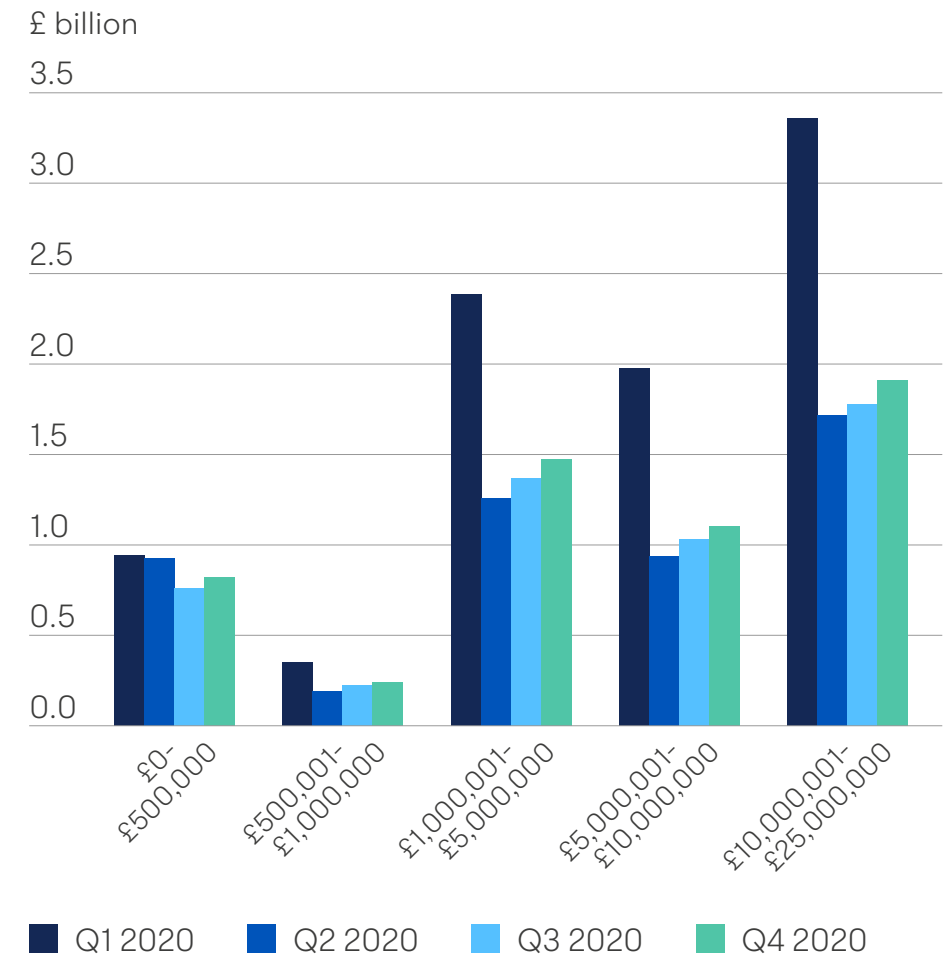
If it was a question of willingness, however, this could reflect that their financing needs in general were relatively low and could be dealt with using their existing finance arrangements, or that invoice finance better suited their finance or operational needs. For example, the facility could be a whole book facility releasing a significant quantum of working capital or could include the outsourcing credit functions through a factoring facility.

Fig B.49

**Quarterly stock of advances, by size cohort**

Source: UK Finance

Notes: Q4 data points are UK Finance estimates projected from monthly figures supplied by a representative sample of UK Finance’s IFABL members.





In Q3, the smallest businesses were again the outliers, but this time as they were only cohort to experience a fall in advances (18%). All other cohorts saw increases ranging from 17% from the second smallest cohort to 3% for the largest. Again, this pattern likely reflects access for the smallest businesses to government guaranteed schemes, and BBLs in particular, coming on stream slightly later in the year than for larger businesses. It may also reflect a delayed impact of other government initiatives such as the VAT deferral schemes on the smallest businesses. The combination of these and other factors likely shifted the consequent impact on intensity of utilisation of commercially provided facilities to later in the year than was observed for larger businesses.

Estimates suggest average advances increased for all size bands in Q4, probably reflecting the increased demand for commercial finance reported by market contacts and the increase in economic activity seen in the second half of the year prior to the tighter measures in the run up to Christmas.

### **Invoice finance will play an important role in helping smaller businesses recover**

For many smaller businesses and their customers, focus on cashflow has been a key theme throughout 2020 and will continue to be so as the economy begins to recover. As discussed in the Part A, while SME cash deposits have reached record highs, many other SMEs have taken on debt during the pandemic and seen turnover shrink. For these companies generating momentum and cashflow will be important as they look to move forward.

Invoice finance will be a key tool in supporting this recovery. As noted previously, there is significant headroom available within existing invoice finance facilities and as the intensity of government interventions roll back, the sector will be able to provide more support for more businesses. This will be further enhanced via the Recovery Loan Scheme, which includes the ability to offer invoice finance facilities of between £1,000 and £10 million per business.

The ability to offer industry standard payment terms can be important when bidding for business, and the economic slowdown and resulting liquidity challenges has likely increased the importance of such non-price terms. Being able to release the funds tied up in invoices quickly can put businesses in a better position to cover company expenses and capitalise on new opportunities when they come along.

An invoice finance facility can be set up usually within a week or two of initial contact with a provider. Once the arrangement is in place, the funds can often be released from an invoice within 24 hours of it being issued to a customer. It is also flexible and scalable, growing in line with the customer business and normally unlocking a greater quantum of finance than would be possible through other types of finance. In addition, unlike conventional loans there is no fixed repayment schedule and because it is secured against the debtor book, an invoice finance facility can often run alongside other finance facilities such as asset finance or term loans which in itself could be of great importance given the increase in debt taken on by many smaller businesses in 2020.



2.10

# Marketplace lending

- Limited lending data is available, but it is likely annual marketplace lending volumes have contracted for the first time
- Accreditation for government schemes has been a challenge for marketplace lenders, but some have been successful by adapting their approach
- 2020 saw the first acquisition of a major UK marketplace lender, 2021 could see more
- Models have and will continue to change





Marketplace lending is a term used to describe the market mechanisms, usually online, that link lenders and borrowers. Previously this was commonly referred to as Peer-to-Peer lending, but as institutional investors have become a significant source of funding this is increasingly inappropriate. Marketplace lending covers consumer, business, property, invoice financing and crowdfunded debt. This section focusses on business lending and invoice financing, which is predominantly to SMEs.

As discussed in the previous Small Business Finance Markets report, in 2019 the FCA concluded a consultation on potential new rules for marketplace lenders. One decision taken was not to enforce new reporting standards on the industry. Unfortunately, in 2020 some marketplace lenders have chosen to reduce their public reporting via data aggregators and, as a result, it is not possible to accurately compare like for like figures for 2020 lending.

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**Limited lending data is available, but it is likely annual marketplace lending volumes have contracted for the first time**

Without an aggregated and standardised data source it is impossible to accurately track how much the overall marketplace values have changed in 2020. The decrease in reporting from the industry does suggest that many have had a tough year however, and it is clear from market contacts and, where available, published accounts, marketplace business lending values have declined for the first time since the industry began.

This may not be an obvious conclusion given several marketplace lenders have been accredited to lend via the Covid-19 government guaranteed lending schemes and have recorded higher lending volumes overall through the year following their accreditation. However, the adjustments some of the players had made to gain accreditation, as well as to attract institutional funding, means much of that lending is not strictly marketplace lending, albeit being originated by marketplace lenders.

After the onset of Covid-19, demand for non-government guaranteed unsecured small business loans plummeted as first Coronavirus Business Interruption Loan Scheme (CBILS) and then Bounce Back Loans Scheme (BBLs) lending attracted those who may have otherwise turned to marketplace lenders for finance (for a more in-depth discussion see chapter 1.4). As a result, several marketplace lenders reported deal flow drying up while some chose to stop writing new business, at least for a few months, and concentrate on supporting their existing customers.



MarketFinance, a marketplace lender which specialises in invoice finance experienced a 55% decline in volumes in the first half of 2020. This was in line with the wider invoice finance market (see chapter 2.9 Invoice and Asset-Based lending).

Similarly, Funding Circle reported a 17% decrease in origination in H1 2020 (£662m) compared to H1 2019 (£798m) despite a strong start to the year in January and February.<sup>143</sup> In their H1 market update they stated this reflected origination being impacted significantly during March and April as we waited for CBILS accreditation.

Not only was new origination a challenge, as marketplace lenders had a more complicated and time-consuming route to accreditation to lend via CBILS than many traditional lenders, they found some of their existing customers paying off their loans. Funding Circle reported loans under management remained flat in the first half of 2020 due to a combination of the lower origination and higher levels of repayments and prepayments, “in part reflecting the fact that borrowers may use the government’s CBILS and Bounce Back loan scheme to help refinance their existing loans.”

### **Accreditation for government schemes has been a challenge for marketplace lenders, but some have been successful by adapting their approach**

Marketplace lenders are varied and as such have faced a range of challenges when looking to supply BBLs or CBILS. However, the two most consistent issues to overcome have been attracting funds while meeting pricing limits and structuring their institutional investors’ funding agreements to meet the legal requirements for the government guarantees. Both are in part due to the fact marketplace lenders traditionally onward lend retail or institutional funds and make their own revenue via fees rather than interest.

As discussed in chapter 1.4, for non-bank lenders who have managed to lend via the government Covid-19 schemes it has required them to put forward proposals designed to give their investors comfort that their funding would benefit from the guarantee. Given marketplace lending involves originating the loan but not using the originators’ own funds to finance the loan this posed a significant and unique challenge for the industry and has resulted in different lending models, including on balance sheet lending.<sup>144</sup>

A further significant change for some has been the funding mix. The decision was taken to not allow retail funds to be used via the government guarantee schemes meaning finance providers have had to use a mix of their own balance sheet and institutional funding to support their BBLs and CBILS lending.

So far eight marketplace lenders have been accredited for either BBLs or CBILS. While they were not amongst the first set of accredited lenders, and as such did not make up a significant proportion of the early lending, they have been more prominent in the second half of the year.

Highlighting this, Funding Circle stated in their H2 results that since they became accredited, they represented ac.25% share of the number of CBILS loans approved.<sup>145</sup> This has resulted in Funding Circle’s UK origination increasing 36% in 2020 (£2.1bn), up from £1.6bn in 2019, with H2 origination (£1.4bn) up 92% compared to the same period in 2019. This was achieved despite pausing all non-CBILS lending from retail and institutional investors to concentrate on CBILS lending.



Furthermore, despite the sizeable drop in their core business in H1 2020, MarketFinance announced a 3.4% increase in its total lending to £342.4m for the first 11 months of 2020, supported by a considerable rise in its business loans and via CBILS lending. Similarly, ThinCats reported that by the end of the year they had provided a record total funding of £289 million, an increase of 44% on 2019.

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### **2020 saw the first acquisition of a major UK marketplace lender, 2021 could see more**

In recent years we have seen partnerships between banks and marketplace lenders, but in 2020 we had the first major acquisition within the industry. Launched in the UK in 2010 as a peer-to-peer platform, RateSetter was one of the pioneers of the industry in the UK, lending more than £4bn to commercial and retail customers. In September Metro Bank bought them for £12m to boost the challenger bank's lending capabilities.

Metro Bank had previously stated a desire to expand its unsecured lending business and said RateSetter's technology would "enable the bank to rapidly accelerate this ambition via an existing, scalable platform". This is yet another sign of more traditional lenders adopting approaches brought to the industry by alternative finance providers to positively impact the process of SMEs obtaining finance. Metro Bank reportedly intend to continue the RateSetter brand but funded via the bank's deposits rather than utilising a marketplace model.

2021 is likely to see further partnerships, mergers or acquisitions as finance providers come to terms with the fallout of Covid-19. One potential buyer is Starling Bank. In a recent interview Anne Boden, CEO of Starling, suggested they were actively on the lookout for a lending business to buy with Europe's non-bank lenders, including marketplace lenders, potential targets.

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### **Models have and will continue to change**

New rules effective from December 2019 placed a limit on investments in P2P agreements for retail customers new to the sector of 10% of investable assets. This led to some lenders seeking to expand their investor base across institutional investors. However, this change from the original peer-to-peer model to one utilising a greater proportion of institutional funding to create a deeper and more permanent pool of capital had been happening for some time already.

The Covid-19 crisis has accelerated the trend towards institutional funding with sizeable outflows in the first weeks appearing to validate many long-held concerns that relying on retail investors could cause liquidity problems for marketplace lenders. Some have temporarily stopped accepting new retail deposits while others have frozen or at least slowed withdrawals.



The rules of CBILS and BBLs may also have sped up the change from retail to institutional investors. Funding Circle had already started originating significant amounts of loans for institutional investors such as pension funds, hedge funds and banks before the pandemic hit, but loans issued through these schemes have exclusively been funded by institutional investors as retail investment is precluded.

The sector experienced headwinds and press scrutiny in 2019 following a couple of failures, now it is having to navigate the Covid-19 induced economic pause. Several lenders have had to put growth plans on hold and undoubtedly some may exit the market altogether, but it appears others may well come out of this experience stronger, with increased and enhanced profiles, greater customer and investor bases and possibly different models.

As the economy starts to recover and smaller businesses and lenders alike transition back to commercial lending, the British Business Bank will continue to support marketplace lenders via products such as ENABLE Funding and the Investment Programme.



# Glossary



### **Asset finance**

The use of credit or leasing facilities provided by a leasing provider to finance the acquisition of assets. The asset finance provider will normally require security to be taken on the asset itself and the cost of the asset finance arrangements is spread over the life of the asset.

### **Asset-based finance**

Funding against a range of business assets including accounts receivable, inventory, plant and machinery, real property and even intellectual property and brands. The most common types of asset-based finance include factoring and invoice discounting (collectively referred to as invoice finance) and asset-based lending.

### **Bank capital requirements**

Standardised requirements for banks, whereby they must hold liquid assets for a certain level of total assets. These are enforced by regulatory authorities.

### **Business angels**

A high net worth individual who provides financing to small businesses in exchange for an equity stake in the business. Business angels are often thought of as a bridge between loans from family and friends and venture capital. Business angels may also provide expertise in helping to run the business.

### **Business churn**

The rate at which new businesses start-up and existing business close over a period of time. In a competitive economy, business churn can help to facilitate economic growth as inefficient businesses close down and are replaced by efficient ones.

### **Capital markets**

The market where debt and equity instruments, such as stocks and bonds, are issued, bought and sold. Institutions and some businesses can use primary capital markets to raise funds by issuing bonds and equity.

### **Challenger banks**

Usually defined as those banks outside of the Big Five UK banks. Challenger banks include new entrants to the market, spin-offs or dis-investments from large banks and existing smaller banks seeking to grow. Some are regionally based, whilst others provide only personal or small business banking rather than the wide range of services provided by the larger banks.

### **Collateral**

Assets pledged by the business as security for a loan, so that in the event that the borrower defaults, the collateral may be sold, with the proceeds used to satisfy any remaining debt obligations.

### **Core bank lending products**

Traditional forms of external finance which include: Bank loans, overdrafts and credit cards.



### **Crowdfunding**

Equity fundraising for businesses where relatively small amounts of money are lent or invested by large numbers of individuals, typically facilitated by online platforms.

### **Debt funds**

A limited liability investment vehicle which invests in businesses using debt instruments. Debt funds provide businesses with bespoke debt finance that is often focused on providing flexible finance for 'event driven', growth orientated companies.

### **Discouragement**

Businesses which would like to borrow but which do not apply for bank finance because they either feel they would be turned down ('indirectly discouraged'), or they've made informal enquiries but not proceeded with their application because the bank seemed reluctant to lend ('directly discouraged').

### **Entrepreneurial ecosystem**

A set of entities such as businesses, investors and public institutions that are connected through relationships and processes that influence entrepreneurial outcomes in a given area.

### **Enterprise investment scheme (EIS)**

This is a tax relief scheme designed to increase the amount of equity finance available to high growth potential businesses by offering investors tax relief.

### **External finance**

Money obtained from lenders or investors outside of the business and its directors with an expectation of a financial return for making the money available.

### **Fintech**

Finance providers or financial service providers which use technology and /or innovative delivery and assessment models within the financial services industry.

### **Flows of finance**

The gross flow of finance is the movement of money from lenders or investors to businesses or individuals (businesses only in this report) over a period of time. The net flow refers to the gross flow, net of repayments over the same time period. For instance the gross flows of bank loans refers to the value of new loans issued over a certain period, whereas the net flow of bank loans is the value of new loans minus the value of repayments over the same period. In theory, the net

flow of bank lending over a certain period should equal the change in the stock over the same period, excluding any other adjustments.

### **Fund manager**

A fund manager is responsible for implementing the fund's investment strategy and managing its portfolio.

### **Growth capital**

Equity investment used for more developed, profitable companies looking to expand or enter new markets.

### **High growth firm**

There is no single definition of a 'high growth' firm. The ONS define high growth firms as 'All enterprises with average annualised growth greater than 20% per annum, over a 3-year period. Growth can be measured by the number of employees or by turnover.'

### **High net worth individual**

High net worth individuals are people that have high income and/or high net assets. These people are often entrepreneurs who become angel investors.





### **Hire purchase (HP)**

When a finance company buys the asset on behalf of the customer, who then pays an initial deposit. The remaining balance, plus interest, is then paid over an agreed period. During this period, ownership rests with the finance company, which is effectively hiring use of the asset to the customer. Once the final payment is made, ownership transfers to the customer.

### **Industrial strategy**

The aim of the government's Industrial Strategy is to boost productivity, create jobs and increase wages across the UK with investment in skills, industries and infrastructure.

### **Initial public offering (IPO)**

The first time a private owned company sells its shares publicly on a listed stock exchange.

### **Institutional investment**

These are typically large organisations that make investments in debt or equity funds as part of a wider portfolio of investments. For example, investment banks, insurers, pension funds and hedge funds.

### **Intellectual property**

Intangible and non-physical goods, which can include names, ideas and computerised information. Ownership of intellectual property can be asserted using Intellectual Property Rights.

### **Invoice finance**

When a third party agrees to buy a business's unpaid invoices for a fee. There are 2 types of invoice financing: factoring and discounting. Factors - factoring finance providers - purchase a businesses' unpaid invoices and advance most of the value of the invoices, with the balance less any charges paid when the invoices are paid by the end customer. Factors also manage the sales ledger and collect payment from the end customer. Discounting is like factoring except the client business retains control over managing the sales ledger.

### **Lease financing**

A contractual agreement where a leasing company (lessor) makes an asset it owns available for use by another party (a lessee), for a certain time period in exchange for payment.

### **Local authority district (LAD)**

These are sub-regional authorities that make up local government.

### **Local enterprise partnership (LEP)**

These are partnerships between local authorities and businesses across England. There are currently 38 LEPs operating across England whose responsibility it is to generate growth in the area.

### **Lower middle market**

The middle market sector comprises of companies sized between larger SMEs and companies that have access to wider capital markets.

### **Management buyout (MBO)**

The senior management of a company buying all of the company's outstanding shares. The management of the company will not usually have sufficient money to buy the company outright themselves, but will use private equity funding to support the purchase.



### Marketplace lending

Marketplace lenders are online platforms that enable investors to lend to retail and commercial borrowers. Unlike banks marketplace lenders do not take deposits or lend themselves; as such they do not take any risk onto their balance sheets. They make money from fees and commissions received from borrowers and lenders.

### Mezzanine finance

A form of debt-finance finance that combines features of both debt and equity in a single instrument. Whilst there is no single model, mezzanine debt usually contains three distinct features: cash coupon; payment-in-kind or PIK, which is only paid at the maturity of the loan; and, warrants or a share in the profits or growth of the company.

### Patient capital

Provision of funding to businesses that are capital intensive with long product lead times, typically but not exclusively in life sciences, clean technologies and advanced manufacturing sectors. Patient capital funding follows on from proof of concept and early stage R&D grant funding, and covers both debt and equity finance.

### Peer-to-peer lending (P2P)

Peer-to-peer finance involves the use of internet-based platforms to match online lenders with borrowers. Given the increased investment from institutional investors, the Bank typically now refers to marketplace lending.

### Private Equity (PE)

Equity ownership in a business that is not publicly-traded. Private equity involves investing in privately held companies and most of the time, private equity investors invest institutional money. Venture capital is a type of private equity finance.

### Publicly listed company (plc)

A company issuing shares, which are traded on the open market, through a stock exchange. Individual and institutional shareholders constitute the owners of a publicly listed company, in proportion to the amount of shares they own as a percentage of all outstanding shares.

### Securitisation

A financial technology which pools individual illiquid assets into liquid financial securities that can be sold on. It is used by lenders to raise funds and manage their risk exposure.

### Seed capital

Equity investment generally used for R&D, and initial concept or product development. Usually businesses receiving the investment are pre-revenue.

### Seed Enterprise Investment Scheme (SEIS)

This is a tax relief launched in 2012 to encourage investors to finance early stage start-ups. The company must be under 2 years old and it must have fewer than 25 employees.

### SME/smaller businesses

These terms are used interchangeably in this report. This typically refers to businesses which have less than 250 employees. An alternative definition is businesses which have an annual turnover of less than £25m.



### **Start-up, scale-up and stay-ahead**

This relates to the British Business Bank segmentation of SMEs, based on broad financing requirements. Start-up solutions focus on enabling business set-up, scale-up on business growth and stay-ahead schemes are generally aimed at businesses aiming to retain or enhance their position. When considering in the context of analysing available survey data, start-ups are classified as trading for no more than five years, scale-up and stay ahead businesses are defined as those trading for more than five years, with scale-ups reporting an ambition to grow.

### **Stock of lending**

The total value of outstanding debt at a given point in time.

### **Trade credit**

An agreement between a buyer and seller, whereby the buyer of the goods or service does not need to pay for those goods or services immediately but can delay the payment for an agreed period of time. This can help alleviate the cashflow of the buyer.

### **Venture Capital (VC)**

The provision of funding to a start-up or young business with high growth potential. Venture capital differs to business angels in that they invest other people's money (mainly institutions). These investments are very risky, and so venture capitalists are looking for high financial returns.

### **Working capital**

Money available for the day to day cash flow operations of a company.



# Endnotes



1. ONS Coronavirus and homeworking in the UK April 2020.
2. ONS Business insights and impact on the UK economy.
3. Bank of England August 2020 Financial Stability Report.
4. The NAO report explains in more detail how the schemes were set up and their underlying objectives.
5. HM Treasury Coronavirus (COVID-19) business loan scheme statistics.
6. This is based on the British Business Bank matching the Companies House IDs of Future Fund recipients into Beauhurst. Some equity deals are not publicly disclosed and so this does not cover the full Future Fund population of supported companies. Deals occurring in Jan to May prior to the Future Fund announcement and application period are included when there is a record of drawdown on the portal. These companies may have required additional equity investment, leading to the Future Fund filling in the funding gap.
7. The low proportion of Future Fund deals being announced may be due to CLA rounds being less likely to be announced or the Future Fund co-investing alongside business angels and other private investors who are less likely to announce funding rounds.
8. Future Fund uses CLA. These are unlikely to be identified as unannounced deals using Companies House filings until the CLA converts to equity at the next funding rounds.
9. Molo Finance also announced a round of £266m in Q4 2020. As the round involved both debt and equity, it was excluded from the dataset.
10. Permanent non-borrowers (PNBs) are those SMEs that show little interest in external finance – they are not using it, nor have they applied for any, nor do they have any plans to apply for any.
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112. The dataset does not have complete coverage of all company valuations as these are not always disclosed.
113. A privately held company with a valuation exceeding \$1bn. See Equity Tracker 2020 for the full definition of unicorn business used in this report.
114. The British Business Bank’s definition is based on companies backed by VCs and other early-stage investors and so this definition excludes Gymshark, which is Private Equity backed.
115. Reaching a \$1bn dollar valuation to become a unicorn is based in nominal terms, and so this important benchmark is reducing in real value each year due to the effects of inflation.
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122. Preqin - Global Private Debt report 2020.
123. Deloitte - Alternative Lender Deal Tracker Q3 2020.
124. Alternative Credit Council - Financing the Economy 2020.
125. British Business Bank - UK Private Debt Research Report 2020.
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128. Special situations lending is not dissimilar to distressed debt, whereby a lender makes an investment in a company with some element of distress, disfunction, or dislocation which may mean the investment is undervalued.
129. PitchBook – 2020 Annual Global Private Debt Report.
130. British Business Bank - UK Private Debt Research Report 2020.
131. Note that the entire dataset was unable to be segmented, as some fund managers provided insufficient information either on the split of their deals or capital invested.
132. While other finance use categories (e.g. recapitalisation, or acquisition) are arguably also ultimately growth-oriented, “growth” here denotes deals that finance business evolution and/or expansion of organic nature.
133. For instance, in Deloitte’s 2020 Alternative Lender Deal Tracker, buyouts and acquisitions represented 34% and 28% of all deals respectively.
134. Note that some fund managers did not provide granular enough information to segment their contribution in this manner, so this analysis does not cover the full dataset.
135. Note that some fund managers did not provide sufficient information to identify the geographic location of every business, hence the above proportions are of the sample with locational information.
136. In 2019 66% of SME equity investment went to business based in London – British Business Bank Small Business Equity Tracker 2020.
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## British Business Bank Research Publications March 2020 – February 2021

The British Business Bank’s mission is to help drive economic growth by making finance markets work better for smaller businesses – wherever they are in the UK and wherever they are on their business journey – enabling them to prosper and grow.

One of our key objectives is being the centre of expertise on smaller business finance in the UK, providing advice and support to the government. Being the centre of expertise on smaller business finance gives us the knowledge and credibility to achieve our other objectives, and to help the government deliver key policy priorities.

We use insights gained from our extensive research and analysis programme to produce publications about UK smaller business finance markets, take part in policy debates, and to provide input into cross-governmental projects.

### UK Private Debt Research Report 2020 February 2021

The UK Private Debt Research Report 2020 analyses primary data collected directly from participating fund managers for the SME and Lower Mid-Market segment of the UK private debt market.

It is, we believe, the first time this has been done for this part of the UK market. The report features data for 55 funds, managed by 37 UK fund managers, and 934 individual deals totalling £18.4bn for 2018 and 2019.

The report demonstrates how the bespoke and flexible nature of private debt finance supports firms across the UK and could play an important role in the UK’s economic recovery from the Covid-19 pandemic.



### UK Venture Capital Financial Returns 2020 November 2020

The UK Venture Capital Financial Returns 2020 report provides a comprehensive assessment of the performance of UK VC funds since 2002. The report draws together data from existing data sources including PitchBook and Preqin, and from the Bank’s own programmes, as well as a new survey of fund managers.

The report finds UK VC funds with 2002-2007 vintage delivered good financial performance, with a pooled DPI of 1.61 and TVPI of 1.99.



### Alone together: Entrepreneurship and diversity in the UK

October 2020

Alone together: Entrepreneurship and Diversity in the UK, examines the profound effects ethnic and economic background, gender and geography have on business outcomes. The research fed into the Commission on Race and Ethnic Disparities established by the Prime Minister.

The report finds that Black, and Asian and Other Ethnic Minority entrepreneurs experience far worse outcomes, on average. Many female entrepreneurs have a fundamentally different experience to those who are male. Outcomes are worst for Black, and Asian and Other Ethnic Minority female entrepreneurs.

The report also finds that money is critical to success and that the place an entrepreneur lives can shape their entrepreneurial outcomes. Those who are poorer experience much worse outcomes and being outside Greater London is better for many.







**UK Business Angels Market Report 2020**

**October 2020**

The British Business Bank’s UK Business Angels Market report 2020 analyses survey responses from more than 650 angel investors. The report finds that angel investors across the UK are continuing to invest in early stage businesses and are optimistic about the future despite current economic uncertainty.

More than half (57%) of angel investors surveyed had made an investment between April and July 2020, with 46% expecting to make new investments to add to their portfolio during the remainder of the financial year.



**Cornwall and Isles of Scilly Investment Fund - Early Assessment Report**

**July 2020**

The independent early assessment of the £40m Cornwall and Isles of Scilly Investment Fund (CIOSIF) carried out by SQW found that the scheme had already generated positive impacts for the beneficiary businesses.

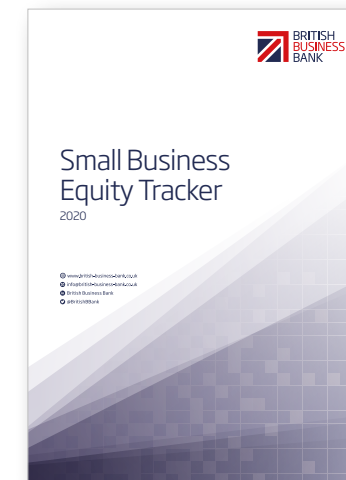
The early assessment analysed a sample of investments between December 2018 and December 2019 finding evidence of outcomes including improved workforce skills, increased investment in R&D and the creation of new jobs.



**Equity Tracker 2020**

**June 2020**

The Small Business Equity Tracker 2020 report provides an in-depth picture of equity finance for smaller businesses. The UK tech sector remains the focus for equity investors, with 47% of investment going to tech companies. Equity investment in the UK’s tech businesses increased by 27% in 2019 to £4.0bn, the highest amount since the series began in 2011.



**Midlands Engine Investment Fund - Early Assessment Report**

**May 2020**

The independent early assessment of the £250 million Midlands Engine Investment Fund (MEIF) carried out by SQW found that the scheme had already generated positive impacts for the beneficiary businesses.

The early assessment analysed a sample of investments between October 2017 and September 2019 finding evidence of outcomes including boosted workforce skills, increased investment in R&D, higher levels of exporting and improvements to business processes. The early assessment also found that MEIF had already helped to create 629 jobs, with 37 per cent paying above the UK upper quartile salary of £36,500 a year.





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