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“Improving Funding for Innovative SMEs in Scotland”

1. Introduction

This paper forms the response from the Centre for Responsible Banking & Finance (henceforth CRBF) at the University of St Andrews to the Scottish Parliament Economy, Jobs and Fair Work Committee Review into Scotland’s Economic Performance: Trends, Challenges and Future Prospects. CRBF welcomes the opportunity to contribute to this very important debate. Myself and other members of CRBF have undertaken a number of recent research projects examining access to finance within innovative and growth-oriented firms. This includes two recent research projects examining access to finance in growth-oriented SMEs for the Institute for Chartered Accountants Scotland (ICAS) (Brown and Lee, 2014; 2017). Together this body of work has led to a considerable amount of expertise in the field of SME and firm growth issues. Given the empirical focus of this work has primarily focused on small and medium-sized enterprises (SMEs), this submission concentrates on funding issues confronting these organisations rather than their larger corporate counterparts.

2. Context: The Nature of the Problem

Small and medium-sized enterprises (SMEs), especially growth-oriented SMEs sometimes labelled “gazelles” (Brown et al, 2017), are widely perceived to be instrumental in driving economic growth and productivity within economies (OECD, 2010; Mason and Brown, 2013). According to the Federation of Small Business, SMEs constitute an important element of the UK’s economy. There are in the region of 5.4 million SMEs in the UK who together employ 24.3m people and account for 99% of all UK businesses. They represent approximately 60% of employment and roughly 50% of total private business revenue. According to the British Banking Authority, their banking business is worth some £2 billion in revenue and SME business loan balances are around £90 billion (Chalmers, 2016). By any standards, this is a sizeable market providing a strong incentive for lenders to target.

Despite this, many SMEs often encounter quite intractable problems obtaining access to finance. Dating back to the 1930s when the MacMillian Report noted the difficulties SMEs encounter when obtaining finance, the issue of SME funding has been a strong concern for UK policy makers for almost a century1 (Hughes, 1997). Indeed, a large body of literature notes the perennial problems that new and young and firms face when accessing finance (Cassar, 2004; Udell, 2015). Smaller firms are unlikely to have substantial assets to act as security against borrowings and many, particularly newer start-ups, may not have a long-standing relationship with a bank (Berger and Udell, 2002; 2006). Additionally, unlike larger firms, SMEs may not have audited financial statements, which further increases ‘informational friction’ between borrowers and lenders (Berger and Frame, 2007). This has been recognised by policy makers across the UK and various national and sub-national initiatives have been implemented to mitigate the adverse effects of these credit constraints.

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1 This noted the particular difficulties SMEs face when attempting to raise capital – the so-called “MacMillian Gap” (Brown and Lee, 2014).
for SMEs. In Scotland, the policy approach has strong focused on the promotion of equity sources of finance promoted by the Scottish Investment Bank's co-investment schemes.

The opacity and resultant difficulties in securing finance varies across SMEs. Evidence suggests that given the sunk cost nature of research and development expenditures and the uncertainty of outcome associated with innovative activity, investors have difficulty in differentiating between good from bad projects (Hall, 2002). As a consequence, innovative SMEs encounter particular difficulties in obtaining external finance, especially when credit conditions are tight (Freel, 2007; Mina et al, 2013; Lee et al, 2015). Rapidly growing firms may also face more acute funding difficulties, many of whom are disproportionately export-oriented (Brown and Mawson, 2016).

In the UK, this problem has been accentuated since the global financial crisis (GFC) by the removal of localised decision-making structures within banks (Degryse et al, 2015), which has led to more mechanistic assessments of SME credit ratings, further favouring larger firms (Lee and Brown, 2016). However, it is important to state that not all firms deserve the finance they apply for, nor is there definitive evidence of the existence of a funding gap for SMEs. The challenge for policymakers is to ensure that finance goes to firms likely to help the national economy, without providing excess capital to firms which are not creditworthy.

Up until 2015 there was a pervasive contraction of credit to the extent problems accessing funding have become the “new normal” for many SMEs (OECD, 2015). These problems have been particularly acute for innovative SMEs and those located in peripheral parts of the UK, especially in northern parts of Scotland (see Lee et al, 2015; Lee and Brown, 2016). Despite the fact that only one in seven SMEs seek external bank lending (Fraser et al, 2015), these firms typically are the most growth-oriented firms who generate the majority of new employment (Brown and Lee, 2014; Anyadike-Danes et al, 2015). Added to the problems of accessing bank finance is the complex issue of “discouragement” which can often dissuade strong businesses from seeking bank credit for fear of being declined (Freel et al, 2012). Therefore, the lack of funding for growth-oriented SMEs coupled with the reluctance to seek external funding may have impeded economic growth in the UK economy since the GFC (Cowling et al, 2012; Brown and Lee, 2014). Owing to this some observers commented that the so-called “funding escalator” for SMEs had broken (North et al, 2013). However, since the GFC, the funding landscape for SMEs has undergone significant transformation. This has seen the expansion and growth of new entrants in areas such as peer-to-peer lending and crowdfunding which has improved access to finance for some innovative SMEs. However, recent research has shown that the main beneficiaries of this new alternative sources of finance have been firms located in the south-east of England (see Atz and Bholat, 2016; Brown et al, 2017).

Despite the improvement in the overall funding environment, recent empirical evidence suggests that some innovative and growth-oriented SMEs continue to encounter certain difficulties obtaining the right types and cost of finance. For example, evidence for the UK suggests that 20% of high growth SMEs consider access to financing to be the single most important barrier to growth, compared to 13% for other firms (Lee, 2014). This finding was recently corroborated by the analysis of the SME finance Monitor which found that high growth SMEs (labelled scale-ups) think that their banks would not agree to give them funding (42% versus 60% of other SMEs) (Scale-Up Institute, 2017). Moreover, many SMEs lack
sufficient collateral to offset inherent informational opacity (Avery et al, 1998). As a consequence, some innovative SMEs are unable to access traditional forms of finance such as bank loans (Cosh et al, 2009) and instead may seek alternatives (Robb and Robinson, 2014). For example, recent research suggests that some SMEs, particularly those who are innovative and growth-oriented, may be turning to other forms of costly forms of short-term finance such as credit cards (Brown et al, 2018). Some researchers also suggest that a lack of finance for these types of firms in Scotland may be encouraging a “sell-out” mentality within entrepreneurs (Brown and Mason, 2014; Brown et al, 2017). Indeed, in economies such as Scotland hardly a week goes by without an example of a trade sale taking place of a growth-oriented SME.

3. Policy Recommendations

I now wish to turn to highlight some of the key issues which are most pertinent to the Scottish Parliament’s review. As previously mentioned these points are mostly concerned with innovative SMEs. However, we are in broad agreement that some of the fundamental weaknesses confronting innovative firms is the inability to attract later stages of finance (such as VC or through stock market listings) for firms to properly upscale. In this respect, the author endorses the need for a systemic approach taken in all aspects of the funding ladder confronting innovative firms. One issue which the author wishes to highlight is the systemic nature of the UK’s entrepreneurial ecosystem (Brown and Mason, 2017). In other words, the nature of premature “exits” noted may not be purely driven by insufficient access to capital. More work is needed to examine the causal determinants of these premature exits and the key contributory factors.

Turning to the main problems in the finance markets for small business finance, our first main point concerns the issue of targeting within policy frameworks. To date, the work of the Scottish Investment Bank has overwhelmingly focused on high-tech firms. The new Chairman of the Scottish National Investment Bank (SNIB), Benny Higgins, has also called for this institution to similarly focus on the funding requirements of these firms (The Herald, 2018b). This type of high-tech myopia has been heavily criticised as being flawed by many scholars examining the sources of high growth firms within economies (Brown et al, 2017). Indeed, most SMEs do not use equity forms of finance. Indeed, my own work on high growth entrepreneurship shows that this form of funding is used by less than 5% of UK and indeed Scottish high growth SMEs (Brown and Lee, 2014). Despite this, the broad thrust of UK (and Scottish) policy in terms of boosting access to finance for innovative SMEs is aimed at developing and/or increasing equity-based forms of capital. While this form of funding is clearly relevant for some SMEs it is not for the vast majority, including the vast majority of innovative SMEs (Brown et al, 2017). The current over-emphasis on VC and business angel forms of finance is not necessarily conducive to increasing the levels of “patient capital” in the UK as most small scale investors in this context have relatively short time horizons and often wish early “exits” as they do not have sufficient funds to undertaken follow-on investments. Therefore, proper consideration needs to be placed on ensuring that debt-based forms of finance and associated financial instruments are central within future policy frameworks, especially the targeting approach adopted by the new SNIB.

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2 For example, this week the Scottish software SME Procure Wizard was sold to the Access Group (The Herald, 2018a). This sell out mentality is not restricted to small tech companies as evidenced by the recent acquisition of Skyscanner by the Chinese firm, Ctrip.
Plus, given the dominance of the UK’s major four banks within the lending market for SME finance in the UK, greater competition is urgently needed. This is especially the case in Scotland where two banks (Bank of Scotland and the Royal Bank of Scotland) essentially form an oligopoly within the market for SME finance. **Encouraging new entrants, especially specialist SME relationship lenders such as Handelsbanken, to enter our highly concentrated market would seem a particularly advantageous step to help increase competition within the market.**

Another important issue concerning targeting concerns firm location. The overwhelming evidence suggests that firm location matters in terms of a firm’s ability to obtain finance. Therefore, innovative firms in peripheral parts of the UK face the greatest challenges accessing growth finance so policy efforts need to help redress this particular problem facing these geographically isolated SMEs. While some authors have highlighted the potential merits of regionalised banks to help overcome these problems (Lee and Brown, 2016), policy makers need to properly factor in the spatially mediated nature of the UK financial system whilst designing future policy instruments. This problem is being strongly accentuated by the recent decision by lenders such as the RBS to close many of their rural branches in recent years. **The potential detrimental impact branch closures will have on local SMEs needs to be closely monitored by policy makers.**

We now turn our attention to various issues in relation to current programmes aimed at assisting firms to access finance within innovative SMEs in the UK. Recurring issue of personal guarantees makes it difficult for firms with sufficient security to obtain credit (Brown and Lee, 2017). In 2009, the UK government introduced the Enterprise Finance Guarantee (EFG) (formerly the Small Firms Loan Guarantee Scheme). Now operated by the British Business Bank, this scheme underwrites the lending for viable firms with insufficient security to receive funding. The scheme provides a 75% guarantee on loans of up to £1m to firms perceived to banks as high risk, such as informationally opaque innovative SMEs. **Given the perceived effectiveness of these kind of programmes (Cowling and Siepel, 2013), perhaps the Scottish government could help to promote this programme more widely, especially through the work of the new SNIB.**

Recent research by the authors (Brown and Lee, 2017), suggests that banks appear to be using EFG scheme inconsistently. Indeed, some anecdotal evidence suggests that some of the banks still require personal guarantees in addition to the guarantees provided under the scheme. These mixed messages will clearly put off many SMEs from using the scheme. Second, it appears that the level of default rates (i.e. those firms who do not repay their loans) within the portfolio of SMEs supported by the scheme is being under-utilized by the banks. In other words, banks are being conservative in their decision making about funding firms despite the fact that the scheme allows 15% of supported firms to default. **This seems a very useful and cost-effective policy instrument so more research is urgently needed to examine how the scheme functions in practice in Scotland with a view to improving its operational effectiveness.**
References


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