Research summary: September 2011

NESTA Making Innovation Flourish

Beyond the Banks

Innovative ways to finance Britain's small businesses

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Introduction

The issue of funding for small business is perennial – and one that has attracted regular public policy initiatives. Back in 1931, the Macmillan committee on Finance and Industry identified a gap in the provision of long-term capital to smaller businesses, in the context of concern about whether British banks served domestic industry well enough. The result was the creation of the Industrial and Commercial Finance Corporation to finance small businesses, a forerunner of 3i.

While equity finance was the main theme of that initiative, the provision of credit by banks to business has topped the recent agenda. Since the financial crisis, successive UK governments have negotiated agreements with the biggest banks on lending targets to business. This year's 'Project Merlin' targets are £190 billion overall and within that £76 billion to smaller companies. At the half-way stage these gross lending amounts were broadly being met. But the figures include undrawn overdraft facilities and exclude repayments. Vince Cable, the business secretary, complained in late July that lending to small and medium-sized enterprises (SMEs) had been contracting since the recovery began in late 2009. *"Lending to the smaller companies with turnover of less than £1 million has been particularly affected,"* he said.

This report for NESTA is set in the context of the big five UK banks – Barclays, HSBC, Lloyds Banking Group, RBS and Spanish-owned Santander – dominating the market for credit provision to SMEs. It follows an event in July, co-hosted by Sam Gyimah MP, NESTA and the Daily Telegraph, which debated the problem and pointed to alternative sources of funding. The aim is to explore in more depth some of the issues discussed and to provide some short profiles of businesses that are working in innovative ways to channel credit to the small business market.

Although loans and overdrafts provided by the big banks may still be the default form of finance for the great majority of businesses, we should also remember that almost half of all SMEs have made no use of external funding – equity or debt – in the past five years, according to the SME Finance Monitor. However, the choices for those that do want to tap outside sources of finance are rising, and a common thread running through many of the examples we highlight is the use of the internet to bring together borrowers and lenders in so-called peer-to-peer online markets.

There are interesting parallel peer-to-peer developments happening in equity fundraising, via sites such as Crowdcube.com, and hybrid advice/fundraising models emerging such as Fundingstore.com. However, this report has focused on the issue of credit, so the case studies described in this report and the lessons drawn from them address the issue of channelling credit to small companies – and potential changes to the way the credit market operates.

Summary of findings

Key trends

- Use of external sources of finance is declining, as debt is being paid off.
- The cost of loan finance for smaller businesses is increasing and there is a shift towards (sometimes more costly) alternatives.
- Although many companies are still keen to expand, many others are investing merely to maintain a 'steady state'.
- **Regulation:** It is not clear how online marketplaces fit into the regulatory framework and asset-based lending is unregulated. While some providers are keen to gain the implicit assurance of being regulated, there is a risk of regulation being too onerous for SMEs.
- **Incentives:** The question is often raised of whether the UK has the right tax incentives in place to encourage a flow of finance to SMEs.

Conclusions

The interviews suggested several promising avenues of inquiry for how innovation might encourage more SME lending:

- **A SME bond market:** there may be potential for something akin to a bond market for SMEs to develop from the peer-to-peer lending model.
- **Asset-based lending exchanges:** auction-based invoice discounting has potential attractions for small business borrowers.
- **Early-stage businesses:** asset-based lending, such as factoring and invoice discounting, could be used to provide more finance to early-stage businesses.
- **Advice:** many of the sources for the report highlighted an 'advice gap'. Most small business managers take little or no external advice, tending to rely on their accountant. The Business Finance Taskforce is addressing this.

Part 1: The post-crunch problem

The tightening of conventional credit

The financial landscape for British companies has changed markedly since the onset of the credit crunch and to some degree has polarised. Larger companies still have access to bank lending at acceptable rates and are making increasing use of bond markets to raise long-term funding. Among smaller businesses, the picture is rather different. Bank borrowing by small and medium-sized enterprises (SMEs) in the UK has gone into reverse, average interest rates charged have risen and there has been a downturn in investment intentions, exacerbated by a faltering economic recovery.

The most recent Bank of England update on lending by the five biggest UK banks, under the Project Merlin agreement, showed that they made available £53 billion to UK companies in the second quarter of this year, including £20.5 billion to SMEs (defined in this report as companies with up to £25 million annual turnover). These totals were up on Q1, but they include undrawn facilities – actual borrowing was flat at less than £27 billion. Factor in repayments and net lending shrank in Q2 by £4.4 billion. Indeed the pace of debt repayment had picked up since Q1, when net lending shrank by £2.8 billion.

Of course, it is important to recognise that 47 per cent of SMEs do not use external funding and have not done so in the past five years, according to the SME Finance Monitor. But for those that do, conditions have certainly changed. The BoE's Trends in Lending report, published in July 2011, shows that growth in the stock of lending to SMEs began to slow in early 2008 and turned negative in about July 2009. The stock of lending to 'larger small businesses' (turnover of £1-£25 million) was contracting at about 4 per cent a year, according to the July report. The effect is more pronounced still among small businesses (turnover less than £1 million), where the stock of lending was shrinking at an annual rate of about 7 per cent.

A similar picture is painted by British Bankers' Association figures. At the end of April, banks' lending to small businesses stood at £39.9 billion, some £2.3 billion less than two months earlier, while overdraft borrowing had shrunk from £7.6 billion to £7.3 billion. At the same time, small businesses were building up their cash deposits to £58.2 billion from £56.8 billion two months earlier. Meanwhile, the default rate on business loans has remained relatively low, with write-offs amounting to just over 1 per cent, according to the BoE. This is well below the levels of close to 3 per cent seen in the early 1990s recession.

Behind these figures lies a story of frustration at banking relationships, inducing some SMEs to eschew the use of bank finance. In their April 2011 report on business conditions, the BoE's regional agents reported: *"Many small and medium-sized firms remained frustrated with their current banking relationships, and some were planning under the assumption that they would not make use of bank finance in the medium term."* By June this year, pessimism about the availability of bank lending had become more acute: *"Small firms generally perceived credit conditions to be very tight. And many small firms were reluctant to approach banks in case it led to an increase in the cost of existing borrowings, or reductions in overdraft limits."*

This withdrawal from loan finance is reflected in data from the Department for Business,

Innovation and Skills (DBIS) showing that the value of applications by SMEs for new term loan and overdraft facilities in the six months to February 2011 fell 19 per cent compared with the same period a year earlier.

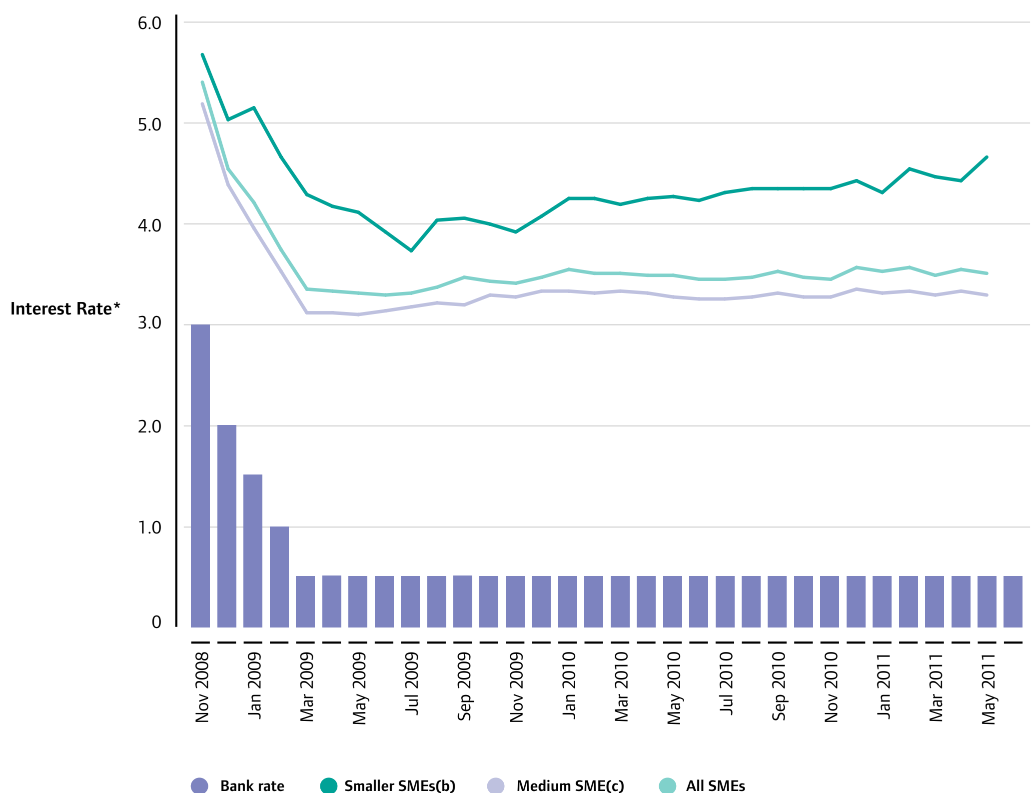
The cost of debt is one explanation of this retreat. Corporate loans are priced in terms of a spread, or interest rate premium, added to a reference rate such as the Bank of England base rate. Recent data show that the average interest rate that the smallest businesses (up to £1 million turnover) have to pay has risen from less than 4 percentage points over base rate (0.5 per cent) in mid 2009 to about 4.7 percentage points by May this year. The spread for larger SMEs was relatively stable at about 3.3 percentage points (see Figure 1).

Other, more anecdotal, insights derived from official sources and interviews for this report suggest that some entrepreneurs have baulked at providing personal guarantees to secure loans and at the long-winded and 'onerous' loan application procedure. SMEs have also reported that banks are seeking to replace overdraft facilities with alternative, more expensive, credit products.

Looked at in the round, there has been both a general withdrawal from lending/borrowing by banks and small businesses, and a repricing of risk by lenders in the years since the credit crunch, with the smallest businesses the worst affected. SMEs, meanwhile, are becoming more concerned about the economic outlook and are unsure whether their existing banking facilities will continue to be available on acceptable terms.

To mitigate the risk of adverse changes in the price or availability of credit, small businesses are repaying bank debt and increasing cash holdings. They remain cautious over any commitment to new investment while economic conditions remain subdued. The CBI's latest quarterly SME Trends Survey of manufacturers showed its first marked decline in sentiment in two years. Investment intentions – the balance of respondents expecting to invest more in plant and machinery in the year ahead – turned negative (-8 per cent) for the first time in a year. The balance of manufacturers planning to invest only to replace existing capital in the year ahead rose to 58 per cent, the highest reading since the CBI began this survey in October 1988.

Figure 1: Loan pricing



* Median by value of new SME facilities priced at margins over base rates, by four major lenders (Barclays, HSBC, Lloyds Banking Group and Royal Bank of Scotland).

Source: BIS, Bank of England.

So is it the supply of credit or the demand for it that is most to blame for the contraction in SME borrowing? A paper in the BoE's Quarterly Bulletin in late 2010 came to the tentative conclusion that the supply of credit was tight: *"Overall, the analysis...suggests that the weakness in bank lending since mid-2007 reflects a combination of tighter credit supply and weaker credit demand. Qualitatively, tight credit supply is likely to have been the dominant influence. For example, independently weak demand would typically be associated with lower spreads on loans, rather than higher spreads. And it is not consistent with the switch into capital market [bond] issuance by some [large companies] during the financial crisis. But it is difficult to assess the relative contribution of demand and supply more precisely."*

It is, however, important to note that some tightening of credit supply was an inevitable reaction to the *"unusually loose conditions that existed immediately prior to the crisis"*, as the BoE bulletin puts it. Several of those interviewed for this report made similar comments, with market participants stressing that the lending conditions that prevailed in 2006-08 were highly unusual. In the words of one, *"too much money was chasing too little business"* at the cost of credit quality. To some degree, then, the contraction in small business borrowing may simply mark a return to more normal conditions after the bursting of a credit bubble.

Alternative sources of finance

Bank lending is only one of several sources of finance. As well as term loans and overdrafts, businesses use leasing and hire purchase finance (much of it supplied by the leasing arms of the big UK banks). There is also some use of so-called asset-based lending, mainly invoice discounting and factoring – closely related services whereby companies can raise money against the face value of their outstanding invoices, releasing working capital and improving cash flow.

In its April Credit Conditions report, the BoE said: *"In recent discussions, a number of the major UK lenders reported that they were seeking to develop improved awareness of alternative credit products, such as leasing or invoice finance, among their SME client base and client-facing staff."* This theme was reinforced by the agents in their June report: *"There had been an increase in the use of asset-based finance for investment. And some small firms were slowly making greater use of different types of financing for working capital, such as invoice discounting, that were available in place of overdrafts."*

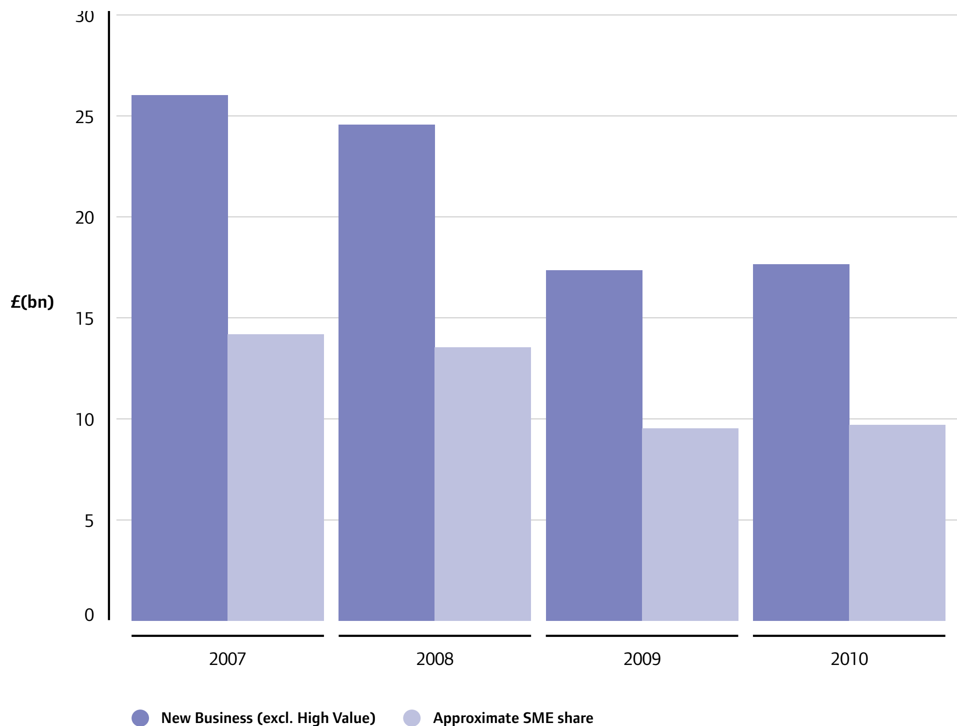
It should be noted that the big five UK banks have dominant shares of lending (more than 90 per cent in the SME market), leasing (around two-thirds of the overall market, according to an estimate from the Finance & Leasing Association) and asset-based finance (70-75 per cent of the market, according to an estimate from the Asset Based Finance Association).

The alternatives to loans have attractions for the big lenders. First, they offer the lender greater control and certainty over the size of its loan book than is possible with simple overdrafts, the use of which is under the control of the borrower. Second, these types of finance also offer lenders good security by matching the cash lent against specific assets or, in the case of invoice finance, against specific receivables (sums invoiced but not received). They also enable sales of profitable ancillary services such as insurance against non-payment of invoices.

Leasing is a leading indicator of business expansion since it generally involves plant and equipment, which is essential to business activity. Leasing companies have seen a marked slowdown in overall new business figures over the past few years (see Figure 2). The FLA does not compile separate figures for leasing by smaller businesses, but based on other survey work it has carried out, Julian Rose, head of asset finance at the association, estimates that 50-60 per cent of the total new business figures for leasing (excluding high-value deals exclusively undertaken with large companies) relate to deals with SMEs. Meanwhile, the overall stock of lease finance has remained stable over the past three years at between £69 billion and £72 billion.

Taken together, these figures indicate that British businesses are investing mainly to replace existing capital stock as it reaches the end of its working life, rather than investing to expand, and that they are seeking to extend the life of their existing plant and machinery. This is consistent both with the latest CBI survey of smaller manufacturers and with the experience of finance providers. In a similar vein, the FLA reports that its members are seeing their strongest growth in sales of

Figure 2: Leasing new business figures



Source: Finance & Leasing Association.

operating leases, under which the equipment is handed back to the leasing company at the end of the term rather than becoming the property of the lessee. The flexibility and lack of commitment offered by this form of leasing is clearly of growing importance to nervous managers.

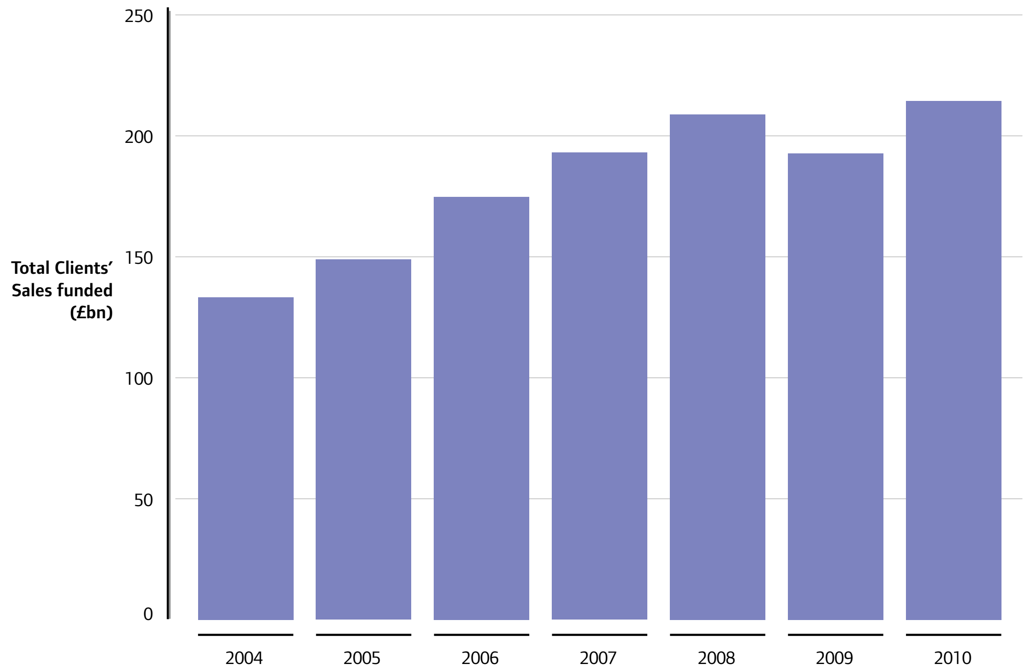
The FLA estimates that interest rates on leasing agreements generally lie in the range of 6-12 per cent, and adds that the spread between the prices charged to the riskier customers compared with the less risky has widened by between one and two percentage points in recent years.

In the case of asset-based finance, and specifically invoice discounting and factoring (under which companies are able to raise money against the face value of their outstanding invoices), figures published by the Asset Based Finance Association show that the overall size of the market grew strongly through the mid-2000s. It then shrank in 2009 before recovering strongly as the economy began to expand once more. However, although the market grew 11 per cent in value, the overall number of clients fell by 5 per cent between 2009 and 2010 (see Figure 3).

According to the ABFA's latest quarterly Economic Report, published in March 2011, advances to customers against their invoice receivables stood then at £14.9 billion, with a further £5.2 billion of unused facilities available to meet any increase in demand. There would seem to be substantial untapped finance capacity available.

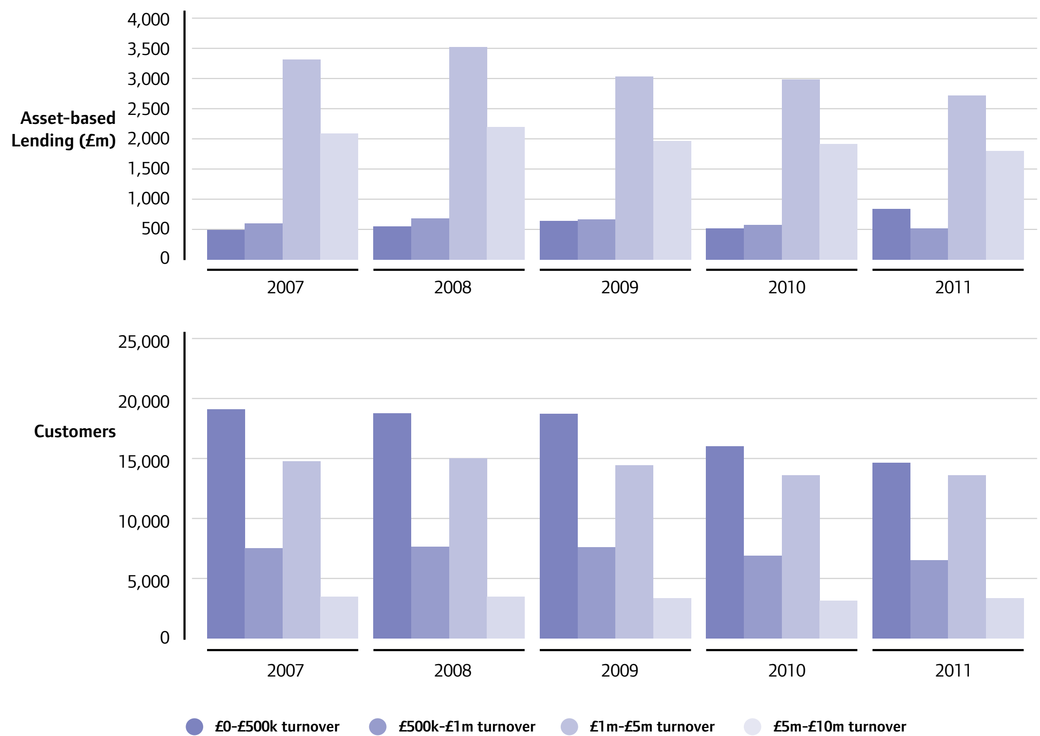
The ABFA figures (see Figure 4) show that not only have the sums advanced fallen across most SME categories since the credit crunch, but also that the number of clients using services such as invoice discounting and factoring has been shrinking across the board. However, when these two figures are combined to produce an average advance per customer (see Figure 5), it shows that among the smallest businesses, a diminishing number is making far heavier use of invoice discounting and factoring than previously. This may be because they are finding access to conventional overdrafts for working capital is becoming more restricted or more costly, or both, and that they

Figure 3: Total clients' sales funded



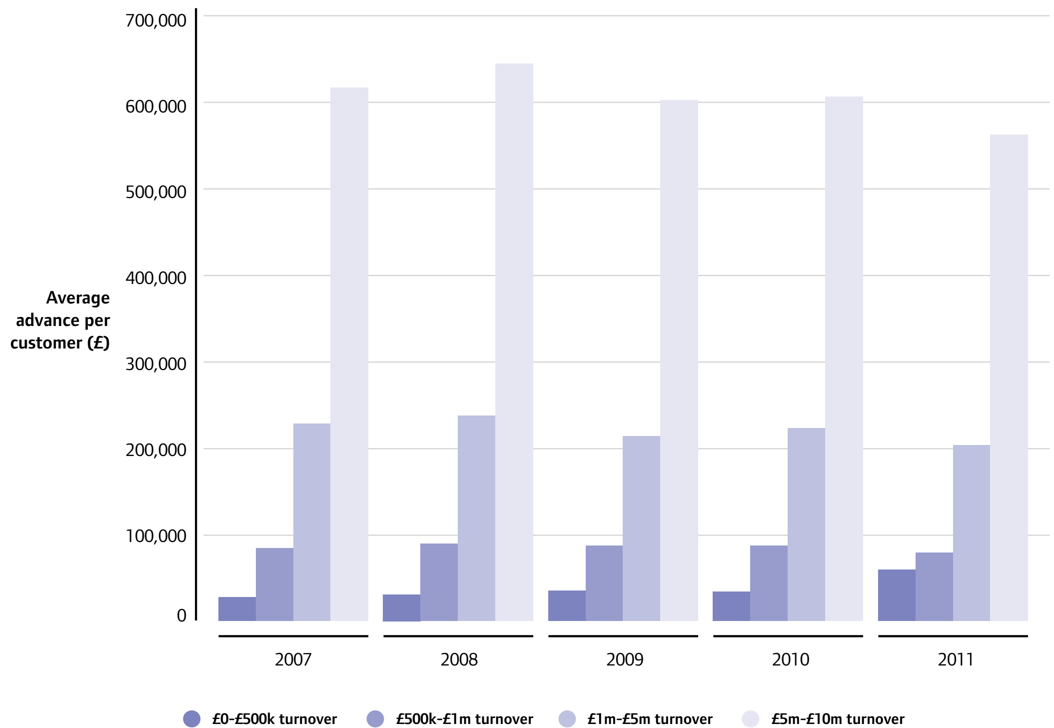
Source: Asset Based Finance Association.

Figure 4: Asset-based lending market totals



Source: Asset Based Finance Association.

Figure 5: Average advance per customer (£), by turnover



Source: Asset Based Finance Association.

are therefore seeking – or being steered in the direction of – alternative sources.

Pricing for asset-based lending products varies according to which service companies choose to use. Where the credit control function remains with the company (invoice discounting), costs will be lower than those that apply to factoring, where the finance provider undertakes to pursue late payments and recover sums owing. Charges are typically split into two parts: a discount (or interest) rate and a service charge. For invoice discounting, the ABFA says the discount will tend to be the Base Rate plus 1-4 percentage points, while the service charge will typically be between 0.1 and 0.5 per cent of turnover. For factoring, where the finance company effectively provides outsourced credit control to the client (and so has more effective risk control), the service charge will typically be 1-3 per cent of turnover. Factoring is frequently the service offered to small business clients. Domestic invoice discounting has a turnover about ten times the size of the market in domestic factoring.

Three key trends

This research highlights several broad trends in the financial circumstances of SMEs in the UK:

1. Use of external sources of finance is declining and debt is being paid off.

2. The cost of loan finance for smaller businesses is increasing and, among some of the smallest companies, there is a shift towards (sometimes more costly) alternatives to overdraft and loan finance, such as asset-based lending.

3. Although many companies are still keen to expand, many others are investing merely to maintain a ‘steady state’, replacing existing equipment as necessary, but not investing to expand capacity. This reflects widespread caution over the economic outlook.

Part 2: Case studies in innovation and conclusions

In Part 2 of this report, we look at several financial companies that are taking an unusual or innovative approach to the SME market, and attempt to distil lessons from their experience.

Two takes on lending

Case study 1: Handelsbanken UK

A Scandinavian bank with an unusual approach to lending

Handelsbanken UK is an offshoot of one of Scandinavia's largest banks, Svenska Handelsbanken. It has expanded steadily in this country over the past decade: in 2000 it opened its fifth branch, in Leeds, and 11 years later it has 107 branches and is expanding the total by about 20 per cent a year.

It is not clear that Handelsbanken's approach to banking can really be called innovative, although it is certainly unusual in this country. It operates a branch-based, relationship-banking business that devolves all critical decision making to the managers of the individual branches. The business is conducted on the basis of direct contact between the branch manager and team, and customers, leading to long-term relationships. As such, this way of doing business closely echoes the branch-based banking familiar to previous generations in this country.

Handelsbanken's managers and staff have no sales targets or budgets, and each branch makes its lending decisions in the context of being responsible for its own profit and loss account. There is no bonus scheme for staff at any level of the group. This means a notable absence of incentives that might prompt efforts to increase the size of the loan book at the expense of its quality.

The branch managers and staff typically come to the bank with many years of experience in a local area gained at one of the large UK clearers. Their local knowledge of people and businesses is strongly emphasised in the process of making loan decisions. Central to the bank's marketing efforts are staff contacts with local accountants, lawyers, estate agents and so on.

Handelsbanken says the salaries it pays are *"certainly competitive"* but does not think this is the main reason people want to work there. More important is the entrepreneurial approach with each branch team running its own P&L. The bank also offers a very long-term profit-share scheme, called Oktogonen, which staff can only start to draw on when they reach 60, providing a strong incentive to stay.

Another difference from the large UK clearing banks is that it does not employ risk models in reaching lending decisions. Instead, its branch managers (with support and resources from the central office) run through a more traditional decision-making process, starting with the basic 'can we understand the business?' sense-check. The branch will then look at the experience and ability of the management team and how well known they are to the bank.

Simon Lodge, general manager of the south region, in describing the process, laid great stress on the need to find and back quality managers: people who would be able to run a business under any conditions. The branch staff will then consider the cash flow and consequent ability to repay, assess 'micro risks' to the business and 'macro risks' facing the

economy or that sector. Finally, they will assess the suitability and size of the collateral. The bank takes a cautious approach to lending, so the process will generally take two weeks or more. *"We don't like to rush things,"* Mr Lodge observed.

The UK bank is able to operate in this unusual fashion because it is part of a large, Swedish-listed group that carries a much more substantial capital cushion relative to its assets than any of the UK's big four. The latest published figure for Handelsbanken's Tier 1 capital under Basel II banking rules is 17.4 per cent, among the highest in Europe and well above the level required under the Basel III rules that come into full effect by 2019. By contrast, the main British banks have significantly lower Tier 1 capital ratios. They remain under pressure to continue to improve their capital positions and, consequently, to hold more capital against their loans.

It should be noted that Handelsbanken is not a 'narrow' or pure-retail bank. At a group level, it is a universal bank, providing access to the wholesale capital markets, for example, by arranging bonds issues for its larger corporate clients in Scandinavia.

The bank's growth, albeit as a small player in the British market, has continued throughout and since the credit crisis. Since September 2008, when Lehman Brothers collapsed, it has made an additional £6.5 billion (gross) available to UK borrowers. It does not measure what portion of its loan book is accounted for by SME customers. The UK loan book stood at £4.8 billion in the bank's 2008 annual report, some £4 billion of it accounted for by loans to companies of all sizes. In the 2010 annual report, the amount was reported at £6.01 billion, of which corporate loans accounted for £4.77 billion. At the end of Q2, 2011, Handelsbanken UK says its loan book stood at £7.3 billion. The loan loss rate across the entire group in the first half of the year was 0.05 per cent.

The strong balance sheet is combined with a low-cost model – it typically opens a branch with only four staff and in modest premises – and the only performance target the group tracks is return on equity, which is assessed against its peers across the Nordic region. It competes on service rather than price: Mr Lodge said it attempted to be in line with market rates rather than to undercut them. The group's most recent published RoE figure is 14 per cent.

Mr Lodge did, however, point out that the bank only lends to established businesses with a solid trading record and sound managements. *"We view our position in the world as bankers, not risk capital providers."* It would not, therefore, back start-ups or very early-stage businesses.

Lessons and Issues

Handelsbanken's steady expansion in the UK bears witness to the popularity among business customers of relationship banking and devolved decision making. When some small businesses are telling the BoE's agents that they are unhappy with their existing banking relationships and have doubts over their bank's commitment to them, the opportunity for Handelsbanken to expand its reach seems obvious. However, it is not clear how replicable this model of banking is for other players in the UK.

Handelsbanken UK is able to operate in this unusual way because it is part of a much bigger banking group that carries a far more generous capital cushion than the UK clearing banks, and many others in Europe. Because the parent bank is conservatively financed, it is viewed as low-risk and is, therefore, able to raise money at lower cost than most European banks. This helps to bolster its lending margins and, combined with tight cost control, enables it to offer a relationship-based service that others might find too expensive and capital-intensive.

Another issue is that this kind of banking does not answer the needs of all types of business. Mr Lodge made clear that the bank would not provide funding to start-up companies and saw a continuing problem of getting risk capital to businesses that needed help to grow. Only after this stage would a relationship with a bank such as his become appropriate.

One option might be to use the unclaimed funds sitting in dormant bank accounts, through the Big Society Bank, to part-fund early-stage businesses and so to underwrite some of the risks involved. This would help to unlock risk capital from other sources.

Case Study 2: Funding Circle

A lender-borrower, or peer-to-peer, exchange for small businesses

Funding Circle is an online lending exchange that allows small businesses to borrow from a pool of individuals and organisations with money to lend. Loans are for between £5,000 and £75,000 each, with lending over terms of one to three years. The maximum loan will rise to £100,000 by the end of this year and £250,000 next year. At the end of August several thousand lenders had between them made offers to provide loans worth some £24 million. Lenders can be private individuals, limited companies, limited liability partnerships or public bodies. The company currently has 13 employees, mainly comprising IT staff and credit underwriters

The business was co-founded by Samir Desai, James Meekings and Andrew Mullinger, and counts veteran private equity investor Jon Moulton among its private backers. While there are now a number of exchanges dealing in personal loans, Funding Circle is the first in the UK to cater for businesses. It made its first loan in August 2010 and has grown quickly since then. In May 2011 it lent £700,000, and in July 2011, £1.5 million. By mid-August, it had lent to 270 businesses with turnover ranging from £100,000 to £18 million.

Funding Circle is not regulated, although the founders say they spent nine months prior to its launch clarifying the regulatory situation and establishing that there was no obligation to gain regulatory approval for their idea. The FSA confirmed that online lending exchanges did not fall into its jurisdiction, but suggested that they might fall under the OFT if they were seen as within the scope of the Consumer Credit Act. The activity is, of course, subject to legislation and compliance obligations in areas such as money laundering.

Funding Circle carries out extensive credit checks on the companies and managers that approach it wishing to raise loans. Potential borrowers must be able to provide current management accounts along with a trading record of at least two years, including filed accounts. Companies and individuals are assessed using this information alongside credit scoring data and payment performance records accessed via Experian. Funding Circle also checks online reviews of the companies by consumers on sites such as Yell.com. Its in-house credit models use this data to assign each borrower a banded risk rating that will help to determine the price of the eventual loan they receive. Some 80 per cent of the loan book is covered by personal guarantees provided by borrowers. Terms for borrowers are flexible, with no penalties charged for early repayment.

Borrowers are charged an arrangement fee of 3 per cent of the amount of the first loan they accept via Funding Circle, and 2 per cent for subsequent loans. The interest rate charged typically falls in a range of 6.3-8.8 per cent. The latest default rate is 0.5 per cent.

Although loans may be more costly than from some other sources, the speed of decision-making and flexible repayment terms are offsetting factors. The company says that its borrowers value, in particular, quick decisions on whether they will be allowed to borrow or not. The process typically takes a few days.

Funding Circle identifies two broad types of borrower. The first comprises companies that wish to borrow to finance expansion. Many of these are able to continue trading profitably on their existing cash flow, but need additional finance if they are to grow. A number of clients approached it after becoming frustrated with the length of time they had to wait for a loan decision from their bank, or they had been deterred from applying for bank finance on the basis of what they had read about banks' willingness to lend.

The second broad class of borrower comprises companies that have reached their borrowing limit with their existing bank, but whose cash flow is sufficiently robust to enable them to service more debt.

Lenders can either pick which borrowers to fund or use the automated feature of the platform, which matches their money to at least 20 borrowers fitting their selected risk profile. The system will automatically start to fill each loan by matching it with offers from the pool of lenders on a best-offer-first basis until the full value is reached. Lenders have access to information on the companies they are backing, including accounts, credit history and details of what the loan is to be used for. Funding Circle charges lenders an annual fee of 1 per cent of their outstanding loans.

It also provides a way for lenders to withdraw their money from the market before their loans are due for repayment. Lenders can sell the unpaid portions of their outstanding loans to others, a process that normally takes about two

How it works: Arcadia Products

Arcadia Products, based in Redhill, Surrey, supplies specialist lighting to aquarium, reptile and bird keepers in more than 50 countries, including China, where sales trebled last year. The company has turnover of £5 million a year and has been seeking to refinance since 2009.

It approached Funding Circle in July 2011 and received a £75,000 loan a week later. It has been invested in further products and associated tooling at the factory in China. The headline interest rate on the loan is 8.49 per cent, rising to more than 10 per cent APR once Funding Circle's fee is taken into account (Arcadia borrowed £75,000, but received £73,500 net of a 2 per cent charge).

Gerard Oates, managing director, said that his existing bank, HSBC, had declined his request because it was *"not interested in funding us further"*. In 2009, the bank had first accelerated repayment of Arcadia Products' loan, and once that was repaid had converted the company's overdraft to a loan that was also now being repaid. Mr Oates said that HSBC had had no objection to Arcadia using Funding Circle: *"When I told the bank manager, he said 'that is obviously the way of the future'."*

Mr Oates had provided a personal guarantee to secure the loan, but said he had *"no real issue with that …because when I submitted the application our company was in a loss situation for the year to date."* His real priority was to get a swift decision. *"What's really important is having the money because it can move the business forward."*

After securing the loan, Arcadia Products also attracted fresh equity investment based on its ability to borrow.

days to complete. According to the company, 99.5 per cent of loans listed for resale at par value achieve that price. On average it takes two days to sell loan parts at par. Funding Circle charges the sellers a 0.25 per cent fee.

It is important to recognise that, from the lender's perspective, this is not an instant-access savings product but rather a longer-term commitment of capital with some flexibility to withdraw early. Lenders are clearly exposed to credit risk, although this can be diversified across a pool of borrowers, and to the technology risks inherent in any online service of this sort. Should Funding Circle experience heavy redemption requests from its lenders, particularly during times of financial stress, liquidity risk could also become an issue. If lenders themselves use borrowed money, then a degree of leverage will be introduced into the system. However, to the extent that lending via Funding Circle is backed by deposits, the market appears to carry little systemic risk. By the same token, a lack of leverage will tend ultimately to reduce the pace at which the value of the loan book can expand.

Lessons and issues

Probably the greatest strength of online marketplaces such as Funding Circle is that the platform offers both borrowers and lenders a high degree of transparency on loan pricing. This contrasts with the market for loans and overdrafts provided by banks, which is much more opaque at the level of individual pricing. However, an online marketplace lies at the other end of the spectrum from a relationship-based operation such as Handelsbanken. It provides a platform for smooth delivery of a commoditised product whose advantages are speed, transparency and flexibility.

Perhaps the most intriguing possibility raised by Funding Circle is whether it contains the seeds of a viable SME equivalent to the corporate bond markets used by larger companies. The exchange appears to have several of the features that would be required. First, its loans are split into parts that can be spread among different lenders in the same way as larger company loans are subdivided into individual bonds. Second, Funding Circle provides a secondary market in which loan

parts can be resold by their owners. Third, it spreads the cost of due diligence on individual borrowers and risk management across the entire user base, thereby limiting the cost impact on any one borrower.

Samir Desai argues that the closest parallel with the service that Funding Circle offers is the existing market in high-yield leveraged loans, through which institutions invest directly in corporate debt rather than in bonds issued by corporate borrowers. He believes that lending of the kind arranged by Funding Circle could over the long term come to make up a significant percentage of the overall market in lending to UK SMEs, perhaps even 10 per cent.

There has been some debate over whether a viable bond market could be created for SMEs as an alternative to bank borrowing. However, this presents very considerable challenges if the model of existing bond markets is followed. According to Alex McDonald, chief executive of the Wholesale Markets Brokers Association, the costs of due diligence and meeting listing requirements for a company that wishes to borrow via the bond market is such that issues of less than about £20 million would not be commercially viable. Mr McDonald points out that not only will SMEs find the administrative costs excessive relative to the size of the loan, but they will have to pay a higher rate of interest than larger, less risky borrowers. Together, these factors mean conventional bond issuance is not an option for small companies.

The founders of Funding Circle believe that their business would gain if it were to be formally regulated, since this would provide an additional level of security to potential lenders. As things stand, individuals who lend via Funding Circle are not protected under the Financial Services Compensation Scheme. This lack of regulatory oversight is likely to become a more important issue as the business grows and starts to attract a broader range of retail investors as lenders.

The company would also like to see mandatory audits for limited liability companies, which it argues would improve the quality of company accounts and reduce the risk in lending to smaller businesses. It regards mandatory audit as a *quid pro quo* for the personal protection provided by limited liability to individuals who set up businesses. This would, however, go against the regulatory trend in the EU and UK to relieve small companies of the mandatory audit requirement.

An alternative approach to asset-based lending

Case study 3: Marketinvoice.com

An eBay for invoice discounting

The UK market in trade receivables is large and liquid, with a total turnover of some £212 billion in 2010. At any time invoices worth tens of billions of pounds are being financed for periods of approximately 30-60 days each, the usual payment period. While invoice discounting is a common form of finance in the UK, it is not normally carried out via auction-based markets. The current practice is for a business wishing to raise money against its outstanding invoices to use a specialist finance company. With factoring, where a finance company takes over the job of chasing up payments, the debtor is made aware that the invoice has been sold on to a third party.

Marketinvoice.com is an online marketplace that brings together companies that want to sell their outstanding invoices in order to release the cash that is tied up in them, with investors who bid against each other to buy the invoices for a percentage of their face value plus a commission.

The service is confidential, so that those who owe money against the invoices do not know that they have been sold to a third party.

The marketplace is in its early stages, having undertaken its first trade in February this year. It has a staff of ten, led by founders Anil Stocker and Charlie Delingpole, and by August had attracted 25 companies as customers. These are established businesses with a trading record and turnover of between £1 million and £10 million a year. Customers have included recruitment businesses, media production and software companies. As of mid-August, it had traded about £1 million of invoices since launch, including £125,000 in the last week of July, according to Jaoa Belo, head of marketing. It has undertaken sales of cross-border invoices but has yet to handle its first entirely international transaction.

There are few companies in Europe currently offering similar services to Marketinvoice.com, though the US has an established operator, www.receivablesxchange.com

Marketinvoice.com undertakes a range of background and credit checks on the companies that wish to sell their invoices, on the directors of those companies and on the

validity of the individual invoices. It also does similar due diligence on the debtors who must pay the invoices. Once a company has set up an account with Marketinvoice.com, each new invoice and new debtor are subjected to further checks.

Once they have opened an account, companies will then set the range of discount to the face value of the invoice that they are willing to accept, along with a 'buy it now' rate that will halt any auction. Bidders compete to offer the most attractive discount to the seller, coupled with the most competitive fee to provide the cash, typically between 0.5 per cent and 2.5 per cent of the invoice's face value. Bidders are able to diversify their risks by buying portions of a range of invoices. Funds are channelled between buyer and seller via accounts controlled by Marketinvoice.com

The firm makes its revenues by taking 0.5 per cent of the face value of each invoice as a fee from the seller, plus about 20 per cent of the buyer's profit. It claims to offer advantages to the companies that sell their receivables on the site since it does not insist on a contractual lock-in, does not seek personal guarantees from the directors and does not charge monthly fees to maintain access to its service.

Access by investors to Marketinvoice.com auctions is restricted to institutions such as asset managers and family offices, and individual Self-Certified Sophisticated Investors. The company sees its opportunity in providing access for investors to a previously inaccessible asset class – trade receivables – that it says can provide returns of between 12 per cent and 25 per cent a year (and on occasion as high as 40 per cent) net of fees.

The chief challenges facing Marketinvoice.com are, first, distribution and marketing. Since it does not use brokers to bring in business, unlike other invoice discounting houses, it needs to create awareness of its service directly among potential customers. It uses telemarketing, attendance at events, online advertising and public relations to raise its profile. A more concerted marketing push was planned for the autumn.

Platform Black Invoice Trading

A second online marketplace for invoice discounting is about to go live: Platform Black Invoice Trading aims to launch at the beginning of October. It will operate a model similar to Marketinvoice.com by bringing together companies that wish to raise money against some or all of their outstanding invoices with investors ready to advance the funds.

The exchange will take fees on a sliding scale, from 1 per cent on small transactions to 0.5 per cent on large ones. Platform Black Invoice Trading differs from Marketinvoice.com in that it seeks to work in partnership with the big high street banks and specialist factoring houses that dominate this business. Several of these large players are expected to be among the institutions that provide funds via the Platform Black Invoice Trading marketplace to companies seeking to raise working capital. This would mark a departure for these banks and factoring companies since until now they have only offered asset-based finance to their existing business customers under long-term, exclusive agreements. As such, it represents a clear sign of the interest that the incumbents are taking in online exchanges as a way of channelling finance to corporate borrowers.

The company is also working closely with a variety of other organisations including the ABFA, Experian, the credit rating agency, and the National Fraud Authority. Although invoice discounting is not a regulated business, the founders of Platform Black Invoice Trading say they intend to comply with all relevant Financial Services Authority standards from launch.

The business, based in Southampton, is led by Christopher Shaw, CEO, who is an IT recruitment entrepreneur, and Louise Beaumont, sales and marketing director. Colin Levins, who is CFO at London & Capital Asset Management, has taken the same role at Platform Black Invoice Trading.

The second challenge is the need to improve general awareness of invoice discounting and factoring, and their reputation. These forms of finance are sometimes regarded with a degree of suspicion since it is felt that companies that need to sell their trade receivables may be suffering cash flow problems, which can be an early warning sign of distress. This explains the importance for many customers of the confidentiality that Marketinvoice.com offers.

The firm operates in an unregulated market and there is no desire to open up its auctions to retail investors.

Lessons and issues

If these invoice discounting exchanges are able to gain sufficient traction, they could become a welcome additional source of working capital for smaller UK companies. Online market-based approaches are effective in creating transparent and competitive pricing for financial products, as evidenced by the success of services such as moneysupermarket.com in consumer finance.

For borrowers, the exchange offers a no-frills service that is more flexible than the arrangements typically offered by the larger players, involving no lock-ins for instance. The auction system means that instead of having to accept the price offered by a single provider, they can benefit from competition among bidders to secure the business. This is a significant attraction.

However, in order to grow, Marketinvoice.com will have to expand the overall market for asset-based lending, since customer mobility is low. Most companies that use this source of funding are locked into exclusive, long-term contracts with existing providers, in many cases the major banks. Given that the data suggest the number of companies using invoice discounting and factoring is shrinking, and without the use of brokers, the marketing challenge may prove significant.

Asset-based lending remains, however, a potentially important way to fund smaller businesses and one with significant room to grow, if only on the basis of funds already committed by lenders, according to the ABFA's figures. Yet it is not well understood. John Nelson, UK commercial leader (commercial asset-based lending and direct leasing) at GE Capital, pointed out that asset-based lending had a very low market penetration when compared with other forms of finance. GE Capital is one of the leading non-bank lenders in the UK market. Mr Nelson argued that that this form of finance was particularly suitable for early-stage companies. Even without a trading record or any significant assets, their invoices could be financed and cash released to help fund their development.

Like Mr Belo at Marketinvoice.com, Mr Nelson was keen to see asset-based lending become a regulated business. Although he emphasised that GE Capital ran its business to 'regulated standards', this is a voluntary undertaking. He said GE Capital was seeking to be regulated through a framework negotiated with the Financial Services Authority.

Case study 4: D&D Leasing

A leasing company targeting the higher-risk end of the small business market

D&D Leasing is the UK arm of a privately owned Canadian company established in 2000. It has been operating in the UK, its first overseas market, since early 2009. D&D specialises in leasing equipment to owner managers and small businesses with turnover of less than £3 million. It offers only 'small ticket' leasing deals worth less than £35,000, often in low-value or out-of-favour areas such as catering and office equipment. It does not finance vehicles or rolling stock. Equipment is provided exclusively under lease hire or rental agreements.

Survey evidence suggests that some consumer-facing businesses are finding it increasingly hard to obtain finance. D&D says it frequently offers funding to companies in sectors that larger and more mainstream finance providers have turned down, for example restaurants or fitness clubs. D&D's chief executive, Bill Dost, says: *"Our target companies are typically those experiencing trouble obtaining finance from other sources."*

D&D's approach is to engage very actively with its end customers, all of whom are brought in by brokers. It monitors its investments closely, which pushes up costs but also helps to ensure repayment schedules are met – with a degree of flexibility. However, because of its focus on higher-risk customers, D&D is one of the most expensive providers in the market. It takes a 20 per cent down payment from the customer to reduce its risk. Its finance rates to the broker start at 26 per cent, on to which the broker will then add its margin.

"We are definitely some of the most expensive people out there," says Mr Dost. *"It has to*

be painful enough for the customer to be a true customer." D&D's high percentage rate charges reflect both the low overall value of the items it funds and the cost of undertaking thorough due diligence and ongoing, one-to-one contact with customers in order to ensure they can work through cash flow issues and still generate a return on D&D's investment.

Each customer must demonstrate that the items funded deliver revenue or cost savings over and above the cost of the funding provided.

Despite the costs, demand for D&D's funding remains healthy and far oustrips the available supply. *"We have always had more than we can possibly service,"* says Mr Dost.

Before a deal is signed, D&D will talk to the end customer and visit it to gain further insight into the business and its circumstances. Once the deal is signed off, D&D will carry out an audit call with each customer every three months for the first year of the leasing contract, which typically runs over three years, and periodically thereafter. This ensures that problems are uncovered and dealt with quickly. Where communications with the lessee are good, D&D is prepared to vary payments temporarily to help a customer get over a short-term cash- flow difficulty. The approach to defaults is one of 'negotiate before litigate', but where a customer is not open and payment problems arise, D&D pursues its debts aggressively. As such, it puts its arrears ratio at sub 3 per cent.

D&D seeks to grow organically on the principle of 'story' credit underwriting, customer service and good due diligence. Business volumes are modest, though the company expects to see strong growth through 2012. D&D remains a small player in the market, but is making overtures to raise additional investment funding to expand its offering.

Lessons and issues

D&D's approach of close attention to its high-risk customers and intensive engagement offers two important and related lessons. First, there is demand to borrow even at very high rates from some parts of the economy, particularly hard-pressed consumer-facing businesses that are finding it difficult to raise money through conventional channels. Second, these higher-risk sectors of the economy – often smaller businesses – demand intensive engagement, due diligence and credit control, which push up the costs to the borrower.

The example of D&D shows how quickly charges can rise, relative to the value of the asset, for small deals in high-risk sectors. Bond markets for SME fundraisings are a problem for a similar reason: the costs of thorough due diligence are high. Along with a higher interest rate to reflect higher risk, the costs can quickly mount up to a ruinous percentage of the sum to be raised.

Conclusions and areas for further investigation

1. A SME bond market: The potential for something akin to a bond market for SMEs to develop from the lender-borrower exchange model is intriguing. It appears to have many of the features that would be required to make this idea work. Exchanges often operate best if liquidity is concentrated rather than being spread across multiple venues, which might give Funding Circle first mover advantage. If this market is to develop and realise its potential, there will be a need for greater regulatory clarity about the protection of lenders' money (if any) and the position that these lenders would take alongside other creditors, such as the banks, in the queue for repayment should a borrower go bankrupt. However, the possibility that some form of online marketplace might provide a workable proxy for a bond market in SME lending is worth further exploration.

2. Asset-based lending exchanges: auction based invoice discounting has potential attractions for many small business borrowers, but the lack of customer mobility in the market may retard its growth. If online providers such as Marketinvoice.com and Platform Black Invoice Trading, can succeed in opening up this branch of finance to new customers, it will be an important addition to the funding options for small businesses.

3. Early-stage businesses: There is also the question of whether and how asset-based lending, such as factoring and invoice discounting, could be used to provide more finance to early-stage businesses and so aid their growth. The ABFA reports that this form of finance is already used quite commonly with early-stage businesses in certain sectors, such as recruitment. Kate Sharp, chief executive of the ABFA, also suggested it could be used elsewhere,

including in manufacturing, where the requirement was clearly for working rather than investment capital.

4. Advice: During the research for this report, many of the interviewees and publications highlighted an 'advice gap' affecting small businesses, in spite of the presence of services such as corporatefinance.org.uk (a network of independent accountants and business advisers) and the Forum of Private Business. Several interviewees reported that the broker channel was by far the most effective sales route, since people valued direct contact, advice and engagement with their business. Most small business managers take little or no external advice, and many rely on their accountant for everything. Survey data gathered for the SME Finance Monitor showed that only 9 per cent of SMEs sought any external advice before applying for or renewing an overdraft facility. Almost all those who did seek advice spoke to their accountant. In the case of loans, 20 per cent sought advice, again talking mainly to their accountant. Among those who had applications for loans or overdrafts rejected, large proportions *"rated the bank's advice as 'poor', with virtually no referrals to external sources of advice from the bank"*. This lack of referral is worrying, but is being addressed. The UK's five largest banks, through the Business Finance Taskforce, are between them co-funding the www.mentorsme.co.uk website. This is a potentially important referral service through which small businesses can contact external advisers and mentors. The banks themselves need to advertise this new service to their small business customers, and to attract professional service providers to advertise on it. The problem of how to reach small business owners with information and messages is a longstanding one. The presence of the major banks in this initiative, with their overwhelming share of small business customers, should help to overcome it provided the service is developed and promoted with sufficient initiative and commitment.

5. Regulation: The online marketplaces profiled here have exciting potential but it is not clear where they fit into the regulatory framework. Asset-based lending is an unregulated business, while online marketplaces for conventional loans are also unregulated. In times of heightened risk aversion, the regulatory vacuum is a problem in expanding certain financing channels, such as asset-based lending – hence the desire of GE Capital to establish a regulatory framework in conjunction with the FSA. Founders of online lending exchanges are also keen to gain the implicit assurance of being formally regulated. There is, however, a risk of new regulation being too onerous for SMEs.

6. Incentives: Several people raised the question of whether the UK has the right incentives in place to encourage the flow of finance to SMEs. The FLA believes, for instance, that rules on capital allowances are not well understood: according to recent research, the rules had no impact on the investment decisions of 80 per cent of SMEs. Not surprisingly, Funding Circle would like to see tax incentives to encourage lenders to make funding available via online exchanges, and suggests this could be via an extension of the Enterprise Investment Scheme. However, any change of this sort might well require the regulatory status of these markets and their users to be put on a more certain footing.

About the Author

Andy Davis spent 15 years on the *Financial Times*, where he became editor of *FT Weekend* and an assistant editor of the *FT*. Other roles included development editor, leading a redesign of the paper, features editor and director of business development in India. He left the *FT* in June 2010 to pursue an entrepreneurial venture aimed at private investors. His work with the Centre for the Study of Financial Innovation includes regular contributions to *Financial World* magazine, which is produced for the *ifs* School of Finance.

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