Powering growth

An SME's guide to accessing finance

May 2022

Building a better working world

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Foreword

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The pandemic has shone a light on SMEs in the UK. Times have been tough for many, but adversity is often the mother of invention, and we have seen innovations across industries and business types that point to a brighter future.

SMEs are becoming more agile and flexible in their responses to regularly changing market conditions; we see evidence of more use of technology and the benefits that being digital can bring. This will lead to greater productivity and growth over time.

And growth of any kind is often underpinned by finance.

In the EY 2018 paper *The Future of SME Banking*, we showed that SMEs were financing their ventures from a range of traditional options such as banks, credit card providers, friends and family. Since then, the options available to them have increased significantly. Accordingly, the CBI, supported by EY, has pulled together this short paper to educate SMEs on what is available in the market.

We provide some context on the need for financing as we emerge from the impacts of the pandemic and provide an introduction and explanation on different financing options.

We intend this guide to serve as an introduction to those starting or growing their businesses. Any decisions should be supported by independent advice.

We hope this proves to be a useful resource for SME businesses across the UK.


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Foreword

Chris Wilford
Director of Financial Services Policy
CBI

Growing UK businesses don't lack strategy, ambition or talent, but all too often, they're not getting the finance they need to take their business to the next level. The CBI wants the UK to be the best place in the world to start and grow a business, and access to the right finance is critical to making this happen. As the UK builds back from the coronavirus pandemic and forges a new global, sustainable future, now more than ever is the time to go for growth.

As this report sets out, SMEs are facing a cumulative burden of repaying loans, cash flow pressures, late and long payments, higher energy prices, and skills shortages, all while continuing to navigate the effects of both Brexit and COVID-19. Working with EY LLP, the CBI is focused on providing resources and information for SMEs to support their growth. This includes promoting government initiatives such as Help to Grow Digital and raising awareness of the support available to SMEs to manage their debts and get the help they need, such as Pay As You Grow and local authority grants.

Last year, the CBI identified a series of prizes that could unlock £730bn by 2030. From global trade to decarbonisation, the opportunities are significant. This report sets out the robust and diverse finance market evolving that can ensure SMEs can play their part by getting the finance they need. Intermediaries play a critical role in connecting businesses with the right finance for them. Still, as this research demonstrates, providers are also changing their offering to support clients on their terms. This will be vital as the sustainability agenda continues to gather pace. Winning the race to net-zero offers benefits to every single business, such as enhanced customer appeal – but it's also the right thing to do for our society. Lenders realise this, and there is a growing wealth of guidance for firms taking the first step on their sustainability journey, as demonstrated in the CBI/UK Finance's Financing green guide for SMEs.

For its part, the CBI will continue to play an active role in debates on finance for growth, pressing the need for a long-term guarantee scheme in the UK. Despite the innovations and progress made to date, the finance gap for smaller businesses has not gone away. We need a competitive finance market that continues to help as many businesses as possible realise their potential.

Challenges aside, it is an exciting time to be a smaller business as new technologies and opportunities present themselves. With the right finance, knowledge and skills, growing businesses can seize the moment and go for growth.

Executive summary

Anita Kimber
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Transformation Leader
EY LLP

The past few years have tested SMEs to the limit, yet they have remained resilient by being flexible and adopting advancements in technology.

When it comes to SMEs, there is no 'one size fits all'. From the sole trader working alone on a market stall to the heavy-duty manufacturer with over 200 employees, the wants and needs of the entrepreneur vary considerably. As businesses develop, so do their financing needs. Yet navigating the finance options available to them can be a minefield. A lack of understanding or availability of the most appropriate options deters SMEs from applying and can be costly if the incorrect product is chosen.

The COVID-19 crisis has amplified this further. With SMEs accounting for over 99.9% of the business population, we cannot ignore these finance needs as they remain a vital lifeline to SMEs who have been struck hardest. Not only do firms often require this funding for business growth or strategic change, but they also use business finance to pay the wages of some of the 16.3mn UK staff employed by them.

Although we have seen increased support from the UK Government in this space during the pandemic, such as developing the Bounce Back Loan Scheme (BBLS), SMEs require more permanent and personalised finance options.

At EY, we believe that this gap surrounding financing options can be closed if traditional banks, challengers and SMEs work closely together. By adding clarity on options available to SMEs, assessing the suitability and understanding individual SME ambitions, there are opportunities for win-win scenarios for both parties involved.

In this guide, we have provided an overview of the types of business finance available to SMEs as a step to supporting SMEs in their financing decisions. We hope that as SMEs gain confidence in understanding and attaining working finance, financial institutions take the opportunity to work in tandem throughout the business life cycle.

1

UK SMEs and the economy

UK SMEs are the lifeblood of the UK economy, accounting for a turnover of £2.3tn and 99.9% of the business population

1.1 | The importance of SMEs in the UK economy

Despite a challenging environment, UK SMEs have remained resilient

The past five years has proved a challenging period for UK SMEs, with unprecedented levels of uncertainty and unfavourable economic conditions caused by events such as Brexit and the COVID-19 crisis. Retaining talent and attaining working capital finance continues to be an ongoing challenge faced by SMEs.

Nevertheless, SMEs have largely been able to adapt and, in many instances, grow. Between 2016 and 2020, there was continuous growth in the number of SMEs in the UK. As shown in Figure 1, the number of micro and small businesses in the UK grew by 7% and 4%, respectively, an increase of 83,975 firms, only falling in 2021. Despite a reduction of the SME population in 2021 from 5.9mn to 5.6mn, many SMEs saw annual turnover increases, with growth year-on-year in each category, as shown in Figure 2.

The ability of SMEs to not only maintain but surpass annual financial growth during this period evidences the resilience of firms to external forces and economic impacts. We have seen more and more SMEs pivoting their business models, becoming more digital and embedding flexibility and innovation.

Figure 1: Total number of UK SMEs by size

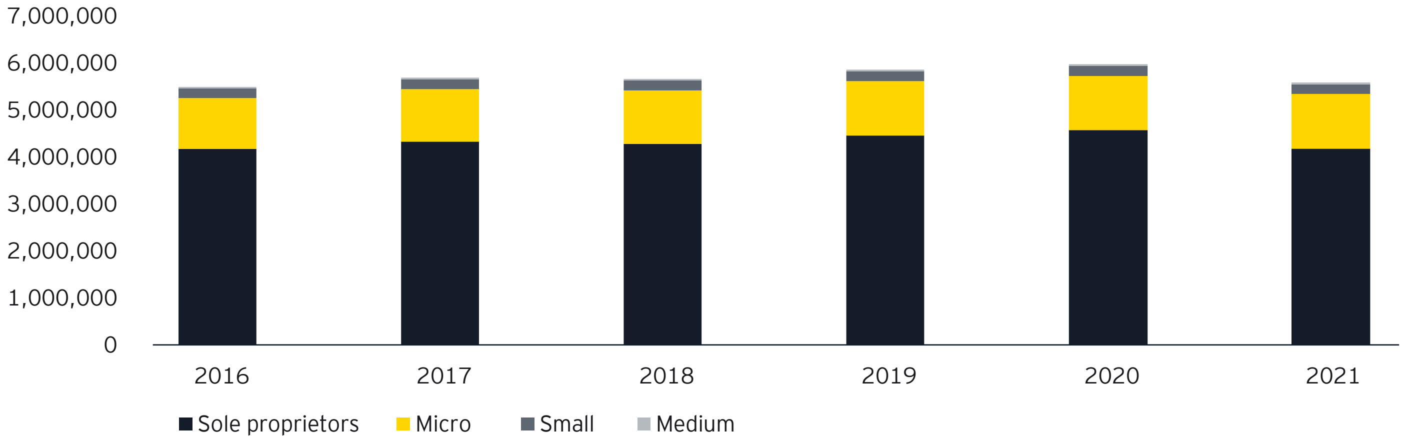
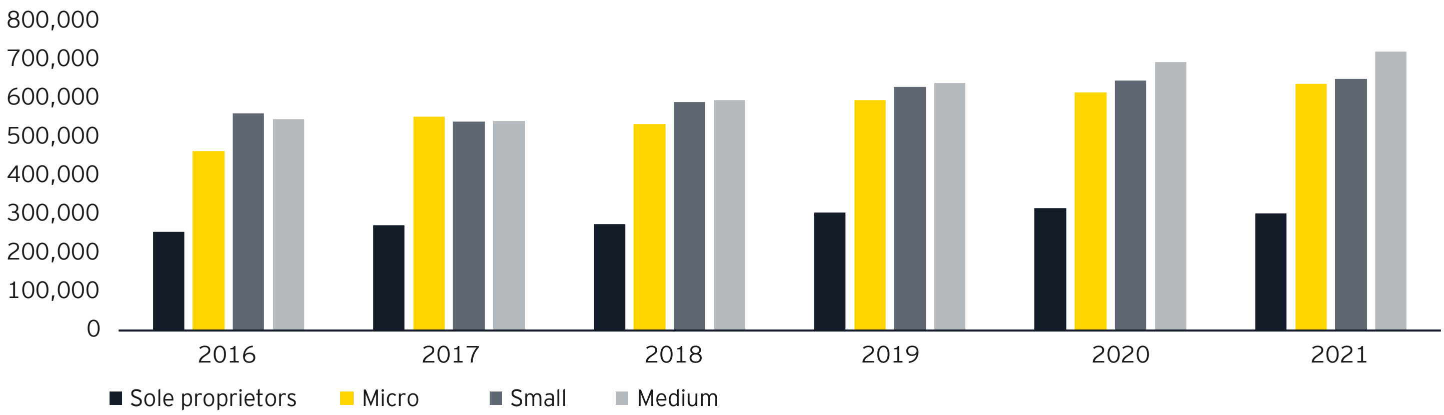


Figure 2: Turnover of UK SMEs by size (£mn)



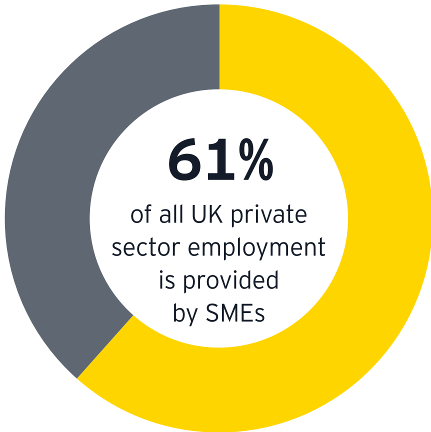
SMEs provide a vital role in the UK economy, providing employment and driving innovation in multiple sectors.

SMEs provide a vital role in the UK economy, providing employment and driving innovation in multiple sectors.

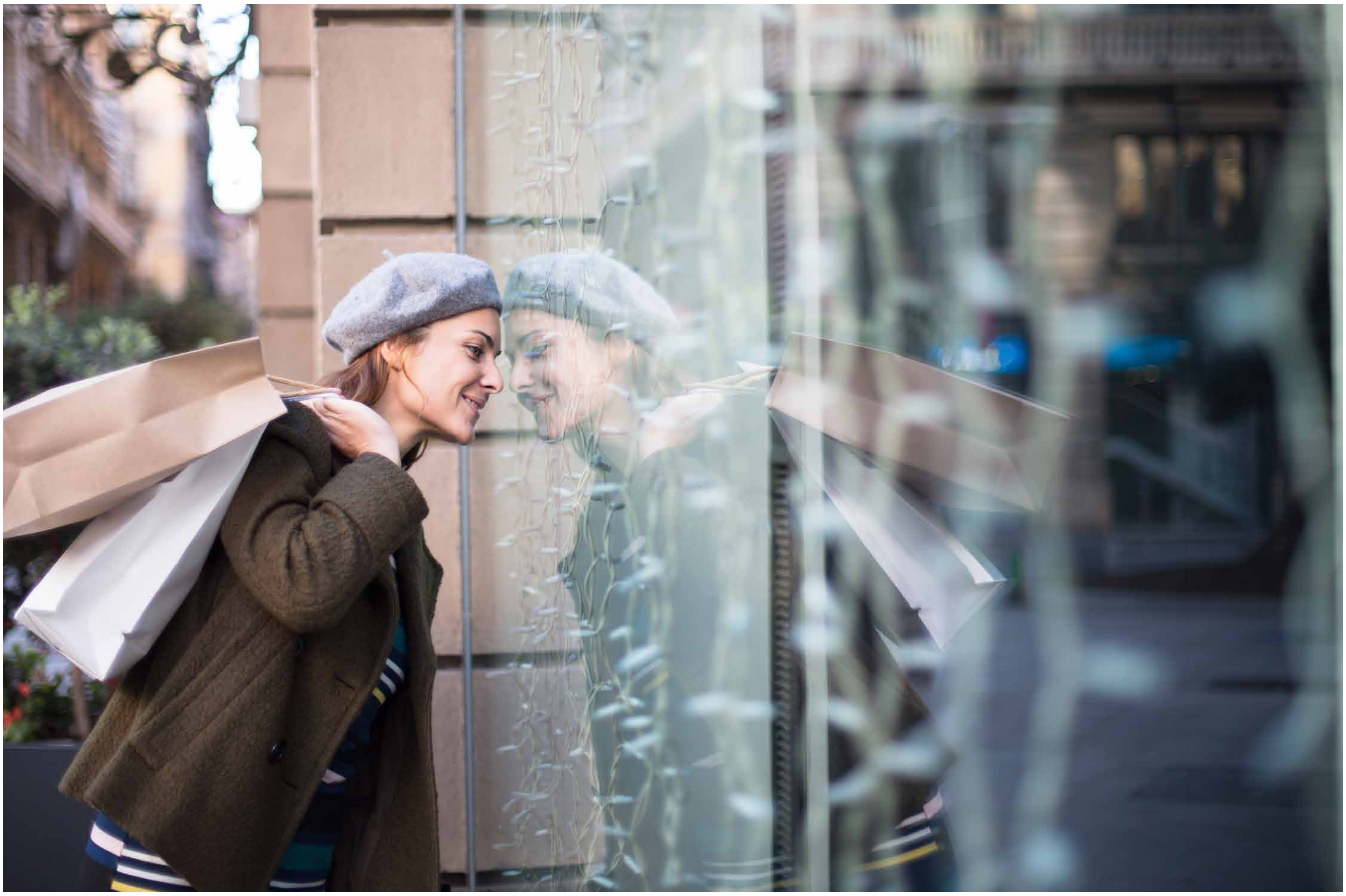
Accounting for 99.9% of the business population, SMEs are often cited as the backbone of the UK, supporting the economy on both a national and local level.

SMEs employ approximately 16.3m people (61% of total private sector employment), providing key training and skills to the workforce. The benefits are felt in local economies, where SME employees provide a multiplier effect to other local businesses, supporting regional growth. On a wider scale, SMEs collectively achieve a combined turnover of £2.3tn, equating to 52% of all private sector turnover in the UK.

SMEs are also core to competition within markets and innovation. Over the past decade, we have seen significant technological advancement and innovation disrupt several industries across the UK, such as the Fintechs in Banking. Often, SMEs pioneered new forms of technology, business models and alternative working methods.



Source: BEIS, EY analysis



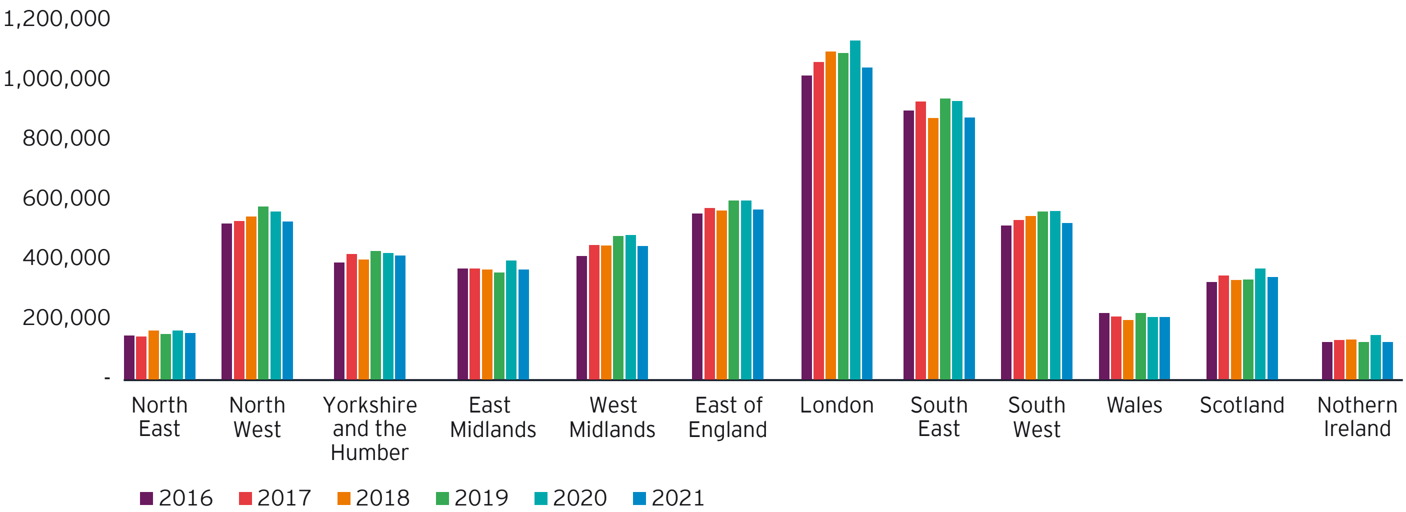
1.2 | The SME landscape across the UK is evolving

For this publication, we have categorised SMEs into four categories; sole proprietors, micro-businesses, small enterprises and medium enterprises. We categorise SMEs by headcount and turnover.

	Employees	Turnover
Sole proprietors	0	-
Micro-businesses	<10	<£1mn
Small enterprises	10-49	£2mn-£5mn
Medium enterprises	50-249	£5mn-£25mn

The expansion of SMEs has been seen across the UK regions, with specific industries concentrated in different parts of the country.

Figure 3: Number of SME businesses by region



10.3% **growth** in the number of SMEs located in London between **2016 and 2020**

7.8% **decline** in the number of SMEs located in London between **2020 and 2021**

On a regional level, SME growth increased in every region until 2021, as shown in Figure 3. Between 2016 and 2020, the West Midlands saw the largest growth, with the total number of SMEs increasing by 17%. London and the North East each saw an 11% rise in the number of SMEs in those areas (BEIS, 2021).

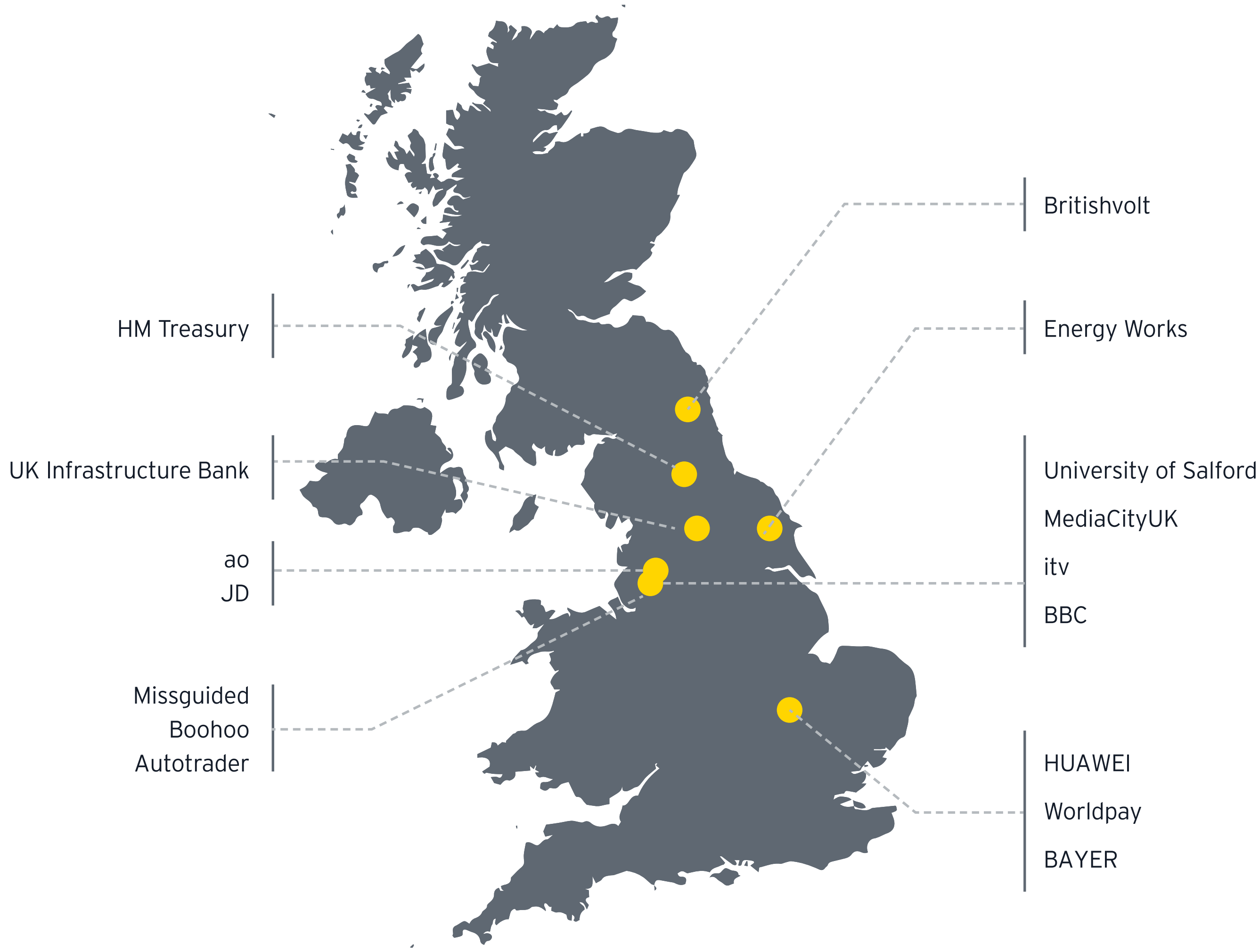
All regions suffered a decline in the SME population during the pandemic in 2021, with Yorkshire and the Humber declining the least.

We also see groups of specific industries. The South West hosts the most SMEs in agriculture, whilst the South East has the most manufacturing firms. We see a shift from traditional regional industries, such as manufacturing in the North East, North West and Yorkshire, to more tertiary industries such as administrative and support service activities in these areas. We also see a relocation of certain industries across the country, such as reductions in the number of SMEs in the transportation sector in London and the South East, countered by enhanced growth in the North East and North West.

Although this growth supports an economic balance across the country, we note that regional disparities continue to exist, with London and South East England accounting for over 2mn businesses (35% of the business population) alone. In contrast, the North East of England has 163,000 private sector firms, employing just 0.76mn people, compared with the English regional average of 2.7mn employees (BEIS, 2021).

Government-backed initiatives continue to support this regional diversity to discourage a national 'brain drain' to larger cities.

Several government-backed schemes have accelerated the development of these regions to encourage an equal economic spread and support SME growth and diversity. Key examples are the Regional Growth Fund (RGF), investing £2.6bn in private sector businesses with the expectation of creating or safeguarding 289,000 jobs, and the Local Enterprise Partnerships, acting as a voluntary partnership between business and authorities. Further, the relocation of key government bodies such as the expansion of the HM Treasury to Darlington and HMRC headquarters to Nottingham, plus the development of the UK Infrastructure Bank in Leeds, encourage SMEs and employees to move to these areas.



Private-sector industries have also implemented regional relocation initiatives, such as the BBC and ITV to MediaCityUK in Salford, retail giant Boohoo group to Manchester and the Energy Works' development in Hull. As a result, areas have developed into industrial hubs across the country, with Manchester now seen as the UK's creative and digital heart, providing event spaces and support for digital startups.

The effects of this diversification are likely to be felt even more over time, especially with the High Speed (HS2) rail network connecting the regions to London. Even now, many SMEs are no longer required to be based in a large city to thrive. The impact of the COVID-19 crisis on digital adoption in the workplace increased flexibility on working locations and reductions in office space across the country.

1.3 | The economic climate has made SMEs focus inwards

Although the economic environment has been turbulent for UK SMEs, it has provided an opportunity for businesses to focus intently on their operations and processes.

The past few years have been challenging for SMEs. Brexit and the COVID-19 crisis provided a foundation of uncertainty, severely impacting how businesses could trade and operate. Government support has been crucial, with the introduction of the Bounce Back Loan Scheme (BBLS) and Brexit support fund. Still, SMEs had to navigate unexpected challenges such as supply chain issues, the move to remote working and staff retention during the 'Great Resignation'.

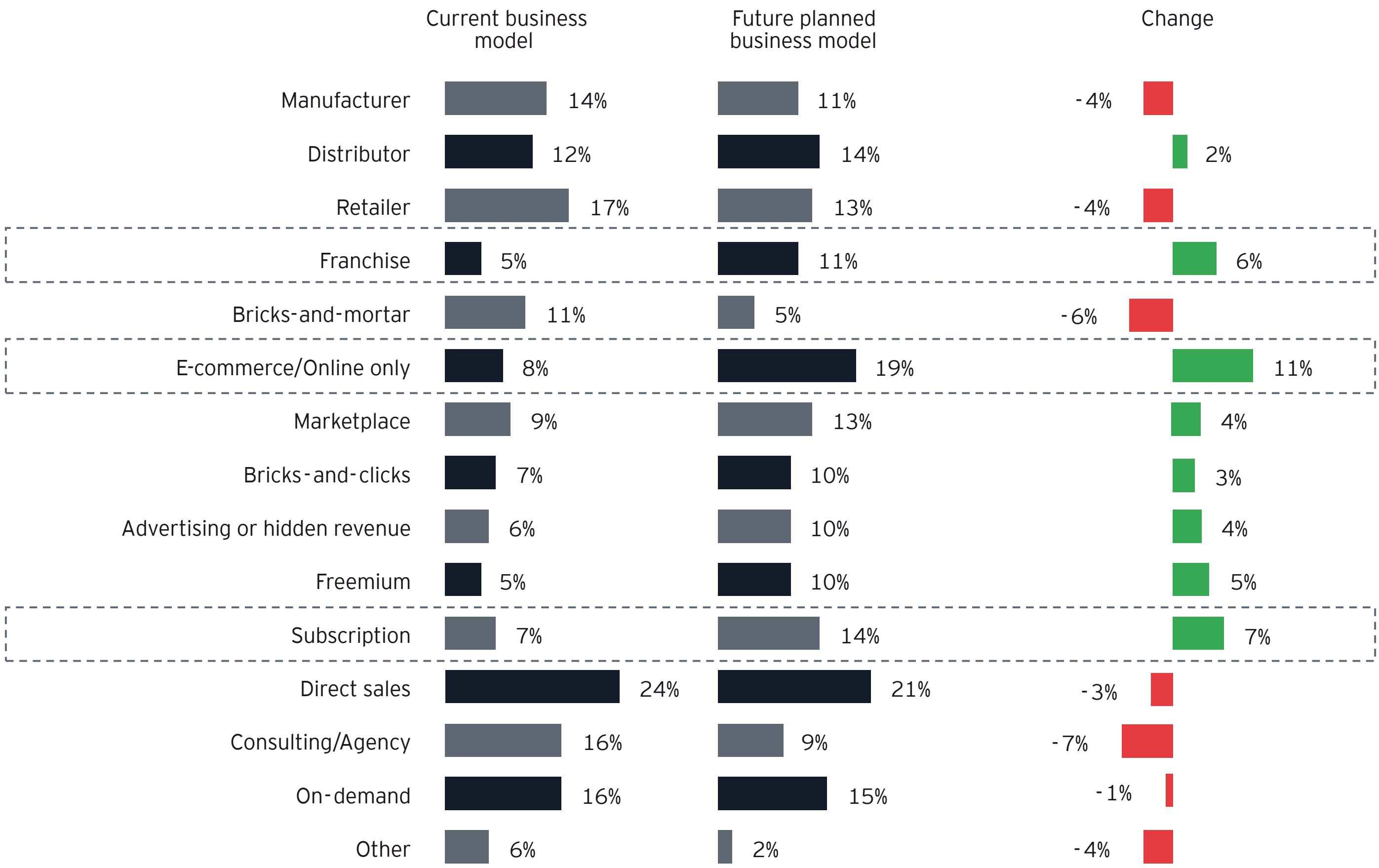
The ability and need of businesses to manage these challenges effectively has been dependent on several factors, including the nature of their industry, potential to access finance, adoption of technology and reskilling of staff. These events have forced SMEs to look inwards at their current processes and focus on what they do and how they do it. As shown in Figure 4, SMEs are now looking to evolve their business models to adapt to their needs and external forces, with plans to diversify into franchising, subscription-based models and, unsurprisingly, e-commerce.

Another key focus for many firms has been their relationships with their banks and the financing options available. Although SMEs have typically had longstanding relationships with their banks, more than one in three surveyed by EY are 'likely' to consider switching in future as expectations of banks' service offerings and support are under scrutiny.

The rise of FinTech firms has also provided an alternative finance provider to SMEs, replacing incumbent banks, often with often more flexible financing terms and options available. This is most true for SMEs within the growth and rapid-growth stages.

As the economy begins to stabilise, SMEs will be focusing more intently on their business demands, whether survival or growth into new markets. Financial institutions must provide stability and personalisation to retain these clients.

Figure 4: Planned changes to business model, ***EY Global SME Survey***



2

The impact of the COVID-19 crisis on SMEs

Lockdowns, supply chain issues and inflationary pressures have pushed many SMEs beyond the brink.

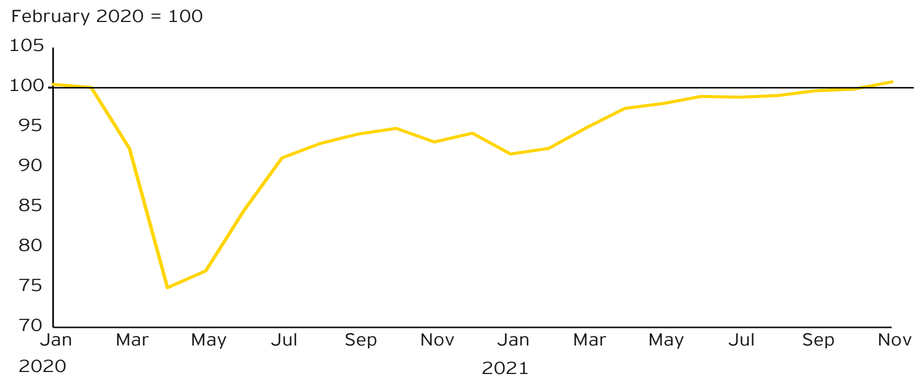
2.1 | The impact of the COVID-19 crisis on SMEs

The COVID-19 crisis has changed how we work, how we shop, how we travel and how we interact with each other.

The UK faced a shock to the economic system not seen since World War 2; headline gross domestic product (GDP) declined by 9.9% in 2020 (Office for National Statistics (ONS)).

The impact on individuals and their employers has been profound. As the lifeblood and backbone of the economy, SMEs have endured significant challenges from the lockdowns and other obstacles, such as supply chain issues and inflationary pressures.

UK: GDP

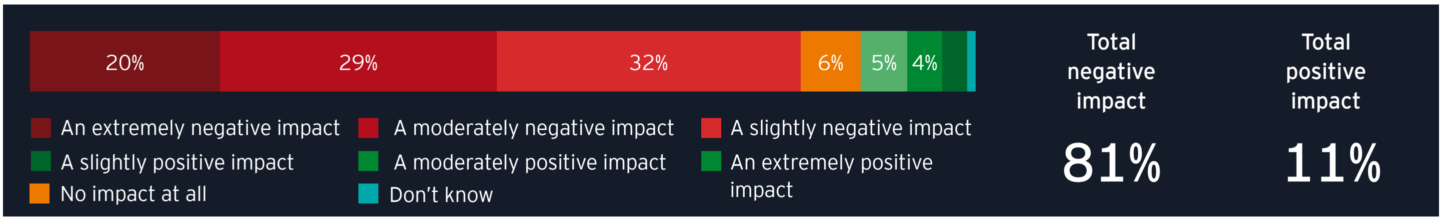


Source: EY ITEM Club/Haver Analytics

GDP in the UK fell by 24% between February and April 2020, with the first national lockdown announced in late March 2020. Despite a slight boost of economic activity in the Summer of 2020 with loosening of lockdown restrictions, GDP continues below pre-pandemic levels, and subsequent lockdowns and reimposition of restrictions continue to impact growth.

The monthly GDP in February 2021 was 7.8% below the level in February 2020, the last full month of 'normal' operating conditions (source: ONS).

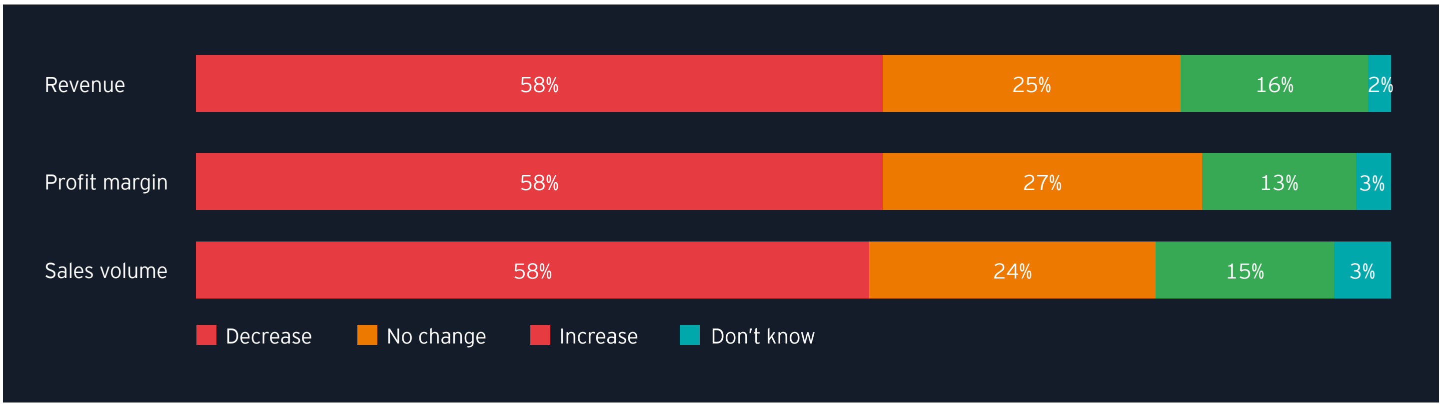
Overall impact of the COVID-19 crisis on business



EY's Global SME Survey indicates that the COVID-19 crisis has negatively impacted 81% of UK SMEs. Further analysis from EY's economic revival modelling of the UK's 88 subsectors indicates that Accommodation & Food Services, Transportation & Storage and Arts & Entertainment were the three sectors hit hardest by the crisis, largely due to their reliance on travel and in-person interactions. These sectors observed revenue shocks ranging from 40%–75% at the peak of the crisis in 2020. Whilst the macro-economic environment is improving, the effect of the crisis will continue to be nuanced and potentially longer-lasting for certain sectors. For instance, select sub-sectors, including Air Transport, Commercial Real Estate (particularly for Retail premises) and Travel Agency & Tour Operators, are not expected to recover by 2023. This is partly driven by ongoing consumer risk aversion in returning to pre-pandemic behaviours (e.g., international travel). There is also a transition to a 'new normal' driven by secular trends influenced by the pandemic (e.g., adoption of digital services, shift to remote and hybrid working practices, migration of consumer spending away from the high street to online channels).

Despite the significant measures introduced by national and local government such as the Furlough scheme, the BBLS, the deferral of VAT payments and various other support measures, it is estimated that 396,000 firms closed in 2020, according to data from the ONS. Thousands of other 'zombie' companies survived due to support measures but would have closed without them.

EY's Global SME Survey found that there was a significant financial impact to SMEs as a result of the crisis:



The survey findings also evidence a significant operational impact on SMEs due to the crisis. SMEs have had to rapidly implement new ways of working, including remote working and, latterly, hybrid working for staff due to 'working from home' orders mandated by the Government for non-essential industries and occupations.

48%

of UK SMEs suffered from a decrease in staff morale/ positivity

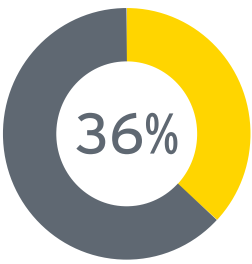
36%

of UK SMEs suffered a decrease in the number of staff available

61%

of UK SMEs had their supply chain compromised

EY Global SME Survey

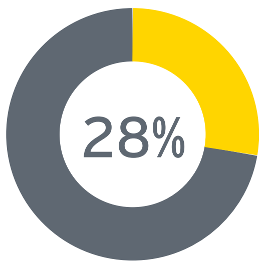


of UK SMEs have digitised business processes or functions as a result of the pandemic

This has led to more and more UK SMEs recognising the need to digitise business processes/functions. Disruptive technologies such as IoT, blockchain, AI and 3D printing have all been leveraged as a response to the pandemic. We have seen SMEs adopting new technology at a rate never seen before.

The COVID-19 crisis also forced SMEs to consider their strategy: what they sell, whom they serve and how they distribute products and services. Many SMEs adapted their business model to meet the rapidly changing environment. For example, we saw hospitality companies pivoting to offer takeaways via platforms such Deliveroo, UberEATS and Just Eat. Art organisations began streaming performances or introducing virtual tours of galleries, often on a subscription basis. For companies who still required staff to be on-site, such as the construction industry, we saw the introduction of NFC technology and other measures to make workplaces COVID-secure.

Many businesses refocused their business models into new markets. We saw some distilleries and beauty companies shift production to alcohol sanitisers – and clothing manufacturers to produce personal protective equipment (PPE).



of UK SMEs in the start-up phase developed a new product or service during the pandemic

EY Global SME Survey

3

Financing options available to SMEs

SMEs have a wide range of products and services available to them. However, SMEs need to ensure that the products and services they select suit the needs of the business

3.1 | Financing options available to SMEs

SMEs are the engine of the UK economy, playing a pivotal role in creating jobs for millions. SMEs are flexible and are often quicker to innovate than their larger peers, adopting new technologies and ways of working, as we have seen during the pandemic.

SMEs must flourish for the UK economy to flourish in a post-pandemic world. Access to capital will be an important factor at play.

From our research with SMEs, directors often complain that lack of finance can hinder their growth ambitions and limits their ability to exploit profitable opportunities. There can often be a gap between the finance currently available to them vs the finance they could productively leverage.

Several reasons for this include a limited supply of funds from investors, increased competition for funding and a lack of education on the various funding sources available to SMEs.

Despite these challenges, numerous sources of finance are accessible for SMEs. Understanding why an SME needs access to finance can help ensure that the right product or service that best is acquired.

EY has identified six key drivers behind the need for financing:

- Meeting working capital requirements
- Refinancing capital borrowed during the COVID-19 crisis
- Resuming the business
- Capitalising on growth opportunities
- Adapting the business model
- Responding to new market and customer expectations, e.g., sustainability

Over the next few pages, we have provided an overview of the key traditional financial products and services available in the market accessible by SMEs.

	Bank loan
What is it?	▸ A loan is a committed term facility typically for asset purchases rather than liquidity, such as working capital funding. It can be tailored to match the asset itself, allowing a business to match repayments with the cash flows generated by a specific asset, project or contract.
What is it used for?	▸ Capital and asset purchases ▸ Investments ▸ Human capital ▸ Stock/inventory ▸ Growth, e.g., M&A activities
Timelines	▸ Short-term: under a year ▸ Medium-term: one to seven years ▸ Long-term: over seven years
Pros	▸ Funds are provided for an agreed period ▸ Loan repayments can be made in line with cash flow ▸ Greater certainty regarding interest rates and charges ▸ Increased flexibility through the ability to obtain secured or unsecured lending
Cons	▸ Covenants (i.e., restrictions) may be in place during the life of the loan ▸ Lending will take precedence over any equity finance in situations where the business is under financial stress ▸ The ability to obtain lending may depend on the existing level of debt ▸ Lower flexibility of early repayments, which may incur additional charges ▸ Subject to some fees, e.g., arrangement fee, security fee, drawdown fee
	Overdraft
What is it?	▸ An overdraft is a product that provides some flexibility in cash flow, providing a business with short-term funding to align with working capital cash requirements
What is it used for?	▸ Overcoming cash flow problems that may occur when money has to be paid out before payments owed to the business have been received ▸ Paying unexpected bills and purchases
Timelines	▸ Short-term: under a year
Pros	▸ Relatively quick and easy to obtain ▸ The business can use as much or little as it wants without exceeding the limit ▸ Interest is only charged on the amount overdrawn (i.e., funds that are used)
Cons	▸ Lenders may limit the amount of lending based on the business ▸ Higher fees and charges compared with a loan ▸ The overdraft is repayable on demand ▸ There could be a negative impact on the business' credit score if used persistently or if the business is frequently overdrawn ▸ The lender may require security, depending on the size of the facility

	Sales (receivables) financing
What is it?	• The two forms of sales financing are factoring and invoice discounting. These are available to businesses trading with other businesses on credit terms and are therefore not available to businesses such as retailers or cash traders. Both forms of sales financing are designed to replace overdraft funding as they provide fast payment against the sales ledger, allowing a business to improve its cash flow.
	• Sales financing can be taken on in two ways: recourse and non-recourse. With recourse, the factor/discounter does not assume the risk of bad debts, and they will reclaim the money from the business if the customer does not pay. With non-recourse, the factor/discounter takes on the risk of bad debt, meaning they will take all of the rights to pursue the customer for payment.
	Sales financing – factoring
What is it?	• Factoring involves a business selling its invoices to a factoring company (the factor). The factor will process the invoices and allow funds to be drawn against the money owed to the business. The factor will agree to advance a proportion of approved invoices with payments being made to the business. The factor then collects the payment on behalf of the business and chases payments as necessary.
What is it used for?	• Cash flow timing • Working capital
Timelines	• Short-term: under a year
Pros	• Provides a way to fund rapid growth in sales and improve cash flow of a business, which can aid financial planning • Factoring can be easier to obtain compared with lending • The cost of financing can be lower compared with other forms of financing • The factor performs collections and acts as a credit control on behalf of the business, reducing administrative overheads • Not repayable on demand
Cons	• Relatively less flexible compared with discounting; less ability to choose what is financed • Higher fees • Customers will be aware that the business is using a factoring company • There are a limited number of providers in the UK market • The use of sales financing may reduce the scope for other traditional borrowing since book debts will not be available to the lender as security
	Sales financing – invoice discounting
What is it?	• Invoice discounting is another means of accessing funds against a business' sales book. However, the business retains full control over the administration of its sales ledger, although the invoice discounter holds legal title to the sales book.
What is it used for?	• Cash flow timing • Working capital
Timelines	• Short-term: under a year
Pros	• Easier to obtain compared with lending • Degree of flexibility for repayments • The business has control over the collection of money and maintains the customer relationship
Cons	• There are limited providers in the UK market • The use of sales financing may reduce the scope for other traditional borrowing since book debts will not be available to the bank as security

	Government or local government grant
What is it?	▸ Defined purpose related to the objectives of the Government or local government
What is it used for?	▸ Example: retail/hospitality for making premises COVID-secure
Timeline	▸ Immediate upon a successful application (may depend on timelines from the Government or local government)
Pros	▸ The grant is not a loan and so does not need to be paid back
	▸ The grant is generally not dependent on creditworthiness
Cons	▸ Application may be required; eligibility criteria ▸ A business may be restricted in what it can use the funds for ▸ A business may be required to show proof of how it has used the funds
	Asset finance – hire purchase
What is it?	▸ A hire purchase (HP) loan can be used to finance the purchase of a fixed asset and allow for the asset's cost to be repaid over a fixed period. The asset belongs to the funder until all payments have been made.
What is it used for?	▸ HP is typically used for fixed assets, including equipment, machinery, computers, motor vehicles and furniture.
Timelines	▸ The loan is usually linked to the useful life of the asset, e.g., 5–7 years for a motor vehicle
Pros	▸ There is no need to have a large amount of cash to pay for the asset upfront ▸ Fixed repayment amounts allow for easier budgeting and cash flow management ▸ The interest rate is lower compared to other facilities such as a loan or overdraft ▸ There are tax incentives from the start of the contract ▸ Maintenance and other benefits may be included in the cost of the HP
Cons	▸ With interest and service fees charged, the cost of ownership will exceed the cost of ownership had a business purchased the asset outright ▸ The business does not own the asset until all repayments have been made ▸ The business may have greater difficulty in liquidating the asset should it need to ▸ The lender may repossess the asset in the event of default
	Asset finance – leasing
What is it?	▸ Leasing is a similar form of finance to HP. The leasing company purchases the equipment on behalf of the business, and the business then pays for it regularly periods over a fixed period. A lease agreement is drawn up between the business and the funder. ▸ A key difference between HP and leasing is that the business never owns the asset outright. However, some agreements allow for the business to buy the asset at the end of the agreement.
What is it used for?	▸ Similar to HP, leasing is used for the purchase of fixed assets, e.g., motor vehicles
Timelines	▸ The loan is usually linked to the useful life of the asset
Pros	▸ There is no need to have a large amount of cash to pay for the asset upfront ▸ Fixed repayment amounts allow for easier budgeting and cash flow management ▸ The interest rate is lower than other facilities such as a loan or overdraft ▸ There are tax incentives from the start of the contract ▸ Maintenance and other benefits may be included in the cost of the lease
Cons	▸ With interest and service fees charged, the cost of ownership will exceed the cost of ownership had a business purchased the asset outright ▸ The business never owns the asset unless the agreement specifically allows it at the end of the repayment schedule ▸ The business may have greater difficulty in liquidating the asset should it need to

	Credit card
What is it?	▸ A credit card is a payment tool that allows businesses to pay for goods and services using unsecured credit. Payment is required several weeks or months after the purchase has been made.
What is it used for?	▸ The purchase of everyday goods and services ▸ Larger purchases, e.g., travel expenditure
Timelines	▸ Short-term: under a year
Pros	▸ No interest is charged if the full balance is paid off each month ▸ More convenient and safer than carrying cash ▸ Some credit cards also provide rewards and incentives ▸ Protection from fraudulent purchases
Cons	▸ Interest rates are higher than other forms of financing, including loans and overdrafts, if the full balance is not paid in full and on time
	Charge card
What is it?	▸ Similar to a credit card, a charge card also provides businesses with an option to pay for goods and services using unsecured credit. However, the agreement between the business and the funder will require that the business pays off the full amount on time and by a set date, usually every 30 days.
What is it used for?	▸ The purchase of everyday goods and services ▸ Larger purchases, e.g., travel expenditure
Timelines	▸ Short-term: under a year
Pros	▸ Businesses are less likely to encounter debt issues as the balance must be paid off each month ▸ More convenient and safer than carrying cash ▸ Some credit cards also provide rewards and incentives ▸ Protection from fraudulent purchases
Cons	▸ Annual fees may be higher compared to credit cards
	▸ Late payment fees may apply, and there may be a deterioration in creditworthiness
	Supply chain financing
What is it?	▸ Supply chain financing, also known as reverse factoring, is a way for smaller businesses to benefit from the higher credit scores of their buyers. Smaller businesses supplying goods to larger customers can receive 100% of the value of an invoice from a lender, minus a fee, once the buyer has approved its invoice and confirmed this with the lender. The buyer will then pay the lender the full value of the invoice.
What is it used for?	▸ The sales of goods and services
Timelines	▸ Short-term: under a year ▸ Medium-term: one to seven years
Pros	▸ Businesses can be paid in days, not months, improving cash flow ▸ Businesses may be able to leverage the buyer's creditworthiness, which may mean lower fees/ charges ▸ The buyer also benefits through extended payment terms, benefiting both partiers and improving the relationship
Cons	▸ Terms and conditions may be applicable ▸ Supply chain financing may involve increased accounting and regulatory reporting requirements

	R&D tax credits/relief
What is it?	‣ Research and development (R&D) tax credits are an initiative designed to increase science and technology innovation. There are two schemes available:
	‣ 1.The SME scheme provides companies with relief of up to 230% on their qualifying R&D costs.
	‣ 2.The Research and Development Expenditure Credit (RDEC) scheme enables companies with no Corporation Tax liability to benefit through a cash payment or a reduction of tax or other duties due.
What is it used for?	‣ Only projects that advance overall knowledge or capability in a field of science or technology, and projects and activities that help resolve scientific or technological uncertainties, may qualify for R&D relief. This can include creating new processes, products or services, making appreciable investments in existing ones and even using science and technology to duplicate existing processes, products and services in a new way.
Timelines	‣ Short-term: under a year
	‣ Medium-term: one to seven years
Pros	‣ The business takes on no debt
	‣ Not linked to the creditworthiness of the business
Cons	‣ Eligibility restrictions apply. In order to claim, the business must have fewer than 500 staff and a turnover of under €100mn or a balance sheet total under €86mn. The business must be a limited company — sole traders, partnerships and public liability companies are ineligible.
	‣ The project must seek to achieve an advance in overall knowledge or capability in a field of science or technology.

4

Debt financing options for SMEs

What is debt finance and what are the options available to SMEs?

4.1 | The power of debt finance: a ‘helping hand’ in the achievement of your business objectives

Many SMEs shy away from accessing debt finance as they do not fully understand the benefits it can offer – and those that do can often implement ‘sub-optimal’ solutions as they are unaware of all the options at their disposal. Debt finance comes in various shapes and sizes. The funding solution that is right for you and your business will depend on various factors.

When utilised correctly, debt finance can be a powerful tool for SMEs to accelerate business growth and support the achievement of their strategic objectives. Over the next few pages, we aim to break down what debt finance really means and what key considerations management teams should take before approaching the market.

1 What is debt financing and what can it be used for?

- Simply put, debt finance is borrowed money from a lending counterparty, such as a bank or debt fund. Under most finance agreements, the borrower agrees to repay the money to the lender within a certain time, together with regular interest payments, to compensate them for taking on credit risk (i.e., the risk that the borrower may default on its loan)
- Debt finance may be used for almost any purpose, not just investment in tangible assets. Other common uses include general working capital management, investment in growth, acquiring other businesses and cash out to shareholders.
- A common misconception is that debt finance will only be provided to businesses with sufficient tangible security, i.e., property, P&M. There are many options for businesses to borrow against profits and cash generation – a ‘cash flow lending solution’.

2 What do you need funding for?

- The debt funding solution that is right for your business will depend largely on your specific strategic objectives:
  - Do you require funding to support the organic growth of your business?
  - Do you need funding for working capital?
  - Are you looking for additional firepower to support a ‘buy-and-build’ strategy to achieve sufficient scale?
  - Do you need to increase capacity across your business or expand to new sites
  - Would you like to establish new sales channels. e.g., e-commerce
  - Do you want to sell into new countries or develop new products?
  - Do you want to reward your loyal employees?
  - Would you or other shareholders want to take some cash out or exit the business?

3 What are your key financing priorities?

- What are the principal benefits you would value the most from any debt financing solution put in place?:
  - Are you simply looking for the cheapest form of debt, or would you be willing to pay more for additional funds, better terms or greater flexibility?
  - Are you looking for a short-term solution or a funding partner that can support the business for the longer term?
  - How much flexibility do you need to retain to manage and grow your business?
  - What level of security would you be willing to provide to lenders?
  - How much restriction would you be willing to accept on dividend payments?
  - What relationship do you want with your debt provider?
  - Do you want one debt provider, or would you be happy to use multiple providers?

4.2 | Debt finance: key considerations

Various debt financing options are available to SMEs and a vast array of different providers. Before approaching any market, you need to be well prepared to ensure the best possible outcome and achieve the optimal debt package that works for you and your business.

Below, we set out some key questions SMEs should consider before approaching the debt markets for funding.

1 Do you have a well thought-through business plan?	▸ What will your business look like in the future, and can you articulate that to lenders? ▸ What steps do you need to take to get there? ▸ How much funding will you require to support that plan? ▸ What are the risks associated with achieving your plan, and how are they mitigated?
2 How will you repay any debt?	▸ Does your business have the capacity to support the amount of debt you need? Does your business generate sufficient cash flow to service any debt repayments (both capital and interest)? ▸ What would your ideal repayment profile look like? Do you want to repay the debt over time or all at once further down the line? ▸ Does repayment of the debt depend on the sale of an asset (i.e., a property)?
3 Do you have a 3-year forecast model?	▸ Do you already have a 3-year forecast financial model that you can be share with lenders? ▸ Have you thought about what your business might look like in a "downside scenario" (e.g., an economic downturn)? ▸ Do you produce regular quality management information?
4 How will you articulate your business' story?	▸ How will you position your business and the sector that you operate in with lenders? ▸ How will you convince lenders that your business is 'supportable' and 'stands out' in a busy debt market? ▸ How will you demonstrate the strength of your business and its management team? ▸ How will you convey the core risks to your business and how they are mitigated?
5 How are wider macroeconomic factors affecting your business?	▸ How has the COVID-19 crisis affected your business and the sector you are in? ▸ Do you have any existing debt facilities that required amendments as a result of the crisis? ▸ What will your business look like in a post-COVID-19 environment? ▸ Are there any other wider macroeconomic factors currently affecting or are expected to affect your business? E.g., has Brexit led to staff shortages or supply chain pressures?

The value of an independent advisor:

- **Getting you the best terms from deal flow insights:** An independent advisor can bring unique insights from recent deal precedents, allowing you to best optimise the commercial terms of any deal. Advisory firms can work on over 100 transactions per year across a variety of debt markets. They have relationships across many lenders, meaning they understand which lenders participated in recent and relevant deals to you and why. This insight allows you to benchmark all the debt financing offers you receive.
- **Put lenders 'on notice':** Lenders tend to respond with sharper terms more quickly in a process when they know an independent advisor is being used (as they know you are receiving external market info).
- **Protect and enhance your relationships:** An independent advisor can act as an external voice, driving commercial terms and having the difficult conversations where required, allowing you to protect and enhance your relationship with your lender. They sit alongside or behind their clients, only stepping out in front when required, thereby not undermining your position as the leading voice in a deal.
- **Independent advice:** Unlike brokers, advisors are truly independent. They can provide an unbiased view of any deal being crafted, supporting internal discussions and approvals around final deal terms based on what is best for you and your business's priorities.
- **Bandwidth on tap:** Using an advisor allows you to prioritise the day-to-day commitments of the business without the distraction of the debt raise process. In addition, advisors can draw on their wide network to provide additional support, such as lawyers, tax advisors and property valuers.

4.3 | Bank debt: a traditional source of funding for SMEs

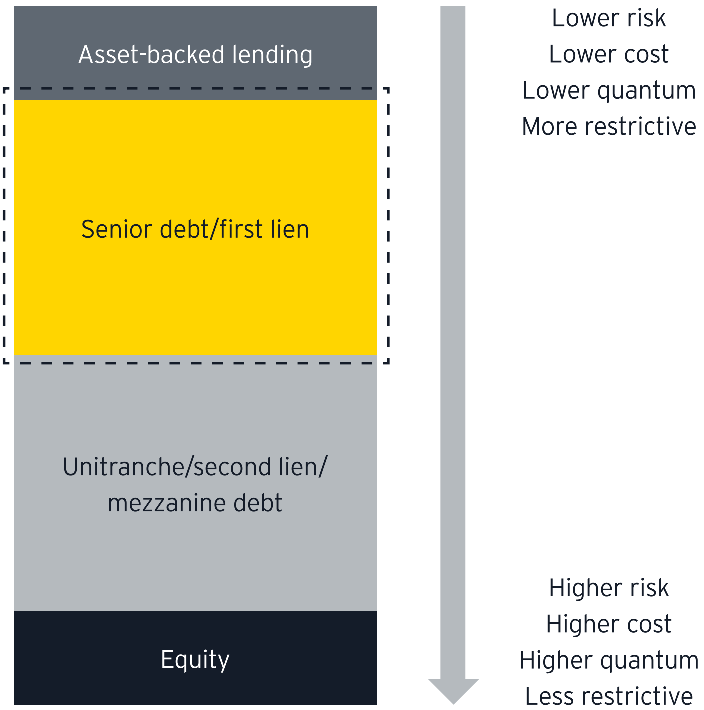
Bank debt is the most common source of debt finance accessed by SMEs and is typically provided by the widely recognised high-street clearing banks. However, other banks and specialist lenders with a less conservative risk appetite can provide more tailored solutions.

Bank debt can come in many formats:	
Term loan	– committed facilities typically used for long-term needs, such as capital projects, share-buy outs and acquisitions. Either secured against a specific asset or on a cash flow solution basis
Overdraft	– uncommitted short-term funding
Revolving credit facility (RCF)	– committed for between 2–5 years and can be drawn and repaid as required
Trade finance	– to support working capital required to import and export product or materials
Invoice discounting	– asset-based lending to support working capital, secured against receivables
Development finance	– to support property or infrastructure development based on asset values

Alongside the high street clearing banks, there is a wide range of alternative banks and specialist lenders, giving SMEs a wider range of options than ever before to access debt finance. Whilst the types of facilities provided by alternative lenders can be more limited, the terms available can be far more competitive than high street banks.

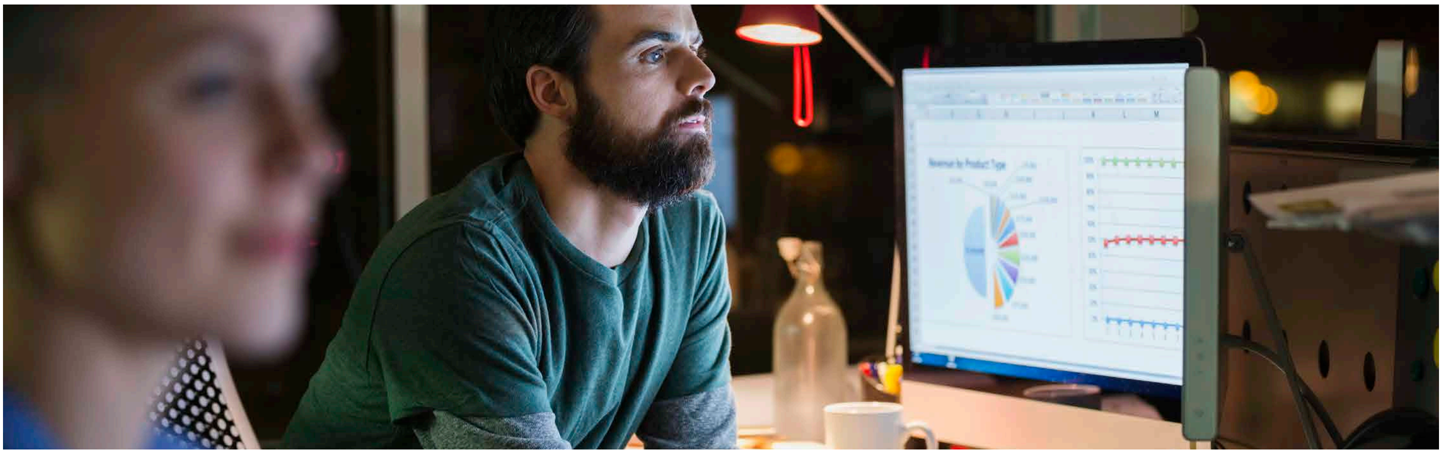
Bank debt providers will require security over the business and its assets, but the borrower does not always have to own tangible assets (e.g., property) to obtain funding. Facilities that do not require tangible asset security are commonly known as cash flow lending solutions.

Term loans, overdrafts and RCFs are often described as 'senior debt' or 'first lien'. These facilities rank high in the 'capital stack' (shown to the right). The capital stack is a ranked representation of the order in which debt and equity holders are given access to a company's assets in the case of default. Senior debt has a higher priority and, therefore, lower risk, meaning the borrower is typically charged a lower amount of interest, reflecting the relative security of the loan.



How a term loan facility (on a cash flow basis) would compare between a clearing and alternative bank:

Facility type	Term loan – as cash flow lending solution	Term loan – as a cash flow lending solution
Risk appetite	‣ Low	‣ Medium
Typical interest rate margin	‣ 3.0%-4.5%	‣ 3.5%-6.0%
Typical maturity	‣ 3-5 years with options to extend	‣ 5-7 years
EBITDA leverage	‣ Max 3x	‣ Max 4.5x
Security	‣ Security held in the form of a fixed charge over specific assets (if available) and a debenture over the company	‣ Security held in the form of a fixed charge over specific assets (if available) and a debenture over the company
Amortisation	‣ Typically ranges from fully amortising to 50% over the life of the loan	‣ Typically open to a lower level of amortisation incorporating capital repayment holidays and significant bullet payments
Covenants	‣ Typically 2 or 3 covenants, including leverage/profitability, cash flow cover and interest cover	‣ Typically only 1 or 2 covenants
Advantages	✓ Full banking relationship with physical branch offering ✓ Lower cost of funding ✓ More localised teams	✓ Greater levels of flexibility on debt structures ✓ Typically have a higher risk appetite ✓ Fewer controls and covenants
Disadvantages	× Less flexibility on terms × Greater number of covenants × Lower appetite for credit risk	× Commonly no day-to-day banking facility provision, i.e., you will need two banking relationships × Smaller or no physical branch presence
Example lenders	Barclays, HSBC, Lloyds Bank, Santander, SMBC, AIB, Bank of Ireland	Shawbrook Bank, Funding Circle, OakNorth Bank, Cynergy Bank, Thincats



4.4 | Asset-backed lending (ABL): innovative funding solutions for borrowers with more niche requirements

For the right kind of business, asset-backed lending may unlock more capital than cash flow lending solutions would otherwise permit.

Asset-backed lending is a form of secured lending where a loan is ‘advanced’ against specific assets of the borrower. Common assets include physical assets such as real estate, land, inventory, equipment and machinery, and specific intangible assets such as intellectual property. Asset-backed lending is generally suited to organisations that require working capital to operate and grow, particularly in industries that operate on low margins or have large working capital requirements, e.g., high inventory levels.

In asset-backed lending, the amount of funding that a borrower can raise will depend on the value of its assets and the ‘advance rates’ applied by lenders. The advance rate is the percentage of the collateral’s value that a lender is willing to extend as a loan. Generally, this rate will depend on the asset’s risk profile. Not all assets will be good collateral for an asset-backed lending facility; for instance, specialised assets not valuable to another company.

Receivables account for by far the majority of asset-backed lending transactions. Receivables are the most favoured asset class by lenders as they may be quickly turned into cash, meaning the advance rate is typically higher than a borrower might get with other physical assets (e.g., inventory). With receivables financing, in particular, lenders will exclude certain ‘ineligible’ debtors, where customer concentration limits are exceeded.

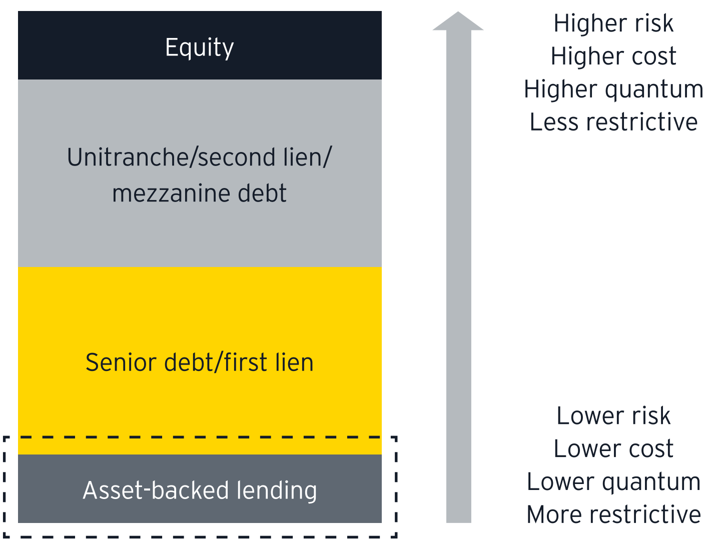
However, there are additional administrative requirements with asset-backed lending. Companies will be expected to file regular reports (monthly or weekly) on the status of the assets used in the borrowing base and may also be asked to maintain credit insurance on their customers.

Some high street lenders offer asset-backed lending-style facilities, usually limited to lending against receivables. Where there is a significant number of specialist asset-backed lending providers, they commonly offer better terms and greater flexibility, taking into account other asset classes (e.g., inventory) in deducing debt financing capacity.

Example lenders:

- Shawbrook Bank
- Leumi ABL
- PNC
- Secure Trust
- Wells Fargo

ABL features	
Facility types	‣ Can be structured against receivables, inventory, plant and machinery, property, IP
Minimum issuance size	‣ Dependent on combination of asset appraisals and advance rates applied by lenders
Typical interest rate margin	‣ 2.0%–3.0%
Typical maturity	‣ 2–4 years
Security	‣ Secured – fixed charge over assets being advanced against
Amortisation	‣ No amortisation
Covenants	‣ Maintenance and more detailed operational covenants
Advantages	✓ Lowest cost of capital by utilising assets as collateral ✓ Simple to execute ✓ Facility amount can be sized to allow the financing to grow in line with the assets ✓ Typically no requirement for Due Diligence
Disadvantages	× More operational reporting requirements × May require credit insurance × Availability subject to movements in asset balances



4.5 | Private credit: flexible and tailored finance solutions to match the unique needs of the borrower

Despite the growth of the private credit industry in the UK during the past decade, many UK business owners remain unfamiliar with this group of lenders and the lending solutions they offer.

Private credit is the blanket term used to describe many forms of credit provided by non-bank or 'direct' lenders. These lenders typically take positions in the capital stack ranking with equal priority or behind senior debt but in front of common equity or potentially combining senior debt and equity positions. Example structures include:

Unitranche loans – combine a senior tranche of debt and a junior tranche of debt in a single loan and provide a blended return to the lender. Unitranche is typically an alternative to a senior bank debt rather than provided alongside.

Second lien – usually forms part of a wider senior debt package but will sit behind the first lien or senior debt in the security structure and get repaid after the first lien in an insolvency situation.

Mezzanine debt – a form of junior debt issued under separate documentation to senior debt, ranking behind senior debt but ahead of equity and typically provided in conjunction with senior debt. It typically has embedded equity instruments attached, known as warrants, creating additional value for the lender.

Private credit typically involves lending to companies on a directly negotiated basis. There are vast numbers and ranges of private credit funds in the UK and Europe, with typical financing sizes ranging between £2.5 million and £500 million, dependent on individual fund parameters.

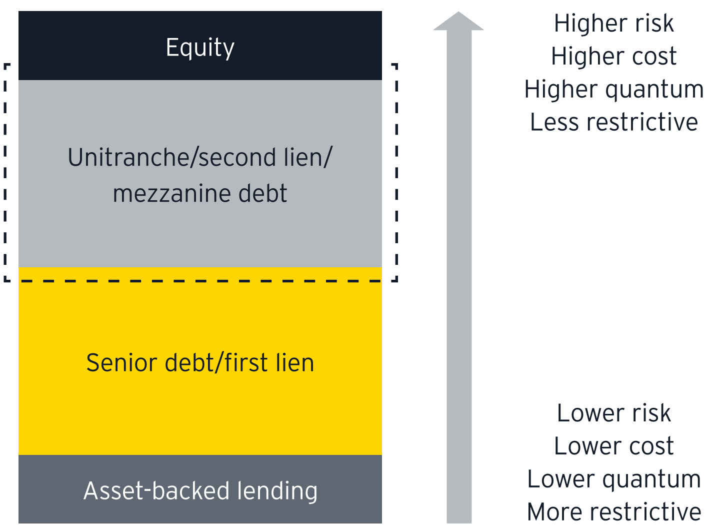
The direct and tailored nature of private lending is often the core element that distinguishes private credit from other forms of financing. Many firms view themselves as a partner to the businesses they have lent to and have business models that rely on their borrowers' ongoing success.

Select example lenders applicable to SME market:

Tosca Debt Capital (TDC)	Boost&Co	Frontier Development Capital (FDC)
Caple	Kreos Capital	Barings
Five Arrows	Kartesia	Beechbrook capital

Private credit features

Facility types	‣ Unitranche/term loans
Typical interest rate margin	‣ 5.5% – 8.0%
Typical maturity	‣ Up to 7 years
EBITDA leverage	‣ 3.5x-7.0x
Security	‣ Secured via debenture over the company
Amortisation	‣ Minimal or none
Covenants	‣ Typically 'Covenant-lite' – one leverage covenant
Advantages	✓ Higher leverage than banks ✓ More flexibility on terms than traditional senior lenders ✓ Minimal or no amortisation
Disadvantages	× May also require a bank to provide a working capital facility × More expensive than bank debt × No provision of day-to-day banking facilities, so a relationship bank will also be required × Availability subject to movements in asset balances



4.6 | Other sources of capital

Although we consider the markets described on the previous pages to be the most suitable for SMEs, additional funding options may currently be or may in the future become available to you, depending on where the business is in its life cycle.

1 Venture debt

- Funding aimed at high-growth scale-ups, provided by specialist lenders. These loans are particularly effective for SMEs that are yet to achieve profitability but have an established business model and clear prospects for growth.
- Fast-growing young businesses with a limited trading history and little or no track record of profitability usually struggle to borrow money from conventional sources such as banks.
- Thus, venture debt can be a powerful financing tool.

2 Angel investors

- High-net-worth (HNW) individuals who make equity investments using their personal money.
- Angels can invest alone or as part of a group, each of whom will have an individual appetite for investment.
- Angels are often former entrepreneurs who have started, grown and sold their businesses. They will often look to retain some involvement in the businesses that they invest in, using their experience and knowledge to help them grow.

3 Private equity

- Medium- to long-term finance provided in return for an equity stake in the company receiving the investment.
- Private equity firms take an 'active ownership' approach to investing. They work alongside the management team to enhance the running of the business, which can involve all areas of operation (top-line growth, efficiency savings, cash generation, procurement, supply-chains, marketing and sales etc.)
- This governance structure leads to much shorter lines of communication between manager and investor, ensuring constant engagement between the two.

4 Public bond

- Publicly traded loans (on stock markets) made to large organisations, including corporates and governments. Typical investors in public bonds are large, sophisticated institutions (e.g., insurance companies).
- The issuer promises to pay the investor a specified interest rate during the life of the bond and repay the principal when it matures after a set time.
- The optimal benchmark issuance size for a public bond is c. £250mn, shaped by investor concerns over secondary market liquidity, index eligibility and size of individual final hold levels.
- This minimum issuance size and the requirement of having an external credit rating means that public bonds are typically not suitable for SMEs.

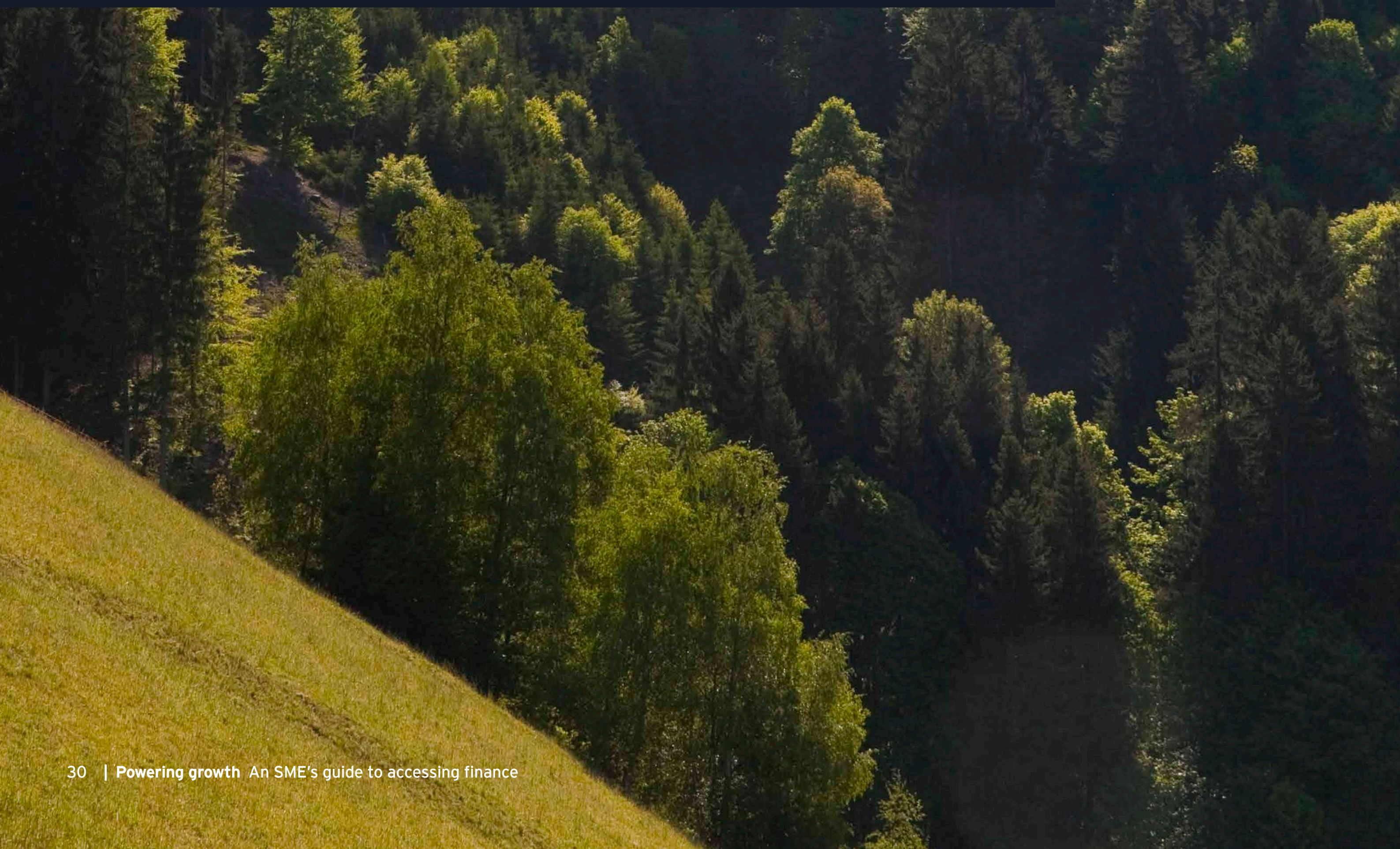
5 Private placement (PP)

- Loans that are privately placed with a non-bank lender or group of lenders, who will seek to have a direct ongoing relationship with the issuer. As with public issuances, the investors tend to be large financial institutions.
- PP debt can be self-arranged directly with investors or placed through an agent (an investment bank) who will solicit bids from investors.
- Unlike public bonds, PPs are not rated and are usually not subject to any ongoing public disclosure requirements.
- Generally, the PP market will only be open to those issuers looking to raise a minimum of £10mn, so not typically a suitable option for many SMEs.

5

The sustainability agenda

SMEs can play a pivotal role in the transition to a greener future



5.1 | Products, services and resources to help you become more sustainable

Owning or running a small business brings challenges beyond access to finance. One key challenge cited in our Global SME Survey relates to becoming a more sustainable business. This page sets out some examples of where to go for more information.

Consumer awareness and expectations for companies to be more sustainable across a range of issues have risen throughout the pandemic. Consumers believe it is the responsibility of companies and organisations to address sustainability concerns. Expectations now go beyond companies to include the behaviours of suppliers and partners. EY's Global SME Survey indicates that 57% of UK SMEs consider running a sustainable business to be very/extremely important. Although the significance is clear, the challenge of doing so remains high. It is becoming increasingly important to financial services providers to support their clients in becoming more sustainable. There is plentiful information available now for SMEs to help them navigate the challenges of the transition, including the CBI/UK Finance's *Financing green guide for SMEs*.

Products

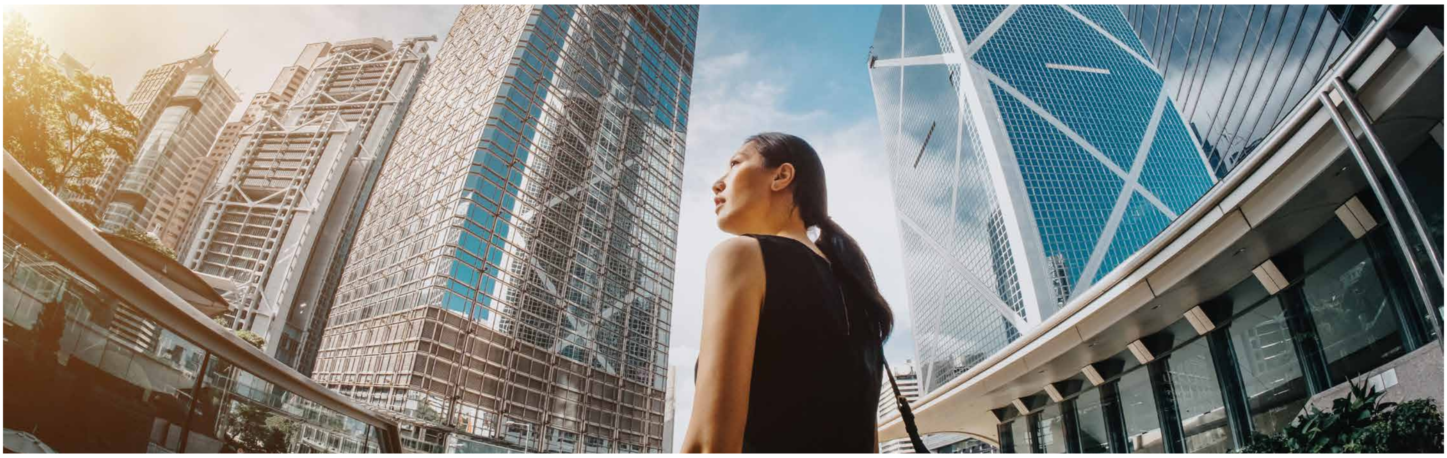
Many lenders provide sustainability-linked or positive impact loans. These often include renewable energy financing, which can help with solar panels and energy-efficient lighting. Many lenders will offer more attractive interest rates, pricing, terms and conditions and value-added services for businesses interested in becoming more sustainable.

Services

Many lenders also offer expert guidance related to lowering environmental impact, keeping up with government regulation and helping to make businesses more efficient. For example, one UK bank has partnered with several organisations to create an app designed to help businesses make smarter choices around electric vehicles.

Knowledge and resources

In addition to a rise in products and services, some lenders are creating dedicated knowledge hubs to help businesses become more sustainable through forums, videos and articles. One UK bank has set aside places on its accelerator programme for green-focused businesses, providing coaching, learning and networking opportunities.



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