UK SME Direct Lending

THE EVOLUTION OF THE UK SMALL AND MEDIUM ENTERPRISE DIRECT LENDING MARKET.

In the persistent low interest rate environment that institutional investors have found themselves in for the last decade, the search for yield continues. This has led investors to consider asset classes such as Small and Medium Enterprise (SME) bank loans. Access has in the main been through the liquid secondary market, as institutional investors have lacked the analytical and operational structure to access assets directly through primary channels. The focus has largely been on diversified portfolios of senior-secured credit, with investors trading yield for speed of deployment. Emerging technologies may, in the near future allow investors to access loans directly.

99%

PRIVATE SECTOR EMPLOYMENT

UK SME's represent 99% of businesses by number, employing 60% of private sector employees[1].

The funding of small and medium sized enterprises has changed considerably since the global financial crisis in the UK and looks set to evolve further driven by the use of new technologies. Post the global financial crisis, much has been written about the retrenchment of banks from areas of private credit - from the gradual decline in long-term infrastructure finance driven by Basel III to the withdrawal of support for shorter term lending to SMEs.

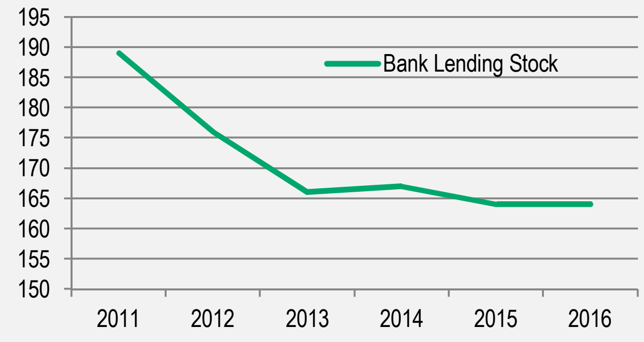
In the UK there are estimated to be in excess of 5.5 million SMEs that play a significant role in contributing to the overall UK economy. SMEs represent over 99% of businesses by number and employ 60% of private sector employees[1] according to the Office for National Statistics. Equally it is recognised that SMEs seeking access to funding, in order to finance growth plans, are an important component of economic growth and productivity[2]. Intuitively, lending boosts employment growth for the recipient of the loan whilst also benefitting companies along the supply chain.

The composition, geographical location and range of industry sectors is diverse, though there are concentrations in the wholesale retail and repair; professional; scientific and technical; information and communication; transportation; and manufacturing and construction sectors. The latter sector, given Central Government's focus on house-building, acts as a relevant barometer of the SME sector with the availability and cost of finance expressed as a challenge for 45% of small builders[3].

Funding and SMEs in the UK

Pre-financial crisis, the traditional method of funding for UK SMEs was bank lending. Table 1 (below) illustrates that, whilst it remains a significant component of overall financing, bank lending stock has continued to fall in the last five-years.

Table 1: Bank Lending Stock



Source: British Business Bank November 2016, GBP£bn.

[1] British Business Bank (2017). Small Business Finance Markets Report (2016/17).
[2] Mason, C., & Brown, R. (2013). Creating good public policy to support high-growth firms. Small Business Economics, 40(2), 211-225.
[3] NHBC Foundation (2017). Small house builders and developers: current challenges to growth.

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A body of academic evidence exists, supporting the notion that small firms face significant challenges when trying to access bank lending. One element of this remains the overall appetite to lend, given simple capacity constraints linked to the closure of regional and local branches and the need for banks to rebuild their balance sheets. Equally SMEs lack the assets that would typically be demanded as security and with respect to start-ups may not have audited financial statements that can be used to assess the likelihood of default. As a consequence of this it is far easier for banks to favour the larger SMEs and overlook innovative, high growth start-ups.

Since the global financial crisis there have been new entrants to the direct lending market including asset management solutions, crowd-funding and peer-to-peer lending[4]. The British Business Bank was created in 2014 by the UK Government to facilitate and increase the supply of credit to SMEs, working with emerging funding models to ensure that declining bank lending stock does not supress growth. In addition the government has been keen to increase market competition by encouraging new 'challenger banks' such as Metrobank and digital fin-tech companies such as Monzo. Neither challenger banks nor digital offerings have, as yet challenged the status quo of the UK's Top Four (Barclays, HSBC, Lloyds and RBS).

As with other areas of private credit, asset management companies have moved into the sector. However, the scale-ability of the business and sheer number of SMEs seeking finance has restricted lending to the larger segments of the market. As a consequence, they are competing with the banks for the origination of transactions, limiting the opportunity for institutional investors. At the smaller end of the SME market, crowd-funding has utilised technology to offer equity financing (particularly to start-ups) and debt-based crowdfunding (peer to peer), though in modest volumes.

Equity financing remains small, and an activity largely undertaken by retail investors. Peer to peer lending grew to account for cumulative lending of £7.1bn[5] by September 2017. Nevertheless both are a fast growing area of the market and are offering a technology-based funding solution that some have argued will further dis-intermediate the banks from lending activity.

Ultimately SME debt lending (whether by asset managers, banks, challenger banks or peer to peer lending) will be contingent on two things: the availability of credit and the effectiveness or standardisation of the credit-risk modelling process. These have prevented both the scale-ability of fin-tech solutions and the proliferation of asset management solutions. Regulations brought in by the Competition and Markets Authority will force banks, previously the privileged holders of their customers' financials, to divulge these to third-parties authorised to access the information. Coupled with filings and financial data from Companies House it may still be a time-consuming process to verify the credit-worthiness of small businesses.

The technology factor

Logically one solution would be the application of 'Big-Data' technologies to transform the credit-risk modelling process in order to achieve the scale-ability required by asset management companies to further enhance their market-share. As this occurs it would become possible to offer institutional clients access to secured and un-secured senior SME debt. Whilst intuitively it would seem to be a risky enterprise for institutional investors seeking yield, default rates published by Moody's would suggest that within a diversified and optimised portfolio of loans, net of losses, the risk-return and diversification benefits of the asset class remains attractive.

Even with the application of technology the processing of loans is a time consuming activity. For clients seeking to build diversified portfolios directly it would remain a challenge. Utilising an asset manager that is able to warehouse transactions, and distribute them to co-mingled investors, would therefore further increase access to direct lending and provide for a more rapid draw-down of committed capital.

UK SME lending will not form the core of institutional private credit exposure as it is inherently more risky than other asset classes. Nevertheless for institutional investors wishing to take advantage of the continued dis-intermediation of the banking sector, this may be another innovative emerging opportunity within illiquid private credit. At a time when impact investing is being openly discussed, the provision of capital to sub-sectors of the UK SME market that would produce e.g. house-building, it would also likely resonate with institutional investors.

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[4] Bruton, G., Khavul, S., Siegel, D., & Wright, M. (2015). New Financial Alternatives in Seeding Entrepreneurship: Microfinance, Crowdfunding, and Peer-to-Peer Innovations.
[5] Peer 2 Peer Finance Association as at 30 September 2017.

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