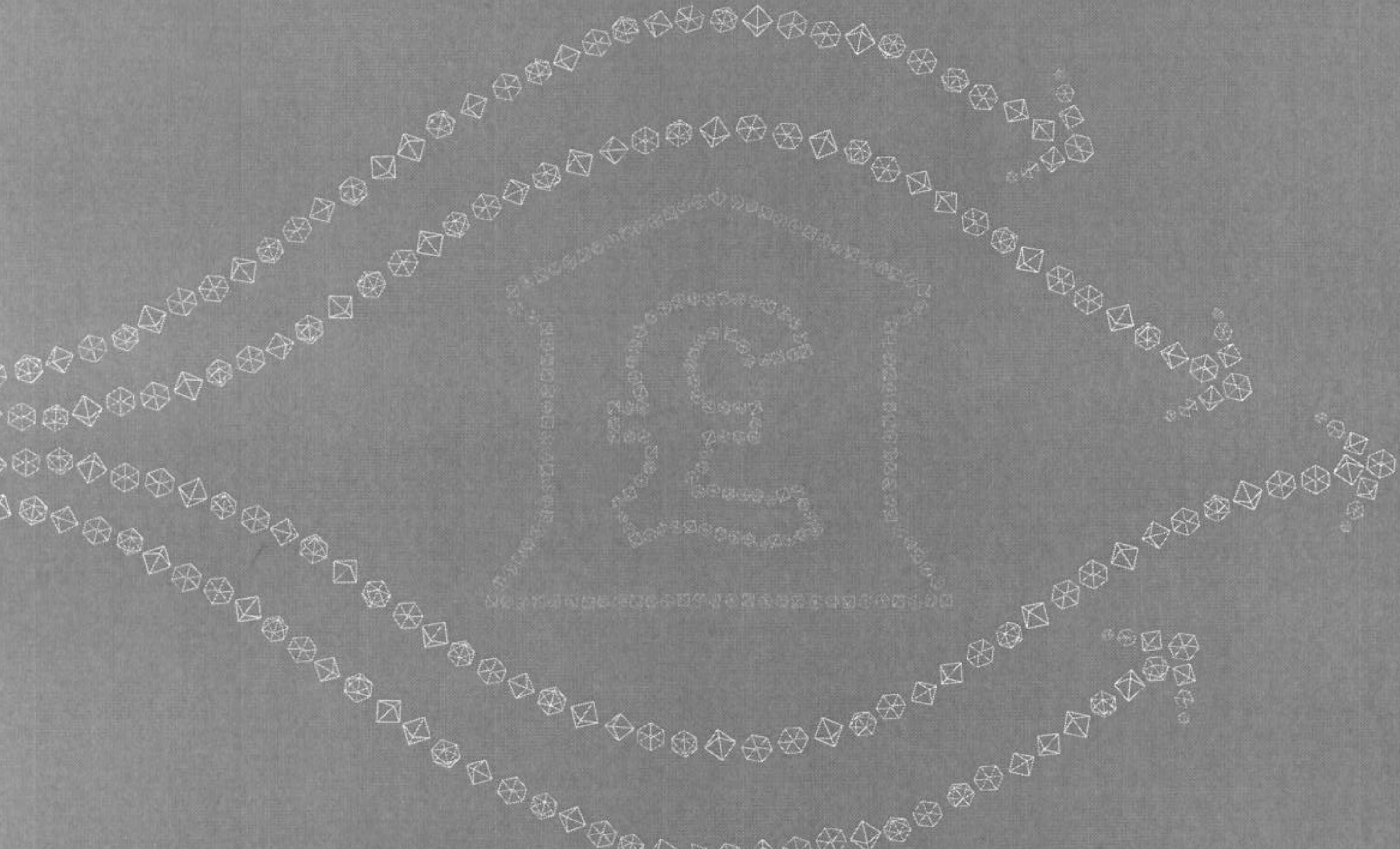
Research summary: September 2011

NESTA Making Innovation Flourish

Beyond the Banks

Innovative ways to finance Britain's small businesses

Andy Davis



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.

About the Centre for the Study of Financial Innovation

Editorial support for this report was provided by the Centre for the Study of Financial Innovation.

The CSFI is a forum for well-informed debate and research about the future of the financial services sector. It does this through a range of activities: round-table discussions, written research and networks. Its work is objective, topical and practitioner-oriented. It is driven by a belief in the value of free markets and open discussion. The Centre's activities are supported by sponsorship from leading institutions in banking, insurance, investment, government, technology and the professions. It is run from London, but its range is global.