The Manufacturers' Organisation

START-UP TO SCALE-UP: FINANCE

Read the complete report here

FOREWORD

The UK is currently the ninth largest manufacturing nation in the world, creating employment, wealth and community cohesion. Businesses in the sector are strategically important to the banking and finance industry, with many of our members providing dedicated teams of sector specialists.

Lenders are providing funding to support growth, innovation, international trading opportunities and the transition to net zero. Addressing climate change will only be effective if communities in each devolved nation and region are supported in the transition and have a fair share of the benefits. This is why we have worked with the Grantham Institute at the London School of Economics as part of the Financing a Just Transition Alliance.

There is a wide range of financing products available in the market, including loans and overdrafts, hire purchase, leasing, invoice finance and export finance. There are also many suppliers, ranging from well-known high-street brands to specialist providers and non-banks.

According to the Bank of England, the finance industry has lent around £43 billion in loans and overdrafts, of which some £12 billion is provided to SMEs. This is an increase of 26% since the pandemic and includes £6.4 billion borrowed by nearly 103,000 manufacturers under the Covid loan schemes. While manufacturers represent 5% of the UK business population, this figure constitutes 9% of drawings by value.

Alongside loan and overdraft finance, businesses are making extensive use of other financing options, such as asset and invoice finance. Total asset finance for new business (primarily leasing and hire purchase) in the nine months to September 2021 was 20% higher than in the same period in 2020. Invoice finance is also playing a key role in supporting business growth. Total advances as at 30th June were £14.8 billion, with additional headroom of £12.7 billion, which is readily available cash. Total advances have increased by 15% in the last 12 months. Around 25% of all invoice finance facilities are provided to manufacturers who are taking advantage of the flexibility and scalability of this product. An estimated £3.7 billion is advanced to manufacturers at any point in time, which equates to an estimated average advance per client of £425,000.

The industry has worked closely with UK Export Finance to launch the General Export Facility, a new scheme designed to provide to exporting SMEs access to a wide range of trade finance products, including trade loans, bonds and letter of credit lines with maximum repayment terms of up to five years.

Approval rates for finance are high; the latest data reported by businesses themselves stands at 87% according to the independent SME Finance Monitor survey of SMEs. However, there are firms that are very liquid, and there has been a significant rise in deposits and credit balances across the sector as companies have built reserves in the face of uncertainty.

Debt finance is not always the most appropriate form of funding, despite its popularity. For early-stage businesses and scale-ups, equity finance plays a crucial role. From business angels at the smaller and newer end of the investment ladder through venture capital and private equity to equity markets, there are options for businesses of all sizes, although availability can be thinner outside London and the South East. Finance providers are well placed for introductions and can operate alongside equity investors.

The Business Growth Fund (BGF), which is entirely funded by major banks and has offices across the UK, has provided £2 billion to SMEs, including vital patient capital to many successful manufacturers.

Although there is a deep pool of finance available in the market, there is more that can be done to ensure that businesses are aware of their options, that the sources of finance are well coordinated and that support is available to ensure businesses are investment ready. Innovate UK and the Catapults are crucial bridges, and by working together, finance, business support, public funding and investment can help develop the UK's competitive position in international markets and help a thriving industry contribute across the UK.

Mike Conroy, Director, Commercial Finance, UK Finance

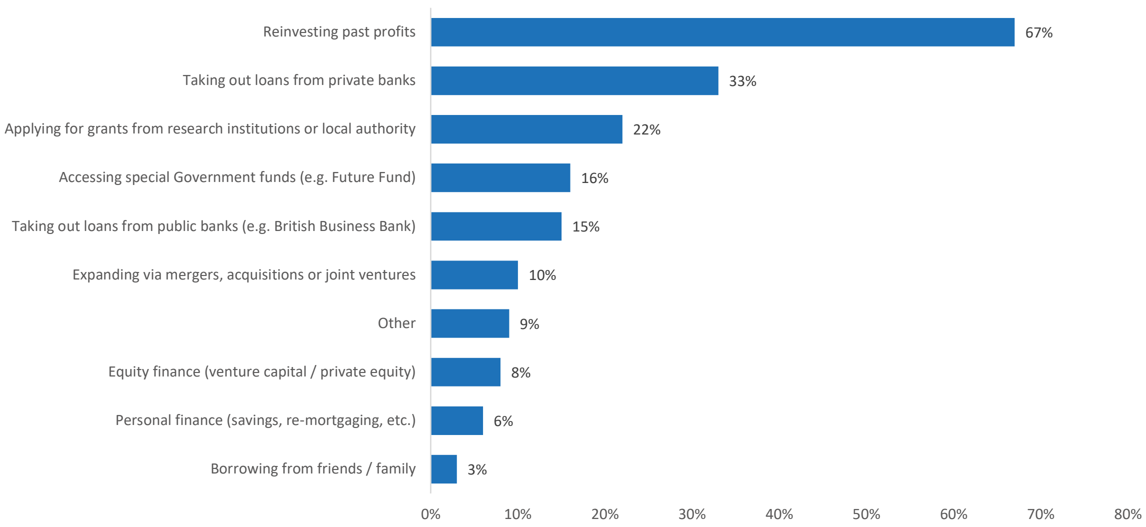
FINANCIAL PREFERENCES

A key ingredient in the journey from start-up to scale-up for many manufacturers is finance, which bridges the gap between ambition and action. Without access to finance, as well as expertise on how best to make use of it, many manufacturers may simply fail to grow, even if they are not challenged by other barriers to growth, such as skills or exporting. This chapter explores SME manufacturers' preferred methods of financing, how the pandemic may have impacted the risk profile of small businesses, the reasons SMEs fail to access finance and what those firms would do if they had access to finance.

SME manufacturers in the UK overwhelmingly prefer to finance expansion using past profits

Two-thirds of SME manufacturers said they expand by reinvesting past profits. This is common for small businesses who generally lack the collateral necessary to guarantee private loans, as well as the know-how to access finance from alternative sources.

Chart 6: Manufacturers' preferred sources of finance



Source: Make UK Start-up to Scale-up survey 2021

REINVESTING PAST PROFITS IS A SOUND STRATEGY FOR ANY BUSINESS TO EXPAND, AS IT ALLOWS IT TO COMPOUND ITS GROWTH OVER TIME. IF EXECUTED SUCCESSFULLY, IT'S POSSIBLE TO ACHIEVE SCALED GROWTH.

A study conducted by Allica Bank covering more than 1,000 SME companies across the UK found that 25% of firms believe reinvestment is critical to a business's success.[13]

According to Allica, the most successful companies reinvested on average 9% of their profits into the business, compared to less-successful businesses that only reinvested 5%. To best support SMEs, it may be beneficial to utilise their preferred method by giving advice on how to reinvest into their business before offering additional lines of credit, which should be used to fill gaps in finance.

[13] "Small businesses should re-invest 9% of profits to succeed, finds new study", Global Banking and Finance Review, undated (https://www.globalbankingandfinance.com/small-businesses-should-re-invest-9-of-profits-to-succeed-finds-new-study/).

However, one of the issues of this strategy for SMEs is that the availability of this type of finance may be a question of luck or of being in the right place at the right time. Smaller firms do not generally have the luxury of planning their future profits, particularly in uncertain economic environments. Therefore, this would mean SME manufacturers may rely on profit windfalls, for example as the medical devices industry did during the Covid-19 pandemic, and reinvest those profits on an ad hoc basis depending on whether the situation allows it. Conversely, larger manufacturers have the capacity to forecast cash flow more accurately, enabling them to plan better how and when to reinvest past profits. To get over this hurdle, it is important that ambitious SMEs with intentions to grow significantly are willing to take that risk to expand instead of waiting for the right opportunity.

WHEN CONSIDERING THE ALTERNATIVE CHOICES, ONLY 33% OF SME MANUFACTURERS INDICATED TAKING OUT LOANS FROM PRIVATE BANKS AS PREFERABLE.

22% INDICATED A PREFERENCE TO ACCESS GRANTS FROM INSTITUTIONS LIKE INNOVATE UK.

Few consider multiple sources of finance together

Examining the top three options cited together, the survey results indicate that only 24% of manufacturers who preferred to reinvest past profits also chose to take out private loans.

This suggests that the more likely a manufacturer is to prefer reinvesting past profits or taking out a private loan, the less likely it is to choose the alternative method, despite the potential in combining two sources to fund greater ventures.

Similarly, manufacturers who prefer reinvestment of past profits are even less likely to consider accessing grants too (only 7% of manufacturers opted for both methods). Whether this is owing to a lack of information on available grants, to bureaucratic processes or to business investments being less innovative, disqualifying them from grants entirely, is uncertain. Finally, only 4% of SME manufacturers chose both private loans and grants as preferred sources of finance (but not past profits). Based on this, it seems SME manufacturers prefer to combine profits with loans more than profits with grants.

It is also worth acknowledging the other options highlighted, which indicate that manufacturers do consider sources such as bespoke Government funds, the British Business Bank or equity finance.

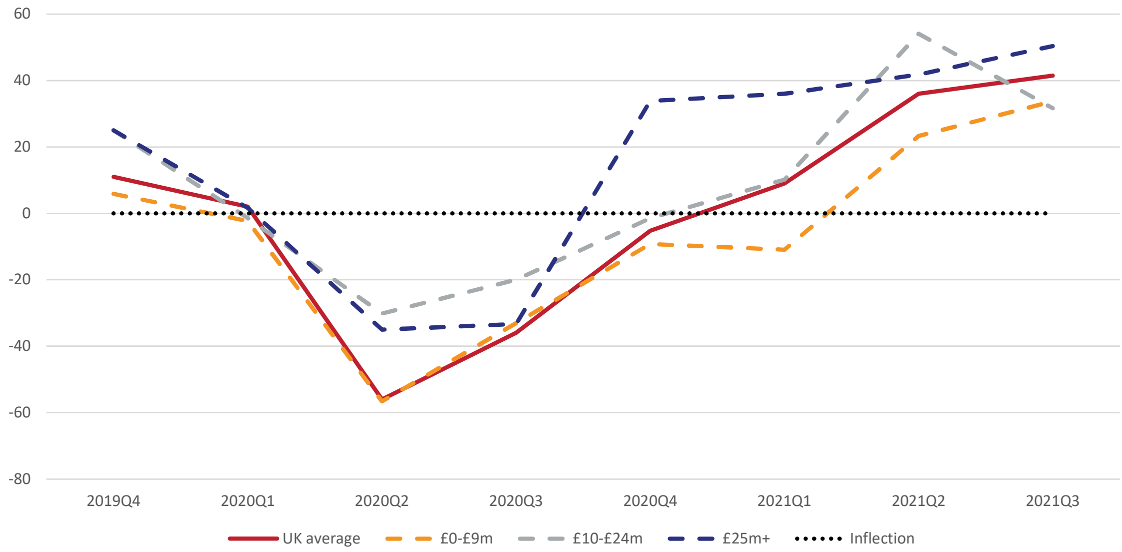
The pandemic may have changed the algorithms to assess financial risk

The Covid-19 pandemic led to many businesses across the UK feeling the brunt of reduced demand, supply-chain disruptions, and limited access to labour, which affected SME manufacturers generally more negatively than their larger counterparts, as evidenced by Make UK's Manufacturing Outlook survey[14] (Chart 7).

According to recent data, smaller manufacturers with less than £10 million in turnover saw output levels decline at a faster rate than manufacturers whose turnover was more than £25 million during the pandemic. Mid-sized firms (£10m-£24m) reported a more mixed performance in the same period, where they didn't fare as badly during the peak of the pandemic but have experienced a more subdued bounce back in activity since the start of the year, where gains appear to be accruing more quickly to manufacturers with turnover of more than £25 million.

[14] "Manufacturing outlook", Make UK, 2019-2021

Chart 7: From record-breaking lows to record-breaking highs, % balance of change in output



Source: Manufacturing Outlook Survey (2019Q4-2021Q3)

The data illustrates how smaller companies tend to fare worse during a crisis, as well as face a more challenging road to recovery post-crisis – highlighting the increased level of risk associated with SME manufacturers. How financial risk is assessed has changed significantly over the last few decades, with each crisis bringing forward new considerations for creditors when assessing whether a business should be granted access to finance, and at what level of severity conditions should be attached to that finance.

Businesses that have accessed Government support, even if just as a precautionary measure, have reported being offered more stringent conditions or higher fees when looking to access new finance, whether that is to expand or to stay afloat as the economic recovery kicks in. It is likely that underwriters within financial institutions have adapted the algorithms used to assess financial risk, with the data indicating that SMEs are more risky than larger firms.

It seems inappropriate to disadvantage firms that faced the greatest difficulties during a crisis by increasing the barriers they face to access opportunities. If history has taught us anything, businesses require access to capital during the recovery stage of a crisis rather than before it; whether that is for growth finance or asset finance to maintain the value of depreciating capital is irrelevant. The Government has already partially addressed these issues with the Recovery Loan Scheme (RLS) to businesses reopening after the pandemic, and even extended it by six months following the Autumn Budget 2021. The RLS is specifically for accessing finance for short-term cash flow needs by providing small loans, overdrafts, or invoice or asset finance. Although this does not address the financial needs for growing a business, manufacturers that are able to manage short-term risks are better able to plan for long-term growth. The UK is still going through the motions of bouncing back, with the manufacturing sector facing some of the biggest challenges (supply chains, freight, labour, energy, etc.).

The next few years will be crucial for manufacturers and scale-ups. For the UK manufacturing industry to achieve true growth at scale, it is imperative that we reduce the barriers to expansion during the early stages of the pandemic bounce-back, as this is where the greatest opportunities lie. One way to do this is for lenders to incorporate a forward-looking outlook on business potential, rather than solely consider historical performance when assessing risk.

HYMID MULTI-SHOT LTD DEMONSTRATES THE IMPORTANCE OF INVESTING TO STAY AFLOAT

Despite the increasing level of digitalisation taking place across all industries, 21st-century manufacturing remains very asset- and capital-intensive when compared to other sectors. This places significant investment demands on manufacturing SMEs which offer a combination of manufacturing and service-based products.

Most SMEs are privately funded in the UK, with many owners / managers likely to have invested their own money into their businesses on start-up, and to have signed up to Personal Guarantees (PGs) to fund growth. Given that they must continually invest to stand still, accelerated growth usually requires further capital expenditure to provide the means to upscale that growth. In the absence of other sources, owners / managers will usually approach banks and mainstream lenders to help asset-finance their equipment, a form of secured loan that is less risky than an unsecured loan.

Hymid Multi-Shot Ltd is a successful manufacturing SME providing innovative component design, precision tooling and technical plastic injection moulding services to blue-chip hi-tech companies across a range of sectors. Based in the South-West of England, it has a track record of steady, profitable growth with several successful asset-finance agreements under its belt, the usual requirement being a 10% deposit. It is often overlooked that a significant portion of manufacturers' investment pertains to the maintenance and upkeep of existing machinery, which depreciates over time and diminishes its output capacity through wear and tear. Therefore, many manufactures must continuously invest to maintain a minimum level of output and quality before they are able to consider new investments.

During the Covid-19 pandemic, Hymid successfully applied for a £200,000 CBILS loan with no requirement for PGs. The company has continued to grow and recently secured a new tooling project that required investment in a larger injection moulding machine to fulfil moulding orders from the new tooling. When Hymid approached its preferred mainstream asset-finance house, which had previously supported every asset-finance application (only requiring a 10% deposit), it found itself being required to provide a 25% deposit. No reason for this was given, but this sudden change in the required deposit is likely a result of the pandemic increasing the risk profile of manufacturing SMEs as financial institution underwriters factor in an assumed higher level of risk. This results in a new system, where businesses must offer greater guarantees to secure finance.

This change in financial risk assessment for asset financing creates a new layer of challenges for SMEs and scale-ups in manufacturing that would not be faced by SMEs in other industries. It does not consider the future potential of an organisation when making finance available, and it hinders the manufacturing sector's efforts to digitise, to build back green and to support the wider economic recovery.

Access to finance needs to be localised to level up

Make UK members often say one of the key methods of accessing private finance is through relationships with local banks or funding institutions. As recent research from WPI Economics (below) highlights, there is a gap in the market for local lenders to meet the needs of SME finance, resulting in low access to, or even low awareness of, the benefits of financing.

Manufacturing is a highly diverse industry, with concentrations of SMEs across the UK. In every region and devolved nation of the UK, SME manufacturers (0-249 employees) account for 99% of the business population. Of those that employ workers and have ambitions to grow, many could be better served with a more personal offering of finance options at the local level.

Research by WPI Economics described the UK banking system as highly concentrated, centralised and non-relationship based. Its research highlighted a critical need to develop local finance options for every business in the UK, specifically though Community Development Financial Institutions (CDFIs) and mutual banks.

Feature of the UK banking system	Description
Concentration	SME banking in the UK has been characterised as a four-firm oligopoly in the past, with the CMA finding in 2015 that the big four banks accounted for approximately 80% of all lending to SMEs in the UK. Recently we have seen some challenge to this rising from FinTechs, with the share of the big four banks dropping significantly following the financial crisis, before rebounding during the pandemic.
Centralisation	Banks can be characterised as centralised or decentralised based on the distance between different agents of the bank, the physical or geographic distance between the various banking establishments and – crucially – the functional distance between a bank's customers and where decisions in relation to those customers are made. Based on this, the major UK banks can be considered highly centralised institutions.
Non-relationship based	As a consequence of this centralisation, the financial system in the UK does not in the main rely on the development of relationships between banks and their customers, which allow for long-term two-way exchanges of information. This means that the UK banks and their customers miss out on the benefits that arise from this, such as the building of trust and creation of high-quality information and data on which to make better financial and business decisions.

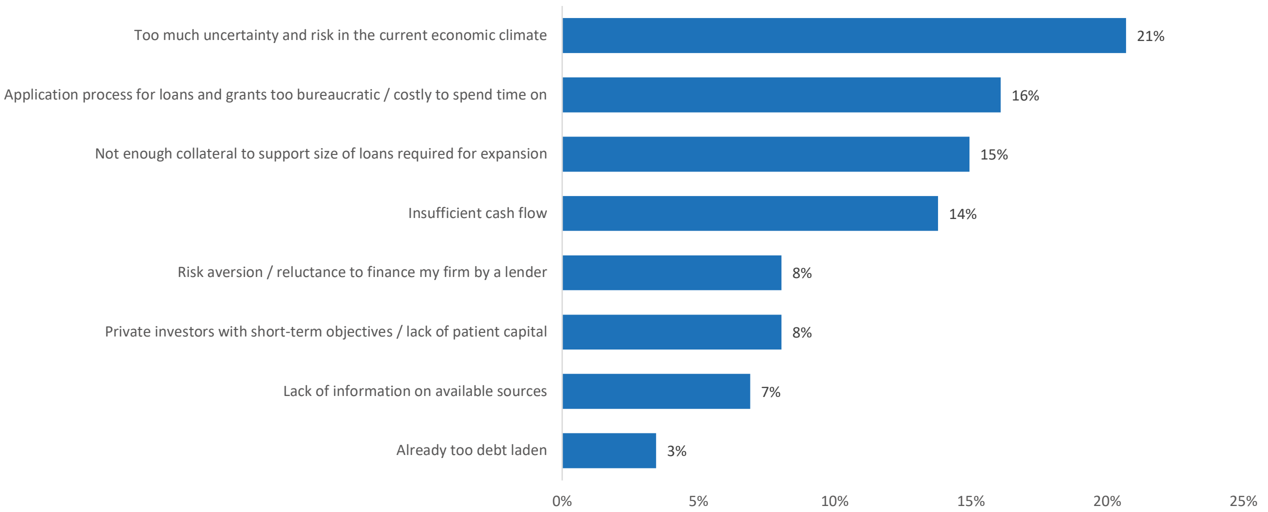
Source: "Scale Up to Level Up: Reforming SME finance WPI Economics", 2021, chapter one
(http://wpieconomics.com/site/wp-content/uploads/2021/09/Scale-up-to-Level-Up-Final-Report-for-the-APPG-on-Fair-Business-Banking_amended.pdf)

SHOW ME THE MONEY

ONE IN FIVE SME MANUFACTURERS INDICATED THAT CURRENT MARKET UNCERTAINTY AND RISK IS THE PRIMARY REASON FOR NOT BEING ABLE TO, OR NOT ATTEMPTING TO, ACCESS FINANCE.

This is sensible, based on the challenges businesses have faced in the last two years, but equally is representative of "waiting for the right moment", which for many businesses just never seems to arrive. This is unfortunately difficult to change for most manufacturers, and therefore access to finance is more dependent on a general appetite for growth.

Chart 8: SME manufacturers' reasons for not accessing finance



Source: Make UK Start-up to Scale-up survey 2021

It is possible to nudge manufacturers towards a mindset of risk-taking even under difficult circumstances by tapping into the role model effect of other scale-ups and successful businesses, which in turn can incentivise others to follow suit.

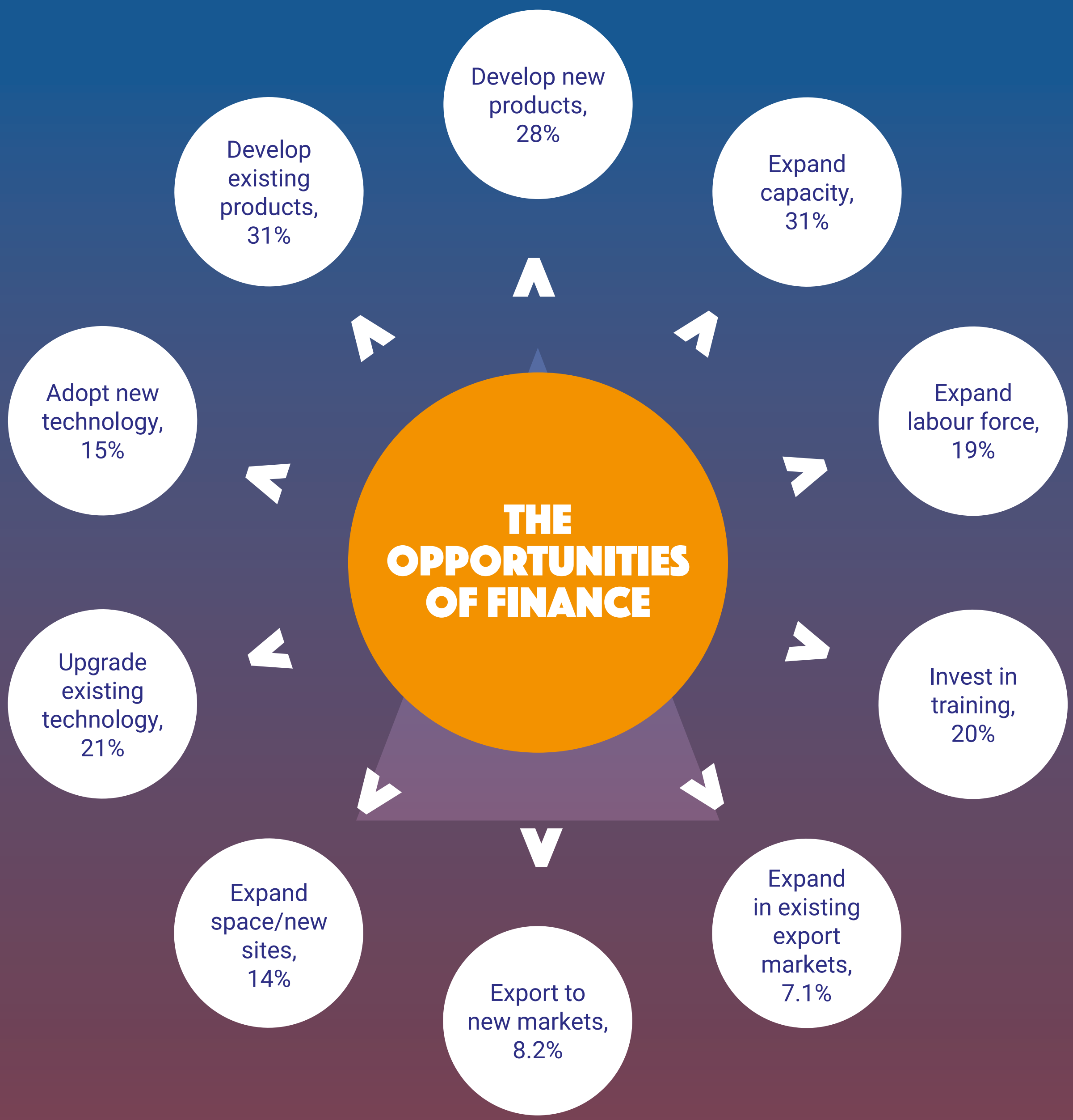
16% OF SME MANUFACTURERS INDICATED BUREAUCRATIC APPLICATION PROCESSES AND THE COST OF TIME ASSOCIATED WITH ACCESSING LOANS AND GRANTS AS A BARRIER TO GROWTH

SME manufacturers often lack the expertise and capacity to devote labour to searching, applying for and using the capital that may be available. The value for those that do pay that price may find the pool of finance available to make productivity-enhancing investments increasing, but the potential cost is "lost time" should that search be too difficult or an application fails. This leaves SME manufacturers dealing with an opportunity cost that larger firms do not face as regularly, given that they have more resources available to devote to overcoming these barriers.

Similarly, SME manufacturers indicated challenges such as limited collateral, insufficient cash flow and lenders being too risk averse or reluctant to lend, as some of the barriers to accessing finance. Many of these issues could be eased if the credit market were to be more willing to take risks on the future potential of innovative manufacturers, but this does place a greater level of risk on lenders. Since the global financial crisis, credit markets have become increasingly shy of taking on risks.

Despite the challenges cited above, there was no true dominating factor recognised as a barrier to accessing finance, with a large share of manufacturers indicating that they do not need access to external finance. This complies with the previous result on SME manufacturers preferring to reinvest past profits, indicating either a low appetite to achieve scaled growth or a lack of awareness of the opportunities that accessing finance could bring.

WHAT SME MANUFACTURERS WOULD DO WITH FINANCE



SME manufacturers indicate that, if they had access to finance, they would prioritise investment in expanding capacity, develop their existing and new products as well as invest in training and upgrade existing technologies.

Make UK is backing manufacturing – helping our sector to engineer a digital, global and green future. From the First Industrial Revolution to the emergence of the Fourth, the manufacturing sector has been the UK's economic engine and the world's workshop. The 20,000 manufacturers we represent have created the new technologies of today and are designing the innovations of tomorrow. By investing in their people, they continue to compete on a global stage, providing the solutions to the world's biggest challenges. Together, manufacturing is changing, adapting and transforming to meet the future needs of the UK economy. A forward-thinking, bold and versatile sector, manufacturers are engineering their own future.

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For more information, please contact:

Fhaheen Khan
Senior Economist
Make UK
Fkhan@MakeUK.org

The Manufacturers' Organisation

makeuk.org

21.11.POL.FK.NB