SME finance and innovation in the current economic crisis

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Anna's research focuses on the development of economic and geographic data sets from various UK company databases; survey design and management, and statistical analysis. Her recent projects include: 'Small and Medium Sized Enterprise Performance and Policy'; 'The 2007 UK Survey of SME Finances'; 'International Innovation Benchmarking and the Determinants of Business Success'; and 'A Survey of National Health Service Reforms and the Working Lives of Midwives and Physiotherapists'.

She has expertise in questionnaire design, survey management and data analysis and has provided technical and statistical input into many articles in medical and social science publications. Anna studied at Uppsala University Sweden and before joining the CBR worked on epidemiological and other medical surveys for the Medical Research Council in London and Cambridge and on large social science surveys at Birkbeck College, London University. She became involved with economic and business data analysis whilst at working at the University of Leeds. Anna will be working on the extensive survey programme planned for UK~IRC projects.

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Andy Cosh is a Reader in Management Economics, Accounting and Finance, Programme Director for Enterprise and Innovation and Assistant Director of the Centre for Business Research at the University of Cambridge and a Member of the UK~IRC Executive Committee. Prior to his current posts Dr Cosh worked at HM Treasury and as a Research Officer at the Department of Applied Economics, Cambridge University. From 1984-2006 he combined his academic roles with the position of Senior Bursar at Queens' College, Cambridge. He has also acted as a business consultant to several firms and as a research consultant for the European Commission, Eurostat, British Bankers Association, DTI, DfEE and DfES (and their successors in title!). His research focuses on innovation and finance, small and medium-sized enterprises, mergers and acquisitions, executive pay and corporate governance.

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Isobel joined the CBR in May 2003 as Assistant Database Manager, supporting the Survey and Database Manager on a variety of projects including the CBR's biennial UK survey of small and medium-sized enterprises. Previously she has worked for two market research companies, in data processing and project management for both Consumer and Business to Business research. She has also worked within technical support for a market research software company, supporting various data collection and analysis products.

Her research interests include assisting in the development of economic and geographic data sets from various UK company databases; and with survey design and management, and statistical analysis. Isobel will be working on the extensive survey programme planned for UK~IRC projects.

INTRODUCTION

In this report we provide an analysis of the impact of the current financial crisis and recession on the financial, growth and innovative characteristics of small and medium sized enterprises in the manufacturing and business services sectors of the UK.

Our analysis draws on a survey of over 800 independent businesses employing less than 500 people in these sectors. The survey was carried out between November and December 2008. It therefore represents the most recent large scale attempt to assess the financial market conditions facing this important sector of the UK economy.

An important feature of our report is that we are able to set our findings for this large sample against the experiences of exactly the same firms in 2004. We carried out a survey in November to December of the same firms in that year. This makes for a unique like-for-like comparison between two periods, the second of which is characterised by the impact of financial crisis and recession and the first of which reflects more stable circumstances.

In addition to this comparison we are able to make a longer term comparison between the results arising from our survey of firms in November and December 2008 and results from a sample of over 2,000 firms which we surveyed in April to September 1991. Its significance in relation to our survey for 2008 is that it allows us to make a comparison between small and medium sized enterprises in the current recession and the experiences of small and medium sized enterprises in manufacturing and business services during a similar recessionary period.

The Credit Crunch: Short Term Policy Impacts

In addition to these short and long run comparisons we specifically designed our 2008 survey so that we approached firms both before and after a number of significant policy changes. These included both the reduction in interest rates and the pre-budget announcements in November of that year.

Our report is structured so that we first report on the differences experienced by small and medium sized enterprises in 2004 and in 2008. We then provide an analysis of the changes over the longer run from 1991 to 2008. In the discussion of results for these periods our emphasis is on financial markets and constraints on growth. We pay close attention to the growth objectives of our survey sample firms in 2004 and 2008 and their subjective views on the factors limiting their ability to meet business objectives in these two periods. We then look in some detail at the ease of obtaining different forms of finance in the two periods. We also look at changes in the terms on which finance is available focusing on interest rates as well as arrangement fees and collateral requirements. We analyse the perceived effect of the November 2008 cut of 1.5% in the Bank of England's base lending rate, on firms' expectations in relation to the demand for output, their capital and R&D expenditure, training expenditures and the likelihood of seeking finance and its cost. We carry out a similar analysis in relation to the package of policies set out in the pre-budget report of November 2008.

In his pre-budget report on Monday 24 November the Chancellor announced a package of measures designed to stimulate demand and assist business. These included a temporary reduction in the VAT rate to 15% until the end of 2009; the bringing forward of £3 billions of capital of spending from 2010-11, including the introduction of a green stimulus supporting low carbon growth in jobs; measures to help small and medium sized enterprises facing credit constraints, including the launching of a new small business finance scheme to support up to £1 billion of bank lending to small exporters; a £50 million fund to convert business debt into equity and a £25 million regional loan transition fund. Also announced was a new HMRC scheme to allow any business in temporary financial difficulty to pay their tax bills on a timetable they could afford; more generous tax relief for businesses now making losses by allowing a temporary additional carry-back of up to £50,000 of losses to be set against taxable profits from the last three years; and finally the deferral of the increase in the small companies rate of corporation tax, and a temporary increase in the threshold at which an empty property becomes liable for business rates. Our follow-up survey to our sample firms in December 2008 was able to ask specifically what the firms' expectations were in relation to the impact of these changes on their business.

The Credit Crunch: A Longer Term Perspective

The recession of 1991 produced a major debate on the extent to which the banking sector in the UK was meeting the demands of the small business sector in an efficient and cost effective way. It led to the development of a range of initiatives by the Bank of England in particular to pull together information and research findings on the relationship between small business enterprises and their sources of finance. The Bank of England held a series of annual SME Finance 'roundtables' and began to produce a regular quarterly report on SME finance. It also produced a regular series of special reports on various aspects of the financing of small and medium sized enterprises, including, for example, ethnic businesses and high technology businesses. In the course of the decade and a half following the recession of 1991 a plethora of SME relevant capital market and tax based support programmes were introduced in the UK. These included the Small Firms Loan Guarantee Scheme, a range of changes to the fiscal system designed to encourage enterprise which included both zero and reduced rates of corporation tax for small and medium sized enterprises, VAT exemption and payment relief, SME schemes of export credit guarantees and community investment tax relief. A number of investment initiatives were also introduced to promote enterprise growth and expansion, including the Enterprise Investment Scheme and Venture Capital Trust Share, Early Growth Funds, Enterprise Capital Funds and Regional Venture Capital Funds. Government initiatives also led to the introduction of late payment legislation to protect smaller businesses. In relation to SME relevant innovation support programmes a wide range of support was provided, including the Grant for Investigating an Innovative Idea, the Grant for R&D (initially the SMART scheme), the development of a variety of attempts to promote public sector R&D procurement in the Small Business Research Initiative Programme, and a wide range of schemes developed locally and regionally and with a variety of European Union support. By 2003-4 it has been estimated that the small and medium sized enterprise community was being supported by £3.6 billion worth of tax breaks *per annum* and government support expenditure of around £4.3 billion per annum, covering support for skills and learning (£1.7 billion), trade, enterprise and innovation delivered by the then DTI/OST (£0.5 billion) and RDA and EU linked schemes (£0.7 billion). This represented a total support of £7.9 billion per annum, or approximately £220 worth of support per person of working age in the UK (Hughes (2009)). At that stage it was estimated there were 267 separate service programmes operated by central government over 50 of which were innovation and design focused as well as over 3,000 national, regional and local support programmes

(PACEC (2006), NAO (2006)). The proliferation of schemes has led recently to major attempts to overhaul and rationalise the support programmes. In relation to technology and innovation in particular this has led to the consolidation of innovation and technology support in the hands of the Technology Strategy Board which is responsible for the delivery of the Grant for Collaborative R&D, the Knowledge Transfer Network Programme, which covers 24 sectors and was formerly known as the Faraday Partnership System, and the Knowledge Transfer Partnership Programme, which was formerly known as the Teaching Company Scheme, and which has received a significant boost in the last year as a result of the Sainsbury Review of science and innovation policy (Sainsbury (2008)).

In the light of these changes one might expect that the SME sector would have encountered the recent financial crisis and recession in a somewhat more robust position than it did in 1991. In addition the outcome of a series of investigations and reports on the state of competition in banking, in particular in the relation to the supply of services to smaller businesses, might have been expected to produce an increase in the quality in competitiveness of services being provided. This is an important consideration since the market for supply of financial services to the small and medium sized enterprise community in the UK remains highly concentrated. The most recent data for the UK suggest that the market share of the top four banks in the SME sector in the UK was 78% in 2004 and 76% in 2007 (CBR (2008)). Moreover, most small firms remain committed to stable relationships with their main banks. The median length of relationship of an SME with its main financial provider in 2007 was 7 years. Around one third of SMEs were benefiting from free banking at that point and a further half who did pay charges were receiving interest on their credit balances. Around 4% of the small business stock had switched their main bank in 2007. Around 17% had considered changing banks, but in general most businesses seemed committed to their existing banks and only 6% were actively considering changing banks.

This relative stability was also a feature of similar surveys in 2004 (CBR (2008)), the largest four banks dealing with the small and medium sized enterprise community in the UK are Barclays, HSBC, Lloyds TSB and the RBS Group, including NatWest. The significance of this group in relation to small business lending and the financial difficulties which they have faced might be expected to have had a significant adverse impact on the environment facing their customers. This of course is a striking difference to the conditions in 1991 where the recession was not accompanied by a major financial crisis in the banking sector in which the main providers of funds were threatened with financial failure.

Against this background in the following sections we consider in turn the 2008 survey and a comparison of results with 2004; a comparison of 2008 with 1991; and finally an analysis of the 2008 data which focuses on the comparative experience of innovative and non-innovative firms and fast and slow growers in the periods 2004-2008. A final section presents some summary conclusions and suggestions for policy development.

THE CBR 2008 SME SURVEY

The CBR has carried out major surveys of finance, growth and innovation in the SME sector in 1991, 1995, 1997, 1999, 2001 and 2004 and three panels have been created. The current crisis facing the SME sector led to a new, more modest, survey being carried out at the end of 2008, funded by the Cambridge Endowment for Research in Finance. The respondents to the 2004 survey provided the sampling frame so that a direct comparison could be made with 2004. The number of responses was 818 and this represented a 44% response rate.

Economic Background

Our first comparisons are drawn from the replies of the same firms at the end of 2008 with their replies at the end of 2004. The economic background was very different four years ago with low and stable levels of unemployment and inflation in the preceding months. The economy was slowing, but still growing well and interest rates were starting to rise from historically very low levels. In contrast, by the end of 2008 inflation and growth are falling sharply and unemployment is rising. The picture for interest rates is complicated by the growing divergence between government-set rates, that were falling, and market-set rates that had been rising.

Growth Ambitions

Chart 1: Growth objectives over the next 3 years - Nov 2004 and Nov 2008

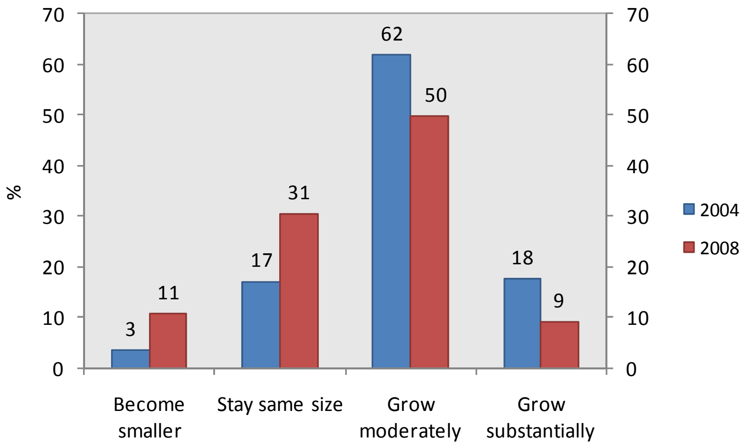


Chart 1 shows the growth ambitions of these firms in 2004 and 2008.

It is very clear that they have declined quite sharply.

The proportion seeking to grow substantially has halved from 18% to 9%.

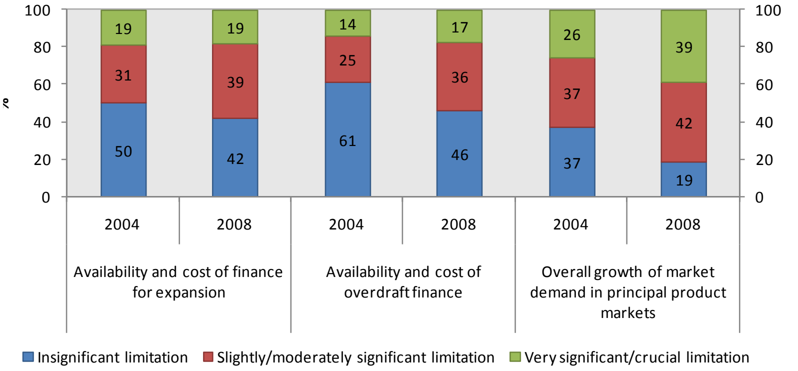
At the same time the proportion expecting to become smaller has increased from 3% to 11%.

However, it is worth noting that in 2008 as many as 59% of businesses intend to grow over the next three years.

Business Problems

In both 2004 and 2008 this group of businesses was asked about the factors that were limiting their ability to meet their business objectives. Chart 2 summarises their response in each year in three key areas. Looking first at the finance constraints, it is clear that these are higher in 2008 than four years earlier. But, it shows that the proportion regarding finance to be a very significant, or crucial, constraint remains below 20% in 2008. On the other hand, the demand constraint has changed markedly.

Chart 2: Limitations on ability to meet business objectives - Nov 2004 and Nov 2008



The proportion that regards the demand constraint as insignificant has halved from 37% to 19%, whilst the proportion who view the demand constraint as very significant, or crucial, has risen from 26% in 2004 to 39% in 2008.

Finance Availability

Charts 3 and 4 examine the current ease of obtaining various forms of finance compared with three years earlier.

Chart 3: Ease of obtaining types of finance compared to 3 years ago (2008 survey, %)

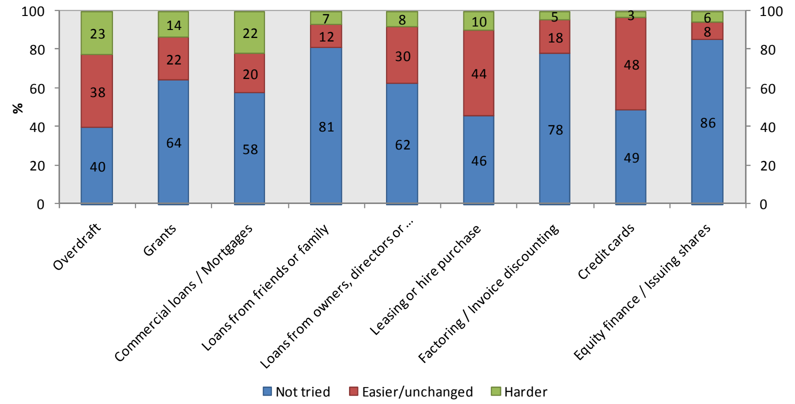


Chart 3 includes those businesses that have not tried and so gives an indication of the frequency of use of each type. Overdrafts, credit cards and leasing / hire purchase are the most commonly used forms of finance. Factoring and invoice discounting, loans from friends and family and new equity are the least common sources.

Chart 4: Ease of obtaining types of finance compared to 3 years ago of those who tried (2008 survey, %)

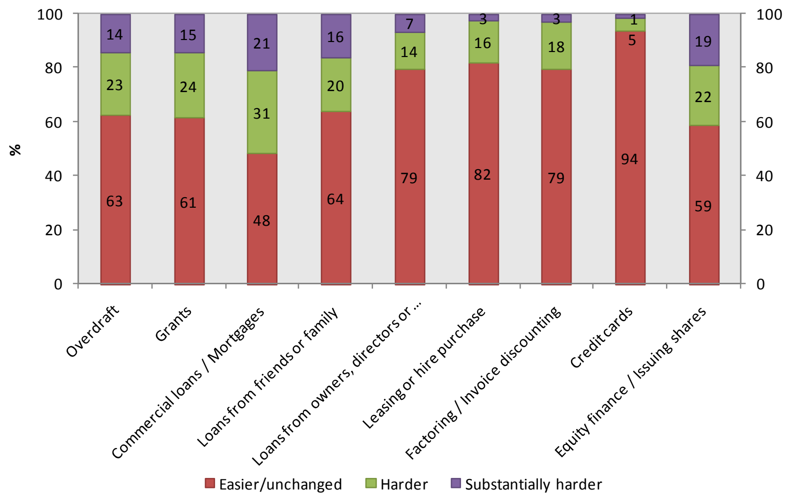


Chart 4 shows, for the majority of businesses using external finance, that there has not been an increase in the difficulty of obtaining that finance at the end of 2008 compared with three years earlier. It is worth focusing on the most common sources of finance. For example, 82% said that leasing and hire purchase finance was not more difficult to obtain and this rises to 94% for credit cards. On the other hand, commercial loans, grants and overdraft had become substantially harder for a significant minority of businesses.

Chart 5: Mean percentage obtained (2004 and 2008 surveys, %)

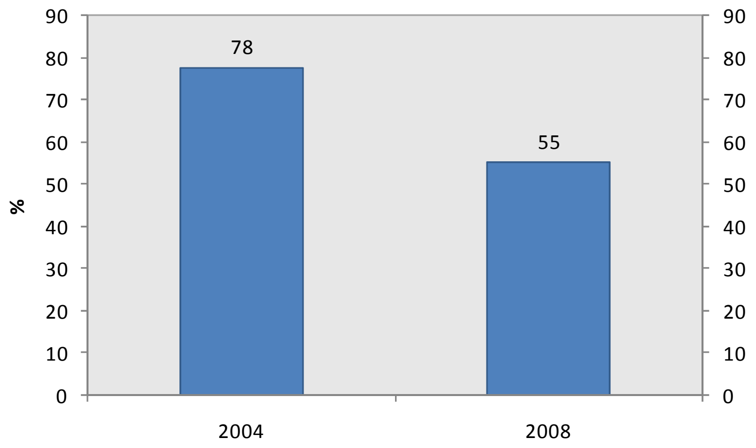


Chart 5 confirms this picture by showing a lower success in seeking finance overall.

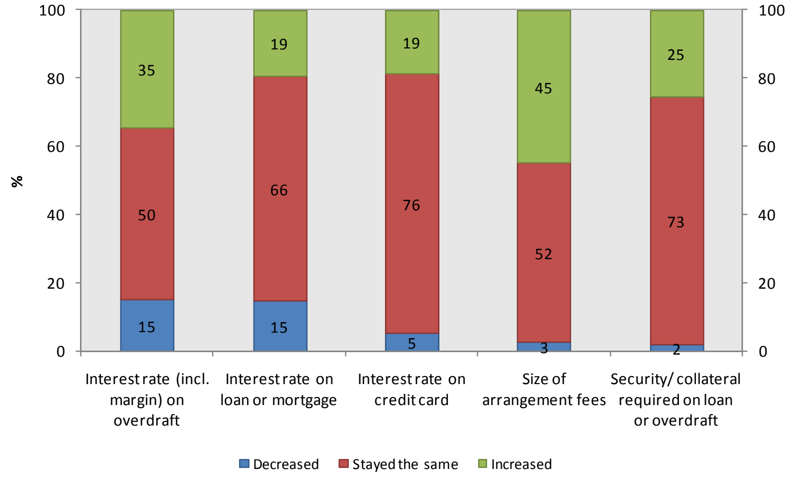
The percentage of finance sought that was obtained in the last year is lower on average than it was in 2004.

Cost of Finance

The rise in the cost of finance, including arrangement fees and the collateral required, over the past year is explored in Chart 6. It shows that there has been no increase in these for over half of the businesses.

Credit cards show little change, whilst commercial loans and mortgages show 15% with decreases (probably those linked to base rate) and 19% with increases. Overdrafts also show 15% with decrease, but 35% with increases as bank margins are increased.

Chart 6: Changes in the cost of finance in the last year (2008 survey, %)



Both the size of arrangement fees and the security, or collateral, required on loans and overdrafts have increased for 45% and 25% of businesses respectively.

Trade Credit

The consequences of the tightening of credit markets over the past year for SME trade credit is examined in Charts 7-9.

Chart 7: Trade credit from suppliers during the last year (2008 %)

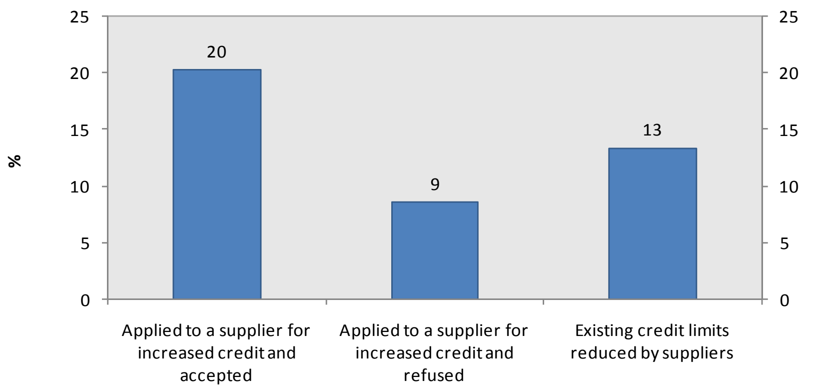


Chart 7 explores the credit received by SMEs during the past year. It shows that 20% of SMEs did get increased credit limits when they applied for them. On the other hand 9% were refused an increase and 13% had their existing credit limits reduced.

Chart 8: Trade credit for customers during the last year (2008 %)

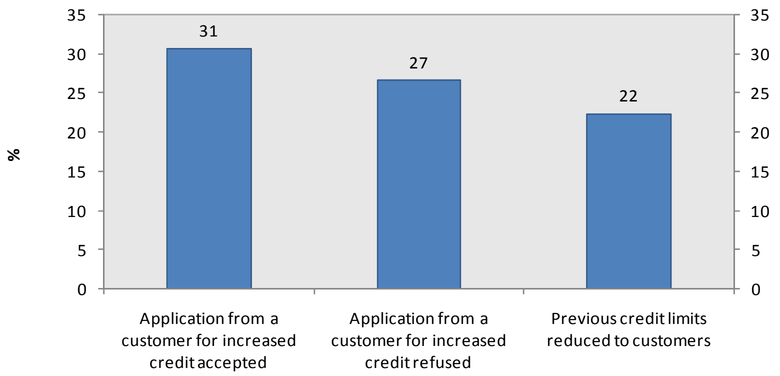


Chart 8 shows that customers have been seeking to increase their credit limits. 31% of SMEs have increased these, 27% have refused to give the increase and 22% have reduced credit limits.

This increased need for and concern about credit limits has also led to an increase in the time spent assessing credit worthiness.

Chart 9: Time or money spent assessing the creditworthiness of customers during the last year (2008, %)

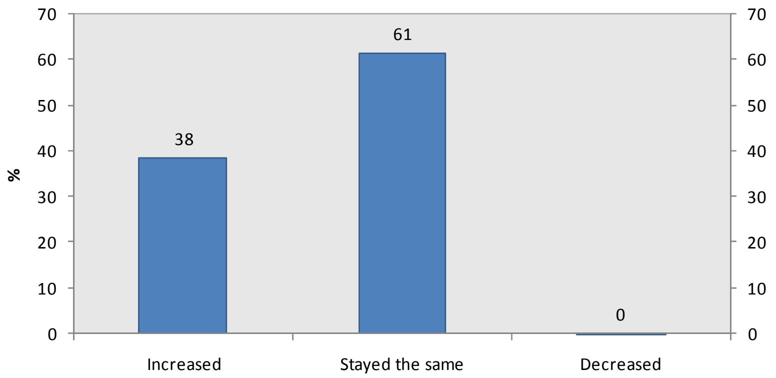


Chart 9 shows that 38% of SMEs have increased the time spent on this activity.

Policy Impact – Interest Rate Cuts

On 6th November 2008, just before the survey began, the Monetary Policy Committee of the Bank of England announced a cut of 1.5% in the base rate. This was the largest single cut since 1981 and brought the base rate to 3%, its lowest level since 1955. The firms were asked about how this would affect their business.

Chart 10: Perceived effect of the 6th November 2008 cut of 1.5% in the base rate (%)

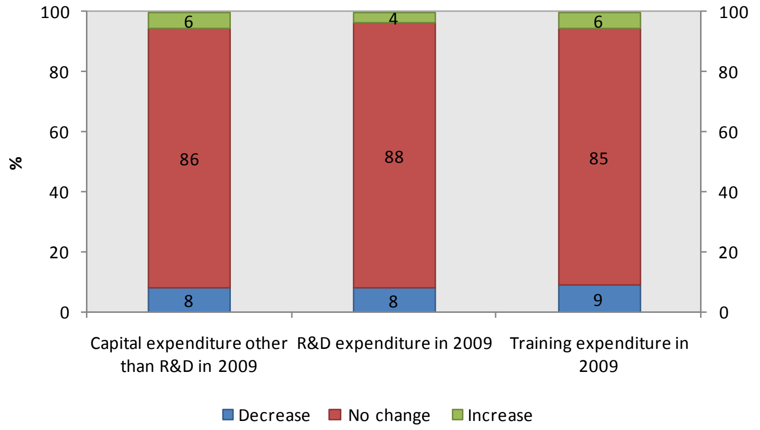


Chart 10 shows little confidence that the measure would work in terms of capital expenditure, R&D, or training expenditures. Between 85% and 88% of firms felt that it would have no impact in these areas and the rest were roughly equally divided between increase and decrease.

Chart 11: Perceived effect of the 6th November 2008 cut of 1.5% in the Bank of England's base lending rate (%)

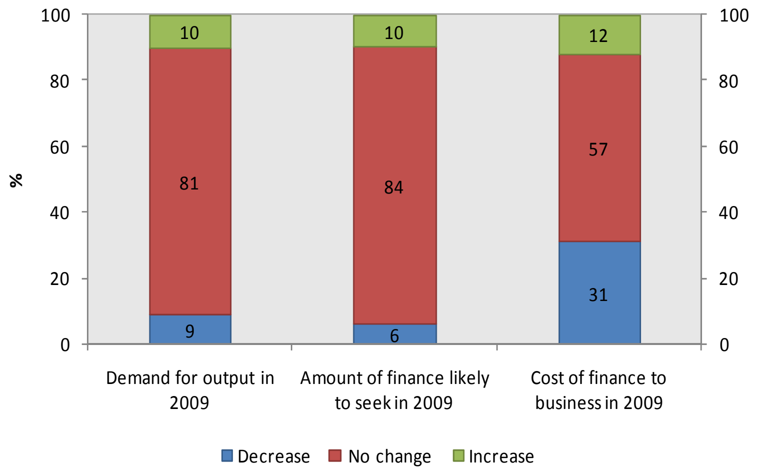


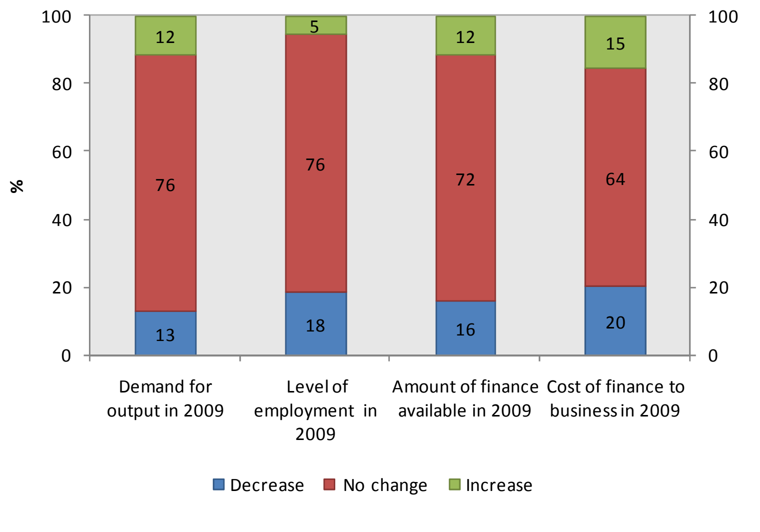
Chart 11 shows much the same picture for the demand for the firm's output and the amount of finance the firm was likely to seek. This lack of impact on funds sought was despite their greater confidence that the cut would result in a lower cost of finance to the business – 31% thought the cost would come down. On the other hand, 57% predicted no change and 12% even that the cost would rise.

Policy Impact – the PBR

In his Pre-budget Report on Monday 24th November the Chancellor announced a package of measures designed to stimulate demand and assist business. These included:

- temporarily reducing the VAT rate to 15% until the end of next year;
- bringing forward £3 billion of capital spending from 2010-11 including introducing a green stimulus supporting low carbon growth and jobs;
- measures to help small and medium sized enterprises facing credit constraints. The Government will launch: a new Small Business Finance Scheme to support up to £1 billion of bank lending to small exporters; a £50 million fund to convert businesses' debt into equity; and a £25 million regional loan transition fund;
- a new HMRC scheme to allow any business in temporary financial difficulty to pay their HMRC tax bills on a timetable they can afford;
- more generous tax relief for businesses now making losses, by allowing temporary additional carry-back of up to £50,000 of losses to be set against taxable profits from the last three years; and
- the deferral of the increase in the small companies' rate of corporation tax, and a temporary increase in the threshold at which an empty property becomes liable for business rates.

Chart 12: Expected effect of the 24th November Pre-budget Report changes compared to expectations before this announcement (%)



This announcement took place during the survey and a number of the measures could be expected to take time to evaluate and to yield benefits, so it is not surprising that they were greeted with little enthusiasm.

Chart 12 shows that in terms of demand and employment three-quarters of SMEs thought that they would have no impact.

The remaining quarter had more suggesting a decrease than those expecting an increase.

Chart 13: Expected effect of the 24th November Pre-budget Report changes compared to expectations before this announcement (%)

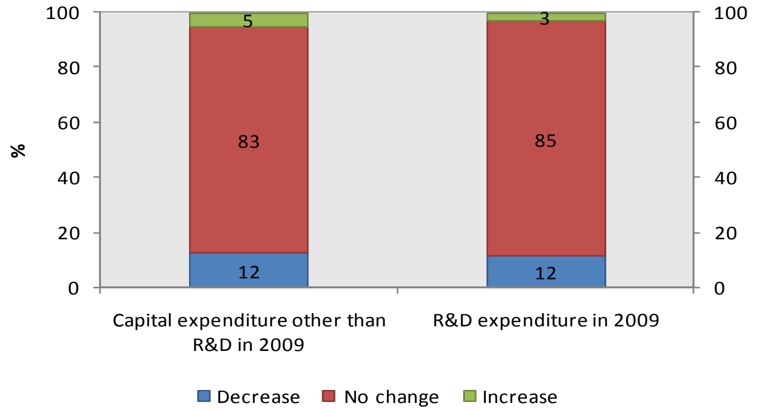
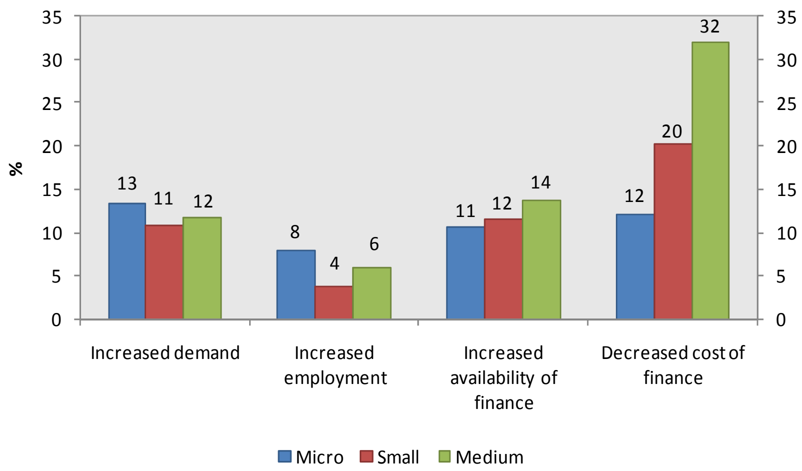


Chart 13 shows the same muted impact for capital spending and R&D.

Chart 14 shows the more positive effects of the measures by examining the proportion of firms that thought things would get better. This is examined by size classes. It shows that in terms of demand and employment there is little difference across the size groups.

Chart 14: Expected effect of the Pre-budget Report changes compared to expectations before this announcement by size (%)



On the other hand, the larger SMEs are more optimistic about the impact on the cost and availability of finance, particularly the former.

32% of larger SMEs felt that the PBR measures would lead to a decrease in the cost of their finance, but only 12% of the micro firms gave that answer.

Chart 15: Expected effect of the Pre-budget Report changes compared to expectations before this announcement by size (%)

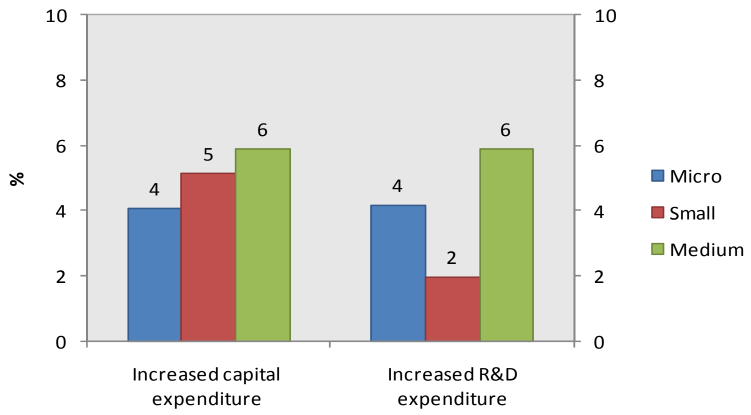


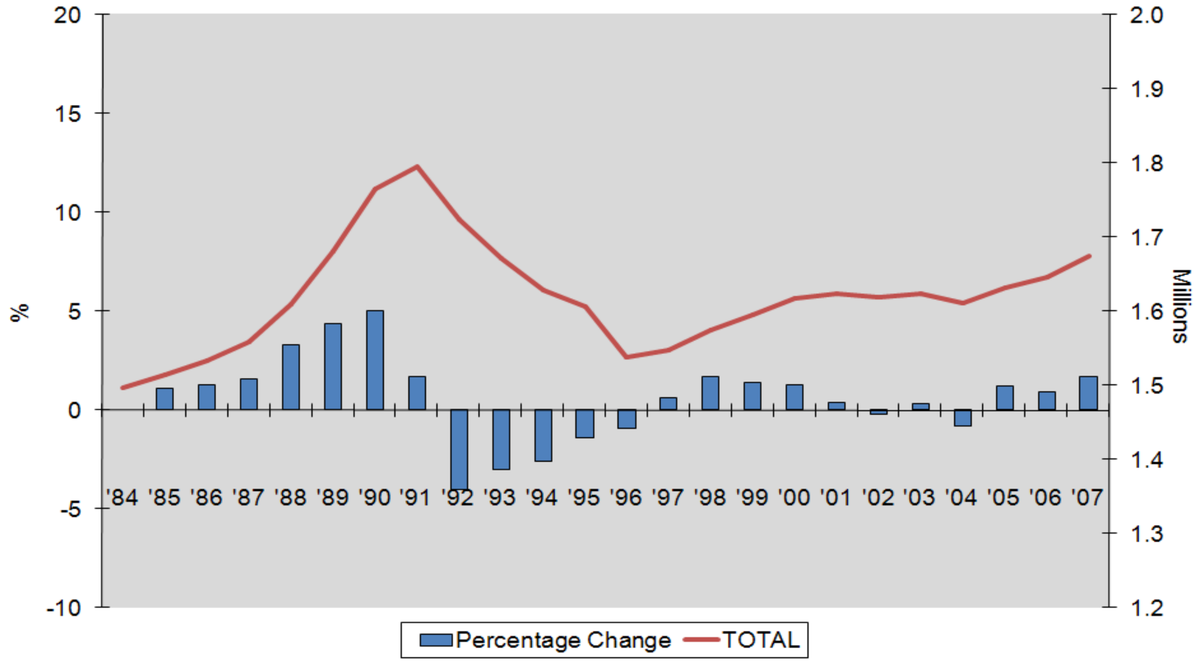
Chart 15 examines the positive answers relating to capital spending across the size groups.

Although, very few saw immediate benefits, it was again the larger SMEs that were somewhat more positive.

SMALL BUSINESSES SINCE 1991: RECOVERY AND EXPANSION

In the decade and a half following the recession of the early 1990s and in the face of a macro-economic policy which introduced a greater stability in the economy and the raft of policy initiatives described in the introduction to this report the response was a slow but sustained recovery in the stock of smaller businesses in the UK. This is shown in Chart 16.

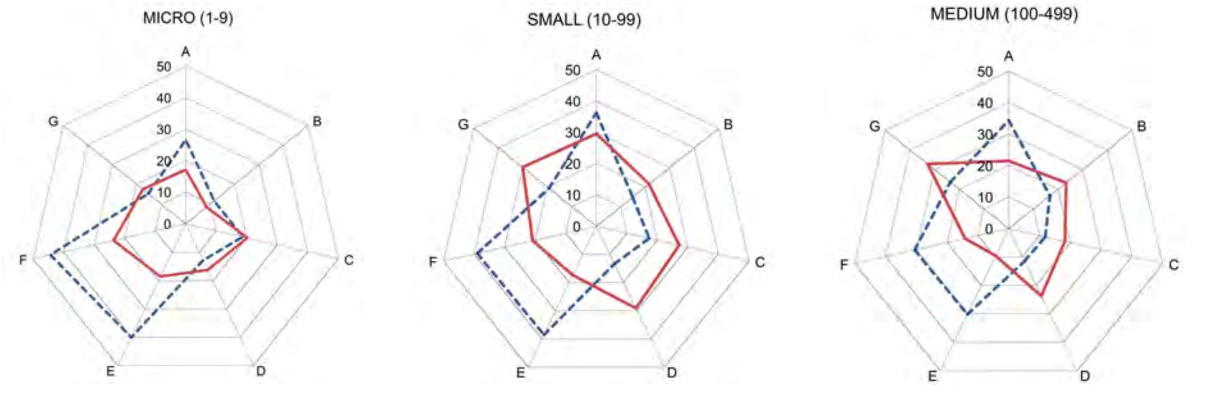
Chart 16: Levels and Changes in the Stock of UK VAT based Enterprises 1984-2007



Source: www.statistics.gov.uk

It is notable that there was a dramatic fall in numbers from 1991 through to 1996 and the stock did not recover to its peak 1991 levels. Only four years after the initial recession did the numbers of UK VAT registered enterprises begin its steady and slow recovery, which was primarily dominated by the growth of the stock of VAT registered enterprises in finance, property and business services. The manufacturing enterprise stock fell over this period. The macro-economic and policy support conditions were, however, associated with an increase in one and three year survival rates between 1995 and 2004 (www.sbs.gov.uk/survival). One of the most striking changes over the period 1991-2004 was a significant decline in the extent to which firms reported the availability or cost of overdraft finance, or the availability or cost of finance for expansion, as factors limiting ability to grow. This is shown in Chart 17.

Chart 17: Factors limiting ability to grow for micro, small and medium sized firms 1991-2004



A=Overall market growth	E=Availability/cost of overdraft	1991
B=Management skills	F=Availability/cost of finance	2004
C=Marketing and sales skills	G=Increased competition	
D=Skilled labour shortage		

Source: Cosh A.D and Hughes A. (eds.) (2007) *British Enterprise: thriving or surviving?* CBR Cambridge

This shows that the combination of macro-economic stability and support policies had altered the balance of constraints away from finance and towards management, marketing and labour skills. There was, however, little change in the proportions of smaller businesses in the UK economy exporting, training, producing product or process innovations or being involved in any innovation activity in the CBR SME survey data. This is on the basis of a carefully matched comparison of like-for-like firms over the period as a whole (CBR (2007)).

On the innovation front there was little change in the commitment of the labour force to R&D over the period as a whole either. On the other hand the extent to which smaller businesses were likely to be involved in collaborative activities with HEIs which had become an important part of government innovation policy had risen substantially. In 1991 12% of the CBR matched sample reported such collaborations compared with 22% in 2004.

The CBR 1991 and 2008 Surveys

The 1991 CBR SME survey was carried out in the summer of that year and provides an excellent basis for comparing the present situation with that recession. The comparison of inflation and unemployment from 2006 until the last quarter of 2008 is made with the period from 1988 until 1994 in Chart 18. It shows the great similarity between the movement into the present recession and that in 1991.

In both cases inflation starts to fall and unemployment starts to rise. Both measures were at much higher levels in 1991. However, the charts suggest and recent forecasts confirm that the rate of change of these variables is greater in the current period. On the basis of these variables, the recession appears to be much sharper in 2008.

Chart 19 compares economic growth and interest rates for the two periods. It shows that the collapse in economic growth is greater in 2008 following a period of modest, but stable, growth.

Interest rates, measured by Treasury bill yields, fell sharply in both periods, but were very much higher in 1991.

Chart 18: Comparison of present recession with the early 1990s - inflation and unemployment

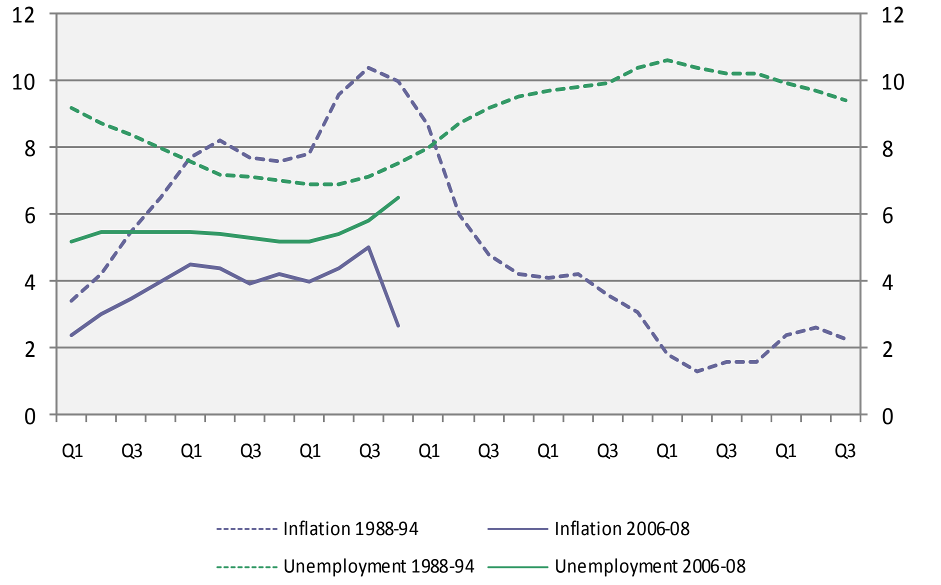
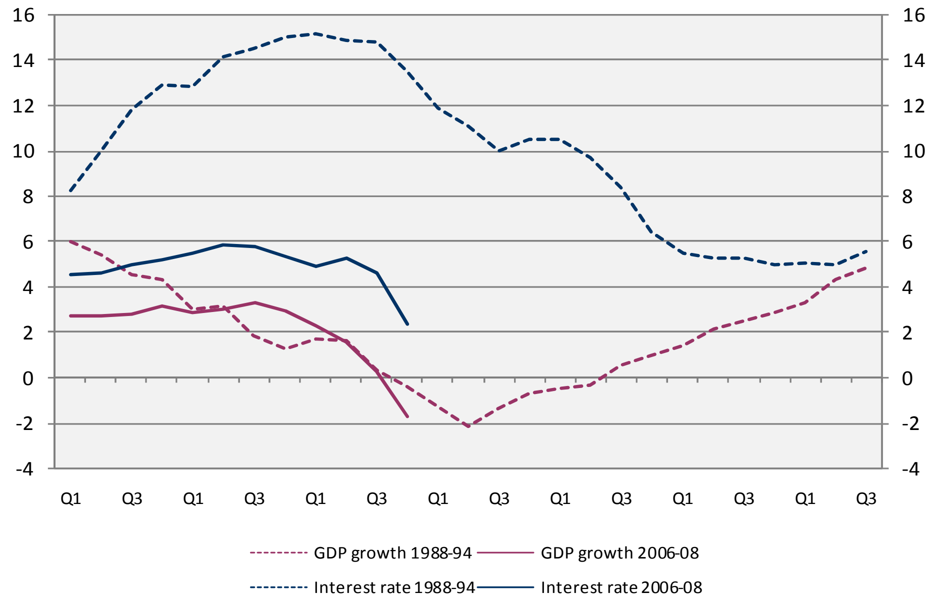


Chart 19: Comparison of present recession with the early 1990s - GDP growth and interest rate



Trade Credit

Chart 20: Pressure on cash flow due to customers delaying payment longer by sector - 1991 and 2008 surveys compared (%)

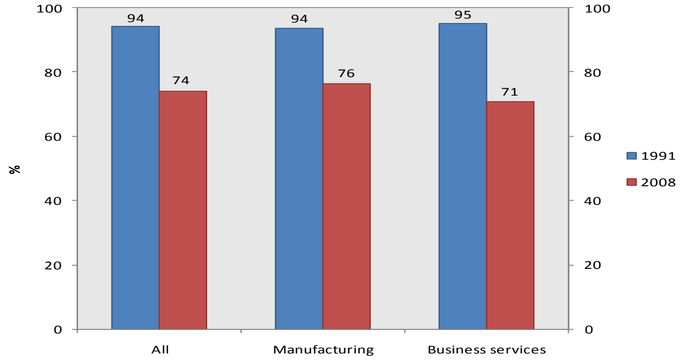


Chart 21: Pressure on cash flow due to suppliers exacting prompter payment by sector - 1991 and 2008 surveys compared (%)

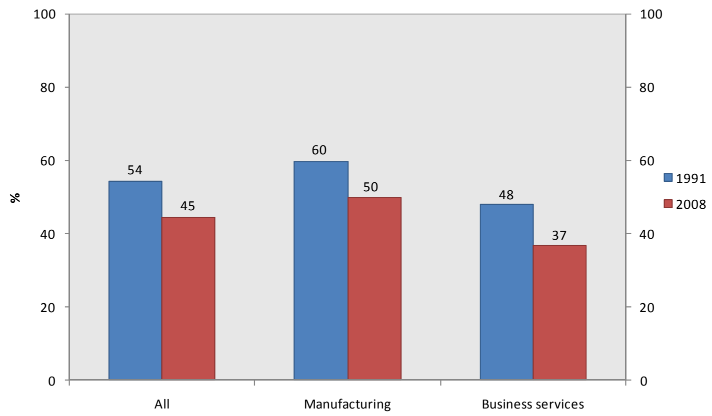
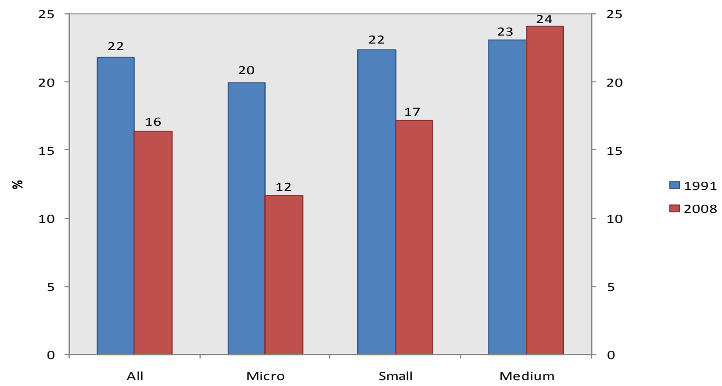


Chart 22: % seeking finance by size - 1991 and 2008 surveys



The complaint in the early 1990s from SMEs about the pressure placed on their cash flows by large customers and suppliers led to the inclusion of questions about this in the 1991 survey. Firms were asked whether these problems had increased during the last year. This question was repeated in the 2008 survey.

Chart 20 shows the responses in both years in relation to customers delaying payment. It shows clearly that, whilst this remains a problem, it is very much lower in today's recession than it was in 1991.

Chart 21 shows the pressure on cash flow from suppliers. This form of pressure is less in both years than that of customers delaying payments. Again we find that 2008 does not seem to be as bad as 1991. In 2008, manufacturing seems to be faring worse than business services.

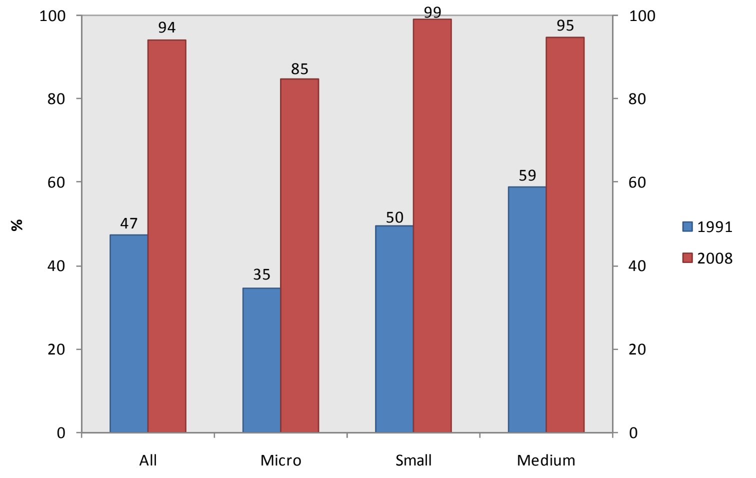
Seeking Finance

Chart 22 gives the percentage of firms seeking finance in 1991 and 2008. It is shown for all firms and by size class. The proportion of all firms seeking finance is lower in 2008, but it is worth noting that this is not the case for larger SMEs – about 24% of these are seeking finance.

Demand and Finance Constraints

Both the 1991 and 2008 surveys asked questions about the limitations faced by businesses in meeting their business objectives. In this section we focus on two key constraints – market demand and the finance constraint (i.e. the availability and cost of finance).

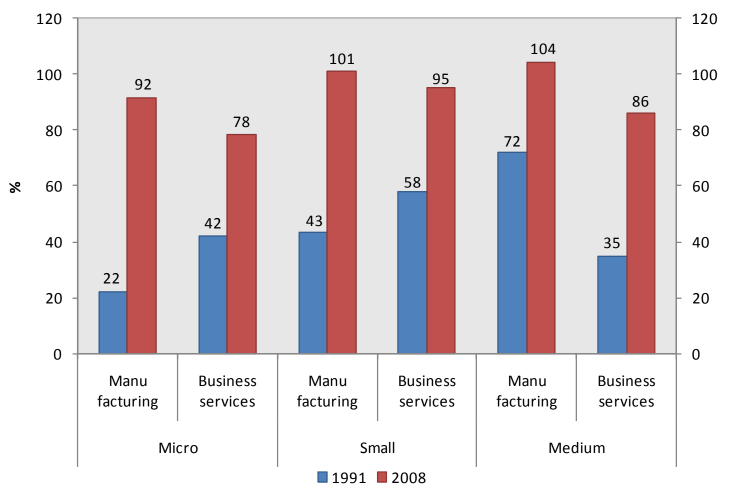
Chart 23: Relative importance of market demand and cost of finance constraint by size - 1991 and 2008 surveys compared (%)



The analysis presented here calculates for each period the relative importance of each constraint. Therefore, in Chart 23 we find that the market demand constraint was regarded as 47% higher than the finance constraint cost in 1991.

Chart 23 compares this measure of relative constraint in the two periods for all firms and for each size class. We can see that the demand constraint is regarded as more important in both recessions, but its relative importance is twice as large in 2008.

Chart 24: Relative importance of market demand and cost of finance constraint by size and sector – 1991 and 2008 surveys compared (%)



The much higher relative importance of the demand constraint in the current recession is found to be the case in each size group, but the contrast is most stark in the smallest size category.

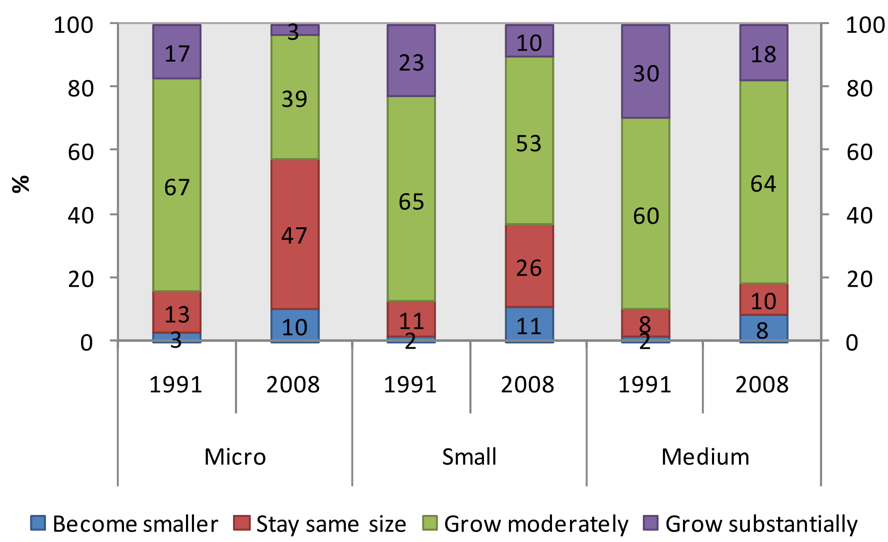
Chart 24 takes this further by looking at these size cuts within sector.

This confirms that the relative importance of the demand constraint has risen in each case when comparing the current recession with 1991. In 2008, the relative importance of the demand constraint is larger for manufacturing than for business services, but the difference between the two sectors in this respect has become much less in the current recession.

Growth Objectives

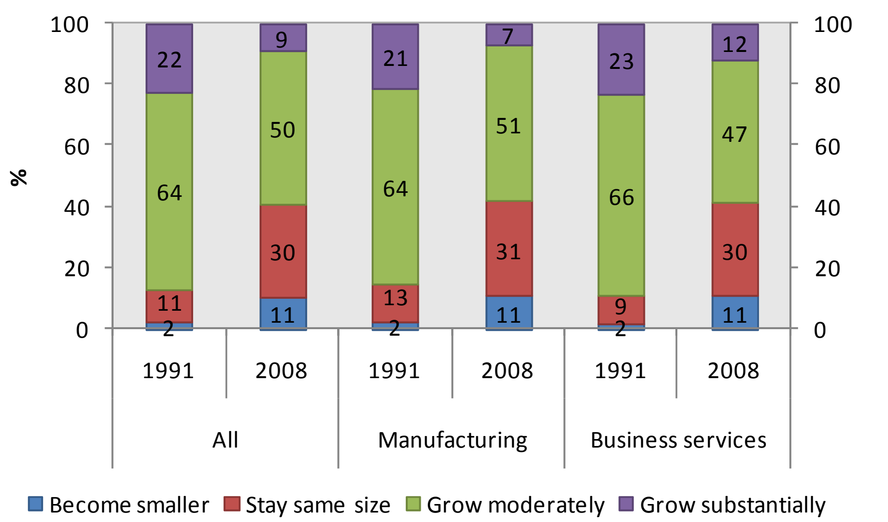
The final comparison that is possible with the 1991 survey concerns growth ambitions for the next three years. This is important since it provides a measure of the potential resilience of the SME sector. Chart 25 examines this by size groups.

Chart 25: Growth objectives by size - 1991 and 2008 surveys compared (%)



On the positive side, at the end of 2008, the proportion of firms seeking to grow over the next three years is 42% for micro, 63% for small and 82% for larger SMEs. On the other hand, in each case these are very much lower than in 1991 and there is a worrying increase in the proportions expecting to shrink in size.

Chart 26: Growth objectives by sector - 1991 and 2008 surveys compared (%)



Finally, Chart 26 explores the issue of sectoral differences.

This shows that, as was found in 1991, the differences in growth ambitions between sectors are less striking than those within sectors over time.

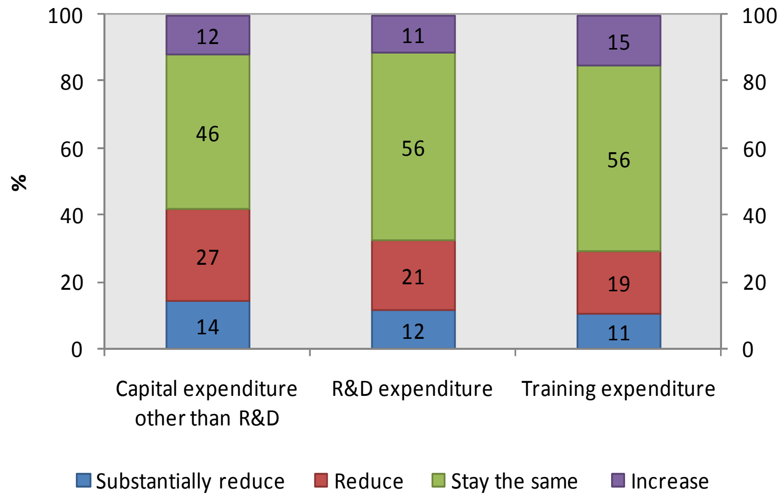
THE CREDIT CRUNCH: INNOVATION

The main thrust of our analysis so far has been on the financial characteristics of SMEs and the impact of relevant policy. The final significant contribution made in this report derives from our ability to comment more directly on those elements of business behaviour which relate to innovation and growth.

We do this both by reporting on what effect the current crisis is likely to have on innovation expenditures and by looking at its impact on particular types of firms. This report focuses on two comparisons: innovative firms (in 2004) versus non-innovative; and fast growth (since 2004) firms compared with the rest. The impact of the credit crunch and recession on these two groups is of particular importance to the future health of the SME sector.

Impact on Innovation Expenditures

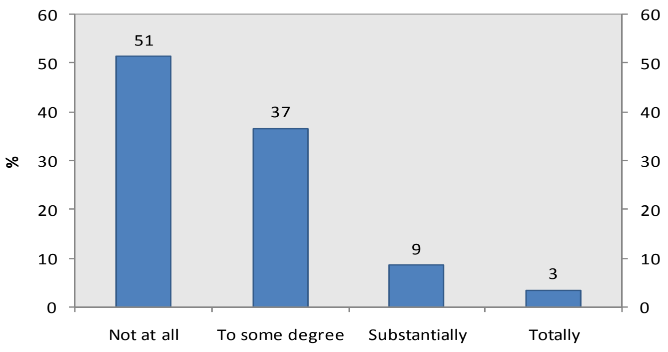
Chart 27: Expected change in expenditures compared with last year (%)



The firms were asked to compare their expected expenditure in three areas this year compared with last year; and the findings are shown in Chart 27.

It shows that about half are likely to maintain their expenditures on R&D, other capex and on training. Increases in these areas are expected for 11-15% of the sample.

Chart 28: Extent to which expectations about expenditure are the result of the cost and availability of finance (%)



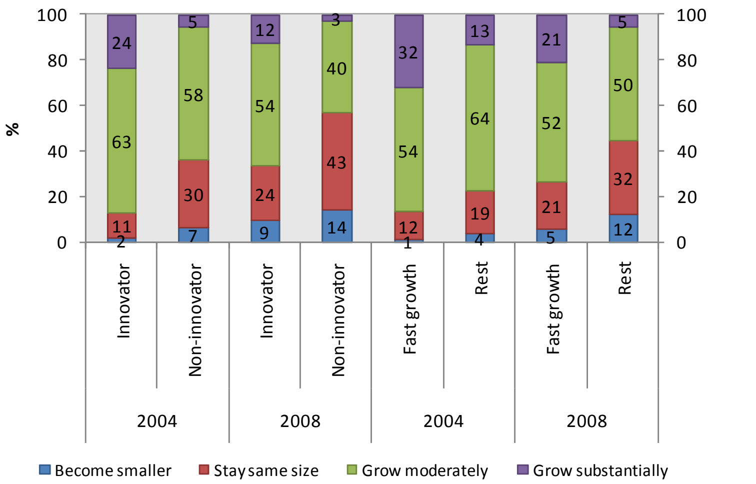
Training and R&D were said to be likely to fall by about 30% of the firms, but over 40% said that other capital expenditure would fall. This was to be expected given their concerns about demand.

Chart 28 shows that over half said that this was not due to a finance constraint. Indeed, only 12% said that their planned innovation expenditures were substantially, or totally the result of financial constraints.

Growth Ambitions

The comparison of growth objectives over the following three years is shown in Chart 29 for both the 2004 and 2008 surveys.

Chart 29: Growth objectives over the next 3 years by innovation and growth categories - November 2004 and November 2008 (%)



Taking first the comparison of innovators with non-innovators on the left-hand side of the chart we can see that in both periods the innovators are more growth oriented. However, the 2008 survey shows that 9% of the innovators now expect to shrink in size. On the other hand two-thirds expect to expand.

Fast growth firms show much the same pattern as innovative firms and about three-quarters of these still intend to grow over the next three years.

Demand and Finance Constraints

Chart 30: Limitations on ability to meet business objectives by innovation and growth categories (2008 survey, %)

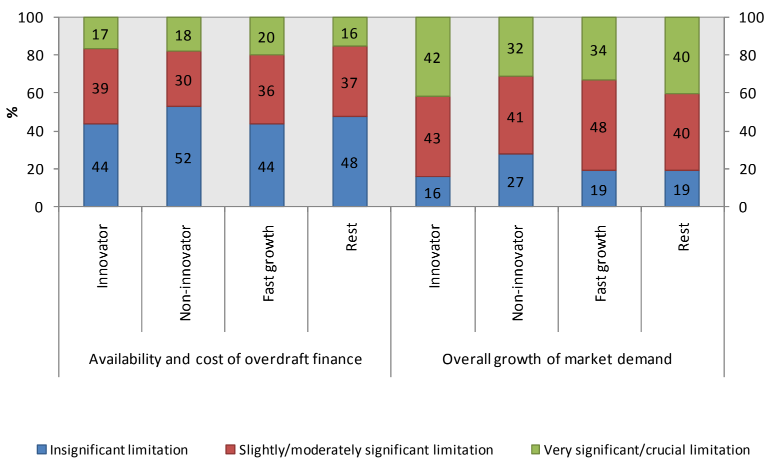


Chart 30 examines the constraints facing these groups of firms at the end of 2008.

We find no significant differences between the groups for the finance constraint. This is significant for between 16% and 20% in each group.

The growth of demand is a greater constraint than finance in each case, but appears to be greatest for innovative firms and less for fast growth firms. We now turn to examine the finance constraint in more detail.

Ease of Obtaining Finance - Innovators

Charts 31 and 32 examine the ease of obtaining various forms of finance and distinguish between innovative and non-innovative firms.

Chart 31: Ease of obtaining types of finance compared to 3 years ago by innovation category (2008 survey, %)

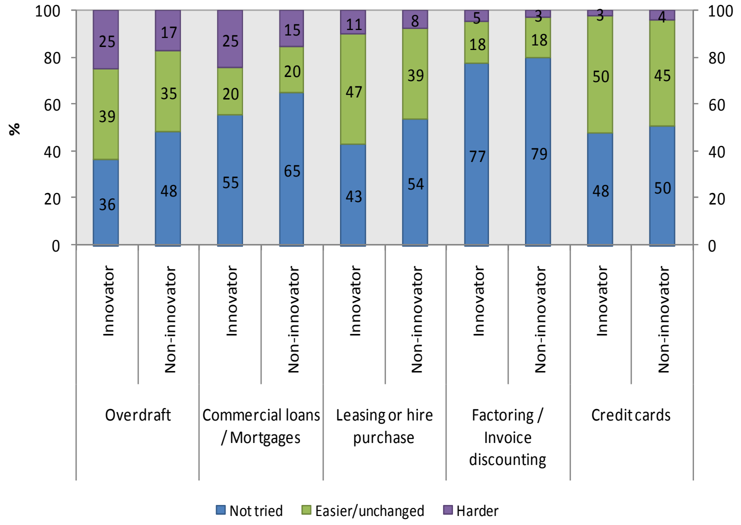


Chart 31 shows that innovative firms were more likely over the past three years to have used every form of finance other than factoring and invoice discounting and credit cards. 64% of innovative firms used overdraft finance, 45% used term loans and 57% used leasing compared with 52%, 35% and 46% respectively for non-innovators.

Chart 32: Ease of obtaining types of finance compared to 3 years ago of those who tried by innovation category (2008 survey, %)

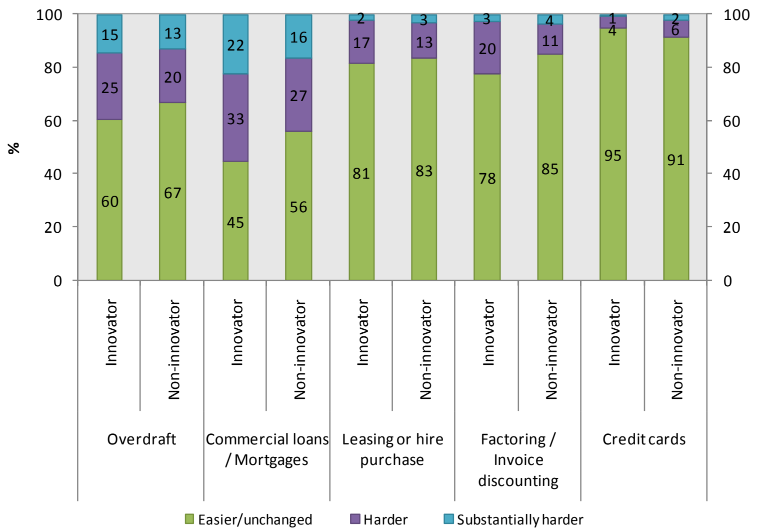


Chart 32 examines whether the ease of raising these types of finance had changed.

It shows that innovative firms have found it somewhat harder to raise most forms of finance, but the differences are not found to be statistically significant.

Despite this, even for innovators, the majority of firms have not found it harder.

Ease of Obtaining Finance – Fast Growth Businesses

Chart 33: Ease of obtaining types of finance compared to 3 years ago of those who tried by growth category (2008 survey, %)

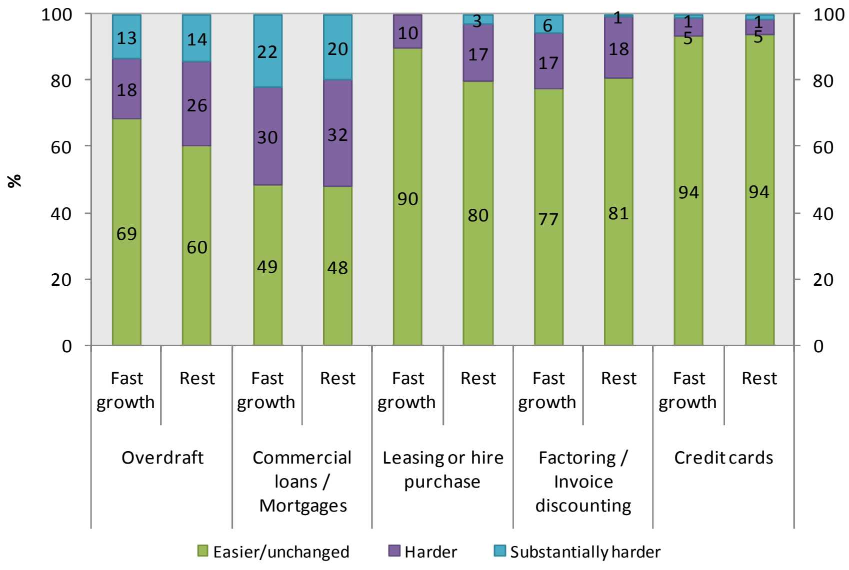
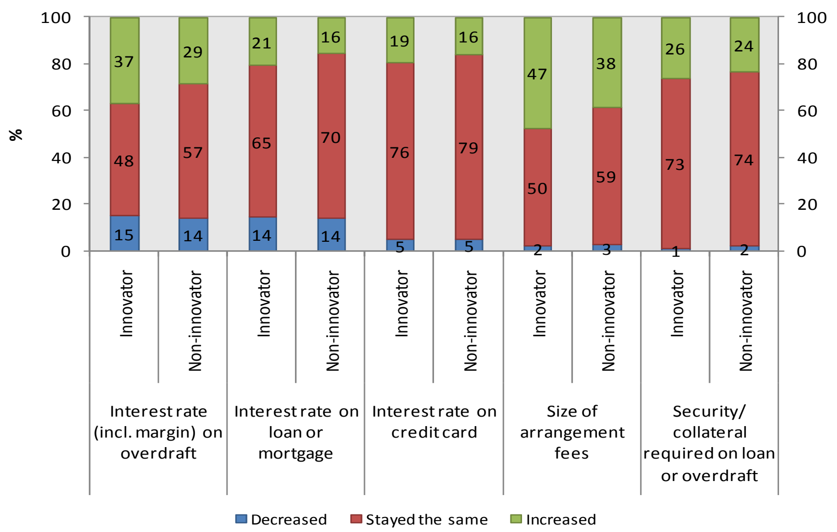


Chart 33 examines the ease of obtaining various forms of finance and distinguishes this time between fast growth and other firms. As we would expect, we find that fast growth firms were more likely to use each type of finance over the last three years. Chart 33 shows that fast growth firms have found it easier than other firms to raise overdrafts and leasing finance.

Cost of Finance

Chart 34: Changes in the cost of finance in the last year by innovation category (2008 survey, %)



Turning from the ease of obtaining finance to its cost, Chart 34 shows that there appears to have been a differential impact on innovators. A higher proportion of them have faced an increase in costs and fees, possibly due to the higher risk profiles of innovative firms.

Chart 35: Changes in the cost of finance in the last year by growth category (2008 survey, %)

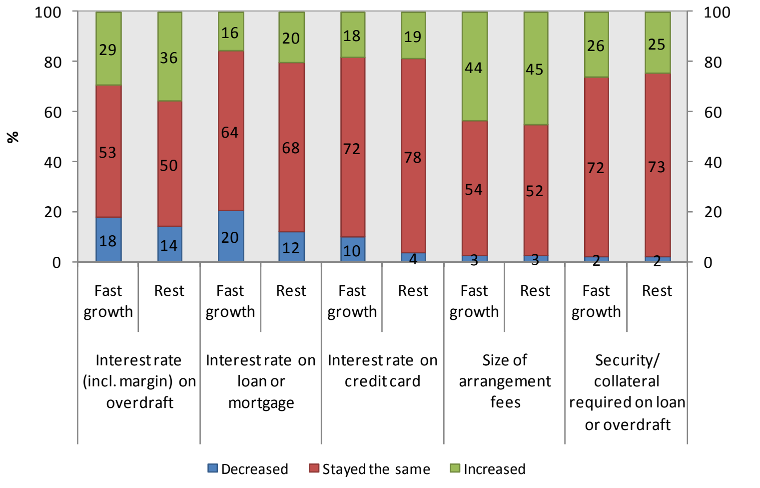
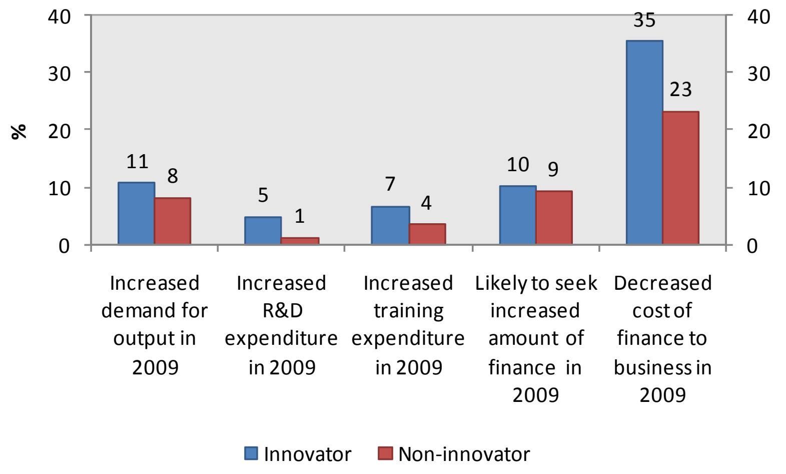


Chart 35 shows that this has not been the case for fast growth firms, which are having a marginally easier time than other firms.

Policy Impacts

Chart 36: Perceived effect of the November cut of 1.5% in the Bank of England's base lending rate by innovation category (2008 survey, %)



Charts 36-39 explore reactions to policy measures by these key groups of firms.

The charts compare the proportions showing positive responses.

Looking first at Chart 36 we see that the key difference is that innovators are more optimistic about the impact of the November base rate cut on the cost of finance than non-innovators. That they were more likely to have suffered rising costs was noted above.

Chart 37: Perceived effect of the November cut of 1.5% in the Bank of England's base lending rate by growth category (2008 survey, %)

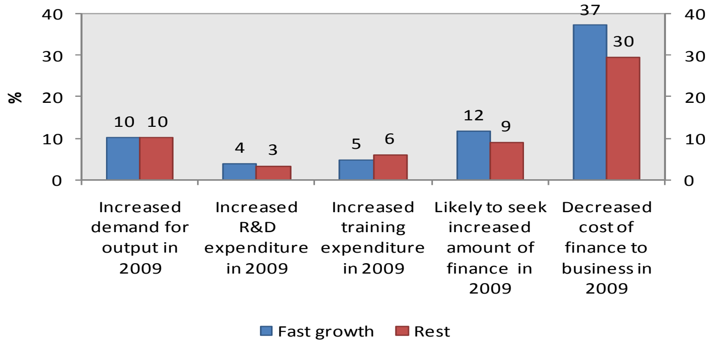
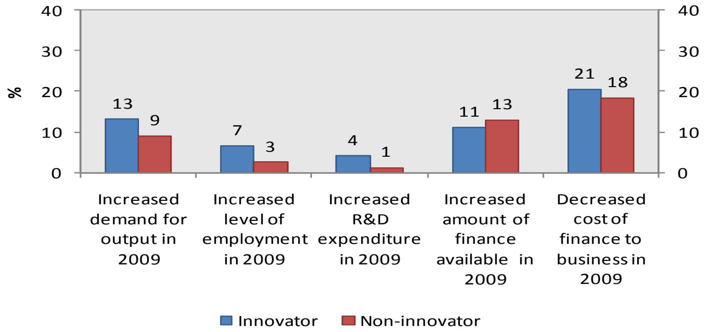


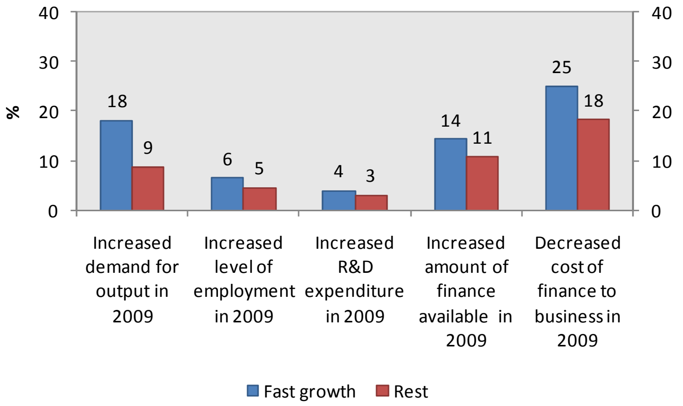
Chart 37 examines the impact of the 1.5% base rate cut on fast growth firms. The differences from other firms are not noteworthy other than the cost of finance. Like innovators, fast growth firms were more optimistic than other firms about the impact of the cut on finance costs.

Chart 38: Expected impact of Pre-budget Report changes to aspects of business in 2009 by innovation category (%)



Turning to the PBR, Chart 38 shows that innovators are generally more optimistic than non-innovators about the improvement to their prospects. An exception is the amount of finance available – they continue to be negative about the ease of raising finance. However, all the differences are small and insignificant.

Chart 39: Expected impact of Pre-budget Report changes to aspects of business in 2009 by growth category (%)



The differences are greater when we compare the response of fast growth firms to the Pre-budget Report with the rest. Fast growth firms show a much more positive reaction to the PBR. 18% think it will improve demand, 14% think it will increase the supply of finance available and 25% of these key firms think it will reduce the cost of their finance.

SUMMARY CONCLUSIONS AND POLICY ISSUES

Short Term Impact of the Recession and the Financial Crisis

Our analysis has shown a substantial decrease in the growth ambitions of small and medium sized enterprises in 2008 compared to 2004. The proportion of firms seeking to grow has halved from 18% to 9% between those years. Even so a substantial proportion do intend to grow over the next three years. Our analysis shows that as might have been expected given current financial circumstances, financial constraints reported by businesses on meeting their objectives were higher in 2008 than in 2004. But the percentage of firms reporting finance as a significant or crucial constraint still remained below 20% in 2008. Much more significant has been the increase in the extent to which businesses in this sector regard demand constraints as a very significant or crucial restraint on meeting their business objectives.

We also found that in general those firms that were seeking finance were not reporting significant increases in the difficulty of obtaining it compared to three years ago. For example, 82% of the respondents said that leasing and hire purchase finance was not more difficult to obtain than before and over 60% reported the same conclusion in relation to overdrafts and grants. However, a majority reported that it was harder or substantially harder to obtain commercial loans or mortgages. Moreover, the percentage of finance which was sought which was obtained declined from 78% to 55% and the costs of obtaining finance had also risen substantially in terms of arrangement fees and the security of collateral required. We also found substantial tightening in the market for trade credit and that the time spent on assessing credit worthiness by businesses had risen significantly.

When we looked at the responses of the sample as a whole to the impact of interest rate cuts and the pre-budget report announcements we found that in the short time available between these announcements and our survey the firms showed little indication that as a group they were likely to significantly change their expenditures and output growth. The vast majority of firms reported that they expected little impact. This was so even though a substantial proportion thought that the likely impact of the interest rate changes, for example, would be to lower the cost of finance to businesses in 2009. In general larger firms felt more positive about the likely impact of the PBR on their capital expenditure, R&D and cost of finance.

Longer Term Comparisons

Our analysis of the current recession and financial crisis with the recession of the early 1990s was particularly revealing. First, it showed that the pressures on trade credit arrangements were not as bad as those experienced in the recession of 1991, even though that recession proceeded less rapidly. Of much greater significance is our finding that when we compare the cost of finance relative to demand as constraints on firms' ability to achieve their business objectives, it is demand which is relatively far more important in the current recession than in 1991. There are a number of reasons for this. First, interest rates were at exceptionally high levels in 1991 and concerns about the cost of finance therefore much more likely to be significant than in the current situation. The contrast between the practice of monetary policy in 1991 and the current active attempts to lower interest rates to encourage expansion is notable. Second, the much more rapid decline in demand in the current recession has placed that of central importance in how businesses perceive their ability to meet their objectives.

We also found that despite the severity of the current recession and the depth of the financial crisis a higher proportion of firms were expecting to expand in the coming years. In this sense the business population response suggests a more resilient frame of mind than was the case in 1991.

Innovation, Growth and the Credit Crunch

When we analysed the sample as a whole and focused on innovation expenditures we found that training and R&D expenditures which have long term benefits were suffering in the face of recession. Whilst there was evidence that this would be the case for a substantial proportion of our firms, our results also indicated that about half of the businesses indicated that they were likely to maintain their expenditures and R&D and on training. Moreover, the extent to which those businesses expecting their expenditures to fall and who said this was due to problems arising from the cost and availability of finance, was very low. Only 12% of firms thought that the cost and availability of finance lay behind their expectations of lower expenditures. This again highlights the extent to which financial conditions *per se,* in the current situation and given the current package of policies in place, is not seen as the fundamental problem.

When we disaggregated our 2008 sample into innovative firms compared to the rest and fast growth firms compared to the rest a number of important conclusions emerged. This analysis shows the significance of analysing the SME sector in a disaggregated way, since movements in the group as a whole conceal important differences. Fast growth and innovative firms show considerable resilience. Thus over two thirds of innovating firms expect to expand over the next three years and the same is true for fast growth firms. For both groups demand is perceived to be a much greater constraint than finance. Nor does it appear that innovative firms are particularly more likely to have found it more difficult to obtain finance compared to three years ago. A majority of such firms have not found it harder to obtain funding. An important result emerges when we look not just at the ease of obtaining finance but at its cost. In this case it appears that the innovators are likely to experience higher costs. To the extent that this reflects an increase in risk aversion in lending in current economic circumstances, then a particular problem may arise for this important group of firms simply as a result of the desire of funders to reduce their overall risk profile in current economic and regulatory conditions. This is an important issue for policy to address.

In terms of policy impacts our disaggregation into innovating and growth firms is also revealing. The fact that innovators were likely to report having paid higher costs of finance in 2008 than in prior years is consistent with our finding that they were also more optimistic that the cuts in interest rates in November would be of benefit to them. The extent to which the cuts in base rates are actually being translated into lower funding costs for innovative businesses is therefore an important question to address. As was the case with innovative firms we also found the growing firms were likely to be optimistic about the impact of the interest rate cuts and the PBR.

Short Term Policy Implications

The first point to make is that public policy in the current financial crisis has produced a major programme of support for the banking sector and for the underwriting of a variety of forms of finance for small businesses. These have been outlined in our report and are well-known and in total provide in principle an unprecedented package of support on the supply of finance side. Key questions to address are the extent to which the delivery of the packages on the ground are able to achieve rapid traction and the way that banks are implementing the various schemes.

Of more significant concern is the extent to which given the substantial package of financial measures in place the reactions of the small and medium sized enterprise sector to them will simply be offset by their deep concern about the future path of demand. This suggests that for the financial package to be effective a parallel programme of fiscal and public sector activity to significantly boost demand will be required.

Our analysis reveals that within the small and medium sized sector as a whole, if we focus on innovative and fast growing firms, then it appears that they are relatively more optimistic about the future and the extent to which policy reaches and reinforces their relatively optimistic views is very important. This raises questions about the ability of lending institutions to both effectively identify and deliver appropriately costed financing packages for these firms upon whom the turnaround out of recovery might be expected to depend. This relates to a longer term set of issues about the organisation of finance for small and medium sized enterprises which we address in the next section.

Longer Term Policy Implications

One of the wider implications of the current financial crisis is the extent to which there are gains to be had in increasing the differentiation in the kinds of institutions which provide finance for the small business sector. The provision of small business finance and retail banking services is very highly concentrated in the UK, although there is evidence that until the crisis struck overseas, e.g. Irish banks were making inroads into loans for larger SMEs. This concentration may reflect the advantages to be had in scale and expertise in providing finance and retail services to the large and heterogeneous small business population in the UK. However, the vulnerability of that system to the globalisation of financial markets and the diversification of banking institutions across a wide range of activities has led to the well-known problems currently under discussion in restructuring international and national systems.

We would argue that in these discussions attention should be paid to a variety of institutional possibilities which may lead to a closer level of interaction and information flows between small businesses and those institutions providing them with finance and retail banking services.

We suggest two institutional possibilities for further discussion. The first is the creation of more locally based lending and retail service institutions. There is already, for instance, discussion within the Cambridge sub-region about the creation of a Cambridge Bank. This may strengthen the quality of information flows upon which decision taking can be based, linked to a detailed knowledge of specific locations and associated sectoral specialisation. Second would be the creation through the current public sector holdings in commercial banks of a specialised small business lending programme focused on the provision of finance for the sector. One possibility would be for this government backed small business loan programme to be delivered through the existing banks retail outlet structure. Another would be to use another existing network (e.g. the Post Office) to deliver a government backed small business finance and retail service. In either case consideration could be given to using the current public sector holdings in banks in a creative way to release assets to establish a more specialised small business finance function.

Furthermore, in view of the extent to which the conventional shareholder based model for financial institutions has come into question, consideration should be given to enhanced support for existing mutual organisations and for the creation of new ones. Their role in resurrecting the market for housing finance also merits attention. Reviving the property market is in itself a key element in restoring small business collateral and access to the credit market.

Venture Capital and the Public Sector

In this report we have focused on the firms for which we can obtain large scale quality responses to the current financial crisis. We have not addressed the important issues which arise in relation to new business formation in high technology and related high risk environments. This question, which relates to the operation of the venture capital market, is also one in which the role of the public sector is important. In this case the role of the public sector is twofold. First, there is the potential for public procurement of R&D contracts by developing an effective SBIR programme. Second, there is the need for a careful review of the relatively rapid recent growth of public/private venture capital support for early stage knowledge-based businesses in the UK. One of the least heralded but most important changes affecting the venture capital market in the UK after the dot.com bubble burst in 2001 has been the extent to which the supply of early stage technology based private sector venture capital on its own has remained stagnant or declined whilst the growth of co-founded public and private sector initiatives has increased. Understanding the potential role that these co-funded initiatives may play and the constraints on their success is also an important long-term policy issue.

The current economic and financial conjuncture has created the possibility of major institutional changes with long-tem implications. It is important not to lose sight of the long-term in the necessarily important current focus on the short-term crisis.

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THE CBR 2008 SME SURVEY

The starting sample for this survey was those firms who had previously responded to the CBR 2004 survey. To begin with we found out the present status of the respondents. Table 1 shows that the potential sampling frame for the 2008 survey was 2137 firms. Of these, 193 had failed and 19 were acquired. This left a final sampling frame of 1925 firms.

Table: Survey response		
Potential sampling frame for 2008 survey	2137	
(less failed or acquired firms)		
Total number of firms failed 2004-08	193	
Acquired and stopped trading	19	
Final sampling frame for total 2008 survey	1925	100%
Refusals	15	0.8%
No response	1055	54.8%
Total number of non-respondents	1070	55.6%
Total usable responses	855	44.4%

From this sample of 1925 we received 855 usable responses, giving a response rate of 44.4%. This total includes those firms stating that they were subsidiaries but these are excluded from the analysis presented here.

The Questionnaire

The questionnaire covered the following main areas: general characteristics of the firm; relationship with finance providers; relationship with suppliers and customers; and advice and public sector policy. A separate ‘Stop Press’ sheet inserted after the Chancellor’s Pre-budget Report asked about opinions on the new measures and their impact on various aspects of business. There were 33 questions, giving a total of 85 variables.

The Survey Process

The survey period ran from mid November 2008 to mid January 2009. A letter and questionnaire were sent to the managing director, partner or proprietor of each firm. Two reminder letters with another copy of the questionnaire were sent at two week intervals to those firms that did not respond. The letter stated that for each returned completed questionnaire, a donation of £2 would be made to one of three charities, Oxfam, UNICEF or Shelter. The respondent was invited to select which of these three charities they would like to receive the donation. The totals donated were Oxfam - £500, UNICEF- £430 and Shelter - £620. Some respondents did not nominate a charity and in these cases no donation was made.