Access to Bank Finance for Scottish SMEs
ACCESS TO BANK FINANCE FOR SCOTTISH SMEs

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It should be noted that since this research was commissioned a new Scottish government has been formed, which means that the report reflects commitments and strategic objectives conceived under the previous administration. The policies, strategies, objectives and commitments referred to in this report should not therefore be treated as current Government policy.
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EXECUTIVE SUMMARY

Introduction

The purpose of this research has been to investigate further the difficulties that a significant minority of Scottish SMEs that took part in the 2005 and 2006 Annual Small Business Surveys (ASBS) (Scotland) reported in accessing finance from banks. Just under a third (29 per cent) of SMEs in the 2006 survey had sought external finance for their business in the previous twelve months, just under a quarter of whom (24 per cent) reported problems. Specifically in relation to bank finance, just under a fifth (19 per cent) of all surveyed SMEs had sought bank finance, with about one in eight of these (12 per cent) reporting problems.

The key question at the heart of this research is whether Scottish SMEs are experiencing difficulties in accessing bank finance because of the unsuitability of the business case that they are putting to finance providers (i.e. demand-side issues), or whether the difficulties result from sub-optimal lending practices, resulting in some potentially viable proposals being rejected (i.e. supply-side issues).

The research aimed to provide detailed insight into the demand and supply-side processes relating to SME bank finance in Scotland, building on the limited information provided by the ASBS for Scotland in 2005 and 2006.

Methodology

The research involved a multi-method approach, comprising of:

(i) An analysis of the ASBS (Scotland) survey data for 2006;

(ii) An extended telephone survey of 51 owner-managers of SMEs reporting difficulties in obtaining finance, drawn from the 2005 and 2006 ASBS (Scotland) respondents;

(iii) Selective in-depth case studies, involving the seven most likely examples of market failure, from which detailed borrowing scenarios were re-created;

(iv) Assessment of the seven case study scenarios by a bank lending expert who narrowed them down to five cases that were suitable for the protocol analysis that was to be used in the interviews with bank managers;

(v) Face-to-face interviews with eight bank managers, at different seniority levels, within three of the four major Scottish commercial banks. Protocol analysis was used to re-assess the five selected case scenarios, to yield information on the processes decision-makers use in banks, how loan applications are dealt with and the main reasons for acceptance, referral within the bank and rejection.
Demand-side Business Survey Findings

1. Thirty-nine of 51 surveyed SMEs experienced problems accessing bank finance. These were typically well established businesses that were growth seeking and disproportionately from the manufacturing, retailing, wholesaling and hospitality sectors.

2. The most frequently mentioned financial constraints were lack of development finance, particularly affecting manufacturing firms, and cash-flow problems, particularly affecting the retail and hospitality sectors.

3. The median project cost for finance sought was £105,000. On average, 81 per cent of the project cost was sought from external sources. However, the scale of borrowing requirements amongst the surveyed businesses ranged from £5,000 to £80 million.

4. Two-thirds of businesses seeking bank finance also considered alternative sources, with around half of them actually approaching alternative sources, mainly for grants, soft loans and equity finance (for some larger firms).

5. There is some evidence of a perceived ‘gap’ in the equity investment market for finance of up to £1 million due to the lack of interest from equity investors for investments below the £1 million threshold and, according to owner-managers, the cautious and risk averse approach of the banks.

6. A striking finding is that almost two thirds of the businesses approached only one bank, typically their existing bank, and did not ‘shop around’ once their application for finance had been rejected. This may suggest concerns about the time and resources involved in approaching other banks, uncertainty in approaching banks with which they were not familiar, or a ‘discouraged borrower’ effect. Supply-side banking interviews indicated that difficulties are more likely to be encountered by ‘new to the bank’ customers - relationship banking suggests that the existing bank is likely to be more sympathetic to funding requests.

7. Just over half of those businesses seeking bank finance had their application turned down. The less successful applicants for bank funding tended to be: manufacturing firms; businesses operating at a loss; businesses seeking smaller scale loans; projects relating to working capital requirements (typically overdrafts and small scale loans); and projects related to new products and market development (typical of manufacturing firms).

8. Half of businesses used external assistance with their loan application: one third from accountants and one fifth from either Business Gateway or Scottish Enterprise (typically larger firms seeking equity finance). A number of firms complained about the cost of accountancy and consultancy advice required in order to support bank loan applications, which cost around £2,000 in some cases.

9. A number of owner-managers were in favour of banks providing a broader range of SME advisory services and nearly one fifth mentioned that they would like to see banks becoming a one-stop-shop for all sources of business finance.
10. Almost one third of the businesses that were unsuccessful in obtaining bank finance indicated that a lack of collateral and/or lack of trading record were the main reasons for not receiving a bank loan, whereas less than a fifth of them mentioned providing an insufficient business case as the reason for rejection. Some businesses complained about receiving inadequate feedback from the bank as to why their application was unsuccessful.

11. A major area of criticism amongst two-thirds of the businesses that had problems accessing bank finance focused on the applications process. Complaints included: delays in the decision making process, misleading information (particularly about overdraft facilities and differences of opinions between local and centralised levels of the banks) and that there was no link between bank finance and alternative sources of finance.

12. Two-fifths of applicants for bank finance took more than six months to get a final decision. Delays were caused by referring applications to centralised teams and bureaucratic procedures.

13. A number of owner-managers referred to specific difficulties in obtaining overdraft facilities, particularly for new businesses in the retail and hospitality sectors. Some claimed to have initially been offered overdrafts at start-up, but were then unable to obtain them once they had started trading.

14. Despite the difficulties they encountered, over half of the SMEs were eventually able to undertake the whole project that they had required funding for and a further eighth to partially deliver projects. Just under a third were unable to go ahead with the project because of lack of funding.

Supply-side Bankers Interview Findings

Key findings from the protocol analysis of five case studies and the analysis of bank lending processes with bank lending officers and key informants provide the following overall conclusions:

15. Bank managers place heavy reliance on personal relationships and knowledge of SME business owners, building up relationships over a period of time. They are prepared to invest considerable time, visiting premises and becoming familiar with businesses.

16. A primary requirement for any proposition from either existing or new business customers is to understand the nature of the proposition and the serviceability and sustainability of the proposed venture. Thus, it is easier for existing business customers to seek funding, particularly where this might fall outside established ‘norms’; for example, for highly geared propositions.

17. Banks have standard financial ‘models’ that are followed in terms of financial requirements, although there may be considerable discretion exercised by individual bank managers, dependent on seniority. In addition, it was clear that bank managers would, as far as their discretion allowed, seek to support established businesses with which they have an established personal relationship.
18. The financial modelling process indicates the strength of the proposition in terms of risk/reward, but with latitude for bank managers to use discretion. However, given the segmentation applied by the banks, it will be easier for larger SMEs to obtain funding. Micro and small firms are more likely to have their propositions credit-scored, reducing the extent of bank manager discretion and flexibility.

19. Entrepreneurs seeking to start new businesses will find it more difficult because of the lack of any trading history. In such circumstances previous experience, age and credit history of the entrepreneur will be important.

20. Credit-scoring may limit the flexibility of bank managers, especially as such proposals are referred for final approval to a central credit department. Propositions that do not match bank preferences and modelling requirements will be difficult to support.

21. Although no sectors are excluded by the banks, SMEs in competitive sectors may find it difficult to raise finance, especially if they are operating in ways that do not fit the banks’ own internal guides on benchmarking for the sector.

22. Rural locations can be difficult environments for SMEs, having limited local markets and limited networks and resources. Large areas of Scotland, the Highlands and Islands and the South of Scotland, qualify as rural under Scottish Government definitions. SMEs in such localities seeking to grow and raise finance may find it difficult to raise bank finance, especially if reliant on local and regional markets.

23. Security is a secondary factor, but nonetheless important. Established SMEs with limited security will find it difficult to raise finance for propositions that contain higher risk or do not meet banks’ financial modelling requirements. Changes to the Small Firms’ Loan Guarantee Scheme under the Graham Review, has meant that the banks have in some cases reduced their use of the Scheme, moving from ‘occasionally’ having referrals under the Scheme to ‘rarely’.

Is there Evidence for Market Failure?

24. Taking the ASBS (Scotland) 2006 survey as a whole, only a small minority of businesses that experience problems in accessing finance (3.4 per cent of 1014 surveyed businesses) had approached banks for finance.

25. The ASBS (Scotland) data also show that 1.6 per cent of SMEs that were unable to go ahead with investment projects in 2005-06 because of problems in accessing bank finance, suggesting that even in cases where bank finance was refused, many firms were able to find other ways of funding their projects.

26. Twenty SMEs in the business survey received no bank funding and these are the focus of attention in assessing the extent of supply-side market failure relating to the banks.

27. Almost two-thirds of the owner-managers of these SMEs believed that they had been rejected because of lack of collateral and trading status, whilst around one third believed that they had been rejected due to the bank’s concerns about the business
case that they were putting forward. From these latter cases the five scenario cases forming the basis of the interviews with the bank managers were selected as the strongest cases of potential market failure.

28. Of these five, it is significant that there were only two that the interviewed bankers considered were worth serious consideration and likely to be supported, since the others raised too many concerns about financial and strategic management issues. Furthermore, of these two, one did actually receive the funding it was seeking by ‘shopping around’ the banks.

29. This leaves just one case that was actually turned down for finance that would appear to be an example of supply-side market failure. The protocol analysis conducted with bank managers would appear to show that there were very few SMEs from the 20 that were turned down for bank funding that might be considered ‘borderline’ cases. For the rest, it was not difficult for the researchers to understand why the applications for finance had been refused.

Conclusions

Although there is very little evidence from this research to support the market failure argument, the research has nevertheless identified a number of problems in the relationship between banks and SMEs which need to be addressed. In particular:

30. There are clearly a number of difficulties experienced by manufacturing businesses that relate to the problems of financing new product and market development and investing in upgrading plant and machinery. The owner/managers of manufacturing businesses frequently criticise the banks for being risk averse and having difficulties understanding the nature of their business.

31. One of the most common criticisms of the banks by SMEs is the length of time that it takes to come to a decision and how initially favourable indications at the local level can be misleading when the application is later rejected at a higher level within the bank. The research identified a number of cases where the application for bank funding was in the end successful but where the delays on the part of the banks were at a cost to the businesses they were servicing.

32. There were very few start-up firms in the ASBS survey which was the primary data source used for this research so they are under-represented in this study. More work is therefore needed on the relationship between start-up businesses and banks and the extent to which market failure may be occurring here. The interview conducted with the PSYBT indicated that young entrepreneurs are facing gaps for relatively small amounts of funding as well as perceived problems in obtaining funding from external sources.
Aim of the study

1.1 One of the most consistent themes in discussions about small business finance in the UK is whether or not there are ‘gaps’ in the market that justify intervention (Storey, 1994). It is sometimes suggested that finance providers are not providing the finance that small businesses need to fund their development and growth and that supply-side failures do exist, particularly relating to certain types of businesses (e.g. new firms and rapidly growing young firms). However, such views frequently rely on rather anecdotal and partial evidence. This study is concerned with acquiring more robust survey data in order to establish whether or not there is evidence of market failure in the provision of finance to Scottish SMEs.

1.2 In particular, the purpose of this research is to investigate further the difficulties that a significant minority of Scottish SMEs that took part in the Annual Small Business Survey (ASBS) (Scotland) reported in accessing finance from banks. The research was prompted by results from the 2005 ASBS survey which showed that, out of the 1002 SMEs that took part in the survey, 11 per cent of them sought finance in the 12 months prior to the survey and just under a quarter of these reported experiencing problems accessing finance. The firms experiencing difficulties were more likely to be proposing to grow, with younger businesses (less than four years old) being proportionally more likely to face problems. The ASBS produced some insights into the reasons for the difficulties, the most frequently cited reason being insufficient security (particularly in the case of micro-businesses); poor business performance/profit margins; no credit history; wrong business sector; and poor personal credit history. However, more evidence is required on the reasons for experiencing difficulties because of the small number of firms answering this question in the survey. Moreover, there is very little evidence in the ASBS survey relating to the sources of finance used by SMEs. Hence the purpose of this study is to explore the reasons for the difficulties that small businesses experienced in greater depth, focusing particularly on access to bank finance.

1.3 The key question at the heart of the research is whether firms are experiencing difficulties because of the unsuitability of the business case that they are putting to finance providers (i.e. demand-side issues), or whether the difficulties result from sub-optimal lending practices, resulting in some potentially viable proposals being rejected (i.e. supply-side issues). This requires knowledge of lending practices, including credit scoring methods used by the banks, and their implications for different types of small business, as for example differentiated by sector, size, age, and gender of the owner. The principal focus of the study will be bank lending to small firms, since evidence shows that commercial banks are the main source of loan and debt finance for SMEs, including a previous Scottish Government study of issues affecting SME financing decisions (Hamilton et al, 2002).

Existing Research

1.4 Before presenting the findings of the study, it is helpful to highlight some of the issues relating to bank finance and SMEs that have been identified in previous studies (for a recent review of much of the literature relating to the difficulties of accessing finance by SMEs see CEEDR (2007)).
Demand-side issues

1.5 Whilst overall the majority of SMEs appear not to have difficulties obtaining external finance, there is evidence to indicate that a number of groups and sectors do face distinct challenges in accessing finance. Existing research evidence indicates that dissatisfaction with the availability of loan finance and overdraft finance from banks is greatest among the youngest and smallest firms (e.g. FSB, 2002). High levels of dissatisfaction with bank finance have also been found amongst women entrepreneurs (Fielden et al, 2003), which may reflect the fact that they do not necessarily fit the normal business owner stereotypes of bank lending managers and that they invariably run low tech enterprises in the personal service sectors. Compared to men, women perceive risks differently and are less inclined to use their own house as collateral (Wilson, 2007).

1.6 There is also evidence to indicate that Black and Minority Ethnic Businesses (BMEBs) are more likely to experience difficulties in accessing external finance than non-BMEBs, and particularly those from the Afro-Caribbean community (British Bankers Association, 2002; Small Business Survey, 2006). In Scotland, research has shown a marked reluctance amongst Scottish BMEBs to approach or attempt to use bank finance, even amongst second generation owners (Deakins et al, 2005).

1.7 Much of the existing research on the relationship between banks and small businesses draws attention to the problems of information asymmetry. For example, a study of micro-enterprises (Lean & Tucker, 2000) found that whilst two thirds of them relied on bank overdraft facilities, many of the difficulties that were encountered revealed that financial providers had a lack of knowledge about the nature of the client’s business on the one hand, and that many business owners had a lack of knowledge about the lending criteria and procedures of the banks on the other. As far as the business owners were concerned, a lack of securable assets was the most frequently cited difficulty in obtaining bank finance. This study also suggested that trends in the banking sector such as market concentration and centralisation have compounded the problem of information asymmetry.

1.8 Furthermore, information asymmetry is particularly acute in new ventures. At this early stage information is limited and not always transparent (Hall et al, 2000; Schmid 2001) and assets are often knowledge based exclusively associated with the founding entrepreneur (Hsu, 2004). Within established businesses information is more efficiently transferred by, for example, an established track record and product branding, mechanisms not readily available to business start-ups. Actual and potential investors in start-ups work with less historic performance data on which investment judgements can be based and this issue is exacerbated because entrepreneurs possess a considerable informational advantage about the businesses for which funds are required. Entrepreneurs may be reluctant to provide full information about the opportunity because of concerns that disclosure may make it easier for others to exploit (Shane and Cable, 2002). Additionally, entrepreneurs seeking funding have an incentive to emphasise the strengths in a business proposal and to keep hidden what they know to be any flaws.

1.9 There is much debate to the exact nature of a finance gap but the perception of such a gap may reduce the willingness of SMEs to approach the banking network to secure appropriate financing. A report for the SBS (Allinson, 2005 p.3) commented: “if people do not present themselves to a financial institution in the first place, because of self-selection
and possibly underpinned by belief in a myth, then it may appear that the institutions’ rates of granting loans are quite high – that they are meeting demand.” This can lead to businesses seeking to ‘bootstrap’ rather than securing more appropriate financial packages. Typically these businesses become dependent on financial support from their own resources and family and friends. “But that leaves a problem for anyone with a viable proposition but without family and friends without any resources to help” (Irwin and Scott 2005 p.6). This scenario is a key issue for some businesses at the start-up phase, Fraser (2005) for example, found that obtaining finance is a major problem at start-up for 10 per cent of businesses: 11 per cent of businesses needing new finance experienced outright rejection; 19 per cent received less than they wanted; and 8 per cent felt discouraged from applying because they expected to be rejected. As Irwin and Scott (2005 p.7) comment: “These figures of course, disguise two problems – the businesses for whatever reason, are unable to raise finance and, perhaps more importantly, those prospective businesses that never actually start because they are unable to raise the finance.”

Supply-side issues

1.10 Some recent work on bank lending decisions, focused particularly on credit scoring, highlights the variability between lending officers working for the same clearing bank in the way in which they applied the same credit scoring framework (Wilson et al, 2006). Interestingly, it also showed the importance that was attached to the character of the business owner, compared with other factors such as collateral and capitalisation.

1.11 There is some evidence that accessing finance may be affected by differences in supply-side practices and policies i.e. in commercial banking policy (BBA, 2002), insofar as they affect the perceptions and attitudes of small business owners seeking to raise finance. For example, commercial banks differ in the extent to which relationship banking is applied to the small firms sector, with some differences in the extent of centralised decision-making, based on credit-scoring methods but with local relationship bankers working with small firm clients, compared with more localised systems of decision-making.

1.12 The extent to which banks work with intermediaries may also affect access to finance for some business owners (Watanabe 2005). For example, this may include referral from agencies or brokers. It is arguable that access to such networks may, in turn, affect access to finance through the ability to call on recommendations (Deakins et al, 2003).

1.13 A related and emerging issue in the literature is the discouraged borrower effect (Kon and Storey, 2003; Fraser, 2005), which can also affect attitudes to seeking finance and the approach to providers of finance. That is, some small business owners may not access finance because at some stage they are discouraged from applying. For example, it may be that some of those firms reporting difficulties may be discouraged from applying by ‘reputational’ effects (as sometimes happens with ethnic minority or women owners, who may be discouraged by perceived bureaucracy or financial requirements) or are discouraged by a first refusal. It has been suggested that banks with extensive and close relationships with some small firm communities may be able to overcome these adverse effects (Watanabe, 2005).

Market Failure

1.14 There is still some academic debate about whether there is still market failure in small firms’ access to finance (Bank of England, 2004). Market failure only exists if small firms
with viable propositions are unable to raise the amount and type of finance required. Market failure will always be a difficult issue to research, since judgements are required about the viability of propositions. However, the issue can be discussed in terms of access to sources of equity and sources of debt finance for small firms.

1.15 On access to equity, there is general agreement that there have been reductions in equity gaps over time. Although venture capitalists face cost issues in carrying out due diligence process for relatively small amounts of equity finance (below £250,000), a number of factors such as the development of business angel networks, the work of LINC Scotland and the success of the Scottish Co-Investment Fund (SCF) in Scotland have all contributed to increased availability of small amounts of venture finance, that is improvements in the supply of equity required by small firms. An indication is the success of the SCF which has provided 219 investments in 109 companies since 2004 (Scottish Government, 2008). In addition, on the demand side, improvements to the quality of business propositions have been possible by investor-ready schemes, better quality of advice and the focus of specialised support on the high growth firms that would qualify for equity finance. However, the former Small Business Service (now the Enterprise Directorate) review of evidence on access to finance suggested that “small businesses find it difficult to obtain modest amounts of private equity finance” (SBS, 2004). Thus, despite developments in the promotion of sources of informal venture capital, there is still some debate about whether there is market failure for small firms seeking venture finance below £200,000.

1.16 Access to debt finance is generally concerned with the ability of small firms to raise finance with the commercial banks. Market failure may exist if small firms are unable to access loan funding for the length of time required, assuming that propositions are viable. Commonly collateral will be required and market failure may also exist if business owners do not have the security levels required by commercial banks. As with access to equity finance, supply-side improvements have been made, for example in advice, making propositions more fundable and in awareness of the requirements of bankers to small firm owners and through greater emphasis by the commercial banks on relationship banking. The announcement by the Bank of England that it was no longer going to produce an annual report on the finance of small firms (the last year that the Bank produced its annual report was 2004) would suggest that the official view is that there are no longer significant issues for small firms in raising finance from the banks. However, some issues still remain that may indicate some continued market failure. For example, entrepreneurs from deprived areas will have limited security which can affect their ability to raise loan finance. The Small Firms’ Loan Guarantee (SFLG) Scheme is designed to tackle precisely this form of market failure and is discussed in more detail, when discussing findings from interviews with bankers later in the report (see section 6.5).

1.17 A separate issue relating to market failure, referred to above, is whether entrepreneurs may perceive difficulties with raising financing (CEEDR, 2007). Whether these difficulties exist or not, entrepreneurs may not seek finance if there are perceived issues. This could be either that they think they will be unsuccessful so there is little point in applying or a perception that they will not have the information and good credit history that it is perceived that banks require. It may occur where entrepreneurs from certain groups distrust bankers, as for example can occur with ethnic minority entrepreneurs who can be discouraged borrowers since they perceive institutional bias in banking institutions. Other work has suggested that women seeking to start-up businesses may also form a category of discouraged borrowers
The extent of any discouraged borrower effect is unknown, but it may be important amongst ethnic immigrant groups.

**Methodology**

1.18 The research has comprised a number of linked stages. An important feature has been to obtain information on the supply as well as the demand for bank finance. A novel aspect of the research has therefore involved interviews with a number of bank managers using the technique of protocol analysis based on a number of actual case study scenarios.

**Analysis of ASBS (Scotland) survey data**

1.19 The starting point was to undertake analysis of the questions on access to finance in the 2006 ASBS (Scotland) for the 64 firms that indicated problems in accessing business finance. As well as information on various characteristics (e.g. age, sector, growth orientation) of the businesses, this provides some data on the nature of the difficulties that the businesses experienced, the type and amount of finance being sought, and reasons for the difficulties.

**Telephone survey of SMEs reporting difficulties in obtaining finance**

1.20 To investigate the issues in greater depth, a telephone survey of 51 Scottish SME owner/managers was undertaken during July and August 2007, drawn from respondents to both the 2006 and 2005 ASBSs in Scotland who had indicated that they had encountered some form of problem in accessing external finance for their business. These comprise businesses that: (i) obtained no finance; (ii) obtained less finance than they required; or (iii) obtained what they required but with difficulties.

1.21 Survey data was collected via extended telephone interviews, undertaken with owner/managers of SMEs. These interviews typically lasted around 30 minutes and in some of the more interesting cases, follow up interviews took place in order to gain greater clarification on the financial status of the firm and the proposed projects that the owner/managers were seeking external finance for. The survey probed in order to find out whether the access to bank finance problems encountered were as a result of (i) risk averse bank lending procedures and decisions, as opposed to (ii) poor business proposals and/or the poor financial status of applicants.

**Case studies**

1.22 The telephone survey also acted as the basis for selecting a small number of test cases of firms that, on the face of it, appeared to have put forward a strong business case for bank finance. These cases are of particular interest to the research since they provide instances of where a seemingly good business proposition has been rejected for loan/debt finance or where the failure to obtain external finance has seriously curtailed the growth of the business. Seven case scenarios were selected and presented to a bank lending expert who narrowed them down to five cases that were suitable for the protocol analysis that was to be used in the interviews with current bank lending officers.
Interviews with bank managers

1.23 A total of eight face-to-face interviews were conducted with managers at different seniority levels within three of the four Scottish commercial banks. These interviews utilised the five chosen case study scenarios developed from the business interviews. The protocol analysis technique involved asking the interviewed managers to think through their decision-making processes using the information provided for the individual case studies. Verbal protocol analysis is a proven social research technique where the subject of the research is managerial decision-making. In this study, there was a need to obtain information on the ‘protocols’ that decision-makers use when making decisions. The technique involves using real scenarios or real cases, or if hypothetical scenarios ones that are as close as possible to real cases, which are then used to ask managers to talk through their decision-making process. As such, the technique is deliberately open-ended and to some extent dependent on the skill of the researcher, as well as on the quality of the real cases. Better analysis can be obtained if a variety of real cases is provided (Ericsson and Simon, 1993). In some cases, it may be an explanation of how a case may be recommended to a central decision-making unit, or it may involve more localised decision-making based on additional material. The purpose of the interviews was to obtain information on the processes decision-makers use in banks, how loan applications are dealt with and the main reasons for acceptance and referral.

1.24 Verbal protocol analysis has been used previously in the analysis of bank managers’ and other funders’ decision-making, although the extent of its use has been limited and the quality of the studies rather varied. This is not surprising given the demanding nature of the technique on resources, on researchers and on access to the key decision-makers. Previous examples include Wilson, et al (2007) who used one hypothesised business proposition in their research with 35 bank managers who were asked to describe their reactions, the criteria they were considering and their loan decision. Also Mason and Stark (2004) used verbal protocol analysis with three bankers, three venture capital fund managers and four business angels who were asked to examine three outline business proposals (taken from Venture Capital Report and Business Angel Bureau). Apart from these examples, however, previous research on decision-making in this area, using verbal protocol analysis has been limited to analysis of venture capital decision-making (Mason and Stark, 2004).

Structure of the Report

1.25 This chapter has discussed the purpose of this study within the context of the various issues raised by existing research on access to finance by SMEs and also has outlined the multi-method approach used in the research. The next three chapters are concerned with the results of the demand-side analysis. Chapter two presents the findings from the 2006 ASBS relating to those SMEs that indicated they were experiencing problems in accessing finance. Chapter three then takes the analysis further by presenting the findings relating to the SMEs that were interviewed for the purposes of this research before looking in more detail at those firms that had particular difficulties accessing bank finance in chapter four. The next two chapters focus upon the supply-side analysis, with chapter five presenting the results of the protocol analysis conducted with the interviewed bank managers using five selected SME case studies and chapter six discussing more generally the way in which Scottish banks deal with applications from SMEs. The final chapter presents the study’s conclusions from both the business survey and the interviews with the bankers, before returning to the key question at the heart of the research of whether the difficulties that SMEs experience in
accessing bank finance are the result of sub-optimal lending practices, or whether they are the result of the unsuitability of the business cases that SMEs are putting to finance providers.
CHAPTER TWO: ANALYSIS OF ANNUAL SMALL BUSINESS SURVEY (SCOTLAND) DATA

2.1 This chapter presents the results of analysing the limited number of questions in the 2006 ASBS (Scotland) survey of 1014 firms that were concerned with accessing finance. As well as identifying the characteristics of the SMEs that sought finance, there were also questions in the survey relating to the type of difficulties the SMEs experienced and the amount of funding they were seeking.

2.2 Before presenting the findings of this analysis, it is important to recognise that the 2006 ASBS (Scotland) data are skewed towards particular sectors, notably manufacturing and hotels and restaurants when compared with the overall broad sectoral structure of businesses in Scotland (see Appendix I). This is likely to have had the effect of inflating the extent to which SMEs in Scotland have experienced problems in accessing finance in this study, given that manufacturing SMEs have a higher propensity to identify such problems than their counterparts in other sectors.

Extent of problems in accessing finance

2.3 Compared to the UK as a whole, a similar proportion of Scottish SMEs had sought external finance for their business in 2005-06 (29.2 per cent compared with 27.9 per cent), with slightly under one fifth (18.7 per cent) of the surveyed firms in Scotland having sought bank finance during the previous year. However, it is only a small minority of businesses that experienced problems in accessing finance. Just under a quarter (23.6 per cent) of SMEs in Scotland trying to access all types of finance reported problems compared to a fifth (20.3 per cent) in the UK as a whole. Moreover, 18.4 per cent of SMEs in Scotland seeking bank finance encountered problems (compared to 17.4 per cent in the UK as a whole). In other words, only 6.3 per cent of the 1014 businesses surveyed in Scotland reported problems in accessing finance and just over half of these, 3.4 per cent of the total surveyed, were businesses that had approached banks for finance.

2.4 The rest of this chapter is based on an analysis of the 64 Scottish SMEs within the 2006 ASBS (Scotland) survey that indicated they had experienced problems in accessing business finance. Of these, 34 reported difficulties in accessing bank finance.

Characteristics of SMEs seeking finance

2.5 The majority of firms seeking finance (84 per cent of them) stated that they will be growth orientated over the next 2-3 years, although it was a lower proportion of those seeking banking finance (77 per cent compared to 93 per cent seeking other types of finance). With regard to recent and near future growth performance, 64 per cent of the businesses indicated some form of growth, although for 17 per cent this was ‘contained growth’, with more than a quarter (27 per cent) of those seeking bank finance indicating this type of growth (Table 2.1). A slightly higher proportion of those seeking bank finance (38 per cent) indicated that they had not experienced any form of growth recently compared to those seeking other types of finance (i.e. grants, equity investment and soft loans) (33 per cent).
Table 2.1  Recent and Future Growth of Business

<table>
<thead>
<tr>
<th></th>
<th>Bank Finance</th>
<th>Other Finance</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sustained Growth</td>
<td>6 (18%)</td>
<td>8 (27%)</td>
<td>14 (22%)</td>
</tr>
<tr>
<td>Contained Growth</td>
<td>9 (27%)</td>
<td>2 (7%)</td>
<td>11 (17%)</td>
</tr>
<tr>
<td>No Growth</td>
<td>13 (38%)</td>
<td>10 (33%)</td>
<td>23 (36%)</td>
</tr>
<tr>
<td>New Growth</td>
<td>6 (18%)</td>
<td>10 (33%)</td>
<td>16 (25%)</td>
</tr>
<tr>
<td>Total</td>
<td>34 (100%)</td>
<td>30 (100%)</td>
<td>64 (100%)</td>
</tr>
</tbody>
</table>

Source: ASBS (Scotland) 2006

2.6 Significantly, almost half of the businesses experiencing difficulties in accessing external finance were either in manufacturing (27 per cent) or wholesaling/retailing (22 per cent). In terms of accessing bank finance, manufacturing, construction, retail and wholesale firms appear to have been most likely to have encountered difficulties.

2.7 In terms of owner-manager characteristics, only one of the business owners seeking finance was aged under 25, whilst just under a third (32 per cent) were aged between 25 and 44 and nearly two-thirds (64 per cent) aged between 45 and 64. More than a quarter (28 per cent) of businesses experiencing problems were majority women owned, with a significantly higher proportion (41 per cent) of those firms encountering problems accessing bank finance being majority women owned compared with those having problems with other finance sources (14 per cent). This significant finding is in line with previous research that has indicated that female ‘would be’ and existing entrepreneurs tend to have negative perceptions about their chances of success in applying for external funding, particularly from banks (Allinson et al., 2005, Carter et al, 2001; Fielden et al, 2003). The reasons for this are complex, but include issues such as inadequate personal assets, sexual stereotyping, lack of business track record, and perceived credibility problems with bankers.

Access to finance

2.8 As shown in Table 2.2, half of the 64 SMEs experiencing difficulties with obtaining business finance were unable to obtain any external finance from the first source that they approached, whereas just over one quarter (27 per cent) obtained some finance, and just under a quarter (23 per cent) obtained all the finance they required but encountered other problems such as delays in obtaining the finance. A slightly higher proportion of those whose preferred source was the banks did not obtain any finance than those who approached other sources (53 per cent compared with 47 per cent).
Table 2.2 Difficulties in Obtaining Finance

<table>
<thead>
<tr>
<th></th>
<th>Bank Finance</th>
<th>Other Finance</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unable to obtain any finance</td>
<td>18</td>
<td>14</td>
<td>32</td>
</tr>
<tr>
<td></td>
<td>53%</td>
<td>47%</td>
<td>50%</td>
</tr>
<tr>
<td>Obtained some but not all finance required</td>
<td>9</td>
<td>8</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>27%</td>
<td>27%</td>
<td>27%</td>
</tr>
<tr>
<td>Obtained all finance required but with some problem</td>
<td>7</td>
<td>8</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>21%</td>
<td>27%</td>
<td>23%</td>
</tr>
<tr>
<td>Total</td>
<td>34</td>
<td>30</td>
<td>64</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: ASBS (Scotland) 2006

2.9 Just over half (51 per cent) of those SMEs reporting difficulties indicated that they were eventually able to obtain the funding that they needed for their business, indicating that 28 per cent of them successfully obtained alternative finance to bridge the shortfall of funding received from the first source that they approached. This may indicate either their ability to raise funding from internal sources or that eventually the external funds proved sufficient for the purpose.

Problem types of finance

2.10 Just over half (53 per cent) of the SMEs indicating problems with accessing finance stated that this was with regard to accessing bank finance, with 36 per cent mentioning problems with bank loans and 17 per cent with bank overdrafts. This compares with 23 per cent identifying problems with obtaining grants and just three firms (5 per cent) mentioning equity investment issues.

2.11 Just 19 cases were able to provide reasons for the problems experienced and of these, the most commonly mentioned being that their funding had reached acceptable limits (9 cases); that they did not have a good credit history, either because they had not been trading long enough or because of a poor credit history (9 cases); that they were unable to provide sufficient security (8 cases); or that they were in the wrong business sector (8 cases).

Amount of finance sought

2.12 As shown in Table 2.3, a significant finding is that nearly three-quarters (74 per cent) of those experiencing problems with obtaining bank finance were seeking between £25,000 and £1 million compared to just over a third (36 per cent) of those experiencing difficulties obtaining other types of finance, the latter being more likely to be seeking smaller sums (44 per cent of them seeking less than £25,000). It is also notable that several SMEs who sought bank finance, but had problems with accessing it, perceived there to be an equity gap for firms seeking less than £1 million, due to the lack of interest on the part of equity investors and the cautious approach of banks.
Table 2.3  Amount of Finance by Type of Finance Required

<table>
<thead>
<tr>
<th></th>
<th>Bank Finance</th>
<th>Other Finance</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>£25,000</td>
<td>5</td>
<td>11</td>
<td>16</td>
</tr>
<tr>
<td>£25-99,000</td>
<td>10</td>
<td>1</td>
<td>11</td>
</tr>
<tr>
<td>£100 – 999,000</td>
<td>13</td>
<td>8</td>
<td>21</td>
</tr>
<tr>
<td>£1 million +</td>
<td>3</td>
<td>5</td>
<td>8</td>
</tr>
<tr>
<td>Total</td>
<td>31</td>
<td>25</td>
<td>56</td>
</tr>
</tbody>
</table>

Source: ASBS (Scotland) 2006

Problems with obtaining bank finance

2.13 The 2006 ASBS (Scotland) survey found that slightly under one fifth (18.7 per cent) of the surveyed 1014 firms had sought bank finance during the previous year. Table 2.4 demonstrates that less than one in five (17.9 per cent) of the firms actively seeking bank finance had experienced problems in obtaining bank finance, with one in seven receiving some or no bank finance and one in twelve (8.4 per cent) being unable to undertake their proposed project. The 16 firms seeking bank finance that were unable to proceed with their proposed business projects represents about half of the 33 Scottish SMEs reporting being unable to proceed with proposed projects due to their inability to access finance during this period. To put it into perspective, therefore, 1.6 per cent of the surveyed Scottish SMEs were unable to go ahead with projects during 2005-06 because of the problems of accessing bank finance.

Table 2.4  Scottish SMEs Seeking Bank Finance 2005/06

<table>
<thead>
<tr>
<th></th>
<th>SMEs seeking bank finance N=190</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firms experiencing problems in obtaining bank finance</td>
<td>34</td>
</tr>
<tr>
<td>Firms receiving some or no bank finance</td>
<td>27</td>
</tr>
<tr>
<td>Firms unable to undertake project</td>
<td>16</td>
</tr>
</tbody>
</table>

Source: 2006 ASBS

2.14 To summarise therefore, this analysis of the 2006 ASBS (Scotland) data indicates that:

- only a very small minority of SMEs that experienced problems in accessing finance in the twelve months prior to the survey, and in about half of these instances the problems related to bank finance.
- the firms experiencing problems accessing bank finance were more likely to be seeking larger sums of finance than those experiencing problems with other sources.
- a significantly high proportion of businesses experiencing problems accessing bank finance were women owned businesses.
• even amongst those SMEs that did experience problems accessing bank finance, very few of them were prevented from going ahead with their project as a result.

2.15 The next chapter makes a more detailed examination of those SMEs that did experience problems accessing bank finance.
CHAPTER THREE: FINDINGS OF THE BUSINESS SURVEY

3.1 This chapter sets out the findings from the survey of SMEs that had reported difficulties accessing finance which was conducted as part of this research. Initially, the survey sample is discussed, detailing the process by which the surveyed businesses experiencing bank borrowing problems were found. This is followed by a detailed profiling of the 39 businesses where the survey revealed bank borrowing problems and a detailed examination of their bank borrowing requirements and the application processes undertaken. There then follows a more qualitative section presenting selective case examples of the different types of projects which required bank funding, highlighting the difficulties experienced in applying for bank finance.

Survey Profile

3.2 The survey was drawn primarily from the 64 cases in the 2006 ASBS (Scotland) survey where respondent owner/managers indicated that they had experienced problems in raising external finance during the previous 12 months and had also stated that they would be prepared to be re-surveyed at a later date (see Table 3.1). Further analysis of these responses indicated that just over half (34) had specifically sought bank finance (23 for a loan, 11 for an overdraft and 2 for a mortgage). Given the relatively small number of firms in this sample that had actually sought bank finance, the decision was made to expand the survey by (i) attempting to survey the remaining 30 cases in order to see whether they had considered using bank finance and actually sought it (perhaps at a later date than when the ASBS 2006 survey took place) and (ii) to include the 26 firms in the 2005 ASBS that had indicated experiencing problems in raising external finance during the previous 12 months and that had agreed to being re-surveyed. In the 2005 ASBS (Scotland) cases, it was not possible to predetermine which firms had actively sought bank finance, only that 16 had been unable to raise any finance, one had raised only partial finance and that nine had raised all of the finance required – albeit, after experiencing some problems along the way. The decision was made to try to interview as many of the 2005 firms as possible in order to find out whether bank finance had been sought and, if so, to then focus more in-depth on these cases.

3.3 The researchers attempted to call all 90 cases from the combined 2006 and 2005 ASBS sample and completed 51 interviews. Of these, 42 (82 per cent) had considered using bank finance and 39 (77 per cent) had actually approached a bank for finance. In the three cases where bank finance was considered, but banks were not approached, this was due to the expense of bank finance (2 cases) or lack of confidence (1 case). It is also notable that a higher proportion of surveyed firms from the ASBS 2006 had approached banks for finance: 83 per cent (31 out of 37 cases) as opposed to just 57 per cent (8 of 14 cases) in the ASBS 2005 surveyed firms that had reported problems in raising finance. In the cases where bank finance was not sought, this was largely due to firms predominately requiring grant finance and in one case leasing finance. These firms were typically seeking grant assistance to help them with staff recruitment and training, purchase of equipment and vehicles and premises improvements. One respondent, the owner/manager of a financial services firm based in a deprived inner city neighbourhood, encapsulated the position of these firms when they stated: “We are a small firm, employing local people in a poor neighbourhood and we feel that the government should provide grant assistance to help us to do this.”
Table 3.1 Selection Process for SME Bank Finance Interviews

<table>
<thead>
<tr>
<th></th>
<th>ASBS 2005</th>
<th></th>
<th>ASBS 2006</th>
<th></th>
<th>Total</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>Row %</td>
<td>No.</td>
<td>Row %</td>
<td>No.</td>
<td>Row %</td>
</tr>
<tr>
<td><em>ASBS Access to Finance Problem</em></td>
<td>26</td>
<td>28.9</td>
<td>64</td>
<td>71.1</td>
<td>90</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>No.</td>
<td>Col %</td>
<td>No.</td>
<td>Col %</td>
<td>No.</td>
<td>Col %</td>
</tr>
<tr>
<td>Refusals</td>
<td>1</td>
<td>3.8</td>
<td>5</td>
<td>7.8</td>
<td>6</td>
<td>6.7</td>
</tr>
<tr>
<td>Unable to Obtain Owner/Manager</td>
<td>8</td>
<td>30.8</td>
<td>14</td>
<td>21.9</td>
<td>22</td>
<td>24.4</td>
</tr>
<tr>
<td>Claimed No Financial Problem</td>
<td>2</td>
<td>7.6</td>
<td>4</td>
<td>6.3</td>
<td>6</td>
<td>6.7</td>
</tr>
<tr>
<td>Number Unobtainable</td>
<td>1</td>
<td>3.8</td>
<td>4</td>
<td>6.3</td>
<td>5</td>
<td>5.6</td>
</tr>
<tr>
<td>Interviewed</td>
<td>14</td>
<td>53.8</td>
<td>37</td>
<td>57.8</td>
<td>51</td>
<td>56.7</td>
</tr>
<tr>
<td>Considered Bank Finance</td>
<td>10</td>
<td>38.5</td>
<td>32</td>
<td>50</td>
<td>42</td>
<td>46.6</td>
</tr>
<tr>
<td>Approached Bank for Finance</td>
<td>8</td>
<td>30.8</td>
<td>31</td>
<td>48.5</td>
<td>39</td>
<td>43.3</td>
</tr>
</tbody>
</table>

Notes to table
The sample was only drawn from ASBS firms that stated that they would allow a follow-up interview.

The remainder of this chapter focuses on the findings from the 39 firms which actively approached banks for finance.

Profile of Firms Encountering Problems Seeking Bank Finance

3.4 Thirty-nine surveyed firms had approached banks during the 12 months prior to the ASBS (Scotland) surveys and reported experiencing problems in accessing bank finance. Generally, these firms are characterised by being well established businesses, typically employing between 6 and 49 employees, operating in manufacturing, retail and wholesale, hospitality and professional services, trading profitably at above the VAT threshold and seeking growth. These firms are profiled in Tables 3.2 – 3.8 below.

Table 3.2 Sector

<table>
<thead>
<tr>
<th></th>
<th>Survey Sample</th>
<th>ASBS 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>%</td>
</tr>
<tr>
<td>Primary</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>18</td>
<td>46</td>
</tr>
<tr>
<td>Retail &amp; Wholesale</td>
<td>7</td>
<td>18</td>
</tr>
<tr>
<td>Hotel &amp; Catering</td>
<td>8</td>
<td>21</td>
</tr>
<tr>
<td>Professional Services</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>Education</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Other sectors</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
<td>100.0</td>
</tr>
</tbody>
</table>

3.5 Four broad sectors; manufacturing, hotel and catering, retail and wholesale and professional services, represent the vast majority (94.8 per cent) of the firms reporting access to bank finance problems, manufacturing firms (46.2 per cent) representing by far the largest single sector.

3.6 Comparison with the sectoral breakdown for the 2006 ASBS demonstrates that manufacturing SMEs stand out as disproportionately encountering problems accessing bank finance compared to SMEs in other sectors. Manufacturing firms also exhibit twice the proportion of problems per bank application (30.3 per cent) when compared to all other
sectors (15.2 per cent). This may be due to banks being less inclined to lend to manufacturing businesses, possibly indicating a lack of understanding about the technical issues relating to the proposals tabled by manufacturing businesses.

Table 3.3 Locations

<table>
<thead>
<tr>
<th>Location</th>
<th>No.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highlands</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Central</td>
<td>13</td>
<td>33</td>
</tr>
<tr>
<td>Central Lowlands</td>
<td>11</td>
<td>28</td>
</tr>
<tr>
<td>Borders</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Glasgow</td>
<td>5</td>
<td>13</td>
</tr>
<tr>
<td>Edinburgh</td>
<td>7</td>
<td>18</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
<td>100.0</td>
</tr>
</tbody>
</table>

3.7 Unsurprisingly, the majority (59 per cent) of surveyed firms reporting access to bank finance problems were located within the Central Lowlands, Glasgow and Edinburgh. A further one third were located in Central Scotland.

Table 3.4 Firm Age

<table>
<thead>
<tr>
<th>Survey Sample</th>
<th>ASBS 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
</tr>
<tr>
<td>&lt;1 year</td>
<td>3</td>
</tr>
<tr>
<td>1-4 years</td>
<td>8</td>
</tr>
<tr>
<td>5-9 years</td>
<td>4</td>
</tr>
<tr>
<td>10+ years</td>
<td>24</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
</tr>
</tbody>
</table>

3.8 More than one quarter of surveyed firms (28 per cent) reporting access to bank finance problems were young firms trading for less than five years, with three firms reporting seeking finance during their start up process. However, the vast majority of firms (62 per cent) were well established, with trading records of at least 10 years.

3.9 Comparison with the 2006 ASBS (Scotland) demonstrates that there is a higher proportion of new and young firms trading for less than five years amongst the SMEs experiencing difficulties in accessing bank finance; 29 per cent compared to 11 per cent in the ASBS survey (Table 3.4). Whilst this is not a surprising finding, it might be indicative of a need to ensure that the SFLGS, which since the Graham Review changes now focuses particularly on younger firms trading for less than five years, is used more effectively by bank lenders.

3.10 Forty-one per cent of surveyed firms reporting access to bank finance problems were micro firms with less than 10 employees, whilst only 13 per cent were medium sized, with between 50 and 250 employees.

3.11 Comparison with the 2006 ASBS (Scotland) survey as a whole demonstrates that the SMEs experiencing difficulties in accessing bank finance include a higher proportion of businesses in the small firms’ employee range, between 10-49 staff (46 per cent compared with 36 per cent). Indeed, the survey sample contains no self-employed/sole practitioners and is also underrepresented in the 1-5 employee range.
Table 3.5 Firm Employment Size

<table>
<thead>
<tr>
<th>Survey Sample</th>
<th>ASBS 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
</tr>
<tr>
<td>None</td>
<td>-</td>
</tr>
<tr>
<td>1-5 Employees</td>
<td>7</td>
</tr>
<tr>
<td>6-9 Employees</td>
<td>9</td>
</tr>
<tr>
<td>10-24 Employees</td>
<td>13</td>
</tr>
<tr>
<td>25-49 Employees</td>
<td>5</td>
</tr>
<tr>
<td>50-199 Employees</td>
<td>4</td>
</tr>
<tr>
<td>200-250 Employees</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
</tr>
</tbody>
</table>

Table 3.6 2006 Sales Turnover

<table>
<thead>
<tr>
<th>Sales Turnover</th>
<th>No.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;£61k</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>£61-100k</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>£100-249k</td>
<td>8</td>
<td>21</td>
</tr>
<tr>
<td>£250-499k</td>
<td>10</td>
<td>26</td>
</tr>
<tr>
<td>£500k+</td>
<td>16</td>
<td>41</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
<td>100.0</td>
</tr>
</tbody>
</table>

3.12 The majority of SMEs (59 per cent) reporting access to bank finance problems had an annual sales turnover of less than £500,000 during their most recent completed financial year to 2006. Of these, only two businesses (5 per cent) were trading at below the VAT threshold. Amongst the larger businesses surveyed, a number reported that their sales turnover was considerably in excess of £1 million, with the highest reported figure being £4 million.

Table 3.7 2006 Profitability

<table>
<thead>
<tr>
<th>Profitability</th>
<th>No.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit</td>
<td>30</td>
<td>77</td>
</tr>
<tr>
<td>Breakeven</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>Loss</td>
<td>6</td>
<td>15</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
<td>100.0</td>
</tr>
</tbody>
</table>

3.13 More than three-quarters of owner/manager respondents (77 per cent) indicated that their businesses were making a profit during the most recently completed financial year to 2006, although one in seven respondents indicated that their business had made a loss.

Table 3.8 Growth Seeking in the past Two Years

<table>
<thead>
<tr>
<th>Growth Seeking</th>
<th>No.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not Seeking Growth</td>
<td>7</td>
<td>18</td>
</tr>
<tr>
<td>Seeking Growth</td>
<td>32</td>
<td>82</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
<td>100.0</td>
</tr>
</tbody>
</table>

3.14 The vast majority (82 per cent) of SMEs experiencing difficulties with accessing bank finance claimed to have been aiming to grow during the past two years.
Constraints upon Business Performance

3.15 Surveyed owner/managers were asked about the main factors constraining their firm’s sales turnover performance during the last two years. Only one respondent suggested that they did not experience any constraints, whilst one third indicated that they experienced at least two forms of constraint. A diverse range of constraints were mentioned, including matters such as international exchange rates and government bureaucracy.

3.16 By far the most commonly mentioned type of constraint was the requirement for project development finance (27 per cent). Whilst this may be indicative of the sample being drawn from firms that were seeking bank finance, it is also a clear indication that lack of finance was perceived as a major constraint to business development. The other most frequently mentioned constraints included: cash-flow problems (10 per cent); the need for larger, more appropriate premises (8 per cent); staff related issues such as recruitment and training (7.8 per cent); advertising and marketing requirements (8 per cent); and legal issues (6 per cent).

Financial Requirements

3.17 This section examines details of the amount of funding required and the range of finance that was considered and sought by the 39 firms which experienced problems in accessing bank finance. There is also an examination of the processes which were undertaken in attempting to secure finance.

Table 3.9      Finance Required

<table>
<thead>
<tr>
<th></th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Project Cost</td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>2,772,500</td>
</tr>
<tr>
<td>Median</td>
<td>105,000</td>
</tr>
<tr>
<td>Minimum</td>
<td>5,000</td>
</tr>
<tr>
<td>Maximum</td>
<td>80,000,000</td>
</tr>
<tr>
<td>External Finance</td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>2,695,947</td>
</tr>
<tr>
<td>Median</td>
<td>85,000</td>
</tr>
<tr>
<td>Minimum</td>
<td>5,000</td>
</tr>
<tr>
<td>Maximum</td>
<td>80,000,000</td>
</tr>
<tr>
<td>Proportion of External Finance to Project cost</td>
<td>81%</td>
</tr>
</tbody>
</table>

Notes to table
N=39

3.18 All 39 businesses provided financial details of their proposed overall project costs and external borrowing requirements. The overall project costs ranged from £5,000 up to £80 million for a large capital investment by an oil and gas industry service supplier, with the median project cost being £105,000. Table 3.9 indicates that on average 81 per cent of the project cost expenditure was being sought through external finance, rather than through internal sources such as re-investment.

3.19 Not surprisingly, there is a direct association between the amount of funding requested and the size of the business. Smaller firms with less than ten staff were typically applying for considerably lower levels of external finance (mean £107,250, median £35,000) than those with 10 or more staff (mean £4,578,636, median £275,000). Similarly, younger
firms trading for four years or less were typically seeking less (mean £176,182, median £70,000) than their older counterparts trading for 5 years or more (mean £3,722,519, median £90,000).

Table 3.10  Types of Non-Bank Finance Considered and Approached

<table>
<thead>
<tr>
<th>Type of Finance</th>
<th>Considered</th>
<th></th>
<th>Approached</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>%</td>
<td>No.</td>
</tr>
<tr>
<td>Equity</td>
<td>9</td>
<td>23</td>
<td>6</td>
</tr>
<tr>
<td>Soft Loan</td>
<td>11</td>
<td>28</td>
<td>8</td>
</tr>
<tr>
<td>Grant</td>
<td>15</td>
<td>39</td>
<td>12</td>
</tr>
<tr>
<td>Leasing</td>
<td>4</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>Other</td>
<td>2</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>Total Firms</td>
<td>26</td>
<td>67</td>
<td>20</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Notes to table</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of N=39</td>
</tr>
</tbody>
</table>

3.20 Nearly half of the surveyed firms (49 per cent) encountering access to bank finance problems only approached banks for external finance, with almost one third (31 per cent) approaching one alternative type of funding and the remaining 20 per cent approaching two or more alternative sources of funding. The most frequently mentioned alternative sources that were considered and approached were grants and soft loans, these being perceived as less expensive and more affordable options to bank finance.

3.21 Nearly one quarter of businesses considered equity finance, but in three cases this was not pursued because of concerns over the ownership of the business and also because “…venture capitalists are not interested in assisting small businesses seeking less than a million and this represents a gap in the equity market.” Whilst this research is concerned with access to bank finance, for businesses seeking a combination of financial options, including bank and equity finance, this perceived gap in the equity market is a concern.

3.22 There was also some fall out between the numbers of businesses considering soft loans and grants and those actually approaching these types of funding providers. This was mainly due to perceptions of red tape, slow processing of applications and the costs of providing match funding in some grant schemes. The leasing option related to acquiring new vehicles and equipment, whilst other types of funding considered and approached related to taking out private (non commercial) loans and mortgages.

3.23 An interesting finding is that only one third of the surveyed firms approached more than one bank, with two-thirds of respondents applying for bank finance only from their existing bank. It is perhaps surprising that so few firms ‘shop around’ when seeking bank finance, although given the evidence discussed later in this report (see section 6.5) of the importance placed by lenders upon having a relationship with the finance seeker, this behaviour may be entirely rational. There is also a heavy dependence amongst the surveyed businesses on using the two main banks in Scotland.

3.24 Table 3.11 indicates that the Royal Bank of Scotland (RBS) and the Bank of Scotland (BoS) were by far the most frequently approached banks, representing more than three quarters (76 per cent) of the total applications for bank finance.
Table 3.11  Banks Approached

<table>
<thead>
<tr>
<th></th>
<th>1st Approached</th>
<th>All Approaches</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>%</td>
</tr>
<tr>
<td>Barclays</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>HSBC</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Lloyds</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Natwest</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>RBS</td>
<td>15</td>
<td>39</td>
</tr>
<tr>
<td>BoS</td>
<td>16</td>
<td>41</td>
</tr>
<tr>
<td>Clydesdale</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Use of External Assistance

3.25  Just over half of the surveyed businesses reporting problems accessing bank finance had used external assistance to support their application (Table 3.12). The most frequently mentioned source of assistance was the firm’s accountant, which was mainly in respect of providing financial information, such as annual accounts, cash-flow projections and profit and loss scenarios. Business Gateway and Scottish Enterprise were mentioned by one fifth of respondents. Scottish Enterprise was typically approached by the larger businesses which were seeking grant, soft loan and equity finance, whilst Business Gateway was approached by new, young and smaller firms seeking information about funding sources, but also requiring advice with business planning and cash-flow projections. Two of the larger businesses surveyed employed consultants in order to undertake due diligence work required for proposed acquisitions. It is notable that nearly half of the firms surveyed indicated that they did not use any form of external assistance with their applications.

3.26  Personal finance was generally avoided and there is little evidence of the use of external assistance in this respect. Two respondents specifically mentioned using external advice, one from a Citizen’s Advice Bureau and one from a bank, with regard to exploring personal finance options. In both cases, this was as a last resort, after failing to secure sufficient business loans from banks and in both cases resulted in taking out a mortgage on the owner-manager’s home. This finding is indicative of the surveyed owner-managers’ aims to avoid the use of personal finance, particularly mortgages over personal property. Two other respondents mentioned seeking advice from friends and family members, initially with regard to making bank loan applications, but eventually relating to receiving personal loans from those people. In two cases personal credit card finance was used as temporary bridging finance.

Table 3.12  Sources of Assistance

<table>
<thead>
<tr>
<th></th>
<th>No.</th>
<th>% (n=39)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Friends and Family</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Business Gateway/Scottish Enterprise</td>
<td>8</td>
<td>21</td>
</tr>
<tr>
<td>Accountants</td>
<td>13</td>
<td>33</td>
</tr>
<tr>
<td>Consultants</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Solicitors</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>CAB</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Total Cases</td>
<td>21</td>
<td>54</td>
</tr>
</tbody>
</table>
Table 3.13 Types of Assistance Received

<table>
<thead>
<tr>
<th>Types of Assistance</th>
<th>No.</th>
<th>% (n=39)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Planning</td>
<td>13</td>
<td>33</td>
</tr>
<tr>
<td>Financial Projections</td>
<td>17</td>
<td>44</td>
</tr>
<tr>
<td>Interview Assistance</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>Finding ‘Soft’ Finance</td>
<td>8</td>
<td>21</td>
</tr>
<tr>
<td>Other</td>
<td>3</td>
<td>8</td>
</tr>
</tbody>
</table>

3.27 As Table 3.13 shows, the main forms of external assistance reported were for financial projections (44 per cent), such as cash-flow forecasts, and business planning (33 per cent). One fifth of respondents mentioned seeking assistance with finding alternative ‘soft’ finance options such as grants and soft loans, whilst one in ten respondents mentioned receiving help with interview preparation and coaching for their meetings with bank lending officers. Other forms of assistance included attending business training courses with Business Gateway and advice from a solicitor with regard to business acquisition.

3.28 The surveyed owner/managers were also asked if there are ways in which external assistance, with regard to accessing finance, could be improved. Just under half (46 per cent) of those surveyed suggested that improvements could be made. These suggestions related to five main themes (with the majority of suggestions relating to improving access to grants and soft loans). The most frequently mentioned improvement (7 cases) related to improving access to non-bank finance such as grants, soft loans and equity investment; three respondents mentioned lack of knowledge of where to find assistance; three respondents wanted advice to be “...clearer and more coherent...”; three respondents complained about there being “...too much red tape and hassle involved with grant applications...” and the “...slow procedure of grant and loan applications...”; whilst two respondents complained about the cost of assistance, particularly in respect of professional services such as accountants, where these services were required to support bank loan applications. One respondent, who had spent over £2,000 on accountancy and consultancy services, was particularly annoyed that this had been a bank requirement and that despite complying with this their loan application had still been turned down.

3.29 More than two-thirds (69 per cent) of surveyed owner/managers knew about Business Gateway’s services. Views were wide ranging about Business Gateway, with several respondents suggesting that they did not think that Business Gateway was relevant because “...it is for start-ups...”, “...only for very small firms...” and “...has no specialist sectoral knowledge or experience.” There was also an even split between those that thought that Business Gateway was a “...useful and positively helpful organisation...” which tended to be start-ups and younger businesses that had actually benefited from their services, and respondents who felt that Business Gateway was “...ineffective and a waste of time...”, the latter being those who had been unable to obtain grants and soft loans, or who had not recently used their services.

Application Process

3.30 One fifth of the 39 SMEs experiencing problems with accessing bank finance were dissatisfied with their meeting with the bank lending officer, feeling that it had not been as successful as they had hoped. In one case, a respondent indicated that their request for a bank
loan had been dealt with by telephone and that they were not offered any opportunity to attend a formal meeting at the bank. This was deemed to be entirely unsatisfactory.

3.31 Generally and from the perspectives of owner-managers themselves, where meetings had not progressed well, this had been due to problems of insufficient trading record and lack of collateral, rather than the presentation of poor business plans and financial projections. Indeed, almost one third of respondents (31 per cent) considered that insufficient collateral and/or a lack of a trading record were the main reasons for failing to obtain a loan, whilst only 18 per cent indicated that they had failed because of a poor business plan or financial projection. Where business proposals were less successful, it is worth noting that manufacturing businesses, in particular, encountered difficulties, in some instances reflecting problems in presenting complex technical development plans. Moreover, some manufacturing owner/managers voiced concerns about the lack of sectoral knowledge of bank lending officers. It was also noted that some more established businesses indicated that they had not been required to present a business plan. Several respondents complained that they “...were never given an adequate or clear reason for being turned down.”

3.32 Some owner/managers were either unable or unwilling to put their own money, or business funds into the projects for which they were seeking bank finance. This is highlighted above (Table 3.9) where it was demonstrated that on average 81 per cent of project costs were sought from external funding sources, including banks. To some extent this related to new and younger businesses where respondents were unable to invest their own personal funds and unwilling to obtain external funds which required taking security over their personal property and possessions. Several respondents mentioned that “... the bank required an unreasonable amount of security...” with one respondent condemning their bank for requiring “...a ridiculous 130 per cent security for the loan, based on my home .... this was outrageous and entirely unacceptable...” Some respondents from more established firms were unwilling to use internal funding resources due to the impacts that these might have on cash-flow, other project development work and contingency funding requirements.

3.33 Around one third of owner/managers were satisfied with their treatment by the banks, whilst the remaining two-thirds were dissatisfied, making a range of criticisms. Table 3.14 below summarises their main complaints and indicates that delays in the decision making process were particularly problematic, affecting one fifth of businesses. In some cases these delays led to lost business opportunities, such as the failure to secure acquisitions. These owner/managers were at pains to stress how disappointed they were with the bank’s tardy approach. One respondent stated that; “Banks keep putting up barriers and objections and you just have to keep battling away and stick with it, until they give in to you.” Another respondent stated that “...we first made our application thinking that we would be able to secure the funds within a couple of months, but it dragged on for more than six months and it almost killed the deal.”

3.34 Nearly a quarter (23 per cent) of owner/managers complained that that the bank lending process was either confusing or misleading. Several mentioned attending meetings with local bank staff who gave an impression that the application would be successful. However, when these loan requests were referred to more senior staff, centrally within the bank, they were refused. Several respondents complained that overdraft facilities, which they believed would be made available, were withheld or not offered. This was highly problematic for new businesses and buy-outs in sectors such as retailing and hospitality, where stock purchase is essential and can lead to initial cash-flow difficulties in new businesses. One
respondent, who had taken over a bar and restaurant in Edinburgh, recounted how their bank had not provided them with an overdraft facility from the outset, despite being promised this service; "...we needed to order products and our request for an overdraft of a few thousand pounds was rejected. We were staggered, as this had been promised and we had to borrow the money from our family just to get by. It could have bankrupted us from the start!"

Confusion also occurred where the banks’ lending requirements were unclear. In one case a commercial loan was restricted to around two-thirds of the amount requested and the remainder had to be sourced via another lender. The bank did not specify how this should be achieved and the owner/manager resolved the matter by taking out a personal loan with another high street lender.

3.35 The lack of linkages between banks and other lending options, such as equity investment and grants was also highlighted as a shortfall in the banking service. Three respondents specifically mentioned the lack of knowledge and understanding of their business activity within the bank. One tourist related business in Aberdeenshire complained that local banks only understood the oil industry and “...it was only when we referred our loan application to the neighbouring region that the banks showed an interest in our proposal.” Two respondents mentioned the expense of the application process, particularly with regard to requirements for professional services for due diligence and accountancy, relating to business acquisitions.

Table 3.14 Main Complaints about the Bank Lending Process

<table>
<thead>
<tr>
<th>No. Complainant</th>
<th>No.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>No Complaints</td>
<td>13</td>
<td>33</td>
</tr>
<tr>
<td>Long Delays</td>
<td>8</td>
<td>21</td>
</tr>
<tr>
<td>Misleading Information</td>
<td>5</td>
<td>13</td>
</tr>
<tr>
<td>Confusing Process</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>No Links to Alternative Finance</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>Lack of Understanding</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>Expensive Process</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
<td>100.0</td>
</tr>
</tbody>
</table>

**Funding Secured**

3.36 The surveyed owner/managers were asked about how much funding they were actually able to secure, including bank borrowing. Overall, funding was secured by 26 out of the 39 surveyed cases (67 per cent) that reported difficulties in obtaining bank funding. However, less than half (46 per cent), just 18 cases, actually received bank finance. The amounts received varied from £5,000 to £32 million, but the median value was £125,000 (Table 3.15).

3.37 Surveyed owner/managers were asked how long the process had taken, between first approaching the bank with their initial application and finally receiving a decision about the finance applied for. Eight respondents were unable to answer this question, perhaps in part due to the ongoing nature of their applications.
Table 3.15  Overall Funding and Bank Funding Received

<table>
<thead>
<tr>
<th>Overall Funding Received</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>3,596,462</td>
</tr>
<tr>
<td>Median</td>
<td>75,000</td>
</tr>
<tr>
<td>Maximum</td>
<td>80,000,000</td>
</tr>
<tr>
<td>Minimum</td>
<td>5,000</td>
</tr>
<tr>
<td>Funding Received from Banks</td>
<td>£</td>
</tr>
<tr>
<td>Mean</td>
<td>2,487,667</td>
</tr>
<tr>
<td>Median</td>
<td>125,000</td>
</tr>
<tr>
<td>Maximum</td>
<td>32,000,000</td>
</tr>
<tr>
<td>Minimum</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Notes to table
N=18

3.38 What is striking about the findings recorded is that more than two-fifths (42 per cent) of respondents indicated that the process had taken more than 6 months, with two respondents indicating that the process had taken at least two years. Although the majority of these longer cases were unsuccessful, this is indicative of the difficulties that the owner/managers have faced in trying to obtain bank finance. Several commented on: the “unwieldy process”; the considerable number of “objections and obstacles” that arose; the “delays in waiting for centralised decisions”, which were frequently different from what had been indicated by the local lending officer. There were also complaints about the lack of overdraft facilities or the delays in putting such facilities into place and sometimes this was the only form of bank funding that was received.

Table 3.16  Time taken to receive Bank Funding Decision

<table>
<thead>
<tr>
<th>Unsuccessful</th>
<th>Successful</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>No.</td>
<td>%</td>
<td>No.</td>
</tr>
<tr>
<td>Up to 1 month</td>
<td>3</td>
<td>23</td>
</tr>
<tr>
<td>2-3 months</td>
<td>2</td>
<td>15</td>
</tr>
<tr>
<td>4-5 months</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>6-11 months</td>
<td>2</td>
<td>15</td>
</tr>
<tr>
<td>12 months plus</td>
<td>6</td>
<td>46</td>
</tr>
<tr>
<td>Total</td>
<td>13</td>
<td>100</td>
</tr>
</tbody>
</table>

Notes to table
8 respondents were unable to provide an answer

3.39 More than half (56 per cent) of the surveyed businesses that had been seeking bank finance were able to undertake the whole of their proposed project. This included five firms that did not eventually receive any bank finance. A further one in eight respondents stated that they had been able to proceed with their project, but that this had been scaled down according to the level of funding raised, whilst almost one third stated that they had not been able to go ahead with their proposed project in any form.
Table 3.17 Impact of External Funding on Proposed Project

<table>
<thead>
<tr>
<th>No.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insufficient to start project</td>
<td>12</td>
</tr>
<tr>
<td>Only partially sufficient for project</td>
<td>5</td>
</tr>
<tr>
<td>Sufficient for whole project</td>
<td>22</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
</tr>
</tbody>
</table>

Views on SME Relations with Banks

3.40 All of the 51 surveyed SME owner/managers (i.e. those who had difficulties accessing finance generally) were asked for their views about the relationship of banks with small businesses in Scotland. The general consensus was that “...the banks could do a lot more...” and that they “...do not understand the needs of small businesses...” The main findings were:

- More than two thirds (68 per cent) of respondents felt that their banks had been unhelpful.
- 72 per cent stated that banks should offer a broader service for SMEs as well as providing finance.

3.41 These findings are, perhaps, unsurprising, given that a majority of these firms were unsuccessful in their applications for bank finance. Whilst some respondents were satisfied with their banking experience and mentioned that they could receive a range of helpful services from their banks, overall, there is a clear message that the banks could do more.

3.42 The main complaints levelled at the banks related to the length of time taken to provide decisions on funding applications. Several respondents complained about the amount of bureaucracy involved, mentioning “...seemingly endless requests for further information and details...” and the “...huge amount of paperwork involved in the process.” There was also reference to the “...mixed and conflicting signals received...” between local bank staff and more centralised decision makers within the bank. This led a couple of respondents to suggest that there should be a return to more autonomous local bank lending officers, more akin to “...the old fashioned local bank managers.” Several respondents also mentioned that the banks were unsupportive of small businesses and new start-up firms’ cash-flow issues and had caused considerable difficulties by refusing to offer relatively small-scale overdraft facilities. A couple of respondents complained that the banks charge too much, particularly with regard to overdrafts, although others did mention the benefits of free business banking services, typically received during the first year of service. There was also a general consensus that the banks should be better at giving advice, which is highlighted by the responses relating to what services the banks should offer.

3.43 The surveyed owner/managers were asked what services, other than the provision of finance, banks should offer. Table 3.18 demonstrates that the most frequently requested service was generic business advice, which was particularly pertinent to very small businesses and new and young businesses. These respondents presented the idea of the banks giving them a broad business service, in return for their custom and felt that they could benefit from developing a closer rapport with a specific person at the bank. To some extent
this type of service is already provided by some banks in the form of business relationship managers, but these are not always locally based in the manner of the ‘traditional local branch bank manager’. Other more specific forms of advice mentioned related to business planning, financial planning and start-up/new start business assistance. In this respect, there is perhaps a role for banks to direct their customers to Business Gateway for this type of advice.

3.44 Nearly a fifth of respondents mentioned that it would be really helpful if the banks were more integrated with other forms of finance and could act as a type of ‘one-stop-shop’ for sourcing funding. In this respect, some respondents mentioned linkages to venture capitalists, whilst others mentioned access to grants and soft loans. Some of these respondents’ views were compounded by the failure of Business Link and Scottish Enterprise to assist them in finding additional funding to augment their bank loan applications. Three respondents mentioned that banks should have sectoral specific knowledge. This response is more about banks needing to exhibit a better understanding of the requirements of businesses in particular sectors, rather than a desire for sectoral advice.

### Table 3.18 Additional Bank Services

<table>
<thead>
<tr>
<th>Service</th>
<th>No.</th>
<th>% (N=39)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Generic Business Advice</td>
<td>11</td>
<td>28</td>
</tr>
<tr>
<td>Access to Other Types of Finance</td>
<td>7</td>
<td>18</td>
</tr>
<tr>
<td>Sectoral Knowledge</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>Financial Planning Advice</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Business Planning Advice</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Start-Up</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Local Managers</td>
<td>1</td>
<td>3</td>
</tr>
</tbody>
</table>

3.45 To summarise, therefore, the key findings of the analysis of the 51 interviewed SMEs that experienced problems in accessing finance are that:

- They were generally well established businesses, although there was a high representation of younger businesses (i.e. less than five years old) than in the ASBS (Scotland) survey panel as a whole.
- Manufacturing SMEs were more likely to experience problems in accessing bank finance than their counterparts in other sectors.
- Typically four fifths of the cost of undertaking investments was sought from external sources.
- Bank finance was secured by just under half of the businesses survey (46 per cent) and in five of these cases (13 per cent) funding was less than had been expected and the proposed project had to be reduced in scope.
- In five cases where bank funding was secured, there were considerable delays of over six months, in receiving bank finance.
- The majority of SMEs do not ‘shop around’ for bank finance, with only a third of surveyed firms approaching more than one bank.
- Only one third of the SME owner/managers who had experienced problems of accessing finance said that they were satisfied with their treatment by the banks.

3.46 The next chapter takes a more qualitative in-depth approach to examining specific case examples where bank funding problems may have exhibited an element of market failure on the part of the banks.
CHAPTER FOUR: THE BUSINESS CASE

Introduction

4.1 This chapter takes a selective case study approach to examining whether there are possible examples of market failure on the part of bank lenders. Unsurprisingly, most firms were not prepared to provide the researchers with the business plans and financial information that formed part of the business case presented to bank lenders. However, after persistent requests, financial details were obtained from the seven case studies which were selected for testing scenarios of potential bank market failure with the bank lending officers in the supply-side part of the research (see chapter 5).

4.2 This part of the analysis focuses mainly on the examples of the 17 firms which were unsuccessful in their applications for bank finance and which were unable to secure sufficient finance to undertake their projects, either in part or at all (in the other three cases where no bank finance was secured the projects were still able to go ahead in full). Consideration is also given to cases where the bank funding process caused excessive delays, to the extent where it impacted on the business project in question. It is also worth noting that in the small number of cases where bank finance was not accessed, but the project was able to go ahead in its entirety, this was due to the ability of the owner/managers to raise finance from family and friends and personal loans and, therefore, may also provide evidence of market failure, to some degree.

Table 4.1 Finance Accessed by Broad Business Characteristics

<table>
<thead>
<tr>
<th>Degree of Bank Finance Accessed</th>
<th>No Bank Finance</th>
<th>Some Bank Finance</th>
<th>All Bank Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Median of:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Funds Required</td>
<td>£50,000</td>
<td>£380,000</td>
<td>£225,000</td>
</tr>
<tr>
<td>External Funds Required</td>
<td>£50,000</td>
<td>£155,000</td>
<td>£225,000</td>
</tr>
<tr>
<td>Median of:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Funds Secured</td>
<td>£45,000 (n=8)</td>
<td>£152,500 (n=2)</td>
<td>£225,000 (n=16)</td>
</tr>
<tr>
<td>Total Bank Funds</td>
<td>£0</td>
<td>£15,000</td>
<td>£225,000</td>
</tr>
<tr>
<td>Existing Debt</td>
<td>£7,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profitability:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit</td>
<td>14</td>
<td>1</td>
<td>15</td>
</tr>
<tr>
<td>Breakeven</td>
<td>2</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Loss</td>
<td>4</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Median of:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm Age (years)</td>
<td>14</td>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td>Employment size</td>
<td>13</td>
<td>16</td>
<td>10</td>
</tr>
<tr>
<td>Sector:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary/Manufacturing</td>
<td>13</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Retail/Wholesale</td>
<td>2</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Hospitality</td>
<td>3</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Professional Services</td>
<td>2</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Location:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Highlands &amp; Central</td>
<td>7</td>
<td>0</td>
<td>7</td>
</tr>
<tr>
<td>Lowlands &amp; Borders</td>
<td>7</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Glasgow &amp; Edinburgh</td>
<td>6</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>20</td>
<td>2</td>
<td>17</td>
</tr>
</tbody>
</table>
4.3 Table 4.1 demonstrates that in most respects, there is little difference between the broad characteristics of surveyed firms requiring bank finance that were able to successfully access bank finance (albeit with some degree of difficulty) and those that were partially or completely unsuccessful in accessing bank finance. A couple of notable exceptions are the high ratio of primary sector and particularly manufacturing firms that were unsuccessful in their applications for bank funding and the higher proportion of unsuccessful firms which were operating at a loss at the time of their bank application. It is also noticeable that the least successful applications were typically for a much smaller amount of funding than those that were successful.

4.4 With the possible exception of a potential bias against the manufacturing sector, these findings suggest that a more crucial factor in the bank’s decision making process is likely to have been the quality and content of the project proposal. This is further explored by considering in-depth the types of projects proposed.

Table 4.2 Types of Project Proposals by Access to Bank Finance

<table>
<thead>
<tr>
<th>Degree of Bank Finance Required: Accessed</th>
<th>Total</th>
<th>No.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No Bank Finance</td>
<td>Some Bank Finance</td>
<td>All Bank Finance</td>
</tr>
<tr>
<td>New Product</td>
<td>5</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>New Market</td>
<td>6</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Capital Investment</td>
<td>8</td>
<td>1</td>
<td>9</td>
</tr>
<tr>
<td>Working Capital</td>
<td>8</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>New Start-Up</td>
<td>2</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Buy-Out</td>
<td>1</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td>Acquisition</td>
<td>1</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>20</td>
<td>2</td>
<td>17</td>
</tr>
</tbody>
</table>

Notes to table
Respondents could answer more than one category

Capital Investment

4.5 Table 4.2 demonstrates that the most frequently mentioned type of project (46 per cent of the cases) related to capital investment, in order to purchase new machinery and equipment. This ranged from a multi million pound scheme to purchase an ice breaking ship that could provide full servicing to the off-shore oil and gas industry to the purchase through leasing arrangements of vans for small-scale service suppliers. These large-scale capital projects were amongst the most expensive in the survey and included most of the cases where access to bank finance took longest to resolve. In several cases where bank funding was not used for this type of project, leasing arrangements provided satisfactory (albeit more expensive) alternatives, which were generally easier and quicker to arrange. As shown in Table 24, half of the firms requiring finance for capital investment projects eventually achieved all the finance they were seeking from the banks, despite encountering other problems such as the length of time the bank took to make the decision.

4.6 A number of the capital projects involved premises work, which proved to be particularly problematic because of increasing land and construction costs, the large sums of finance required (when compared to the value of the business) and the long lead times in developing such projects. One interesting case is that of a long established chip shop where
funding was required to expand the shop and purchase additional equipment. After lengthy delays, bank finance was refused and alternative, more expensive, finance was sourced, costing the business time and money.

**Capital Investment Case Example 1**

A chip shop, established for 40 years in an urban location, with 6 staff, seeking to expand their current premises and purchase additional equipment in order to increase output to meet a growing market demand.

The business had banked with their current bank for 10 years and had no outstanding debts, other than a standard small overdraft facility which had been managed conservatively, without problems. The bank was approached for a loan of £70,000 and requested a full financial review of the business which cost £2,000 in accountant’s fees. Initially, there was a strong indication from the bank that they would provide a sufficient loan facility, but eventually, after requiring security based upon the business premises valued at over £200,000, the bank refused the loan.

“Our hopes were raised and we had to spend a considerable amount of money on accountants fees to meet the bank’s demands, but eventually the bank just wasted our time and money and said that we had insufficient security …. this was odd, because our accountant thought it was fine!”

Finally, the owner/manager took out a loan with a telephone bank, at very high interest, but it was the only way to move forward, given the amount of time wasted by their existing business bank. After a delay of almost two years, the business has recently opened its expanded premises and is already increasing sales and profitability.

4.7 Another interesting case relating to capital investment is presented below. Whilst this firm did eventually receive a bank loan, delays in the bank lending process were costly to the firm and potentially damaging to the business development opportunity for this manufacturing firm.

**Capital Investment Case Example 2**

Glasgow based heating engineering firm, trading for 22 years, with 14 staff, seeking to grow and develop market opportunities by opening a second office in Edinburgh. The business had an overdraft facility of £10,000 to assist with cash-flow issues and was trading in profit at the time of the bank application.

The overall cost of the office purchase project was £110,000. An application was made to the firm’s business bank for a loan of £50,000. The firm had also successfully obtained £30,000 from the West of Scotland Loan Fund, with assistance from Business Gateway/Scottish Enterprise. The owner/manager felt that the business proposal was strong and that his presentation to the bank went well. They had undertaken a considerable amount of market research through trade shows and trade journal research to demonstrate market feasibility for the project. However, the bank delayed giving a response to the loan application and “...did not provide an adequate explanation for the delays. The bank kept making little objections and niggling requirements, which took time to address....they were slow to respond and it became a marathon ... I eventually wore them down!”

The delays may have been due in part to the relatively short two year period that the firm had been with the bank and their “...uneven trading record.”

After more than five months of negotiating with the bank the £50,000 loan was approved and the project went ahead in its entirety. With the opening of the new office, the business is experiencing more than the 10% increase in sales and profitability that they had forecast, with forecast sales for 2007 expected at £3.1m, compared with £2.5m in 2006. The delay in accessing the bank finance set the business back by several months, potentially costing the business £50,000 per month in lost trade.
Working Capital

4.8 Working capital was the second most frequently mentioned type of project (26 per cent of the cases) and typically related to requirements for overdraft facilities and short-term loans in order to cover cash-flow shortages, during the early stages of business start-up, for stock purchase, to bridge periods waiting for slow payment by creditors, or in a period where the business had met an unforeseen problem. Only one of the ten firms seeking working capital finance achieved all the funding they were seeking from the bank whilst another received some bank finance; the other eight firms were all unsuccessful (Table 4.2).

4.9 Several owner/managers commented on difficulties that they had experienced in obtaining overdrafts for their businesses during the early stages of trading. One partner in a newly established grocery store complained bitterly about their bank not providing them with a £2,000 overdraft facility from the start of trading. They thought that this had been promised and were shocked when they were forced to draw on their personal savings resources in order to overcome initial short-falls in cash-flow in order to purchase essential materials and stock for the business: “it is not as if the bank was not aware of our overdraft requirements – they had seen what was required when they looked at our cash-flow projections!”

4.10 A particularly interesting case, presented below, is that of an established carpentry business, where the owner/manager was injured and was unable to continue working at full capacity for several months. Although the business had a good track record and outstanding debts which had been successfully managed within an existing agreed overdraft facility, the bank refused to provide any extra finance to cover the period of sales turnover shortfall. As a result the owner had to take out a series of expensive personal loans and used alternative loan finance, which spiralled out of control, turning an initial requirement of £30,000 into outstanding debts of £50,000 over a period of 18 months. Eventually, after a visit to the Citizens Advice Bureau, it was arranged to consolidate these business related debts by remortgaging the owner’s home. Subsequently, the owner/manager has fully recovered and the business is now trading successfully with increasing sales turnover and profitability.

**Working Capital Case Example**

_A joinery business, established for 15 years, with 3 employees. The business has a regular annual sales turnover in excess of £250,000 and has successfully managed an overdraft facility of £15,000 for several years in order to overcome cash-flow issues relating to the 60 day creditor payment regime in the construction industry and the need to purchase materials, equipment and pay staff wages. Around 40 per cent of current sales turnover is generated through subcontracting work for one established large construction firm client._

_Additional working capital was required in order to keep the business running during a period of almost year, after the owner/manager had suffered a broken wrist which took a long time to heal fully. The business continued to operate, in order to meet a heavy workload of existing orders, but required additional staffing during the times that the owner was unable to work. Unfortunately, the business did not have any key worker insurance cover and therefore alternative sources of funding were required._

_The business’s bank, which it had banked with for 12 years, was approached for a loan of £30,000. The bank refused to provide any additional funds to the business, over and above the existing overdraft facility, did not offer to meet the owner/manager and did not offer any financial advice._

_The owner/manager did not seek alternative high street bank finance and instead, without consulting external advice, sought to use personal finance solutions. This resulted in “...spiralling credit card debt and the use of alternative loan shark finance. It was only after a visit to the citizens advice people, that I realised that the only option was to consolidate my debts through remortgaging .... by this stage I needed £50,000.”_
The owner/manager is now fully recovered and the business is operating at increased levels of sales turnover and profitability.

New Products and Markets

4.11 One fifth of surveyed firms were seeking bank finance to assist them with developing new products and a similar proportion with regard to new markets. This mainly applied to the surveyed manufacturing firms, where a number of owner/manager respondents referred to their objective to diversify business activities into more profitable areas of work. It is notable that a high proportion of these applications, specifically relating to developing new markets, were turned down by the banks, with three-quarters receiving no bank finance and one other firm only receiving partial finance (Table 4.2). In part, this poor success rate may be due to the nature of new market development, which can have a long developmental lead time. Indeed, a small number of these cases are still pursuing finance for projects where they first contacted the banks around two years ago. However, there is also an indication that the manufacturing sector is finding it difficult to raise bank finance for this kind of project.

4.12 An example of the problems in accessing bank finance for new product and market development is detailed in the case below, where a well established engineering business was seeking to obtain up to £500,000 by a combination of bank and venture capital finance. The two main partners, one of whom was an ex-banker, found themselves in a “...catch 22 situation...” with the banks being “risk averse”, whilst the “...venture capitalists were not interested in such a small-scale project.”

New Markets and Products Case Example

A precision engineering business, established 25 years, with 49 staff operating profitably with an annual sales turnover of £4 million, seeking to realign its marketing strategy in order to move from an existing highly competitive international trading market to a global niche market.

Considerable trade research, including attending global trade shows and exhibitions led this firm to develop a new product with new global market applications for the commercial logistics industry, notably with regard to transporting LPG.

Despite already having a considerable overdraft, the firm applied to their bank for up to £500,000 in order to facilitate product and market development. Scottish Enterprise was also approached with a view to securing venture capital finance. The business was unable to secure any external finance, despite producing a detailed business proposition and full financial details (including full profit and loss and cash-flow forecasts), due to lack of collateral.

“We were informed that there is an equity investment gap affecting businesses seeking up to £1 million and we received no interest from venture capitalists and business angels .... The bank was risk averse and wasn’t interested, so we are faced with exploring options to raise the finance internally, perhaps by selling off part of our existing business.”

Thus far the project has not taken place and, 18 months on from their initial approach to their bank, the business is still looking for external funding opportunities. If successfully adopted, the proposed new product and market development would “... represent a step change for the business, raising sales and profits considerably.”
Buy-Out

4.13 Only one surveyed example of a buy-out firm failed to receive bank funding and this is an interesting case, which highlights the dual problems in accessing bank finance for those working in lesser known sectors and coming from a public sector/non-commercial background. The details of this case are presented below. For the remaining six businesses seeking bank finance for buy-outs, the full amount of required bank finance was secured, but problems with delays in accessing finance were encountered. Some of these delays may have been due, in part, to the changing structure and status of the buy-out businesses, which may have led them to be perceived as start-ups.

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**Buy-Out Case Example**

A conservation studio, specialising in conserving and restoring museum artefacts – formerly operating for 20 years as a public sector organisation, with four staff. The business had an existing client base of Scottish museums and art galleries, with a full order book of work for the next 12 months.

Three partners, who were made redundant from the original business, paid £12,000 of their redundancy payments to buy-out the existing conservation business, but required a further £8,000 in order to purchase new equipment and to secure cash-flow during the early stages of running the business. A £5,000 grant was secured from Historic Scotland, which assisted with 50% of the cost of new equipment purchases, but the business’s existing bank delayed for several months to offer a £3,000 overdraft facility. Eventually, when funding was made available, “…it was at a ridiculous cost ... they did not provide a reasonable explanation for the delay, or for ignoring our repeated requests for overdraft assistance. I believe that they saw us as a new business – having come from a public sector background – and they didn’t understand our sector. This probably contributed to the delays and the unreasonably high interest charged on the overdraft. It was too expensive for us and we decided to use our own money instead.”

The business has subsequently changed banks and has been established for a couple of years. After a slow start, the business was profitable and generated £120,000 in sales turnover in the last financial year and is on course to increase sales by 50% this year.

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Start-Ups

4.14 The four surveyed businesses which referred to approaching banks for finance during their start-up phase experienced mixed fortunes in their efforts to secure bank finance, with two businesses failing to obtain any bank finance. These start-up businesses were involved in a variety of sectors, but the two businesses failing to secure bank finance were both from the hospitality sector. The two cases below are indicative of the problems facing business start-ups seeking to raise bank finance.

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**Start-Up Case Example 1**

A café and mobile food service business, selling hot and cold snacks, employing seven staff. The owner and his wife had been working abroad for several years prior to starting the business and were not considered by the bank as resident, for commercial lending purposes. Business Gateway was approached for help, but other than providing grant assistance to employ staff (who had been long-term unemployed), there was no financial assistance available to them.

The business was initially funded using £40,000 of the owner/managers’ savings. A commercial business account was opened, but no overdraft facility was provided and the business suffered considerably from cash-flow problems. Funding was also required to enable the purchase of three vans for the mobile catering business and, after the bank refused to offer a loan, the vehicles were secured through leasing arrangements.
“The banks regarded us as too risky ... we had been out of the country for a while and the business is cash based, with a lot of the money not passing through the bank at all! They wanted to go through our accounts in detail, but this wasn’t practical. We managed to open up a commercial account with our personal bank, but they would not offer us an overdraft and, despite being mainly cash based, it was difficult to control cash-flow when some invoices were taking more than 60 days to clear .... We rejected factoring as this was too expensive.”

The business is now three years old and generating sales turnover of £250,000 per annum. Whilst the business has only managed to breakeven thus far, the respondent owner/manager believed that they would make a profit in the next financial year.

Start-up Case Example 2

Two recent graduates, each aged 23, had the opportunity to buy an existing bar and restaurant business in Edinburgh as the existing owners were planning to emigrate. The young entrepreneurs sought a £100,000 bank loan to purchase the business which they regarded as a very good opportunity having decided that they wanted to run this type of venture. They had a plan for taking over an existing well run business and building on its existing customer base. Their focus was on its timing, with the smoking ban and the ability to make use of the outdoor space that this business had. The entrepreneurs received help from their parents, who had business experience, in putting together a business plan and preparing cash-flow projections.

Several banks were approached but although they were initially encouraging, they all turned the application down for similar reasons. Whilst the business plan was accepted, the owners were seen as lacking previous management experience and lacked a business banking track record. They also did not have any collateral and were only able to put £10,000 into the business themselves. In the words of one of the founders “the banks promised a lot but in the end delivered nothing”. Eventually the money to purchase the business was raised by means of their parents re-mortgaging their houses.

Acquisition

4.15 The three businesses seeking bank finance for business acquisition purposes were all from the manufacturing sector, operating in long established markets facing strong and increasing levels of competition. These businesses were seeking to grow and develop by establishing a foothold in new product and geographical markets through the purchase of existing businesses. Whilst acquisition had been a long-term strategic plan in some of these cases, when the opportunity arises for a takeover it can require a fast response and these owner/managers complained about how slow their banks were in responding to their loan requests. One respondent referred to a delay on the part of the bank of two months, when matters were referred to a centralised team in Edinburgh, which “…nearly killed the deal.” Interestingly, this case was the only one, amongst the surveyed firms, where the Small Firms Loan Guarantee Scheme was specifically mentioned, perhaps indicating that this form of bank finance is rarely utilised.

4.16 The case where an acquisition failed to take place because of the late withdrawal of bank lending support, outlines the extent of the problems encountered, when bank funding is required within relatively tight time deadlines.
Acquisition Case Example

A manufacturing firm specialising in making windows for commercial vehicles (e.g. buses and trains), established for 10 years, with a workforce of 80 staff based on three sites. The firm has been experiencing increasing foreign competition in its main markets and has been seeking an opportunity to diversify into the more lucrative, higher value added, and less competitive commercial vehicle door manufacturing market.

An opportunity arose to acquire a UK based commercial door manufacturing firm, which had gone into receivership. Full due diligence was undertaken by a specialist consultancy firm, at considerable expense and the firm approached their bank with a detailed set of financials (including 3 year projections, full accounts and a detailed business plan), with a view to raising £1 million in bank and equity finance out of a total project cost of £2.2 million. “Initially, at the local branch, our bank was interested in lending us the full £1 million and venture capital options were not followed up. However, our loan request was referred centrally to Edinburgh and then delays started to take place. Eventually, the bank refused our loan application with two days remaining before the deal had to take place – effectively leaving us with no options but to withdraw.” The only reason provided for refusing the loan was that the business was reliant upon three main clients “…but they were aware of this from the start.”

Subsequently, the business has changed banks. One of the directors, an ex-banker, was “…disgusted with the actions of the bank … and embarrassed to have once worked for them.” Using internal business funding, they have started up their own commercial door manufacturing division and, although on a small scale, after only a year it is contributing one tenth of the annual £4 million sales turnover with the division’s sales forecast to rise four-fold during the next two years.

4.17 To summarise, therefore, the more qualitative analysis of the 39 surveyed firms that reported difficulties in applying for bank finance and particularly the 17 of them that did not obtain any bank finance shows that:

- Whilst there is little difference between those firms that successfully applied for bank finance (but experienced some difficulties) and those that were unsuccessful, it is clear that a higher proportion of manufacturing firms were unsuccessful in their applications for bank finance than firms in other sectors.

- The applications for bank finance that were unsuccessful were typically for much smaller amounts than those that were successful.

- The most common reason for seeking bank finance was capital investment, principally for the purchase of new machinery and equipment or undertaking work on premises. Half of these applications were successful (albeit after delays etc).

- The second most frequently mentioned reason for seeking bank finance was working capital, typically in the form of overdraft facilities and short-term loans to cover cash-flow shortages.

- Most the firms (mainly manufacturing firms) who had problems accessing finance for new product and market development were unable to obtain any funding from the banks, indicating the particular difficulties that firms experienced in raising finance where diversification into new product/market areas and therefore a higher degree of risk was involved.

4.18 Having analysed the data relating to the experiences of SMEs in applying for bank finance, the next chapter looks at a number of selected case studies from a supply-side perspective, based on interviews with a sample of bank managers from three Scottish commercial banks.
CHAPTER FIVE: BANK MANAGER’S PROTOCOL ANALYSIS OF THE CASE MATERIAL

Introduction

5.1 The research team, with assistance from the Scottish Government, approached the four main commercial banks in Scotland. Three of the commercial banks agreed to participate, for which the research team and the Scottish Government are very grateful. Participating banks included the Clydesdale Bank, the Bank of Scotland and the Royal Bank of Scotland. These banks have the largest market share of SMEs as banking customers in Scotland. In addition to the participating banks, an independent banker, who was formerly a senior executive with national responsibilities for business finance, was involved at an initial stage to verify the case material, the interview structure, the nature of questions, the nature of analysis to be expected in each of the cases, the criteria that should be applied and that nature of process and protocols that were likely to be applied. As a result of this verification stage, one of the proposed cases was dropped from the portfolio of case material. This case had limited information and it was considered to be difficult to present to bank managers. The interview structure was also validated and amended.

5.2 Five case studies of firms whose applications for finance were rejected were eventually selected for analysis by the participating bank managers. These five cases, after verification from the independent banker, provided a varied range of scenarios (see narratives below), size of business, turnover and credit requirements. Four of the five cases had extensive financial information. One of the cases was included as a narrative only (case 4). Although the narratives for each of the cases were anonymised, in order to handle sensitivity issues, additional financial information, including in one case a full business plan, was sent out as hard copy by courier or post in advance of the interviews. Eight bank managers from the three participating commercial banks took part in this stage of the research. They all received the case studies in advance of the interview together with the interview structure. All banks segment the SME business market, generally on the basis of the size of the business, which resulted in the division of cases for one of the participating banks between the bank managers. Extensive pre-interview work and time was, therefore, completed by each of the eight bank managers and all interviews were conducted face to face by members of the research team from PERC, each interview taking up to two hours.

5.3 The methodology employed by the interviewers was one of verbal protocol analysis (explained in section 1.3 above). We invited each of the bank managers to talk us through how each case would be dealt with, the processes involved and to give their views on the strengths and weaknesses of each case, together with an indication of the level of interest and how the case would be taken forward if that was appropriate. It is important to mention that, for each case, the managers’ were unaware of the eventual outcome. This methodology formed the first part of the interview with the pre-seen case material. This was supplemented by the second part of the interview with a semi-structured questionnaire to reveal additional findings on issues on SMEs’ finance from the bank managers’ perspectives including start-ups and established customers.

5.4 The rest of this chapter details the findings from the case study protocol analysis with summaries and separate comments for each of the five case studies. The discussion of each case is preceded by a descriptive narrative of the business and the reasons for seeking
finance. Following the discussion we give a summary of the actual outcome of the finance application and the business owner-manager’s views on the relationships between SMEs and banks more generally.

Protocol Analysis

**CASE 1**

**NARRATIVE**

**FUNDING REQUIRED:** £1 million for new product development

**PROFILE OF BUSINESS**

This is a manufacturing company which was established in 1998 as part of an employee buy-out of the manufacturing division of a larger company. The main business activities of the company are subcontract manufacturing and gas generation equipment. The company has specific expertise in the product design and development, metal transformation/fabrication and electronic/mechanical assembly and testing.

The company’s activities can be split into three main areas:

(i) **Solutions Business:** within this sub-contract business, the company works mainly for a large multinational company in the UK, Canada, China, Brazil and India. Turnover from this aspect of the business was £10.1 million in 2005 of which 71% came from this single customer. There is a real expectation of increasing the Solutions Business to over £17m over the next two to three years.

(ii) **Gas Generators:** the company has a product range of gas generators that supply high purity cases suitable for use in laboratories and the food and drink industry. Annual sales of laboratory gas generators such as those produced by the company are estimated to be $30m worldwide.

(iii) **Midgeater and Midg-it products:** These are products designed and manufactured in house and intended to attract all disease bearing insects such as midges in the UK and mosquitoes in Africa and the Far East, through a gas generated scent of carbon dioxide. The company has now established two distribution partnerships with Calor Gas for the UK and Rentokil for the Far East. The company sold 3,000 units of these products over the last 18 months and as a result of its marketing programme and a strengthening of its distribution network expects an increase by 50% in FY06 and a further 30% in FY07.

The company now has an international customer base, with customers in Canada, South America, Europe and the Far East

The company employs a total of 150 people (148 working full-time while only 2 of them are working part-time), having grown from 84 employees in 1998.

The management have been actively trying to grow the business during the last two years, although shortage of cash has been the main factor constraining sales performance. Despite this, the objective remains to grow the business.

**NATURE OF THE BUSINESS CASE**

**New products**

The company requires finance from the bank in order to help them to further develop their insect catching devices. These will result in increased sales turnover, profit and the international “footprint” of the company. Currently these products account for less than 10% of the turnover of the company, but they have the potential
to contribute more than 25% of turnover. The company has identified their customer product needs through market research, contacts, common sense and through experience of the business.

There are several US based companies that offer similar products to the Midgeater, although many of them concentrate their sales effort on the US. The company will therefore be focusing its sales effort on other territories and therefore will not enter into direct competition with them.

**Interviewed bankers assessment**

5.5 This case provided a range of issues for all the interviewed bank managers. It was of interest; strengths for all the managers being that it was well established, with new product development (NPD) and an established management team. It was considered to be rather different from the ‘normal’ with an MBI/MBO scenario, but with a professionally produced business plan. In terms of protocols, all the managers stressed the importance of getting to know the management team and understanding the nature of their business. It was felt essential in all cases that a visit would be necessary to the business premises to get to know the nature of the business, all the management team and an understanding of the purpose of the credit facility. Also, because of the nature of the history of this business, it would be necessary to understand the background, although if an existing customer, this would be known. As pointed out by the majority of the bank managers, the high dependence of the company on one customer for a high proportion of their turnover would have been a focus for further investigation in terms of understanding the nature of the management team’s business.

The participating banks all had a financial modelling computer-based system that would be used for a case of this nature. In all cases this was a fairly sophisticated modelling system that would produce a guide for decision-making, more in terms of a strength and risk of a proposition rather than accept or reject decisions (as for example would be the case with credit-scoring, see later discussion). In one bank, a case would need to be prepared together with the financial modelling result that included a narrative. This would then be referred to a central credit department. In general, the managers were uncomfortable with this case as a lending proposition, it was highly geared/leveraged with existing debt compared to equity funding and currently loss making. The NPD involved R&D which is an intangible asset. Partly as a result, there was a commonly held view that any security taken would have to be in the form of intangible assets or as a floating charge; that is a charge against non-fixed assets. (One manager also expressed a view that taking a floating charge had become more difficult since the Enterprise Act.) Diversification though was seen as a potential strength.

5.6 The importance of other financial and management information varied between the eight bank managers. There was some concern with the nature of a track record that included some acquisitions that had not been successful and the majority were concerned that the existing management team were ‘technical’, perhaps without marketing expertise. There was some concern at the nature of the sector, which was felt to be highly competitive. In addition, one banker thought that cost savings could be made by producing abroad, hence some concern with the existing location. The age of the management team was a factor for two of the bankers as two of the directors were nearing retirement and they were concerned to see a succession plan in place. However, the composition and nature, competencies and skills of the management team were important for all the bank managers, with one banker viewing the key staff as particularly important. Two of the bankers picked up that the business plan was prepared by a non-executive director. A number of the bankers thought that it would be necessary to bring in a more specialist team from the bank. All of them felt that they would need to get a better understanding of the finances of the business, including the nature and
age of debtors and creditors. It would be necessary to ‘drill down’ behind the figures and to conduct some sensitivity analysis. Only one banker thought that it would be worthwhile to bring in specialist support agency advice, referring to the Scottish Manufacturing Advisory Service of Scottish Enterprise; otherwise potential advice/referral from support agencies was not mentioned. The nature of the order book was important for all the bank managers.

5.7 All the bank managers agreed that security would be necessary if this was taken forward, but this may not be possible (to cover the debt) given the nature of the business. More likely, it was considered that if taken forward the bank would seek to put together a funding package, and that additional equity would be required to make this feasible.

**Overall Assessment**

5.8 This was a difficult case for the bank managers to support having the combination of high gearing, previous loss-making activities, competitive sector and limited levels of security. Managers also disliked the high reliance on one major customer for a high proportion of the company’s existing turnover. However, they could see that logically there was a case for diversification. Whether this proposition was supported would depend on whether it was an existing or new business customer. As a new business customer, without further equity it would be difficult to support and challenging. It would be approached with a good deal of caution and it was seen as relatively risky. If the company was an existing business customer, all the managers thought that the bank would seek to put together some sort of deal to help the company, even though it was recognised that this would be difficult. One bank manager considered that the track record of the company suggested that it was in an intensive care situation.

**Comment**

5.9 This case would almost certainly not be supported as a new business customer. Although all the bank managers that discussed this case had considerable authorisation limits, all new businesses had to be referred for final approval by a central decision-making unit. The financial modelling required would give a category that would be difficult to support. The nature of the development through R&D and NPD meant that the banks saw this as essentially something that was difficult for them to support, although a funding package of bank debt and equity was seen as a viable alternative. All the banks stressed the importance of getting to know the managers/directors, the business and its products. The nature of relationship management with the bank would determine whether it could be taken forward. This case would need to be referred for approval and the indications were that the financial modelling computer-based systems used by the banks would produce a high risk category proposition that would be difficult to make a case for.

**Actual Outcome**

The company only applied to the bank that they normally used. Their application was turned down with the recommendation that they should approach equity investors instead. The main reasons for the refusal were:

- (i) the company was too highly geared;
- (ii) they were too dependent on one customer;
- (iii) they were in a high risk area, being a manufacturing business.

The company had sufficient collateral to offer, but were not asked to do so. They were considered to have a
good trading record, a strong business plan and cash flow projections sufficient to justify the application. The managing director felt that in retrospect the company could have put forward a stronger case. He felt that the bank was unfair by refusing the finance on the above grounds. He was of the opinion that banks take a cautious view in everything and worry too much about their exposure. Therefore, in general he considered the banks to be unhelpful to the success and growth of small businesses, especially manufacturing businesses.

The company eventually raised half the funding it was seeking (i.e. £500,000) from its existing shareholders which enabled the project to go ahead, but on a smaller scale.

CASE 2

NARRATIVE

FUNDING REQUIRED: £50,000 for the purchase of new packaging machinery and new computers.

PROFILE OF BUSINESS

This is a manufacturing company which began trading in 1992. The company is privately owned and specialises in manufacturing garden products. It has a turnover of £0.5 million.

The main business activity of the company is the manufacture of garden products such as giftware, garden twines, ropes and display stands.

(i) Giftware: this is a range of high quality design led giftware for gardens which was launched in 1999. This eclectic range of practical gifts utilises all natural materials where possible, incorporating wood, terracotta, jute, and cotton which are manufactured in the UK.

(ii) Twines: this product range is fashioned using natural jute, which is biodegradable. They are packed in tins, which help to maintain the twine clean and tangle free. The company offers a comprehensive range of twines including jute, cotton, sisal and polypropylene, available in spools and balls. Its popularity with gardeners has grown significantly over the years as it is kind to plants. Twines are used for plant support, general gardening, commercial growing, decorative tying, craft use, ticketing, arts and crafts.

The company employs 14 staff, all working full-time. The management has been trying actively to grow the business during the last 2 years and growth remains the firm’s objective for the next 12 months.

The company’s brand of products is protected by membership of a trade association. Although growth is a business objective of the company, it is careful not to over supply the market in any one region, working in partnership with customers to ensure exclusivity is maintained within a selling area.

Since the launch of the range of giftware for gardeners in 1999, the product line has been developed and grown to meet the demands of customers. The growth of the company is national as well as international in nature, offering a next day service throughout the UK mainland, and deliveries being made to ports for shipment worldwide.

The main factor constraining sales performance of the company during the last 2 years is lack of finance.

NATURE OF THE BUSINESS CASE

Capital investment

The company requires finance from the bank to enable them to purchase new packaging machinery and new computers. This investment will increase the company’s productivity and efficiency. The overall profitability of
the company will also increase significantly.

Before reaching a decision to purchase the equipment, the company evaluated the capital expenditure proposal using various evaluation techniques such as monitoring the products on a daily basis, observing the market, assessing what competitors are doing and using experience of the business.

Working capital

The second reason for seeking funding from the bank is for working capital purposes. The company has a cash flow problem capable of putting it out of business. The major cause of the cash flow problem for this company is an outstanding debt of £300,000. However, the management of the company has been dealing with this problem by trying to boost sales through attracting more customers and by diversifying all the time.

The profitability of the company has improved significantly. For example, the company was making a loss of £60,000 in 2005/06, but in 2006/07 the loss has reduced to only £6000.

Interviewed bankers assessment

5.10 This case was relatively straightforward and was the smallest funding requirement of all the five cases sent to the bank managers. It was of potential interest, but would be dealt with by local business relationship managers. A representative comment was that they would not normally see a case like this. A number of features were picked up by all the bank managers. One of these, and of an immediate area of concern for all the managers, was the high level of debt compared to turnover, with the company having £300,000 debt against a turnover of only £500,000. A further issue being that the company was trading with relatively small, individually priced items. An attraction again for all the managers was that the company was well established. In terms of process and protocols, although a small company, the managers indicated that they would still need to see the management and get to understand the nature of their business. It was considered that this would help to establish the nature of the £300,000 debt, which was one of the major concerns, particularly the extent to which this might be a bad debt. If progressed, two of the bank managers, from different banks, considered that invoice discounting (or cash-flow discounting) would be appropriate for the company which would mean bringing in a specialist department concerned with asset financing. By contrast, other bank managers felt that this may not be appropriate due to the nature of the existing financing of the company. With the existing large debt, one banker considered that this made invoice discounting inappropriate because it was considered that if the debt is not insured, the invoice finance facility will be ‘basically appointing a receiver or administrator.’

5.11 In terms of additional information required all the bank managers required three years’ previous trading accounts including profit and loss and balance sheets. More detailed information would be required on debtors and creditors and credit terms, with an understanding of who is responsible for finance in the company, or whether this is completed by a separate accountant. This would then be followed by more understanding and information required on the management and key staff. One banker commented on how they liked to be able to judge people in an interview before progressing with a proposition of this nature. Two of the bankers questioned the ability of the company to grow as whilst it was fairly well established, it only employed 14 people. A key issue for all the bank managers would then become serviceability or the ability of the company to repay and service its debt. The existing outstanding debt, therefore, created a problem for them. As with all the cases visiting the premises was important. One banker commented on how this gave them a feel for
the efficiency with which the business operated, taking signs such as the ‘tidiness’ of the premises as an indicator of how well run the business was. All the bankers stressed that it was the current nature of the operation that was important, if they could understand that, then it was more likely that they would treat a proposition favourably. One of the bankers indicated that they may want the company to take some initial measures before taking the proposition further. In this case there was some questioning of the outstanding debt and the current position of the company seeking further credit, the view being that some initial internal measures by the company’s management may have to be taken before this could be taken further. In addition all the bank managers indicated that it would be dealt with at branch or ‘local’ level. Given the level of funding, one banker indicated that this would be credit-scored (rather than processed through a financial modelling system), implying that the bank manager would have to follow the credit scoring outcome. Only one interviewed banker recommended that the company should discuss their requirements with Business Gateway.

Overall Assessment

5.12 All the managers indicated that there was interest in taking this forward, but a number of issues with this case meant that further investigation would be required. The specific difficulty was the outstanding £300,000 debt compared to the level of turnover in the company and a need to understand the business and the nature of financing. The possibility of additional equity was raised, but some form of invoice discounting was the most likely outcome.

Comment

5.13 Although this case was relatively straightforward, it was apparent that the outstanding debt was a stumbling block for the bank managers, particularly in terms of understanding the nature of the business. The nature of trading history and the relationship with the company’s local manager would have been crucial to taking it forward.

Actual Outcome

The company applied to just one bank which was the local branch of the bank that they normally used. The application was turned down on the grounds that the business had too much debt (£300,000) as a result of funding previous extensions to the business and the difficulties of managing cash flow. The owner was told “there is nothing we can do for you anymore – don’t ask us for money anymore”. There was no issue with the business plan or with the business case presented by the company. The company also had sufficient trading record and their cash flow projections were sufficient to justify the application. The bank asked for a personal guarantee which the managing director considered to be too much.

However, the company obtained £35,000 funding from equity investors within one week of being turned down by the bank which allowed the project to go ahead on a smaller scale.

On the relationship between banks and SMEs generally, the managing director thinks the banks are very risk averse and that managers tend to be younger and less experienced than they used to be. Consequently, they are unable to use their discretion – “unless you tick the right boxes, you don’t get anything”.

In general, the owner felt that the banks are not helpful to the success and growth of small businesses.
CASE 3

NARRATIVE

FUNDING REQUIRED: £100,000 to ‘restart’ the company

PROFILE OF BUSINESS

This is a metal fabricating company specialising in metal cutting including burr-free abrasive cut-off metal tubes, wires, rods, and related capabilities required to meet customers’ tight tolerance and high-precision requirements. The company was established in 1995. It currently has a turnover of £490,000.

The company’s main activity is laser cutting and is experienced in manufacturing a broad range of customer specific, rapid turnaround parts from minute precision electrical components to robust automotive parts.

The company provides an innovative technology and high productivity by using laser cutting for an increasing number of applications in sheet metal processing. The company’s competitiveness is based upon its high levels of production flexibility and the virtually unlimited diversity of materials and shapes that it is able to work in.

The company employs 15 people, two of whom are working part time. It has pursued growth as a business objective for the last 2 years. The main factor constraining further growth of the company during the last 2 years has been a shortage of finance. The present owner is now aiming to re-structure the company in such a way as it can concentrate on better quality, higher value added work. This will provide the platform for the future growth of the business.

THE NATURE OF THE BUSINESS CASE

The company requires finance from the bank to help them restart the business by:

- downsizing and
- focusing more on higher margin customers

Although competition in this industry is intense and increasing, the management believes that the project will increase turnover and result in a change in overall profitability of £50,000 representing a 10% change in the first year.

Interviewed Bankers Assessment

5.14 This case created some difficulties for the bank managers as they saw it effectively as a downsizing within a competitive market and sector. A number of comments were made about the difficulty of understanding the nature of the case. Historical information would be required to understand the performance of the company. Three years historical trading figures on profit and loss and balance sheets would be required before the bank managers could take this forward. Although the case was categorised as a ‘re-start’ in the information provided, managers interpreted this case as re-structuring to downsize the company. The managers considered that the company had a limited capital base, implying that security may be difficult. One banker considered that invoice discounting would be appropriate. A further difficulty for the bank managers was that two scenarios were involved in the case, one which was for the purchase of premises. If the purchase of premises was taken forward then one of the bankers commented that it would be necessary to bring in a more specialised retail team. Some of the bankers indicated a potential positive interpretation with an assumption that the company was progressive, innovative and seeking to focus on higher margin customers. All
of them indicated that they would need to understand the management and the nature of the business, but indicated that if they could be satisfied about the more positive scenario, the proposal could be treated favourably.

5.15 In terms of additional information that the bank managers would require, this focussed on the trading record of the company and understanding the purpose of the proposed ‘re-start’. There were some differences of opinion expressed on whether the re-structuring could be a strength or a weakness. Some accepted that such a re-start or restructuring could be beneficial, especially in the sector which was seen as very competitive. There were comments by one banker that such re-structuring had been done with other companies in the sector to beneficial effect, particularly if it led to concentration on higher quality, more profitable products. As a result, the bank managers were interested to obtain additional information on the competitive edge that the company could offer. However, one banker thought the re-structuring was a potential weakness as the view was that the company could have difficulty in adjusting to the market quickly. All the bank managers wanted additional forecast or projected information for up to three years. The provision of this information may have some greater importance due to the nature of this particular case which was focused on a re-structuring of the company and a consequent change of strategy. Additional financial information would be required on debtors and creditors.

5.16 In this case, the company was predicting a loss of £30,000 in the first year projections. There was some difference of opinion between bank managers in how this would be treated. One saw it as perhaps being realistic but it was a problem with another, in as much that additional understanding of this would be required and the extent that it would affect serviceability.

**Overall Assessment**

5.17 This case may have been supported by some of the bank managers but the general view was that it was ‘unconvincing’. Therefore, there was limited interest in taking it forward. The case was difficult for the managers to support as a new business customer, but as an existing customer they were more likely to fund the proposition and to understand the purpose of the credit facility. One banker commented that if it was a new customer, up to seven or eight meetings might be required before sufficient understanding was acquired and there was satisfaction with the purpose of the proposition.

**Comment**

5.18 There were some differences in opinion between the bank managers on the way that this case would be perceived and treated. Although the company was well established, it is likely that the proposition would be treated as relatively risky and not supported and they seemed to have difficulty accepting funding for a re-structuring case. The nature of the sector was a further factor affecting this case. It was unlikely that managers would be satisfied that the company could service the credit facility required.
Actual Outcome

The company applied to just one bank for finance, which was not the bank that it had dealt with previously. Because the company was changing ownership, it was thought that they might obtain a better deal from a different bank. Although finance was not given to this company, the bank was satisfied with the business case presented. The managing director believed they had sufficient collateral, trading record and cash flow projections to justify the application.

The bank gave the managing director the impression that they would finance the project, the local bank manager saying "yes we can do it", but it fell down in the end. The managing director believed that part of the reason for the refusal was that the bank did not understand their business.

However, after a six month period of negotiation, the bank was prepared to give all the money requested to the MD personally. This delayed the project, but enabled it to go ahead completely.

In terms of the relationship between banks and SMEs, the managing director believed that there was not enough personal contact between banks and small businesses. He also felt that contact persons at most banks do not have decision making power.

Generally, he thought that the banks are not helpful to the success and growth of small businesses in relation to providing finance. He also felt that the analysis of funding applications is based too much on risk instead of potential gains and that banks should provide advice on financial planning.

CASE 4

NARRATIVE

FUNDING REQUIRED: £1 million for a business acquisition which will enable new product and market development.

PROFILE OF BUSINESS

This is a manufacturing company which was established in 1997. The main business activities of the company are the manufacture and design of commercial vehicle glazing systems – mostly bus windows. There are three factory units in Scotland, plus satellite units in Cheshire, manufacturing windows and Halstead in Essex, manufacturing automatic doors for buses. The current turnover of the company is £4 million.

It employs 81 staff, including 5 in Essex and 16 in Cheshire. The management has been actively trying to grow the business during the last 2 years through two field/sight acquisitions. Growth remains a business objective of the company for the next 12 months. For example, the door business in Essex is expected to grow since it is in a product/market area in which there is limited competition.

The main factor constraining sales performance in this company is foreign competition, including competition in the glazing market from Eastern Europe, Turkey and India.

NATURE OF BUSINESS CASE

New products

The company seeks money from the bank in order to help them to buy-out an existing door manufacturer for commercial vehicles, representing a new product line for the firm and an opportunity to diversify into a complementary activity to their existing commercial glazing business.

The commercial vehicle automatic door industry is a much higher value added activity than glazing.
Commercial windows sell at under £100 per unit, whilst the automatic doors are worth £1000 per unit, plus there is the added value of the servicing and maintenance contracts.

The proposed new product will be a complementary activity to the existing business activities. The company already has a strong customer base comprising commercial vehicle manufacturer and service providers. The company’s customers consist of large industrial or commercial customers and large repeat customers. They include major manufacturers such as Optare in Leeds, which is the third largest bus manufacturer in the UK (very secure blue chip firm). The company also services all their customer service providers such as Stagecoach, Arriva, London Transport etc.

Whilst the commercial vehicle glazing market is under threat from increasing competition, the commercial vehicle door market is less competitive, particularly within the UK and there is a clear niche for the company to exploit. The company will be able to take over a considerable share of the market and design and manufacture a high quantity product, which is better and cheaper than their competitors for the UK market. The new products will be distinctive from those of their competitors and will be UK designed and built.

The potential market is considered to be huge and the company has very good relations with UK’s major commercial vehicle manufacturers. Therefore they are aware that there is a requirement for a new door manufacturer and they know what product is required. They are able to supply the best quality product at less cost than their competitors and yet maintain reasonable margins.

The main competitor in the UK is Dean and Peters Door systems, based in Beverley (East Yorks) and Braintree (Essex). They are the only large-scale competitor in the UK. They have three competitors in Europe, one of which is Ventura, a Dutch firm that they have a good working relationship with. Ventura have now recognised that this company is a growing player in the UK market and the company have offered to buy a 25% of their firm. There are on-going discussions.

The MD’s background is that he has vast experience of the market. He previously worked in the industry as the Operations Director for a Swedish firm operating in the UK market, prior to setting up this business ten years ago.

Buy-out

The opportunity for the buy-out came up quickly. With 10 years in the industry, the management has come to realise in recent years that there is an opportunity to diversify their activities into door design and manufacture and know that there would be much more service support attached to this high value added activity. The company had wanted to get into this market, but did not have the hands-on expertise. The opportunity to buy into this through acquisition is just what they are looking for, but it is an opportunistic situation.

To carry out the evaluation of the proposal, the company ran a full financial analysis, undertook full due diligence, and presented sales scenarios for 3 years, demonstrating that it will be a very good acquisition.

During the first year of the door manufacturing venture the company has a target turnover of £400,000 which would just about enable it to breakeven at the end of year 1. However, in year two sales will increase to circa £1 million and in year three they expect to increase sales to circa £1.5 million. Thereafter, it will probably even out at around that level.

Interviewed Bankers’ Assessment

5.19 As mentioned in the introduction to the chapter, this case provided a narrative only, without additional financial information being given to the researchers. The discussion of this case, therefore, focused on the extent of interest, the process if taken forward and the additional information required. The case was relatively attractive to the bank managers, allowing for the form in which it was presented. The company was well established and with over 80 employers and several operating sites, represented a medium-sized business with a turnover of over £4 million. The nature of the operation of the company was also relatively attractive, importing materials and providing relatively high value-added through their
specialisation in the commercial vehicle market. However, there was some concern expressed by the interviewed bank managers on the extent to which the company may be over dependent on certain large companies (for example, Stagecoach) for a significant amount of their sales, who may subsequently switch to alternative suppliers. However, the nature of the repeat business that was involved was seen as a strength. This concern was taken forward by one of the bank managers, who considered that it would be necessary to bring in industry specialists from the bank, ‘at an early stage’ to obtain the additional knowledge that would be required to understand the niche sector of the company. Another bank manager considered that it would be necessary to involve Management Buy-Out (MBO)/Management Buy-In (MBI) investment specialists from the bank or an acquisition finance team, given that the funding was required for an acquisition. Some of the bank managers were relatively keen on taking the proposition forward; one banker was ‘most positive about this one’ and another considered that it ‘looks a goer’. Other bankers were more cautious with the standard view that they needed to understand ‘what is going on in the business’.

5.20 All the bank managers, however, were interested enough to judge that they would like to pursue an interest in the case. In taking this forward, given the nature of the business, the funding required and the stated purpose, all of them commented that a ‘due diligence’ process would be required with a business plan. They would need to satisfy that the debt would be serviceable. Financial modelling would be completed with the banks’ computer-based modelling systems, which, as indicated before, would produce a guide to the risk and category of the proposition which would assist the decision-making of the bank manager. As in other cases, visiting the company’s management and the premises would be essential. One banker considered that, dependent on the location, the case may be more appropriate for a more locally-based bank manager to take forward, say for example in the West of Scotland rather than the East of Scotland. The local manager would know the business, would have built up a relationship and would have taken it forward.

5.21 All the interviewed bank managers were sufficiently interested to take this case forward in terms of their own internal due diligence and protocol procedures. This would be obtained through an understanding of the financial structure of the company and through an expectation for a business plan. It may be worth noting that in this case the company’s owner/managers indicated that a full business plan had been prepared, but were reluctant to supply this to the research team. The banks’ internal financial modelling would be applied which would produce a risk and ‘strength’ result. One of the banks indicated that there were potentially a large number of categories that could be produced indicating the quality and riskiness of a proposition. All of the managers were relatively confident that this proposition could be taken forward, with perhaps additional specialists from the bank being brought in to aid the decision-making process.

Comment

5.22 Given the size and well-established nature of the company with its ‘blue chip’ customers and the credit facility required at £1 million, it was clear that all the banks were prepared to spend some time with the company to carry out their own due diligence and modelling processes. They would want to work closely with the company and were prepared to bring in specialist members of the bank to assist in the decision-making process. In addition, there was noticeably less concern with trying to understand further the purpose of
the credit facility, there being more acceptance of the logic of the strategy of the company compared to some of the other cases. This seemed more appealing as a result to the managers.

**Actual Outcome**

The company applied to just the one bank which was the one it normally used. The presentation of the business plan, full financials with 3 year projections and due diligence reports on the intended acquisition went well and the company was given every indication by the local bank manager that they would be able to raise the finance. However, the application had to be referred to the bank’s central committee who eventually decided to reject the application, just two days before the time period for the acquisition was up. A single reason was given for the application being turned down, this being that the company was too exposed, being dependent on just three main customers. This was very frustrating for the company, since this situation had been stated from the outset and had not been considered as a major stumbling block in the earlier discussions.

The managing director considered the bank to be risk averse. It proved to be an expensive experience, given the amount of time and money that was invested in this proposal and it would have been helpful if a quicker response had been received from the bank and if they had flagged up the problems with over reliance on 3 main customers at an earlier stage in the process.

By the time that they received the bank’s response, it was too late for them to do anything further and the opportunity for the acquisition was lost. They felt badly let down by their bank and the problems seemed to come from the bank’s central committee.

The managing director thought there are too many middle men in the bank finance system. They had to pay a lot of money to go down the process of trying to raise finance from their bank i.e. by providing full accounts and due diligence work – all of which represents a huge burden, particularly when the process is ultimately unsuccessful.

He also felt that there is insufficient support for manufacturing and a lot of manufacturers would really benefit from assistance with purchasing new machinery in order to improve their systems. Too many established manufacturers are making do with old machinery because the cost of new machinery is prohibitively expensive and there is not enough support for them to obtain the finance to facilitate this. Soft/lower cost loans would help, as this would help these manufacturers to become more competitive.

**CASE 5**

**NARRATIVE**

**FUNDING REQUIRED**: £450,000 for new product and capital investment

**PROFILE OF BUSINESS**

The firm was established in 2003 to sell hand crafted items, mainly Scottish handicrafts. The company employs 6 people, including the two directors. It has a turnover of £120,000.

The management has been trying actively to grow the business during the last 2 years and growth remains the objective for the next 12 months.

The main factor constraining sales performance is the fact that the company is in a rural location, so they have to advertise in order to develop trade.

**NATURE OF BUSINESS CASE**

**New product**

The company wants to build a 550 sq feet building to hold a larger gallery and craft centre (3x current gallery size), plus a restaurant with 80 covers. The restaurant represents a new service and they plan to lease this out at
£30,000 per year, plus a share of profits if takings go above £300,000 per year. They have an existing well established restaurateur on board, who has a good banking track record.

The new restaurant site is highly complementary to their art/craft/gallery business. It would attract even more people onto the site, as they can advertise restaurant services on the site as well and attract a wider range of customers. It will also be very attractive to tourists.

The owners have undertaken a huge amount of market research, attending trade exhibitions, reading trade journals and also checking out similar types of facilities in the US and UK-wide. The management is well aware of what it takes to succeed in this market and what other ‘competitors’ are doing.

The company intends to offer high quality restaurant service and a wide range of catering, from tea and cakes, to lunches and dinners and even corporate catering function which are what the customers are looking for.

Main competitors do not really exist, they are UK wide in terms of other galleries and crafts shops. Because of their Scottish crafts bias, they are mainly in competition with Scottish galleries in more tourist related areas such as the Highlands and Western Isles.

Although there is UK wide competition, there is not really much competition locally for the company as they are pioneers of arts and crafts in Aberdeenshire and also in tourism in the area, which is really underserved up until now for tourism activities.

**Capital investment**

The main reason for seeking to borrow money is to undertake the £600,000 building development required to house the new enlarged gallery, craft shop and restaurant. Potentially, the company can increase the range of their service offer, through diversification activities and a wider range of craft work display. This should provide more interest to a wider range of local and tourist customers and even specialist crafts buyers.

The company believes that the project will increase profit margins from 25% to closer to 35%.

**Interviewed Bankers’ Assessment**

5.23 This case was of interest to the interviewed bankers and ‘worth exploring’, but there were a number of issues that caused concern. The case involved a small company in a rural location seeking to undertake a relatively large scale project. The location and the rural environment caused a number of concerns. Although several of the bankers were comfortable that garden centres could be profitable, citing known examples and, therefore, comfortable with the sector, the nature of the rural market ‘was a problem’. Rural businesses have limited and dispersed local markets, unless there are any facilities that may attract seasonal tourist demand. Two bankers, from different banks, mentioned the example of the development of the ‘House of Bruar’ on the main A90 road north of Pitlochry, as an example of a very successful rural business enjoying trade ‘all year round’. Thus, the notion that a good quality facility could be provided to attract additional trade in a rural location that could be successful was accepted, however, there were concerns to understand the nature of the rural location. For example, one of the bankers was concerned to understand what rurality meant in the context of the company; that is, the extent to which the business enjoyed passing trade, as would be the case with the House of Bruar, or was it more isolated and difficult to get to. Seasonality was mentioned by some of the bankers, but this was less of a concern than what were perceived to be limited local markets and the possibility of relative ‘isolation’. The nature of the location was also associated with issues with the need for additional marketing. Given the small size of the company with just six employees, questions were raised as to whether the company would possess sufficient marketing expertise to attract the additional trade which would achieve the required growth in the business. Therefore, a further concern
was the relatively ambitious plans of the company compared to its current size, seeking a £450,000 credit facility with turnover of £120,000. However, the logic and strategy of seeking to build a restaurant facility was accepted as a strength by all the bank managers. Other strengths included that the directors were relatively experienced and the restaurant facility would be leased to a separate company rather than run by current directors. Bank managers were also comfortable with the business seeking growth in the garden centre sector. The proposition involved the directors providing additional finance, which was seen as a further strength. The larger nature of the credit facility requirement compared to the investment of the bankers was not considered to be an issue.

5.24 In terms of protocols and processes in taking the case forward, the bankers expressed a need to understand and clarify the rationale for the £450,000 funding requirement and also to understand the nature of the business, particularly addressing some of the ‘rurality’ and ‘locational’ concerns discussed above. The standard previous three years’ trading accounts would be required for profit and loss and balance sheets, showing how profitable the business is on the current levels of turnover. There was some concern with understanding the nature of the business and management strategy, more in terms of what the company was trying to achieve in the nature of the business, with some discussion of whether they were focused on ‘garden’ or ‘craft’ products. One of the bankers expressed a need to meet and understand the key staff/directors. Given the nature of this case and the size of the facility, financial modelling would be required and one banker mentioned that additional sensitivity analysis would be required. One banker considered that a full business plan would be required. If taken forward, because of the nature of the proposition, the bankers discussed the need to get forward valuations of the proposed ‘restaurant’ facility. This would require separate quantity surveying costings and an independent valuation of the facility from their panel of approved valuers. All bankers stressed the need to satisfy serviceability requirements before taking security, but valuations would be required for security in this case. In terms of the nature of projections, the initial forecasted losses were not perceived to be a major concern, so long as eventual profitability could be demonstrated and that the debt was serviceable. Given that the company was relatively recently established, it was considered that the Small Firms’ Loan Guarantee Scheme might be applicable. One banker commented that they would need to clarify eligibility with the Department for Business, Enterprise and Regulatory Reform. One banker also commented that the relative complexity of the tax position for the directors meant that they would need to seek advice from a specialist tax accountant.

5.25 The case would be dealt with by a local business manager who would be familiar with the company.

Overall Assessment

5.26 A clear difficulty for all the bankers in this case was the rural location of the business and concerns that the market would be limited. The possible relative isolation of the business may have been a constraining factor. This apart, the bankers expressed a sympathetic attitude to the proposed strategy of providing a relatively high quality facility as an attraction for additional customers. They would need to understand the nature of ‘how this would work’ and the nature of the business, but the concept of leasing to a specialist restaurateur was attractive.
Comment

5.27 In principle, this case was attractive to the bankers, even though the size of the credit facility was high compared to the existing operation and turnover size of the company. The nature of the proposition to create a facility, which would provide security, with investment by the directors was attractive. As an existing customer the local bank manager would know the business and, more important, know the local market and have sufficient local knowledge to make decisions on what was viable. It appears that this would be critical in whether this proposition would be taken forward.

Actual Outcome

The company considered a number of funding sources including making approaches to four banks. All the providers appeared keen to lend to the company, but were concerned about lack of trading records and collateral. The first bank offered finance, but it was not enough for the project to go ahead.

The company had to shop around and obtained sufficient funding from another bank within the timescale. The lending bank was persuaded by the company’s plans to lease out the restaurant to a restaurateur who was already a good customer of the bank. The bank required 130% of guarantee which was secured against the company’s property.

The director of the company felt they learned a lot from the process, which was understandably stringent. Despite obtaining the requested funding from one of the banks, the director also criticised the banks for being very conservative and being quite slow in offering finance.

The director also felt that the amount of security required for the loan at 130%, was very high and this could have put many prospective borrowers off. He thought that banks in Aberdeenshire did not have any understanding or demonstrate any support for a tourism/craft related business – as they do not come across these type of businesses in this region. They actually sought finance from banks in a neighbouring tourist region, as they had more understanding of the sector that they are working in.

Apart from providing finance, the director of this company thought banks could be quicker to assess applications and explain to potential business borrowers how they can improve their applications. This could avoid creating lengthy delays in the process. Perhaps more should be requested up-front in order to facilitate this process.

Conclusions from the Case Analysis

5.28 A number of key conclusions can be drawn from the interviewed bank managers assessments of the five case studies put before them:

- All cases would involve meeting the management team and visiting premises, although with the small companies, this would be by the local business or relationship manager. The purpose would be to seek a better understanding of the business and of the management team.

- The management team, strategy and purpose seemed to be equally as important as financial analysis.
Financial analysis would be prepared with a view to undertaking financial modelling analysis which would produce a guide outcome and category, although all the banks seemed to indicate that there was some discretion as to whether the bank managers’ were required to follow the modelling outcomes.

All the banks segment the SME market, the larger companies would have been dealt with by ‘corporate’ bank managers, smaller by local or ‘business’ bank managers.

Three of the cases (cases 1 to 3), provided scenarios that were difficult to support for varying reasons by the bank managers. This was caused by a combination of financial and strategic management issues. The sector and location were additional issues.

Two of the cases (cases 4 and 5) were likely to be supported and of most interest to the bank managers. However, in both there were potential factors that may have resulted in the decision not to take the case forward. In case 5 the rural location seemed to be particularly important as a limiting factor.

Case 4 (involving an acquisition that would enable new product and market development) was treated most favourably in terms of interest, however, a full business plan would be required and due diligence to satisfy the banks’ internal processes.

There is little clear evidence of any market failure in SMEs access to bank finance from this analysis of what were five of the most promising cases for bank finance resulting from the business survey. Even if there were some issues with financial performance and track record, the banks would try to engineer a solution for existing business and existing bank customers, There was also evidence that the banks would attempt to pull together a ‘funding package’. However, this would be more difficult for a new to business bank customer.

The case analysis indicated that potential difficulties for SMEs in accessing bank finance could still exist in the following circumstances:

- For small businesses in a rural location seeking growth.
- For SMEs in perceived ‘competitive’ sectors, especially in manufacturing, that could not satisfy bank internal modelling and computer-based processes.
- For SMEs seeking growth through R&D and NPD, especially where it is difficult for banks to get the required degree of ‘comfort’ through security.
- For well established SMEs seeking a radical change/re-structuring with limited security.

5.29 With the interviewed bank managers’ analysis of the five specific cases in mind, the next chapter is concerned with a more general discussion of the issues relating to funding SMEs from the perspective of the eight interviewed bankers.
CHAPTER SIX: BANK MANAGERS’ DISCUSSION OF GENERAL CRITERIA WITH SME PROPOSALS

Introduction

6.1 As well as conducting the protocol analysis based on the selected five case study scenarios, the interviews with the bank managers also covered more general questions relating to their dealings with their SME business customers. This covered questions relating to each of the three participating bank’s protocols and procedures, the type of information they would typically require about clients and their business propositions, and the importance they attached to various criteria in making funding decisions. Although there were some interesting differences between the three banks, most of the answers confirmed the findings of the protocol analysis presented in the previous chapter.

6.2 In addition to the interviews with the eight bankers, an additional interview was conducted with the Princes Scottish Youth Business Trust (PSYBT) in order to obtain a better insight into the problems of accessing finance experienced by start-up businesses run by young entrepreneurs. This interview focused particularly on the extent to which these new businesses also approached banks for finance. The results of this interview are presented in the final section of this chapter.

Protocols and Procedures

6.3 All three of the interviewed Scottish banks indicated that they have a segmentation approach to the SME business market. In two of them, this is based on the turnover size of businesses, with a turnover of £1 million being the threshold. For the third bank, the segmentation approach is based on the size of the credit facility within different ‘tiers’ of lending requirement. A £250,000 credit facility is one threshold, although there is some overlapping authorisation between different tiers. Therefore, the size of the SME concerned and the borrowing requirement would dictate, partly, how the business customer would be dealt with in terms of the processes of the bank and the nature of the relationship with the manager.

6.4 All the banks have a ‘relationship management’ approach. With existing customers this could lead to a streamlined decision-making process where the bank manager undertakes a minimum due diligence procedure, particularly where an existing business customer is facing what is perceived to be temporary difficulties (e.g. the foot and mouth crisis in farming). It is evident that considerable time could be spent with individual SME client businesses. Following an initial approach, time would be spent understanding the business, its management and visiting the premises. For one bank manager, it is considered to be ‘very important’ to meet the client face to face.

6.5 For existing businesses the standard three years’ trading accounts would be required and the way that the account was managed is clearly important to determining whether the facility would eventually be approved. Financial modelling would be used in most cases, however, for smaller amounts (such as that involved in case 2 in the previous chapter), a more streamlined credit-scoring system would be used. However, this varied between the banks (see section 6.3 below). Such a system gives more limited discretion, producing one of
three outcomes i.e. accept, reject or refer. A refer decision would need sanctioning by a central decision-making credit department; in other words it might be approved if a case could be made acceptable to the central credit unit. Generally, however, for existing customers considerable discretion for authorisation is given to the bank managers themselves.

6.6 For start-up propositions additional forecasting information is required. The interviewed bank managers implied that more time may have to be spent with start-up propositions in order to establish the information required, with one banker commenting that ‘a lot more information is required with start-ups’. They are generally willing to use Business Gateway as a referral mechanism for start-ups in order to ensure the entrepreneurs received appropriate advice, training and support with preparation of business plans. Authorisation and discretion is more limited with start-ups and all start-up approvals are required to be sanctioned from a central credit department by at least one of the banks.

Information Required

6.7 Some discussion of the information required has been given above, especially in terms of the differences between existing business customers and start-up businesses. Beyond this serviceability is an important factor, or the viability and sustainability of a proposition. For example, one banker commented that they needed to be ‘convinced about the business and the serviceability of the debt’. The nature of the client’s credit history is regarded as essential information and generally historic information is considered to be more important than projections for existing businesses. As noted later, this means that greater information is required for start-up propositions, even if the entrepreneur may have been associated with a previous business. Additional or more specialised information would depend upon the purpose of the proposition. All the managers indicated an ability to bring in a specialist team of staff if necessary, dependent on the nature of the proposition. For example, if the application was from a technology-based, company, concerned a management buy-out, or concerned property investments, the bank managers have the ability to call on specialised staff and intelligence usually from within the banks themselves.

6.8 As was apparent in the case scenarios, the bank managers would seek an understanding of the business and the management team by visiting premises. The importance of the company’s management and strategy compared to financial information varied a little between the interviewed bankers. Interestingly, two managers from the same bank when presented with the same case scenarios were found to have contrasting priorities.

6.9 In taking propositions forward all the banks use a financial modelling system, apart from in the case of some smaller applications. The indications are that this produced a risk-reward categorisation which is a guide to decision-making.

Credit Scoring

6.10 As mentioned earlier, credit-scoring is used with smaller applications in a more streamlined situation. The bank managers that participated in this research were relatively senior and would not normally deal with applications that might be allocated for credit-scoring. Of those that discussed this issue, one banker indicated that it would only be used for credit facilities below £100,000 and another that it would only be used for businesses with a
turnover below £1 million, indicating that alternative thresholds were applied by the different commercial banks. One banker indicated that where credit-scoring is used with a new business proposition it would provide re-assurance rather than be used as the sole basis for making the decision.

Reasons for Non-procedure

6.11 Non-procedure would usually result from a failure to meet the requirements in the process that has been outlined above. Generally, this meant that there are historic problems with credit history or with a lack of historical information on trading accounts. One bank manager referred to ‘holes’ in the information set which could lead to non procedure or seeking to do a different level of credit facility.

Importance of Different Criteria

6.12 The bank managers were presented with an extensive list of different criteria, verified in advance by the research team, and asked to comment on their importance for decision-making. There was some variation between them in the importance they attached to a number of the criteria but also some consistency on others.

6.13 There was a consistent consensus that knowledge of the business owner/managers is very important, which confirmed the importance of this factor from the analysis of the case scenarios. The personal relationship between the SME owner and the local bank manager is a critical factor and as indicated during the case analysis, bank managers invest considerable time and effort in developing their relationships with their SME business customers. For example, for a new potential customer, one banker considered that it is essential to be satisfied that they have the right competencies and skills. Another banker commented that in the case of a new to bank business customer it would help ‘if a recommendation is made through an accountant or valuer, or one of our other professional contacts’.

6.14 Location, particularly related to the issues of peripherality, accessibility to markets and where local markets are perceived to be limited, is regarded as a factor that could be important, confirming its importance from the case scenario analysis. The discussion also reinforced the importance of local knowledge and local business relationships. Although some bank managers have extensive regional and geographical remits, one manager commented that ‘they tend to deal with clients within 25 miles of our centres’.

6.15 There was some variation in the importance attached to sector between the bank managers. For one banker ‘no sector would be ruled out’. There was consensus that all sectors would be considered, apart from those excluded for ethical and legal reasons. For another banker, the sector did matter, indicating that some sectors may be out of favour, although propositions would always be considered. As indicated by the case scenarios, some sectors are regarded as competitive and additional information may be sought on them centrally for financial modelling purposes. One banker considered that there are some sectors that are ‘not actively pursued.’

6.16 Previous trading history, authorised accounts, profitability and the management track record are regarded as essential by all the bank managers. This would give them a trend
analysis. As mentioned previously, banks like to have three years’ trading history. This allows them to ‘benchmark’ against central information on the nature of businesses and their performance in different sectors as part of the overall appraisal. Forecast information is more important for start-ups and new businesses, forecast cash flows being essential for new businesses.

6.17 The importance of personal factors such as age, gender, and experience varied a little between the interviewed bank managers. There were strong opinions expressed that gender is irrelevant and ‘never considered’. However, one female banker thought that there may be a perception amongst female entrepreneurs that gender could be important (which may support other evidence of discouraged borrowing by female business owners). Certainly the banks’ protocols and systems should, in principle, be gender neutral with all banks reminding their managers regularly that all customers and potential customers should be treated equally. There was some variability between bank managers on the importance of the age of the business owner. Some were concerned that, with older owners, there should be succession planning in place and one banker commented that, with younger owners, it is lack of experience that could be a factor. Another banker commented that ‘age is not barrier, but experience is’. Experience, generally is considered to be very important.

6.18 All the bank managers considered that available security is of secondary importance to the main considerations which focus on previous financial history, management track record, forecasts, serviceability and an understanding of the business. As with the discussion of the case scenarios, the interviews revealed that security could become an important issue, although it would not be the first issue to be considered. As one banker commented, ‘security is considered, but it’s not the main thing as the first consideration is can the business repay its debts’.

6.19 A related issue is the importance that the banks give to the Small Firms Loan Guarantee Scheme (SFLGS). The discussion of the case study scenarios revealed that in certain specific cases the bank managers found that it had become more difficult to apply the SFLGS since the Graham Review\(^1\) largely because the Scheme now targeted businesses less than five years old and entrepreneurs from social groups under-represented in enterprise. One of the bankers commented that they refer to specialists ‘who are up-to-speed on the Graham Review’. Another said that ‘where possible we will use it but [for] many of the businesses we deal with there are alternative forms of security that we should be using first’. One the bankers said that they had not used the Scheme since the changes, even though the sector criteria had been relaxed. One manager commented that ‘we do use it on occasions, (but) it really is a lender of last resort for a viable business’. Generally, therefore, the SFLGS is used very much as a last resort and only for certain qualifying small businesses. However, these findings need to be treated with caution and are not surprising given that the SFLGS has become more targeted at start-ups and young businesses. Data from the Department for Business, Enterprise and Regulatory Reform indicates that in Scotland the Scheme is achieving expected take-up rates following its re-focusing after the Graham Review (BERR, 2007). There were 235 approvals granted in Scotland from a total for the UK of 2,702 (8.7 per cent of UK approvals, but 9.6 per cent by value) under the revised Scheme to the year ended 31 March 2007.

\(^1\)New form of SFLGS introduced from 1\(^{st}\) December 2005, following the independent Graham Review of the Scheme
6.20 Other factors that were discussed with the interviewed bankers included the nature of existing (additional) shareholders or investors, the role of support agencies such as Business Gateway, referrals from third parties and the role of credit references and customer recommendations. The role of additional investors, including business angels, is considered to be a potential benefit, but with a need for managers to understand their role. One bank manager commented as follows: ‘it depends on what influence they exert, whether that’s good or bad, in terms of their investment. If you can raise some additional finance it would help to get the deal off the ground. I would welcome that, but if it came with strings attached, or if it is a cash injection looking for a return, or a cash injection and keeping an eye on running the management, I really need to know who I am dealing with’. The use of referrals to support agencies is variable, but Business Gateway is seen as particularly valuable for referrals of start-ups. Referrals from third parties are treated generally favourably, although this is not an important factor. The use of credit references and customer recommendations is an ‘added comfort’ level, but again not an important factor in decision-making, apart from sometimes in the case of new to bank business customers.

6.21 There was further discussion of the relative importance of existing and new business customers. Whilst bank managers have targets for new business, the importance of existing business SME customers was reiterated, indicating that a higher level of information is required for new business customers. Finally the current credit environment (at the time of interview\(^2\)) was perceived to have no effect on current relationships with SMEs, nor was it restricting lending.

Summary of General Criteria

6.22 The discussion in this chapter has reinforced the importance of a significant number of criteria that were revealed in the findings from the analysis of case studies with the bank managers. As indicated earlier, there were some variations between the bankers in the importance attached to different criteria, but this is partly attributable to differences in their seniority as well as to different internal processes within the three participating banks. In summary, the following factors emerge as important criteria:

- The management track record of the management team.
- The existing personal relationship with the SME’s local bank manager.
- The immediate financial history of the SME including the previous three years’ trading accounts.
- Location for some businesses.
- SME sector, particular if some sectors are ‘out of favour’.
- Security is seen very much as a secondary factor, but, taking into account the case discussions, it is a factor that could be important for ‘high risk’ lending situations with some SMEs.
- A related issue is that it appears from the interviews with the bank managers that the use of the SFLGS has declined since the Graham Review which might be expected given that the intention of the Review was to make the Scheme more focused on

\(^2\) Interviews were undertaken before the financial turbulence that started in autumn 2007. It is unclear whether SME lending will be impacted upon.
young businesses and entrepreneurs from under-represented groups. However, this may be acting as an additional constraint on well-established SMEs without identifiable security (as they are now ineligible under the Scheme).

- Existing business customers should find it easier to seek bank finance than new to bank customers.

Additional Consultation with PSYBT

6.23 The Princes Scottish Youth Business Trust’s (PSYBT) clients in Scotland are young entrepreneurs, less than 26 years of age, seeking to establish a new business. PSYBT support young entrepreneurs that qualify and satisfy their funding panel with a loan of up to £5,000 and a grant of £1,000. Successful clients are eligible for Development Loans of up to £10,000 and Accelerator Loans of up to £25,000 for business growth, if they have been in business for less than five years and are aged under 31.

6.24 The PSYBT deliver support through business advisers who provide ‘aftercare’ for two years. PSYBT considered that up to 15 per cent of their clients would seek commercial funding after the two year PSYBT support programme, but it was considered difficult for the client group to secure commercial funding due to the lack of personal credit history and a limited business trading period. It was considered that only about five per cent of clients of PSYBT succeed in getting any support from commercial banks at the start-up stage and that some of their clients go to three or four banks before being allowed to open a business account. Business Gateway and Highlands and Islands Enterprise are close enterprise partners and participate by referring 67.9 per cent of all new clients to PSYBT and by filtering out projects which are unsustainable (Scottish Enterprise, 2007).

6.25 In order to qualify for financial support a client has to be ‘disadvantaged’ and have used up any other source of finance that is available. PSYBT is seen as the ‘lender of last resort’. In the case of young entrepreneurs, their age, lack of both experience and trading history can cause them problems with banks and other lenders. Evidence gathered from the research conducted for Scottish Enterprise (2007) about PSYBT found that the main source of finance for 82.7 per cent of start ups came from personal savings and their family. Bank finance was used as the main source of funds by 5.7 per cent. Most young people said they had, on average, £1,000 to invest at start up.

6.26 However, the evidence of market failure present in the PSYBT client group takes the form of a perceived problem of securing finance from external sources. Seventy per cent of respondents did not try to get funding from another source before approaching PSYBT, even though 61 per cent of them knew of other ways to secure finance. The reason given was a belief that they would be unlikely to obtain the necessary funds (Scottish Enterprise, 2007).

6.27 PSYBT makes 500 agreements a year, with typical lending on average £3,600 and, in their experience, 80 per cent of their clients repay on time. However, they did consider that a lack of financial record keeping is a problem, with only 25 per cent of clients having adequate financial records. Therefore, it is reasonable to assume that there would be problems with raising finance at the banks, once their clients are out of the Aftercare Scheme.
6.28 Overall, PSYBT considered that there is a funding gap for their client base with relatively small amounts of funding, perhaps less than £10,000. In general a funding gap for smaller businesses was considered to exist for amounts less than £100000.
CHAPTER SEVEN: CONCLUSIONS

7.1 This final chapter starts by drawing upon the findings of both the demand-side and supply-side research to address the primary question that lies at the heart of this study before presenting the conclusions of the business survey and the interviews with the bankers separately.

Is there evidence for market failure?

7.2 The primary purpose of this study has been to assess the extent to which there is evidence of market failure in the market for finance involving SMEs and commercial banks in Scotland. Specifically, to what extent is there evidence of good, robust business cases for finance being refused by the banks which might be an indication of sub-optimal lending practices by the banks? Alternatively, to what extent can the failures by SMEs to obtain bank finance be attributed to the unsuitability of the business cases that they are putting to the banks (i.e. demand-side issues)? As discussed in Chapter 1 (section 1.2), these are not easy questions to answer as there are numerous factors that can effect the relationship between SME owner/managers and bank managers and therefore the chances of a business securing the funding it needs, not least the willingness and ability of the entrepreneurs to share the risks involved, the problems of information asymmetry, and various factors that can influence perceptions on both sides. However, putting these complications aside for a moment, has this study produced evidence to support those who argue that there continues to be market failure relating to SMEs access to finance in Scotland?

7.3 The first point to emphasise is that, taking the 2006 ASBS (Scotland) survey as a whole, it is only a very small minority of businesses that experience problems in accessing finance; in the twelve months leading up to the survey, just under a fifth of SMEs sought bank finance and of these, just under a fifth experienced difficulties. Put differently, only 6.3 per cent of the 1014 businesses surveyed reported problems in accessing finance and just over half of these, 3.4 per cent of the total surveyed, were businesses that had approached banks for finance. Moreover, not all of these will have had their applications for funding turned down as the problems may have been of a different kind. In fact, the ASBS (Scotland) data show that 1.6 per cent of SMEs were unable to go ahead with investment projects in 2005-06 because of problems in accessing bank finance, suggesting that even in cases where bank finance was refused, many firms were able to find other ways of funding their projects. There are also sound reasons for expecting the proportion of SMEs experiencing problems with bank finance to be smaller than these findings indicate in the population of Scottish SMEs as a whole, given that manufacturing SMEs were over-represented in the ASBS (Scotland) survey and that it has been shown that these are more likely to encounter problems accessing bank finance than firms in other sectors.

7.4 It is the 20 businesses in the business survey conducted for the purpose of this research where no bank funding was received which therefore become the focus of attention in assessing the extent of supply-side market failure relating to the banks. The business survey revealed that almost two-thirds of the owner-managers of these SMEs believed that they had been rejected because of lack of collateral and trading
status, whilst around one third believed that they had been rejected due to the bank’s concerns about the strength of the business case that they were putting forward. It was from these latter cases that the five scenario cases that formed the basis of the interviews with the bank managers were selected. It was the opinion of the researchers together with advice from the banking expert that these were the strongest business cases from amongst the 20 businesses that were turned down for bank funding. Of these five, it is significant that there were only two that the interviewed bankers considered were worth serious consideration and stood a good chance of being supported, since the others raised too many concerns about financial and strategic management issues. And of these two, one did actually receive the funding it was seeking by ‘shopping around’ the banks. This leaves just the one case that was actually turned down for finance and that would appear to be an example of supply-side market failure. The protocol analysis conducted with bank managers would appear to show that there were very few SMEs from the 20 that were turned down for bank funding that might be considered ‘borderline’ cases. For the rest, it was not difficult for the researchers to understand why the applications for finance had been refused.

7.5 Having said that, much of course depends upon the degree of risk that the banks are prepared to take and judgements about market failure cannot be divorced from views about what is a reasonable level of risk for banks to accept. There is a view, strongly expressed by some of the interviewed SME owner-managers, that the banks tend to be over-cautious and risk averse. The research evidence does provide some support for this view in that it tended to be the more risky projects, especially those involving diversification into new product and market areas, which were most likely to turned down by the banks. Thus the banks attitudes to risk may have the effect of discouraging some of the more innovative, higher risk projects from going ahead which, it might be argued, may constrain business growth and competitiveness.

7.6 At the very least, this research has identified a number of problems in the relationship between banks and SMEs which need to be addressed. In particular:

- There are clearly a number of difficulties relating to manufacturing businesses that relate to the problems of financing new product and market development and investing in upgrading plant and machinery. The owner/managers of manufacturing businesses frequently criticise the banks for being risk averse and having difficulties understanding the nature of their business.

- One of the most common criticisms of the banks by SME owner/managers is the length of time that it takes to come to a decision and how initial favourable indications at the local level can be misleading when the application is later rejected at a higher level within the bank. In a fast moving and fluctuating business market, SME owner/managers frequently have to respond to opportunities quickly, but it is felt that the banks seem not to appreciate this. The research identified a number of cases where the application for bank funding was in the end successful but where the delays on the part of the banks were at a cost to the businesses they were servicing.

- Unfortunately, there were very few start-up firms in the ASBS survey which was the primary data source for this research so they are under-represented in
this study. More work is therefore needed on the relationship between start-up businesses and banks and the extent to which market failure may be occurring here. There is some indication from both previous research evidence and the interview conducted for this research with the PSYBT that there is a funding gap relating to new business ventures. There was also little evidence from either the business survey or the bank interviews of the Small Firms Loan Guarantee Scheme being used to provide funding for younger businesses where lack of security may be a concern to the banks.

7.7 The rest of this concluding chapter summarises the key findings from first the business survey and then the interviews with the bank managers.

Business Survey - Conclusions

7.8 The results of the survey of 51 businesses, conducted as part of this study and based on SMEs that had previously participated in the 2005 and 2006 ASBS (Scotland) surveys, leads to the following conclusions:

- Those businesses experiencing problems accessing bank finance (39 of the 51 that were interviewed) were typically well established businesses that were growth seeking and disproportionately from the manufacturing, retailing, wholesaling and hospitality sectors. The most frequently mentioned financial constraints were lack of development finance, particularly affecting manufacturing firms, and cash-flow problems, particularly affecting the retail and hospitality sectors.

- The median project cost for which finance was sought was £105,000, with a median external borrowing requirement of £85,000. On average therefore 81 per cent of the project cost was sought from external sources. However, the scale of borrowing requirements amongst the surveyed businesses ranged from £5,000 to £80 million.

- Two-thirds of those businesses seeking bank finance also considered alternative sources, with around half of them actually approaching alternative sources, mainly for grants, soft loans and equity finance (for some larger firms). There is some evidence of a perceived ‘gap’ in the equity investment market for finance of up to £1 million due to the lack of interest from equity investors for investments below the £1 million threshold and, according to owner-managers, the cautious and risk averse approach of the banks.

- A striking finding is that almost two thirds of the businesses approached only one bank, typically their existing bank, and did not ‘shop around’ once their application for finance had been rejected. This may suggest concerns about the time and resources involved in approaching other banks, uncertainty in approaching banks with which they were not familiar, or a ‘discouraged borrower’ effect. (The supply-side interviews indicated that difficulties are more likely to be encountered by ‘new to the bank’ customers - relationship
banking suggests that the existing bank is likely to be more sympathetic to funding requests).

- Just over half of those businesses which had encountered problems accessing bank finance had had their application turned down. The less successful applicants for bank funding tended to be: manufacturing firms; businesses operating at a loss; businesses seeking smaller scale loans; projects relating to working capital requirements (typically overdrafts and small scale loans); and projects related to new products and market development (typical of manufacturing firms).

- Half of businesses used external assistance with their loan application: one third from accountants and one fifth from either Business Gateway or Scottish Enterprise (typically in the case of larger firms seeking equity finance). A number of firms complained about the cost of accountancy and consultancy advice required in order to support bank loan applications. In terms of improvements to the services provided by the banks, a number of owner-managers were in favour of banks providing a broader range of SME advisory services and nearly one fifth mentioned that they would like to see banks becoming a one-stop-shop for all sources of business finance.

- Almost one third of the businesses that were unsuccessful in obtaining bank finance indicated that a lack of collateral and/or lack of trading record were the main reasons for not receiving a bank loan, whereas less than a fifth of them mentioned providing an insufficient business case as the reason for rejection. Some businesses complained about receiving inadequate feedback from the bank as to why their application was unsuccessful.

- A major area of criticism amongst the businesses that had problems accessing bank finance focused on the applications process. Two-thirds of them complained about aspects of the way in which banks processed their applications: one fifth complained about delays in the decision making process; one eighth stated that information provided by the bank was misleading (particularly about overdraft facilities and differences of opinions between local and centralised levels of the banks); and one tenth noted that there was no link between bank finance and alternative sources of finance. Two fifths of applicants for bank finance took more than six months to get a final decision. Delays were caused by referring applications to centralised teams and bureaucratic procedures.

- A number of owner-managers referred to specific difficulties in obtaining overdraft facilities, particularly for new businesses in the retail and hospitality sectors. Some claimed to have initially been offered overdrafts at start-up, but were then unable to obtain them once they had started trading.

- Despite the difficulties they encountered, over half of the businesses that reported difficulties in accessing bank finance were able in the end to undertake the whole project that they had required funding for and a further eighth to partially deliver projects. This leaves just under a third that were unable to go ahead with the project because of lack of funding. Where banks were not
prepared to advance the funding themselves, they were sometimes able to suggest, or in a few cases introduce, the businesses to other external sources such as equity investors.

Bankers Interviews – Conclusions

7.9 The protocol analysis of the case studies together with the discussion of the banks’ procedures and lending criteria leads to the following overall conclusions:

- Bank managers place heavy reliance on personal relationships and knowledge of SME business owners, building up relationships over a period of time. They are prepared to invest considerable time in visiting premises, interviewing managers, and becoming familiar with businesses. A primary requirement for any proposition from either existing or new business customers is to understand the nature of the proposition and the serviceability and sustainability of the proposed venture. Thus, although bank managers have targets for new business, it is easier for existing business customers to seek funding, particularly where this might fall outside established ‘norms’, such as highly geared propositions, or relatively large credit facilities compared to the size of the firm and turnover.

- Banks have standard financial ‘models’ that are followed in terms of financial requirements, although there may be considerable discretion exercised by individual bank managers, dependent on seniority. In addition, it is clear that bank managers would, as far as their discretion allowed, seek to support established businesses with which they have an established personal relationship. The financial modelling process produces a result which indicates the category for the strength of the proposition in terms of risk/reward, but with latitude for bank managers to use discretion. However, given the segmentation applied by the banks, it will be easier for larger SMEs to obtain funding. Although how the SME market is segmented varies between the banks, micro and small firms are likely to have their propositions credit-scored (reducing the extent of bank manager discretion and flexibility). This is likely to make propositions from small firms that differed from bank ‘norms’, such as highly geared propositions with limited security, difficult to accept, especially if there are any issues with credit history and the trading track record.

- A number of factors can affect the financial modelling process and hence the extent of latitude and discretion of managers. Entrepreneurs seeking to start new businesses will find it more difficult because of the lack of any trading history. In such circumstances previous experience, age and credit history of the entrepreneur will be important. These are likely to be credit-scored which may limit the flexibility that bank managers have, especially as such proposals are referred for final approval to a central credit department.

- Additional factors include location and sector. Although no sectors are excluded by the banks, SMEs in competitive sectors may find it difficult to raise finance, especially if they are operating in ways that do not fit the banks’ own internal guides on benchmarking for the sector. A similar comment can be made on location. Rural locations can be difficult environments for SMEs, having limited
local markets and limited networks and resources. Large areas of Scotland, the Highlands and Islands and the South of Scotland, qualify as rural under Scottish Government definitions\(^3\). SMEs in such localities seeking to grow and raise finance may find it difficult to raise bank finance, especially if reliant on local and regional markets.

- Security is a secondary factor, but nonetheless important. Established SMEs with limited security will find it difficult to raise finance for propositions that contain higher risk or do not meet banks’ financial modelling requirements. Changes to the Small Firms’ Loan Guarantee Scheme following the Graham Review by the UK Government, has meant that the banks have in some cases reduced their use of the Scheme, moving from ‘occasionally’ making referrals under the Scheme to ‘rarely’.

7.10 Whilst this study has produced little evidence of there being an issue of market failure relating to SMEs access to bank finance in Scotland, the above conclusions do nevertheless raise a number of more specific issues relating to the nature of the relationship between SME owner-managers and the commercial banks which are deserving of further attention by both the banks and the Scottish Government.

\(^3\) Although Scottish Government definitions of rural locations are different from standard ONS definitions based on size of settlements, these take account of the more dispersed patterns of settlement in rural areas of Scotland.
Appendix I:

Sectoral Representativeness of the 2006 ASBS (Scottish) Survey

Table: Broad Sectoral Comparison of 2006 ASBS Survey and 2006 ABI for Scotland

<table>
<thead>
<tr>
<th></th>
<th>2006 ASBS (a)</th>
<th>2006 ABI (b)</th>
<th>Weighting</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No</td>
<td>%</td>
<td>No</td>
</tr>
<tr>
<td>Primary Activities &amp; Energy</td>
<td>56</td>
<td>5.4</td>
<td>4,206</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>187</td>
<td>18.4</td>
<td>10,047</td>
</tr>
<tr>
<td>Construction</td>
<td>90</td>
<td>8.9</td>
<td>15,528</td>
</tr>
<tr>
<td>Wholesale &amp; Retail</td>
<td>288</td>
<td>28.4</td>
<td>39,031</td>
</tr>
<tr>
<td>Hotels &amp; Restaurants</td>
<td>168</td>
<td>16.6</td>
<td>15,074</td>
</tr>
<tr>
<td>Transport</td>
<td>61</td>
<td>6.0</td>
<td>7,877</td>
</tr>
<tr>
<td>Business Services</td>
<td>124</td>
<td>12.2</td>
<td>45,142</td>
</tr>
<tr>
<td>Public Services</td>
<td>17</td>
<td>1.7</td>
<td>21,526</td>
</tr>
<tr>
<td>Other Services</td>
<td>23</td>
<td>2.3</td>
<td>15,104</td>
</tr>
<tr>
<td>Total</td>
<td>1014</td>
<td>100</td>
<td>173,535</td>
</tr>
</tbody>
</table>

Notes to table
Source: ASBS 2006 and ABI 2006 (NOMIS)

The table indicates that when compared with the overall broad sectoral structure of businesses in Scotland, the raw data from the ASBS 2006 is considerably skewed in favour of manufacturing (3x) and hotels and restaurants (2x), whilst it is skewed against ‘other’ services (1/4) and business services (1/2). Therefore, the statistical findings drawn specifically from the raw ASBS data with regard to problems accessing bank finance will need to take this bias into account, when applying overall trends to the situation in Scotland as a whole.
References


FSB, (2002) Lifting the Barriers to Growth in the UK Small Businesses, Report to the Federation of Small Businesses, Survey undertaken by Department of Marketing, Strathclyde University


