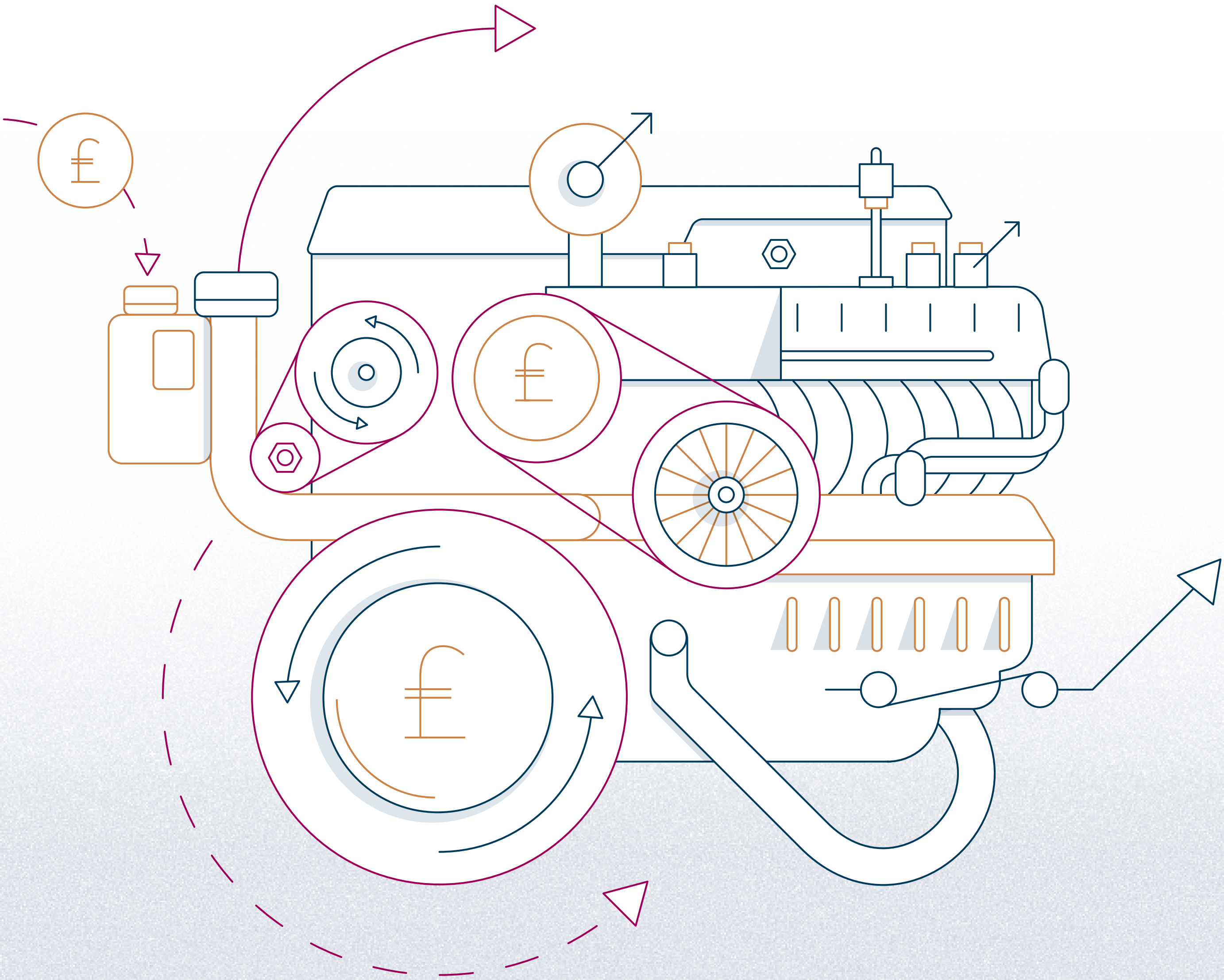
Financing growth; how the mid-market is driving economic recovery

An independent report by BLME



Disclaimer

Contents

Introduction

The UK mid-market is a powerful driver of the economy. Often unfairly misrepresented, these firms make huge contributions to jobs and growth. Over the last 12 months the economic picture has continued to brighten despite flashpoints remaining; uncertainty in the run up to the general election, the prospect of a Greek exit from the eurozone, the confirmation of an EU referendum before the end of 2017, and growing concerns over productivity and exports.

Despite these challenges the mid-market continues to perform, driven by successful applications for finance. We estimate that as a result of these successful applications, mid-market firms have added £148 billion in output and 152,900 jobs to the UK economy over the last four years. These are compelling statistics.

Financing growth; how the mid-market is driving economic recovery, the third annual instalment of Bank of London and The Middle East's (BLME) research into the growth of the mid-market, uncovers a fascinating set of trends which point to a real opportunity for finance providers targeting this section of the business community. We find that 70% of the mid-market applied for bank finance in the last four years – one in five from a challenger bank – and an overwhelming 93% were successful. Intriguingly, plans to look at alternative sources of finance like private equity and peer-to-peer lending are also at the highest levels we've ever recorded.

But we also find issues which need addressing, if mid-market businesses are to continue to grow and support the economy. Two in five exporting mid-market firms want to export more, but feel constrained by cost and red tape. There are also signs that firms are thinking twice about how they do business with the European Union – the biggest export destination for the UK mid-market – in light of the imminent referendum on Britain's EU membership.

Underpinning this report is our continued belief that the UK mid-market deserves a better hearing. Too often these firms are coupled with small businesses or the largest multinationals, both groups of businesses with utterly different needs and priorities. It's critical we treat the mid-market as a distinct group with its own characteristics and not offer solutions designed for their smaller or larger peers.

Our findings come from in-depth interviews with leaders and senior decision makers at mid-market businesses across the UK. Here's a tantalising suggestion which emerges; that the UK's challenger banks, themselves in the middle of the big high street names and newer alternative finance providers, may be the ones best placed to meet the bespoke needs of UK mid-market plc. Food for thought as we look ahead to the challenges and opportunities an ever-strengthening economy presents.

[1] Department for Business, Innovation & Skills

> *"As a result of finance secured over the last four years we estimate that mid-market firms have added £148bn in output and 152,900 jobs to the UK economy. These are compelling statistics."*

Jervis Rhodes.

Jervis Rhodes,
Head of Corporate Banking
BLME

Summary of key findings

70% of mid-market businesses applied for financing from a bank in the last four years

20% of these applications were made to a challenger bank

93% of firms were successful in their application

87% of businesses say turnover has increased as a result of the finance – generating £148billion over the past four years

84% of mid-market leaders are confident in the outlook for their business

E F

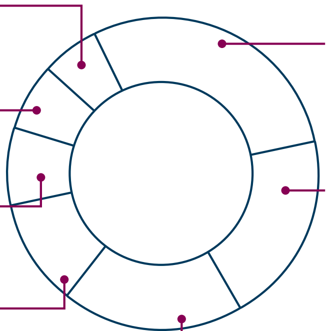
A pen portrait of average company taking part:

6% in South West

7% in East

8% in Scotland

11% Midlands

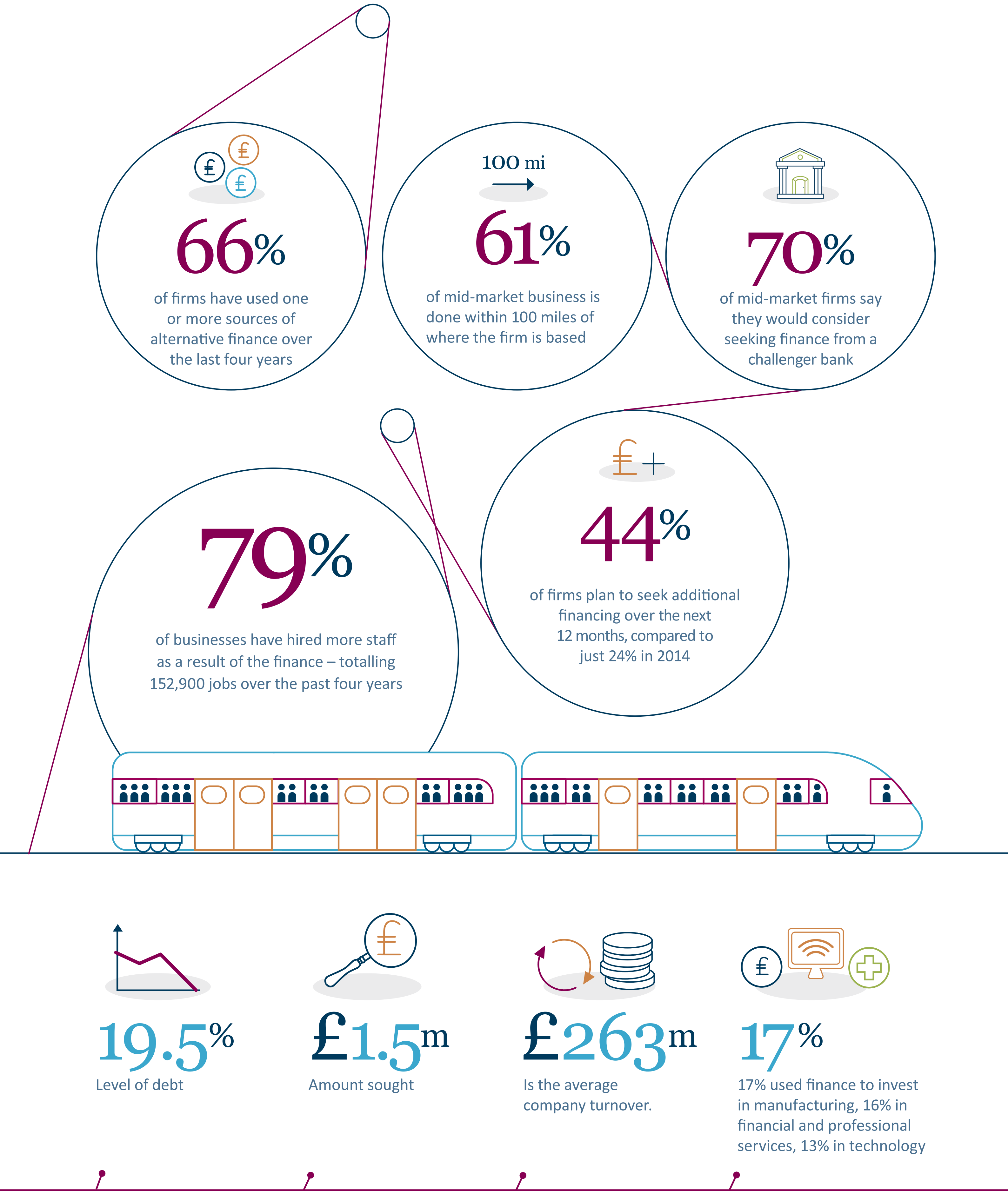


29% in London

20% in South East

19% in North England

666 Headcount


66%
of firms have used one or more sources of alternative finance over the last four years
100 mi
61%
of mid-market business is done within 100 miles of where the firm is based
70%
of mid-market firms say they would consider seeking finance from a challenger bank
44%
of firms plan to seek additional financing over the next 12 months, compared to just 24% in 2014
79%
of businesses have hired more staff as a result of the finance – totalling 152,900 jobs over the past four years
19.5%
Level of debt
£1.5m
Amount sought
£263m
Is the average company turnover.
17%
17% used finance to invest in manufacturing, 16% in financial and professional services, 13% in technology

The lending environment

The mid-market appetite

The mid-market appetite for bank finance has not diminished. In fact, it has increased. 70% of the businesses we surveyed applied for financing from a bank over the last four years, compared to 47% in 2014 and 64% in 2013.

The appetite appears greatest among the bigger firms in the mid-market. 67% of firms with an annual turnover over £500m said they applied over the last four years, and 87% of those between £401-500m, compared to 59% of firms turning over less than £75m annually.

Of all the businesses who applied for finance, one in five (20%) applications were made to a challenger bank.

What do we mean by "challenger bank"?

Exact definitions will vary but it's generally accepted to mean anyone outside the big four of Barclays, HSBC, RBS Group and Lloyds.

Outcome of applications

The good news for mid-market firms is that, overwhelmingly, they are securing the bank finance they apply for.

93 % 93% of firms in 2015 said they were successful, compared to 94% in 2014 and 88% in 2013.

87 % This finance continues to have a tangible impact. 87% of businesses say turnover has increased as a result of the finance – up from 76% in 2014 and 72% in 2013.

Based on the average levels of turnover growth reported, and the size of the UK mid-market, bank finance is projected to have contributed £148bn to national output over the last four years.

17 % The mean increase in turnover is 17%

79 % And 79% of businesses have hired more staff as a result – just down from 80% last year.

51 The mean number of staff added is 51

Based on the average number of new staff reported and the size of the UK mid-market, bank finance is projected to have contributed 152,900 new jobs over the last four years.

Reason for application

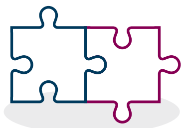
49% of businesses applied for bank finance to invest in the growth of their businesses – still comfortably the most popular reason for doing so, as in 2014 (52%) and 2013 (59%). The most popular growth areas given were:

41 %

Investment in plant and machinery, up from 27% in 2014 to 41% in 2015

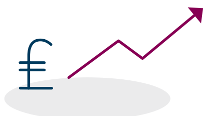
37 %

Finance for property, up from 16% to 37%



30 %

Research & Development, up from 20% to 30%



14 %

Elsewhere, 14% of firms also sought finance to release capital to shareholders, up from just 6% in 2014 and 8% in 2013%

Use of alternatives

As in previous years, we have asked the mid-market about their use of alternative forms of finance as well as bank finance. This year's findings reveal some eye-opening trends.

29 % 29% of mid-market firms have used private equity in the last four years – up from 21% in 2014 and 19% in 2013.

11 % 11% have used peer-to-peer lending – up from 6% in 2014 and 8% in 2013.

66 % Overall, two in three mid-market firms (66%) have used one or more sources of alternative finance over the last four years. This compares to 44% in 2014 and 43% in 2013.

Reasons for alternatives

When asked why they sought alternative forms of finance in particular, 46% of mid-market firms said it was because they believed they would understand their business better – the top reason cited. 38% said they thought alternative finance sources would be more willing to lend, and 35% said they thought it would be cheaper to obtain finance from alternatives.

“*The stranglehold the UK's big high street banks have on the business lending sector is well documented, and has been the catalyst for endless discussions about how best to increase competition. Against that backdrop, the fact that one in every five mid-market firms has sought finance from a challenger bank is cause for real optimism. As well as established challengers there are more new names entering the fray – recent figures revealed 29 live applications for UK banking licences. This will hopefully drive innovation and create a healthy, vibrant landscape for business lending.*”

“These figures suggest strong levels of confidence among the mid-market. Releasing capital to shareholders is not something which happens much during bad times, while the surge in plans to invest in plant & machinery, property and R&D is proof positive that firms feel comfortable about thinking longer term and planning ahead.

It also points ahead to an improvement in productivity, which is one of the biggest challenges facing the economy at present. The mid-market looks set to continue making a healthy contribution to the British economy.”

Compared to the number of firms seeking finance from banks, alternatives are still some way behind. But there's no doubt about it: the gap is narrowing. Our research finds no evidence that bank finance is becoming less attractive to mid-market firms, or that they are having less success obtaining it. But clearly alternatives offer something different which is proving increasingly attractive. Banks can't afford to let this trend pass under their radar.

(CONTINUED)

The lending environment

Confidence

New confidence in the mid-market stands at 84% up from 66% in 2013.

This confidence is feeding through into plans for future finance. Nearly half (44%) of firms plan to seek additional financing over the next 12 months, compared to just 24% in 2014 and 29% in 2013.

Looking more closely at where these firms plan to go for their finance, a compelling picture emerges. Of those who plan to seek additional finance, banks remain comfortably the number one source they'll consider. But the proportion saying they'll do so has fallen from 65% in 2013 and 67% in 2014 to 52% in 2015.

At the same time, the proportion of firms who will consider the following alternatives is on the rise.

21% Peer-to-peer lending: 21%, more than double the 10% recorded in 2013

22% Mezzanine finance: 22%, up from 6% in 2014

21% Borrowing money from individuals: 21%, up from 10% in 2014

Why is the mid-market looking more at alternatives?

47%

believe they will be more willing to lend – up from 39% in 2014 and 41% in 2013.

44%

say they are doing so because they believe alternatives will be cheaper – up from 31% in 2013.

Why more finance is needed

55%

As we have found in previous years, the most common reason more finance is needed is to invest in the growth of their business. This year 55% of firms say this is their primary reason.

19%

19% say they are seeking finance in order to provide additional working capital.

> *The jump in the proportion of firms looking for finance over the next year is a big opportunity for lenders. But banks should take note, as more and more businesses will be weighing up whether peer-to-peer lenders or mezzanine finance options are more suitable than before. Should banks interpret this trend as a threat, or an opportunity?*

New faces to drive growth

Looking more closely at the specific growth areas firms are keen to finance, 42% plan to fund a merger or acquisition. This is more than double the 16% who said the same when we first asked this in 2013. Furthermore, 42% plan to invest any additional finance in new skills and resource – up from 30% in 2013.

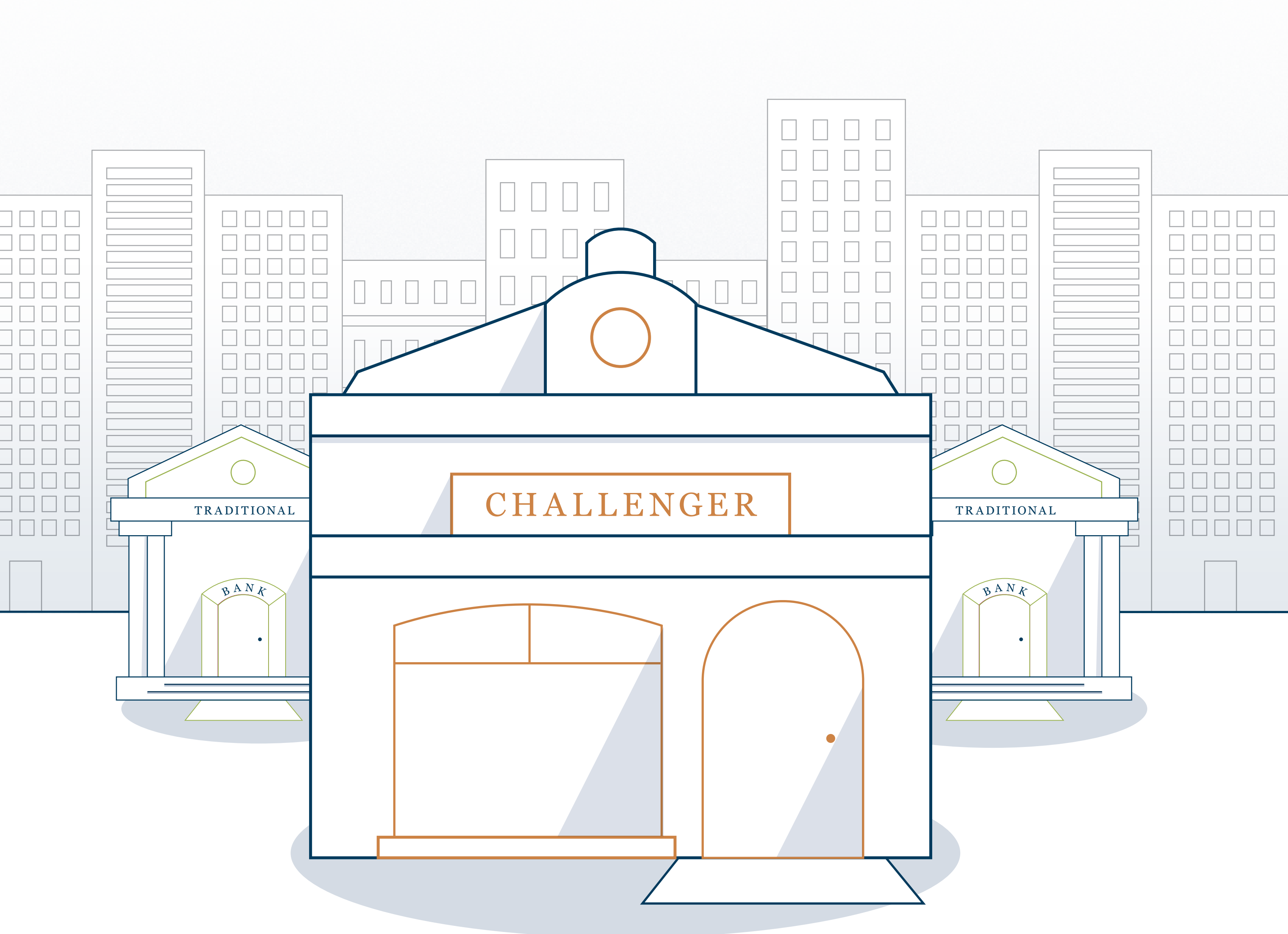
Whether it be through joining forces with another outfit, or bringing in new talent to the firm, there's a growing trend within the UK mid-market to drive growth by ensuring the right people are on board. M&A activity can be driven by a whole host of factors of course – not least a desire to own a greater share of market. And new skills and resource may be needed to plug specific knowledge gaps or productivity issues. Neither steps are taken lightly, but these figures suggest mid-market firms are more confident than they have been for some time that now is the right time to make these investments.

42%

plan to invest any additional finance in new skills and resource – up from 30% in 2013.

Challenger banks

This year's research has already uncovered widespread use of challenger banks – those outside the big high street names – among the UK mid-market. But what's the appeal of these challenger banks? And more broadly, what do mid-market business leaders look for in a bank before they apply for finance?



Choosing a bank

#1

We asked business leaders to name the single most important factor when deciding which business bank to use:

32%

Among those firms surveyed with over 1,000 employees, the top factor cited is cost (by 32%)

24%

Whereas among those with 50-250 employees, the top factor cited is simplicity (24%)

19%

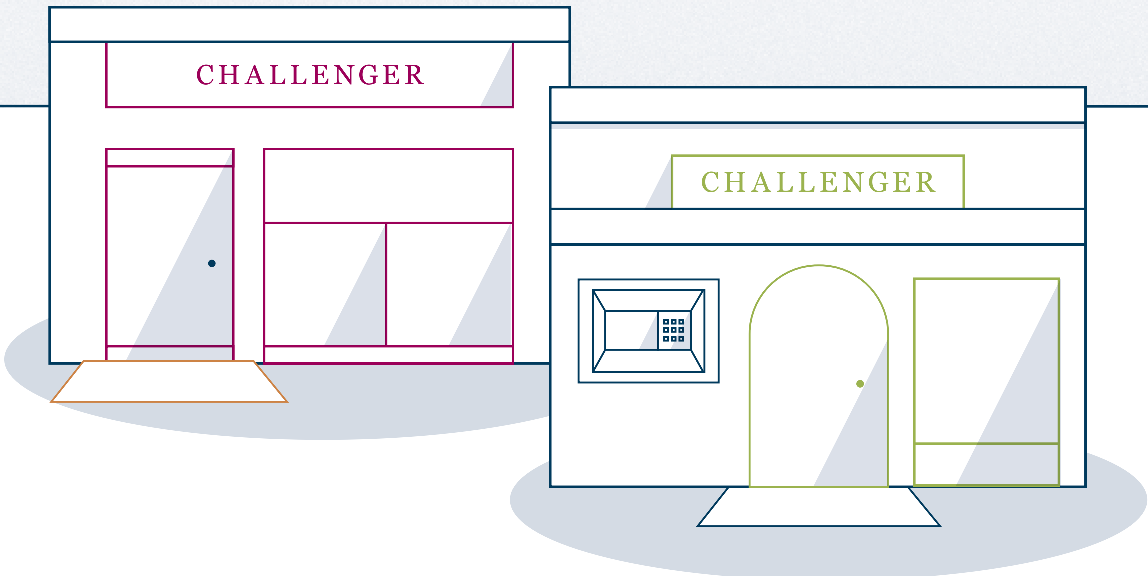
The most popular factor, cited by 19% of firms, was cost.

18%

said high quality service is the most important factor

11%

11% believe the flexibility of a bank to deal with their particular circumstances is most important.



Challenger banks

(CONTINUED)

Use of challenger banks

Our research reveals that a significant proportion of mid-market businesses have either already chosen banks outside the big four for their financing needs, or would consider doing so.

23% said they have used a challenger bank before and would do so again, while another 47% said they have not yet but would consider it. That represents 70% of the UK mid-market who would use a challenger bank.

23% of businesses told us that they have not previously used a challenger bank and have no current plans to do so. When asked why, what stands out is that the reasons given uncover a lack of awareness or knowledge – something which can be remedied – rather than bad experiences – which arguably cannot.

27% of those firms unwilling to consider a challenger bank put it down to a lack of awareness

18% don't believe that challengers will offer the breadth of products and services they need

13% say they don't like using a brand they have not heard of

> *"For all those challengers vying to compete with well-established banking institutions, the findings we have uncovered here are mightily encouraging. Clearly, there is an appetite for real competition – driven by a desire for lenders that are flexible enough to meet the specific needs of the mid-market. But what's also encouraging is that those businesses not yet thinking about challenger banks are there to be convinced. Central to it will be education, increasing awareness and addressing misconceptions."*
>
> **Jervis Rhodes,**
> **Head of Corporate Banking, BLME**

The reasons firms give for considering challenger banks are revealing:

36% of those willing to consider a challenger bank would do so to encourage more competition in the banking market

57% Particularly so with bigger firms: 57% of the biggest surveyed would use a challenger bank for this reason

Case study: Kallidus

Kallidus is an award-winning developer of people management software, providing its learning and talent management solutions to over 200 companies globally.

In 2015 BLME provided £3 million senior debt for the acquisition of Kallidus by FF&P Private Equity as part of a management buyout. As part of this management buy-out Kallidus will invest in growing its product suite which will enable it to continue to compete on a global scale. The choice to invest in product development means Kallidus joins the increasing number of firms that are investing in development, up from 20% in 2014 to 30% this year.

Kallidus reflect another trend in the mid-market space with more business accessing alternative finance and the associated benefits. Overall, two in three mid-market firms (66%) have used one or more sources of alternative finance over the last four years. This compares to 44% in 2014. Companies are attracted to the flexibility, tailored solutions and having investors that are engaged in the business.

45%

BLME found that over 45% of mid-market firms sought alternative forms of finance for the same reason Kallidus did, because they believe they would understand their business better.

“*Kallidus is entering an exciting phase of growth and it is important that during this period, that our investment partners understand our business, sharing our ambitions and enthusiasm. As a challenger bank BLME is small enough to provide flexible and tailored financing, but large enough to back Kallidus as we continue to grow and develop our business.*”

Rob Caul,
CEO of Kallidus.

32%

say it’s because they have heard good things about challenger banks from other users

25%

think that as a mid-market firm, their respective scales are a good match

Where the mid-market transacts

Alongside financing the mid-market, this year's research explores where UK firms are doing business – both domestically and abroad. Recent ONS figures found that in the second quarter of 2015, UK exports increased by the biggest amount in almost a decade[1]. Given the strength of the Sterling, the scale of the rise was largely unexpected.

To what extent are mid-market firms exporting – and where?

Where business takes place

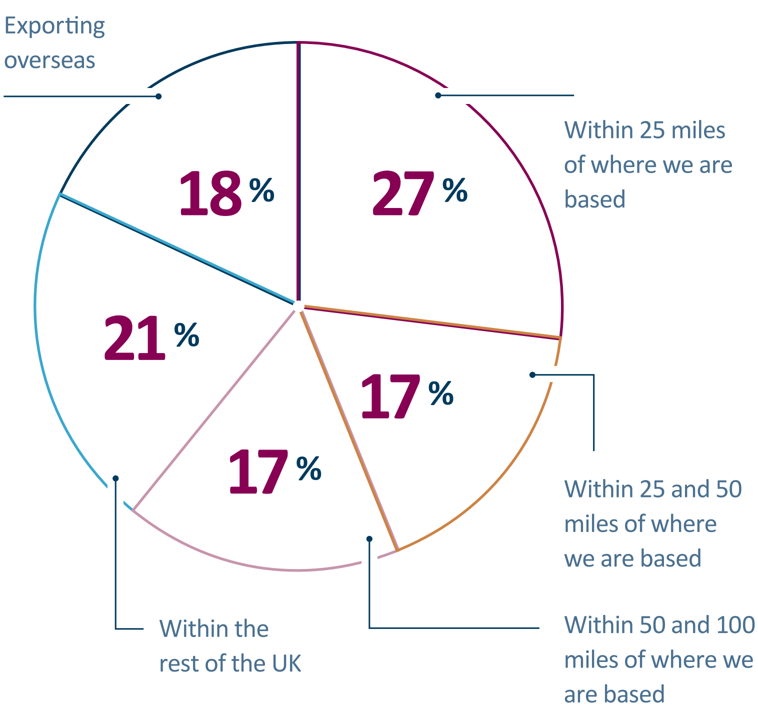
Our findings reveal that:

61% nearly two thirds of mid-market business is done within 100 miles of where the firms are based

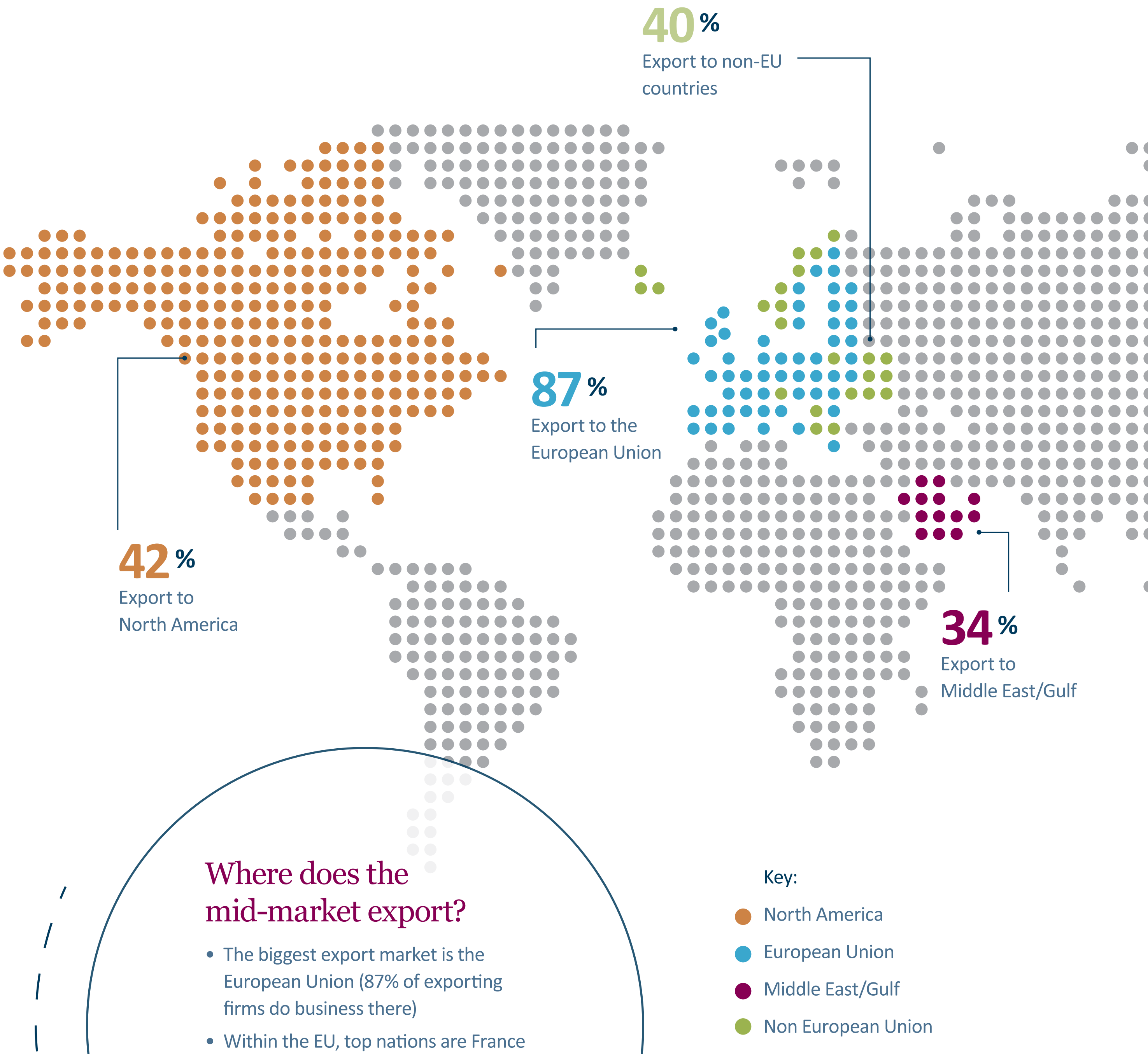
18% In total, however, only 18% of sales are made overseas.

28% Smaller mid-market firms (turnover £41-75m) export the most. On average, exports account for 28% of their sales

Proportion of mid-market sales which occur within the following geographic areas:



[1] Office for National Statistics, Sky News



Where does the mid-market export?

- The biggest export market is the European Union (87% of exporting firms do business there)
- Within the EU, top nations are France (72%), Germany (70%) and Spain (47%)
- The EU is the number one market where businesses want to export more (52% want to export more there)

Where the mid-market transacts

(CONTINUED)

Export levels

41% of firms currently do not export. 18% don't export but plan to start in the next two years, while 23% do not export and currently have no plans to start.

19% of firms are happy with the level at which they export but nearly four in ten firms (39%) want to export more.

- Interestingly, there is a greater desire to export more among bigger firms. 47% of the biggest firms we surveyed (£500m-1bn turnover) want to export more, compared to 41% of the smallest (£41-75m)

What stops the mid-market exporting more?

Despite a desire among many firms to export more, we also uncovered some significant barriers to them doing so. These will provide real food for thought for policymakers and business leaders alike.

24%
The amount of red tape

21%
The cost of exporting

21%
Exchange rate risk

14%
Cultural differences

14%
Language barriers

11%
Lack of overseas demand for our products/services

Outlook

Mid-market businesses have enjoyed a successful period of securing much needed finance to grow their operations, increase turnover and boost headcount. Looking forward, firms report similarly healthy levels of confidence.

The mid-market has told us that their net confidence in the outlook for their firm now stands at 84%, up from 76% in 2014 and 66% in 2013.

Market confidence

To a certain extent, some disruption from a referendum is inevitable as uncertainty about the outcome makes planning more difficult. But given how important the EU as a trading partner is for so many firms in the UK mid-market, these figures are a reminder to the Government that openness and transparency will be paramount in order for firms to maintain some confidence in their ability to do business with Europe.

EU referendum worries

Our findings confirm that the European Union is comfortably the biggest export destination for the UK mid-market. But with the Government confirming it will hold an in/out referendum on the UKs membership of the EU by the end of 2017, this will have an impact on the level of business between the UK and the EU:

39%
of firms do export and want to export more

87%
The biggest export market is the EU – 87% of exporting firms do business there

82%
of firms we spoke to – the vast majority – say that the prospect of an EU referendum will have an impact on their export plans, or has already.

Of those firms:

52% are actively exploring other markets

42% are planning to export less to the EU

35% are scaling back export activity altogether

15% think it will have no impact

There is a real demand among the mid-market to export more, but they are telling us there are barriers preventing it from happening. These need addressing as a matter of urgency. If overcome, the boost the mid-market could provide to the UK's economic growth and global competitiveness is potentially huge.

Recommendations

Based on the findings of our research, we have four key calls to action:

01

Challenger banks need to go on a charm offensive.

Mid-market firms say they want competition, and they also tell us they like the sound of challengers to the market. The experiences of those who have used them before is good. But a quarter still have reservations because they don't know enough about the smaller players yet. The potential, if they can be reached, is huge. There is a significant opportunity for challenger banks, and the time is now for them to grab it and make the most of it.

02

The mid-market needs more support on exports.

There is some success on this front already - lots of firms already export and generate lots of revenue from it – but there is a pressing desire to export more. However, barriers such as red tape, and the cost of exporting, are holding them back. Addressing these should be priorities for policymakers, as well as ensuring total transparency around the EU referendum to minimise uncertainty. The benefit to the wider economy if these barriers are broken down will be substantial.

03

The mid-market is turning to alternative forms of finance at an ever increasing rate.

Banks need to be alive to this and react accordingly if they want to remain the number one source of lending for businesses. It might mean expanding capabilities, or targeting particular types of lending for particular purposes, but without action banks could see their competitive advantages diminish. It might just be that challenger banks are in the best position to plug the gap. Nestled between the big four banks above them, and smaller alternative finance providers below, the scale and flexibility of challengers could see them perfectly placed to offer the best of both worlds.

04

Resist the urge to treat the mid-market like other businesses.

This is the third year we've conducted this research and this salient point remains. These firms face a separate and distinct set of needs and opportunities to the small firms that make up the S in the arguably redundant 'SME' phrase, and to the very biggest international corporations. With a new parliamentary term led by a new majority Government underway, it is critical that policymakers recognise these distinctions and provide meaningful, tailored support – not least on exports.

Appendix

Research methodology

The research was carried out online by ICM, between 24 June and 2 July 2015, with 175 business leaders.

Methodology for turnover created by bank lending:

- According to ONS figures there were 5,830 businesses in the UK in 2014 with annual turnover between £50-500m.
- From our survey 70% applied for borrowing, i.e. 4,081.
- Of these, 93% were successful, or 3,795.
- 87% of these say that this created turnover growth, i.e. 3,302 companies.
- Our pen portrait shows that average turnover is now £263 million and that 17% of this is due to bank lending, therefore £44,710,000 increase in turnover.
- Multiply this by the number of firms that successfully borrowed: £44,710,000 x 3,302 = £147,632,420,000 or £148bn.

Methodology for jobs created by bank lending:

- According to ONS figures there were 5,830 businesses in the UK in 2014 with annual turnover between £50-500m.
- From our survey 70% applied for borrowing, i.e. 4,081.
- Of these, 93% were successful, or 3,795.
- 79% of these said they employed on average 51 more people as a result. So 2998 x 51 = 152,900.

Contact Details

Jervis Rhodes
Head of Corporate Banking

Email: jervis.rhodes@blme.com
Tel: 020 7618 0061

For media and marketing enquiries contact:

Michelle Arnold
Head of Marketing and Communications

Email: michelle.arnold@blme.com
Tel: 020 7618 0078

About BLME

For more information visit www.blme.com

Bank of London and The Middle East plc

Cannon Place,
78 Cannon Street,
London, EC4N 6AG

Tel: +44 (0)20 7618 0000
Fax: +44 (0)20 7618 0001
Email: info@blme.com
Website: www.blme.com