

**Evaluation of the Scottish Loan Scheme**

**SE Appraisal & Evaluation Team**

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# Introduction

Over the course of 2023, Scottish Enterprise’s (SE) Appraisal and Evaluation Team undertook an evaluation of the Scottish Loan Scheme (SLS or the Scheme). Support was provided by the Market Insights Team within Growth Investment. This report sets out the findings of the evaluation.

## The Scottish Loan Scheme

The SLS was launched in late 2018 to provide debt funding on a pan-Scotland basis to Scottish companies looking to borrow between £250,000 and £2m (and up to £5m in exceptional circumstances). Initially offered to all sizes of company, it was later refined to be SMEs only (that is up to 249 employees).

This was the segment of the market where there was felt to be a gap and where a lack of access to finance was felt to be preventing companies from being able to grow, innovate, increase productivity, create or safeguard jobs and seek opportunities in new markets. Companies were expected to demonstrate that they had been unable to raise funds elsewhere from the private sector. Loans were to be provided on a commercial basis, thereby satisfying the Market Economy Operator Principle (MEOP), for terms of up to seven years and in exceptional cases up to 15 years. The operating principles stressed flexibility both in terms of loan security (with SE being willing to consider a subordinate position behind senior lenders) and loan repayments, with capital and interest holidays being approved as appropriate.

The SLS was initially introduced as a six-month pilot, aimed at gaining intelligence on the level of demand for the Scheme and insight on the fit of the lending criteria. In 2019, the Scheme was reviewed, and a decision made to continue beyond the pilot, with no fixed end date. SLS remains open to applications and referrals at the time of publication of this report The evaluation has considered loans made from the Scheme’s launch to the end of March 2023.

## Scottish Transformational Loan

Alongside the SLS, a similar product known as the Scottish Transformational Loan (STL) was also piloted from mid-December 2018. This aimed to provide ‘softer’ (i.e. sub-commercial) lending, as opposed to the commercial rate of the SLS, to early-stage companies that were showing traction. Following the pilot, a decision was taken in 2019 to discontinue STL. Based on SE research it was felt that there has been difficulty in determining when it was appropriate to offer the STL to companies compared to other products, and a lack of clarity on whether it was filling a market gap. SE staff involved with its delivery have also highlighted during this research that while STL was offering debt to early-stage companies, the reality was that these firms needed equity. Therefore, the STL was usually offered with a convertible loan note.

During the pilot, STL funding was provided to three companies. Given the similarity with SLS and its delivery being through the same Team, these loans have been included within the scope of this evaluation. Two STLs remain within the current debt portfolio.

## Evaluation Objectives

The following objectives were set for the study:

* Conduct analysis on the Scheme’s performance compared to the ambitions set out in the approval paper;
* Consider the performance of the Scheme, in terms of loans paid back and defaults. This was also to consider the impact of the COVID-19 pandemic on company performance;
* Assess the economic performance of the Scheme in terms of net impacts: specifically Gross Value Added (GVA), the Impact Ratio (net GVA per £1 of SE spend), employment created and safeguarded and the Cost per Job. Indicative economic impacts of the scheme were stated in the Approval Paper, based on an average Impact Ratio from existing evidence, assessed against different loan default rates;
* Consider the rationale for public sector involvement in the provision of debt finance to private sector companies and assess if the original rationale underpinning the Scheme was still valid;
* Assess the impact of the Scheme on the supply of debt finance to businesses in Scotland, highlighting changes in provision and the implications of these; and
* Draw the evidence together and make recommendations to improve the operation and impacts of the Scheme.

## Method

Alongside the review and analysis of background documents and data, a programme of primary research involved:-

* Interviews with senior staff in SE who were responsible for developing and delivering the Scheme;
* Workshops with delivery staff;
* Interviews with companies in receipt of SLS/STL funding; and
* Interviews with several other providers or brokers of debt funding.

Each will be considered in further detail.

Three senior staff were interviewed within the SE Growth Investments Team, the part of SE within which the Scheme sits. This took in the Team Leader who currently manages the Scheme, the previous Team Leader, and the Head of Investment with overall responsibility for it.

Workshops were carried out with three groups within SE:

* Six members of the Financial Readiness Team;
* Four Debt Specialists responsible for delivering the Loan Scheme; and
* Two Equity Portfolio Managers, where companies have both a SLS loan and SE equity investment.

The population of companies that had received SLS/STL support was 31 (28 SLS and 3 STL). Of these, five had repaid their loans in full. It was felt that it would be challenging to interview these companies, as there was unlikely to be any corporate memory of the loan, its use and impact. In some cases, the main contact had moved on or had retired. Two other companies were experiencing financial difficulties and it was agreed not to contact them. For the remaining 24, attempts were made to undertake online video interviews. The process was:-

* Initial emails seeking co-operation were sent out in three tranches;
* For those who responded positively further emails were sent to arrange a mutually convenient date and time for an interview;
* Non-respondents were sent a reminder email; and
* Any who had still not responded were approached by the appropriate contact from the SLS Team and asked to co-operate.

Just over half (17) of loan recipients were interviewed (**Table 1.1**). Whilst a response rate of 55% is respectable, it is lower than anticipated given the effort that went into chasing up the companies and the close relationship that most of the companies have with SE. However, when those whom it had been decided not to contact are excluded from the survey population the percentage responding increases to 71%.

**Table 1.1: Business Survey Respondents**

|  |  |  |
| --- | --- | --- |
| **Status** | **Number** | **Percentage** |
| Completed interviews | 17 | 55% |
| Declined to participate | 2 | 6% |
| No response from company | 5 | 16% |
| Companies which had repaid the loan (not contacted) | 5 | 16% |
| Advised not to contact (for example sensitivities, new loan) | 2 | 6% |
| **Total companies receiving funding** | **31** | **100%** |

To support the researchers’ understanding of the current availability of debt funding for SMEs and how the SLS fits in, interviews were also undertaken with several other organisations active in the debt market. This included banks, debt brokers and two similar public sector loan funds (five in total). **Chapter 5** gives a summary of their views on changes in the funding market. To complement this, **Appendix A** gives the latest overview of the debt market for companies in Scotland and wider UK.

# Overview of the SLS

This Chapter provides an overview of how the SLS was managed and delivered, the volume of loans and repayments to date, and the companies supported through the Scheme.

## Management and Delivery

The SLS was established in 2018 within what was then known as the Scottish Investment Bank, latterly Growth Investments. The Approval Paper for the pilot Scheme, agreed by SE’s Executive Leadership Team in November 2018, set out the eligibility criteria for SLS loans:-

* Companies could borrow between £0.250 million and £5 million (although the Scottish National Investment Bank (SNIB) on its launch in November 2020, generally assumed the remit for loans of over £2 million– albeit SE still retained the ability to offer loans in the £2m-£5m bracket where appropriate, such as where it did not fit with SNIB’s area of focus);
* Applicants should explain why funding from other sources was “not available or appropriate”;
* Companies should be headquartered or have an existing or planned operational presence in Scotland;
* There should be an anticipated economic impact in Scotland: creating or safeguarding economic activity to a level proportionate to the support offered;
* Companies should be at least two years old with minimum turnover of £250k, and either profitable or forecasting profits within the next 12 months;
* Funding could be used for a variety of purposes including working capital, capital investment, innovation/product development and scenario planning. Funding should not be used ‘exclusively’ to buy-out shareholders or refinance existing debt as this would not result in additional economic impact;
* There was a requirement for Fair Work practices; and
* There were some restricted sectors that could not be supported such as banking and gambling.

In addition to the above criteria, the Approval Paper set out several other factors that are integral to how the Scheme has operated:-

* Adopting a flexible approach to loan security, with SE being willing to take a sub-ordinate position behind senior lenders. The Scheme has a policy of not asking for personal guarantees, which could be a reputational risk to SE in the event of their being called up;
* Allowing up to 25% of any loan to be used to support the exit of existing shareholders. The justification for this was that this would allow management and employee buyouts to be supported;
* Loan repayment arrangements would be flexible, allowing companies to defer up to two consecutive repayments in any 24-month period. SE was “exploring” the possibility of allowing companies to redraw repayments under certain conditions if there was a requirement for short-term funding. In addition, capital and interest holidays of up to 12 months and 6 months respectively could be considered; and
* The loan application processes were to be efficient with systems in place to make decisions quickly with diligence being proportionate to loan value.

Clearly, there have been several significant changes to the wider economic context since the Scheme was both established in late 2018 and reviewed in mid-2019. Notably, the period since includes the COVID-19 pandemic and the steep rise in inflation since early 2022, increasing costs, supply chain challenges and deteriorating economic context.

Two change requests were approved for the Scheme in mid-2020, reflecting the circumstances of the pandemic:-

* In early May 2020 three-month capital and interest repayment holidays were made available to all loan recipients, irrespective of any previous holiday. This was felt to be a necessary response to the COVID-19 pandemic, particularly as Government support schemes were still being developed. Companies were given the option to extend this holiday to six months, subject to provision of more detailed forecasts and funding plans; and
* In late June 2020, a second change request was approved to enable loan recipients to access additional loan funding through the UK Government-backed Coronavirus Business Interruption Loan Scheme (CBILS) adding this to the debt/security ranking agreement which SE is party to.

The interest rate for SLS was originally priced based on the EU reference rate, until movement between this and UK base rate became apparent in 2022. Therefore, to ensure commerciality it was agreed to switch to a more aligned, comparable UK rate. Interest rates have been relatively high (when compared to earlier periods), reflecting both the risk to SE and the need to avoid displacing private sector lenders.

The SLS/STL pilot was delivered by a team of five: three secondees from elsewhere in SE and two recruits in fixed term contracts.. The SLS is now delivered by a permanent team of four along with one team leader. All have a background in private sector commercial banking.

## Performance

The Approval Paper for the pilot SLS set out one SMART target, which was to gather market evidence of demand and supply of loan finance in Scotland to inform the future focus of the SLS, over a six-month period. This was achieved and the resulting findings set out in a presentation in July 2019.[[1]](#footnote-2) Following this, the Scheme became part of SE’s core offer in August 2019.

On top of this, there were four strategic objectives:-

* Grow Scotland’s economy through the provision of additional funding to Scottish companies to accelerate their growth;
* Increase and broaden the diversity of supply of finance to eligible and viable companies by addressing a gap in the debt funding market;
* Allow companies to undertake investment in facilities, people and initiatives to facilitate sustained employment and/or business growth; and
* Increase confidence of companies to invest by demonstrating government support through the provision of debt finance.

At the end of financial year 2022/23, £18,132,000 had been invested in 31 companies through the SLS and STL schemes – see **Table 2.1** (SLS loans) and **Table 2.2** (STL loans).

**Table 2.1: Overview of SLS Loans**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Year** | **2018/19** | **2019/20** | **2020/21** | **2021/22** | **2022/23** | **Total** |
| Number of companies | 2 | 14 | 6 | 0 | 6 | 28 |
| Value  | £2,000,000 | £7,440,000 | £2,600,000 | - | £5,282,000 | £17,322,000 |

The STL was like the SLS, with the key difference being that loans were offered on a ‘softer’, that is on a less commercial, basis, with a lower rate of interest and option for conversion to equity, reflecting the higher risk nature of these investments. On review in 2019, it was decided to discontinue STL, as demand was still felt to be unproven, and it was unclear in which situations it should be offered instead of the SLS. Given the similarities between the two schemes, the evaluation has assessed their performance and impact together.

**Table 2.2: Overview of STL Loans**

|  |  |  |
| --- | --- | --- |
| **Year** | **2019/20** | **Total** |
| Number of companies | 3 | 3 |
| Value (£) | £810,000 | £810,000 |

In 11 instances, payments for the SLS/STL were made in tranches, which allowed monitoring of company performance prior to the follow-on payments being made, reducing the overall risk. This also staggered the repayments for companies, which can help make the initial repayments more manageable.

At the end of March 2023, total income to the Scheme was just under £10.4m (**Table 2.3**).

**Table 2.3: Income (to 31/3/2023)**

|  |  |  |
| --- | --- | --- |
| **Metric** | **Value** | **% of total** |
| Loan repayments | £8,472,455 | 82% |
| Interest | £1,721,556 | 17% |
| Arrangement fees | £186,020 | 2% |
| **Total** | **£10,380,031** | **100%** |

Of the 31 companies, five have fully repaid their loan and exited the Scheme. There have been two loan write-offs, both of which occurred during 2023/24:-

* One company had its remaining balance of £0.227 million written off (from an initial loan of £0.500 million) in September 2023 to allow for 80% of its shares to be acquired by another company, thereby safeguarding the business and 100 jobs; and
* One company entered liquidation in October 2023, citing a slowdown in orders. It had £0.356 million outstanding from a £0.500 million loan. The liquidator has estimated a recovery of £0.314 million, so the potential write-off is relatively low.

**Table 2.4** summarises the loans’ status.

**Table 2.4: Loans’ Status (November 2023)**

|  |  |  |
| --- | --- | --- |
| **Metric** | **Number** | **% of total** |
| Loan fully repaid | 5 | 16% |
| Interest and capital repayments ongoing | 24 | 77% |
| Loan written off | 2 | 6% |
| **Total** | **31** | **100%** |

## Profile of Supported Companies

Just over a quarter of supported companies (26%) provided some form of digital/IT/data product or service as their main business activity. Most operate on a Business-to-Business (B2B) basis, often focused on a specific sector (**Table 2.5)**.

There was a cluster of loan recipients in the energy supply chain, largely based in the north-east of Scotland. Most of these manufactured industrial components for use in the oil and gas industry (including decommissioning), with some also crossing over into offshore renewables and emerging technology such as geothermal.

**Table 2.5: Sector of Loan Recipients**

|  |  |  |
| --- | --- | --- |
| **Sector** | **Number** | **%** |
| Digital / IT / data | 8 | 26% |
| Energy - supply chain | 8 | 26% |
| Manufacturing - other | 5 | 16% |
| Food and drink | 5 | 16% |
| Construction | 2 | 6% |
| Consumer electronics | 1 | 3% |
| Life sciences | 1 | 3% |
| Business services | 1 | 3% |
| **Total** | **31** | **100%** |

**Figure 2.1** shows the main business locations of loan recipients in Scotland. Since receiving their loan, one company has been acquired by a large American firm, with the loan repaid in full at point of takeover. All other companies are headquartered in Scotland. The loan schemes have been available on a pan-Scotland basis, with three loans completed in the HIE (one) and SOSE (two) areas over the period covered by this report.

**Figure 2.1: Location of SLS/STL Recipients**
Map: Google Maps

## Other SE Support

The extent to which the SLS portfolio has engaged with other parts of SE varies widely: some are Account Managed companies in sectors of the economy where SE is very active, while others have had limited engagement other than through their loan. Over the last decade, SE has provided other forms of support to 29 of the 31 companies, based on analysis of project and service records. Across these companies, there have been upwards of 500 different projects, with an average of 18 per company. The most common form of support has been from internationalisation specialists. Other common forms of support have been large and small grants, support from Business Growth specialists (such as Innovation, Workplace Innovation, and Intellectual Property) and participation in leadership training.

Of companies who have accessed other support from SE, most (92%) accessed this prior to their successful loan application. This indicates they were familiar with and receiving support from SE prior to their application.

Grant support from SE has been accessed by 21 of the companies over the last 10 years, totalling £2.2 million in 140 separate grants. This gives an average grant value of around £15,600, so that most have been relatively small project support grants.

SE also has equity in four of the 31 SLS/STL companies (within an equity portfolio of around 300 companies). There is no clear pattern of when the equity investment and loan offers were made: in two cases the loan came much earlier (>3 years), for one company they occurred around the same time, and for the final company the loan came much later (6 years).

The above does not consider support that companies may have received from partner agencies, particularly for the two loan recipients based in the South of Scotland and one in the Highlands and Islands.

However, what the scale of other support does highlight is one of the key strengths of the Scheme: its ability to complement other SE support: something that other funders seem unlikely to be able to do, certainly not on the same scale.

# Survey of Grant Recipients

Interviews were completed with 17 companies, representing just over half (55%) of all those supported through the SLS and STL schemes up to March 2023. Companies had been loaned between £0.250 million and £2.200 million (the latter made up of two separate loans).

## Initial Engagement and Reasons for Applying

Just under two-thirds of respondents first found out about SLS through their existing relationship with SE, frequently their Account Manager (**Figure 3.1).** As noted in Chapter 2, most companies had received support from SE in the year or years prior to their SLS loan, based on analysis of service records.

A smaller proportion (18%) became aware of it through another organisation, which was specified as a financial advisor, consultant or bank that they worked with. Of those answering ‘Other’, one stated it was through a friend, and another saw a reference to it on LinkedIn and followed this up.

**Figure 3.1: Awareness of the SLS**
N=17

Respondents were generally satisfied with the initial stages of their involvement with the Scheme, including their initial contact (rated by 82% as good/very good) - **Figure 3.2.** Some felt the approval process could have been faster and others that the application process could be more straightforward, although the need for due diligence when it comes to use of public funds was generally understood by respondents. One company stated that the time it took for their application to be approved meant that their business circumstances had changed by the time the funding came in.

The promotion and marketing of the Scheme received a more mixed rating, with 41% scoring this as good/very good and 24% as poor/very poor. Some felt the Scheme could be more widely promoted, and that they had been unaware of its existence prior to being introduced to it by someone else.

**Figure 3.2: Satisfaction with Initial Engagement**
N=17

Respondents reported their main reasons for accessing SLS funding were to sustain their existing business operations and meeting working capital requirements (59%) and to support capital investment in their business (47%) (**Figure 3.3)**. Only one respondent reported that they had used the funding to develop an alternative ownership model – in this case a management buy-out. These reasons are supported by the wider evidence. For example, the SME Finance Monitor 2023 reported that of the SMEs with a need for funding 69% said the main reason was to support cash flow and 37% business development (see Appendix A for details).

**Figure 3.3: Reasons for Accessing SLS Funding**
N=17

All loan recipients stated that they had tried accessing funding from other sources prior to applying to SLS, in line with the requirements of the Scheme (**Figure 3.4).** Nearly all (94%) had made enquiries to their existing bank or lender, and just under half (47%) had approached another bank or lender. Around one quarter (24%) said they had approached an alternative lender, with several specifying Funding Circle. As can be seen from these figures many companies had approached more than one funder.

**Figure 3.4: Enquiries Made to Other Funders Prior to Accessing SLS Funding** 

N=17

Just under two-thirds of respondents (65%) said that their enquiries to other funders did not result in any funding being offered (**Figure 3.5)**. A variety of reasons were given for this, including:-

* Poor recent trading history, including through the COVID-19 pandemic;
* A lack of an asset base to secure against a loan; and
* A perception from lenders that their line of business and/or locations they trade in were high risk.

Around one quarter of respondents (24%) were able to secure funding from another provider that went some way to meeting their needs. This was typically due to the scale of the project, with no single funder willing to put all the required funding in.

A smaller proportion of respondents (12%) said that they were made an offer of finance from another source but turned it down. In one case, a bank refused to provide loan funding but suggested invoice discounting as an alternative, which was unsuitable for a pre-revenue company. In another case, a company was offered angel investment but felt that the offer represented poor value for money, as the investor wanted to take a sizeable share of business in return, despite their revenue stream already being proven.

**Figure 3.5: Outcome of Enquiries to Other Funders**


N=17

Overall, most companies (82%) made use of other funding alongside their SLS loan (**Figure 3.6)**. Given that more than half of companies used the SLS funding to meet working capital requirements, it was sometimes hard for them to specify exactly what each portion of funding was used for (i.e. if it contributed to the same project as the SLS funding). Nonetheless, 35% said they had a loan from another bank or lender, 29% accessed grant funding, and 24% used their own funds. Grant funding included grants administered by SE, including Large R&D Grants, Green Jobs Fund and SMART. This use of multiple funding sources is something supported by other evidence. For example, Appendix B reports that 32% of SMEs are now considering raising finance from multiple sources.

**Figure 3.6: Other Funding Sources Used Alongside the SLS Loan**

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N=17

## Satisfaction with the SLS

Overall, feedback from the SLS recipients was highly positive and this was reflected in the satisfaction scores shown in **Figure 3.7.** In particular, very high ratings were provided for the amount of loan funding offered, the loan terms, loan holidays and flexibility, and the ongoing relationship with the SE Debt Specialist (all 94% good/very good). The relationship with the Debt Specialist was ranked especially high, with 76% ranking this as Very Good.

**Figure 3.7: Satisfaction with the SLS**
N=17

When it came to interest rate, some felt this was high given the very low base rate at the time of their loan. However, most understood that this related to risk and recognised that they had been unable to obtain debt funding from elsewhere. Given that the interest rate was fixed a number commented that the rate now seemed very competitive. Most felt that the monitoring requirements have been reasonable and several highlighted that they would collect this information regardless. The lack of personal security guarantees and flexibility offered by SE, particularly with the repayment holiday offered at the onset of the COVID-19 pandemic, were particularly praised by respondents. A small minority felt the monitoring requirements were onerous. However, this may be more a reflection of internal company governance issues rather than any fault of the Scheme.

## Impacts and Benefits

All respondents were able to detail at least one benefit or impact that had occurred or was expected to occur because of the project or activity that they used the loan funding for (**Table 3.1).** The most common was new or safeguarded employment (82%), followed by increased or safeguarded business turnover (76%).

**Table 3.1: Impacts and Benefits of the Support**

|  |  |  |
| --- | --- | --- |
| **Impact or benefit1** | **Number** | **Percent** |
| New or safeguarded employment2 | 14 | 82% |
| Increased or safeguarded business turnover | 13 | 76% |
| Increased confidence with investing to grow our business | 12 | 71% |
| New products or services developed | 12 | 71% |
| New or increased exports | 9 | 53% |
| Improved productivity and efficiency | 7 | 41% |
| Attracted external investment | 7 | 41% |
| Made our business more competitive | 6 | 35% |
| Cost savings3 | 4 | 24% |
| Developed a new business/ownership model | 1 | 6% |
| **Total** | **17** | **100%** |

Note:

1. Respondents were able to give more than one response.
2. Respondents were not asked to distinguish between jobs created or safeguarded.
3. Cost savings were not defined.

Further analysis of the economic impact of the Scheme has been undertaken in **Chapter 6**.

## Project Performance and Other Funding

Respondents were asked to what extent, after receiving their loan, they were able to follow the growth and investment plans set out in their application. Just over half (59%) said that they had been able to proceed exactly or mostly as planned, with the remainder experiencing some challenges or delays. These challenges typically related to the pandemic and resulting difficult trading conditions. For example, one company had to postpone construction work on a new manufacturing facility for ten months, while another saw a 96% drop in revenue in the second quarter of 2020 and a third that had been hoping to develop overseas sales was unable to do so because of travel restrictions.

**Figure 3.8: Extent to Which Original Growth/Investment Plans Were Followed**


N=17

Nearly all respondents were positive about their forecast performance over the next 2-3 years and described plans for continued recovery and/or growth. This is reflected in the projected economic benefits (Chapter 6).

Since obtaining the SLS loan, around three-quarters of companies (76%) had accessed other external funding in some form. The most common was a commercial loan/debt (53%), with several specifying that this was through the UK Government-backed CBILS scheme. Some also had hire purchase agreements in place for capital equipment or vehicles although this was seen as “business as usual”.

**Figure 3.9: Other Funding Accessed Since SLS Loan**
N=16

Grant funding included a Large R&D Grant and a Digital Development Loan from SE, an Innovate UK grant for new product development, and a SOSE-funded feasibility study on green hydrogen production.

## Learning and Future Needs

Respondents were asked to identify the main strengths and areas for improvement of the Scheme. Common themes were:-

* Both the availability of debt funding and the amount on offer;
* The flexibility when it came to loan repayments and holidays;
* The positive relationship with the SLS team, who it was felt genuinely wanted their business to succeed; and
* The lack of personal guarantees.

A selection of comments reflecting this are included below:

* *“The SE team were keen to understand our business and became very involved. They really understood what we were trying to build out and were always available and very supportive. Delighted to have identified them as a funder. Very supportive and sympathetic – allowed repayments to be reduced when needed.*”;
* *“Scottish Enterprise went to find a pragmatic solution when conventional banking was running a mile… SE asked ‘How do we make this happen?’. They acted quickly and found an answer. When cashflow got tight last year, due to cash being needed for product development, they helped with a repayment holiday.”*;
* “*The flexibility* (capital holiday and extended terms) *and the dialogue with our loan manager. There was far more dialogue than with the bank – it was like a ‘traditional’ banking relationship.”;*
* *“It was availability of the funding. There wasn’t another debt funder that we could have accessed.”*; and
* “*The process was far better than a bank – they would look back and [overfocus on] the potential risks. SE were more interested in the business plan and the potential future growth.*”

Key suggestions for improving the Scheme were:

* Five companies felt the decision-making process could be quicker, with one adding that there was *“a lot of meetings back and forth to get things over the line – SE could outline the asks earlier”* and another that it *“took almost a year and this could have killed the business but for the chair’s deep pockets”*;
* Three companies said that the monitoring/reporting requirements could be lessened, with one mentioning that they felt monthly reporting is excessive, as they *“don’t have monthly board meetings and the bank is happy with quarterly reports, so why not SE?”*;
* Three companies felt the Scheme should be more widely promoted and marketed. Related to this one company stated that it had been told there would be some PR and a press release around its loan, *“but this never happened, and we were not told why”*; and
* One company felt that, if the loan was being paid in tranches, interest should be lowered after the first tranche, as by this point the loan should be considered lower risk.

Nearly all respondents said that they would be very likely (88%, 15) to recommend the SLS to other companies in Scotland (**Figure 3.8).** This reflects the positive experience of most companies.

**Figure 3.8: Likelihood of Recommending the SLS to Other Companies** 
N=17

Companies were asked how easy or difficult they felt it was to obtain debt funding at the time they accessed SLS. Nearly all felt it was difficult or very difficult (89%), with the remainder taking a more neutral stance. Companies explained their views by describing how they had tried and failed to secure all or most of the funding they required from other sources. In general, the view was that lenders are risk averse and have been for some time. Again, this is a view supported by other evidence (Appendix A) which reports that the banks risk appetite for lending is now lower. Difficulties commonly related to a lack of assets to secure against a loan; an overseas customer base considered risky by lenders; and an ambition to achieve rapid growth, which requires investment but means they do not necessarily have a track record of profits.

**Figure 3.9: How would you describe the market for obtaining debt funding around the time you accessed the SLS loan?** 
N=17

The overall view was that access to debt funding remained a challenge, particularly given interest rate rises since early 2022. Despite this, the wider evidence is that the percentage of SMEs reporting a need for external debt finance is returning to pre-pandemic levels (see Appendix A). Alternative funders, while potentially willing to offer funds, were also felt to be very expensive; one company cited an example where the interest rate and arrangement fees were approaching 30% of the loan value. Another highlighted that the equity market is unsuitable as investors offer poor terms and *“want to take everything”*.

However, looking at their individual circumstances, some felt they were in a better position than previously. A few companies said that thanks to the growth and positive results they have seen since accessing the SLS loan, they are now in discussions with other funders. One said, *“when you really need money, it’s too high risk, then when it’s easy… everyone wants to lend to you”,* and another said the regional director of a high street bank is keen to meet with them as they *“can see we’re growing.”*

# Consultation Feedback

This Chapter summarises the feedback from consultations undertaken with a selection of SE staff involved in the management and delivery of the Scheme, set out by theme.

## The Context

From the outset of the evaluation, it was clear that there have been major external shocks to the economy between the launch of the Scheme in late 2018 and the present, notably:-

* The COVID-19 pandemic and associated restrictions in 2020 and 2021; and
* The Russian invasion of Ukraine in early 2022 – while relatively few businesses were directly affected by the war (for example through sanctions), most were impacted by the consequences of the invasion. There were significant increases in energy prices during 2022, placing pressure on virtually all businesses and driving a steep rise in inflation. The rises were particularly stark in the UK. This in turn led to consecutive rises in the Bank of England base rate, impacting the cost of borrowing and business investment. **Appendix A** includes up to date insight on the economic context and how this has impacted on the debt market.

The flexibility of the Scheme, particularly the repayment holidays offered to all companies in 2020, was felt to be key in helping companies get through the pandemic. It was noted that many companies, both within the Scheme and wider economy, also took on government-backed loans (CBILS and the Bounce Back Loan Scheme (BBLS)) that were widely available during this period. Some concerns were raised by SE colleagues that many companies are now sitting on a suboptimal level of debt, and in some cases, this has made it difficult to offer loans to potential new SLS customers as they are already overleveraged.

These changes in the wider economy mean that any assessment of the impact of SLS must be seen against this background of what are probably an unprecedented number of significant economic shocks.

One other impact of the pandemic was a move away from face-to-face meetings with companies. It was felt that visiting companies prior to agreeing a loan with them is beneficial, rather than having a wholly virtual relationship.

## Demand and Overall Performance

Overall, the Scheme was felt to work well, meeting an otherwise unmet need and supporting a diverse portfolio of companies to create additional economic impacts.

Most successful referrals were said to be warm introductions, either through word of mouth or a referral from an Account Manager. When the Scheme was marketed during its pilot (alongside other SE products), there were many enquiries but overall, the quality was felt to be poor. As such, there is a reluctance to market the Scheme too widely: *“If we advertise too much, we raise expectations from businesses we can’t lend to”.* Where companies have been turned down, they have usually been referred to SE’s Financial Readiness Team for advice and support and have rarely returned to the SLS for a second go (and some are known to have found funding elsewhere).

It was highlighted that some loans have been very challenging to manage. At the initial stages, some companies have required a lot of support to get them *“debt ready*”. In hindsight, debt was offered to a few companies that were perhaps not fully ready to take it on, in some cases because of a lack of other options in SE such as grant funding. There was a feeling that it can be difficult for SE to say “no” to a company. However, the lessons from this have been taken on board and it was said that the suitability of companies for the Scheme has improved over time. The STL scheme had a specific focus on earlier stage companies and was discontinued after being piloted.

That there have only been two defaults to date – both very recently – was felt to reflect well on the Team and the wider SE support offer, particularly the flexibility that has been offered to customers.

However, as one member of the Debt Team mentioned, the whole point of the SLS is go where other funders have been reluctant to: *“They are high risk, so if everything ran perfectly then that would be a sign that something is wrong”.*

## Key Strengths and Areas for Improvement

Stakeholders in SE, including the Team delivering the Scheme, identified the following main strengths:-

* The general principle of (effectively) unsecured cashflow lending against forecast growth, rather than heavily secured lending based on past performance, was felt to be of great benefit to expanding companies and something that is rarely offered in the marketplace anymore (see **Chapter 5**). The customer successes and impacts that have occurred off the back of this lending were highlighted as particularly gratifying;
* Relationships with companies were said to be strong, with the SE Debt Specialists able to develop positive and trusted relationships with their loan portfolio. This was backed up by the findings of the company survey (**Chapter 3**);
* While the ‘front-end’ of the scheme was said to be quite commercial in focus, with a detailed application process and commercial rate of interest, the post-loan relationship was said to be more flexible. In some cases, this has meant SE has gone well beyond what a commercial bank would offer. However, this reflects the strategic focus of the Scheme on economic development and supporting company growth, and it was noted that *“it is not in SE’s interests to make a company go under”* so the Team *will “do everything we can to keep them ticking over”*;
* Providing loan payments in tranches (which has happened with 11 companies) was felt to be good practice, helping to keep the company focused, allowing monitoring of performance against forecasts and agreed milestones prior to subsequent payments being made, and reducing the size of the initial repayments;
* The rigour of the application process and resulting loan management helps professionalise businesses, assisting them to understand their finances more fully, and where they are on their growth journey. In some cases, it has encouraged them to invest in a dedicated finance function for the first time; and
* It was noted that where things have gone well, there has sometimes been a feeling from the customer that SE could have offered the loan to them at a cheaper interest rate, something reflected in some of the survey feedback (see Chapter 3). However, the rate has reflected the risk at the time the loan was made and on the basis that companies have struggled to find funds elsewhere. It was also noted by one SE colleague that companies are welcome to refinance their loan and exit the SLS if they find a better deal elsewhere. This flexibility was felt to be a positive.

Suggested **improvements** included:-

* As noted earlier, some companies felt the application process and decision on their loan could have been speedier. SE staff recognised this and agreed that applications should be dealt with as quickly as possible, although highlighted that it can take time to ensure that proper due diligence is carried out and to prepare a paper and take it to one or two investment committee meetings for approval. It was also noted that it can take time for companies to produce the necessary financial information, which can incur delays.
* Similarly, a few of the surveyed companies felt the monitoring requirements could be lighter touch. Some stakeholders agreed that, in cases where a company is felt to be stable, management information could be provided quarterly rather than monthly. However, it would be appropriate to retain the option to bring it back to monthly if concerns grew about any company;
* SE could potentially offer longer capital and interest holidays to allow companies more time to become profitable (which currently must be projected within one year) and to start servicing the loan later. This would open the Scheme to more applicants, who are currently being turned down as they are unable to project profit and serviceability within one year. However, this would increase the overall risk profile of the Scheme, and it may be that debt is not the most appropriate option for these companies; and
* Some tweaks are needed to the documentation, in particular bringing SE’s standard Terms and Conditions and the loan documentation into one coherent document. However, at present only the shorter Loan Confirmation document is prepared and agreed by lawyers, so making this document bigger would likely incur higher legal fees. It was also noted by the Debt Team that some of the language needs to be reviewed and updated to bring it in line with current SE procedures.

## Geographical and Sectoral Differences

The two workshops with SE staff explored whether it was felt that companies based in certain geographies or sectors were disadvantaged when it came to raising finance.

In terms of geography, it was felt that companies in the more remote areas, in particular the Highlands and Islands, faced greater problems. Indeed, it was felt that often they needed to relocate to larger population centres to be able to gain funding support although it was not clear why this was the case. However, others did not see geography as being an issue it being felt that Scotland was too small for there to be geographical differences in terms of access to finance. Of the companies interviewed one was from the Highlands and Islands Enterprise area, in Moray. Geography did not feature in discussions as to why the company had found it difficult to raise funds from the conventional banks.

In terms of sectors there was general agreement that companies involved in Oil and Gas found it hard to get support from the public sector but also private investors, where they can come up against increasingly stringent Environmental, Social and Governance (ESG) criteria. This reflects the increasing policy importance of net zero and the climate emergency over the last five years. However, it is also true that among the cohort of 31 companies supported to date through SLS and STL, a sizeable proportion (26%) were involved in the supply chain for the Oil and Gas industry. The extent to which they have diversified is mixed: for example, some are also involved in Decommissioning of Oil and Gas infrastructure, some in Offshore Renewables, and others in emerging areas such as Geothermal energy.

Other sectors that were highlighted as facing difficulties in raising finance were:-

* Construction, although it was felt that this could vary according to economic conditions; and
* Food and Drink, especially distilleries where the market was now felt to be very crowded.

It was noted that the sectors where commercial operators, including high street banks, were keen to offer funding were to ones that have a guaranteed income stream (such as Health and Care and Property) and were less prone to external economic shocks.

# Changes in the Funding Market

The funding landscape in Scotland has changed quite significantly recently, especially in 2023. To explore this the various company and SE interviewees were asked for their perceptions of market changes and if it was any easier or more difficult now for small companies to obtain financial support and to explore the role of the high street banks. To complement this, interviews were also undertaken with other funders (five in total). This took in FSE Group, UMi Debt Finance Scotland, a clearing bank, a challenger bank, and a debt broker.

FSE Group are among the operators of the new Investment Fund for Scotland, a British Business Bank initiative[[2]](#footnote-3). This Chapter pulls the various views and opinions together. UMi Debt Finance operate a loan scheme on behalf of the Scottish Government, with loans of between £25,000 to £250,000 available to eligible SMEs[[3]](#footnote-4).

## Recent Changes to the Debt and Equity Markets

The changes in the funding landscape (with more entrants, both public and private, entering the market) has been said by one commentator as likely to signal *“a new foundation for how the economy can be grown”[[4]](#footnote-5).* What provoked this comment was:-

* The launch, by the British Business Bank (BBB) in October 2023 of a £150 million “Investment Fund for Scotland”, which includes two debt funds – £20m allocated for smaller loans between £25 - £100k managed by DSL Business Finance and a £40m fund delivering larger loans between £100k to £2m managed by FSE Group. At the time of writing it was unclear what impact these funds would have;
* Par Equity setting up a £100 million Venture Fund to support scale up companies in health, climate and industrial technologies. Although the geographic focus is wider than Scotland, the Scottish National Investment Bank (SNIB) is a co-investor; and
* SNIB’s investment of £221 million in 27 businesses since its 2020 launch.

This was described by the same source as a *“trifecta of financing flows amount(ing) to the emergence of a new funding environment that simply didn’t exist until fairly recently”.*

However, this is only part of the story. For example, recently Oaknorth (which already has investments of £350 million in Scottish businesses) has opened a Glasgow office whilst there are established players such as UMi, which have been active in the Scottish market for several years, that is now delivering a fund on behalf of the Scottish Government. In addition, South of Scotland Enterprise launched its £2 million Business Loan Fund in October 2023. This is to provide loans from £50,000 to £0.5 million to businesses in the council areas of Scottish Borders and Dumfries and Galloway. Eligible businesses must have a two-year trading history, be profitable and able to demonstrate Fair Work practices and that they are transitioning to Net Zero.

Waiting in the wings is Alba Bank which intends to specialise in lending to Small and Medium sized enterprises having gained its banking licence in March. It is unclear what its impact on the market will be.

The entry of these players into the market, not just in Scotland but more widely in the UK, is probably responsible for 2022 being the second year in a row when the challenger and non-traditional banks accounted for a higher share of gross lending (55%) than the traditional high street banks, continuing a trend that has been apparent in recent years. This may have been accelerated by the move of the high street banks towards lower risk lending (see **Appendix A**).

Perhaps a more significant change than simply the number of investors and the amount of money that is available to invest, is the investment criteria: some of the new lenders are, like SLS, willing to lend on financial projections, rather than base lending decisions on past performance. This means that new starts may find it easier to raise capital.

However, there may be a need to strike a note of caution about this view that Scotland is now entering into a *“new funding environment”[[5]](#footnote-6).* Several Interviewees made the point that the funding market in previous years had often been quite dynamic, if not volatile. New entrants had entered the market but often they had not stayed for very long. Clearly some, for example SNIB and BBB, are likely to be here for the medium to long term. Others may prove to be less permanent.

## New Lenders

It was recognised by most of the interviewees that there were many new funders in the market, with Funding Circle and Lending Crowd being mentioned most often. However, it was felt that often these were not adding much variety. For example, it was said that Lending Crowd had the same lending criteria as the banks, for example a track record of profitability. Many were also, like the banks, risk averse and therefore wanted assets against which to secure lending such as property or capital equipment. They were also said to be more expensive not just in the interest rate charged but in terms of “add-ons”, for example charging investees for monitoring the investment. All these factors meant that often the new entrants to the market were not seen as being suitable for early-stage companies lacking a track record of profitability with few assets against which a loan could be secured. The overall view was that the new lenders were recognised but it was not felt that they had made any significant impact upon the market that SLS was targeting.

It was also felt that secondary lenders were not as flexible as SLS, with instances cited where the Scheme had been willing to help a company, for example by restructuring a loan, when the other lenders were not willing to do this.

## Demand

The view of some of the investors interviewed was that there was considerable demand for funding of all types, for example: hire purchase, invoice discounting, asset refinancing as well as conventional loans and equity. They were very busy and seemed to be optimistic about future demand. Indeed, it is reported that 2022 saw the second highest bank lending on record, second only to 2020, when Covid distorted the figures, although when adjusted for inflation the increase is less dramatic (**Appendix A**). This contrasts with other business surveys which have found that high interest rates and uncertainty about the economy are meaning that smaller businesses are deferring investment or are trying to fund this from internal resources and are therefore not borrowing[[6]](#footnote-7),[[7]](#footnote-8). It remains to be seen if this will ultimately have an impact of the timing and scale of growth. This view was shared by two providers of debt finance who felt that demand had recently fallen considerably, driven by high interest rates and inflation. This resulted in companies being far more cautious about taking on debt. However, it was felt that this was temporary: there was a funding cycle and eventually demand would increase as the economy began to settle down. One thing said to be likely to drive demand was insolvencies as the weaker companies failed. This would then open markets to those that survived as well as to start-ups.

## The High Street Banks

One explanation for this apparent contradiction (most of the interviewees saying demand was high whilst survey evidence shows the reverse) may be seen from one funder who cited an example of a company with an annual turnover of £50 million that could not get its existing bank to fund it as it could not provide five years of sales forecasts. Similar views, about the reluctance of the banks to lend (even to existing customers), were expressed by other funders. It was felt that the high street banks only want to lend to companies where there was either minimal risk or the risks were adequately covered by security. They were not in the business of supporting innovation nor were they interested in supporting start-ups (this was the case with the bank interviewed), in fact any businesses without a trading record or security. This was the case with the clearing bank which stated that it looked at a company’s historic performance when deciding to invest. That many businesses had also taken out Covid related loans and were, as one interviewee said, “*massively exposed” was* a contributory factor: banks and other funders were unwilling to lend when these debts were outstanding: *“no lend rather than a bad lend”.* This might be one reason for the claim made by one interviewee that the banks were now boosting their recovery and insolvency teams rather than investment staff. Indeed, the wider evidence is superficially contradictory. For example, although the banks are said to be far more risk averse, 2022 saw the second highest bank lending on record (Appendix A). This may reflect the fact that the banks are just far more selective in their lending and are unwilling to invest in the type of companies that SLS supports. This would then reinforce the need for public sector funds such as SLS.

Personal contact had also generally been lost, with contacts for businesses with turnovers under £5 million being generally dealt with through call centres. The high street banks had closed branches and now had fewer resources devoted to supporting business clients. Most of those interviewed felt that for the start-up and small firms markets personal contact and relationships were vital, indeed the company interviews highlighted this as a key strength of the Scheme. Interestingly this view was confirmed by the clearing bank spoken to, with all businesses it funded having a named contact in the bank whilst there was a stress upon building long term relationships through dedicated relationship specialists who were felt to “*add value*”.

However, it was felt generally that the banks had a limited appetite for risk and were not interested in what one described as *“project-led funding*” that is funding based on business plan projections. It was also felt that they were not willing to provide smaller amounts of funding (defined by one as being below £1.5 million).

Clearly there may be exceptions to this, although the clearer interviewed was supporting businesses up to a turnover of £15 million and did not support start-ups so seems to be operating at the top end of the SME market.

## The Businesses’ and SE’s Views

These views were very similar to those expressed by the companies interviewed and SE staff. All had views on how the debt market had changed between 2018, when the Scheme was established, and 2023. For the companies, these views were based on their experiences of trying to raise finance, often from one bank. The SE interviewees, especially those from the Financial Readiness and the Debt Teams, had a more comprehensive view based both on their banking experience (and ongoing contacts in the sector) and the number of companies that they had, and were, working with.

The general view was that the situation in 2018 for early-stage companies, without a record of profits and limited assets against which a loan could be secured, was very difficult. It was felt that the clearing banks wanted risk free investments: loans had to be 100% secured and/or personal guarantees were required. The banks wanted to invest in profitable businesses, with cash reserves, that had assets that provided security.

Now the situation was felt to be even worse. There was generally no relationship between companies and their bank: there was no personal contact especially for relatively small companies with turnovers under £5 million. It was felt that often the bank has no idea what the company does. The days of banks having sector specialists were felt to be gone. There was no interest from the banks in taking on new customers unless they had a track record of profitability and lending could be fully secured. If these requirements could not be met, then it was felt that the bank would push companies towards invoice financing or asset finance rather than provide a loan. Neither of these options are suitable for early-stage companies that may have limited trading records and few physical assets.

It was felt that the high street banks were not interested in this market at all, with claims that they were *“open for business”* being described as “*smoke and mirrors”.* Often any funding offers had terms that were so onerous that they were in effect *“constructive declines”.* Alternatively, support would only be provided if this could be fully secured. As one SE interviewee commented: “*There are no positive stories from customers about the banks”.* It was felt that the banks’ risk aversion might get worse if the default rate on Covid recovery loans proved to be significant so that smaller firms and start-ups may find getting support even harder.

## The Market

This was felt to be a market where it was difficult to make a profit. Paradoxically high risks needed high interest rates which then made the probability of these risks being realised greater. However, there was a degree of inevitability about this as high-risk unsecured lending required that capital be set aside to cover potential defaults.

The consensus seemed to be that, despite the entry of new funders to the Scottish market, there were relatively few who were willing to lend on projections. Most were providing invoice financing or other forms of secured lending such as asset based. There is still a very small market for unsecured funding of the type that SLS in involved in. Other players are UMi, Oaknorth and the British Business Bank, although the latter is relatively unknown given that its two Scottish debt funds were only launched in October 2023.

It seems to be the case that:-

* Most of the new entrants seem to be operating in a similar way to the banks in that they are lending on past performance and wanted a high level of security. However, some, like Funding Circle and Market Finance, whilst being easy to access, rapid in making decisions and flexible in the terms offered, were felt by some interviewees to be very expensive. This was a view confirmed by some of the companies interviewed that felt that they were *“unaffordable”.* The general feeling was that these new entrants were not really adding much variety to the market; and
* There are a number that are projection led, that is they are, like the Scheme, willing to lend against financial forecasts, what is felt to be a sound business plan and a good management team.

It is this latter group that may pose challenges to the Scheme in so far as they are often overlapping, not just in being projection led but in terms of the scale of funding gap that they are targeting.

## SWOT Summary

If the Scheme is compared to the other funders who are projection led then it is possible to highlight its Strengths, Weaknesses, Opportunities and Threats (SWOT).

The Scheme has a number of **Strengths**, that is competitive advantages:-

* It does not take personal guarantees, something that the businesses interviewed highlighted as a key strength. Some of the new entrants, for example the larger BBB debt fund, seem likely to have this as an option;
* The amount of personal support that it can offer investees seems likely to be greater and more intense than other funders. For example, four staff are managing/managed the £18 millions of investment in 31 companies[[8]](#footnote-9). The British Business Bank debt delivery partner FSE Group will have 5 staff managing a portfolio of £40 million (for loans between £100k and £2m), whilst Oaknorth has a portfolio of £350 million in Scotland (albeit a lot of this is invested in property with two staff in its Scottish office);
* It seems likely that it will be able to be more flexible in terms of such things as loan terms and conditions than other lenders where the need to meet funding targets may limit manoeuvrability;
* It is lending in a funding range where some lenders find it hard to make a return given that the due diligence can be, relative to the size of the loan, very expensive. There is therefore a tendency to go for larger loans. This might provide a greater market opportunity for SLS; and
* Interest rates, whilst being commercial, may be lower than some of the competitors. For example, BBB says that, depending upon the risk profile, it will charge the base rate plus 7% to 14%. This was confirmed in interview.

The **Weaknesses** include:-

* The Scottish Government’s stance on supporting companies involved in the Oil and Gas industries. Given that 27 new licence offers for Oil and Gas exploration were announced in October in the North Sea as part of the 33rd round of hydrocarbon exploration licenses, this growth market may be something that the Scheme is unable to support. However, it is clear from the companies supported to date by the Scheme that many involved in extraction also crossover into other areas, including Decommissioning, which itself represents a major economic opportunity; and
* The Scheme may also be at a competitive disadvantage in that investees need to make commitments to work towards a range of social and environmental criteria including Fair Work and Net Zero. Whilst some of the new funders will assess investments against similar criteria, they were described by one as being *“not a deal breaker*”. It may be that if the funders delivering Government schemes are struggling to targets, then these criteria may be ignored or watered down.

The main **Opportunities** would seem to be:-

* The synergies that the Scheme and its staff can provide for potential investees. This ranges from Financial Readiness support for companies with limited financial knowledge through to equity funding. As well as these products, companies can be supported with advice, from general business management through to access to a range of SE’s specialists. This would seem to be a competitive advantage that few, if any, other funders can offer; and
* As the economy gradually improves (as it is assumed it will) then despite the new entrants to the market, SLS may be able to exploit its strengths and make more investments.

The main **Threats** to the Scheme may come through:-

* The speed at which decisions are made with it being said that businesses want a quick decision and certainty of funding. As one said there aren’t many companies that can “*hang around for months waiting for half a million and, if they can, they probably don’t need it”.* There may be threats here. For example, one of the funders interviewed said that it aimed to give a decision in principle within 24 hours. This is in marked contrast to the experience of some of the Scheme’s investees; and
* Given that there now more projection-based lenders[[9]](#footnote-10) there could be budget pressure on SE to retreat from this market on the grounds that it is adequately covered by other funders. However, this is something that would need to be monitored.

## Conclusions

Undoubtedly the Scottish funding market has changed and is changing. These changes have been largely brought about by new entrants to the market who in their turn may have been stimulated by the attitude of the high street banks. The consensus is that they are risk averse (both from this research and the wider evidence (Appendix A)) and generally unwilling to lend other than to companies where any risks are fully covered by some type of security. It is perhaps this perceived gap, caused by the banks, that has stimulated new market entrants.

The Scheme would still seem to have advantages over the other funders, even those who provide projection-based lending. The key one would seem to be the relationships between the delivery staff and the companies. Although other funders also recognise the importance of this, some may struggle to replicate the relationships that the Scheme has been able to develop. Being part of SE also brings considerable advantages to the investees in that other advice and support can then be levered in.

The Scheme therefore needs to monitor demand as well as monitor the activities of the other funders, as far as this can be done. One can speculate about a variety of scenarios for the Scheme, for example:-

* Demand decreases significantly as potential investees feel they can get a better deal (defined in its broadest terms) from other funders; or
* Demand increases as investees feel that the terms offered by the new funders (for example interest rates and personal guarantees) are too onerous.

There may be many other possibilities. All that can be suggested is that the situation needs to be monitored and action taken depending upon how the market is changing.

However, a more optimistic note was struck by the high street bank interviewed. The interviewee felt that the entry of lenders such as BBB into the market was good in that it increased the funding options available for businesses. The same interviewee also felt that although funding was an issue for companies it was secondary to staffing which was now felt to be the biggest challenge faced by business in Scotland.

# Economic Impact

This Chapter provides an estimate of the economic impact of the SLS and STL loans made up to the end of 2022/23, based on data gathered from loan recipients.

## Gross Impact

A total of 14 companies provided quantified impact data, either achieved to date (13) or anticipated in the future (five). While this is a small absolute number, it represents almost half of the companies (45%) which have accessed a loan through the SLS or STL since the scheme was launched. The impacts reported by beneficiaries are shown in **Table 6.1.**

**Table 6.1: Impacts as Reported by Companies (Unrounded)**

|  |  |  |
| --- | --- | --- |
| **Metric** | **To Date** | **In the next three years** |
| **No. reporting impacts** | **Total** | **No. reporting impacts** | **Total** |
| Employment | 13 | 434 FTE\* | 5 | 223 FTE |
| Turnover (annual) | 11 | £62.5m\* | 5 | £38.6m |

\*Includes one significant outlier who identified that SLS support had safeguarded all employment & turnover within the business

There is likely to be a degree of optimism bias when it comes to estimating future impacts. We have therefore applied a figure of 25% optimism bias to future impacts to take account of this likely overestimation (i.e. taken 75% of the reported figure)[[10]](#footnote-11). **Table 6.2** shows the gross impacts with optimism bias applied. From here on all reported figures have been adjusted for optimism bias. Turnover impacts have been converted to GVA using a conversion ratio based on the broad sector of the economy for each company, derived from Scottish Annual Business Statistics.

**Table 6.2: Summary of Gross Impacts**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Gross Employment (FTE)** | **Gross Turnover (annual)** | **Gross GVA (annual)** |
| To date  | 434 | £62.5m | £24.5m |
| Future years | 170 | £29.0m | £14.0m |
| Total | **604** (365 excluding outlier) | **£91.5m** (£51.5m excluding outlier) | **£38.5m** (£24.1m excluding outlier) |

Jobs rounded to nearest 5 FTE and turnover and GVA rounded to nearest £0.1m.

We have then assessed the extent to which these gross impacts are directly attributable to the SLS support they have received from SE. For this, we have relied on company responses and found that all businesses that reported impacts said there was some degree of additionality. Most of those reporting impacts indicated that most or all the turnover and/or employment impacts would not have occurred (and/or will not occur) in the absence of the support (87%) - **Table 6.3**.

**Table 6.3: Impact Attribution to SLS**

|  |  |
| --- | --- |
| **Level of Attribution** | **% of responses** |
| All the impacts would have occurred/ will occur anyway (100%) | 0% |
| Most of the impacts would have occurred/ will occur anyway (75%) | 13% |
| Around half the impacts would have occurred (50%) | 0% |
| Some of the impacts would have occurred/ will occur (25%) | 31% |
| None of the impacts would have occurred / will occur (0%) | 56% |

N=14

Additionality adjustments were made based on these responses. For example, in the case of a company reporting that around half of the impacts would have occurred, a factor of 50% is applied to the gross impacts reported by that company.

**Table 6.4** summarises the gross additional impact i.e. the total overall change in economic activity attributable to the project.

**Table 6.4: Summary of Gross Additional Impacts**

|  |  |  |  |
| --- | --- | --- | --- |
| **Metric** | **Gross Additional Employment (FTE)** | **Gross Additional Turnover** | **Gross Additional GVA** |
| To date | 395 | £57.2m | £22.1m |
| Future years | 135 | £23.6m | £11.4m |
| Total | **530** (295 excluding outlier) | **£80.8m** (£40.8m excluding outlier) | **£33.5m** (£19.1m excluding outlier) |

## From Gross to Net

Moving from gross additional impacts to net additional impacts takes account of the following factors:-

* **Displacement:** the negative effects on non-beneficiaries which arise because an intervention has generated positive outcomes for beneficiaries, that is the impact has been displaced from elsewhere in the Scottish economy. This occurs due to increased competition in the markets in which beneficiaries participate. The level of displacement has been estimated based on qualitative and quantitative feedback from each company (e.g. proportion of turnover from exports and level of competition). Overall this averaged 18% across the sample, that is 18% of the gross impact were not additional;
* **Leakage:** the proportion of gross impacts that accrue outside the target region (Scotland). Across the sample leakage averaged 15%, that is 15% of the gross impacts benefited economies outwith Scotland; and
* **Multiplier effects:** the impacts associated with additional purchases of inputs from suppliers based in the target area (supplier linkages) and additional consumption expenditure on goods and services of those employed via direct and supplier linkage effects (income multipliers). Multipliers are drawn from Scottish Input-Output Tables for the relevant broad sectors of the economy applicable to each supported company. The average Type II multiplier across the sample was 1.75, covering direct, supply chain and induced impacts.

**Table 6.5** reports on the net additional impacts.

**Table 6.5: Net Additional Impact of Surveyed Beneficiaries**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Net Additional Employment (FTE)** | **Net Additional Turnover**  | **Net Additional GVA**  |
| To date | 385 | £55.1m | £21.5m |
| Future years | 150 | £26.6m | £12.7m |
| Total | **535** (330 excluding outlier) | **£81.7m** (£46.4m excluding outlier) | **£34.2m**(£21.5m excluding outlier) |

N=14

The net additional impacts presented in **Table 6.5** are reflective of the sample of the 14 companies providing quantified impact data. Overall, the level of additionality (comparing net impacts to gross impacts) is assessed at around 101%, reflecting that the supply chain multiplier effects narrowly outweigh other (negative) additionality effects. As noted previously, there was a low level of ‘deadweight’, with nearly all respondents highlighting that few of the reported impacts would have happened in the absence of the SLS loan.

## Estimate of Overall Programme Impact

To assess the total net additional impact and calculate an Impact Ratio (Net GVA per £1 of SE support) reflective of the entire programme, we have undertaken a ‘grossing up’ exercise to estimate the impacts generated by the complete cohort of 31 beneficiary companies. The companies that were not surveyed were similar in terms of size and sector to the surveyed ones, so it is felt that the grossing up to the population was valid.

The impacts were grossed up to the population based on the inverse of the proportion responding to the survey (e.g. a response rate of 20% generates a grossing up factor of 100%/20% = 5). The outlier was removed and added back in after grossing up, to avoid skewing the figures. Three scenarios are presented:

* **Low impact scenario**: assumes no impact from companies unable to provide figures;
* **Middle impact scenario:** mid-range between the low and high impact scenarios; and
* **High impact scenario:** assumes that those reporting no figures were in line with the average i.e. an assumption has been made that they will have similar benefits to those able to report and quantify impacts.

The impacts are shown in **Table 6.6**.

**Table 6.6: Grossed-up Economic Impacts (Estimated)**

|  |  |  |  |
| --- | --- | --- | --- |
| **Metric** | **Net Additional Employment (FTE)** | **Net Additional Turnover** | **Net Additional GVA** |
| **Low impact scenario** |
| To date | 550 | £74.6m | £29.7m |
| In future | 295 | £51.6m | £24.6m |
| Total | 845 | £126.2m | £54.3m |
| **Medium impact scenario** |
| To date | 610 | £85.0m | £34.8m |
| In future | 620 | £108.4m | £61.4m |
| Total | 1,230 | £193.4m | £96.2m |
| **High impact scenario** |
| To date | 665 | £96.5m | £39.9m |
| In future | 945 | £165.2m | £98.1m |
| Total | 1,610 | £261.7m | £138.0m |

There are two relative impacts: The Cost Per Net Job and the Impact Ratio (Net GVA per £1 of SE support). The total value of SLS loans to the 31 companies in early 2023 was **£18.132m**.

The relative impacts are presented in **Table 6.7** for the three scenarios.

**Table 6.7: Cost Per Net Job and Impact Ratio**

|  |  |  |
| --- | --- | --- |
| **Impact scenario** | **Cost Per Net Job** | **Impact Ratio****(Impacts to date and over the next three years (2026))** |
| Low | £21,500 | 3.0:1 |
| Middle | £14,700 | 5.3:1 |
| High | £11,300 | 7.6:1 |

It is likely that the true impact is somewhere around the middle impact scenario, if we assume that some of those who were unable to quantify impacts will have similar impacts to the sample and that some will have no impact.

## Performance Against Indicative Forecast Impacts

The Approval Paper for the Scheme[[11]](#footnote-12) presented some broad indicative impacts based on the performance of other funds, although none had the same parameters as the Scheme. The main conclusion was that the returns would be heavily influenced by the loan default rate, although even with high rates it was still possible to demonstrate a positive Impact Ratio.

The Paper presented looked at varying defaults rates (from 10% to 50%) and reported:-

* Impact Ratios ranging from 2.68:1 to 1.35:1; and
* A net Cost per Job of between £17,000 and £32,000.

If the Middle Scenario (Table 5.7) is taken as the most likely, then its Impact Ratio of 5.3:1 and Cost per Job of £14,700 is better than any that were outlined in the Paper. This is even the case for the Low Scenario. Given this the Scheme seems to have performed well, in part, perhaps, because of the low default rate (3.2% based on the amount invested and 6.5% based on the number of loans).

## Caveats

The impacts reported above need to be treated with a degree of caution as for some companies, especially the larger ones, failure to gain SLS support might not have resulted in company closure but more likely a take-over or some other positive outcome. For example, one of the largest companies supported (some 250 employees) had a long trading track record and contracts with major “blue chip” customers. It was, however, facing short term cash flow problems due to rising utility and raw material costs. Its bank was unwilling to provide further funding. If SLS had not provided funding it would seem likely that the company would have survived but not in its current form or ownership. It would seem to be an attractive target for other companies in the same sector. Accordingly, possibly all, or a proportion, of the jobs (and associated turnover and GVA) would have been safeguarded. Accordingly, the impacts outlined above may be overly optimistic.

# Conclusions and Recommendations

The purpose of this final Chapter is to draw broad conclusions, explicitly addressing the objectives of the brief and then make recommendations based on the earlier evidence. In drawing conclusions, the intention is not to repeat the detail of the earlier Chapters but to present a succinct summary.

## **Conclusions**

Chapter 1set out the objectives of the brief:-

* Conduct analysis on the Scheme’s performance compared to the ambitions set out in the approval paper;
* Consider the performance of loans, in terms of such things as exits, loans paid back and defaults. This should take into account the impact of the COVID-19 pandemic on company performance;
* Assess the economic performance of the scheme in terms of net impacts: specifically Gross Value Added (GVA), Impact Ratio, employment and Cost per Job. Indicative economic impacts of the scheme were stated in the Approval Paper, based on an average impact ratio from existing evidence, assessed against different loan default rates.
* Consider the rationale for public sector involvement in the provision of debt finance to private sector companies and assess if the original rationale underpinning the scheme was still valid;
* Assess the impact of the Scheme on the supply of debt finance to businesses in Scotland, highlighting changes and the implications of these; and
* Draw the evidence together and make recommendations to improve the operation and impacts of the scheme.

Each will be assessed in turn.

## Performance Against Objectives

The Approval paper had four strategic objectives. These have generally been met:-

* Scotland’s economy has been grown in that funding has been provided to companies to both create and sustain jobs. Without the Scheme the companies would have struggled to obtain finance from other sources;
* It has made a small contribution to increasing the supply of funding by filling a funding gap;
* The companies supported have grown employment and turnover, grown exports and introduced new products and services (**Table 3.1**); and
* There is evidence to show that investment confidence has increased. For example, since receiving support through the Scheme three quarters of interviewed companies had accessed other external funding (**Figure 3.8**) whilst the growth stimulated by the Scheme’s support had resulted in other lenders now being more likely to provide support (see Chapter 3).

## The Scheme’s Financial Performance

No financial performance targets were set for the Scheme. By 2022/23 £18.132 million had been invested and by March 2023 income amounted to £10.389 million of which 82% was loan repayments and 17% interest. Of the 31 investees, five have fully repaid the loans and have exited the Scheme. There have been two write-offs, with losses totalling £0.583 million (3.2% of the amount invested).

Given that the period for which these figures relate coincided with the COVID lockdown the Scheme’s performance seems good. For example, during one of the interviews with other funders it was said that there had been a 6% default rate on a Fund run for the Scottish Government which was well below the 20% rate originally planned for. The Scheme’s performance therefore is good.

## Economic Performance

The Scheme has enabled viable companies to survive and, as Chapter 6 has shown, has had a positive economic impact. Based on the companies interviewed, 385 net additional jobs have been created, there is an additional £55.5 million of turnover and net GVA is estimated to be £21.5 million. These are “to date” impacts. Estimated future impacts increase these figures. The relative impacts are also good: an Impact Ratio of between 1:3 to 1:8 depending upon the impact scenario selected. The Cost per Job is, on all three Scenarios, low and acceptable.

## The Rationale for Public Sector Support

What is clear from the interviews is that the Scheme is filling a market gap. Most of the companies interviewed had tried and failed to raise funding from alternative sources such as the High Street banks. Even companies with established trading records had been rejected for support because of their perceived risk profile. If they had not been funded by the Scheme some were unlikely to have survived whilst others seem likely to have been restructured in some way. The evidence is therefore very strong to show that the Scheme has brought economic additionality to Scotland and that there is still a justified rationale for its continuation.

## The Supply of Debt Finance

Since 2018 the funding market has changed and is changing. Some of the new entrants seem to have investment criteria that are very similar to those of the Scheme. For example, they are projection led and are intending to invest in the same funding range. It is, however, too early to say if they will mean that the Scheme will no longer be needed. What is recommended below is that the situation is monitored before any decision is made.

However, there is little evidence to show that the Scheme has been responsible for changing the debt market. Indeed, the other funders interviewed did not think that there was any evidence to justify such a claim.

As to whether there are any other funding or support needs that the type of companies the Scheme funds require, this seems not to be the case. The reason for saying this is that many of the investees already benefit from the comprehensive support that SE can offer, for example Account Management, grant and equity support and advice from various Specialists. Indeed, this is one of the Scheme’s key strengths that may mean that, regardless of new funders in the market, the Scheme can have an ongoing role.

## **Recommendations**

The Recommendations relate to the management and processes for the Scheme rather than anything more fundamental. In part this reflects the fact that very few of the company interviewees made any suggestions for change, being generally happy with the Scheme and the way it was run.

However, before looking at the relatively minor recommendations, it is worth stating that:-

* The Scheme is **filling a market gap** where there does seem to be a marked market failure. It is too early to say if the new entrants to the funding market will change this but the situation needs to be monitored.

The key strengths of the Scheme that need to be retained are:-

* The **added value of the relationship** between the Debt Specialists and the investees which go well beyond merely managing the loan;
* The **synergies** that exist between the Scheme and the other services that SE can offer, ranging from advice to other funding support; and
* Its **flexibility** in being able to respond to changing circumstances in a way that investors who are more target driven might not be able to do.

The main suggestions are:-

* Given the new funders that have entered the market, **monitoring** of demand for the Scheme and its rationale should be regularly undertaken to see if the Scheme needs to be modified in any ways;
* The Scheme should be **more widely marketed** as “*It seemed to be invisible”,* a view from the companies and some of the other funders. It is accepted that the danger with this is that it attracts applicants who do not meet the investment criteria or creates a volume of demand that SE cannot satisfy within its budget. However, the other funders interviewed faced these problems (including the BBB’s newly launched debt fund) and seem to have developed systems to screen out unsuitable applicants early in the process;
* The **approval process could be quicker** (three companies). This was something that several of the other funders felt was important when working in this market. However, in fairness some of the delays with the Scheme reflected the difficulties experienced when trying to support companies involved in Oil and Gas;
* **Documentation could be improved**. For example, currently the standard loan terms and the loan agreement were two documents which could be combined (although it has been flagged that this could incur higher legal fees if the longer document needs to be prepared and signed off by lawyers, so this needs to be factored into any decision on this);
* **Some loan terms and conditions might benefit from being reviewed**. For example, there are references to EU legislation that are no longer relevant. Some consultees felt that the requirement for accounts to be provided by companies 100 days after year-end could be lengthened, with Companies House requiring them 9 months after;
* **Covenants could be reviewed** and potentially standardised; and
* It may also be worth thinking about the **security taken**, as when SE is ranked second or third behind other lenders this may do little or nothing to safeguard SE’s investments and would seem to be tokenism rather than any realistic attempt to protect public funds. This was something highlighted by one of the other funders who said that often the time and effort involved in setting up a second charge was not worth doing as, if things went wrong, there would be no value in having done this. However, it has been highlighted that taking security allows SE to rank as a preferred creditor, meaning they have to consent to the company taking on further debt. This ensures the loan is being serviced by company earnings rather than additional debt.

# Appendix A: Debt Finance Update

The **Development and Market Intelligence Team** within Growth Investment have prepared an update on the debt finance market for SMEs, included below. This has helped to inform the report conclusions and recommendations on the ongoing rationale for the Scheme.

## Introduction

The following is a summary of available evidence on the performance of the UK SME debt finance market. Much of the data available focusses on the UK market as a whole and the working assumption is that Scottish businesses have very similar traits to businesses elsewhere in the UK.

There are also limited data cuts to focus on high growth companies, with the vast majority of research looking at SMEs in a wide sense rather than high growth or innovative businesses. The data sources also apply different methodologies and approaches which may result in different conclusions and make it difficult to compare sources. However, the overarching themes and trends can be identified and are detailed below.

## Background

2022 saw unprecedented economic challenges for companies, not just in the UK but across the world. With the increase in energy prices and interest rates in response to wider economic and geopolitical uncertainty, the cost of doing business has reached crisis point. This, coupled with the emergency lending that was sourced by companies during the COVID-19 pandemic, has left companies’ ability to take out debt finance and bank’s risk appetite for lending lower than pre-pandemic levels. A further challenge is Brexit related where companies reported confusion around regulations affecting supply chains and import-export restrictions.

## Summary

* 2022 had the second highest gross bank lending on record, second to only 2020, when SMEs were using COVID-19 recovery schemes to help them get through the pandemic. However, when inflation is considered, 2022 was the 6th highest year for gross bank lending. [*Small Business Finance Market Report 2023*](https://www.british-business-bank.co.uk/wp-content/uploads/2023/02/J0189_BBB_SBFM_Report_2023_AW.pdf)
* British Business Bank contacts have stated that SMEs were looking to restructure their existing debt now that they were coming out of the pandemic, but into the further economic uncertainty of high inflation and interest rates. Instead of servicing multiple large loans, consolidating under new terms may explain the high levels of market-based lending.
* There has been a reduction in the percentage of smaller businesses using external finance – down from 44% to 33%. [*Small Business Finance Market Report 2023*](https://www.british-business-bank.co.uk/wp-content/uploads/2023/02/J0189_BBB_SBFM_Report_2023_AW.pdf)
* The percentage of SMEs reporting a need for external debt finance is slowly returning to pre-pandemic levels. [*SME Finance Monitor*](https://www.bva-bdrc.com/wp-content/uploads/2023/03/BVABDRC_SME_FM_Q4_2022_Management_Summary-FINAL.pdf) *2023*
* 18% of Scottish Businesses stated that access to capital is a growing concern, the third highest in the UK, with London and South West in the first and second spots respectively. [*SME Finance Monitor*](https://www.bva-bdrc.com/wp-content/uploads/2023/03/BVABDRC_SME_FM_Q4_2022_Management_Summary-FINAL.pdf) *2023*
* Innovation and growth were not considered the main drivers for applying for debt finance. 69% of SMEs with a need for funding stated the main reason was for cashflow. 37% of SMEs looking for debt finance stated it was for business development purposes. Note- some companies stated both as reasons for seeking finance. [*SME Finance Monitor*](https://www.bva-bdrc.com/wp-content/uploads/2023/03/BVABDRC_SME_FM_Q4_2022_Management_Summary-FINAL.pdf) *2023*
* There was a shift in the type of debt products used in 2022 when compared to previous year, with government guaranteed loans (GGL) at an all-time low and market-based lending at a record high. [*Small Business Finance Market Report 2023*](https://www.british-business-bank.co.uk/wp-content/uploads/2023/02/J0189_BBB_SBFM_Report_2023_AW.pdf)
* 2022 was the second year in a row that challenger and non-traditional banks accounted for a higher share of total gross lending (at 55%) than traditional banks. With lending, excluding overdrafts, to SMEs totalling £35.5bn in 2022. [*Small Business Finance Market Report 2023*](https://www.british-business-bank.co.uk/wp-content/uploads/2023/02/J0189_BBB_SBFM_Report_2023_AW.pdf)
* The percentage of SMEs that were successful in obtaining all the finance they needed from one provider dropped from 80% in 2021 to 64% in 2022. [*Small Business Finance Market Report 2023*](https://www.british-business-bank.co.uk/wp-content/uploads/2023/02/J0189_BBB_SBFM_Report_2023_AW.pdf)
* Companies are starting to consider more than one finance provider to service their needs, with 32% of SMEs considering sourcing finance from multiple sources, the highest since 2019.
* Loan applications and lending slowed in the second half of 2022 as economic headwinds meant that it was increasingly difficult to source affordable debt finance. This is not the case for Scotland, however, where lending grew consistently throughout the year. There was a significant drop in the percentage of SMEs using external finance in 2022 (11%), with 78% classing themselves as “non-seekers” (no new borrowing in the next 3 months) and 51% classing themselves and “permanent non-borrowers” (no borrowing in the last 5 years). [*Business Finance Review 2022 Q4*](https://www.ukfinance.org.uk/system/files/2023-03/Business%20Finance%20Review%202022%20Q4.pdf)
* In 2022, 75% of firms expected growth in the Scottish economy over 2023 to be weak. Since then this has come down to 60% expecting growth to be weak.  While an improvement it is still the case that the majority of firms expect poor growth over the next year. There is however, positive sentiment in employment and turnover but negative in terms of anticipated capital investment and expected export activity. [*Scottish Business Finance Monitor*](https://fraserofallander.org/wp-content/uploads/2023/01/Addleshaw-Goddard-Fraser-of-Allander-Scottish-Business-Monitor-Q4-2022.pdf) *2023*
* Growth in the Scottish economy has been faltering over 2023, with high interest rates and wider economic uncertainty leading to investment being delayed or cancelled.  University of Strathclyde researchers (Fraser of Allander) have set out their new forecasts for the Scottish economy. They are forecasting growth of 0.2% in 2023, 0.7% in 2024 and 1.2% in 2025. For 2023, this is a revision down from the Institute’s previous set of forecasts in June, as data for 2023 to date has been much weaker than expected. [*Fraser of Allander- October 25th 2023*](https://fraserofallander.org/scottish-economy-showing-signs-of-apathy-as-many-businesses-choose-to-hold-back-investment/)

## Evidence

### British Business Bank [Small Business Finance Market Report 2023](https://www.british-business-bank.co.uk/wp-content/uploads/2023/02/J0189_BBB_SBFM_Report_2023_AW.pdf)

Gross bank lending in 2022 totalled £65.1bn, according to the Bank of England. This is a 12.8% rise on 2021 and is the second highest amount in one year, excluding 2020- when borrowing totalled £105bn. However, when inflation is taken into account, in real terms gross lending totalled £62.3bn. This places 2022 as the 6th highest on record below: 2020 (£105bn), 2016 (£66.3bn), 2015 (£66.1bn), 2017 (£63bn) and 2018 (£62.5bn).

There was a shift in the type of debt products used in 2022 when compared to previous year, with government guaranteed loans (GGL) at an all-time low and market-based lending at a record high. During 2020 and 2021, there were significant drawdowns from GGLs such as Coronavirus Business Interruption Loan Schemes (CBILS) and Bounce Back Loan Schemes (BBLS) due to the ongoing COVID-19 pandemic. This was especially the case in 2020 – the height of the pandemic – when 55% of all gross lending was administered via a GGL.  The table below illustrates the shift in product usage:

|  |  |  |  |
| --- | --- | --- | --- |
| **Year** | **Total Lending** | **Government Guaranteed Loans (%)** | **Market Based Lending (%)** |
| 2022  | £65bn  | £1.2bn (3%)  | £63.8bn (97%)  |
| 2021  | £57.7bn  | £8bn (15%)  | £49.7bn (85%)  |
| 2020  | £105bn  | £56.9bn (55%)  | £48.1bn (45%)  |

British Business Bank contacts have stated that SMEs were looking to restructure their existing debt, now that they were coming out of the pandemic but into the further economic uncertainty of high inflation and interest rates. Instead of servicing multiple large loans, consolidating under new terms may explain the high levels of market-based lending. This may explain the high amount of market based lending.

2022 was the second year in a row that challenger and non-traditional banks accounted for a higher share (55%) of total gross lending than traditional banks. Gross lending, excluding overdrafts, to small and medium-sized enterprises (SMEs) by challenger and specialist banks in 2022 was £35.5bn, the highest since records began in 2012. This was a 21% increase on 2021 (£29.2bn) and 29% above pre-pandemic levels in 2019 (£27.5bn).

The rise of the challenger and specialist banks may be due to several factors. BBB market contacts suggest that challenger and specialist banks are operating where the big 5 banks are not. This is reflected in Bank of England reports that state that challenger banks are more willing to lend to companies that had been affected most by the COVID-19 pandemic.

As challenger bank business models are typically risk based, they will operate where the risk-adverse big 5 will not. British Business Banks’ Finance Survey reported that the proportion of SMEs that were successful in obtaining all the finance they needed from one provider dropped from 80% in 2021 to 64% in 2022. The survey also shows that companies are starting to consider more than one finance provider to service their needs, with 32% of SMEs considering sourcing finance from multiple sources, the highest since 2019. This could show that when SMEs that are not sourcing the full amount of finance they need, they will often look to more than one provider, which includes challenger and specialist banks.

In 2022 there was a significant drop in the percentage of SMEs using external finance, dropping 11% between Q3 2021 and Q3 2022. Only 33% of SMEs were using external finance in Q3 2022, the lowest level since the BBB Company Finance Survey began in 2011. Over the same period, “permanent non-borrowers” increased from 39% to 51%. The British Business Bank defines “Permanent Non-Borrowers” as:

SMEs that seem firmly disinclined to borrow because they meet all of the following conditions: are not currently using external finance, have not used external finance in the past 5 years, have had no borrowing events in the past 12 months, have not applied for any other forms of finance in the last 12 months, said that they had had no desire to borrow in the past 12 months and reported no inclination to borrow in the next 3 months.

### BVA BDRC [SME Finance Monitor](https://www.bva-bdrc.com/wp-content/uploads/2023/03/BVABDRC_SME_FM_Q4_2022_Management_Summary-FINAL.pdf) 2023

The percentage of SMEs reporting a need for external debt finance is slowly returning to pre-pandemic levels. In 2020 9% of SMEs reported a need for external funding in the previous 12 months, this increased to 12% in 2021. Pre-pandemic levels typically were around 4% and 2022 saw a slow return to these figures with 6%.

Innovation and growth were not considered the main drivers for applying for debt finance. 69% of SMEs with a need for funding stated the main reason was for cashflow. 37% of SMEs looking for debt finance stated it was for business development purposes. It should be noted that some companies stated both as reasons for seeking finance.

Of those SMEs that were using external finance, 50% had increased their debt when compared to pre-pandemic levels, this is the equivalent to 15% of the total SME population in 2022. This includes both new loans, increasing of overdrafts and loan payment holidays. Around a third of those using more debt products than pre-pandemic are concerned about repaying the debt financing that they currently have, making them concerned about how they can operate and grow the business.

78% of SMEs in Q4 2022 were not expecting to apply for new or renewed finance in the next 3 months.

62% of all loan applications were accepted between Q3 2021 and Q4 2022. However, this varied by company size, sector and financial history. Those SMEs that have 50-249 employees had a success rate of 94% when applying for loans, however applications made by 0 employee SMEs had a success rate of 54%. Those who had borrowed previously had a higher success rate (68%) than those who were first time applicants (56%).

While SMEs remained cautious, the proportion of SMEs that felt that it could be difficult for them to source external debt funding dropped. Around 3 in 10 thought it would be difficult for them to source finance, with smaller and younger SMEs feeling that it would be challenging for them secure an approval.

85% of SMEs agreed that their plans are based on what they could afford at the present moment, with around a third of those stating they would be happy to borrow money in order to grow.

34% of SMEs reported an injection of personal funds in 2022. This was down from 37% in 2021 but was still higher than seen immediately before the pandemic.

### UK Finance [Business Finance Review 2022 Q4](https://www.ukfinance.org.uk/system/files/2023-03/Business%20Finance%20Review%202022%20Q4.pdf)

Loan applications and lending slowed in Q2 of 2022 as economic headwinds meant that it was increasingly difficult to source affordable debt finance. 60% of total lending in the year took place in Q1 2022, with quarterly borrowing slowing in Q3 & Q4. This can be attributed to the rising cost of doing business and an uncertain economic outlook with a risk of recession and interest rates rising.

Scotland, however, bucked this trend – seeing increases of three per cent, quarter-on-quarter in 2022. The modest rise in Scotland is consistent with a more stable path of lending since the end of the government-backed loan schemes in 2021.



While demand for loans slowed in Q2 2022, there was a noted increase in the use of overdraft facilities over the course of the year, higher than 2021. The number of overdraft applications rose by 22% when compared to 2021 but still remained at below pre-pandemic levels. Research shows that the purpose of these overdrafts was typically working capital, possibly a response to the increased costs of running a business and energy costs.

Scotland, again, has much higher overdraft approval rates, with 49% of all applications being approved. This places Scotland as the region with the highest overdraft approvals, ahead of the North East (40%) and East Midlands (32%).

The value of repayments made by SMEs in 2022 dipped slightly year-on-year. Across the UK total repayments amounted to £1bn in 2022, a decrease of around 2% when compared to 2021. More than half of the regions in the UK followed this trend, however, Scotland, as well as Wales and the East of England saw a slightly larger decline in total repayments, with Scotland showing a decline of around 4% over the previous year.

### ICAEW [Business Confidence Monitor (Scotland)](https://www.icaew.com/technical/economy/business-confidence-monitor/scotland)

The Q1 Business Confidence Monitor (Scotland) shows that Scottish companies’ confidence is slowly returning to a positive view but still remains very weak. Concern over future sales with high inflation and interest rates is a concern, as is how tight governmental fiscal policy will in the in months and years ahead.

There are a wide range of challenges that currently face Scottish companies, that are all compounded by the current debt finance market. There are difficulties in the labour market, with businesses continuingly being challenged by the availability of non-management skills and turnover of staff.

Driven by low business confidence, growth in both capital investment and research and development are expected to slow in 2023. This, combined with slowing profits, implies that debt finance rates are also expected to slow.

At a UK level, interest rates rose to 4% on Feb 2nd and again on March 23rd to 4.25%. The BoE has stated that they will increase interest rates again to tackle inflation, despite prominent bank failures in the US and Europe, namely Silicon Valley Bank and Credit Suisse. Banking confidence is back into positive territory but is still weak against a challenging economic background.

### Fraser of Allander Institute - [Scottish Business Finance Monitor](https://fraserofallander.org/wp-content/uploads/2023/01/Addleshaw-Goddard-Fraser-of-Allander-Scottish-Business-Monitor-Q4-2022.pdf) 2023

In 2022 the most common concerns among responding businesses were the costs of energy (88%) and the price of inputs (87%). However, looking toward the next 6 months, the majority (75%) of businesses expect total employee costs to be the key cost driver in the economy.

Mo re than 60% of firms reported that the current energy crisis has encouraged them to make energy-efficient improvements to their business. However, 60% of businesses say that costis a barrier to making these energy-efficient improvements to their businesses.

9 in 10 Scottish firms have seen their costs increase over the past year, with over 1/4 of manufacturing and 40% of hospitality and construction firms experiencing cost increases by more than 50%.

In 2022, 75% of firms expected growth in the Scottish economy over 2023 to be weak. Since then this has come down to 60%, an improvement but still the case that majority of firms expect poor growth over the next year. There is therefore positive sentiment in employment and turnover but negative when it comes to expected capital investment and expected export activity.

### [Fraser of Allander - July 2023](https://fraserofallander.org/survival-of-the-biggest-smaller-firms-struggle-amidst-cost-of-doing-business-crisis/)

There has been a significant difference since 2021 between small firms (0-9 employees) and large firms (250+ employees). In July 2021, 53% of small firms reported high confidence in paying their debts compared to around 68% of large firms. In July of this year, just 19% of small firms had high levels of confidence compared to 46% of large firms. Just 14% of hospitality firms felt highly confident in July.

Q3 2023 Update

In Q3 2023, there seems to be cause for cautious optimism for the SME debt finance market. With the decrease in inflation and the BoE’s decision not to increase interest rates again, confidence is returning to businesses to use debt finance as a tool for business growth.

With an increase of loan and overdraft applications, as well as approvals, the first half of 2023 looks as if it is starting to trend in a positive direction when compared to Q2 of 2022.

### [Fraser of Allander Update 03.11.23](https://fraserofallander.org/weekly-update-the-bank-presses-pause-and-the-state-of-the-labour-market/)

In November 2023, the BoE agreed to keep the standard interest rate at 5.25%. While the inflation threat remains high, there appear to be no immediate appetite to increase rates.

### [British Business Bank - Nations and Regions Tracker](https://www.british-business-bank.co.uk/wp-content/uploads/2023/10/nations-and-regions-tracker-2023.pdf)

Across the UK, there are signs of recovery in the use of debt finance for growth in small to medium businesses, when compared to 2022. 36% of smaller businesses were using external finance in 2022, this is a 7% reduction from 2021 (43%). However, the first half of 2023 has brought some signs of recovery, with external finance use returning to 2021 levels (43%)

The success rates in finance applications in the first half of 2023 remained at below pre-pandemic levels, however, year-on-year there has been an increase (53%), when compared to 2022 (44%).

### [UK Finance - Business Finance Review 2023 Q1](https://www.ukfinance.org.uk/news-and-insight/press-release/sme-lending-fell-in-first-quarter-although-demand-finance-showing)

The weak demand for finance at the end of 2022 continued into Q1 of 2023, with lending falling by £1.2bn when compared to Q1 2022. The biggest falls were seen in the south west and Scotland, with the biggest rises (7% year-on-year) in the south east.

Q1 2023 saw an increase in applications of both loans and overdrafts, with banks reporting an increase of 20% and 11% respectively. This is also reflected in the number of successful applications, when compared to Q4 2022, as detailed in the graph below.



Each sector highlighted has seen a marked increase in the number of applications accepted, when compared to Q4 2022, with some sectors seeing higher acceptance rates than the whole of 2022 (accommodation & food and human, health & social).

### [Fraser of Allander Institute – 25 October 2023](https://fraserofallander.org/scottish-economy-showing-signs-of-apathy-as-many-businesses-choose-to-hold-back-investment/)

Growth in the Scottish economy has been faltering over 2023, with high interest rates and wider economic uncertainty leading to investment being delayed or cancelled.

University of Strathclyde researchers have set out their new forecasts for the Scottish Economy. They are forecasting growth of 0.2% in 2023, 0.7% in 2024 and 1.2% in 2025. For 2023, this is a revision down from the Institute’s previous set of forecasts in June, as data for 2023 to date has been much weaker than expected.

Angela Mitchell, Senior Partner for Scotland at Deloitte, states- “This quarter’s commentary shows a thoroughly mixed outlook for our economy and, accordingly, for business and consumers. Notably, the rate at which businesses are delaying or cancelling investments is high. This chimes with findings from our latest CFO Survey, which found CFOs are focused on reducing leverage and capital expenditure is seen as a low priority. However, the commentary encouragingly notes that there are signs that the investment hesitation is only temporary.”

### [UK Finance - Monthly Economic Insight November 2023](https://www.ukfinance.org.uk/system/files/2023-11/Monthly%20Economic%20Insight%20-%20November.pdf)

In March 2023, the Office for Budget Responsibility judged that the risk of prolonged recession in 2023 has receded and inflation was expected to drop back sharply in response to the BoE’s increase of interest rates.

The OBR’s forecast update later in November will likely see an upgrade to their 2023 growth expectations but will strike a more cautious note about the year ahead. Inflationary pressures have proved more persistent than expected leading to a greater monetary policy response from the Bank of England.

1. Scottish Loan Scheme​: 6 Month Review​ Slides (30/7/2019) [↑](#footnote-ref-2)
2. <https://www.thefsegroup.com/news/launch-investment-fund-scotland-provides-ps150m-boost-small-businesses> [↑](#footnote-ref-3)
3. <https://findbusinesssupport.gov.scot/service/funding/umi-debt-finance-scotland> [↑](#footnote-ref-4)
4. Grant, J. Big lenders signal new funding environment for Scottish businesses. The Scotsman Online, 4th November 2023. [↑](#footnote-ref-5)
5. Grant, 2023, op. cit. [↑](#footnote-ref-6)
6. See, for example, FAI Economic Commentary 2023 Q3 (23rd October 2023) which quotes Angela Mitchell Senior Partner for Scotland at Deloitte’s: *“the rate at which businesses are delaying or cancelling investments is high”* and *“capital expenditure is seen as a low priority”.* [↑](#footnote-ref-7)
7. There are also differences according to firm size, For example, Adam McGeoch (Survival of the biggest? Smaller firms struggle amidst cost-of-doing business crisis. The Herald 25th July 2023) reported on the ONS’ Business Insights and Conditions Survey, which showed that in July 2023 only 19% of small firms (0-9 employees) reported high confidence in paying their debts compared to 46% of larger firms (250 plus employees) [↑](#footnote-ref-8)
8. The staff are involved in delivering other investment schemes as well. [↑](#footnote-ref-9)
9. For example, OakNorth states that it will lend against projections although it will be looking for a strong and credible management team whilst the BBB contractor (FSE) says it will be projection based, although, as yet, it is unclear to what extent this will be a factor in its decision making. [↑](#footnote-ref-10)
10. While there is no exact science for calculating optimism bias, HM Treasury guidance states that project appraisers and evaluators should make explicit, empirically based adjustments. SE would typically place this between 20% and 40% - the 25% adjustment has been arrived at following an assessment of the data (and wider evidence) gathered during the primary research with beneficiaries. [↑](#footnote-ref-11)
11. Scottish Enterprise, The Scottish Loan Scheme, 20 November 2018, ELT (19) 195 [↑](#footnote-ref-12)