Moore MT Thompson

How SMEs can access finance

Our guide to funding and growth

SMEs and the economy

The old adage that small businesses are the backbone of the economy possesses a kernel of truth.

The number of Small and Medium-sized Enterprises (SMEs) has grown 13 per cent since 2013, weathering a number of economic storms in the meantime. 95 per cent of UK businesses have nine or fewer employees, with a collective turnover of £808 billion, or 19 per cent of the total.

Despite lower turnover and fewer financial resources than large companies (defined by 250 or more staff), SMEs account for 61 per cent of jobs and 51 per cent of total business turnover.

SMEs cover an incredible range of sectors, with the largest including construction (914,175 in 2022), scientific and technical (761,735 in 2022) and wholesale (547,190 in 2022).

Sectors with high growth potential are particularly attractive to small business owners for a number of reasons, including the relative abundance of financing options and nationwide investment in skills.

> ***Overall, SMEs make an invaluable contribution to the UK's economy and financial health. To achieve growth and make the business sustainable in the long term, owners may seek to secure additional financing from external sources.***

Why SMEs need finance

The greatest quality of an SME – its innovation and growth – can also be its greatest weakness, certainly financially.

All businesses need a healthy cash flow from sales revenue and external financing, but it is especially crucial for SMEs in a growth phase.

SMEs typically do not have access to the revenue and reinvestment powers of larger firms, nor might they have the same backing from investors and other stakeholders, or steady income from customers.

However, every enterprise needs funding to grow, meaning SMEs are in particular need of support from external funding sources.

They may need funding for:

- Purchasing new equipment
- Developing new products or services
- Investing in infrastructure (i.e. office space)
- Bringing on new staff
- Marketing and brand awareness
- Consultation and support

The good news is that there is a diverse range of ways that SMEs can access the finance that they need.

Traditional loans

For most businesses, traditional bank loans will be the first port of call when it comes to obtaining finance for a business. There are two major type of bank loans – from a ***traditional*** bank or a ***challenger*** bank.

Applying for a traditional bank loan

How you apply for a bank loan will depend on which institution you approach, but you will typically need the following information:

- Your financial records, including existing finance
- Evidence of assets and the value of your business
- A business profile
- Record of ownership and management
- A business plan for how you will use the funds
- Projections to ensure you'll be able to repay the loan

You will also be subject to a credit check before your loan is approved.

Most banks will have a 'Responsible Lender' policy in place, meaning that they will not approve your loan if they think that you won't be able to pay it back.

Traditional bank loans

A traditional bank loan is a sum of money loaned to an enterprise by a major bank, credit union or building society. They are typically used to support growth or invest in equipment or new products, but they may also be used to support a business through uncertain times.

Some banks may set limits on how much they are willing to lend businesses depending on whether the loan is secured or unsecured – £100,000 is a common figure.

An unsecured loan is a loan that doesn't require business assets to be put up as collateral when taking it out. They typically allow businesses to access financing more quickly than taking out a larger, secured loan.

A secured loan requires that business owners put assets up as assurance that they will repay the loan. They typically allow businesses to borrow more than if they took out an unsecured loan.

Once the loan is secured, it is simply repaid, along with interest, over the agreed time period.

The major issue with traditional bank loans is that they may reject your application if they do not think that you can meet your repayment obligations, or if your business has a poor credit history.

Challenger bank loans

Set up as alternatives – or challengers – to traditional banks, challenger banks are recently-established banks that directly compete with the 'Big Four' – Barclays, HSBC, Lloyds Banking Group and NatWest.

Distinguished by embracing a technological approach to banking, these banks might not have brick-and-mortar branches, instead favouring online services and loan applications.

They may be able to provide a traditional bank loan to businesses in need of additional finance with a more accepting credit policy.

> ***Challenger banks are popular with SMEs because of their forward-thinking approach to technology and lending.***

The main downside of challenger bank loans is that, because these institutions are smaller and less established than major banks, they may have less capital at their disposal and therefore be able to lend you less money and there may be higher rates of interest applied to the loan.

Working Capital Funding

Working capital finance is essential for covering the gap between a business's stock and debtor value and its creditors. Keeping a robust cash flow is crucial, even with strong sales, and there are various financial solutions available to support businesses in this area.

Business Credit Cards
These function similarly to personal ones, designed for short-term lending to finance purchases and cash withdrawals. Using a business credit card can enhance cash flow with minimal costs, streamline expense management, build a credit history, and segregate personal and business finances. However, they come with associated costs like annual fees, interest rates, late payment charges, foreign transaction fees, and cash withdrawal charges.

Stock finance
Similar to debtor finance, stock finance mitigates the impact of costs associated with unsold stock on cash flow. It allows businesses to borrow against the value of their unsold inventory. Common in industries like car sales, stock finance can be part of broader invoice financing solutions for various trading businesses.

Overdrafts
Akin to personal ones, allow spending and withdrawals beyond the account balance, up to a certain limit. They provide flexibility in managing short-term cash flow fluctuations, although extended use can lead to substantial costs. Lenders evaluate overdraft requests based on several factors, with the requested amount ideally aligning with the balance among stock, debtors, and creditors.

Debtor financing
Tied to the debts owed to a business, debtor financing includes invoice discounting and factoring. This type of financing is scalable with business growth, as the available financing increases with the amount owed by trade debtors. Invoice financing, where a lender pays a percentage of each outstanding invoice, is useful for managing cash flow affected by late invoice payments.

Investment and third-party funding

For small businesses seeking an alternative to taking on additional debt, or who may have been denied a bank loan for any reason, you can obtain funding from other sources, including investors, private growth schemes and Government grants. Here are the most common type of third-party funding that you may be able to access as an SME:

- **Private investment:** Funding from private investors typically involves receiving a sum of money or repeated payments from a third party in exchange for a later benefit. This may include a portion of your net profit or a decision-making stake in the business. Common types of private investors include:

- **Angel investors:** Individuals or groups which provide capital for a business start-up, usually in exchange for shares or an ownership stake in the business. They often are entrepreneurs themselves or executives who not only invest but may also provide valuable management advice and important contacts.

- **Venture capitalists:** Venture capital firms provide funding to start-ups with high growth potential in exchange for equity. They typically come in when a company has a proven track record and is ready to scale. These firms generally have a lot of capital at their disposal but may also demand higher returns.

- **Crowdfunding:** This involves raising small amounts of money from a large number of people, typically via online donations. Platforms like Kickstarter and Indiegogo allow businesses to fundraise through donation or reward-based campaigns, others like Seedrs offer equity-based crowdfunding.

- **Peer-to-peer lenders:** These online platforms match lenders with borrowers, offering another avenue for businesses to secure funds without going through traditional banks. Rates can be competitive, and the process is often faster and more flexible than other types of investment.

- **Grants:** Grants are a type of funding that may be provided by a local authority, Government department, public sector thinktank or charity, or by private companies. They are typically designed to support growth in a particular sector – usually high-growth sectors like health, technology and sustainable manufacturing – and do not have to be repaid.

There are many different types of grants available to many different sectors, so you must carefully consider your eligibility and which grants are right for your business.

Types of grants may include:

- **Innovation grants:** Governments and private organisations often provide grants for research and development. These are usually for specific projects in sectors where growth is encouraged, and do not require repayment, though they may require detailed reporting and adherence to strict guidelines.
- **Local development grants:** Are provided by local authorities and are typically aimed at projects that will stimulate local economic development. They may support business expansion, job creation, or regeneration projects.
- **Green grants:** For businesses with an environmental focus, there are various grants available to support sustainable development. These can be for anything from Merchant Cash Advances: For businesses with a steady stream of credit card payments, merchant cash advances offer a way to receive cash upfront in exchange for a portion of future credit card sales.

Government schemes

Aside from grants, the Government may periodically target growth in a particular sector or across the economy as a whole. During this time, certain departments may offer funding opportunities for SMEs to support job creation and income generation.

Many Government schemes are now run by the state-owned British Business Bank or may be overseen by the Department for Business and Trade. Here are some of the ways that the Government is helping SMEs to succeed:

- **Start Up Loans:** In the UK, the Government backed Start Up Loans company provides loans for business of up to £25,000, with a fixed interest rate of six per cent per year, to be repaid over one to five years. These come with free mentoring and support for applicants.

- **Enterprise Finance Guarantee (EFG):** This scheme facilitates lending to smaller businesses that have a sound borrowing proposal but are unable to provide sufficient security for a loan. The government provides the lender with a guarantee for the loan, supporting financing between £1,000 and £1.2 million.
- **Research and Development (R&D) tax credits:** SMEs with under 500 staff can claim a further 86 per cent deduction of their qualifying costs from yearly profit, in addition to the standard 100 per cent deduction. You may be eligible for this credit if your business is working on an innovative project in science and technology.
- **Local Enterprise Partnerships (LEPs):** Across the UK, LEPs offer support and funding to local businesses to help them grow and create jobs in the area. As of April 2024, the management and funding of LEPs will be transferred to the relevant local authority.
- **Approved venture capital schemes:** The HMRC have approved four venture capital schemes to help SMEs raise finance – Enterprise and Seed Enterprise Investment Schemes, Social Investment Tax Relief and Venture Capital Trusts. Each have their own qualifying requirements and non-qualifying industries.

You can seek investment or Government support in addition to securing a traditional loan or in place of it.

It's important to research eligibility and decide how you will use any funding you receive prior to your application. This will provide your application with direction and substance that increases your chances of success – and help you to grow your business more effectively.

Boosting your appeal to investors

If you are concerned that you will not be approved for funding, or have been rejected for funding the past, then you may look at ways to improve your appeal to lenders or investors.

The driving motivation behind any financial support package is that the lender or investor believes that you will succeed – meaning they will get their money back and any dividends owed to them.

You should always have this in mind when applying for funding. Here are some of the ways that you can address your suitability to receive funding:

- **Have a comprehensive business plan:** Detailed and compelling business plans that articulates the company's vision, mission, and operational strategy can help you to secure funding. The plan should provide deep insights into market research, competitor analysis, sales and marketing strategies, and clear financial projections. A well thought out business plan showcases your commitment to your business and its viability.
- **Demonstrate financial discipline:** Maintain organised and transparent financial records. This includes consistently updated balance sheets, profit and loss statements, cash flow analyses, and tax returns. A clean financial history, timely tax payments, and a record of profitability (or a clear path to it) highlight a company's reliability and potential for success.
- **Showcase your strong management:** Investors often look at the experience, expertise, and track record of the management team. Highlighting the credentials, past successes, and relevant skills of key team members can instil confidence in potential investors and lenders. A strong team signifies effective leadership and execution capabilities.
- **Be prepared to offer collateral:** Depending on the nature of the financing, businesses can offer collateral or a stake in the company. This reduces the risk for the investor or lender. Offering equity or a share of future profits might attract investors looking for longer-term returns, while collateral can be more appealing to traditional lenders like banks.

- **Identify potential growth:** Investors want to see how they'll realise a return on their investment. Businesses should clearly outline their growth trajectory, potential market share, and any future plans for mergers, acquisitions, or public listings.
- **Have a clear exit strategy:** A well-defined exit strategy shows investors that you want their involvement to be profitable, and that you intend to provide them with a profitable route to exit the partnership further down the road.

Ultimately, you need to assess whether your business is truly ready to access finance. SMEs are typically in a period of uncertainty and growth, which may make them a riskier investment than larger, established companies.

Managing SME finances

For SMEs and small businesses, securing external funding – whether from grants, loans, or investor contributions – is often a pivotal moment that can catalyse rapid growth.

The effective management and distribution of these funds is crucial to ensure long-term sustainability and to maintain the confidence of stakeholders. Your funds need to be used in a way that maximise their impact and achieve real results. Achieve this by:

- **In-depth planning:** Begin with a robust financial plan. Outline how you intend to use the funds, setting clear goals and milestones. This not only ensures strategic allocation but also creates a system of accountability.
- **Prioritising immediate needs:** Address pressing financial obligations first. If there are existing debts with high interest rates or operational deficiencies that could hinder growth, allocate funds there first.
- **Allocating for growth:** Instead of exhausting all resources immediately, set aside a portion for future opportunities or unforeseen challenges. This ensures the business remains agile and prepared for dynamic market conditions.
- **Monitoring:** Regularly track how funds are used and whether there are areas that could benefit from reallocation.
- **Reinvesting:** All of your funding, and a large proportion of the profits it generates, should be reinvested back into the business in the form of R&D, marketing, additional staff or expanding operational capabilities, to maximise growth.
- **Engage financial expertise:** Consulting with financial advisers or accountants who can provide insights tailored to your business model and industry. Their expertise can guide strategic decisions and maximise the impact of external funds.

External funding can be a game-changer for SMEs. However, it will only achieve its purpose if managed correctly and supports your long-term growth goals.

You also need to understand your other obligations and how to meet them when taking on funding.

Your obligations

The majority of external funding will have conditions and obligations attached to it. Meeting these have clear moral implications but may also carry serious legal consequences if you fail to do so.

What obligations will you need to consider when accessing finance?

Transparency and accountability

Different types of financing will require different levels of disclosure, but it is good practice to have strict financial reporting and accountability measures in place.

Some types of financing require regular reporting and transparency as to how you are using the money. For example, you may be required to provide evidence of ongoing R&D or innovation if you're in receipt of an innovation grant – particularly where public money is involved.

Private financing may also carry certain conditions. These are likely to relate to transparency on the size and profitability of the business to fulfil contractual obligations with your investors.

With traditional loans, you have more freedom to use the money wherever it is needed most within the business – but you must not use it for personal expenses.

Tax

When you receive additional funding for your business, you will not typically have to pay tax on it. That is because the money is not income your business has earned, rather it is a loan or other business expense.

You do not normally have to pay additional tax on traditional bank loans.

Income and Corporation Tax are paid based on the profits that your business makes, meaning that most forms of investment are also exempt from tax.

The exception to this general rule is that grants typically count as taxable income, just like any other earnings from your business.

However, your business may also be liable for a higher tax bill following any growth driven by additional financing.

Specific projects

Some funding will have the requirement that you use it for a specific project or sector.

If you fail to do so, or don’t keep track of how you have used the money, you may face difficulties and legal repercussions obtaining future funding.

Financial obligations

If you have obtained a traditional loan or loan from the Government or support project, then you must make repayments in accordance with your contract.

This includes paying on time and with the correct amount of interest.

Defaulting on your loan could result in the loss of assets or collateral, and a negative impact on your company credit, which could hinder future loan applications.

The future of SME financing

As the Government seeks to encourage growth in key sectors and the creation of highly skilled jobs, it's likely that funding for SMEs will grow in certain industries.

This may also be true for private sector financing, as individuals and firms seek to capitalise on new and innovative firms.

In order to succeed and access funding, firms will need to look beyond simply achieving growth. Business owners will need a robust plan in place to mitigate a range of economic challenges and demonstrate that they will innovate as well as expand.

The range of options available for SMEs to access funding is good news for the future, as the sector seeks to protect itself from market fluctuations.

Finally, businesses will need to continue to prioritise compliance and reporting – particularly when receiving funding from the public purse, as taxpayers demand increased transparency from the Government and local authorities.

Contact us

Spalding office
Bank House, Broad Street, Spalding,
Lincolnshire PE11 1TB

T: 01775 711333
E: admin@mooret.co.uk

Market Deeping office
27 Market Place, Market Deeping,
Peterborough, Cambridgeshire PE6 8EA

T: 01778 380850
E: deeping@mooret.co.uk

Stamford office
22 St George's Street, Stamford,
Lincolnshire PE9 2BU

T: 01780 755170

Wisbech office
Monica House, St Augustines Road,
Wisbech, Cambridgeshire PE13 3AD

T: 01945 465767
E: wisbech@mooret.co.uk

Peterborough office
7 Swan Court, Forder Way, Cygnet Park,
Hampton, Peterborough PE7 8GX

T: 01733 560160
E: peterborough@mooret.co.uk

moorethompson.co.uk

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