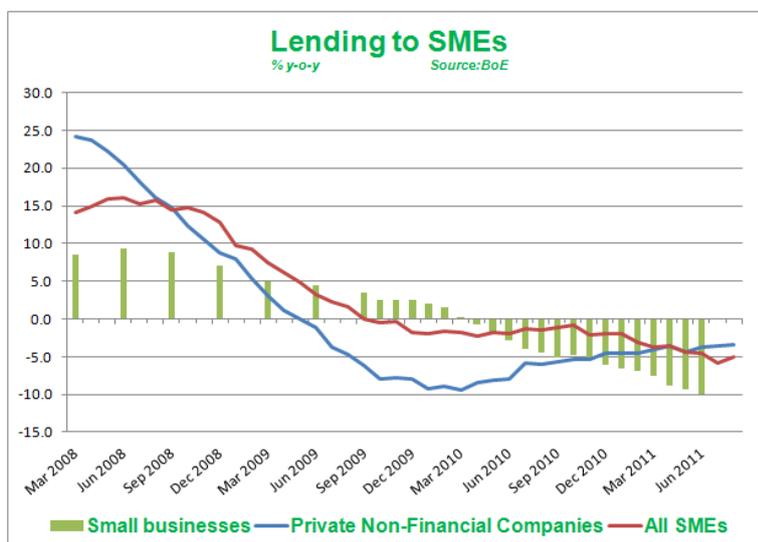


Manufacturing Update: Financing Growth

- Lending to SMEs continues to contract
- Financing for Manufacturing remains problematic
- Venture Capital provides some options for finance, but usually for Services
- Community Development Finance Institutions offer may an alternate solution.

While liquidity conditions have eased for large and medium-sized corporations since the onset of the credit crunch in 2007, credit conditions for smaller businesses continue to remain difficult. While small business monthly lending data only became available in September 2009, BoE data does highlight how difficult these conditions have become for SMES and Privates Non-Financial Companies, but particularly for



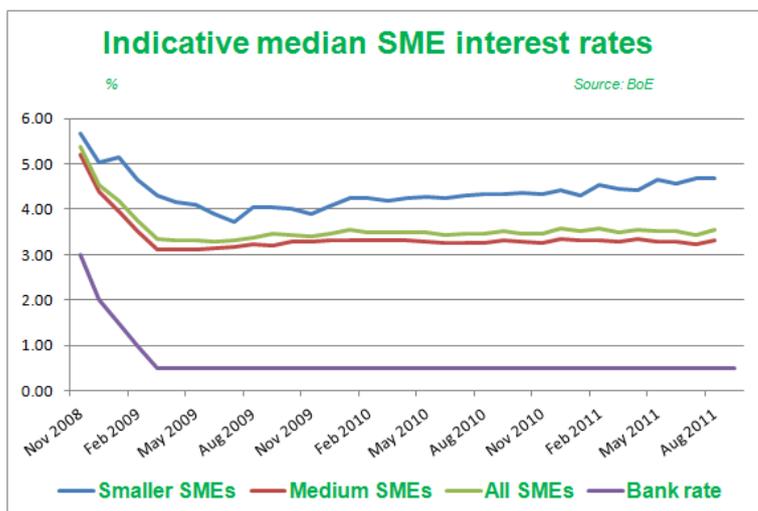
small businesses. The latest data for August 2011 records contraction of -5.1%, -3.4% and -10% respectively in August on the previous year, a period itself when contractions of -1.5%, -6% and -4.5% were recorded on August 2009.

There has been much debate as to whether this reflects a supply issue or a demand problem, with many main lenders arguing that they are meeting Project Merlin lending targets. Past BoE research suggests however, that it remains a problem of supply. Indeed, widening indicative interest rate differentials since the middle of 2009, suggest that access to credit for small business has become more difficult. Anecdotal evidence, moreover, indicates that the costs of borrowing and attendant conditionalities for small businesses is actually more expensive.

The issues for financing growth, particularly for manufacturing and industry, is however more complex and cannot be simply reduced to the lending appetite of banks, whatever the means by which that appetite is determined. It does appear true that while the scale of quantitative easing made available in recently has provided

sufficient liquidity for financial institutions, large corporations and some of the bigger medium-sized enterprises, this has not been the case for small businesses, particularly at the smaller end of the spectrum.

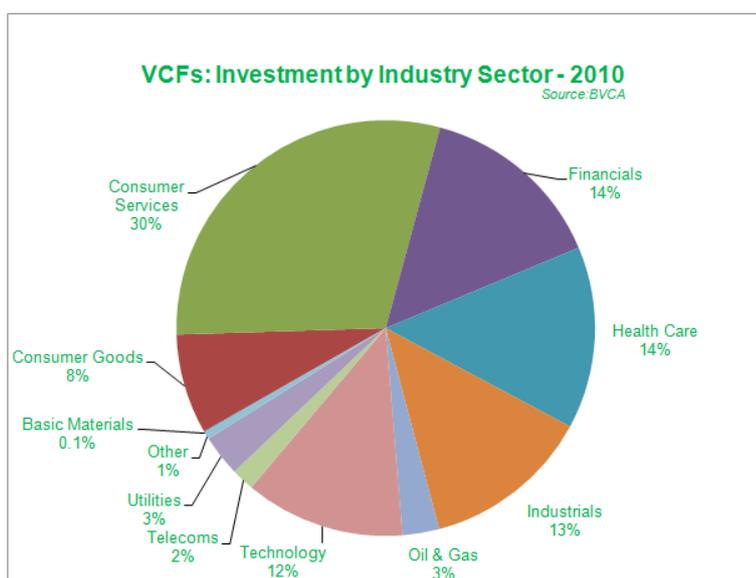
This is probably because the problem is more deep seated than a temporary shift in credit market conditions, as a result of changes in the business cycle, however pronounced. These issues were identified by the 1931 Macmillan Committee, which concluded that banks always require non-associated collateral to fund SME expansion, a problem has never been effectively addressed.



If banks are not making credit available to smaller business, how is growth to be stimulated in the SME sector and finance made available to sustain it?

There is a growing body of academic evidence, that one of the best sources of economic expansion, is amongst SMEs that have some longevity and capacity to innovate. For medium-sized enterprises, there is usually sufficient cash-flow and indeed collateral to attract finance to fund expansion and innovation. However, for small business, volatile or lumpy cash-flows and weak collateral resources, may preclude access to sufficient finance.

There exist an array of venture capital funds (VCFs), at national and local level, that are prepared to make available the risk finance, that most banks seem generally



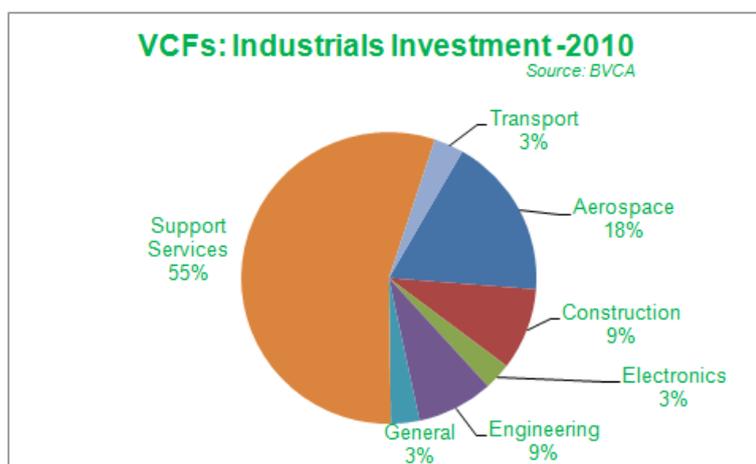
reluctant to undertake. Excluding start-ups, which require a different set of inputs, VCFs are prepared to take a proportion of unsecured finance, but as a result the SMEs receiving the finance, recognise that there are inherent risks attached to the

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expansion and that a higher return is required, usually base rate + 5%. The VCF also accepts that it will have to accommodate irregular repayment pipelines and that business plan will be subject to revision, problems equity participations offset.

Available evidence suggests, VCFs provide a key component of the financial continuum. However, as VCFs themselves perhaps recognise, their funding models are applicable only to certain sectors of the economy. Venture capitalists tend to be favourable to service-sector business, computer-related businesses (primarily software), the medical sector, communications, and electronics. While VCFs can undoubtedly facilitate re-balancing of the economy, through financing of these sectors, there are limitations.

Most notably, there is an apparent reluctance of VCFs to lend to parts of the manufacturing sector. The automotive sector appears to be particularly problematic, given the high capital expenditure requirements, lengthy product development cycles, annual costs downs, customer concentration, sole-supplier issues creating de-stocking vulnerabilities and especially for a venture capitalist, that the companies sell for low profit multiples on exit. Given the lack of attractiveness of the industrials sector to VCFs, especially the closer to the machine-shop floor a



project gets, and the understandable reluctance of the banks to undertake high risk finance, there appears to be a significant market void SME manufacturing lending.

As the SME manufacturing sector tends necessarily to be component producers supplying large industrial exporters, failing to facilitate expansion of this sector will contribute to a deepening of net imports and undermine real growth prospects. Furthermore, in a period when the just-in-time global supply chain is proving increasingly wanting, as a result of a variety of events (natural and financial), large-scale manufacturers are increasingly looking for proximity of components suppliers. Thus if effective rebalancing of the economy is to be achieved, growth in the SME needs to be promoted. However, the output capacity of the SME manufacturing

sector over the past three decades, has been severely eroded, with cluster networks and infrastructure considerably depleted. There are many reasons for this, not least sustained periods of an overvalued exchange rate and policy focus on the financial services sector. Nevertheless, the UK manufacturing sector remains the sixth largest in the world, and the tenth largest manufacturing exporter - access to appropriate capital and finance, would enable the sector to be reinvigorated..

In an attempt to facilitate this, there have been calls to create an Industrial Bank sponsored by the government, and supported by the largest manufacturers. However, this poses considerable risks of metamorphosing into a full blown interventionist industrial policy, with all its attendant problems of resource allocation. Any proposed solution needs to be effectively founded on sound commercial and economic viability. However, an effective solution may be available in existing institutions that provide finance to SMEs, namely Community Development Finance Institutions (CDFIs) and Small Business Loans Funds.

CDFIs provide small loans to SMEs, usually to those that have been initially refused finance from banks. Currently the loans made available by CDFIs are in the range of £20,000 to £30,000 over three-to-five year terms, with loan books in the region of £3-7 million. Small business characteristically, tend to require small loans to fund expansion. With professional development of risk, asset and liability and credit management systems, CDFIs could be rapidly expanded to provide much needed medium-term finance to the manufacturing sector. With £200 million of government provided capital, up to £2.5 billion of fresh funding, at commercial rates could be made available annually to English SMEs providing a significant growth stimulus. Private-sector funding would be attracted by the capacity of CDFIs to absorb non-performing loans, through their not-for-profit structures and access to publically-funded equity reserve cushion and ability to issue tax reducers, hence the capacity to significantly multiply any public-sector contribution. The viability of the CDFI-model to fund SME expansion is at least worthy of further examination.

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