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Innovative SMEs in the UK

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Introduction – Foretelling the future?

Where will innovation come from in the new economic environment in which we find ourselves? What challenges will small firms face in growing and also in just maintaining their company at the level it has already achieved? Which sectors will drive innovation and which actions will support growth in the Small and Medium Enterprises (SME) sector?

This paper explores the current context for SMEs, looks at the financial challenge faced nationally and regionally, taking the UK Northwest as an example. From this a picture emerges of firms likely to survive and thrive in the economic downturn and, taking regional evidence of reactions to change, it identifies ways to promote or support better SME innovation

The paper is in five sections. The first sets out the current context in terms of SME perceptions of the economic climate and of finance and credit supply. The second takes a regional perspective while the third looks at impacts from aspects, which receive less attention, including the Royal Wedding. The fourth returns to the underlying themes of confidence identified in section 1 while the fifth identifies what the current UK government has identified it will do to support innovative UK SMEs

Current contexts – when is a recession not a recession?

The answer seems to be – when you have a manufacturing firm. In just the same way that the continuing economic climate is impacting across the European Union, in the UK, "the dynamic economic recovery in industry and manufacturing continues" with positive industrial confidence and business outlook but the construction industry is still in decline (European Union, 2011). Similarly, in the UK, growth in other areas is slowed by issues in the construction industry. As a result, the recovery of the UK economy is expected to be sluggish, with GDP growing by only 1.4% in 2011 and by 2% in 2012, (NIESR, 2011). Despite this rather gloomy forecast, manufacturing is enjoying its best figures in 16 years and exports are expected to grow by 6.9% in 2011 and by at least 4.3% in 2012 (NIESR, 2011; CBI, 2011). Still, Germany exports six times more than the UK does into the BRIC economies, with 45% of EU exports to China coming from Germany (HSBC, 2011).

Again, despite the official forecasts showing a slowing economy, surveys carried out with the owners of SMEs consistently show good levels of confidence (Cisco, 2011; CBI, 2011). In the UK, SMEs are defined (e.g., in the BIS survey used by the Bank of England) as businesses with an annual turnover of up to £25 million. In the Cisco survey, 44 % of those questioned had increased their revenues in the previous 12 months and 66 % were optimistic about their prospects for 2011/2012. Owner-managers attributed this to their flexibility (56 per cent), agility (54 per cent) and better customer service (49 per cent) compared to larger firms.

SMEs are defined as firms with up to 250 employees, (UKTI, 2009) but in the UK almost all enterprises (99.3 per cent) were small (i.e., 0 to 49 employees). Only 26,000 (0.6 per cent) were medium-sized (50 to 249 employees) and 6,000 (0.1 per cent) were large (250 or more employees) (DBERR, 2008). Taken as a whole, SMEs accounted for more than half of the employment (58.5 per cent) and turnover (51.3 per cent) in the UK while small enterprises (with 0 to 49 employees) accounted for 46.8 per cent of employment and 37.0 per cent of turnover (NHS, 2008).

SME views and finance

“Any conversation with an SME very quickly gravitates towards issues of access to finance,” said Vince Cable (Chancellor of the Exchequer). “Access to finance is absolutely critical for SMEs. Without access to finance, they can’t grow, and in some cases can’t survive.” (Real business, 2011)

One issue affecting growth and innovation is of course the role of finance and the supply of finance and credit to SMEs, without which growth (and perhaps – given the way cash flows work in smaller firms – sometimes survival) cannot occur. The stock of lending to all UK businesses overall contracted in the three months to February 2011, the same applied to small firms, with contraction in the stock of lending to small and medium-sized enterprises (Bank of England, 2011). Also, the Bank of England reports that the annual rate of growth in lending to SMEs has been negative since late 2009 and fell to -

3% in 2010, DESPITE total lending to SMEs representing approximately 25% of lending to all UK businesses by banks and building societies.

The smallest firms, however, are in a worse position. The growth rate of lending was -6% in December 2010 to the smallest businesses, (i.e., those with a turnover up to £1 million). This was more negative than that for the whole SME segment, a trend that has continued since June 2010 (British Bankers' Association, 2011). There is less credit available for SMEs than there is for larger corporate organisations, and this is reportedly often accompanied by requirements to offer personal guarantees and onerous credit application procedures. This has been seen in reports from some SMEs about the replacement of overdraft facilities with alternative, more expensive, credit products (Bank of England, 2011).

Credit figures also show broadly flat or negative trends in applications for new credit and in the flows of new lending to SMEs. Reports from the major UK lenders reported, that the value of applications by SMEs for new term loan and overdraft facilities in the six months to February 2011 was 19% lower than in the same period a year earlier (Bank of England, 2011). This has been attributed to risk aversion and perhaps understandable caution on the part of SME owner managers to engage with credit at a time of uncertain business prospects. As the UK debt /GDP ratio may be set to top 70% next year we are indeed seeing retrenchment as a sign of the times.

This is not, however, borne out by the Cisco survey above or by the Confederation of British Industry Quarterly SME Trends Survey, which showed little change over the previous half year in SME owner-managers' optimism about their businesses. This business optimism was broadly similar across the range of small and medium-sized SMEs and remained positive.

Thus we know that credit is a factor – but is it a significant one in understanding innovative SMEs? There were companies where credit was cited as an issue. Six per cent of manufacturing SMEs did cite 'credit or finance' as a factor likely to limit output in the next quarter. This did not represent an increase, however, as this was the same proportion cited in preceding CBI Surveys over the previous 18-24 months. It indicates that 94% of manufacturing SMEs did not see this as a barrier to output.

Also, manufacturing bucked the general trend in having its sharpest rise in 16 years over the past 12 months. The upturn in sales among small manufacturers rose from +9% to +14%. Manufacturers are also the most optimistic sector for the coming quarter (+23%) and report the highest positive expected investment balance (+5%) (Bank of England, 2011). Optimism regarding export prospects for the year ahead rose at a slightly faster pace than in the previous two surveys. So far there has also been growth for manufacturers in domestic markets; the strongest increase since January 1997, although the growth in domestic orders is expected to decelerate slightly in the coming three months. Again optimism about the general business situation remained positive and was broadly unchanged, for the third successive quarter (CBI, 2011).

This is despite on-going problems with the external business climate, competition and inflation (Open University, 2011). Nationally then manufacturers seem to be enjoying better fortunes than they have for the last decade, however, how does this work on a regional basis? The UK North West provides a useful indicator to show how SMEs are emerging from the downturn.

Regional perspectives

As with the range of surveys and indicators cited above, there are a number of regional surveys. We have selected the Lloyds TSB North West Business Activity Index, which is seasonally adjusted and measures the combined output of both manufacturing and service sectors in the region.

The last Lloyds TSB report showed a decrease in regional output to 54.3 in April (from 58.1 in March) but this is still above annual average of 53.5 and may be indicative of regional effects of “Holiday Aril” enjoyed or endured by UK businesses which includes a range of bank holidays and of course the Royal Wedding (Smith, 2011).

Regionally, two years of sustained growth was indicated by the receipts of new business across the North West private sector with stronger export demand (particularly from the

US and Asia). More importantly perhaps, both manufacturing and services register further solid growth (Bank of England, 2011)

Nationally, headcount rose within SMEs, at the strongest rate since April 1995. Growth was evenly spread across small and medium sized firms, and the rate for small sized companies was the fastest since April 2008. Overall, SMEs, however, expect a slightly slower increase in employment over the next quarter.

Regionally, consistently high levels of new product launches have been accompanied by increases in the numbers of additional staff employed, bringing the current run of expansion to three months. Despite this expansion of staff, a shortage of labour has now been cited more often as a factor likely to restrict investment, with the number of citations the highest since July 2008 (CBI, 2011).

There were also lower levels of time lost than in previous years. This 'time lost' comprises factors due to variations in weather and holidays but this year they may also be affected by special events – like the Royal Wedding.

That Wedding

The impacts of April 2011, with a scattered pattern of statutory holidays potentially disrupting production (including the impacts of the Royal Wedding see Smith (20011)) are still to be determined but companies further raised activity levels to accommodate inflows of new business in this period. During April, UK companies lost 22nd and 25th April; 29th April and 2nd May, but because Easter fell so late, many schools had holidays from April 1-15.

Those with children faced children being on holiday during the first two weeks in April, then the statutory holidays, then other children potentially having different dates (the last 2 weeks in April). In my own case, our projects finance manager was on holiday for the whole of April to cover her children's school holidays. She took personal holiday time to do so but it meant that many activities were more difficult and that new projects were delayed as we wanted for her to return and work through proposed budgets.

Confidence …

Although the output figures were good there were issues on the input side.
Nationally, average unit costs have increased consistently over the past year and as a result, SME manufacturers raised both domestic and export prices at the fastest rate since October 2008 with prices again expected to rise even more markedly over the coming three months (CBI, 2011).

Regionally, input price inflation in the North West remained strong by the historical standards of the survey in April, despite moderating further from February's 31-month high. Firms commonly linked higher input costs to rising raw material and fuel prices. As a result of the burden of higher input costs, many private sector companies raised their tariffs in April, the sharpest rate of increase since September 2008, with manufacturers increased tariffs at a faster pace than service providers.

The Open University Business School's National Survey findings support this, suggesting that inflationary pressures are influencing pricing decisions across sectors, with a balance of +25% for small manufacturers and wholesalers expecting to increase their prices, and even higher balances for small retailers (+39%) and the agricultural sector (+29%). This is also true regionally, with increases in tariffs across sectors but manufacturing companies planning to increase prices (or having already done so (MEN, 2011).

Other indicators include SMEs' investment intentions for the year ahead. These have strengthened further, with plans for plant & machinery spending anticipated to be the most positive since January 1997. More firms report plans to authorise investment to expand capacity, consistent with a rise in capacity utilisation in this survey (CBI, 2011).

So lots of confidence expressed but where does – or will – this growth come from?

We use the term 'growth' but there are several definitions of growth in common use, often placing much weight on anticipation. This section explores what 'growth' is before reporting some evidence on exports and innovation as these are seen as key to growth by governmental and academic sources. Other possible routes to growth for innovative SMES include procurement opportunities, long expressed as an aim by both the EU ad the UK but still an issue for the SMEs themselves to engage in.

Definitions include **sustained growth,** when employee numbers have grown over the last 3 years and there is substantial growth anticipated over the next 5 years. This can be compared with **contained growth** where employee numbers have grown over the last 3 years but there is no anticipation of substantial growth over the next 5 years and **New Growth** where employee numbers have not grown over the last 3 years but they are anticipating substantial growth over the next 5 years. This only leaves **No Growth** where employee numbers have not grown over the last 3years and they are not anticipating substantial growth over the next 5 years (UKTI, 2009)

The firms most likely to receive media attention and financial support are **high growth** firms. These are firms where employee numbers have grown by more than 75% over the last 3 years (understandably this exempts firms established in the last 3 years). Among these are those growing rapidly from start up – the **Gazelles.** Gazelles are those SMEs that have grown their employee numbers by more than 75% over the last 3 years and they are less than 5 years old

Having defined those terms, the links between exporting and innovation as a theme in growth are often reported. This is particularly true for product-based businesses such as manufacturing firms. As we said above, manufacturing is clearly identified as a strong sector in the UK First of all the strong export figures have a strong connection with manufacturing SME growth in the UK. When comparing countries, a DBERR report (2008) showed that a strong difference between UK and US companies related to their export orientation. " Whilst firms in the US were able to achieve growth by supplying the US market, in the UK the niche nature of the business activities meant that they had to export if growth was to be achieved," (DBERR, 2008; 55) UK firms, on the other hand, relied on exports for a greater proportion of their sales than US companies.

Unlike the strategic partnerships to connect with US markets seen in the US, UK SMEs gained ground by targeting overseas partners and opening offices abroad. In addition, the business growth seen in the first 4 months of 2011 came from both domestic and export orders. The lower value of the pound was of benefit to manufacturers and other sectors contracting overseas to develop and win competitive bids for many contracts (DBerr, 2008; Conway, 2011).

Although exporters are in the minority in the whole SME population, exporting is more prevalent among those SMEs investing in research and development, which are innovative or hold intellectual property (UKTI, 2009). Therefore it is likely that the exporting firms are those offering greater value added through research and development, and innovation.

Defining innovative firms, the UK Trade and Investment body defines companies as innovative if they have more than one employee engaged either wholly or partly in research and development and more than one employee engaged either wholly or partly in new product or service development; this may also include any R&D employees are involved in the 'development of scientific or technical knowledge that is not commonly available' (UKTI, 2009).

They are also defined as innovative if they have employed someone external to the business to conduct new product or service development activity in the last year or have derived some of their turnover from products and services introduced in the last 3 years, especially where these products and services are completely new and have not been introduced by anyone else previously (UKTI, 2009). There are issues in expressing innovation in this way.

Basing it on anticipated outcomes rather than results may lead to governmental and private sector resources backing the wrong horse by basing investment on hoped for outputs rather than track record issues. In the new fiscal climate however this is less f an issue. Recent primary surveys of high technology small firms show that they are investing more in preparing business cases and taking more than one attempt to source funds to support business growth (Martin et al, forthcoming). There are issues related to sectors too. With only two IT firms in the FTSE 100, SMEs in this sector may struggle to obtain the right sort of capitalisation funding (not an issue in the USA), and relative support for these firms may also be lower (Business Daily, 2011).

Other less obvious factors also impact on how well small companies do, such as opportunities for procurement. Here both the Olympic Games and international disasters such as the Japanese earthquakes and nuclear problems, present potential advantages. The Olympic Games in London in 2012 and the opportunities that will bring both before and after the events are open to small firms as well as large – if they are able to take advantage of procurement possibilities. Although most activities will be in London, others are scheduled across the UK so construction projects around those events and associated activities will generate new business growth, albeit less than is anticipated in London.

However, procurement continues to be an issue for many SMEs in gaining ground compared to larger bidders for competitive tenders, whether private or public sector based. The UK government has a target for procurement to SMEs – to award 25 per cent of its contracts to SMEs. This will be achieved "through streamlined, standard pre-qualification questionnaires, which the government has developed in cooperation with the Federation of Small Businesses, and which will be mandatory for all central government departments" (Realbusiness, 2011; FSB, 2010). This standardised pre-qualification questionnaire will also allow businesses to bid for multiple tenders using one form.

However, recent research with SMEs (Turner, 2011) continues to indicate that structural and linguistic demands and processes set out in framework documents may maroon smaller firms from taking part. Small business owners see a "mystery" around procurer expectations and often struggle to exhibit entrepreneurial practice in a written form. Do tenders invite or inhibit innovative thinking? The need for compliance required in most of these documents suggests that innovation may not be the first thing on procurers' minds.

According to some observers, recent disasters overseas have also led to benefits for UK firms. As a result of international uncertainties, many large international businesses took the opportunity to rethink the length and nature of their supply chains, with trade from other European countries coming back to UK firms, which had previously struggled to compete with the costs basis of efficient and just-in-time Asian producers (Times, 2011; Conway, 2011).

The upsurge in international piracy is also causing rethink of trade routes to avoid the horn of Africa, again impacting on supply chains (Financial Times, 2011). Extra cost to insurers when ships and their crews are lost or delayed for long periods in the hands of pirates mean that the longer supply chain routes are also new factors in costs and delivery estimations (Warren, 2011). Some of the results of the Japanese disaster and of supply chain rethinks have been a return to UK firms may be a temporary benefit exacerbated by rising oil prices; however, UK online retailers have also experienced a growth surge since the Play station hacking, which may be related to perceived higher security levels of UK based secure payment systems (Conway, 2011; Warren, 2011).

Another opportunity heralded in UK governmental pronouncements relate to the cuts in public sector funding. These are also anticipated to result in new opportunities for small firms, despite the downward effects also accompanying redundancies and reduction in public sector contracts for capital investment. SMEs are anticipated to ‘fill the gap’ in services by rethinking how services are provided, developing new employment and creating wealth in the process. The next 12 months should determine how correct these particular predictions have been. However, initial indications show that more entrepreneurial small firms have identified the more profitable end of public service offerings with perhaps a predictable shortfall in more ‘difficult’ services areas.

Governmental intervention

The incoming Coalition government has identified two ways in which it will support SMEs. One is through the promised reduction in bureaucracy – “red tape” – which has been a consistent feature of SME surveys. The other is in practical finance support through credit guarantee schemes for innovative SMEs. This support so far follows the same model as the last government by providing loan guarantees for small growth and for high growth firms.

The Enterprise Finance Guarantee scheme provides support for relatively small loans, of around £1 million. First announced by the then Chancellor Gordon Brown in 2003, the Coalition has committed to supporting this scheme so that it will continue after March 2011 until 2015. The government estimates the Enterprise Finance Guarantee scheme will provide support for some 6,000 SMEs each year. It works by providing a government guarantee for around £2billion worth of individual loans over the four-year period (with approximately 6000 SMEs per annum taking part), with roughly £600 million ring-fenced for 2011. This scheme aims to help viable small businesses without a credit history or sufficient collateral to access finance and lending for growth, R and D and innovation.

Larger amounts needed for capital investment by those high growth firms and gazelles, as described above, are the target for other funds, such as Enterprise Capital Funds. An extra £200 million which will be injected into Enterprise Capital Funds from April 2011 to aid those seen as potentially the highest growth SMEs to attract equity investments from VCs and angels.

Other funding models however have arisen to try to provide different routes to fund their business, which some have compared to the provision of a UK bond scheme (Business Daily, 2011b). One is the provision of online market places (e.g., SecondMarket) where lenders provide money for businesses with good investment potential (Entrepreneurial Thought Leaders, 2011). The UK version of this has resulted in around £4,000, 000 which has so far been routed through this site to business, with activities higher this year than last year. The benefits of this scheme provides a good rate of return compared to banks – currently paying savers at 1% over base, while these schemes provide between 3-8% over base. Loans can also be sold to other lenders. The website charges 2% to lenders – and to borrowers – on completion of transaction.

Growth is the target of a range of public sector measures, including Business Coaching, Growth Hubs etc; Business Coaching for growth provides 1 to 1 support to develop an action plan for growth. It is also developed via private sector funding. Banks such as Goldman Sachs and Santander have supported SME programmes; Cooperatives UK have set up enterprise hubs. Innovation is similarly supported as part of these initiatives and Innovative SMEs are encouraged, for instance, via creativity focus workshops, via networking groups and via creative management programmes. Private sector initiatives include the setting up of a High Growth Foundation in Manchester led by entrepreneur John Leach, a membership organisation with 1000 participants.

So where does that leave us?

Writing this paper was difficult because in the UK we are in a time of economic and social change, following a protracted period of uncertainty. Academic sources necessarily take longer to be able to reflect the results of research, such that the journal articles being prepared on the current situation will be published on average 2-3 years from now. Relying on media reports and on the surveys and comments published by professional bodies necessarily brings its own difficulties but it seems to tell a coherent story.

And it's a good and more cheerful story than we might expect. Despite the gloom and doom reported consistently in the main newspapers and TV channels, the underlying views of those in SMEs remains positive. Figures on confidence levels have remained robust and at the same levels as pre-downturn surveys. This is consistent across surveys of innovative and high growth firms and more general surveys across the small business base, as explained above.

Owner-managers in innovative SMEs which export or have export potential are the most confident because they are seeing major export growth. Interestingly, money, however restricted it appears to be, is being found to fund this growth. Some growth has been sourced from groups of fellow SMEs; others have identified more unusual sources such as SecondMarket, an alternative model to traditional banks. Other ways to access funds includes being more bankable in the way you approach your business and the way you try to envisage and fund your growth.

Last thoughts

We started with a series of questions

- Where will innovation come from in the new economic environment in which we find ourselves?
- What challenges will small firms face in growing – and what challenges in just maintaining their company at the level it has already achieved?

- Which sectors will drive innovation and which actions will support growth in the SME sector?

While fortune telling is out of the scope of the authors, and so we may leave some questions unanswered or be cautious in doing so, it does seem that innovative firms have successfully grasped the opportunities they see in these changed conditions. The famed flexibility of the small firm which enables it to deal with change more readily than a large firm can do – and the ability of entrepreneurs to recognise and mobilise opportunities form part of this picture.

In 1996 a Bank of England report commented on the cartel operating on the British high street and the need to open up the financial services sector. In 2009-2011 we have seen a rapid contraction in the number of providers with consolidation by larger companies such as Santander, and a reduction in the types and nature of financial services, together with a consistent failure of lending by UK Banks, despite promises to the UK Government in 2010. The proposed venture capital actions maintained by the UK government cover the £10 million plus category, typically limiting access for most small firms. Similar trends in the USA led to the quantity of funds lent by business angels overtaking venture capital funds for the first time in memory.

So – while the task environment may seem unfavourable in terms of credit or finance, money is still being found to fund growth and this has supported new sector activities as well as traditional activities such as manufacturing. The reduction in public services is seen as a niche gap to be filled; the lack of credit met by dogged persistence in tackling funders whether high street banks or angel investors, raising capital from a wider circle of acquaintances, forming groups to lend to each other. Small firms keep on responding and altering their business processes to meet new challenges

So a hopeful picture? Time – and the entrepreneurial ability of UK SMEs – will tell

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