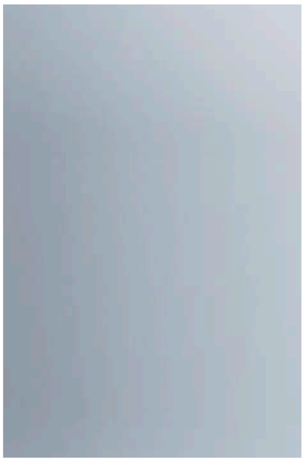
THINCATS



A NEW APPROACH TO FUNDING UK BUSINESSES

Contents

Why should the UK care about finding alternatives to traditional bank funding?

What is the problem?

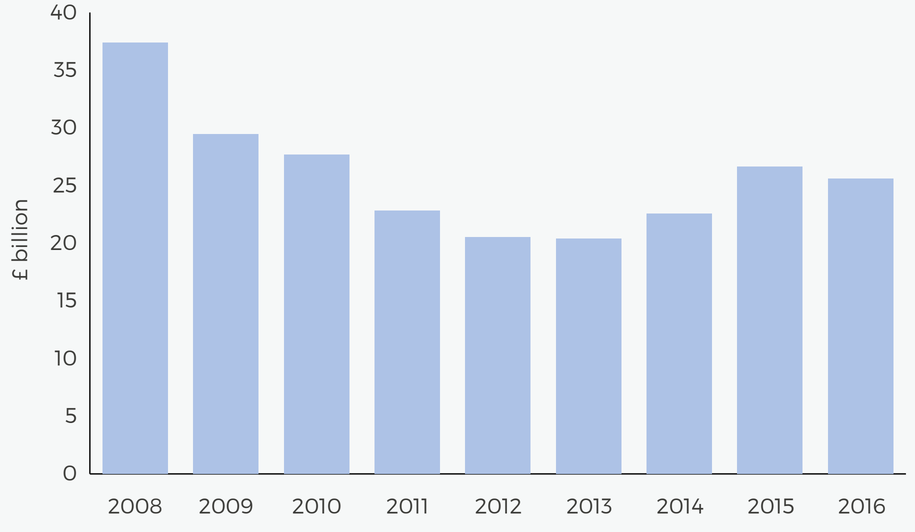
10 years on from the financial crisis, many UK SMEs are not receiving the funding that they require from traditional lending sources such as the banks. The problem is particularly acute for growing SMEs who do not have large amounts of assets against which the banks are more willing to lend. As a result, many SMEs are not investing in their growth, or are delaying until such time as they can fund it themselves. The knock-on effect is that the UK's productivity and growth is being held back.

It is well known that bank lending to SMEs fell dramatically following the 2007/8 financial crisis. Although banks have shored up their balance sheets since, regulators have introduced stronger capital requirements in subsequent years, meaning banks remain restricted in the types of loans and businesses that they can fund.

Ongoing cost pressures on banks have also led to the closure of hundreds of branches across the UK resulting in a less personal, less flexible process for securing business loans. Tapping into the experience and knowledge of bank managers who were once immersed in their local business communities, has become less important to banks when assessing potential business loans.

The chart below demonstrates that although lending to SMEs has recovered somewhat since 2012, it's still below pre-crisis lending levels and actually declined during 2016.

UK SMEs new business lending



Source: OECD (2018), Financing SMEs and Entrepreneurs 2018 : An OECD Scorecard, OECD Publishing.

What is the solution to narrowing the funding gap?

The solution lies in finding a different way to fund SMEs using capital from sources other than the banks.

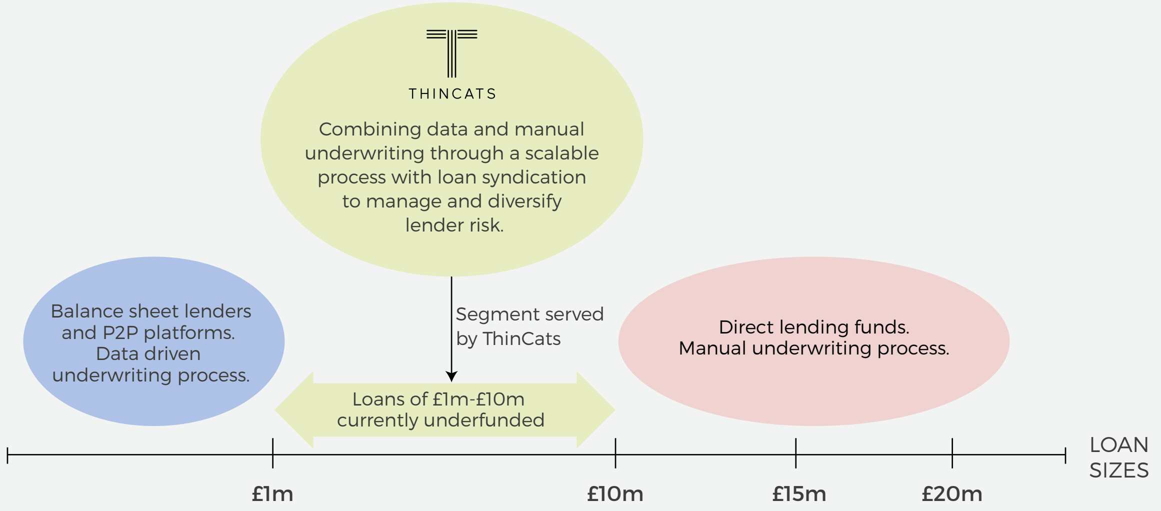
Non-bank capital has already started to flow to SMEs via alternative funding solutions, however, these tend to focus on two ends of the funding spectrum. Business loans of less than £250,000 are typically served by peer-to-peer platforms of which Funding Circle is the dominant player. Larger loans of more than £10m are served by direct lending funds from companies such as Hayfin.

The reason for this polarisation is that smaller ticket, granular investment, which is attractive to both retail and institutional investors, is driven primarily by cost-effective data decision making. Funding for loans of £10m+ is attractive for large institutional investors, but requires specialist, resource-heavy credit teams.

The gap in the middle of £1-£10m lending is an area that requires a new approach where data, technology, relationship management and credit skills can be combined to provide a scalable business model.

Filling the funding conundrum for £1m-£10m lending

Current funding sources



What does the alternative business lending model look like?

The alternative finance landscape is diverse and there are a number of different ways in which direct lenders connect with the businesses that are seeking funding.

Digital and direct

Companies such as Funding Circle, which is the largest alternative business lending platform, match borrowers and lenders through its online peer-to-peer service. Loans are assessed using data-driven rather than manual underwriting techniques. Businesses come direct to the platform for unsecured loans from £5k-£500k while investors can typically choose from pre-built portfolios of loans offering different risk/return profiles. Investors are a mix of individuals and, increasingly, institutions attracted by the excess returns available compared to those from investment grade corporate bonds of similar credit quality.

Advised

As the number of alternative lenders has grown so has the network of accountants, commercial finance advisers and corporate finance boutiques advising businesses on non-traditional funding options. For simple funding needs, of small amounts, SMEs may consider using a direct online platform as mentioned above. However, for more complex, larger value loans, SMEs are likely to consult their accountant or other commercial finance adviser. Typically this funding is to cover more strategic funding needs such as acquisitions or other transformational events.

Alternative lenders that use the business advisory networks to connect to borrowers are usually challenger banks or direct lending platforms.

Relationship management

Based on the traditional branch-based banking model which has contracted dramatically in recent years, some alternative lenders operate a physical network of regional business development managers spread across the UK. These are typically former business advisers from banks who have excellent and long-established relationships with their local business, accounting and legal communities. Using this local knowledge, these originators are ideally suited to dealing directly with SMEs, or with their business advisers. Typically they will arrange funding for larger deals to support strategic capital requirements.

They also personally manage the critical information gathering and communication required between the SME, its business adviser and the credit team.

In the case of ThinCats, the business development team is helped in delivering a high level of service by having regional credit heads on hand. This allows ThinCats to meet a potential borrower and understand its business early in the credit process, so that it can structure a funding solution in collaboration with the SME and its business adviser.

Combining elements of the above leads to a more bespoke, joined-up approach, and is seen by clients as a key advantage when compared to the one-size-fits-all model offered by the banks. In an ironic twist, the tailored approach now being adopted by some alternative lenders is a new take on what banks used to offer through their network of local branch managers.

How does this benefit investors, SMEs and the UK economy?

One benefit to investors of direct lending is that they can earn attractive potential returns from an asset class that is not directly impacted by swings in stock market sentiment. Perhaps more importantly, though, against a backdrop of current low returns from liquid fixed income instruments with the risk of loss from spread widening, the excess returns available from direct lending are highly attractive.

The benefit for SMEs is that they now have access to a source of funding other than the banks. Not only does this bring more choice and competition to the funding market for those SMEs to whom the banks are still willing to lend, but more importantly, also gives a route to funding for those SMEs that don't meet the current stringent and inflexible lending criteria of the banks. ThinCats believes there is a large number of growth and expanding companies which deserve funding but are being excluded by the banks.

Without the new sources of funding being opened up by alternative finance providers, SMEs will be held back from investing in the new technologies and skills training required if the UK is to compete more effectively. This may become even more important post Brexit as the UK looks to open up new international markets and as the supply of skilled and unskilled labour becomes harder to source from EU countries. Investment is widely recognised as a key element in improving the UK's productivity.

The withdrawal of funding by the big banks and the widely reported mistreatment of small businesses by some banks following the 2008 financial crisis has led to many SMEs no longer seeking any external funding. Sometimes called the permanent non-borrowers, this group represents almost half of SMEs in 2017 up from 1 in 3 in 2012* (Source SME Finance Monitor Q4 2017).

The lack of access to potential funding and the withdrawal by almost 50% of SMEs from seeking external funding is acting as a powerful and damaging handbrake on the future performance of UK SMEs and the UK economy.

The role of alternative lenders is to help release this handbrake by bringing together those that genuinely want exposure to investing in business loans with those SMEs that recognise that securing appropriate external funding is critical to achieving their long-term growth ambitions.

Whilst some alternative lenders, offer a substitute to the banks for smaller sized, unsecured commercial loans, ThinCats focuses on larger, more strategic loans from £100k up to £10m.

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Where next for alternative funding?

Institutional involvement

The arrival of institutional investors as serious sources of alternative capital for UK SMEs is a defining moment for supporting the growth ambitions of UK entrepreneurs. Asset managers, pension funds and life insurance companies have billions of pounds to allocate to the type of returns produced from commercial lending.

UK entrepreneurs are globally recognised for their innovation and creativity. By opening up new flows of capital to UK SMEs, alternative finance is playing an important part in helping UK talent drive improved economic growth.

Big and clever data driving volumes

The alternative finance industry is competing with institutions which have amassed a vast bank of data over their extensive histories. Although embryonic in comparison, fintech companies have the technical skills and the flexibility of not being tied to unwieldy legacy systems to find innovative ways of analysing data in more meaningful ways. Increasingly fintech companies are building models capable of interpreting huge volumes of SME data. This enables alternative lenders to identify patterns in financial data that can be used to predict future performance.

Open banking regulations introduced in January 2018 enable alternative lenders to combine their own data sets with those held by the banks. This will help with the initial assessment of credit worthiness and help monitor the affordability of repayments through the life of the loan.

At a macro level improved data analysis techniques allow alternative lenders to see which sectors, regions and types of company are likely to prosper and which may be heading into distress. This insight can be useful to government agencies in planning how best to support businesses at a national and regional level.

Secondly, this data can be used to target those companies with the relevant growth and balance sheet metrics that mark them out as likely to require funding and as attractive companies for its lenders to invest in.

Conclusion

Alternatives to traditional commercial lending have emerged since the financial crisis as banks have had to tighten up their lending criteria. Peer-to-peer platform technology has enabled individual investors to participate in direct lending, however for SMEs looking for larger, more complex loans to fund strategic initiatives, it is unlikely that individual investors on their own will be able to fill the gap.

Institutional investors have considerable assets to fulfil this role and are showing increasing interest in the attractive risk adjusted returns of direct lending. ThinCats believes that by connecting institutional investors with the growth companies that traditional lenders struggle to support, will help SMEs fund the strategic investments required to grow and become more efficient. As SMEs are the driving force behind the UK economy, this is a very welcome development for UK plc.

Different models for connecting alternative lenders with business borrowers have emerged. For small, relatively straightforward loans, online platforms are widely used by investors to choose a risk/return profile to suit them and by businesses to apply for a loan.

For larger, more complex loans, SMEs will look to their business advisers (typically an accountancy or commercial finance advisory firm) to find an appropriate lender.

ThinCats understands that many growing businesses seeking funding between £1m and £10m are currently underserved by both traditional and alternative lenders. These businesses do not meet the stringent lending criteria of the banks, need to borrow too much for the data-decision making process of the online platforms, yet too little to attract interest from the direct lending funds.

ThinCats aims to fill this gap through a hybrid model that combines the best bits of traditional banking with the latest data analytics and modelling techniques. Its team of national development managers serves the growing universe of alternative funding advisers to identify funding opportunities, whilst its underwriting process uses experienced credit experts and data analysts to assess the creditworthiness, security cover and price of potential loans.

For alternative lenders to succeed in the £1m-£10m segment, ThinCats believes lenders will need to marry the bespoke service of traditional lending with the technology and data skills of a fintech. In addition, strong investment experience is needed to meet the growing demand from institutional investors to access the attractive risk adjusted returns that business loans can deliver.

John Mould, CEO
ThinCats

What does ThinCats do?

ThinCats matches UK SMEs that require funding with institutions and individuals looking for the investment returns produced from business lending. ThinCats' skills lie in securing funding from investors and in assessing the risk/reward characteristics of SMEs as potential borrowers. The former uses ThinCats' experience in investment management, while the latter makes use of its expertise in credit, data analytics and its network of business development managers based across the UK.

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