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EXECUTIVE SUMMARY

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Exploring External Finance links to *Build Back Better* a Green UK SME Economy

Small Grant Longitudinal Small Business Survey (LSBS) Report to Enterprise Research Centre (ESRC)

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Research Questions

This study's main research question is:

- How does external finance, including different amounts and types (public supported schemes and grants, or private debt, equity) of finance, impact on the low carbon (energy efficiency), green growth of UK SMEs?

Additionally, the following sub questions are investigated:

- How is SME green external financing related to SME skills and capabilities and use of external assistance?
- How is SME green financing related to sectors and location?
- How is SME green financing related to future business intensions (e.g. growth)?

Methodology

We focus initially on descriptive univariate analysis of the most recent 2019 (n=11,002) and 2020 (n= 7,619) LSBS Waves where there is sufficient SME cross-sectional case data of the two waves alongside the self-reported environmental 'green mission' (2019 section D) and the adoption of energy efficiency practices during the 12 months prior to interview wave (section E 2019 and 2020, represented in each wave by a one third of survey cohort). We also track performance and innovation changes (noting these may be lagged) for energy efficiency adoption longitudinally for cases spanning 2019 and 2020 (n=5364).

Econometric analysis was then undertaken by pooling data, from 2017 and 2019 for green mission and from 2019 and 2020 on the adoption of energy efficiency practices, to increase the size and robustness of the data sample. A series of probit estimations assess the business characteristics associated with being green (the extent of having green mission priorities) and becoming greener (by increasing green priorities, or taking green energy efficiency actions), within the survey wave timeframe, and whether green SMEs perform better over time.



Key Findings

Paucity of useful data

There is a paucity of useful UK green SME data provided by the LSBS (and other UK SME surveys). Findings are constrained by inability to gain sufficient baseline of data for green investment taking place prior to the LSBS waves examined. The LSBS is limited to defining green SMEs by their green mission status, which is only captured biennially since 2017. Furthermore, the LSBS, limits the assessment of SMEs going green to a one third survey cohort for energy efficiency government programme awareness and adoption measures. Such limited data thus renders it impossible to undertake meaningful analysis of the different financing needs and activities of these businesses. This survey design seems at odds with such a high government policy priority!

Developing a Green Taxonomy of SMEs

Descriptive (univariate) analysis and supporting regression models highlight key differences between the proactive green mission enterprises that are more likely to invest in going green or becoming greener (the already converted) and the non-green mission laggards.

Green mission companies significantly ($<.001$ significance level) tend to be larger SMEs (with 10 or more employees) and those established at least 6 years with ability to self, or part fund green investments and absorb the lag in green efficiency payback. They are significantly ($<.001$) more likely to be high priority green mission businesses making changes for Net Zero impact, rather than (at least initially) to improve their bottom-line profit margins. They are more likely to introduce new products and services, but (perhaps due to lagged performance efficiencies, not yet recorded) do not perform any better than their counterparts (in terms of turnover and profits). Green SMEs are also significantly more likely ($<.05$) to be rural, in devolved nations and regions with higher ratios of installed renewable capacity to GVA, from sectors which are either more heavily environmentally regulated (e.g. primary, construction, manufacturing, retail) or from cultural backgrounds which are more sympathetic with the environment.

Green laggards, the majority of UK SMEs (circa three quarters) are profit driven. They are more likely be motivated to make changes when they can see a clearer financial imperative for getting on board with 'green growth'. Our evidence suggests that tightening of the UK economy due to the onset of the Pandemic was leading to both raised awareness of the need



to go green, but a reduction in appetite and available (internal or external) finance for the laggard SMEs to invest in going green. These businesses may have reduced their appetite for investment, or switched to more immediate marketing requirements (such as increasing online services).

Barriers to going green

Businesses in rented premises are less likely to undertake green energy efficiency measures, probably because this is under the control of their landlords.

SME green finance policy is crucial: Strong regression evidence suggests that government grants and loans are associated with going green and can tip the balance. Despite the availability of relatively 'cheap' business loan finance (interest rates may be below inflation rates), going green or becoming green appears to involve a wide range of external financing and less so private bank lending. The evidence here is of a search for cheaper funding that might tip the balance in favour of green investing – given the perceived and actual lag in performance and payback.

Improved UK SME Going Green Awareness

Awareness of government programmes is increasing. More than half (55%) of UK SMEs know about UK SME energy efficiency related programmes and there is take up of these services. Going green is becoming more attractive, and the current rise in energy prices will only underline the strength of this message.

However, there is clearly a lot more required from UK government policy to engage with SMEs. Many remain green laggard businesses. SMEs do not have any mandatory environmental (or social or governance – 'ESG') reporting - to develop their awareness and actions to develop a Net Zero green and sustainable economy. Thus, whilst we find that high priority green mission businesses are not seeking external advice - they are already the converted, but are also more likely to be receptive to using external training – the overall evidence (univariate and probit) suggests that **advice and support are required for the remainder of** (often less receptive) **laggard SMEs**.



Key Recommendations

Recommendation 1: Increase the size of LSBS survey and questions in relation to SME green missions, intentions and financing options to fully explore their motivations and what can lead to more effective take-up of SME green activity – widening this to include innovative green business models and approaches and not just energy efficiency.

Recommendation 2: The UK government needs to develop appropriate incentivising financial support mechanisms to encourage going green, particularly for laggard SMEs. This may come in the form of grants, soft loans with low interest and repayment holidays, or other forms of inducement such as improved energy feeder tariffs, green R&D tax credits etc.

Recommendation 3: To address the *prisoner* effect of SMEs in rented accommodation, government should give greater attention to landlord incentives and aggregating schemes to incentivise landlords and SMEs to work together to achieve green solutions.

Recommendation 4: An improved, coherent, national programme of SME Net Zero awareness, with support and advice for SMEs to becoming Net Zero are required. The small number of SMEs (c. 3,000) that have signed up for the BEIS SME Climate Hub and its lack of connectivity with DEFRA's Handbook on Nature Impact and the relationship between Net Zero and preservation of natural capital and biodiversity (see Central Bankers Biodiversity report, 2022¹) clearly demonstrates a big gap in the UK's green growth strategy aims and its implementation. Development and provision of widely accessible universal online support tools to nudge and assist SMEs to become greener are urgently required. This could be supported by SME Net Zero champions who offer role models and mentoring to the SME sector, acting as beacons for the way forward and to ensure that this coverage goes beyond the rural and more advanced regions and sectors which are already more aware of environmental matters and the value of going green.

¹ <https://www.ngfs.net/en/central-banking-and-supervision-biosphere-agenda-action-biodiversity-loss-financial-risk-and-system>